Speech to the Bruges Group by Derek Scott

Europe: economics, democracy and the threat to Germany

Thank you very much for that introduction. Anybody who knows me will probably recognise that my economics are pretty Anglo-Saxon and although Tony Blair was very complimentary actually to me in his diaries, he did say that dealing with Gordon Brown I had the diplomatic skills of Dirty Harry. So perhaps you know where I'm coming from in terms of the economics.

Now there's very little attention in the newspapers about the future of the football world and Mr Blatter and it seems to me that if one group of people are living in a greater sense of denial and Mr Blatter is, it's what my friend Bernard Connolly refers to as the Brussels nomenclature.

And that includes politicians in individual countries and it's particularly in Germany I want to talk about the implications of Germany. I'm not suggesting that other countries aren't under threat but I do want to focus on Germany because it seems to me its one thing to talk about political unrest in Greece, in Portugal, it's quite a different thing to talk about the nature of political unrest in Germany.

And it seems to me that German leaders, I suspect not knowingly, are leading in my view the German people into a very dangerous world. And I think one of the problems about this is that there's a fundamental misunderstanding about the nature of the crisis that is confronting us and confronting Europe and that's reflected in most of the country in the British newspapers as well.

The nature of this present crisis is not fundamentally one about budget deficits and debts although they are a shambles and we all know the Greeks and probably most other countries apart from Germany and Holland lied before this thing was set up. But it's not really about that, it's what happens in a monetary union when a country loses competitiveness and loses it in a major way.

Now the peripheral countries they've got their differences but they're all suffering from fundamental loss of competitiveness against their major trading partners, particularly against Germany.

Now the solution that is being put forward or we're being asked to implement is essentially what I refer to as two thirds of an IMF package. I used to work for Denis Healey many years ago which probably destroys any credibility I might have but nonetheless when the IMF came into Britain and a lot of countries they'd normally demand three things: cuts in expenditure, rises in taxes and depreciation of your currency. And if you can't do the last, which clearly the European Union can't, all you do is make things worse.

Ireland has had five austerity budgets and its budget deficit is now worse than it was and it started with and the same will be true for Greece and Portugal and the rest.

Now generally I think he is a bit misguided, his interview was very much in a sense if only every country would behave like Germany then everything would be alright. Well not every country can have a current account surplus unless you're going to trade with Mars and more importantly that is not actually how Germany got out of its difficulties when the Euro started.

When the Euro started Germany had been unified with Western Germany in simple terms had taken out the clapped out economy in Eastern Germany so Germany as a whole was uncompetitive. And it tried to do various things, it tried to improve its labour market, it tried to squeeze its budget but the real reason that Germany regained its competitiveness was not anything Germany did, its what others did because what happened was that the ECB kept interest rates at a level that was appropriate for Germany, i.e. very low, and that helped weaken the Euro which helped Germany in non-European export markets.

Those low interest rates had another effect; it increased inflation in the periphery countries of Europe so it increased the competitiveness of German goods in those markets. It was sustained here in low interest rates not only increased inflation but set off an asset price and a credit bubble in these areas so it increased the demand for these new competitive German goods. And still Germany did not consolidate its budget deficit, it had to go to the Ecofin in 2004 and asked not to be fined – I mean there was never any question of fining them – but it had to pass to be fined.

Now the point about that is that the Germans lost its competitiveness was about a third as great of the lost competitiveness of these countries we're now focusing on today: Greece, Spain and Portugal.

Now what are the solutions? Bail outs won't work, whether they're for two years or three years or whether they're for €100 billion or € 700 billion because they do not deal with the competitiveness issue.

Structural reforms we're being told, this is the solution, Europe must reform itself, clearly it should, all kinds of things could change in Greece and Spain and Portugal. I understand this may be a apocryphal but I understand if you're a worker in Greece you get a bonus if you work outside, now it may be a apocryphal but there's a whole series of things that need to be done in Greece and these other countries.

But a reform in this sense why it is important is the initial effect of those kinds of reforms is actually to progress your economies, people get thrown out of work, the companies go bust and fear takes over. Now with that monetary policy that could happen again, be reinforced.

And the other thing is that suppose these countries did undertake reform, suppose Greece did do all the things that were necessary and one of the things that would have happened is that the rates of return on investment in Greece would rise much more quickly than those countries where reform wasn't taking place, which means that even more necessary for them to have their own monetary policy.

Asset sales are being suggested as a solution. Well there are quite a lot of assets the Greeks could sell off, but the thing you've got to remember about asset sales, assets by definition have an income stream and what happens when you move it from the private sector to the public sector or you move from anyone, what happens is somebody else gets that income stream.

Now it's perfectly possible that given that these things are already in the public sector that if you transfer it to the private sector then there will be a better rate of return, a better income stream. But the benefit to Greece is only the income stream differential, it is not the 50 or 60 billion that are being talked about. And of course if foreigners buy these assets they get no benefit at all because then Greece will not get the benefit of those income streams.

So in economic terms there are only two solutions. One is a massive depreciation of the Euro; a small depreciation only helps Germany. So the kind of scale that we're talking about here to enable these countries if you like to regain their competitiveness in another way would probably mean the Euro would have to go down to something like 50 or 60 cents against the dollar, which would simply send inflation sky rocketing in Germany.

The other solution is not one-off bail outs but regular transfers, gifts rather in the way that West Germany gave gifts to East Germany, which incidentally are still running at €60 billion a year and the scale of that is just horrendous.

If you assume that if one of these countries went the rest would go, if you assumed that in some sense the current account deficits of these countries were met not by trying to screw their economy down to the ground, not through depreciation because you couldn't do that but transfers, you are talking roughly speaking about €150 or €200 billion a year forever, forever.

