1

The Origin of Mistrust

"Chacun Sa Merde"

It did not either knock on the door, or crash the gate. In September 2008, the global financial crisis entered in Europe in silence and brought it to the brink of collapse in a surreal obscurity.

While all the lights were focused on Wall Street's bankruptcies shaking the world, Chancellor Angela Merkel entrenched herself behind a wall of silence as she saw Germany, hidden from public awareness, head toward the same financial meltdown, as one bank after the other risked crumbling before her eyes.

On October 4, 2008, on the stairway of the Elysée Palais in the heart of Paris, she did not even want to pay heed to Nicolas Sarkozy, the French president, who was asking for an immediate, coordinated European reaction. Turning away from her and from the microphones, the French president confessed to his advisers: "If we cannot cobble together a European solution then it will be a debacle. But it will not be my debacle; it will be Angela's. You know what she said to me? 'Chacun sa merde!' (To each his own *merde*)."

Actually, according to an aide of hers, Merkel had quoted a proverb taken from a work written by a monumental figure of German culture, Johann Wolfgang Goethe: "Ein jeder kehr' vor seiner Tür, und rein ist jedes Stadtquartier" (Everyone should sweep in front of his door and every city quarter will be clean).[1] To make the disagreement between the two leaders more ironic, Sarkozy turned back to the press and uttered: "It is absolutely obvious that there are differences between our cultures. . . ."

The reason why Merkel was so opposed to putting on the table "some money," as Sarkozy called it, and backing up the dramatically endangered

European banking system, was indeed also a matter of cultural differences in the heart of Europe. Merkel was shocked by the amount of incalculable risks that she was discovering in her own country and who knows what was hidden in the other countries: homework had to come first. Sarkozy, in that moment of need, had the intuition instead that he could solve the French banks' problems by leveraging a European common response.

It was also a typical Sarkozy-Merkel confrontation: the former's politics by instinct versus the latter's politics by program. "You do not have a real plan," Merkel said to Sarkozy at the Elysée. She did not consider Sarkozy's proposal a credible course of action. Setting up a common fund, mainly financed by Germany, that could become a self-service stash for any country trying to rescue its own banks was a non-starter in her eyes. In a government meeting in Berlin, Merkel had just reckoned that the European bank–umbrella plan that Sarkozy was demanding would make Germany contribute €75 billion, without knowing precisely for what use. Although the French president was urging the move as matter of survival for Europe, Merkel maintained that putting together a common fund would require months of preparations and preliminary negotiations. It was impossible in a few days to arrange a proper legal framework, even only at the national levels. And Merkel did need to make each step legally watertight and she needed also to know how to involve the German Parliament: "They would not understand." She was not le Président, she was die Kanzlerin in a federal, democratic system. Moreover, a common teller open to each and every bank would confuse the responsibilities. Any bank, from any country, could help itself, tap the common resources, and maybe even remain unknown. Finally, and most important, she had learned that it was not a matter of just "some money." It was hundreds and hundreds of billions of euros.

That first disagreement at the Elysée was a milestone in a long story of national interests, political hesitations, and half-hearted reciprocal trust that would make Merkel, Sarkozy, and the other leaders of the euro area accompany the euro to the brink of collapse several times in the following years. It was indeed a crucial moment for the destiny of the euro. National leaders—driven foremost by local economic and political interests—denied that Europe was on the brink. They succeeded in keeping the reality temporarily hidden from the public, but from that very moment they undermined the possibility of a common European response to the crisis. Ever since, the financial threat hitting some banks—particularly in Germany, France, the Netherlands, and Ireland—willingly neglected, mystified, or downplayed, grew larger month by month. In the following years, it became almost impossible to recover the road to unity. Eventually, the seams of the euro area were torn by the consequences of that initial division.

In fact, before coming back at the end of the next chapter to this eventful meeting at the Elysée at the beginning of October, it is necessary to look in

some depth at the dramatic events of the weeks and even of the years beforehand and to see at work the powerful factors that made a European response impossible when it was most needed: the fact that the original responsibility for the crisis was primarily American; the hidden problems of the European banks; the national political interests behind the banks; and the conflict between the governments' interests and the action of the European institutions, first among them the European central bank. This is a combination that will be determinant for the rest of the crisis.

On September 15, 2008, three weeks before the Elysée meeting, the U.S. secretary of the Treasury had decided to let the investment bank Lehman Brothers go bankrupt, creating the biggest financial crisis in recent memory anywhere in the world. European leaders were growing aware that the Wall Street crisis, "the American mess" as they called it, was about to haunt them with equal vehemence. The initial, underlying feeling of relief that the difficulties of the "Anglo-Saxons" (as some Europeans sometimes referred to the Americans and the British) were not being visited upon the Europeans and that the speculators in the United States had gotten their just desserts was rapidly fading. The sense of immunity was unraveling, and with good reason: American toxic securities, including the infamous subprime mortgage assets, had been massively absorbed by European banks, and contagion was spreading fast, all the more so because financial interconnections among the twenty-seven European Union countries had grown inextricable in the previous years. Although practically no one was aware of it at the time, Germany had in fact been less than one step away from launching itself and the rest of Europe into a catastrophic crisis triggered by the near-collapse of a German bank. "A few days before, we had just defused the nuclear meltdown," a central banker remembered. "Nobody had understood how close we were."

This is what Merkel knew, and she was particularly worried about the political consequences of what was happening around the world and in her country. A financial crisis was almost inexplicable to European citizens who, all of a sudden, had to be told that they were losing their jobs because some highly paid bankers somewhere in the universe had taken too many risks using their money. The chancellor had seen that people in her country were growing disgruntled with the symbols of power, notably bankers and politicians. She was not going to throw the money of German taxpayers at irresponsible and wretched bankers in her own country, let alone in others. Eventually this whole story was a matter of democracy, not of instinct.

In fact, uncertain over the extent of the crisis, and certain of popular discontent, most European leaders remained hesitant and wary of each other. Just a few days before the October meeting at the Elysée, the Irish government had broken ranks with the rest of Europe. In sheer panic, Dublin announced that it would

guarantee all deposits in its six biggest financial institutions for the next two years. If any of the national banks got into difficulties, Irish savers would be sure to get their money back. What would happen to the foreign depositors at the same banks? Or to the foreign banks in Ireland? “Chacun sa merde!” Not one word had been offered to coordinate or even prepare other governments. The decision was aimed at avoiding bank runs and was thus rational from a purely Irish political perspective. However, if other EU countries had attempted to do the same, savers would naturally have withdrawn their savings from banks in countries where these were not guaranteed by the state and channelled them to banks in countries where they were.

