

# The continuing crisis of the euro — a weak link in the global financial system?\*

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## Resumo

*A origem e as causas da crise financeira europeia são analisadas. Dívida, desequilíbrios orçamentários, recessão e desemprego são as imagens da Europa de hoje. Esses problemas vêm sendo tratados com medidas voltadas aos interesses dos credores de corte de gasto público e aumento de impostos. Qual a perspectiva de a União Europeia (EU) reconquistar seu “momentum” em termos de integração econômica e imagem? Há outro caminho de saída da crise diferente de um prolongado regime de austeridade? A forte onda esquerdista das recentes eleições na Grã-Bretanha, na França e na Grécia foi vista como sinal de uma oposição do sentimento popular contra a quebra da rede de seguridade social e das despesas públicas em geral como solução para os problemas orçamentários, mas quanto isso pode se traduzir em mudança nas posições seguidas pela União Europeia e pelo Banco Central Europeu? Ou será que a UE está dirigindo-se sem esperança para uma fratura não apenas da Zona do Euro, mas também de seus outros instrumentos de integração econômica? O crescimento de forças nacionalistas de direita na Hungria, na França e, em menor intensidade, também na Grécia são indicativo nessa direção. Antes de tratar da questão central, é necessário começar por algumas questões fundamentais sobre o euro como sistema monetário e seu lugar na economia mundial. Ao final, algumas conclusões são tiradas da presente crise do euro em relação ao estado da teoria econômica em geral, conclusões que podem ser relevantes para o debate entre economistas no Hemisfério Sul.*

## Palavras-chave

**Crise financeira; integração econômica; teoria econômica.**

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## ***Abstract***

*The origin and causes of European financial crisis is analyzed. Debt, budgetary imbalances, economic recession and unemployment are the figures of today's Europe. Those problems are been cope with measures targeting creditors interests of cutting public expenditures and rising taxes. What are the prospects for the European Union to regain its momentum in terms of economic integration and image? Is there a way out of the crisis other than that of a prolonged austerity regime? The strong leftward swing in the recent elections in UK, France and Greece have been seen as a sign of a popular mood opposing a continued crackdown on social security nets and public expenditures in general as a solution to present budgetary problems, but how far can this be translated into changes of the main orientations of the EU and its central bank, the ECB? Or is the European Union helplessly driving towards a break-up not only of the Eurozone but also of its other instruments of economic integration? The rise of right-wing nationalist forces in Hungary, France and to a lesser extent also in Greece might suggest this. Before going into the subject matter it is necessary to start with some fundamental questions regarding the euro as a monetary system and its place in the world economy. At the end, some conclusions will be drawn from the present euro crisis concerning the state of general economic theory, conclusions that might have salience also for debates among economists in the southern hemisphere.*

## ***Key words***

***Finantial crisis; economic integration; economic theory.***

**Classificação JEL: F15, F36, G18.**

## **Introduction**

Some years ago the process of enlargement and integration of the European Union was widely considered among Latin Americans as a successful attempt of constructing a larger area of economic and political cooperation that could be used as an example to learn from. Whereas the different attempts in Latin America such as CAN, Mercosur and CEPAL had fluctuating and variating fortunes much dependent on political conjunctures the development of the European Economic Community into a European

Union seemed to be a continuous process with much larger scope and depth. It was also an image that the EU representatives sought to project in all fields of their cooperation with regional partners in South America and Africa.

This impression seemed to be confirmed by the haphazardness of the development of the US economy in the last decade: it was the prime locus of the bust of the IT-bubble in 2000, and the US government tried to restart the economy by a consumer driven growth with untenable deficits in both trade balances and capital accounts only to end in the financial meltdown of the subprime-crisis epitomized by the collapse of Lehman Brothers in 2008.

But after 2009 this impression of European Union as a success model has changed profoundly. As in all other developed economies the ratio of public indebtedness has risen sharply in almost all of the EU member states, whether being part of the Eurozone or not. However the peculiarities of the monetary policies and especially the role supranational role of the euro have quickly produced financial crises, in turn developing to political and social crises threatening the whole fabric of the European Union.

Given the economic weight of the European Union, with its 350 million citizens and a combined GDP equalling that of the United States the future of the EU is a question that is not only of regional concern, it will a factor influencing geopolitical arrangements and the development of the world economy as a whole.

What are the prospects for the European Union to regain its momentum in terms of economic integration and image? Is there a way out of the crisis other than that of a prolonged austerity regime? The strong leftward swing in the recent elections in UK, France and Greece have been seen as a sign of a popular mood opposing a continued crackdown on social security nets and public expenditures in general as a solution to present budgetary problems, but how far can this be translated into changes of the main orientations of the EU and its central bank, the ECB?

Or is the European Union helplessly driving towards a break-up not only of the Eurozone but also of its other instruments of economic integration? The rise of right-wing nationalist forces in Hungary, France and to a lesser extent also in Greece might suggest this.

Before going into the subject matter it is necessary to start with some fundamental questions regarding the euro as a monetary system and its place in the world economy.

At the end, some conclusions will be drawn from the present euro crisis concerning the state of general economic theory, conclusions that might have salience also for debates among economists in the southern hemisphere.

# **1 This is not a crisis of the euro — it is the third phase of the ongoing global financial crisis**

The discussions concerning the untenable rises of the ratio of public indebtedness in the last year have been focusing mostly on individual countries within the European Union: Greece, Ireland, Spain, Portugal and Italy. The Anglo-Saxon pink sheet economic newspapers have dubbed them the PIIGS-countries, an abbreviation with a sense of humour that smacks of contempt. And then many — mostly in United States and Great Britain — have seen it as an evidence that the euro-project was wrong all along. They evidently abhor as well the idea of the euro as a competitor to the US dollar as the prospect of the continental marketplaces challenging the role of the City of London. Undoubtedly there are inconsistencies in the creation of the European Monetary Union and its currency. One thing must however be very clear: the crisis within the euro system is above all a part of the deeper global financial crisis that has continued since the crash of US mortgage market and the Lehman Brothers in 2008. The fact that UK is not part of the euro have not prevented Great Britain's economy from running untenable deficits. Deficits that the current conservative government is now trying to tackle with measures of slash down in public expenditures as harsh as most of those used by his counterparts in the Eurozone countries.

Nor has the fact that the financial policies of the United States are the opposite from that of the EU countries saved it from running into an indebtedness that exceeds 15 trillion US dollars, more than its gross GDP.

The euro crisis is the third phase of an ongoing crisis process. The two first ones were characterized by the massive rescue plans to banks and industries to save the financial metabolism from a thrombosis and the drastic slowdown of growth in the US and EU economies due to the new conditions of uncertainty.

Still this larger financial settings have brought the frailties of the euro-system and its weaker links in a drastic lime-light. To these I will now turn.

## 2 The euro-zone: is it an adequate monetary area?

Today there are 17 countries in Europe that have the euro as a common currency.<sup>1</sup> More are in the wings. The euro-zone countries have together a GDP at par with that of the United States and a consumer market of 7.700 billion euros, next only to that of the US.

