Understanding the Euro Crisis: How did the subprime crisis become a sovereign debt crisis in Europe?

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Abstract

This article discusses the Sovereign Debt Crisis in Europe. It analyses the imbalances embedded in Europe due to the functioning of the Euro Zone. The way the single currency area was developed had contradictions in itself that led different nations to different economic paths. The objective of this article is to carefully describe how the Euro Zone architecture promoted trade unbalances amongst the European Nations, with surpluses at the north (Germany, Netherlands, Belgium, Finland…) and deficits in the southern nations (Greece, Spain, Italy…), trying to verify if there is a "two tier Europe", as Artus (2009) states, with countries divided depending on how their trade balances behave. It is also going to be discussed how the impacts of the subprime crisis where fundamental for the destabilization of the Euro Zone, and how it was metamorphosed into the Sovereign Debt Crisis.

Resumo

O presente artigo discute a crise da dívida soberana na Europa. Ele analisa os desequilíbrios embutidos na Europa devido ao funcionamento da Zona do Euro: a maneira pela qual o euro se desenvolveu apresenta contradições inerentes que levaram as diferentes nações a diferentes trajetórias. O objetivo do artigo é de descrever cuidadosamente como a arquitetura da Zona do Euro levou a emersão de desequilíbrios comerciais nas nações europeias, com superávits no norte (Alemanha, Holanda, Bélgica, Finlândia, etc.) e déficits nos países do sul (Grécia, Espanha, Itália, etc.), tendo em vista a validação da hipótese de uma "Europa em dois níveis" (Artus, 2009), com países divididos dependendo de como suas balanças comerciais se comportam. Discutir-se-á também como os impactos da crise do *subprime* foram fundamentais para a desestabilização da Zona do Euro e como isto se transformou na crise de dívida soberana agora vivida.

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Introduction

The adoption of the euro and the simultaneous creation of the Euro Zone – or the Economic and Monetary Union (EMU) – and the European Central Bank (ECB) can be viewed as significant steps on the deepening of European integration. The single currency represents reduced transactions costs among member countries in many areas, such as trade, financial transactions, etc. But, mainly, the euro also represents the adherence of these countries to a particular set of institutional and policy arrangements which make part of a broader project of integration, at the top of neoliberal agenda (Arestis and Sawyer, 2002).

When one imagines countries under the same conditions and the same currency, one would expect that the differences between them would be reduced. So, when the EMU was conceived, the expected effect was that members would pursue a process of convergence throughout the years. Considering lower national disparities, liberal, industrial and social policies would be carried out with more legitimacy, and the proper ECB would have more legitimacy to act. In that context, lower government spending due to Maastricht convergence criteria would be justified, and economic coordination would be much easier, making stabilization more achievable.

To pursue those goals, a new economic system was developed in the Euro Zone with three pillars. The first was a common monetary policy pursuing price stability conducted by BCB. The second was the creation of European procedures to control national fiscal policies, and force countries to maintain a relatively balanced budget on the mid-run, avoiding them to use it as contra-cyclical stabilizer and letting play the automatic ones. The third encompasses a set of liberal structural reforms that would permit growth to boost in the mid-run. All these three pillars integrate the liberal agenda, following the Anglo-Saxon model, and, again, share the understanding that the full compliance with them would lead to full convergence (Fitoussi and Le Cacheux, 2004; Mathieu and Sterdyniak, 2003 and 2006).

However the actual results are quite different. Countries found constraints in applying recommended policies. Populations around Europe were not in accordance with the neoliberal project, and governors implementing those policies experienced falling popularity. People were used to equality, high employment rates, reasonable wages, good healthcare systems, decent pensions, as well as forty years of prosperity, and had trouble letting go so easily those benefits. The liberalization movement was slow and painful.

In the meantime persistent and sometimes growing gaps in GDP, inflation, competitiveness, unemployment and external imbalances were verified since 1999. The unique currency, and the monetary system that comes with it, imposed one single economic policy to different countries and societies. Although they were expected to converge in that context, the exact opposite happened. By treating equally the different, differences between them rose.

These imbalances are brought to the fore in the recent European sovereign debt crisis, which emerged after the subprime crisis. The last came accompanied by slashing in growth, the freezing of money and capital markets, rising unemployment. In this context, inflation, competitiveness and external imbalances were translated to different conditions in the sovereign debt market faced by members countries. More specifically, the so-called peripheral countries found difficulties in rolling-over their public debts. Restructurings, prospect of defaults, and bail-outs followed naturally.

The objective of this article is to carefully describe how the Euro Zone architecture promoted trade unbalances amongst the European Nations, with surpluses at the north (Germany, Netherlands, Belgium, Finland…) and deficits in the southern nations (Greece, Spain, Italy…), trying to verify if there is a "two tier Europe", as Artus (2009) states, with countries divided depending on how their trade balances behave. It is also going to be discussed how the impacts of the subprime crisis where fundamental for the destabilization of the Euro Zone, and how it was metamorphosed into the Sovereign Debt Crisis. More specifically, we analyze fiscal and external indicators of Euro Zone countries in order to detect these tendencies.

For this, the current article is divided as follows. Section 1 analyzes the imbalances that the single monetary policy has embedded in the Euro Zone, while the focus of Section 2 is the national strategies and its relation with structural imbalances which arose in the Zone. At these two sections the period of analysis will be from the adoption of the euro until the year previous to the spreading of the Subprime crisis. In doing so, it will be possible to gather information about the evolution of the zone in smooth economic conditions and to analyze structural imbalances, without considering the ones linked to periods of economic crisis. Section 3, in its turn, presents the path that led Europe to a sovereign debt crisis, considering the aftermath of the subprime crisis. We argue that the imbalances are already there and the subprime crisis contributed to reveal them by its effects on financial markets and real economy. Final remarks are presented at Section 4, stressing that the current crisis represents an opportunity to rethink the conception of the Euro Zone, despite policymakers insist that the previous framework must be deepened. We argue that only with substantial changes in policy choices the Euro Zone could avoid its complete disintegration.

1. One prime rate, many real interest rates

In 2007, the now seminal article published by Henry Sterdyniak and Catherine Mathieu (2007) had quite revealing data. It showed that the imbalances were already present in the Euro Zone, even before the hatching of the crisis.

The three countries with the most rapid growth were Ireland, Greece and Spain, while the rest of the Euro Zone had less than a mediocre performance, usually lower than 2% of GDP growth per year. The reactions to the single monetary policy were clearly distinct. The small peripheral nations were able to perform rapid, irregular and imbalanced growth (as is going to be discussed next) and the ancient industrial potencies had a steady low growth.

The reason why this occurred can be easily understood if we take into consideration real interest rates. Spain and Germany, for instance, had completely different inflation and growth rates, and optimal interest rates applied to them should have been different. However, the single European interest rate did not cope with that necessity, and ended up being extremely expansionary to some, and restrictive to others, while the average could be considered appropriated.

Table 1 – GDP growth per year and GDP per capita (PPP)

	Taux de croissance en % par an			PIB par tête (PPA)	
	1985-1991	1992-1998	1999-2005	1991	2005
Zone euro	**3,1**	**1,8**	**1,9**	**100,0**	**100,0**
Allemagne	3,5	1,5	1,3	108,9	101,5
Autriche	3,1	2,2	2,0	113,8	114,8
Belgique	2,7	1,8	2,0	108,7	111,1
Espagne	3,9	2,3	3,6	79,2	92,8
France	2,6	1,8	2,2	104,2	102,7
Finlande	1,8	2,5	2,8	97,6	108,7
Grèce	1,7	1,8	4,3	67,0	78,9
Irlande	4,0	7,2	6,5	78,8	130,6
Italie	2,9	1,3	1,2	105,3	97,6
Pays-Bas	3,6	2,7	1,7	107,0	117,4
Portugal	5,1	2,4	1,6	68,6	67,2
Danemark	*1,5*	*2,7*	*1,9*	*106,7*	*116,2*
Royaume-Uni	*2,6*	*2,7*	*2,7*	*93,6*	*110,4*
Suède	*1,9*	*2,7*	*2,9*	*108,2*	*111,6*
Etats-Unis	**2,8**	**3,6**	**3,0**	**131,1**	**139,7**

Source: Mathieu, C. et Sterdyniak, H., 2007.

