Big Finance and the Euro are undermining the European Union

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It is argued here that most design faults of the euro have so far not been addressed by EU governments. Neither has a reform of the financial sector been implemented while this sector is at the root of the present crisis of the European Union. Strangely, it seems that for the EU fiscal prolificacy of euro governments is at the centre of the crisis, although corporate debt is far higher than public debt. The roots of the euro-zone problems lay in the private rather than in the public sphere. But the euro can only be saved in the context of a EU political and economic union that the population does not want. If implemented, it can lead to a corporacracy, in which the bankers dominate, undoing what has been achieved in Europe since World War 2. First we will look at the design faults of the euro.

The birth of the euro

Monetary union was the compromise between France and Germany after the latter incorporated East Germany (1991). France consented under the condition of acceptance of EU monetary union, in this way hoping to contain German ambitions. However, monetary integration happened under German conditions and the euro was introduced without attaining necessary economic preconditions. The European Central Bank had the Bundesbank as example, that means 'independent' of government interference. The only mission of the ECB was keeping inflation low, in line with German obsessions. Unlike other Central Banks, the ECB cannot lend to EU governments, making governments dependent on the banks for their deficit financing.

During the early 1990s there was a vivid discussion about widening and deepening of the EU. It was deemed necessary to give Central and Eastern European countries a clear perspective of EU membership, which meant that they were taken in before necessary deepening of EU integration was accomplished. Also, the more members, the more cumbersome decision making within the EU became, despite some improvements in this respect.

The roots of the euro-zone problems lay in the private rather than in the public sphere.

More importantly, popularity of market fundamentalism was at a height point during the 1990s. It was assumed that markets are functioning effectively and that for the euro area only provisions for government spending, government debt and inflation should be in place (convergence criteria). It was assumed that imbalances could only emerge in the public sphere. Private capital flows should be encouraged within the EU. Financial deregulation meant the proliferation of an unregulated shadow banking system, with the concomitant de-facto privatization of money creation, the increased leverage of European banks, the increasing role of private equity (causing a wave of mergers and acquisitions) and hedge funds, 70 per cent of which are operating from London. Speculation in foreign currencies exploded.. Also, banks increasingly bought exotic financial products such as financial derivatives based on US subprime mortgages. Most of these derivatives were sold by US banks, often from London, and mainly sold to European customers. European banks shifted their activities in the direction of trade in very risky products. The context of the introduction of the euro was the emergence of casino capitalism across Europe and the decriminalization of financial fraud. This dimension is usually ignored in analyses of the euro-crisis.

When the euro was launched there were internally already doubts about Italy and Greece. Italy, with its high state debt, was let in because it was inconceivable that a founder state of the EU would be left out. Those who warned against the shabby foundations of the euro were ignored or silenced.[1]

A decade of bust and boom

From the early 1990s Germany tried to adjust to the extremely expensive reunification and started to liberalize its economy. German wages stagnated while in most other European countries wages saw substantial increases. The German economy could expand thanks to exports, two thirds of which went to other EU countries. Also some of Germany's neighbors implemented an export led growth strategy. On the other hand, many countries on the periphery had a debt fueled growth strategy. This led to faster growth in most peripheral countries.[2] The European Monetary System was there equated with Easy Money Soon. Unit labor costs, a proxy for (lack

of) competitiveness, increased during 1995-2007 in Italy by 30 per cent, in Spain by 40 per cent, in Portugal by 44 per cent and in Greece by 61 per cent. In Germany it decreased by 3 per cent (*Vox*, 31 March 2011).

The debt fueled growth was enabled by deregulated finance that took consciously enormous risks, in order to make easy profits. For example, banks should have known about the shaky foundations of the heavily indebted Greek economy. The banks should have known that a external per capita debt of more than half a million euro is unsustainable for Ireland. They knew, the mass media kept silent and governments were ignorant.

Generally, above mentioned imbalances and risky lending went also unnoticed by international institutions. Spain and Ireland have, up till 2009, been praised by IMF and OECD for their economic policies.[3]