It is in itself an enormous feat to merge the currencies of different countries in this way. It was done in two steps. The ratification of the Single European Act of 1986 was in principle instituting the free mobility of goods, capital and labor between the member states of the Union. And with the Maastricht Treaty of 1991 a set of budgetary principles — mainly of German inspiration — were set as well as a timetable for establishing a common currency. According to the promoters, among them Jacques Delors — French socialist heading the European Commission 1986-1994 — it should lead to higher efficiency and increased growth. Still the growth was rather lagging behind that of the US its first ten years and the system is now in deep crisis. Even if the dimension of the problems of public debt in some countries have been exacerbated these last years these problems are only a symptom of deeper abnormalities within the construction of the common currency.

**What are the advantages** with a larger monetary area, according to theory? The first one is that it increases the stability in the interregional trade since the weapon of competitive devaluations is no longer available within the Eurozone. This larger stability will also stimulate a wider market integration and larger markets paves the way for increased competition, higher efficiency and higher productivity. That is in theory.

There are however some preconditions for these theories to hold:

- The benefits of free competition holds only as far as completion is really free. And the competition can be considered to be free only if productivity levels are not too different. Brazilian football players don't need to do their best when meeting Swedes, they will win anyhow. The pressure towards the maximum efficiency would not hold in such a case.
- The mobility of factors has to be general: not only goods and capital but also labour has to be mobile.
- On the macro level the degree of interdependency is important. The business cycles have to be closely related for an economic policy to be efficient.

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<sup>1</sup> Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Luxemburg, Malta, the Netherlands, Portugal, Slovakia, Slovenia and Spain.

- And the theory in itself has a time problem: the adjustment process towards higher efficiency is not instantaneous. For the theory to hold historical experience has showed the need of an active regional and countercyclical intervention from a strong state.

These conditions are in fact badly met in the euro countries.

There are vast disparities in productivity levels between the euro countries, especially between its six founding countries and the latecomers. Even within the founding members the disparities in industrial structure has proved to be major obstacles: Italy's dramatic differences between an industrialized North and a lagging Mezzogiorno have been reproduced on the European scale, with the increased divergence between a high-tech industry in the north (Germany) and a "peripheral" Europe in the south with developmental problems reminiscent of those in what once was called the "Third World".

The mobility of labor is severely restricted not only by labor laws but above all by language barriers. The parallel with the mobility of the US labor market is sometimes made, but there the language barrier — even it exists — is much less.

The relative strength of the state compared to the size of the economy of the currency area is the greatest disparity between dollar and the euro areas. The vast majority of the state resources in the US are on the federal level, the resources of the individual states within US are less than 10% of the totals and largely dependent on decisions on the federal level. In the European Union the relations are totally reversed: the EU-budget represents only 1% of EU GDP, while the budgets of the member states are at ratios above 40% of GDP. When it comes to economic realities EU is still a cooperation between national states, not a confederation. And even less a federative state entity.

From the start the euro-system thus suffered from being incomplete: there was no federal level able to balance the disparities between its members. And it is fair to say that the greater these disparities were, the greater is the need of such a countervailing force.

The only strong federal institution EU has is the ECB, European Central Bank. And its main weapon is monetary policy — via the interest rate. But how to have the same thermostat for the arctic North and the Mediterranean countries? Such a regulation will probably be somewhere in between — adapted to Frankfurt, Germany, the seat of the ECB. In fact, this is not in between but along the lines of the strongest.

Is the Eurozone and adequate monetary area? The first answer on this question obviously is: **No. It was inappropriate and unbalanced from the start.** In fact that although the criteria for the admission into the euro zone were couched in strictly financial terms it was obvious that in some cases the decision to grant the admission was purely political. It was a Polichinella

secret that the national accounts of Italy and Greece were highly unreliable, but it was deemed impossible to refuse either of them entry into the euro zone.

The fundamental problems with the euro as a monetary area have grown in the last years. When weaker countries can't shield themselves away from stronger industrial neighbours by devaluations they are competing in other ways. Ireland has lowered their corporate taxes, pulling companies and tax resources away from other member states. Slovakia, Rumania, Hungary and other new member states are competing by low wages. And German industries has also used competitive devices to gain market shares for their exports. They have been outsourcing parts of their production to neighbouring countries in Central Europe and when not pressuring wages downward leaving the labour force without any compensation for productivity gains.

Instead of creating a "level playing field" each country — and each industrial group — is trying to cheat the others to gain advantages. The common result has been an erosion of consumer demand and of the tax basis for the member states throughout the union. With gradually increasing budget deficits that needs to be financed.

And this deepening divergences within the euro zone area has proven to be an opportunity that the "finance industry" has seized upon. The continuous growth of public debt in the EU member states — especially that of its weaker states — has become a secure source of profit for banks and investment funds in a situation where other investments more oriented towards long term projects in the "real economy" seem unsafe.

So what was inappropriate and unbalanced from the start has now become untenable.

### **3 Why are the PIIGS-countries in debt crises?**

The so-called PIIGS-countries (Portugal, Ireland, Italy, Greece and Spain) have been at the center of scrutiny when discussing the problems in the euro-countries. Each of them has its specific problems making them especially vulnerable to the vast deterioration of the international economy caused by the global financial crisis. But it must be stressed that the basic factor behind the increased public indebtedness is the general slowdown of the EU and US economies.

The specific problems were different. In Greece the public debt, primarily caused by tax evasion and clientelism, had for a long time been

hidden<sup>2</sup>. In Ireland and Spain the banks had been recklessly lending to a building boom that crashed. In UK as in the US it was irresponsible lending to consumer credits and mortgages that paved the way for market slumps.

The rapid rise of public indebtedness had however not at all the same consequences in Europe as in the US. Since the ECB — unlike the Federal Reserve in the United States — was forbidden to lend money to the member states they had to get loans on the open market. And these loans proved to be very expensive ones, especially for the weaker states. From the outset the banks were demanding interest rates on 6-7% but as the debts were increasing and the speculation on coming defaults growing they rose to 20% in Greek government bonds at the end of 2011.

Both the states and the banks are in untenable situations. The financial institutions have reaped heavy profits the last year — it is not uncommon for banks to set a 15% overall profit as their goal — but for how long? How sure are their assets in Greek, Spanish or Irish bonds?

In June 2011 Robert Peston, the business editor of BBC, presented the following picture of the risky and potentially risky assets of some banks, drawn from a report by Bank for International Settlements (BIS) (PESTON, 2011)

Private bank exposure of financial risk of some government bonds (billion USD )

Greece		Ireland		Portugal	
French	65\$	Brittish	194\$	Spanish	106\$
US	41\$	German	158\$	German	50\$
German	40\$	US	105\$	US	46\$

As for Spain he didn't present the full picture but mentioned that the exposure of the US' banks was estimated to 179 billions \$. Summing up the total risk exposure for these countries already then exceeded 1.000 billion \$. This is considerably larger than the joint resources of the European Facility for Financial Stability (EFFS) and the projected European Stability Mechanism. The volumes of the risky exposures of the banks were already in June 2011 such that any significant default would have created havoc in the banking system.

