The Euro Trouble and the Global Financial Crisis

By Christoph Deutschmann

Eberhard Karls Universität Tübingen,
christoph.deutschmann@uni-tuebingen.de, cd@mpifg.de

The problems around the Euro are still far from being settled. The trouble started with the rumor around a possible Greek insolvency in early 2010 which triggered a series of meetings of the European Governments. At the end, the principles of the Maastricht treaties were revised in two major points: First, a joint rescue fund, called "European financial stability facility" (EFSF), was created in order to help member states to refinance themselves at acceptable conditions. In practice this meant that the "no bail-out" principle of the Maastricht treaties was abandoned – at least until the scheduled termination of the program in 2013. Second, the European central bank abandoned her sacred principle of not buying state bonds and intervened in favor of Greece. At that time it had been already clear that Greece would not remain the only country having problems with refinancing its public debt; further candidates – Portugal, Spain, Italy, Ireland, Belgium – became the object of concerns and were downgraded in their credit ratings. After Greece, Ireland run into acute trouble and had to seek shelter under the European umbrella. Interest rates and risk premiums for Portuguese and Spanish bonds have risen remarkably too, and the European Commission has entered into controversial discussions with the Governments on the proposal of a further expansion of the EFSF (Der Spiegel 2011) and on the idea of introducing "Euro bonds". The strongest resistance against a further Europeanization of public debts comes from the German Government, who is not enthusiastic about the prospect of taking the role of a permanent paymaster. However, as a consequence of the lasting political discussions, unrest in the capital markets will continue and most likely will create further trouble for the Euro.

The present dilemma has reanimated the old debate on the contradictory institutional design of the Euro. It is water on the mills of the Euro-opponents who now feel fully justified in their view that a common European currency could not work without a political union or at least a political coordination of fiscal and economic policies. However, the Euro crisis must be seen also in the context of the global financial crisis after 2008. Without that earlier crisis it certainly would not have developed in the same way. As we know today, the American subprime crisis had been only the prelude of a global crisis, resulting from a long term over-accumulation of private financial assets, which additionally had been promoted by aggressive expansionary strategies of the international finance industry. A tremendous volume of uncovered titles had been piled up which due to its dimensions and inherent "systemic risks" could not simply be written off. Therefore the crisis became a political issue. The US- and European Governments intervened by voluminous parcels of credit, credit guarantees, subsidies and public expenditures in order to prevent a deepening of the collapse. They exchanged "bad", defaulted private assets for "good" public bonds, thus actually guaranteeing the profitability of private capital by tax money. On the one hand that helped to bring about an immediate stabilization, on the other hand, public debts exploded due to the costs of the bailout programs and to the fiscal strains resulting from the economic downturn. The increase of public debt had been even more marked in the US and in Britain than in Euroland. As a result, the financial markets became suspicious about the creditworthiness of the very agency that saved them from collapse, the national states. This means that the financial industry has managed to externalize her own problem and to transform it into a problem of the states.

Both factors – lack of fiscal and economic coordination in the European monetary union (EMU) on the one hand, the impact of the global financial crisis on the other – actually are interacting in the present European crisis in a complex way. This can be shown briefly for the cases of Greece and Ireland.

At first sight, Greece seemed to be a clear case of European mismanagement which showed clearly the deficiencies of political coordination within the EMU. The public sector was inefficient and disorganized, corruption and circumvention of taxes were widespread practices, public debt was far above the Maastricht criteria even before the country joined the EMU. The access to the union had been made possible only with the help of faked statistical figures. The membership in the EMU then had the effect of an invitation to continue the inherited practices, additionally prices, wages and imports soared – until the situation finally became untenable in 2010. There is no doubt that

the Greek problems would not have reached the present dimensions, if the country had kept its own currency. On the other hand, there is no debt without credit. Without the cooperation of the international finance industry, including Goldman Sachs and even more, German private and public banks, the accumulation of such a voluminous debt would not have been possible either. For the investment banks, Greek bonds offered a profitable outlet for their idle capital. In spite of the dubious circumstances, the business appeared almost risk free, as the banks could expect to be bailed out in the case of emergency. Among the German banks, the most engaged purchaser of Greek bonds was the Hypo Real Estate bank. The same bank came into serious trouble during the financial crisis and had to ask for Government support. Because of the "systemic risks" involved, the Federal Government finally decided to nationalize the Hypo Real Estate bank. This explains why Germany – after some hesitation – took initiative for a coordinated European action in favor of Greece. A possible default of Greece would have meant a considerable additional financial burden for the German Government herself. By agreeing to the help for Greece, Germany actually rescued her own bank sector. Seen from this point, the Greek crisis does not simply reveal the consequences of the institutional deficiencies of the EMU. Actually, the Greek case demonstrates the intermingling between these deficiencies and the repercussions of the global financial crisis.