Table 2 – Inflation and Real Interest Rates reduced of the GDP growth.

	Niveau des prix	Inflation (prix du PIB)	Taux d'intérêt réel moins taux de croissance du PIB	
	2005	1999-2005	1992-1998	1999-2005
Zone euro	**100**	**1,8**	**2,5**	**– 0,6**
Allemagne	104,9	0,7	1,6	1,1
Autriche	101,9	1,5	1,3	– 0,4
Belgique	101,1	1,7	1,6	– 0,6
Espagne	88,6	3,9	2,1	– 4,4
Finlande	109,5	1,2	1,3	– 0,9
France	103,8	1,4	2,9	– 0,5
Grèce	81,4	3,6	6,7	– 3,3
Irlande	116,3	3,9	– 3,5	– 7,3
Italie	97,3	2,5	3,9	– 0,6
Pays-Bas	103,5	2,7	0,9	– 1,4
Portugal	81,5	3,4	1,6	– 1,7
Danemark	*129,7*	*2,3*	*2,5*	*– 0,9*
Royaume-Uni	*105,5*	*2,5*	*3,7*	*0,3*
Suède	*112,1*	*1,4*	*1,7*	*– 0,8*
Etats-Unis	**93,9**	**2,2**	**– 0,1**	**– 2,4**

Source: Mathieu, C. et Sterdyniak, H., 2007.

These diverse rates affected the economies in also diverse ways. The restrictive rates in Germany impeded the country to grow faster, even if the inflation was controlled. On the other hand, in countries like Spain, where inflation was faster than what was desired, rates were encouraging for investors and consumers, and boosted growth, even if imbalances were still there. The three countries with the fastest growth were also the three countries with the lowest real interest rates: Ireland, Spain and Greece. The Monetary Policy was, for that reason, at the root of the problem of diverging growth performances.

Divergent growth by itself is not necessarily a problem; in this case it could even be considered as something positive, as less developed countries were growing faster in a converging catch-up process. Nevertheless, as it is going to be explained further on, the way it was happening was problematic.

Divergent Inflation and a key problem: competitiveness

An extremely important condition for the proper functioning of a single currency area is a relatively homogeneous evolution of prices level between its members. Important differentials would modify competitiveness intra-zone and affect the balance of international trade. The exports of inflationist countries would become more expensive and competitiveness gradually reduced, if compared to more stable neighbors. At the same time imports from other nations would become cheaper. If there is a low trend on exports and rising imports, the expected result would be a current-account deficit. [1]

Structurally, less developed economies have higher inflation rates, as bottlenecks are frequent, infrastructure insufficient, smaller scale raises prices and eventual offer shocks are usual[2]. Taking this into consideration, it would be normal that the southern countries should experience higher inflation than the northern mature neighbors, when they are submitted to the same monetary framework. This means that even in the absence of asymmetric shocks, in ordinary economic situations, there is a structural trap that impedes the convergence of inflation levels of different economies in a same economic framework. (Mathieu, C. et Sterdyniak, H., 2007, page 322)

To resolve this problem, rebalancing mechanisms should have been put in place, as many economists suggest, but they were not. The European Monetary System treated equally the different. The same interest rate to countries with different growth and structures resulted in low real interest rates to the ones with higher growth and less developed structures. It seems obvious that applying the lowest real interest rates to the countries growing faster would result in higher inflation, and it really did.

Table 2, shown above, displays data for inflation of countries in the Euro Zone. Once again, Spain, Ireland and Greece top the list of higher levels, this time accompanied by Portugal. Those were the countries submitted to the lowest real interest rate, which had the fastest growth and faced faster inflation rates. The exception is Portugal, which had low real interest rate, high inflation, but had almost no growth. Not by accident, those were the four countries the most affected by the subprime crisis, leading to theirs sovereign debt crisis. Three of them, Greece, Ireland and Portugal, have already asked for financial help, and Spain is on the verge of doing so.

Those countries were growing fast (with the exception of Portugal), were importing a lot, and were not exporting that much. The resulting current-account balance deficit was financed by borrowing. Lending to these countries was not considered a problem because of the confidence the European Union and the Euro aspired. That way current-account deficit could easily be financed, and would not be a problem in the short term. Nonetheless, a crisis arose in the USA, and things shifted, and these nations started to be attacked.

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[1] It is important to note that this problem occurs only when two or more countries share the same currency. There are historical examples of high growth coupled with high inflation (the 1960s and the 1970s in Brazil for instance) that did not result in loss of competitiveness, as exchange rate variations could absorb the rise of inflation with regards to the international trade.

[2] Less developed countries tend to depend more on agricultural production then advanced industrial nations. This sector is much more susceptible to random or less predictable phenomenon (such as heat waves, frosts, plagues, etc…) that can affect offer levels. In short, agricultural GDP is simply more volatile than the industrial one.

Mundell's four preconditions for an Optimal Currency Area: not present in Europe.

The European single currency project was largely influenced by Robert Mundell's concept of 'Optimal Currency Area' (Mundell, 1961). One of the reasons why Mundell won the Nobel Prize in 1999, this concept analyses the conditions necessary to the optimal functioning of a region of different nation-states organized around one single currency. One basic condition Mundell sees as fundamental is a high level of economic integration. Free trade and unrestricted capital flow must be present for a single currency project to be considered. This appears to be the case between Euro Zone countries. But Mundell goes a bit further.

Apart from the basic prerequisites four other conditions are listed as important for a proper working of a single-currency zone: significant labor mobility inter-nations, wage and price flexibility, a mechanism that transfers fiscal stimulus from best performing states to the weaker ones, and a relevant level of synchronization between business cycles (Guttmann, R. et Plihon, D., draft, page 8).

If we take a closer look at these conditions, we can see that they are all tools that which provide more liberty to the market rules in order to operate. They create a better framework for stabilization plans and market adjustments. Basically, these conditions represent a situation with less government intervention, and a desired coordination between economic agents from different states. They are, however, astute in noticing that there must be some mechanism to reduce differences between stronger and weaker states. Mundell points out that a transfer mechanism is particularly important in situations where an external shock affects differently the diverse regions of the system differently.

The conception of the Euro Zone had these theoretical prepositions as an intellectual basis, but none of the four conditions are truly present in the Euro Zone.

Firstly, even if the unions are a lot weaker in Europe nowadays, it is still a continent with relative strong labor movements. Almost everywhere in the world there is a certain downward rigidity in prices, including the price of labor. In Europe this phenomenon seems to be even stronger, especially in France where unions are still quite unified and organized.

Secondly, working force mobility can be growing in Europe after the Schengen Agreement, that facilitates the movement of people from one country to another, but it will hardly reach a level where it could work as a market price adjustment. Cultural, linguistic and climate differences are too strong, and populations tend to stay locally based. Migrants face so many adaptation costs that it is hard to imagine someone migrating from Italy to Finland because of a marginally higher wage.

Regarding business cycle synchronization, it is also clear that this does not happen in the zone. If culture and climate are different between nations, naturally the business cycles will also function differently.

Those three aspects show that the necessary conditions to a market self-regulation to function are simply not present. Consequently, the whole framework of a Central Bank with one single prime rate and inflation targeting is not likely to work in Euro Zone, according to neoclassical economists, who themselves designed those institutions.

Finally, Mundell's insightful observation for the need of a fiscal transfer mechanism was not properly considered. Politically, Europe is just not unified enough to provide such a mechanism. Only a small fraction of national tax revenues are remitted to the European Commission, which makes that European budget is tiny, running around 1% of the summed up GDPs. Individual national budgets are much bigger. It is difficult to think of any significant transfer mechanism in this still too individualistic structure. Political integration should have gone further before putting in practice a single-currency project. Fiscal policy must go towards a more 'federal' direction. This is still largely a matter of national policy-making. (Guttmann, R. et Plihon, D., draft, page 9)

All of these facts ultimately mean one thing: The Euro Zone, conceived under a neo-liberal paradigm, does not take into consideration the preconditions that neo-liberals themselves consider important for an optimal situation. The next chapter will show that the badly designed institutional European framework generated internal imbalances, and the lack of coordination allowed countries to choose individual development paths that were non-cooperative.