The growing public indebtedness has thus become a major source of profit for the private banks — but is at the same time something of a bomb that is ticking.

<sup>2</sup> Incidentally the conservative government that was brought down in 2010 was helped in this endeavor by the US investment bank Goldman Sachs concealing debts as financial derivatives. The present head of the Italian government, Manuel Draghi, should know all about this since he was one of its chief executives.



## 4 Should the euro-system be dismantled?

The Eurozone is thus an artificial product, shaped by political concerns. A product has not lived up to its promises, that has increased tensions between member states and developed into a number serious indebtedness crises.

Many of those who are criticizing the inconsistencies of the euro holds that the only sensible way out would be to break up the euro-system into smaller parts more adapted to the criteria of monetary unions, with more equal economic structures. In France this argument is heard from the left as well from the right. In France Bernard Cassen, the distinguished former editor of *Le Monde Diplomatique* is arguing along these lines as well as Jacques Nikonoff, former president of *Attac-France*. With somewhat different arguments this is also the position of Marine Le Pen, the president of the *Front National*, France's xenophobic rightwing party and Nicolas Dupont-d'Aignan, a nationalist in the Gaullist tradition.

It might seem as a straightforward recipe. If Greece left the euro its currency would rapidly be devaluated. The exports would benefit and producers for the domestic market would more easily compete with import goods that would become more expensive. The hopefuls would say that the downside — that everything will be more expensive for consumers-will solve itself once the growth comes. But the downside is much harder than that:

- The public debt (in euros) will immediately grow by 20-50% in the national currency.
- The distrust against the ability of Greece to service the debt will lead to higher interest rates on Greek bonds.
- It would probably lead to a collapse of the Greek banking system, with concomitant ripple effects on the real economy. The Argentine crisis scenario comes into mind.

While the positive effects will come gradually the hardships will come within a week.

As other French economists (Dominique Plihon and Thomas Coutrot from *Attac France* for instance) argue that the break-away would probably lead to a chain reaction also in the political sphere in Europe that is hard to calculate but where nationalistic gestures would be hard to contain.

And of course such a measure concerns not only Greece: if one country breaks away — others will probably also be hurt. If we reflect a bit on the total risk exposure of private banks mentioned above it clearly represents not a regional but a systemic risk for the European banking system and beyond.

There are thus strong reasons why the German chancellor Angela Merkel and the French president Nicolas Sarkozy when announcing “rescue packages” for Greece last autumn solemnly declared that they would never allow the euro system to fall apart.

## 5 The Euro-plus Pact: necessary cures or dead-ends?

Thus, the governments of the euro-zone are decided not to allow the euro fall apart: but how should it be saved? Here there are two different outlooks confronting each other. On the one hand the presently dominating neo-liberal view held by current governments, the EU Commission and the board of the ECB. On the other, the “Keynesian” outlook developed by Joseph Stiglitz, the head of the official French economic research institute OFCE, Jean-Pierre Fitoussi and a host of other economists, most notably joined in a Manifesto by Appalled Economists, “*Manifeste des économistes atterrés*” published in August 2010 (FITOUSSI, 2010).

According to the first view it is the budget deficits that are the major problem and which have to be dealt with first of all. Some hard years of austerity cures are needed to bring down the deficits but once this is done the confidence of the markets in the government bonds will return. Then the interest rates will come down and then there will be prospects for a normal economic growth. But it is necessary to act swiftly and vigorously to bring the deficits down. Cures recommended include cuts in the public employment, lowering of social benefits, delayed retirement age, increased taxation on consumption and — if necessary — wholesale privatizations of public assets. This is the Greek way — they are now into their eighth austerity package. In both Greece and Italy it proved impossible to enforce such drastic measures through ordinary parliamentary means, under the pressure from both financial markets and EU authorities situations of national emergency developed where “a-political” technocrats were brought into head “crisis governments”. In both cases the saviors turned out to be bankers with close ties to banking establishment and the ECB.

But the expediency of “emergency situations” to sidestep parliamentary democracy could not be relied upon continually. Since — according to prevailing consensus in the EU establishment — it was the budget deficits that were causing the vicious circles in the economy the EU Council has decided to take preventive action: it must be made practically impossible for any national parliaments to allow budget deficits.<sup>3</sup> This is the main content of

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<sup>3</sup> The one that was called for to lead the Greek government, Lucas Papademos, had been head of the Greek central bank, and as such responsible for the deal with Goldman Sachs hiding away part of the public debt in a dubious transaction. Mario Monti, the banker and former EU Commissioner that was brought in to replace Berlusconi as prime minister in Italy in November 2011, was serving as international advisor for Goldman Sachs when he was brought in. To complete the picture it might be mentioned that the new head of the ECB, Mario Draghi, was international vice president of Goldman Sachs 2002-2005 before entering the direction of the ECB.

the so-called Euro-plus Pact adopted by the European Council in March 2011.<sup>4</sup> EU shall from now on issue guidelines concerning budgetary margins for each parliament to follow. If they disobey severe economic sanctions will follow.

The opposite, “Keynesian” view holds that the budget deficits are only the symptoms of other, deeper problems that can be specific as well as of a general nature. The creative book-keeping in Greece and the irresponsible credit policies in Spain are examples of such specific causes. But the basic problem is of a quite different order — it is a combined effect of a dysfunctional construction of the euro system and derailment of an irresponsible “financialized” capitalism. By attacking the symptom instead of the problem the austerity cures will only aggravate present problems further. According to this view neo-liberal economists simply don’t understand the interplay between the public sector economy and the markets. Joseph Stiglitz has recently characterized the Euro-plus Pact as an “outright catastrophe.”

The real circles that the austerity measures have produced have produced so far have been down-ward ones. The real effects of the cures — increased unemployment, lowered livings standards — will not bring any deficits down. Rather they will make the economies be grinding to a halt, thereby automatically lowering tax receipts and cancelling any projected lessening of the deficits. The financial markets — who where those who in the first place urged on these cuts — have been quick to notice the promised effects didn’t materialize — and so pushing up the interest rates of vulnerable countries further making a default still more likely. This is the real spiral we are now seeing unfolding in Greece, Ireland, Portugal and Italy. Soon also in Spain and maybe in France. The social revolts we have seen so far are probably only just a beginning.

Confronted with such spirals it is hard to believe that a harder, more elitist governance of the EU should be a tenable solution.

## **6 The euro-crisis is to a large degree self-inflicted**

But the weaknesses of the present Euro-Plus pact has deeper roots. It has mainly to do with the fundamental framework of the European Monetary Union: the criteria of the Maastricht Treaty and of the *Growth and Stability Pact*.

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<sup>4</sup> Originally an agreement between Germany and France called “Competitvity Pact”, its official name now is Pact for the Euro”.

They stipulate among other things that the gross debt ratio to GDP should not be higher than 60% and that the budget deficits not should be allowed to exceed 3% of GDP.