The case of Ireland seems to be completely different from the Greek one. Until the outbreak of the financial crisis, the country was a model for fiscal solidity with annual budget surpluses in the years before 2008 and an accumulated public debt of only 25% of GDP. The disaster came with the international financial crisis and the subsequent collapse of the domestic housing boom which previously had generated spectacular economic growth rates. Again German banks were heavily involved. With the economic recession and the enormous expenses, the Government had to shoulder for the stabilization of the domestic banks, the public household deficits exploded. At first sight, the Irish crisis – and also the Spanish one which shows many similarities with the Irish constellation – appears to be a direct outcome of the international financial crisis. Nevertheless it would be premature to conclude that it had nothing to do with the economic coordination deficiencies of the EMU. The housing boom itself had been possible only on the background of the central regulation of interest rates in the EMU. Given the high rates of inflation and the strong increases of nominal wages not only in Ireland, but also in Spain, the interest rates set by the European Central Bank were clearly too low for these countries, although appropriate for Germany. The cheap financing costs were a decisive factor heating the housing boom, moreover prices, wages and import surpluses soared. Again the conclusion is that the crisis is the outcome not only of one factor but of the interaction of two problem complexes: The financial crisis as well as of the EMU coordination deficiencies.

A thorough debate on ways out of the present dilemma has to consider this intermingling of the two problem complexes. Any possible solution for one of the two problems will not necessarily provide a solution for the other one, with the likely result of an overall failure. The most radical way to solve the EMU coordination problems would be the return to national currencies (Krugman 2010), or, alternatively, splitting up the Euro bloc into a "strong" northern and "weak" southern zone. This would mean the restoration of the foreign exchange market as the key coordinating mechanism of the European Economies. However, even if such a solution could be achieved without creating a monetary chaos, at reasonable costs and within reasonable time – which is not realistic –, the key objection against it is that it would not solve the debt problems of the EMU member states. Contrarily, the debt burden, which still would be denominated in Euro, would become completely unbearable for the southern states. At the same time, the "stronger" states in the north would have to write off a considerable part of their foreign investments. Moreover, the outcome for the northern states – in particular for Germany – would be a drastic appreciation of their currencies, with corresponding negative consequences for exports, growth and state revenues. Thus, even the "strong" economies would suffer from an abandonment of the EMU. This makes it highly unlikely that the German, Dutch and French Governments will follow the populist moods against the Euro in their countries und underlines the credibility of their determination to defend the euro.

Today, almost everybody agrees about the need of an improved "coordination" of national fiscal and economic policies at EU-level. The political "deepening" of the EMU, which always has been demanded by the Euro-criticizers, now meets almost unanimous support among political and economic decision makers. Actually however, this is a thorny issue already going back to a vast discussion. The Maastricht sanctions against member states violating the budget deficit benchmarks have proven nearly inefficient in

practice. The German Government herself (besides France) had been one of the pioneers in circumventing the Maastricht stability pact in 2005. Member states getting assistance from the European rescue fund indeed have to accept a tight supervision of their budget policies and to commit themselves to fiscal austerity. However, even if the Governments are able to secure parliamentary support such unpopular measures, the key point is again that fiscal austerity is not a remedy against the overdebt problem (Spahn 2010). To the contrary, policies of raising taxes and reducing expenditures will curb economic growth and make the national debt burden even heavier. For highly indebted states it will become even more difficult to escape the vicious circle of declining tax revenues and rising interest obligations. Fiscal austerity has a symbolic function as a ritual of self-sacrifice that may calm down the capital markets for some time; however they cannot cure the real problem. The European Governments are now facing the challenge to find a viable strategy for the time after 2013 when the EFSF will run out.

According to widely discussed ideas, the European Commission should be equipped with enlarged powers to coordinate the fiscal and economic policies of the member states, including the right to intervene into national tax policies and expenditures, perhaps even to regulate trade imbalances (Dullien/Schwarzer 2010). Many of these ideas do not appear overly realistic either, as they would presuppose a cumbersome and time consuming revision process of the EU treaties. Moreover, they would further nourish the already virulent concerns about the democratic deficit of the European Union, and will meet correspondingly strong political and juridical opposition. An additional transfer of economic regulatory powers to the EU commission would also touch the delicate political balance between "small" and "large" and economically "weak" and "strong" states. The strong states will resist any arrangement that will oblige them to pay the cost of the regulations without giving them a corresponding amount of political control. Last, but not least: Even if the idea of giving more power to the European Commission would succeed, it again would hardly help to settle the overdebt problem of some member states. In short: The idea of politically "deepening" the EMU looks sympathetic and meets approval from almost all sides. In practice however, progress on this way, if possible at all, will be slow and cumbersome. What remains, are appeals to improve the intergovernmental coordination of economic and fiscal policies within Europe (Schäuble 2011). The EMU members find themselves in a situation which actually ties them together (because the breakup of the union is no viable alternative), without being able to establish an efficient coordination mechanism in the foreseeable future. This is a constellation which is likely to breed continuing political conflicts and unrest at the capital markets.