2- National strategies, external imbalances and internal competition

As aforementioned, the framework established by the Euro Zone was quite simple: limits were imposed to the participation of the State, the Maastricht criteria, and little else was carried out. National strategies were not discussed beyond public deficit and debt limitations. A 'laissez faire' environment was created. In that context, each nation veered towards one different development strategy. If the idea was to converge, by letting countries do what they wanted, or more precisely, advising them to do nothing, did not seem to be the best way to do so. The differences between Greece and Finland, for example, would not be resolved if there was no action. It is more likely, in fact, that those differences would be reinforced if nothing was done.

> None common policy was put in practice in Europe. The different situations between countries were not taken into account, since no national inflation, external deficit, growth or employment chriteria existed, as the objectives of public finances do not involve the national conditions. In these conditions, it is normal that the diparities persist. (Mathieu, C. et Sterdyniak, H., 2007, page 335, our translation)

At the social-economic level, once again, no model chosen. Wage policy, social security, public health and retirement were ignored and no standards were put in place. There was absolutely no coordination regarding social-economic measures. The Maastricht rules constrained nations with completely different welfare systems, and did not coordinate them to move in the same direction.

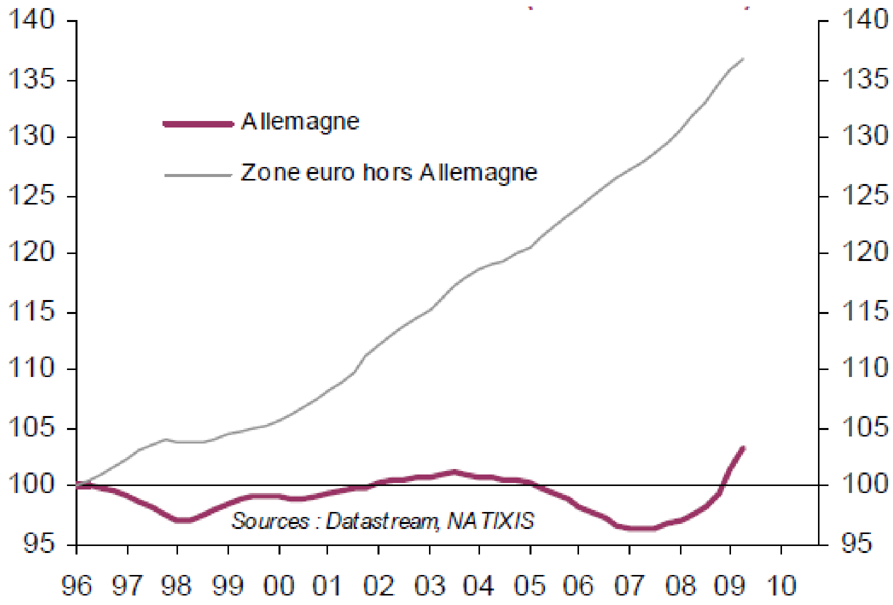
Reducing wages and fiscal competition strategy: suitable for one, not for all.

As there was no coordination effort, nations chose their policies individually. Facing the competitiveness problematic imposed by the single currency and divergent inflation dynamics, some decided to reduce salaries to gain a competitive advantage in labor costs. Lower labor costs would permit lower prices and enhanced competition.

The use of this kind of policy is dangerous, as it is essentially non-cooperative. Its use should be discussed between the zone members, and if it must be applied, it should be on the nations facing higher inflation levels that eroded competitiveness. If we take a look at table 2, Spain (3.9%), Ireland (3.6%), Greece (3.6%) and Portugal (3.4%), had the higher inflation rates between 1999 and 2005, and wage contraction would have been justified in those countries, in order to reestablish previous competition levels. However the exact opposite happened. Germany, and to some extent the smaller neighbors with similar characteristics[3], having the lowest inflation rates between all the countries in the Euro Zone in that same period, were precisely the nations who employed this policy most intensively.

In Germany, an explicit project aiming to reduce wage earning in order to boost economic growth was implemented, in the Schroder administration, called the Agenda 2010. The contraction was evident, as it is going to be shown below.

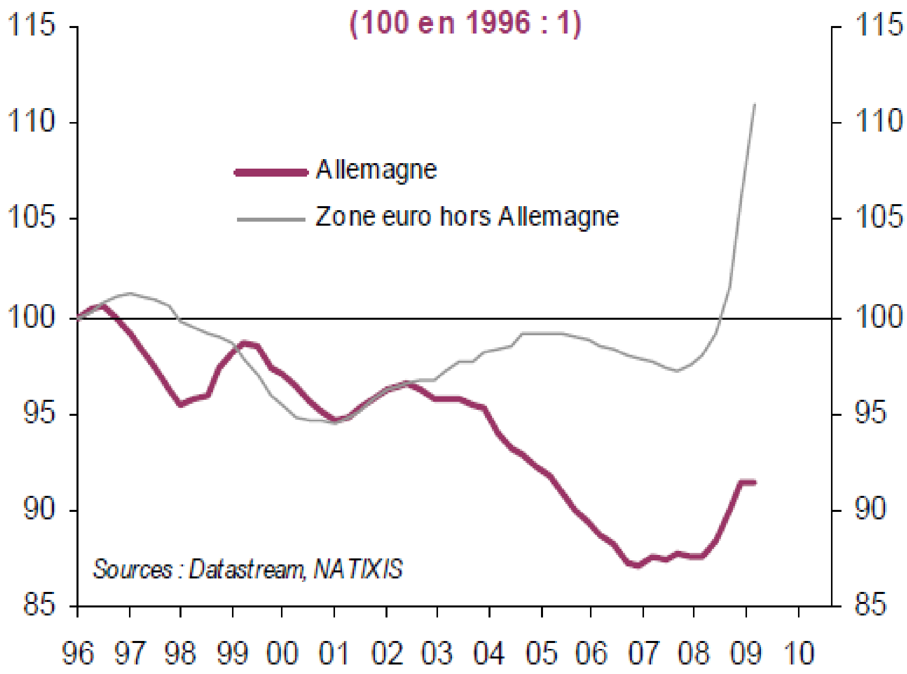
Graph 1– Total labor unity cost (100 in 1996)