These figures were sealed off hand in a discussion between mainly French and German bankers and were advanced by the officials of the German *Bundesbank* as a precondition for giving up the sovereignty of the D-mark. It has often been said that they were driven by the fear of inflation, justified by the experience of the hyperinflation in the 1920's. May be so, but it is more salient to their criteria as a way of continuing the monetary policies of the strong D-mark. This had long been the monetary tool for German industrial policy: the strong D-mark meant a continuous pressure on labour costs and productivity to sustain an export driven economy. Now this recipe was applied to a monetary area where employment structure and productivity levels were quite different.

These Maastricht criteria are now accepted as sacrosanct by the EU and ECB establishment. The German chancellor Angela Merkel and other leading politician are talking about them and the "Golden Rule" of the Euro Plus Pact as if they were part of the Ten Commandments. But outside these closed quarters more and more economists and concerned citizens are asking themselves: why should 60% be a definite level the debt ratio? Japan has managed to have debt ratios of more than 100% without creating chaos a long time now. And the US Treasury continues to sell low yield government bonds to the Fed even if their gross debt is over 100%.

And even if a relative low level of deficits generally might be considered as preferable, how could the target of 3% in a time of economic crisis be presented as precondition for growth and not its possible result? This "golden rule" of a rapid return seems all the more ideologically biased since it advocates that the major effort should come from cuts in public expenditures or sellout of public assets.

## **7 The focus on public debt and deficits: a logical and ideological incoherence**

Today the whole focus of the media put on the indebtedness of individual states. But what happens if we compare it with that of the other actors, the banks for instance? This was done recently by the French economist Bernard Vallage as, using the official French statistics published by the INSEE.

Financial assets and liabilities in France (billions €).  
Situation of different agents in December 2009

Economic agent	Gross debt (billions €)	Share of gross debt	Financial assets (billions €)	Net debt (billions €)
Total national economy	20.631	100%	20.598	33
Public agents (state, municipalities, social insurance system)	1.841	9%	873	968
Financial institutions (banks, funds)	10.580	51%	10.947	-367
Non-financial institutions (corporate sector)	6.884	33%	4.945	1.939
Households	1.301	6%	3.703	-2.402
Non-profit institutions (associations)	23		68	-45

SOURCE: INSEE This statistics is clearly showing three things:

1. If we are talking about gross debt is that of the banks that was the problem in France. It represents 51% of the whole, the public debt only 9%.
2. If on the other hand we look on the net debt it is the corporate debt that seems to be the most vulnerable, since it represents two-thirds of the net liabilities.
3. The net public liabilities were only half of the gross debt.

Obviously it is foolish not to take the financial assets into the picture when discussing public debts in Europe but this is what the criteria of the EU economic treaties are doing. The Maastricht criteria concerning debt ratios is only concerned about the gross debt, neither the public financial assets nor the public material assets are taken into account.

From a banker's normal point of view this is illogical, when judging the creditworthiness of an industrial firm or a household it is self-evident that the financial resources and other assets also enter into the judgment.

This lack of logic is not fortuitous, it is ideologically motivated. It stems from the neo-classical — and neo-liberal — view of the market as the “natural” economy and the public sector as a regrettable but sometimes unavoidable exception to this state of nature. By exaggerating the public indebtedness and by forcing the member states to turn to the private financial markets to cover their current expenditures the rules established for the ECB are putting a strait-jacket on the public sector while at the same time providing a safe profit-machine for the finance industry.

Who is vulnerable in the French economy, as depicted by the available statistics? If we apply the same way of analyzing the situation of the banks as we use when analyzing the states we will undoubtedly find that in the vast majority of EU states the gross indebtedness of the financial institutions is by far exceeding that of the public sector, we will find that their capital base is by far much weaker than that of the national state and that the safe earnings

of the banks are much weaker than those of the state. In fact the average capital base<sup>5</sup> of the European banks is between 5 and 8%.

This means that their outstanding liabilities are more than ten times as great as their assets proper.<sup>6</sup> Moreover, given their heavy engagement in derivatives of all sorts it is evident that their assets are valued on extremely shaky grounds. Current valuations of commodity prices, interest rates, currency relations, stocks — all are at the mercy of sudden shocks. The BIS' report of June 2011 (BIS, 2012) estimated the sum of the risk exposure of the banks to the PIIGS countries to be around 1.000 billion USD. But this is only a tiny part of the total risk exposure of the banks. According to current BIS statistics the "ultimate risk exposure" for the banking system in late 2011 was considered to amount to 16,9 trillion USD. Of the "consolidated claims" the CDS trade represented 55% and the derivatives of different kinds 25% (BIS, 2012).

The banks do what they always do in times of crises: they try to lessen their risk exposure, they deleverage. From a position of massive overextension they are increasing pressures on their customers by increasing the interest rate spreads between deposits and credits and downsizing credit lines to enterprises and households but most of all they are trying to cut down their losses, selling off toxic assets to careless speculators or central banks.

Evidently it is the banking system that is in an extremely vulnerable position, and when still pursuing its speculative activities in order to reap maximum profits it does so recklessly banking on the governments rescue should they fail.

## 8 The banker's great fear: credit crunch

Even if the general opinion is above all preoccupied with discussions on public deficits the banking world is fully aware about where the real and most dangerous vulnerability is situated: it is in the generally high level of risk exposure of the banks in a situation of prolonged economic stagnation and most specifically in the entangled web of inter-bank relations.

In the boom years of credit expansion the banks were heavily using a day-to-day lending system to increase their credit facilities. Prior to the Lehman crisis Federal Reserve estimated that as much as 40% of the

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<sup>5</sup> The ratio between its most safe assets (common equity + Tier 1 capital) and its total Risk Weighted Assets (RWA). The present requirements according to the Basel III criteria demands this ratio to be 7-9,5%.

<sup>6</sup> Since total amount of risk-weighted assets and its common equity and Tier 1 capital are corresponding to the gross outstanding liabilities.

overall profits of the major US banks were the result of these interbank day-trading activities.

The rapid rise of this trade was dependent on the mutual confidence between the banks: that the collaterals provided for the loan were in fact genuine and not “toxic”: overvalued or carrying hidden liabilities. The LIBOR<sup>7</sup> interest rate was a measure of the degree of confidence, any hike in these rate signifying an increased wariness an loss of confidence between major actors in finance. The Lehman Brothers crash was a heavy blow to this trade, LIBOR rates surged an the interbank lending virtually came to a standstill. From a situation of very easy access to credits it became virtually impossible to have access to short term credits, what was called a “credit crunch”. It can be resembled to a heart attack in the arterial system of global finance. It was to avert a total breakdown that the Federal Reserve and the US government, together with its western European counterparts, massively injected liquidities into the major banks in the autumn 2008 and in the first months of 2009.

Although the acute credit crunch was thus averted in 2008 the basic fragility of the banks still persists. The banks have indeed recovered and returned to high profits — thanks to the guarantees offered by the various governments — but as the BIS statistics shows financial instruments of speculative nature still represents an important part of the structure of their underlying assets. The fear of a possible credit crunch has not disappeared since the mutual confidence between be major banks has not returned. Such a credit crunch it could be triggered by almost any dramatic event of political or economic nature in the present situation of insecurity. In the crisis strategy of the direction of the ECB this fear of new credit crunch represents a major obstacle. Their strategy is based on a rapid return to “normal” market conditions after the “abnormal” interventions in 2008-2009. This fear of credit crunch distorts — and potentially disrupts — the market mechanisms whereby proper prices were to set on all tradable goods, be it commodities or financial instruments. So in a situation where confidence between bankers was low the central banks had to assure liquidity by all necessary means. As tensions grew over possible defaults of Greece and Spain last autumn the ECB decided to put 1.000 billion € at the disposal of the private banking sector, in two tranches emitted in December2011 and February 2012. These loans were given with a long maturity (3 years) and at a very low interest rate (1%).