Had this spiral of “beggar-thy-neighbor” measures escalated, the integrated financial market would have been shattered and renationalized into domestic markets. The rights of foreigners would be denied and, step by step, legal and political conflicts would have erupted among the EU countries for the first time since 1957 and the Treaty of Rome establishing the predecessor body to the EU. Chancellor Merkel was on a flight to St. Petersburg when she was informed from the news wires of Dublin’s decisions. Her reaction was blunt: If requested, the Germans would not bail out any ailing Irish banks, even though she knew that German banks, the public-owned Landesbanken in particular, were among the biggest creditors of Irish financial institutions. It would have been the perfect moment for the European Commission to take the initiative. This supranational institution in Brussels is the executive arm of the EU and is expected to put the interests of the citizens above those of single states. The commission could impose the priority of the common European interest over any uncoordinated initiative. But instead there was no protest against Dublin from Brussels. Not incidentally, the member of the EU Commission responsible for financial services was an Irishman. That was a fateful and telling sign: since the beginning, the European story of the crisis was being told as much by silences as by shouts.

Good-Bye to American Capitalism: Europe’s Turn to Lead

The financial crisis had severely damaged American credibility. From a European perspective, Wall Street was the epicenter of greedy speculations that had triggered an unprecedented global shock. But while the United States was the largest net debtor in the world—reflecting its large current account deficits during the previous decade—the euro area was the world’s largest holder of external assets and liabilities. The rapid spread of the crisis globally had highlighted the exorbitant role of finance that, superficially, seemed to distinguish the American from the continental economic models, but actually linked the two worlds. The shock originating in the U.S. financial system had led to disruption in the banking systems in Europe and around the world. In turn, the financial collapse gradually transmitted to the “real” economy (that is, the non-financial sector), as was

more and more evident in the United States. Even the impressive growth of the past decade in America—on average 1 point of GDP each year greater than in the euro area—proved misleading once one took into account that the American growth had been inflated by extensive debt creation in the private sector.

But financial integration, promoted by the new, adventurous capitalism imported from Wall Street, had created also a strong interdependence around the world. The American problem was not a problem for America alone. The wealth of European citizens, and their capacity to consume and invest, were influenced by rapid swings in the prices of foreign assets. In part, this was because banks had put a great deal of foreign bonds and stocks into the portfolios of European households and firms. The volatility of foreign asset prices also had large consequences across borders. For all of its suspicion about international finance, Europe had a 50 percent larger amount of foreign assets than the United States relative to the GDP—even without taking into account the intra-EU allocations. Finally, when risk aversion or outright panic emerged in the United States, it rapidly spread throughout the world, changing the investment climate everywhere. Europe discovered it was by no means isolated from the U.S. financial excesses. Its banks had willingly participated in the go-go years of easy finance, maintaining later that it was an Anglo-Saxon manipulation of the European virtues of saving and restraint. Criticism of the influence of Wall Street and of the City of London in spreading toxic financial assets in Europe was not unfounded: for instance, two-thirds of the European holdings of U.S. toxic assets par excellence—long-term corporate mortgage-backed securities, the infamous subprimes—were traded through the Cayman Islands, the City of London, and Ireland. American insurance giant AIG alone sold from its London subsidiary $500 billion of credit default swaps to European counterparts, making them the final victims of the securitization "global food chain." Entire real estate markets, like the Spanish, had been transformed into speculative "bubbles" through the supply of cheap mortgages by the British banks that pushed the debts of households sky-high.

In an atmosphere that seemed to represent the twilight of global capitalism surrounding the crisis, "leading the world" became more than just a slogan for European politicians. Europe had long preserved a certain skepticism toward the primacy of the economy and the rightfulness of markets. A culture of political morality had produced both devastating wars and their antidotes: democracy and the separation of powers. The welfare state embodied in European social programs had become the only way to reconstruct a collective sense of positive patriotism after the annihilating experiences of the totalitarian regimes of the first half of the twentieth century. The same historical motivation had led peoples and states to choose the way of the integration of nations and had generated the project of European-wide institutions after World War II. The

EU itself was also an attempt to rise to the global challenge. Taken together, the EU's twenty-seven countries are the largest economic block of the world, and their combined population of around 500 million is the third-largest after China and India. The euro area alone has a larger population than the United States. The EU countries accounted in 2008 for just more than 28 percent of global GDP, greater than the United States (25 percent) and the single largest block in the world.

Their unique form of both supranational and intergovernmental cooperation relies on a new and untested form of power, where leadership derives from consent, and diversity leads to dialogue. In principle, national sovereignty gives way to the will of the majority among European citizens. This was intended to be a pattern that, in the spirit of the founders, could be extended to peaceful cooperation in the world, offering a model for the new emerging powers and, finally, giving a sense of destiny and goodness to Europe's history and thus solving the Schuldfrage, the guilt question, of a continent tarnished by wars and atrocity during the twentieth century. But beneath the grandeur of the European dream remain national interests, personal ambitions, and politics. If "leading" is still a nontranslatable word for Germans, it persists as an oneiric temptation that leaders of these ancient and aging countries, trapped between symbols and traditions of their nineteenth-century sovereignties, cannot resist. Most of them are still governing from within ancient palaces among baroque mirrors that deform the present. They breed fictions of sovereignty and fight deadly domestic political battles while actually yielding power month by month to the global markets or to supranational institutions. Eventually, if they could not find a way to govern globalization, their national powers would be based on denying reality.