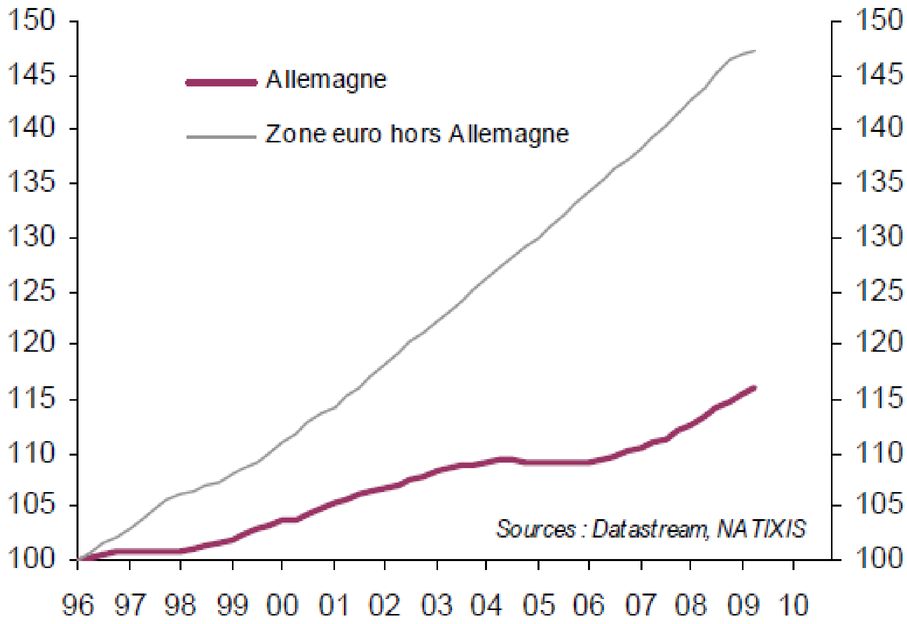
Source: Artus, P. 2009

[3] Austria, Netherlands, Slovakia, Finland and Belgium

Graph 2 – Unit labor cost on manufacture



Graph 3– Nominal Wage Per Capita

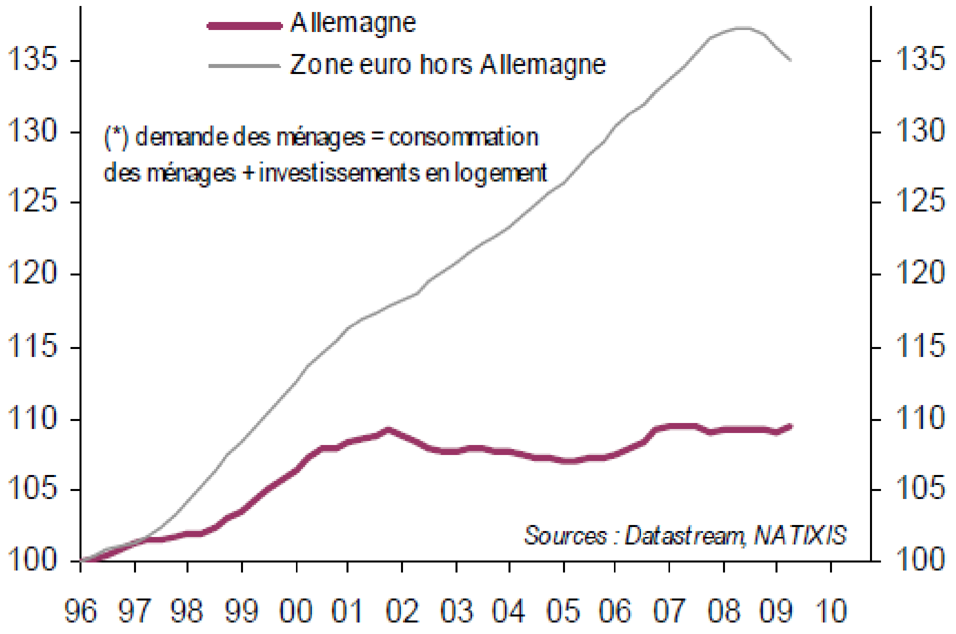


Source Graps 2 and 3: Artus, P. 2009

We can see in graph 1 that, while the rest of the Euro Zone had an evolution of labor cost of around 35%, the cost in Germany stagnated, and during some periods was reduced. Manufacture labor cost, shown in graph 2, reduced roughly 10% in Germany, while it rose 10% in other Euro Zone Nations. Even the nominal wage evolution was contracted in Germany if compared to the other nations (15% rise against 45% rise), as it is shown in graph 3.

This means that the nation with the lowest inflation rate during this period, with a natural competitive advantage, employed an extremely restrictive wage policy boosting its competitiveness even more. A policy that should be used to reduce the gap of price performance was used in such a way that the gap got even wider. In addition to that the internal demand in the biggest economy of the zone was considerably constrained (graph 4), if compared to the evolution of its neighbors.

Graph 4– Household Demand

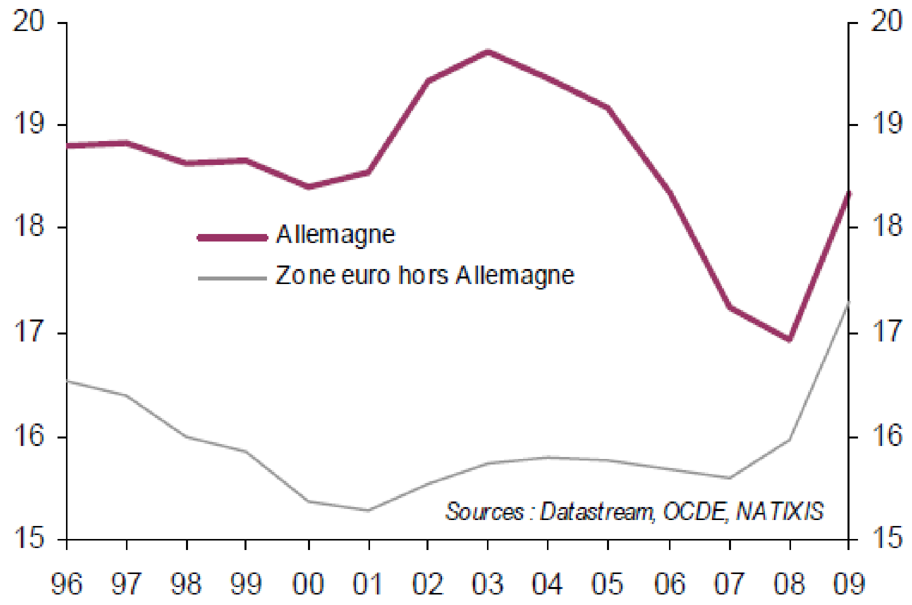


Source: Artus, P. 2009

If other nations had followed the same path, the result in terms of global demand would be even worse and the effectiveness of the policy would be null. In other words,*'...if all the other countries of the zone had followed the same policy of cost contraction as Germany, demand would have fallen in all those countries, and none would benefit from this policy* (Artus P., 2009, our translation).

Another strategy carried out by Germany that goes in the same direction was the modifications on fiscal structure. The amount of taxes charged, in proportion of the GDP, was reduced and social charges paid by firms where focused on the most. Essentially, the modifications were: simplification of income tax, deduction of interest charges from firms and limitation of employer social quotas (rises in social security spending are now financed only through wage taxing) (Artus, P. 2009, graphs 5). In doing so, German authorities expected to attract more firms to be established in their territory and to maintain the ones that operate there, fundamentally the same motivation as to the wage contraction.

Graph 5 – Social Benefitis in proportion of GDP



This reduction of tax payments did not have positive externalities in demand to other nations, as could have been the case. Usually lowering taxes has an expansionary effect on consumption. In this case, however, the tax exemptions where focused on firms and produced almost no effects on household consumption.

Both initiatives, the wage and tax contraction, must have had an important impact on competitiveness and they are equally non-cooperative. If all nations had applied it, results would be catastrophic in terms of global demand and fiscal equilibrium, and competitiveness conditions would be strictly the same as they were prior to these measures. Its application should raise cautious analysis as it is highly harmful to other Euro Zone members. This kind of action had strong consequences to the zone members' current accounts as it is going to be explained further on.

Impoverishment and inequality

One important feature is frequently ignored regarding the strategies chosen to raise competition in Germany. There are 2 possible basic ways of being more competitive: one can either raise productivity or reduce costs. The more progressive choice would clearly be raising productivity, as output would rise and wages would not be modified. But even if the choice is reducing costs, wages and social spending must not necessarily be reduced. Infrastructure can be improved, efficiency can be boosted and waste reduced. All these alternatives have better results than wage compression, but they take longer and more effort to be employed.

If wage and social spending are easy and effective ways of reducing costs, they are nonetheless hazardous, not only in terms of global demand, but also regarding poverty and inequality. If there is one feature in Europe that makes it a better place to live than its economic rival, the USA, it would be its social standards and diminished inequality. As innumerous economists, anthropologists, social scientists have pointed out for years, inequality and poverty are fuels for violence, and violence affects everyone:

> 'The link to higher crime comes through the inability of unskilled men in high inequality societies to play traditional male economic and social roles, including a plausible contribution to family income. But higher crime and violence is only the tip of a distribution of social relationships skewed toward the aggressive end of the spectrum, with low average levels of trust and social capital. In short, inequality at the national level should certainly be a target of public policy, even if just for the sake of the prosperous.' (Wade, R. 2004.)

The macroeconomic model chosen in Germany is already impacting equality levels. The Schroeder era contracted wages for too long, while profits were able to flourish. The gap between the richest and the poorest, which was in Germany one of the smallest, is getting wider each year.