This was not an isolated event — it was only another step in a long sequence changing the role of the central banks in the wake of the 2008 financial crisis and even prior to that. In an article discussing the changing role of the central banks Christophe Blot (BLOT, 2012), an economist

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<sup>7</sup> London Interbank Offered Rate, the average interest rate that leading banks in London charge when lending to other banks.

working at the French research institute OFCE, has showed how massively the gross volume of the ECB monetary assets have risen since 2002. Prior to the Lehman crisis its ratio to the Eurozone GDP was 14% but with these last efforts of “quantitative easing” it has risen to 3.023 billion €, a GDP ratio of 31%.<sup>8</sup>

This means that by providing such vast amounts of liquidity the ECB is effectively if not replacing the inter-bank day-trading markets at least putting its market pricing out of function. The ECB is assuring the liquidity of the day-trading market and it does so at the price of itself becoming a major actor in the financial markets. An active role in spite of its professed neo-liberal dogma of a hands-off role, solely concerned with price stability.

There is thus a drastic divergence in the current dominant EU discourse on economic policy: while the discussion in the public sphere and the solemn commitments of government to the Euro Plus pact have been dominated but the need of austerity measures to cut down public expenditures the monetary policies of the ECB have thus been characterized by an extreme laxity towards the banking system giving them almost limitless access to virtually free credits.

The idea is that this monetary expansion should encourage the return to “normal economic growth” by restoring the proper working of the market mechanisms in the financial sector.

This was based on the simple assumption that when interests are lowered investments will grow. But what if the crucial factor for industrial investments is not the availability of credits but that of demand? What if households in times of general insecurity are foremost concerned with lowering their liabilities (consumer credits or mortgages)?

In such a situation is rather more probable that banks will use their easy credit for hoarding or speculating. And this is indeed what has happened. Since the basic rate for deposits in the ECB is above 3% financial institutions that have access to the ECB liquidity can relocate easy credits as deposits while waiting for secure investment opportunities to arise. According to the OFCE chief economist Henry Sterdyniak the ECB deposits of the banks rose from 169 billion € to 1.156 billion € between January 2007 and March 2012 (STERDYNIAC, 2012).

And the other line of conduct for the financial actors in a time of economic stagnation is to make speculative bets. In the stock market it is made by financial actors with excess liquidity: through “Aquisitions and Mergers” (A&M) windfall profits can be reaped by restructuring, cost-cutting and closing down industrial plants. But a larger source of profits is to be found in the market of financial derivatives and Credit Default Swaps.

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<sup>8</sup> The corresponding ratios for the Fed was 7% (2007) and 19% (2011). The BCE ratio 2011 was 24%.



This is where the combined effect of the specific rules for the ECB and the ever growing complexity of financial globalization have produced new and unintended results.

## 9 The statutes of the European Central Bank and the interest rate scam

By virtue of its statutes the European Central Bank is forbidden to come to the rescue of the members of the euro zone in the way that the US Federal Reserve supports the US Treasury or the Japanese Central Bank supports its Japanese equivalent.

The Euro countries thus have to go to the open market to sell their bonds while the Fed through their various quantitative easing procedures is giving the US government virtually free access to liquidity.

In the beginning this peculiar feature of the ECB was explained by the need of budgetary discipline to be enforced in all countries — countries which had been “spending beyond their means” should be forced to pay a price, the interest rate on the financial markets, for their irresponsibility. But with the development of the “insurance industry” in the financial sector the picture has changed dramatically. With the rise of new techniques in the derivatives markets — selling short speculating on rising interest rates, speculating on national defaults via Credit Default Swaps and so on — the differences between different interest rates have risen dramatically and thereby also the windfall profits reaped by traders.

As an illustration can be given the differential rates as they presented themselves in June 2011:

Type of credit, equity	Interest rate June 2011
3 yr credit from ECB to private banks	1/1,5%
German bond yield	1,8%
US, UK bond yield	2,8%
French bond yield	3,5%
EFFS lending rates to Greece(on conditions)	4,2%
Open market rates for Greece	18%

What this amounted to was a real interest scam where private banks had virtually free access to cheap liquidity that could be used to speculate against a coming Greek default, a default being all the more probable because of the volumes in the CDS trade against Greece. And the “rescue packages” delivered to the Greek government by the Eurozone stability fund — on condition that they obey the instructions on budgetary policy given by the IMF/ECB/EC troika — were in fact also quite lucrative for the

fund providers (Germany, France) since it gave them a yield considerably above their own bonds.

If you look at this interest rate scam there is one simple question to ask: why are the euro-zone states back bound by severe rules while the banks are to be saved at all costs? Why should the citizens be punished for deficits they have not caused while the banks are allowed to create speculate insurance instruments without ever being forced to take responsibility for their recklessness?

## **10 Back to the larger picture — a phase in the global deleveraging of finance capital**

Before answering these questions we will have to return to the larger picture. As I stated in the beginning the “euro crisis” although it has its specific features must be seen apart of a general crisis of the global financial system.

This can best be characterized as a result of an over-extension of the credit — creation in the private banking system. A privatization of the right to print money, to put it a bit simplified. Through globalization of financial markets and deregulation within the finance sector the banks have been totally free to extend their credits and increase the volume of their lending and loaning.

The part that has risen most spectacularly is the Over-the-counter (OTC) transactions, transactions outside the major exchange places and outside even their very slack regulations. According to current statistics by the Bank for International Settlements the OTC derivatives market is covering notional amounts adding up to 648 trillion USD (a figure roughly ten times the annual Global GDP) at an estimated market worth of 27 trillion USD (BIS, 2012). Although the sum of these assurances and bets are adding up bets and counterparts in intricate chains it is likely that they in many cases represents commitments impossible to discharge.

As the French example above shows it is reasonable to argue that it is not the states that are basically vulnerable in this situation — they have large material and financial assets at their disposal, they have means to secure a steady and even rising flow of resources through taxation. As the case of the US shows they can even sometimes afford running large deficits for a long period of time, provided there is confidence in the relative stability of their economy. What really makes them vulnerable is rather that the political authorities in the major countries (US, EU and Japan) are allowing speculative devices such as Credit Default Swaps to be used against weaker states without coordinated measures of defense.

The real vulnerability clearly lies with the banking system. It is easy to see why economic journalists in general are avoiding this evidence: talking openly about the vulnerability of specific financial actors immediately increases their vulnerability. One might say that talking about this general level of vulnerability increases the likelihood of a financial crash while hiding the fact is falsely reassuring and thus increases the dimension of such a crash.