According to analysts of the Royal Bank of Scotland, out of 2,2 trillion euro in debt to Portugal, Ireland, Italy, Greece and Spain (PIIGS) from non PIIGS EU banks and institutions, 567 billion is government debt, 534 billion euro loans to non banking companies and 1 trillion euro to banks. Loans to Spain amount nowadays to 1,5 trillion euro (to Greece 360 billion euro). French banks have the highest exposure to the PIIGS (229 billion euro), Germany is second with 226 billion euro and British and Dutch banks follow with about 100 billion euro. One bank, the German Hypo bank, has 80,4 billion euro in public debt of the PIIGS countries on its books (*International Herald Tribune*, 4 June 2010). Total liabilities of eurozone banks are now three times bigger than eurozone governments (Paul de Grauwe, in *Vox*, 28 November 2011). Ireland attracted a lot of money because of its extreme laissez-faire attitude towards finance. It competed also with a low corporate tax level. Another oddity, related to the efficient market hypothesis, is the existence of a pirate's nest of unregulated finance (City of London) in the EU, where most big European banks conducted their most risky operations, hidden for regulators in the home country. The greatest structural imbalances occurred in the private sector. Public sector debts in the eurozone actually declined from 72 per cent in 1999 to 67 per cent in 2008, the year the Great Financial Crisis erupted (see for peripheral state debt figure 1). Debt of PIIGS countries decreased from 88 per cent in 1999 to 75 per cent in 2007 and then went up to 87 per of GDP in 2011.

The debt fueled growth in the Southern eurocountries and the export led growth in Germany is reflected in divergent current account balances (figure 2)

On the surface, there has been convergence in the EU. Living standards converged. But below the surface, there was divergence (reflected in unit labor costs, current account balances, inflation rates).

Zombie banks

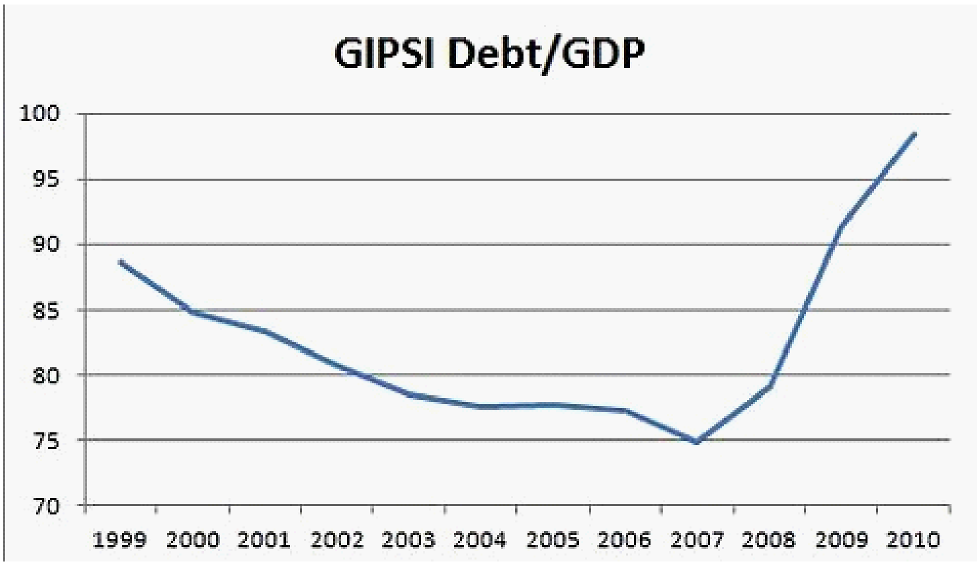
When the Great Financial Crisis erupted the so-called 'sovereign debt crisis' did not affect yet the EU. First there was a crisis around insolvent banks that had too much leverage and were faced with too many toxic assets on their balance sheets. In order to survive, many of these banks needed injections with huge amounts of tax payers money. These bail outs increased public debt enormously.

Early 2010 attention was shifted from the private to the public sector when it appeared that Greek public debts were not sustainable (and after it appeared that the Greek government had deceived the EU, among others with help of Goldman Sachs).[4] The 'sovereign debt crisis' started here and since then the mass media and governments focused on public, not private debt. The perception of enhanced risk led the banks to ask higher interests for loans to heavily indebted PIIGS countries. It also shifted attention from the need to reform deregulated finance. As far as there were concrete proposals to reign in finance, they were usually effectively blocked by Great Britain and its EU allies.

Focusing on sovereign debt was a cover up for the, mainly Northern European, banks that were exposed to debt from the PIIGS countries. Popular support for financial support for these countries was sold under the pretext of solidarity, while in reality it were the Northern banks that were saved. It was maintained that bankruptcy is out of the question and that debtors have to honor their obligations. It also diverted attention from the far greater private debt in the PIIGS countries.