If there is anything like a "key" for all difficulties, it lies in the debt burden which the EMU states (like other ones) had accumulated even before the global financial crisis, but which had been enlarged substantially by the latter. Without a solution of the debt problem the chances for a political deepening of the EU will be equal to nil; if a solution would be found, this would surely also improve the success chances of the Euro. The problem of overly indebtedness – to emphasize it again – cannot be cured by austerity measures. The only way out is that the private creditors must be brought to renounce a part of their claims, be it in the form of an ordered restructuration of the debt, or in the form of a general "haircut". Given the dimensions of the problem, a one-for-all tax on all capital assets could also be considered. To raise tax revenues, higher taxes on capital incomes and a general financial market transaction tax would be helpful either. However, just these potentially most efficient measures are the most difficult to be executed. The mere discussion about them is being avoided because of her negative performative effects on the markets. They would induce capital flights and meet strong political opposition from the side of the proprietors and the international financial lobby. They could be efficient only under the presupposition of a minimum of international political coordination within and beyond the EU. Given the disappointing experiences with transnational coordination of financial markets at G-20 level (Mayntz 2010), quick progress on this way again does not appear likely.

Given the prospect of Portugal joining the club of EFSF-recipients perhaps in the near future, of continuing refinancing problems of the members of this club, of interest rates and risk premiums on the bonds of further member states (Spain, Italy, Belgium, France) to rise, what will actually happen then? As Germany with its strong export economy is the main economic profitier of the EMU – the key economic and political decision makers are well aware of this – it is not a risky prediction that the German Government will give up her current resistance against a further expansion of the EFSF and perhaps even to a partial introduction of Euro-bonds during the next acute crisis. Moreover, Germany possibly will have to take steps in order to reduce its current excessive export surpluses and

to stimulate domestic demand. However, there may come a point where even the German accumulated debt, which too has already grown significantly above the Maastricht limit of 60%, might reach a critical level. To prevent or at least slow down such a development, the pressure on the European Central bank to keep interest rates low and to purchase bonds of overly indebted states will remain and increase. Clearing the problem with the help of central bank money surely would be the easiest solution, the way of least resistance, which under the given circumstances certainly has its charm for the decision makers. And there is no reason for premature alarm, because with such a policy the European Central bank would only follow the footsteps of the British, US and Japanese central banks. Actually, the monetary policy of the European central bank had been comparatively conservative and restrictive so far, so that surely there would still be some leeway on such a path. However, what would be the outcome, if a reflationary race between the key global currencies should develop? A wave of inflation, resulting perhaps in a new financial crash would annihilate the stock of global capital assets probably to a degree that would surpass by far the losses which the owners would have had to expect in the case of an ordered restructuration. Thus, again I arrive at the conclusion that the debt problem is the key for settling the trouble of the Euro. The question is only whether the solution will come about in a politically coordinated way, or via the burst of a new global financial bubble with unforeseeable social and political repercussions. Clearly it is the first option which would be preferable, but unfortunately it does not seem the more realistic at present.

***Christoph Deutschmann**, born 1946, Professor (emeritus) at the Department of Sociology, University of Tuebingen, currently guest researcher at the Max Planck Institute for the Study of Societies, Cologne. Main research areas: Economic sociology and sociology of work. Key recent publications: A pragmatist theory of capitalism. In:* Socio Economic Review, Vol. 9, No. 1*, 2011, 83-106; Paradoxes of social rise. The expansion of middle classes and the financial crisis. In:* Journal of Social Science Education, Vol. 9, No. 1*, 2010, 20-31; with Jens Beckert (eds.):* Wirtschaftssoziologie. *Sonderheft 49 der Kölner Zeitschrift für Soziologie und Sozialpsychologie, Wiesbaden 2009: VS;* Kapitalistische Dynamik. Eine gesellschaftstheoretische Perspektive. *Wiesbaden 2008: VS-Verlag.*

References

Der Spiegel, 2011: *Der Spiegel online international*, January 24.

Dullien, Sebastian/ Daniela Schwarzer, 2010: Die Zukunft der Eurozone nach der Griechenland-Hilfe und dem Euro-Schutzschirm. In: *Leviathan 4/38*: 509-532.

Krugman, Paul, 2010: Anatomy of a Euromess. In: *The New York Times Opinion Pages*, February 9.

Mayntz, Renate, 2010: *Die transnationale Ordnung globalisierter Finanzmärkte.* MPIfG Working Paper 10/8, Max Planck Institute for the Study of Societies, Cologne.

Schäuble, Wolfgang, 2011: Für eine bessere Verfassung Europas. In: *Frankfurter Allgemeine Zeitung, January 27*.

Spahn, Peter, 2010: Die Schuldenkrise der Europäischen Währungsunion. In: *Direkt. Analysen und Konzepte zur Wirtschafts- und Sozialpolitik.* Friedrich-Ebert-Stiftung, Bonn.