This extreme vulnerability of the banking system is not an individual psychological feature of the bankers and traders in BNP-Paribas, Goldman Sachs, Bears Stearns or any individual investment bank or hedge fund — although there has been a lot of cases of reckless gambling in these circles. The recent loss of 2 billion USD by a trader in JP Morgan shows that the string of spectacular gambling losses is not over. The general vulnerability is however much more the consequence of a long process of privatized credit creation through the ingenious production of opaque and ever more sophisticated “financial instruments”.

I’ve mentioned the volumes in the derivatives trading: it is evident that should there be a systemic miscalculation of this network of educated guesses the number of defaults and write-downs will be innumerable.

A factor that is complicating this process even further is the deep cross-border integration of financial flows. According to current statistics Cross-border claims amounted to 31,1 trillion USD (for reference Global GDP 2011 was 62 trillion USD). A large part of these claims (51%) were short term claims, which means that any major disturbance would rapidly ripple through the international financial system.

Evidently this picture of the volumes and the depth of international interdependencies is ripe with struggles exacerbated by conflicting national interests. The sum is adding up to an intractable mess of vulnerable credits and uncovered assurances. It is forcibly reminding an observer of the way Keynes characterized the situation after WW I:

[...] the vast paper entanglements which are our legacy from war finance both at home and abroad. The war has ended with every one owing everyone else immense sums of money. Germany owes a large sum to the Allies, the Allies owe a large sum to Great Britain, and Great Britain owes a large sum to the United States. The holders of war loan in every country are owed a large sum by the State, and the State in its turn is owed a large sum by these and other taxpayers. The whole position is in the highest degree artificial, misleading, and vexatious. We shall never be able to move again, unless we can free our limbs from these paper shackles. (KEYNES, 2012).

The present situation is of course far from analogous but “the vast entanglement” is even more crippling today. As with every round of deleveraging and bankruptcies the prime question is: who will pay? In this

the first round the EU establishment have settled for the most obvious choice: the citizens and their systems of social welfare.

But if the economic stagnation in Europe continues and deepens into recession it would seem probable that will see intricate bankruptcies and heightened national conflicts not only with the European Union but also between financial centers in US, Europe and Asia.

## **11 The healthy way out: why there is an excellent basis for a socially, ecologically sustainable European development**

The Eurozone countries are thus caught in a destructive maelstrom at the moment. But is there a way out? A growing number of European economists think there is.<sup>9</sup>

If we only lift our eyes from the turmoil of interest rate speculations and debt ratios it is easy to see that countries of the European Union have in fact formidable assets to build on should they choose to. They are possessing an enormous richness in terms of cultural, technological and social assets. They have highly sophisticated production apparatuses with a highly skilled labor force. This is also shown in the area's international trade relations: the EU economy as a whole is running a trade surplus and its consumer market is of great attraction for their trading partners.

Taken together these countries have great synergies, based on the regional division of labor that has evolved since the 19<sup>th</sup> century. 60% of the international trade of the EU countries are intra-regional. This deep level of integration is making the euro countries self-sufficient in a lot of areas.

Furthermore, the economic successes of the European countries during the latter part of the 20<sup>th</sup> century were built on social models regulated through interplay between corporate executives and trade unions, between the state and the companies in the industrial sector.

An as noted above — it is not the states that are vulnerable, should they act together.

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<sup>9</sup> Impossible to give justice to these debates here. Let me only mention three networks that have been inspiring for me. The Euro-Memorandum Group, a network assembling some sixty active scholars from more than ten EU-countries, has been developing a Keynesian agenda for more than ten years. The German research institute WEED is combining ecological concerns with acute analysis on financial policies. And recently the manifesto of Appalled Economists in France has developed into an network organizing more than 2.000 scholars and professionals.

The governments of the euro countries — especially when working together — have a creditworthiness by far exceeding that of the private sector. The Greek government is of course in a situation that is different from that of the German government but if the euro-countries would abandon the unrealistic and self-defeating criteria of the Lisbon Treaty a new range of possibilities would be open.

And finally — the European Union as a whole is not like the US dependent on borrowing hundreds of billions of US dollars each year to sustain its economy. As I have shown above there are in fact two reasons why the euro countries also ought to be able to surmount the crisis: Firstly because the acute dimension of the crisis to a large degree is self-inflicted and secondly because the actual framework rests on a logical, ideologically biased incoherence.

## 12 What might be the basics of a common solution on the Euro-crisis?

How then to use all the fantastic human, technological and economic assets that these countries have?<sup>10</sup>

The very first measure would be to **make the ECB serve the peoples and their governments**. ECB should not be the institution that is helping the banks and investment funds to plunder the weaker members of the European Union. The ECB should buy government bonds on a massive scale at a low and fixed interest rate. This means suspending the articles 101 and 104 of their statute.<sup>11</sup>

Secondly — **speculation on government default should be prohibited**. The so-called Credit Default Swaps are illusory and destructive devices only serving short terms gains. Destructive because they are self-fulfilling prophecies, illusory because the “insurers” are never able to stand by their commitments should a national default actually happen. Those who are buying bonds must themselves take the risks involved — after all that’s why they get interests.

A third measure would be **profound tax reform beginning with a return of the taxation on fortunes**. It would signal a return to the earlier

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<sup>10</sup> The suggestions that follow does not claim originality. I’m relying on arguments developed by French economists such as Husson, Coutrot and Plihon (2012) and Euro Memorandum Group, 2012.

<sup>11</sup> The articles 101 and 104 of the Lisbon Treaty concerns the rules for managing public sector deficits and public debt ratios and are explicitly excluding direct purchases of government bonds by the ECB. The Lisbon Treaty was signed in November 2007 and is in function since 2009.

social capitalism in Europe where not only the wage-earner but also the rich had some civic responsibility towards the societies where they live. In 2007 3,1 million households in the euro countries had more than 750.000 € in financial assets. Taken together their assets amounted to 7.300 billion €, which was more than the combine public debts of their countries. Evidently it is necessary to have a comprehensive taxation reform.

Apart from these immediate measures there is a need of a fundamental change of paradigm in our way of thinking how growth and development should come about. A **rapid growth in public employment** is the safest way to create virtuous circles in the economies, both in terms of GDP growth and public budgets. As was understood before neo-liberalism, public expenditure does not crowd out private investments in times of vast unemployment.

But to put Europe on the road of an ecologically and socially sustainable long term development more is needed. What is needed is **coherently planned, massive and prolonged investments** in infrastructure, health and educations services in all the EU member states. In order to secure the long term financing of such an effort a fifth measure is needed: Emission by the ECB, EIB or another European agency of euro — or Union bonds on a massive scale on a low and fixed yield.<sup>12</sup> Bonds that banks should be stipulated to hold as a part of their capital base. They would also be widely accepted as a safe investment.

Of course these measures would also entail a re-establishment of the **public control over the capital markets and specifically transactions with tax havens**. There is an ongoing discussion between radical economists about what to do with the finance: regulate or curtail? For some time there seemed to be a large consensus — even including parts of the dominant economists like Martin Wolf in *Financial Times* — for the case of regulation of finance. But what regulations? And how?