Table 3 – Inequality of Income Distribution: highest / lowest quintile ratio.

	1999	**2009**	**Variation**
Ireland	4,9	4,2	-14%
Slovakia	3,9	3,6	-8%
Belgium	4,2	3,9	-7%
Greece	6,2	5,8	-6%
Portugal	6,4	6	-6%
France	4,4	4,4	0%
Austria	3,7	3,7	0%
Slovenia	3,2	3,2	0%
Spain	5,7	6	5%
Italy	4,9	5,2	6%
Netherlands	3,7	4	8%
Finland	3,4	3,7	9%
Germany	**3,6**	**4,5**	**25%**

Source: Eurostat data, Euro Zone members over 2 million inhabitants.

Table 3 shows how many times the richest 20% of the population earn more than the poorest 20% of the population. Germany had a ratio of 3.6 in 1999, a number close to Finish standards and between the lowest of the world. In 2009 the ratio was of 4.5, which represents a 25% rise, the biggest evolution among the Euro Zone members. It means that the richest 20% of the German population is earning 25% more than they did in 1999, when compared to the 20% poorest. Germany is now in a standard similar to that of Ireland or France.

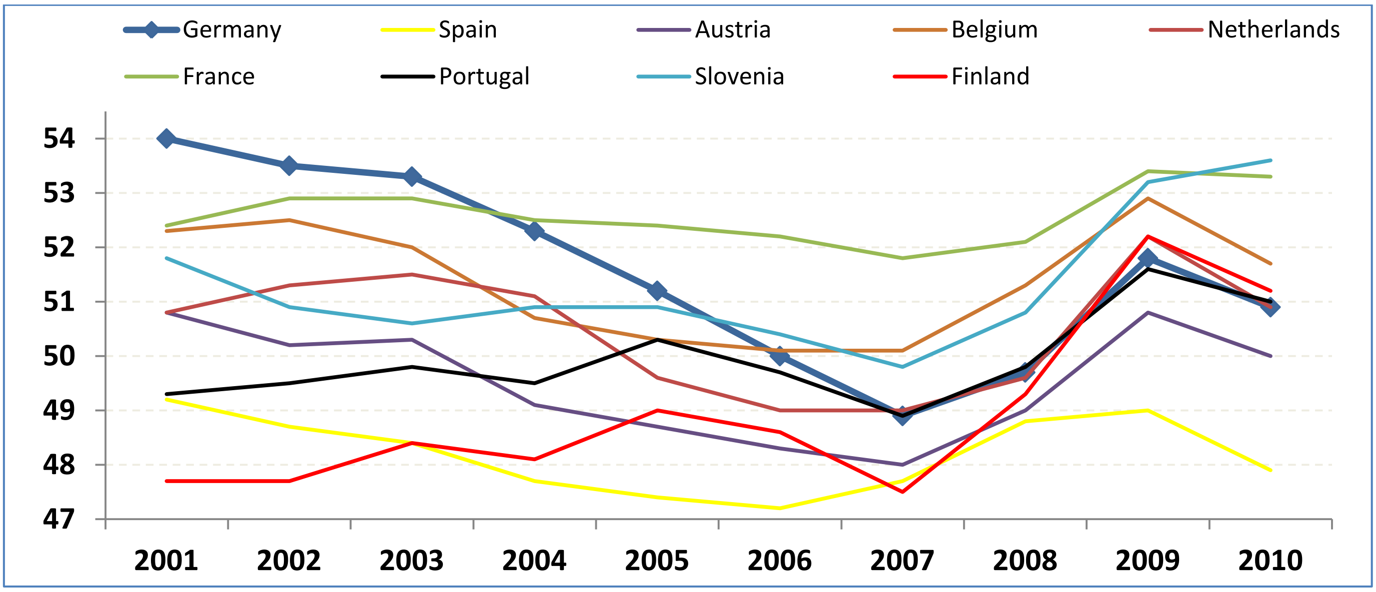
Table 4 – Gini Coefficient

	1999	2009	Variation
Ireland	32	28,8	-10%
Belgium	29	26,4	-9%
Slovakia	26,2	24,8	-5%
Greece	34	33,1	-3%
Spain	33	32,3	-2%
Portugal	36	35,4	-2%
Austria	26	25,7	-1%
Slovenia	22	22,7	3%
France	29	29,8	3%
Netherlands	26	27,2	5%
Italy	30	31,5	5%
Finland	24	25,9	8%
Germany	**25**	**29,1**	16%

Source: Eurostat data, Euro Zone members over 2 million inhabitants.

The Gini Coefficient (Table 4) shows the same results. In 1999, Germany was between the most equal countries in Europe with a coefficient of 25, only higher than Slovenia (22) and Finland (24). However, in 2009 the coefficient was 29.1, which represents a 16% evolution, the highest among the selected countries. Now Slovenia, Finland, Slovakia, Belgium, Netherlands, Austria and Ireland can be considered more equal than Germany, according to the Gini Coefficient.

Graph 6 – Wage Share on GDP



Source: Eurostat, selected Euro Zone members

Graph 6 shows the reason why the income gap is widening in Germany. The wage share has been falling in an extremely fast rhythm. The wage contraction policies of the Schroeder era were quite effective. The wage share only recovers in 2008 and 2009, when the crisis curtailed profits, but falls again in 2010, when the German economy rebounds. The wage share suffered a 6% reduction in ten years, again the fastest among the Euro Zone members. It was the highest in 2001 and now it is similar to Portuguese standards. This data shows a clear political choice towards higher profit shares.

Violence data still does not reveal any evolution in Germany. The wage earner living standard is still quite elevated if compared to other nations around the world, and even amongst European nations. Unemployment levels in this moment quite are reasonable (7.1% in 2010), even if they were high in the pre-crisis period (11.2 in 2005 for example). The export industry, as we will see in the next session, is sustaining the employment level. Nevertheless, the trend is clear, and consequences will not take long to emerge, especially if the other European nations react against the mercantilist policies Germany has been taken.

Neo-mercantilism and its implications to the national current accounts: the twin imbalances

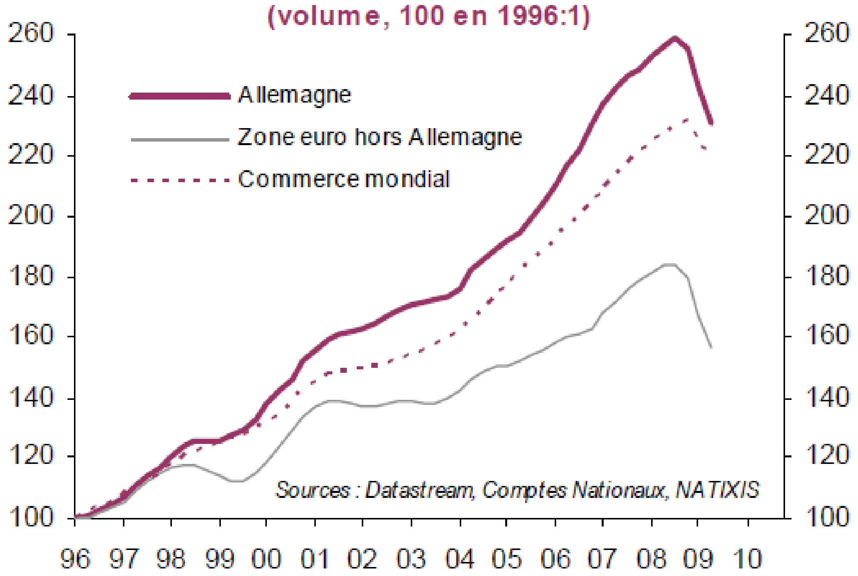
The wage contracting strategy employed by Germany is in reality a part of a set of measures taken to improve export possibilities. It could be seen as a neo-mercantilist strategy that tries to boost exports and restrain imports in order to accumulate current-account surpluses. This would permit international foreign exchange reserves to increase, what can function as a safe cushion in periods of speculation. This is originally a Chinese strategy, which is coupled, in their case, with extremely high public and private investments. The Chinese model enhances robust growth, while the German model, with much lower investment patterns, does not.