In fact, above European citizens hovers a sense of incipient decline, as China, India, Russia, and Brazil appear to be on the rise. Hegel's prophecy—whereby the spirit of the world moves from east to west ("following the movement of the sun")—seems relevant now, and the circle is closing as it approaches Asia. Europeans seem intimidated by the growing social complexity of a globalized world, between changing local conditions and irresistible external pressures. Individuals grope for orientation in increasingly overheated political competitions at national levels, where it is difficult for them to distinguish between action and empty communication. The sense of becoming negligible manifests itself in the spasms of populist politics or in a last nationalistic gasp of its leaders. In a debate at the British Parliament in December 2008, Gordon Brown argued that he had "saved the world," provoking such an outburst of derision from the ranks of the opposition that he strived to regain control, groped awkwardly, and repeated the phrase several times—that he actually had "saved the world . . . banks." At the IMF meetings in Washington, just five days after the fateful summit of October 4, German finance minister Peer Steinbrück attacked the hegemony of the

Americans and the British who "through financial domination had brought the world on the brink of collapse" instead of accepting the wisdom of the German Sozialmarktwirtschaft (social market economy), a sentiment that was widely shared in Berlin. During the previous months, Steinbrück had a number of frontal clashes with the Bush administration. He was still furious remembering how his American counterpart had once received him for just eleven minutes, while standing in a hall. Things had changed now. One official in Washington remembers the climate in those days: "Suddenly we were like pariahs; we were not in the condition to even put forward a suggestion. People were yelling at us and we ourselves knew we bore the responsibility."[2]

During the Bush administration, Europe had stepped up its universalist rhetoric. With good reason, Angela Merkel had used the words "to lead the world" while she was fashioning European policies against climate change and pushing to enact substantial initiatives along those guidelines. At a meeting on October 11, 2008, in the salons of the Smithsonian's National Portrait Gallery in Washington, French finance minister Christine Lagarde recalled that one month earlier she had warned her American colleague, Henry Paulson, of "the coming tsunami" if he let Lehman fail: "The situation is so critical," Lagarde said then, "that my take is that the U.S. has listened, is listening, and will continue to listen to the advice and recommendations of the Europeans. . . . For decades, Europe has been forced to run after the United States, and what is abusively called the Anglo-Saxon world, regarding finance. Now we are clearly seeing a changeover."[3]

In Italy, Silvio Berlusconi boasted offhandedly that he had convinced the American president of the need to bail out the U.S. banks, and had avoided a return to the cold war after Russia invaded Georgia by making a few persuasive calls to his personal friend Vladimir Putin. In fact, the European ambition to "lead the world" became intellectually and politically more compelling with the diplomatic maneuvers of Nicolas Sarkozy, who had assumed the rotating presidency of the European Council (the EU's top policy body composed of heads of state and government) in July 2008, just as the Georgian crisis was coming to a head. With a string of visits and timely and well-aimed initiatives, Sarkozy won the signatures of Moscow and Tbilisi for a six-point ceasefire agreement prepared by French diplomats. "We talk a lot of the importance of a global role for the European Union; we now have an opportunity to prove it," he said to his European colleagues shortly thereafter, according to a participant.

And Sarkozy certainly did not mean to confine European leadership to the diplomatic realm. America in late 2008 was mired in the shocks and controversies of the waning Bush administration. An election would bring a new U.S. president, who would take office the following January. In the meantime, Sarkozy argued, Europe had the opportunity and the duty to lead the world away from the kind of "free-wheeling capitalism" that had taken it to the verge of

collapse. Sarkozy called instead for a "new world," in an address to the United Nations General Assembly on September 23, shortly after the collapse of Lehman Brothers. "Let us rebuild together a regulated capitalism in which whole swathes of financial activity are not left to the sole judgment of market operators, in which banks do their job, which is to finance economic development rather than engage in speculation, in which prudential rules apply to all and serve to avert and soften shocks instead of exacerbating them, in which credit agencies are controlled, in which transparency replaces opacity, in which modes of remuneration do not drive people to take unreasonable risks, in which those who jeopardize people's savings are punished."[4]

Sarkozy is the kind of energetic person who can enter a revolving door behind you and unmistakably get out before you. Elected to the French presidency in May 2007 at age 52, he had been considered predestined for the job for a decade. "What made me who I am now is the sum of all the humiliations suffered during childhood," he said once. But he had regularly managed to convert his frustrations into new ambitions. On that October 4, for instance, he had gathered in Paris the heads of government of the four European countries belonging to the Group of Seven (G-7). The idea of the summit had emerged in the previous week, during Sarkozy's daily telephone contacts with Angela Merkel. Besides himself and Merkel, there were also prime ministers Gordon Brown of Britain and Silvio Berlusconi of Italy. They were then joined by the president of the European Commission, José Manuel Barroso; the president of the European Central Bank, Jean-Claude Trichet; and by Jean-Claude Juncker, the chairman of the group of the finance ministers of the euro area (Eurogroup). The EU needed to find a common position ahead of a meeting of the full G-7 to be held in Washington just six days later on October 10, and which was supposed to offer a remedy to the crisis of capitalism. Sarkozy wanted to show that Europe was capable of reacting to the crisis better than the United States. He had planned to set up a common European fund to rescue the banks, more effective than the one created in America after the Lehman Brothers disaster, the crisis of American Insurance Group (AIG), the U.S. government–sponsored enterprises, Freddie Mac and Fanny Mae, and dozens of other smaller financial institutions. Finally, he wanted to convince the United States to take part in a summit of the world's leading economies and at that event to "recast capitalism in a way to allow European ideas to flourish." In simple terms, he sensed that it was the time for Europe to lead the world.

The European Bad Conscience about the American Financial Pest

German and French naïve innocence in the face of the world's financial alchemies probably represented more a consequence of ignorance and misunderstanding than chutzpah. Sarkozy and Merkel had simply not taken the measure

of the financial interconnectedness that had developed since the origin of the euro area in the 1990s. Germany's massive savings were being regularly channelled to the United Kingdom, Spain, Ireland, and the United States, although often in the form of credits and loans. France's financial role was more similar to that of the United Kingdom—as a financial intermediary in the heart of Europe. Paris received financing from other financial centers, including from the United States, largely in the form of deposits and loans to its financial institutions, and invested them in debt bonds of other euro area countries and extended loans to Spain and Italy.

The analogy with the United Kingdom is not casual; the French authorities had been trying since 1998 to supplant London as the financial center for Europe—based partly on the fact that the British government had stayed outside the euro zone. This effort had met with little success, however. In 2008 London was still ranked as the most important global financial center and Paris was not even in the top ten, while Frankfurt was aiming at developing a global trading platform.[5] The financial services business was the largest positive contributor to the UK balance of payments. The yearly net value was understandably coveted by the French because it was equivalent to an added 2 percent of the French GDP. Paris therefore supported the French banks in conquering the business of traditional intermediation at the core of the euro area. French rhetoric resembled that of an ideological battle against finance, while it concealed strong national economic interests. But, as so often is the case, the two—ideology and interests—were not in contradiction. In the wake of the crisis, Sarkozy saw renewed importance for the role of the state, with a duty to bridle competition and free movement of goods, especially money.

