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European Crisis: Precise Solutions in an Imprecise Reality


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By George Friedman

An important disconnect over the discussion of the  [future of the European Union](#) exists, one that divides into three parts. First, there is the question of whether the various plans put forward in Europe plausibly could result in success given the premises they are based on. Second, there is the question of whether the premises are realistic. And third, assuming they are realistic and the plans are in fact implemented, there is the question of whether they can save the European Union as it currently exists.

The plans all are financial solutions to a particular set of financial problems. But regardless of whether they are realistic in addressing the financial problem, the question of whether the financial issue really addresses the [fundamental dilemma of Europe](#) — which is political and geopolitical — remains.

STRATFOR has examined the plans for dealing with the financial crisis in Europe, and we find them technically plausible, even if they involve navigating something of a minefield. The eurozone's bailout fund, the European Financial Stability Facility, would be expanded in scope and reach until it can handle the bailout of a major state, the default of a minor state and a banking crisis of unprecedented proportions. Given assumptions of the

magnitude of the problem and assuming general compliance with the plans, there is a chance that the solution we see the Germans moving toward could work.

The extraordinary complexity of the plans being floated in Europe is important to note. It is extremely difficult for us to understand the specifics, and we suspect the politicians proposing it are also less than clear on them. We have found that the more uncertain the solution, the more complex it is. And the complexity of the European situation is less driven by the complexity of the economics than by the complexity of the politics. The problem is relatively easy: Banks and countries under massive financial pressure almost certainly will default without extensive aid. By giving them money, default can be avoided. But the political complexity of giving them money and the opposition by many Europeans on all sides to this solution contributes to the complexity. The greater the complexity, the more interests can be satisfied and — ultimately — the less understanding there is about what has been promised. Some subjects require complexity, and this is one of them. The degree of complexity in this case tells another tale.

The Foundation of the Crisis

Part of that tale is about two dubious assumptions at the foundation of the crisis. The first is the assumption that interested parties are genuinely aware of the size of the financial problems, and to the extent they are aware of it, that they are being honest about it. Ever since 2008, the singular truth of the financial community globally has been that they were either unaware of the extent of the financial problems on the whole or unaware of the realities of their own institutions. An alternative explanation is, of course, willful ignorance. This translates as the leaders being fully aware of the magnitude of the problem but understating it to buy time or to position themselves personally for better outcomes. It could also simply be a case of their being engaged in helpless hopefulness — that is, they knew there was nothing they could do but remained hopeful that someone else would find a solution. In sum, it combined incompetence, willful deception and willful delusion.

Consider the charge that the Greeks falsified financial data. While undoubtedly true, it misses the point. The job of bankers is to analyze data from loan applicants and to uncover falsehoods. The charge against the Greeks can thus be extended to bankers. How could they not have discovered the Greek deception?

There are two answers. The first is that they didn't want to. The global system of compensation among financial institutions — from home mortgages to the purchase of government bonds — separates the transaction from the outcome. In other words, in many cases bankers are not held responsible for the outcome of the loan and are paid for the acquisition and resale of the loan alone. They are therefore not particularly aggressive in assessing the quality of a given loan. Frequently, they work with borrowers to make their debt look more attractive.

During the U.S. subprime crisis, in the mortgage crisis in Central Europe and in the sovereign debt and banking crisis in Europe, the system placed a premium on transactions, immunizing bankers from the repayment of loans. The validity of the numbers systematically were skewed toward the most favorable case.

More important, such numbers — not only of the status of loans but also about the economic and social status of the debtors — inherently are uncertain. This is crucial because part of the proposed European solution is the imposition of austerity on debtor nation states. The specifics of that austerity and its effect on the ability to repay after austerity heavily depend on the validity of available economic and social statistics.

There is an interesting belief, at least in the advanced industrial countries, that government-issued statistics reflect reality. The idea is that the people who issued these statistics are civil servants, impervious to political pressure and therefore likely providing accurate data. A host of reasons exists for looking at national statistics with a jaundiced eye beyond the risk of politicians pressuring civil servants.

For one, collecting statistics on a society is a daunting task. Even small countries have millions of people. The national statistical database is based on the assumption that all of the transactions and productions of these millions can be measured accurately, or at least measured within some knowable range of error. This is an overwhelming undertaking.

The solution is not the actual counting of transactions — an impossible task — but the creation of statistical models that make assumptions based on various methodologies. There are competing models that provide different outcomes based on sampling procedures or mathematical models. Even without pressure from politicians, civil servants and their academic mentors have personal commitments to certain models.

The center of gravity of our global statistical system, particularly those of advanced industrial countries, is that the selection of statistical models is frequently subject to complex disputes of experts who vehemently disagree with one another. This is also a point where political pressure can be applied. Given the disagreements, the decision on which methodology to use — from sampling to reporting — is subject to political decisions because the experts are divided and as contentious as all human beings are on any subject they care about.

And this is the point at which outside decisions are made, based on outcome, not on the subtleties of mathematical modeling. There is a connection between the numbers and reality, but the mathematics of a bailout rests on a statistical base of sand. It is always assumed that this is the case in the developing world. This creates a certain advantage, in that it is understood that the statistics are unreliable. By contrast, the advanced industrial countries have the hubris to believe that complex mathematics has solved the problem of knowing what hundreds of millions of people in billions of transactions actually have done.