Another difference is that China works on its own, while Germany is engaged in a Currency Union. If the Chinese policy is a concurrence challenge to other nations, the German strategy poses a huge problem to its hand-tied neighbors. There is no exchange rate to modify; there are no protectionist policies available; and no monetary policy flexibility. In short, it is an aggressive individual strategy used in communal circumstances. The only instrument that the other Euro Zone members could use would also be the wage contraction, but when it is used by everyone it has no effectiveness at all.

So, summing up together the extremely high inflation differentials between Germany and other euro zone countries, emphasized in the first part, plus both the wage contraction and tax reduction policies, gave Germany a huge competitive advantage. The expected consequence would be that Germany would perform better current account results compared to the rest of the zone.

Graph 7 shows that the German exports of goods and services grew substantially since the implementation of the Euro, while in the rest of the zone performed a much lower growth, with periods of decline and stagnation. German exports growth was higher than the world trade, whilst in the rest of the zone it was significantly lower.

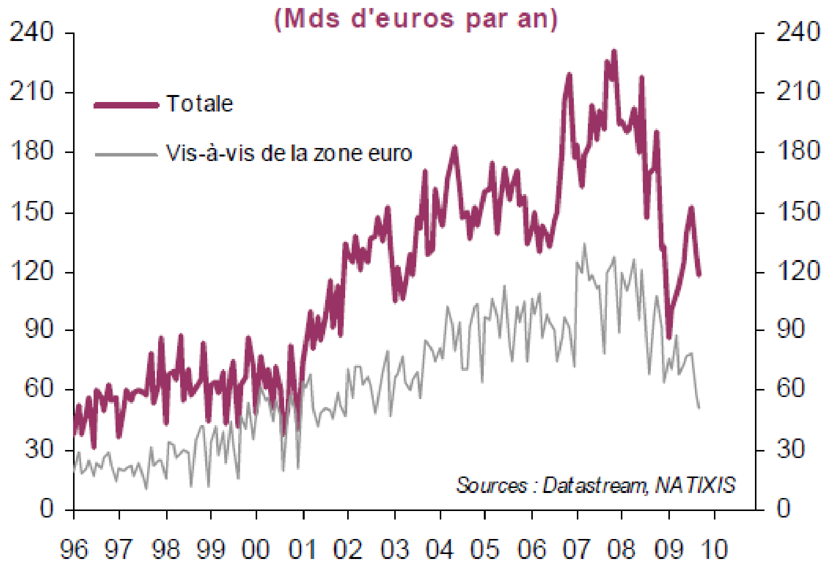
Graph 7 – Goods and Services Exports



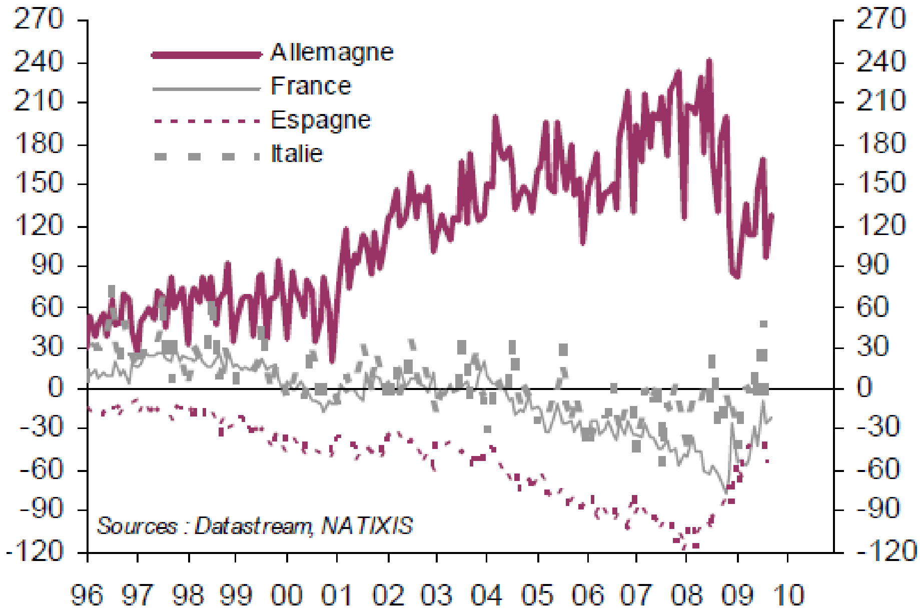
Source: Artus, P. 2009

Europe has always been the major German commercial partner, and during most periods of recent history, Germany had trade surpluses with these partners. In 2008, just to give an idea of the importance of the European markets to German exports, according to the Bundesbank, 62% of the German exports went to European Union countries, and 50% went to Euro Zone members. If we take France, it absorbed 10% of German exports. Graph 8 shows that the German trade surpluses increased in general, and also with euro zone members, what could be a consequence of the gain of competitiveness mentioned above.

Graph 8 – Trade Balance



Graph 9 – Trade Balance in selected Euro Zone member



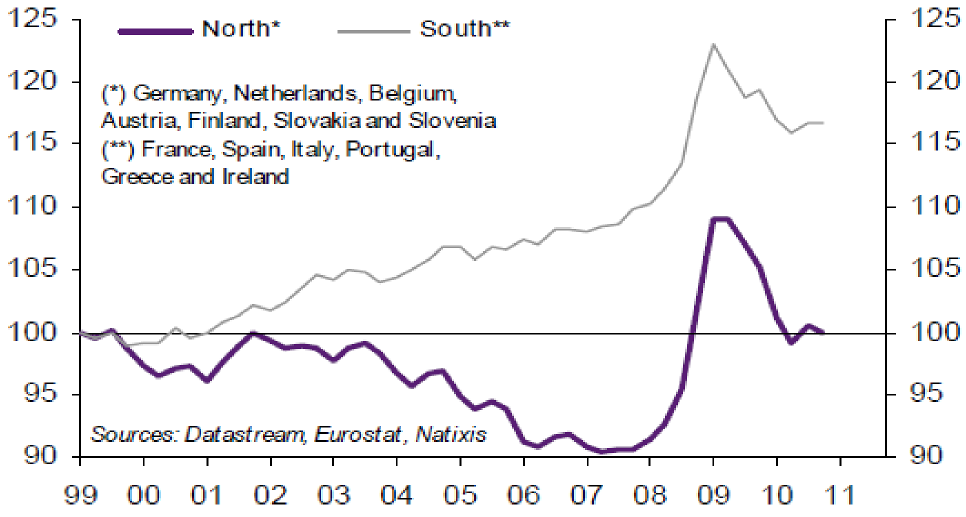
Source Graphs 8 and 9: Artus, P. 2009

The other countries of the, specially the southern ones, however, had the opposite performance. France started to have deficits in the trade balances in 2000, the same for Italy and Spain intensified the deficits since 1999. (graph 9).