There is an obvious contradiction between advocating the role of national states and invoking Europe's unity, but European culture is also intrinsically plural, and the French president was confident he could create a consensus around a revision of the free-market doctrine. Victim of a frequent French misunderstanding of German capitalism—where market forces are tempered by social concerns and by the centrality of banks, but actually are less directly under the influence of the state than in France—Sarkozy called on Germany to act together with France, decisively and fast. "Europe hit by the unprecedented crisis that is shaking the world," Sarkozy said, "will be able to intervene only if France and Germany will work together in the utmost reciprocal trust and in the most exemplar friendship."[6] He was leading the way, but stubbornly, and to his eyes, inexplicably the Berlin government was blocking the road.

In fact, there was an even deeper problem preventing Sarkozy and Europe from leading the world: an outright denial of reality. The "merde" of which Merkel had spoken had been kept hidden by everybody. In spring 2007, Deutsche Bank suddenly cut its credit lines to a small German bank, IKB

Deutsche Industriebank, which then asked the German public authorities for a bailout. IKB was over-invested in U.S. subprime securities, which, according to the German government, had been sold by Deutsche Bank itself, by Goldman Sachs, Morgan Stanley, and Lehman Brothers. The full details of Deutsche Bank's involvement have never been made public. On August 9, 2007, BNP-Paribas, a leading French bank, had suspended the reimbursement of three investment funds (in effect, freezing their activity), claiming to be unable to give a market valuation for certain derivatives and other structured products contained in their portfolios. During a meeting in Brussels, EU finance ministers discussed a report of an American bank estimating that 40 percent of all the risky assets sold by American counterparts had ended up in Europe. But in the run-up to the October 4 summit, each country, and each national regulatory authority, was still pretending that the European financial system was in good health. On the morning of October 2, Jean-Claude Juncker, who was both head of the Luxembourg government and president of the Eurogroup (the finance ministers of the euro area), said: "European banks are healthy and Europe does not need plans to support them." Irish Central Bank governor Patrick Honohan acknowledged later that in the weeks leading up to the summit, the magnitude of the challenge had not been properly measured: "At no point in the period was it thought by the authorities that any of the banks was facing imminent underlying solvency risks."[7]

A Good Time to Cry Wolf

National interests in protecting their governments and the financial industry were so strong that they silenced the few European officials who were not blind to reality and urged common responses to the risks of a financial crisis. Starting in 2002, Tommaso Padoa-Schioppa, the intellectual force behind the birth of the euro, had alerted the European Central Bank of his concerns while he was serving as a member of its board. He had set up simulation tests in the event of a major failure of the financial system, which he saw as likely. That silent work had allowed the ECB to react promptly in August 2007, by pumping liquidity into the markets, at the first sign of the crisis. Immediately afterward, in September 2007, the European Financial Committee, a technical group of EU financial officials, approved a confidential report calling on all member countries to consider the crisis in European financial institutions as a matter of common interest and not solely of national importance. In October 2007, the Economic and Financial Affairs Council (ECOFIN), the council of the twenty-seven European finance ministers, pledged to respect the logic of the common interest, but in fact did not introduce any of the incentives to banks or to the authorities that were needed to make the formal appeals concrete.

Padoa-Schioppa, who at that time had become the Italian finance minister, tried to break the gridlock created by the other governments and circulated among his colleagues a letter proposing the urgent commitment to "two limited and specific goals: a common handbook for the rules of financial supervision and the sharing of all information about the largest European banking groups."[8] London moved immediately to undermine Padoa-Schioppa's proposal. It was no surprise. "London is jealous of its prerogatives and has been consistently blocking any common initiative on financial regulation whenever it could," confessed Barroso, the European Commission president. In order to force the governments to meet their responsibilities, the Italian called for a vote of the ECOFIN. The result was that a number of governments large enough to form a blocking minority sided with London, thus preventing action. The political logic of preserving domestic interests and national prerogatives prevailed, and the vote remained secret since the ECOFIN minutes are not transparent enough to report the voting decisions. As a result, until the spring of 2008, nothing changed: the EU formal recommendations against the eventuality of a banking crisis were minimal and practically identical to those made seven years earlier in the so-called Brouwer Report, at a time when the euro was not even adopted as a currency in circulation.[9]

On May 14, 2008, the European Council endorsed the proposals of a committee headed by the former general manager of the Bank for International Settlements, Alexandre Lamfalussy, providing an ambitious framework to improve common controls and exchanges of information, particularly concerning the multinational banking groups. But to complete a process that in some cases began in 2004, the council set the target date of late 2008 or mid-2009. Three action plans were prepared and a crisis simulation was in the works for spring 2009, but this just proved to be too late.

The delay was particularly unfortunate because the crisis that eventually struck was so violent. While its origins will remain a matter of controversy, there is little doubt that financial transactions were the transmission channel of the crisis from one side of the Atlantic to the other. A protracted period of accommodative U.S. monetary policy by Alan Greenspan's Federal Reserve from the 1990s through the early 2000s and of massive capital inflows from China had allowed both an unprecedented increase of bank credits and a greatly reduced perception of risk. Even in Europe the more prudent European Central Bank had not reacted to years of increased volumes of credit, especially in countries where real estate bubbles had developed. Total credit to the nonfinancial private sector from euro area monetary financial institutions increased in real terms by around 40 percent between 2003 and 2007. The growth of credit was facilitated by easier lending conditions and increased leverage among large cross-border financial banks. The low yield in the money markets had been an incentive to take ever-greater risks or increase the profitability of firms and banks through

leverage, that is, through debt often re-invested in riskier but more profitable assets. The volumes of credit invested in securities or property had generated the so-called bubbles, thus creating spiraling increases in values of shares and houses. In Spain, for example, the price of real estate had tripled in ten years. Between 1997 and 2007, Spanish households had been massively assuming mortgages at interest rates that were barely above the inflation rate. Money seemed to be free.