And if you apply some kind of reasonable discount rate for one of these things to work, roughly speaking and it is of course rough, but roughly speaking you are talking about 7% or 8% of German GDP, which is rather greater than the reparation that was demanded of Germany and not paid after the First World War. Therefore these solutions don't seem to me to be very likely they are likely to wreck Germany.

Now the German solution for this at the moment is more austerity and more lending. Well more austerity just makes things worse and you can't enforce it, unless there's a new law for the European army which I haven't read about, you can't enforce it and more lending simply kicks the can down the road, as Mr Obama refers to it in a different context obviously.

Now the thing about this that strikes me as being very odd is that when this enterprise was set up it obviously replaced exchange rate risk for credit risk. The thing is though that as far back as 1994 Mr Trichet said that one advantage of monetary union was that this premium would go down to zero, that is there'd be no credit risk.

And so what has happened is that exchange rate risk has been exchanged for credit risk but the credit risk was mispriced so we have a credit bubble and everything else, the single currency was a credit bubble on top of anything made in the United States. But the credit bubble's gone bust but the creditors haven't been hit and you've got this bizarre position of Irish and other European taxpayers supporting French, German and many other banks.

I mean this is ultimately not a sustainable position so what is the best way out of this mess? And we are in a mess and there will be no painless way out of the mess and it will affect Great Britain as well although we're not in the Euro.

Now the best solution would actually be for Germany to leave the Euro but they won't do that partly because the Germans seem to take the view that somehow they can't behave in a German way, they have to operate in the European way whatever that means.

Germany also seems to think that it's somehow benefitted from the Euro. Now in a sense it has because Germany has used both the Euro and the exchange rate mechanism as a way of maintaining German manufacturing but that has been an expense of German taxpayers and German consumers.

It's certainly true if Germany did come out the new Deutsche Mark would appreciate, its manufacturing would become most competitive but other areas of the economy, service sector economy would have to develop and Germany as a country would be much more prosperous.

Now the other side of this of course is that although German manufacturing has been very prosperous and very successful because in a sense it used the exchange rate mechanism and the single currency, this current account surplus or trade surplus in particular that they've earned has been channelled into these periphery countries, they are the biggest creditors.

So it seems to me that there's a dilemma for Germany, it would be very costly to rescue the German banks and their exposure to these countries but the longer this goes on the more expensive it will be for Germany and other countries who rescue sovereign states as they go bust. To that extent it seems to me, I don't know how it will happen, I've no idea when it will happen and nor does anybody else but it seems to me that in its present configuration the single currency cannot survive. And in fact within monetary union Portugal, Spain and Greece are already insolvent and Ireland is probably insolvent.

Now the likelihood is that, as with every other crisis that Europe has had, will be used to bring about more Europe, a degree of integration that was not acceptable before. And we can see what the French are playing at, the French have always had the desire for an economic Government but they thought the Germans understand where they were coming from.

President de Gaulle said many, many years ago that for him Europe was a coach and horses and Germany was the horse and France was the coachman.

Now we all know that this whole project was a political one but it's underpinned by some very bad economics and ultimately bad economics leads to bad politics. And this comes on top of a political system that was already in my view a lie because its pretended that somehow the European Union is in favour of democracy and the rest of it and we know that the introduction of the whole course of this enterprise has been one where power has gone from Member States to the centre and indeed we've ended up with the worse of all worlds.

You could make a theoretical case for a federal Europe but we've ended up with the worst of all worlds, a mixture of super-national, national and bureaucratic with no accountability and no responsibility, no responsibility to Member States or their people.

And in recent time when no means yes I'm interested to know what if the vote on the Lisbon Treaty in Ireland and finding we're on the second wave whether we've said that no meant yes; the whole idea that somehow people only vote against this thing when they don't understand it, its insulting.

And I think the other more important point if I may say so is that what Europe has done politically is undermine the institutions that define and give especially to national sense of identity without replacing it with something else and the danger of that sort of environment is that when national or political sense of identity is undermined people will seek the identity in other areas: in race, ethnicity and the tribe and that is all that will happen.

And we have here the biggest crisis since the 1930s and in my view we're only beginning to see the beginnings of the political fallout. The European Union has in a sense created a political vacuum in Europe and the single currency has destroyed and is in the process of destroying economies.

In that environment it seems to me whatever happens in one sense or another new Europe, at least for the foreseeable future, will take on connotations that are in some sense more German. And I don't think Germany or its peoples really want that because we are ending up with an environment and a danger of a crisis where Germany either ends up footing the bill which will ruin it, or it ends up by being the bully that tries to reinforce discipline in other countries.

Because once the Germans sign up to economic Government the French will not be concerned about discipline or these other things, they've been taken for a ride and I think that's very, very dangerous not just for Europe but for Germany. It reinforces national stereotypes, I don't imagine that Germany is going to fall into some kind of right-wing new Hitlerite or whatever it could be just as left-wing but the danger of political instability in Germany I think is a very real one and to that extent it seems to me that it is in the interests of Europe, I mean Europe not institutional Europe, the real Europe, it is in the interests of Europe and Germany that Germany says no to France on something that really matters to the French.

It's often said that the European Union is like riding a bike that if you stop you fall off. Well that is not my experience of riding a bike, it is perfectly possible to stop and put your foot down and look around and see where you want to go. Way back in the 50s when this whole enterprise was being discussed there was a choice to be made between the views of Ludwig Earhart who wanted much lighter union, a free trade area and on the other hand Adenauer and Adenauer won

And the great paradox is that the model that Earhart envisaged was much more appropriate for a nation of 27 and a world in which capital flowed freely and the other developments had taken place than the one we've got.

But we’ve got what we’ve got, its heading for a crisis, its unsustainable and in my view one of the biggest dangers is actually how Germany respond and I’m not sure that the German politicians actually understand