A Culture of Opaque States

Compounding this challenge, the European Union has incorporated societies on its periphery that never have accepted the principle that states must be transparent, a problem exacerbated by EU regulations. Southern and Central Europeans always have been less impressed by the state than Germans, for example. This is not simply about paying taxes but about a broader distrust of government, something deeply embedded in history. Meanwhile, regulations from Brussels, whose tax and employment laws make entrepreneurship and small business ownership extraordinarily difficult, have forced a

good deal of the economy “off the books,” aka underground.

While not an EU state, Moldova — said to be the poorest country in Europe — is an instructive example. When I visited it a year ago, the city (and villages outside the city) was filled with banks (from Societe Generale on down) and BMWs. There was clear poverty, but there also was a wealth and vibrancy not captured in intergovernmental statistics. The numbers spoke of grinding poverty; the streets spoke of a more complex reality.

What exactly is the state of the Greek, Spanish or Italian economy? That is hard to say. Official statistics that count the legal economy suffer from methodological uncertainty. Moreover, a good deal of the economy is not included in the numbers. One assessment says that 10 percent of all employees are off the books. Another says 40 percent of Greeks define themselves as self-employed. A third estimates that 40 percent of the total Greek economy is in the grey sector. When evaluating what tries to remain hidden, you're reduced to guesswork. No one really knows, any more than anyone really knows how many illegal immigrants are participating in the U.S. economy. The difference, however, is that this knowledge is of profound importance to the entire EU bailout.

The level of indebtedness and the ownership of the debt of European banks and countries are as murky as who held asset-backed securities in the United States. Yet there is a precise plan designed to solve a problem that can't be quantified or allocated. The complexity and precision of the plan fails to recognize the uncertainty because the governments and banks are loath to admit that they just aren't certain. The banks have grown so big and their relationships so complex that the uncertainty principle parallels the state's. The United States — where the same governing authority handles all fiscal, monetary and social policies — powered through such uncertainties in the 2008 financial crisis by sheer mass and speed. Europe, with dozens of (often competing) authorities, so far has found it impossible to exercise that option.

The countries that face default and austerity have no better understanding of their own internal reality than the financial institutions understand their own internal reality. Greek numbers on the consequences of austerity for government workers do not take into account that many of those workers show up to work only occasionally while working another job that is not taxed or known to the state statistical services. Thus, one has a complete split between the state and banking systems' ability to honor debt obligations, the insistence on austerity and the social reality of the country.


Germany has always been different. Ever since the early 19th century German philosopher Georg Hegel declared the German civil service had ended history, the idea of the state as the embodiment of reason has meant something to Germans that it did not mean to others — in both a noble and a horrible sense. We are now at the noble end of the spectrum, but the idea that the state is the embodiment of reason still doesn't capture the European reality. The Brussels bureaucracy is based on the German view that a disinterested civil servant can produce rational solutions that partisan politicians and self-interested citizens could not.

The founding concept of the European Union involves joining nations that do not share

this view, and even find it bizarre, with a nation for which it is the cultural core. This has created the fundamental existential issue in the European Union.

The realization that the rational civil servants of Brussels and Berlin have failed to create systems that understand reality strikes at German self-perceptions. There is a willful urge to retain the perception that they understand what is going on. From the standpoint of Southern and Central Europe, the realization that the Germans genuinely thought that the states on the EU periphery had reached the level of precision of the German civil services (assuming Germany had in fact reached that stage), or that they even wanted to, is a shock. Their publics, which saw the European Union as a means of getting in on German prosperity without undergoing a massive social upheaval putting the state and the civil service — disciplined and rational — at the center of their society, experienced an even greater shock.

The political and geopolitical problem is simply this: Germany is unique in Europe in terms of both size and values. It tried to create a free trade zone based on German values allied with France that looked at the world in a much more complex way. The crisis we are seeing, which Germany is trying to solve with extraordinary complexity and precision, rests on a highly unstable base. First, the European banking system, like the American banking system, does not understand its status. Second, the entire mathematics of national statistics is inherently imprecise. Third, the peripheral countries of the European Union have economies that cannot be measured at all because their informal economies are massive. The fundamental principles and self-conception of Germany and Central Europe diverge massively. The elites of these countries might like to think of themselves as Europeans first — by the German definition — but the publics know they are not, and they don't want to be.

The precision of the bailout schemes reveals the  underlying misunderstanding of reality by Europe's elites, and specifically by the Germans. To be more precise, this is willful misunderstanding. They all know that their precision rests on a foundation of uncertainty. They are buying time hoping that prosperity will return, mooting all of these problems. But the problem is that a precise solution to a vastly uncertain problem is unlikely to return Europe to its happy past. Reality — or rather the fundamental unreality of Europe — has returned.

In some sense, this is no different from the United States and China. But the United States has its Constitution and the Civil War's consequences to hold itself together in the face of this problem, and China has the Communist Party's security apparatus to give it a shot. Europe, by contrast, has nothing to hold it together but the promise of prosperity and the myth of the rational civil servant — the cultural and political side of the underlying geopolitical problem.

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