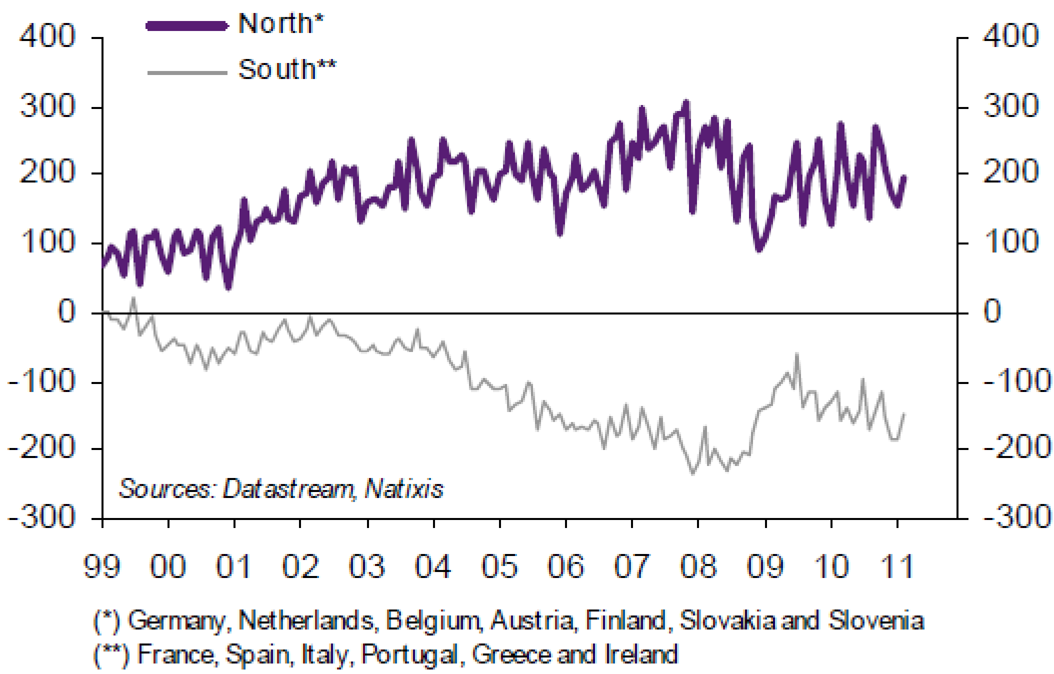
Germany was highlighted here because of its importance, but the same argument could be extended to the other 'northern' nations, that follow similar macroeconomic strategies: Austria, Netherlands, Finland, Slovakia, Slovenia and Belgium. If we compare these countries with the 'southern' ones, France, Italy, Spain, Portugal, Greece, Ireland, following the suggestion of Artus (2011), we will find the same imbalances as we observed before. Artus calls the attention to a two tier Europe, the north and its surpluses and the south with deficits. Just as it happened in Germany, the northern nations contracted wages, and this could have helped the increase of competitiveness, besides the fact that, in general, they performed much lower inflation rates (graph 10):

Graph 11 shows that, for the role period since the creation of the Euro, the north performed repeated and growing surpluses, and the south had growing deficits. These twin imbalances are, to some extent, a result of the inflation differentials and individual choices of national strategies in a context of a currency union. The Euro Zone institutional structure conditioned these results, through the unique prime rate to the different nations, with no rebalancing mechanism, and nations intensified this process individually by implementing wage contraction policies without considering the effects on its neighbors.

Graph 10 – Euro Zone Manufacturing Wage Cost (1999:1 = 100)



Graph 11 – Euro Zone: Trade Balance (EUR bn, anualised)



Source: Artus, P. 2011

It could be said that both regions had different development strategies. On one hand the southern nations wanted to keep growing based on their internal demand, and from on the other, the northern countries wanted to sell them their products and boost their manufacturing industries. Both situations could be complementary if there was complicity between the zone members. Northern nations should be aware that they needed southern demand, in order to export, while the southern nations needed fiscal transfers, as many economists argue (De Grouwe, 2011, Palley, 2011). With no complicity the growing south external deficits would become a problem. Not surprisingly this was the very root of the Sovereign Debt Crisis, as it is going to be explained later.

The way the Zone was conceived does not allow countries to have different roles in the economic functioning, as it occurs between different states in the USA for example. Each country must be individually balanced as there are no transfer mechanisms.

3- How did the subprime crisis become a sovereign debt crisis in Europe?

It is known worldwide what the basic cause of the Subprime crisis was. Literature is rich in this subject and in short words what happened was that a malfunctioning in the American financial sector was spread to the whole world economy:

> 'Widespread securitization of mortgages nourished fast growth of credit and lowered credit standards, as banks believed they had passed on credit risk. Well-paid rating agencies decorated the new assets with triple-A ratings even though they were obviously far riskier than that. Banks shifted credit off balance sheets into structured investments to escape regulatory requirements on capital. All this combined to fuel a massive property bubble, which eventually overshoot and burst' (Guttmann and Plihon, Draft)

Innovations and financial dynamics had gone too far and destabilized the American economy. Then, the problem went across the globe:

> '… financial globalization had already accomplished its work: the world market was simply localized in the US, and all the financial actors mainly from the rich countries played in this market, spreading the toxic assets all over the world. Hence, even if the number of spectacular bankruptcies in Europe was limited, the banking sector proved to be as fragile as the American one. The consequence is that the chain of events is extremely similar, even in size, across the ocean: banking sector insolvencies, confidence crisis, drying up of interbank markets, flight to safety and asset depreciation, negative wealth effects and credit crunch, drastic private spending reduction.' (Fitoussi et Saraceno, 2010, page 5)

Financialization was not only the primary cause of the problem, but also the reason why it became global. The thirst for profit made capital originated in a real-estate bubble travel throughout the globe, carrying with it the dangers of a possible explosion. The local specific malfunctioning became a major international crisis.

The crisis hit hard on Europe, and the responsible and cautious policy making that relied largely on the rebalancing market mechanisms was too slow and insufficient to cope with such a major problem. The ECB kept interest rates unchanged between June 2007 and June 2008 at a 4% level, while in the USA rates were brought rapidly to a level close to zero. Only in the fall of 2008, when the threat of deflation was obvious, the ECB started to cut interest rates. Europe was forced to face a strong loss of performance and output, which worked as an asymmetric shock that revealed other fragilities in the European framework. (Fitoussi and Sarraceno, 2010)

Table 5 – Current Account Deficit and Gross Government Debt in 2009

Current Account Deficit 2009		**Gross Government Debt 2009**	
Germany	5,6%	Slovenia	35,2
Netherlands	4,9%	Slovakia	35,4
Austria	3,1%	Finland	43,8
Finland	2,3%	Spain	53,3
Belgium	0,4%	Netherlands	60,8
Slovenia	-1,4%	Ireland	65,6
France	-1,9%	Austria	69,6
Italy	-2,1%	Germany	73,5
Ireland	-3,1%	France	78,3
Slovakia	-3,2%	Portugal	83
Spain	-5,2%	Belgium	96,2
Portugal	-10,9%	Italy	116,1
Greece	-11,0%	Greece	127,1

Source: Eurostat

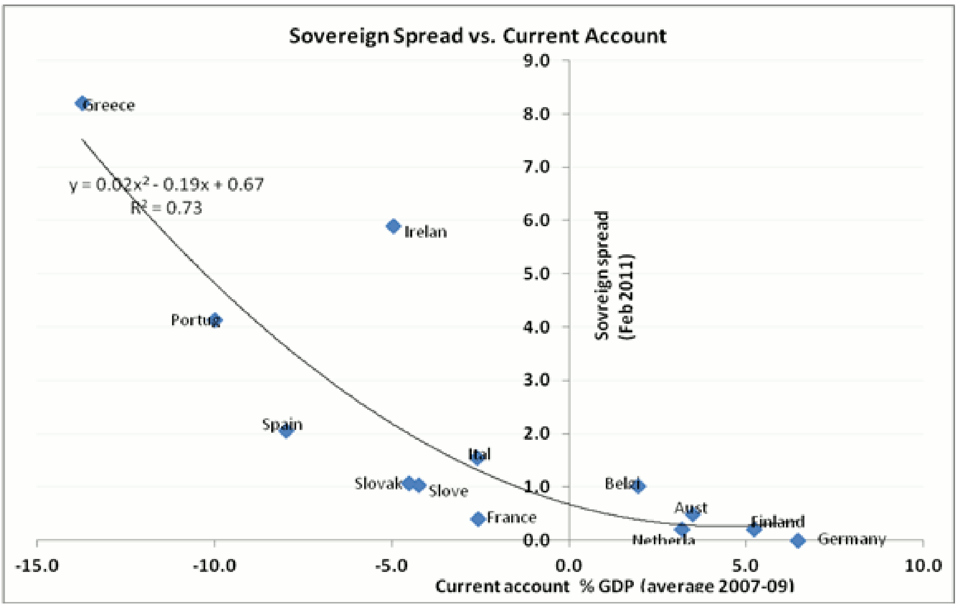
When the recession became a reality, budget deficits were boosted and European real-estate and financial bubbles exploded. Ireland had difficulties to save its banking system, and huge public spending was necessary in order to avoid the complete financial chaos. The Northern neo-mercantilist countries were able to sustain economic activity by rising deficits, but the already constrained southern countries (the ones with current-account deficits, as it is shown in table 5) had to raise the public debt to unreasonable levels, at least to the market agents' opinion. As financialization had already made its job, speculation broke the euro safety barrier and through credit-default swaps the Sovereign Debts started to be attacked. Greece was the first in the line, dragged by the announcement of the country's debt data review that showed a much worse deficit than it was announced by the precedent governor. This was the sign speculators needed to choose the first victim.