For banks that participated in this dangerous game, the risks were greater because of the nature of their business, which was based on a continuous daily refinancing. Bank capital was directly dependent on the value of the securities and was used to borrow huge amounts of money for the short term. Banks renewed their own debts every few hours or days, while providing loans on much longer maturities. Furthermore, since the 1980s, financial deregulation had created a burgeoning shadow banking system outside the radar of regulators. A young American presidential candidate, Barack Obama, called it "an age of greed and irresponsibility in New York and in Washington."

When the first crises broke in the United States in the summer of 2007, banks became aware that many institutions were heavily invested in complex financial instruments whose real value was obscure. The financial system had become an insecure place and banks began to question the creditworthiness of other banks. They stopped trading loans to each other and the interbank market virtually shut down while risk premiums soared to unprecedented levels. Banks were facing severe liquidity shortages. It became ever more difficult to roll over the short-term debt. In this case, the interbank markets acted like a double-edged sword. On the one hand, interbank markets play a very important role in providing liquidity among banks. On the other hand, if a bank fails, or simply risks failing, the interbank market transmits the shock through "contagion." As a consequence, the fear of interbank contagion may reduce interbank lending, creating a credit crunch for firms and households. The simple risk of a bank failure is enough to affect the real (nonfinancial) economy, unless bank surveillance worldwide is so effective as to give transparency to every corner of a financial system. The exchange of information would have been the most effective weapon against the banking crisis, but regulations mandating disclosure were segmented along national lines and nobody wanted to be singled out as a candidate for bankruptcy. As a result, regulators and governments had an incentive to withhold data and even to forge fake information.

The Worst Crisis since 1931

Policymakers thought that European banks were facing nothing more than a liquidity problem that would inevitably normalize. In the years leading to fall 2008, the European economy was thriving and beating expectations. Germany, in particular, had staged a fantastic recovery and overcame the hurdles caused by

its reunification in the early 1990s. Reforms in several countries were finally paying off. In 2008 the confidence index of firms and households in Germany and France had reached their highest historical levels. In some cases banks might face a solvency problem, but nobody considered the possibility of contagion and systemic collapse. In fact, once the situation of the American banks became unsustainable, it should not have been a surprise that the sizable European financial industry also was at risk: the European Union boasts the largest banking sector, the largest insurance industry, and the largest payments system in the world. The EU also has the largest private market for fixed-rate securities, and its derivatives and equity markets are comparable to those of the United States.

As noted earlier, the first dramatic alarm bell rang in Europe on July 28, 2007, when IKB Deutsche Industriebank had to be rescued after reckless investments in American subprime assets. The goal then was to avoid what Jochen Sanjo, president of the German Federal Office for Financial Surveillance (Bundesanstalt fuer Finanzdienstleistungsaufsicht [BaFin]), defined at the time as "the worst banking crisis after 1931." Sanjo's mention of the years between the two world wars should have been a shocking alarm for everybody in Europe: it evoked the ghost of the monetary disruption that played a prominent role in enabling the subsequent rise to power of Adolph Hitler's Nazi regime. "Nine days before the intervention of the government," then Finance Minister Peer Steinbrück said, "the chairman of the board of directors of the IKB, Stefan Ortseifen, released a press communiqué that the bank was expecting to close the year with a positive operative margin of 280 million euro, while the problems on the mortgage market in the United States would have had practically no effect on the institute." But the reality was completely different. "It was my first sad experience," Steinbrück observed later, "with the incompetence, risk denial, and disinformation played out by bank managers."[10] The surveillance board of IKB was kind of a "Who's Who" of the German economy. The minister raised the possibility of letting the bank go bust, but he was convinced that this would be followed by a domino effect and that Germany's role as a financial center would gravely suffer if the first European bank to fail was German.

Then in mid-February 2008, almost exactly one week after the G-7 summit in Tokyo where Hank Paulson, U.S. secretary of the Treasury, informed his European colleagues that the situation was under control, Europe saw the first run on a bank, the United Kingdom's Northern Rock, in many decades. On March 16, 2008, one of America's oldest investment banks, Bear Stearns, went belly up. Then it was the turn of problems at the Dutch bank ABN-Amro and at three German banks: Westdeutsche Landesbank, BayernLB, and SachsenLB.

But the bankruptcy of Lehman Brothers was the real trigger for European banks. The tipping point—according to the Bank for International Settlements—came on Monday, September 15, 2008, when Lehman Brothers

Holdings filed for Chapter 11 bankruptcy protection: what many had hoped would be merely a year of manageable market turmoil then escalated into a full-fledged global crisis. The previous weekend, at the headquarters of the European Central Bank on the Kaiserstrasse in Frankfurt, had been spent in a sense of extreme alert. The ECB board felt unanimously that Paulson was making a lethal mistake by letting Lehman fail. One of the ECB top bankers tells of frantic calls day and night to Washington to stop Paulson. The bankers knew very well that the failure of a bank as large as Lehman could also tip the European banking system over the edge. But pressures from countries of the euro area were not really taken into consideration in Washington. Paulson was dealing primarily with Gordon Brown, hoping to secure the intervention of Barclays Bank as a rescuer for Lehman. After that last attempt failed, Paulson did not even bother to communicate personally with his colleagues in Europe. Informed of Lehman's failure only after the fact, French finance minister Christine Lagarde reacted wryly: "What I said? I said 'Holy cow!' " At the Berlin Chancellery, the same opinion prevailed: "When I was informed I remained speechless," Merkel's economic adviser, Jens Weidmann, revealed. "Lehman was turning a U.S. crisis into a global one."

European banks dealing with Lehman—most of them in London—saw their assets disappear overnight. There were immediate knock-on effects on other banks. The European and the global financial system froze in a matter of hours. The whole commercial paper market, which many European companies depended on for the funding of their operating expenses, collapsed at once. Stock plunges stopped any firm's plan for capital increases. Corporate growth forecasts were slashed downward. Even so, in the following week European governments behaved as if the problem was not of their concern. The mess was American-made, and it was up to Washington to clean it up. "Europe should not change its policy and in no way imitate the U.S. while dealing with the international financial crisis," Luxembourg prime minister Jean-Claude Juncker advised on September 17. He strongly rejected U.S.-style fiscal stimulus packages aimed at reviving growth. Juncker, who had recently been re-elected for the third time as Eurogroup president, explicitly denied that Europe was in recession: "The main worry we have is inflation." The Budget Law discussion at the German Parliament demonstrates how unaware and uninformed the governments were. According to a German minister, "None of us knew what a CDO or a CDS was," referring to two types of the financial instruments that had gotten Lehman and companies into trouble: collateralized debt obligations and credit default swaps. While Paulson, a former boss of Goldman Sachs, was contributing to the crisis as U.S. Treasury head in Washington, at the German finance ministry in Berlin, perhaps only two officials had a real understanding of how the financial markets worked.