What have been accomplished so far, the BIS's proposals for bank regulation (the so called Basel III criteria) seems if not counterproductive at least totally incapable of coping with systemic events. I'm inclined to agree with the French economist Frédéric Lordon: they main principle should not be "supervise and correct" but "forbid and punish".<sup>13</sup>

To make the commercial banks return to their original function the separation between commercial banks and investment banks has to be hermetic, not cosmetic. And investment banks should make their bets on their own, expecting no aid from public authorities. Apart from measures concerning the financial sector nothing of the measures above is really questioning the market economy or the existence of private companies. It is

<sup>12</sup> The idea is very well exposed by Hollandin (2011).

<sup>13</sup> Frédéric Lordon: "L'éffarante passivité de la 'ré-régulation' financière" in Sterdyniak, H. (et al) *Changerd'économie! Nos propositions pour 2012*(Liens qui libèrent, 2011).

merely a question of recreating a kind of balance between state and markets, between labor and capital.

These measures would make Europe once again look like a place of modernity.

Still nothing — or almost nothing- of all this is likely to happen in the short run.

And the reason is political.

## **13 Why the European governments still will be unable to find common solutions**

There was a moment when a fundamental change seemed possible — immediately after the crash of Lehmann Brothers in 2008. Then all governments were “Keynesian”. But since then the only real concern of governments to be to “reassure the markets”.

What we are witnessing at the moment is not a return of Keynesian policies but a new wave of neo-liberalism, more authoritarian, more disciplinary than the former one. It bears strong resemblances with the deflationary path that the governments in US, UK and France were pursuing after 1929.

What is also worrying is that this is accompanied by a growing exploitation of national prejudices to support this new agenda. Mainstream media in stronger EU economies are actually exacerbating the national conflicts by blaming the populations in the PIIGS-countries for the general problems of the Eurozone. Short sighted nationalist feelings are thus on the rise in many parts of Europe. The populist party of “True finlanders” in Finland don’t want to help “lazy Greeks” and Irish anymore. The German general public also thinks they have done enough sacrifices for EU members in the periphery when the only ones for whom they — at least the working class — have made sacrifices are the wealthy shareholders and the banks.

Economic journalists in general bears a heavy responsibility for this development since they are routinely making false analogies between the management of a household’s economy and that of a whole country. Instead of explaining the intricate interrelationship of trade balances and budgets within the EU Eurozone’s problems are boiled down to simplistic questions of honesty (“paying ones debts”) and responsibility (“not living beyond one’s means”).

There are indeed differences in national experiences and outlooks that partly explains why common solutions are being blocked. The British government is absolutely against capital controls and taxation on financial transaction because they think this might endanger the situation of the

world's largest tax haven: The City of London. The German government and leading German bank officials adamantly refuses to let ECB support the member countries directly since they think that would weaken the euro and lessen the budgetary discipline and increase the danger of inflation.

But still more important is the problem of the strength of vested interests. The role of the industrial lobbies, notably the *European Roundtable of Industrialists*, in the decision making within the EU have long been subject to hard criticism from NGOs and trade unions. There are reasons to believe that the ruling networks in the banking industry is exercising an even more dominant role in the strategic decisions of the EU Commission. There are strong personal links between the banking world and the EU authorities, bankers in executive positions get appointed to senior posts in the EU bureaucracy and top EU officials become 'senior advisers' to the biggest banks when they leave office. This is especially visible in times of crisis: as noted above the newly appointed prime ministers of Greece and Italy and of the ECB all had close links to the investment bank Goldman Sachs. When the European Union created a separate commission to propose a bank reform<sup>21</sup> of the 23 members are professional bankers. In the so-called *de Larosière*-group that is working on a new financial architecture 4 out of 8 are actual or former employees of Goldman Sachs, Citigroup or BNP Paribas. It is rather unlikely that any serious new approach curtailing the finance industry will come from these gentlemen.

It would be unfair not to mention that there are a lot of progressive efforts in the European Parliament and in various commissions to re-regulate and introduce new taxes. But the pattern is nevertheless clear good proposals are invariably watered down. There is only remnants left of the proposed Financial Transaction Tax, the issue of Eurobonds is diluted into "Project bonds" with much lesser potential, and so on. It is to be feared that the same thing will happen with the growth stimulus that the newly elected French president François Hollande want to add to the Euro Plus Pact.

The European Integration project promised an "ever closer union" between the peoples of Europe. What it has produced so far, with its bureaucracy — some 30.000 officials strong — looks more like a new Versailles. And as receptive to popular demands as the old one.

## 14 The euro — a weak link in the architecture of global finance?

We are actually witnessing a very dramatic time in Europe. The pressure that the financial markets have been able to put on vulnerable economies have already produced the implosion of the governments in



Greece and Italy and more are perhaps to come. The democracy is in reality being put on hold by the dictates of the EU/ECB/IMF-troika. The agenda of the EU, ECB and the German government seems absolutely clear: more austerity even at the price of recession.

In view of this formidable fortress defending the euro and the Euro Plus Pact that is supposed to defend it, in spite of all difficulties, the most likely scenario is that the European Union will go through a prolonged period of economic stagnation and increased inner tensions, as a return of the vicious dynamics between “center” and “periphery”. These difficulties will in fact by some be seen as the “cure” necessary to overcome its illness, a proof that the economy is on the right path to recovery. Such a process with furthermore have its vociferous supporters since it will come with a by-product: large scale privatizations at bargain prices and with windfall profits. Should such a pattern prevail it will entail a recomposition of the regulation of the fabric of the European economies: a deepening of the neo-liberal character of social systems and a further strengthening of the power of finance capital over that of the “real economy”.

There is however two factors that are undermining such a prospect. The first one is the voracity and impunity of speculative capital. Some government officials are talking about the need of a ten year long process. But is this time scale is compatible with that of the financial markets? We have already seen how swift the financial markets were to react on the “threat” of a referendum on the Greek debt last year. And when the Greek people were called to new elections in June — with the possible prospect of a majority refusing to accept the terms of the EU/IMF/BCE “rescue package” — Greek papers reported that sums equivalent of one trillion euros left the Greek banking system within a couple of days.

Even if the banking system as a whole stands to gain by the Euro Plus Pact individual financial actors will inevitably gain windfall profits by attacking fixed rules that are unsustainable. By using the financial instruments at their disposal they are like wolves attacking the most vulnerable members of a flock of lambs. Currently it is Greece that is under attack, but there are other suitable targets coming up should the Greeks be subdued: Italian and Spanish banks are only too obvious examples.

In the absence of any coherent measures by the ECB and the EU governments against the speculative attacks not only on the weaker euro countries but also of vulnerable banks it is hard to see how major defaults can be avoided.

The other factor undermining the EU establishment’s consensus on the austerity policies of the Euro Plus Pact is the fundamentally national character of democratic legitimacy. The various institutions of the European Union taken together effectively wield an enormous power over individual

member countries, through treaties and pacts binding individual governments to specific obligations.

And the governance in the EU is so intricate that it can successfully blunt any proposition advanced from below. But the EU institutions have this power only as long as the individual governments play by the rules.