The debt level was not the only feature to be considered when countries were chosen to be attacked by speculators. If that was the criterion, Greece should have been followed by Italy and Belgium (table 5), and Germany should have higher spreads than Ireland. Current-account deficits seem to have been taken into consideration. The six countries with higher current-account deficits are now the most endangered countries, with the exception of Slovakia that has extremely low debt levels and can still accumulate deficits for a long time.

Belgium, the third highest debt level amongst the Euro Zone members, was not until now attacked. Its spreads are still pretty similar to German ones. That is because of its good performance in exporting and making its current account positive. So the criterion to attack countries debts is not that much the level of debt a country has. What is aimed is its ability or not to keep external surpluses. When current-account deficits become higher, spreads to this country rises too, making debts progressively more difficult to pay. Of course the debt stock is also considered, but not as much as the current-account deficit trend.

If we put together Sovereign Spread and Current Account we will that there is a strong correlation between the two variables:

Graph 12 – Sovereign Spread vs. Current Account

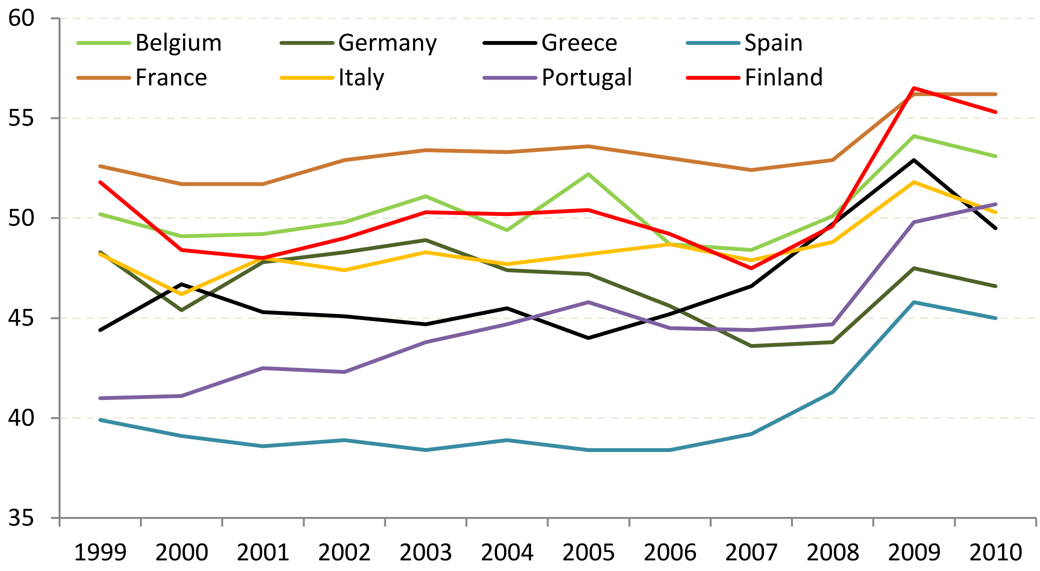


Source: Gros, Daniel, 2011.

Graph 12 shows clearly that sovereign spreads responds almost linearly to the current account. Countries with lower spreads are the countries that perform surpluses in the current account: Germany, Finland, Austria, Netherlands and Belgium, the northern nations aforementioned, according to Artus' (2011) paper.

But what about the argument that the nations that are now in crisis, and on the verge of bankruptcy, were lax and spent too much? Graph 13 is clear in showing that until 2006 the government spending was lower in Greece than in Germany, and much lower than in Finland, Belgium and France, nations still well rated with low spreads. After the crisis, expenditures naturally rose, and they raised more in Greece, because the country was more harshly affected. Even then, expenditures remained lower in Greece than in France, Finland and Belgium. It seems clear that the government expenditure cannot be by itself the explanation for the crisis in Greece, Spain and Portugal[4]

Graph 13 -Total general government expenditure in % of GDP



Source: Eurostat

What is interesting is that the architecture of the Euro Zone, as aforementioned, played a major role in reinforcing disparities between exporters and importers. Southern countries did not have much to do against the German movements towards enhanced competitiveness. So there is not that much room for the argument of lax policies in the south. It was pretty much the way the zone was conceived that divided countries that way.

Maybe if the Subprime crisis had not occurred, the asymmetry between northern and southern countries would never be exposed. The critical situation of a crisis, revealed what was camouflaged by high growth rates: a complete imbalance between countries on the interior of the zone.

The crisis was irreversible and the question was how to control the situation and what to expect from Europe's future. This is precisely when policy makers made even bigger mistakes. It

[4]Ireland was not included because of the difference of scale. After the crisis, government expenditure levels unknown in history, in order to bail out the failing banking system.

was an opportunity to rethink the conception of the zone, but the chosen solution was that the previous framework had to be deepened. The interpretation of the crisis was that the European project was not properly adopted, and as soon as the established rules were respected prosperity would rebound. Not only respecting the rules is not the best solution to the crisis, they are simply impossible to be respected in such a catastrophic scenario. Public deficit and debt will not fall in a recession context, even if the most ambitious austerity plan is adopted. The volume of expenditures can be reduced, but if the economy and the revenues are shrinking, the debt/GDP ratio will only get worse.

4 – Final Remarks – What could be done to put Europe on the proper track.

The possible solutions to the Euro Zone Crisis are many. Many articles have been written proposing a number of solutions, and the analysis of those propositions could be a subject for a new discussion. However, two measures seem inevitable in order to restore financial stability in the Euro Zone.

The first and must obvious solution is to carry further the integration of the European Union. So far, the Euro Zone is just a trade and monetary union, but politically there is no integration. That means, as well, that every single country has its own budget and taxation. This could be partially solved if some transfer mechanism were implemented, which could improve infrastructure conditions on the European periphery, using a development bank that could function as the Brazilian BNDES (National Social and Economic Development Bank). This would improve the periphery competitiveness, boost aggregate demand and restore the economic environment. Taxpayers in Germany would have to understand that Greece buys German products, and that it is Greece that finances the German growth.

At the same time, some debt reduction will also be necessary. Due to the crisis and the new interest rates, debt has become too high on the periphery, especially in countries like Greece and Ireland. Without debt reduction, those countries cannot recover, and will be trapped in authority measures. Different ways to reduce debt have been used around the world. To chose the most appropriate one is a difficult job, and could be a theme for a PhD thesis, but the most discussed in between the economists is the creation of the Euro Bonds. As Thomas Palley describes it:

'…euro zone member countries would create an EPFA that would issue jointly and severally backed bonds and operate as follows. (1) The authority would be able to sell new bonds of all maturities at its discretion. (2) Bond sale proceeds would be paid over to national governments. (3) The ECB would have the right to buy and sell already issued EPFA bonds. (4) EPFA would be governed by finance ministers of euro zone member countries, representing their national governments. (5) Voting rights within EPFA would be allocated across countries on a per capita basis. (6) Distribution of bond sale proceeds would also be on a per capita basis, as would countries' obligation to pay debt interest on EPFA bonds.' (PALLEY, 2011, page 11)

Those bonds would be European Bonds, backed and the nations in the Euro Zone. It would avoid the debts to be attacked, as the bonds will rely on the German stability and strength. It would also be a strong bond because of the restoration of monetary policy. If those bonds are created by the ECB, it can also be backed by simple monetary emission. It would bring back to life monetary policy in the Euro Zone.

But certainly what must happen in Europe is a reduction of the tensions between countries. If the project is to become integrated, a broader acceptance of differences would have to occur amongst the various European cultures. The fear of the neighbor is probably the worst barriers for the European integration.

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