But day after day, a different reality began to emerge. ECB president Trichet began to make the rounds of European chancelleries to sound the alarm. Mario Draghi, head of the Italian Central Bank and also of the G-7's Financial Stability Forum, accompanied by other national bank governors, visited as many finance ministers as possible to explain clearly the drama they were observing. One after the other, European banks were also sending alarms and calling for financial aid—among them the United Kingdom's Bradford & Bingley, France's Dexia, and Belgium's Fortis. The case of Fortis highlighted a unique aspect of the European crisis hitherto little considered: The size of the Belgian bank's liabilities was in fact several times greater than the entire gross domestic product of Belgium. For some individual states, such as Belgium, it thus would be impossible to intervene and absorb the losses of individual institutions. In the 1990s and 2000s, many European banks had grown far too big to be saved by the single countries hosting them. According to statistics provided by the Bank for International Settlements (BIS), the combined assets of the three largest banks of each country were equivalent in 2009 to 118 percent of German GDP (compared to only 38 percent in 1990), 250 percent of French GDP (70 percent in 1990), and 406 percent in the Netherlands (154 percent in 1990).[11] As the governor of the Bank of England remarked, "These banks are global in life, but national in death."[12] Indeed, the typical large European bank conducts less than half its activity in its home country (in contrast to American banks, which do more than 75 percent of their business in the United States).[13] The need for a common European fund intervention seemed compelling.

Suddenly, with markets increasingly in disarray, a growing number of financial institutions faced the risk of default. Rumors of increasing problems spread around the Landesbanken, the powerful German regional state-owned banks, linked to the capillary system of the saving banks (Sparkassen). The German government, whose participation is essential to any common initiative in the EU, had some solid reasons to oppose a common European fund. The first and most conventional was that Berlin was afraid to pay an over-proportional share of the banking bailouts in other countries. The second reason was its inability to ascertain the status of financial institutions due to a lack of transparency across Europe—a problem for which Berlin itself had major responsibilities. But the third and most important reason was that Berlin knew quite well that several unexploded bombs were buried under the European financial ground, and one of them was sitting squarely in German territory.

On Monday, September 22, 2008, the heads of the G-7 governments held a crucial teleconference where they committed not to replicate the Lehman mistake of allowing any bank to fail, no matter how big. But on that very same day, the German government was officially informed of a liquidity problem hitting another German bank: Hypo Real Estate. It was this bank that really brought

Europe to the brink of a financial meltdown. The story of Hypo, shrouded from public view in those days, is key to understanding the uncooperative reaction of the German government to Sarkozy's initiative during the October 4 summit, and Merkel's behavior during the whole development of the European crisis.

"Worse than Lehman": The Last-Minute Rescue of Hypo Real Estate

The story began in Munich, the beautiful Bavarian capital and a fateful city for German history. While the drama of Hypo Real Estate was unfolding, Bavarian citizens were called to the polls to vote for the renewal of the regional parliament, the Landtag. It was the most important electoral appointment before the German federal election, scheduled almost exactly one year later. A popular citizen's movement that had been relatively uninfluential until now, the Freie Wähler (FW), the Free Voters, was capturing the limelight, sending shockwaves around the political establishment. FW was a protest movement, defending the rights of the "simple people of Bavaria" to such things as kindergartens, low local taxes, and the environment. Its leader, Hubert Aiwanger, then 37, was a farmer from a small village. His rhetoric, in a strong southern Bavarian accent, had nothing of the dreary tones of the beer houses of the 1930s that saw Adolph Hitler rise to power from his original base in Bavaria. But among the ranks of the movement, some more populist and extremist exponents also existed. As with similar movements in other European quarters, members of Freie Wähler used strong words against immigrants and most of all against "corrupt and decadent" politicians. Indeed, according to the latest polls, the movement was eroding the consensus of the traditional parties that had been the pillars of German democracy since 1948. By 2008 Germany was the only country in Europe that had been spared insidious populist movements, but the fears of the political establishment were not paranoid: In thirty years support for the old parties had almost halved. This vacuum could give way to political unknowns. The center-right Christian Social Union, which had governed Bavaria with an absolute majority for fifty years, knew that the global crisis was playing into the hands of the Freie Wähler and feeding into the discontent of citizens against the elites, the politicians, and most of all against the bankers. Not incidentally, in the last weekend of September, tension at the Kanzleramt (Chancellery) in Berlin was heightened in the wait for the outcome of the vote for the Bavarian Landtag.

Just north of Munich is the seat of Hypo Real Estate Holding AG (known as HRE), a holding company composed of a group of mortgage banks. Despite being one of the thirty major German industrial or financial firms, it was founded only in 2003 as an offspring of the crisis-stricken Bavarian banking group Hypovereinsbank. In 2007 HRE bought Depfa, a financial group that had moved its headquarters to Ireland to exploit the lax regulation and taxation regime. Depfa had built up massive debt in the short term through which it

could finance its long-term investments. The failure of Lehman and the suspension of activity on the interbank market made it impossible for Depfa to refinance, and so the company faced a crisis. HRE sent out a liquidity alarm the week after the Lehman bankruptcy, alerting the German government and the chancellor herself. At first, it looked like a solvable problem: the German central bank, the Bundesbank, might have opened a credit line and supported the group until market conditions could return to normal. But the reality proved to be quite different. HRE was hiding the biggest black hole in Europe's financial history. A confidential memorandum of October 9, 2008, by BaFin, the German banking supervisory board, recorded in detail the dramatic meetings on September 26–29, a few days after the failure of Lehman, when Merkel was called on to save Hypo Real Estate from collapse, and with it the entire financial system in Germany and Europe. HRE was a listed company—legally bound to communicate to the authorities any relevant information and especially any shortcomings that could influence its price. Therefore it would have to announce publicly the real status of its finances by Monday, September 29, at 1 a.m., as soon as the Japanese markets were to open.[14]

The story began less than sixty hours earlier. On September 26, 2008, at 2:30 p.m., an emergency meeting took place at the modern quarters of the banking regulator, BaFin, in the Lurgiallee, in the northern outskirts of Frankfurt. The three top managers of Hypo Real Estate, led by President Georg Funke, were present and accompanied by six legal experts, representatives of the three major private banks, four representatives of the Bundesbank led by President Axel Weber and later also by his vice president, Franz-Christian Zeitler. Finally, five top managers of BaFin sat around BaFin president Jochen Sanjo, who led the meeting.