Any government that is invested by a strong democratic mandate, be it through elections or popular referendums, has the choice of refusing to accept previous agreements. The experiences made by Argentine and Iceland shows that this creates a situation where the relationship of forces changes drastically. If any government with the euro zone would undertake such a measure, enacting an immediate moratorium on debt payments, events would drastically illustrate the fragility of the federal pretensions of the European Monetary Union. Such a unilateral step would unleash a process of which only the initial developments can be imagined here.

Financially, a moratorium by say Greece, would not only lead to the immediate bankruptcy of Greek banks — or more probably, their nationalization and a host of measures to defend the Greek economy. It would also mean severe blows to French and German banks, forcing their respective governments to intervene.

Politically the difficulties of the EU authorities to meet such a challenge would be obvious. What could they do? Expel the country? Punish it economically? There are hardly any formal procedures prepared to handle such a situation. A more probable outcome would be a rapid — and real — renegotiation of terms in the way Iceland managed to renegotiate in 2010.

What is outlined there is a dramatic process with ripple effects not only financially but also politically: as recent elections in Europe have shown there is a growing popular resentment against current austerity policies in the European Union. Should any single country dare to unilaterally confront the dominant nexus of finance and EU bureaucracy it will probably meet a favourable echo in other parts of the Union.

Should either of these two developments occur the outcome would certainly lead to important changes of the current international system of finance. In view of this it seems reasonable to say: yes the Eurozone crisis is a weak link in the system of global finance.

## **15 Some implications of the euro zone crisis for theoretical issues in political economy. The need to reconsider the concepts of debts, monetary creation and national accounting**

When talking about the chaotic financial situation in Europe after WW I subsequent to the catastrophic settlement of war reparations Keynes characterized it as a “vast entanglement with everyone owing everyone else immense sums of money”. What he thought was needed to get out of such an “artificial, misleading and vexatious” position was to reconsider the terms of these financial relations: “we shall never be able to move again unless we free our limbs from these paper shackles”. This imperative holds also today: the combined effects of reckless overexpansion of global finance, production of financial “weapons of mass destruction” and large scale rescue operations by governments in the US and EU are indeed vexatious and have created a vast entanglement from which there is no issue unless major reconsiderations on theoretical issues are made. There is indeed a lot of “paper shackles” that we need to free ourselves from. In conclusion I would like to highlight three such issues: our understandings of debts, monetary creation and national accounting.

Debt is commonly — especially in the dominant discourse in EU — viewed as a one-sided obligation: once you’ve contracted a debt you’re bound to pay interest rates and down payments due. But inspired but the debt audit organized by the government of Ecuador and by economists in CADTM (the Center for Annulment of Debts of the Third World) social movements in Europe have raised the questions of illegitimate and odious debts. How the debt is contracted is important and between which parties: it is by no means evident that third parties — such as citizens — should be forced to pay for debts contracted without their consent. Moreover debt is clearly a double-sided obligation: bankers who allow credits on terms that they know are unsustainable must bear the risk for doing so. After all the interest rate is supposed to be the price paid for taking that risk. Debt is sometimes also a relation that has a moral component: the war debts contracted by UK through the Lend-Lease-Agreements with US during WW II where in fact impossible to repay after the war, there were accordingly cancelled in 1945. (Not without conditions, but that is another story.)

More than a financial obligation a debt represent a power relation. It is however not as one-sided as creditors want people to believe. There is the question of size. As a common proverb says: “When you owe the bank a

thousand dollars you have a problem, when you owe it a million the bank has a problem.” The debtor may always seem to be in the weak position but to the extent that the debtor can incur damage on the creditor it is the debtor that is in a position of force. This is for instance evident in the case of a possible default in Greece: such an event would certainly produce very damaging chain reactions far outside the Greek borders. A full awareness of this double-sided vulnerability — and political use of it — could probably be used to enforce real renegotiations between financial institutions and indebted countries in many places.

A second concept that has to be rethought is that of money — or that of money, credits and monetary creation. We may have left the old notion of the value of money as something tied to the value of gold but there is still a very quantitative understanding of money dominating. The idea that “printing money” will inevitably lead to inflation is an expression of that thought. This is also reflected in discussions about budget policies: “there is no money left” has been a current outcry each time the national accounts are showing deficits. This certainty made a pause in 2008-2009 when governments in the US and Europe suddenly found resources amounting to 9.600 billion USD in loans and guarantees to save the financial system and their economies from collapsing. Even if the old tune is back in Euro-land it is an event that should not so easily be forgotten. In fact ‘money’ is only to a small degree a physical thing, the vast amount of it is electronically processed evaluations of assets and liabilities resting on the confidence between the contracting parties. The majority of monetary creation the last thirty years has not been the result of “money printing” of central banks but of decisions of credit expansion in the private financial industry. Vast amounts of “assets” have thus been created during periods of economic growth, only rapidly to evaporate in times of crisis. There is a close relation between credits and confidence. Banks have used the confidence they enjoyed under ideologically favourable conditions to expand their credit volumes — and thus their economic power. Sometimes reasonably, sometimes recklessly. The time has now come to fully realize the credit-creating power of governments. Popular confidence in democratically elected governments when they advance long term planning for investments projects that the citizens view as just and sustainable give these governments a creditworthiness that can financially sustain such projects. Moreover, such projects have a potential of creating sustainable growth far beyond the limits actually accepted. Just as the wartime needs gave the governments a mandate to finance the war time efforts by imposing a forced saving by war bonds held by banks and households similar measures can be taken now. Governments should think otherwise on monetary creation than to go begging on the financial markets.

Finally the whole question of budget deficits needs to be reconsidered. The Stiglitz-Fitoussi report in 2009 eloquently demonstrated how inadequate

the actual growth measures are to show economic development in a broader, more qualitative sense. This goes also for the current system of national accounting: it is utterly incapable of showing the qualitative development with vast sectors such as health services, education and research. What is even more important in the discussions about budget deficits is the traditional distinction it makes between current consumption and investments. All costs for education and health services and the majority of publicly financed research routinely fall under the heading of costs for current expenditures. This stems from the old view that the private market economy is the real economy while the public sector expenditures as a whole are a cost that is regrettably necessary but has to be kept as low as possible. But what if national wealth is not created by material production but by the interplay between sectors of production and reproduction? What if education and other social services are not consumption costs but investments in “human capital”? Then these costs evidently have to be evaluated not on the yearly basis but on the long term effect it is considered to have on each country’s national wealth, not only material but also human and moral. It is of course extremely difficult to construct a new national accounting system along these lines but the artificial and prejudiced terminology of the present system ought at least to be emphasized.

The coming phase of the current process of crisis in the global financial and economic system will probably see massive write downs of finance capital. It is quite possible that we will see a period of heightened geopolitical tensions: between emerging powers and declining hegemons, inside each area and with diverging regional dynamics in South America, Asia, US and Europe. If we are to avoid that such tensions degenerate there is a need for a internationally organized public sector- driven credit creation for projects for an ecologically and socially just growth lessening social and regional inequalities. So far, however, the prospects for such a development seem bleak.

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