Funke, president of Hypo Real Estate, gave a very reassuring representation of the situation: Granted, HRE was in the red, but the problems were confined to its Depfa subsidiary and were purely related to the lack of liquidity in the market. It would suffice to open a credit line of €24 billion in 2008 and another €9 billion in 2009 to solve the problem. Sanjo argued, to the contrary, that the situation was so severe that no temporary solution was acceptable: If anybody were to learn the bank's real situation, no one would lend anything to Hypo Real Estate. It was vital to involve in the rescue the whole German banking system. The heads of the big German banks had to be invited, along with the government, for a meeting the next day.

At 3:05 p.m. on Saturday, September 27, the meeting resumed in the presence of the president of the Deutsche Bank, Josef Ackermann—probably the most important figure in European finance—and of Commerzbank's Martin Blessing. Axel Weber, president of the Bundesbank, announced that the government had refused the invitation to participate in the negotiations. In the United States, the Federal Reserve had been able to inject liquidity of $87 billion into the markets,

but this was not doable in Europe. Weber had consulted with ECB president Trichet: European rules are such that the ECB cannot save a single bank from bankruptcy. It can only finance the system, that is, help solvent institutions that request funds through the regular repurchase agreements. "So either we heal HRE now and make it possible to access the ECB financing facility, or the other German banks must secure funding and channel it to HRE," Weber said. The plan was for the Bundesbank to present to Trichet a "national solution." Then the ECB would create on Monday morning an Emergency Liquidity Action that would finance the German banks and let them turn the money over to Hypo Real Estate. "We will have only that cartridge to shoot," the president of the Bundesbank warned. "It is therefore essential that the calculations we're doing are the right ones." HRE apparently needed €35 billion, of which €15 billion could be recouped by selling the assets of the bank. The rest, €20 billion, had to be found. "The government," Weber said, "can do its part."

Weber appealed to the celebrated system-solidarity in Germany, where all powers, political and financial, close ranks to solve national problems. The Bundesbank itself, for all its vaunted independence, plays the same tune. According to documents revealed during the subsequent judicial process involving Hypo Real Estate, it appeared that the German Central Bank had been aware of the bank's problems since February 2008.[15] In that same year, two other banking crises—involving Commerzbank and Salomon Oppenheimer—had been solved over the phone by Merkel and Ackermann. But this time, the government resisted action, and the banks also refused to put up the necessary money. The HRE crisis, the bankers said, was simply too big to be handled. According to the head of Commerzbank, "HRE would be just the beginning." In a matter of weeks, the spiral could sink the most important country in Europe.

Saturday night, with the reopening of the markets fast approaching, a meeting was called again for 9 p.m. Around 11 p.m. Ackermann estimated that HRE had "€185 billion in securities of dubious quality." Bundesbank's Weber called harshly, demanding that the banks put up the money needed to save HRE. He described a dramatic scenario: on Monday endless lines of depositors would be at the doors of German banks across the country withdrawing their savings. Letting HRE fail would be the death of the entire German banking system.[16]

"I Cannot Use Citizens' Money to Help the Banks"

On Sunday morning, while Bavarian citizens flocked to the polls, a top-level group resumed at the BaFin building in Frankfurt. Finally, private banks put down money: Ackermann's Deutsche Bank committed €5 billion; Martin Blessing promised €2.5 billion from Commerzbank and Dresdner Bank; Wolfgang Sprissler for HypoVereinsbank (UniCredit) brought to the table another €2.5 billion; Postbank offered €1 billion; and a few hundred million euro came from

smaller institutions. The package seemed ready: €15 billion of liquidity would be provided by private groups, buying assets or securities owned by Hypo estimated at €42 billion. The remaining €20 billion would come in the form of loans from the ECB against collateral guarantees offered by the Berlin government (which still had not seen the proposal). Half of any losses would end up with the banks (but not more than €2 billion) and half with the federal government.

Finally the government stepped in. Jörg Asmussen, state secretary at the finance ministry, arrived at 5:05 p.m. at BaFin's headquarters. Weber explained to him that in those same hours, the French government was extending a full guarantee for a bank and the Benelux governments were doing the same thing: "You cannot let HRE fail," he told Asmussen. But Asmussen quoted the text of the law dictating the rules for the federal budget. The government could offer guarantees only in case the risk of suffering losses was not greater than 50 percent. It would, in any event, require a parliamentary decision and even the reopening of the budget law: "I must speak with Minister Steinbrück and until Monday that will not be possible." The tension escalated, the chairman of Deutsche Bank accused the ministry of being informed of the situation for four days, then stood up and announced he would leave in order to get to the Deutsche Bank headquarters, the two twin towers that dominate the Opernplatz; he had to prepare his institution for the collapse of the interbank market that would occur in the next hours as soon as the news of HRE's failure triggered panic around the world. All the bankers, indeed, then left the premises.

Meanwhile, at 6 p.m. that Sunday, the German television channels ARD and ZDF released the first forecast on the Bavarian vote: for the CSU, Merkel's ally, it was a catastrophe. The party scored its poorest result since 1954 and lost its majority in the Bavarian Landtag for the first time in forty-six years. It was a stinging defeat for Chancellor Merkel, especially in light of the upcoming federal election in 2009. The grassroots movement of Freie Wähler gained seats in the Landtag for the first time; with more than 10 percent of the votes, it was to be the Landtag's third largest party. Merkel was profoundly upset by the results and appeared, to her aides, to be in a state of shock. While the Hypo Real Estate drama was unfolding, Merkel was in the midst of her worst political moment.

In that state of mind, Merkel received a desperate call for action from ECB president Jean-Claude Trichet, who was in Brussels helping to solve the crisis of the Fortis bank. But Trichet's pleas were rebuffed: Merkel insisted she could never throw the taxpayers' money at the banks. Trichet insisted as persistently as he could, explaining how dramatic for all of Europe the situation might become. But Merkel was resolute: no public money for HRE. Trichet grasped exactly the sense of catastrophe: "We are finished," he confessed to his interlocutors. He tried time and again to call Merkel and convince her, but she seemed not to share his alarm.

In the BaFin building, Asmussen had been left alone. Finally, a telephone call from the finance minister urged him to resume the talks. At 10:45 p.m., the meeting was again convened. The session opened with an ultimatum from the government that the bankers had to come to an agreement within twenty minutes: the losses emerging from an HRE bailout must be shared, 45 percent to the government and 55 percent to the banks with no cap on the losses for the banks. Ackermann stood up again, yelling: "This is the death of the German banking system!" The potential losses, estimated at €17 billion, would put at risk the credit ratings of the private banks and their ability to refinance in already difficult market conditions. The whole system would become fragile, undercapitalized, and vulnerable to any change of wind. At 10:55 p.m., two hours from the opening of the Japanese markets, Ackermann again threatened to scupper the whole deal.

At 11:30 p.m. Asmussen made a last offer. The losses would be divided evenly between the government and the banks, but without caps. These terms had been dictated not only by Finance Minister Steinbrück but also personally by the chancellor herself. The bankers refused and abandoned the meeting. The negotiation had failed. Asmussen and Weber immediately informed the Irish government, which was responsible for the surveillance of Depfa, and ECB president Trichet. In the room, only Sanjo and his team were left, in despair, with memories of the German crisis between the two world wars that ushered the country into the biggest tragedy of the twentieth century.

But the door reopened surprisingly at 11:57 p.m. Ackermann announced that the bankers wanted to resume the negotiations and had their own proposal. He had called Steinbrück trying to spell out clearly the size of the problem if he did not agree: "Herr Minister, you will have to hold a press conference tomorrow around ten o'clock and explain to the world that the German financial industry will have more or less to be nationalized." Steinbrück immediately called the chancellor. Five minutes after midnight, Asmussen returned to the room. During the next forty minutes, the negotiation was intertwined with a stream of phone calls. Imagine the iconic film scene of a countdown before a nuclear explosion as an apt metaphor here. But, again, at 12:48 a.m. Asmussen announced that Chancellor Merkel would not accept Ackermann's proposal.

The opening of the Japanese markets was only twelve minutes away. When the clock struck 1 a.m., Merkel threw on the table a last counterproposal: 60 percent of the losses to be borne by the banks, 40 percent by the government, and a cap on maximum losses for the banks at €8.5 billion. Almost immediately, Ackermann announced agreement. The Japanese markets were already open, but in five minutes a press conference was hastily called to communicate the success: Hypo Real Estate is safe.[17]

A €100 Billion Bailout and Zero Trust

Little will leak outside the walls surrounding that absurd waltz danced in the northern periphery of Frankfurt by political and financial powers of the leading European country. "If Lehman was a tsunami," said Wolfgang Sprissler, the head of Hypovereinsbank, to an inquiry commission of the German Parliament, "then HRE should be described as Armageddon." The official total asset balance of the bank was €400 billion, but its off-balance activity reached €1 trillion, larger than the average GDP of a European state. Eventually, the German government would have to pour more than €100 billion of taxpayer money into the bank. The ECB also lent at least €90 billion to that single bank, more than it would lend to entire states. A member of the Financial Market Stabilization Fund, established the following month, admitted that what happened before and even after September 2008 was out of control.

There was a reason why global markets were paying no attention to the "European Lehman" going bust in Frankfurt. On September 29, just hours after German bankers and the government reached their agreement, the U.S. House of Representatives voted to reject the first version of the Treasury's proposed $700 billion plan to rescue the U.S. financial industry (it was passed into law in revised form at the end of the week). The Washington debacle was a shock that made it all too evident how difficult it was for democracy and markets to manage the same priorities. The consequences of the rejection by the House were immediately visible in U.S. equity markets, which suffered steep declines in a matter of minutes and continued to sell off during the day. The S&P 500 fell 8.8 percent, led by financial shares.

The Hypo Real Estate drama also showed how difficult it was for Berlin to understand the depth of the financial crisis and the risks of inaction. The political agenda was dictated by popular sentiments—understandable and legitimate as they were—and by the unrelenting cycle of electoral appointments in the German political system. Focused on Bavaria, the government, the parties, indeed all the political system, did not understand that they had to rise to a different kind of democratic challenge, one forged by a complex and interdependent world.

Instead, few self-critical feelings emerged among German government officials, even though a commission that investigated the Hypo Real Estate debacle later discovered that BaFin had alerted the government eight times between January and August 2008 about HRE's situation, without getting a reaction.[18] Even the Bundesbank had sent alarms about Depfa in February and March that year after a special test of the bank. What remained in Merkel's mind, for all the shortcomings of her ministers and of her private and public advisers, was mainly a sense of mistrust. The fact that the crisis occurred out of public view allowed

her coalition government to develop a self-indulgent and even dangerous explanation of the events. The government's analysis was simple: Very well-hidden risks and unreliable information on the state of the banks had obscured the problem, nobody could trust anyone, and even the damages caused by medium-sized institutions could be enormous. As demonstrated in the negotiations on HRE, the government could influence the solutions with extreme difficulty and behind closed doors, but only within the national borders where it could still flex its muscles.

An empirical study conducted by the ECB later suggested that bond yield spreads across Europe started to open markedly just after the Lehman crisis on the basis of fiscal imbalances—not of the banking systems predicaments.[19] In fact, keeping the banking mess under cover helped Germany to profit from its emerging privileged fiscal position. Just when Germany's banking system was in shambles, and thanks to that problem having been kept quiet, German government bonds—the benchmark in the euro-denominated bond market—assumed a safe-haven investment status. This was the kind of role that they had never had and to such an extent.[20] The bottom line in Berlin was that everybody was to take care of his own junk. This code of survival was hidden in one single word: mistrust.[21] Exactly one year later, news coming from Greece would sadly provide additional reasons for this feeling.