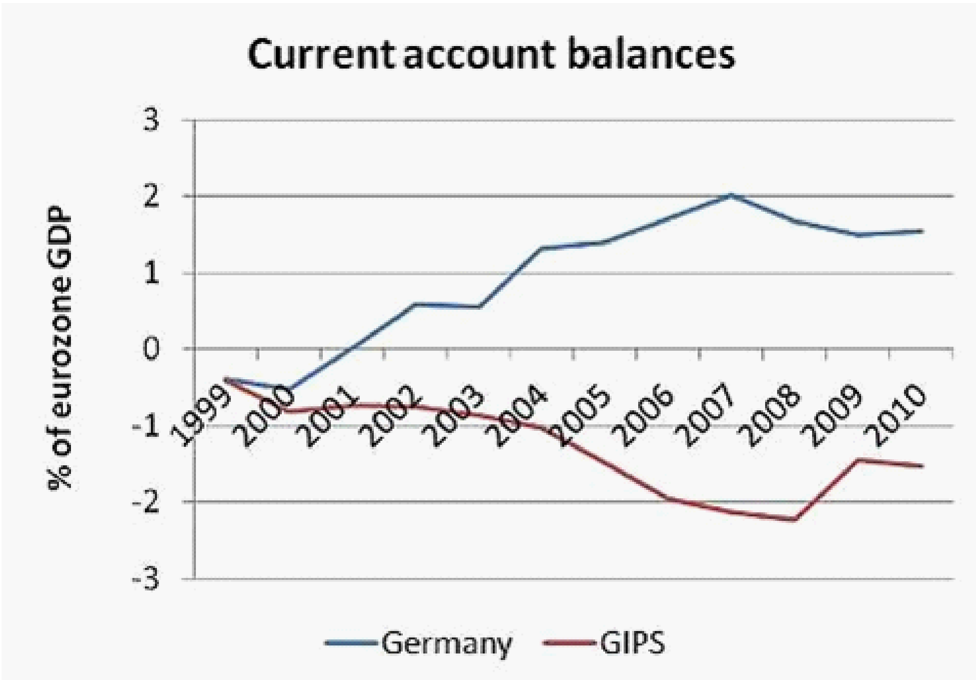
Banks that are too big to fail and that were bailed out by government used their increased influence with EU governments to convince them that if some countries, like Greece, could not honor their debt obligations, a catastrophe would occur. It would trigger a chain reaction in which many banks would fall. Through credit default swaps (CDS) most banks had insured their debts, above all with US banks.[5] It meant that if Greece could not pay 360 billion euro in (state)debt, its impact upon financial systems in the EU and USA could be four times bigger, through the multiplier of

Figure 1:



Source: Krugman blogs

Figure 2:



Source: Paul Krugman, *Social Europe* 28 November 2011

CDS. It was the same trick that had been used in 2008/9 with the first round of bail outs. It is blackmailing from the part of banks in which EU governments are kept hostage while they equate saving the banks with saving the economy as such. In this way creditors are protected at all costs. The IMF does the same in the case of heavily indebted states. It says that bankruptcy would mean the worst case scenario.[6]

The fact of the matter is that early 2012, the financial system in the EU is as wobbly as it was in 2008 while the roots of the problem, deregulated finance, have not been addressed.[7] But in the meantime millions of people lost their jobs (e.g. 22,8 per cent unemployed in Spain, January 2012), public debts mushroomed and the economy stagnated. This after several rounds of bail outs.

Nowadays European banks have more than 2,6 billion euro in debt to club Med countries, that amounts to 22 per cent of GDP.[8] Not counted are the many toxic assets that are still on the banks books. European banks have 75 per cent more exposure to toxic debt as American banks. Write downs have been 738 billion $ in the US but only 294 billion$ in Europe.[9] Not counted is the 1500 billion euro exposure to Central and Eastern Europe (90 per cent of credits to Central and Eastern Europe are from European banks). Corporate debt in the EU is 95 per cent of GDP (and how many of these loans are risky?). European banks were also much more active with (risky?) lending to countries in the global South. Sixty three per cent of credits extended to Latin America were by European banks (Asia and Pacific: 46%) (*Frankfurter Allgemeine Zeitung*, 14 October 2011).[10]

The two stress tests that have been conducted by the EU showed the overwhelming majority of EU banks in good health. Soon after these stress tests, banks that were deemed healthy needed additional governmental injections.[11] The stress tests were not only a public relations stunt. The problem is also that banks are often black boxes. It is not clear what are assets and what are liabilities. Over the past two decades banks did everything possible to obscure the books in order to boost profits and in this way to be able to pay out bigger bonuses.[12] With help of structured investment vehicles, a lot of assets and liabilities were put off balance. Often, what was booked as assets appeared to be liabilities. And how to value toxic assets for which is no market?

Most big European banks are zombie banks. They know it very well and this is the reason they do not trust each other anymore. They stopped lending to each other, while mutual lending was the lifeblood of the financial system. US banks stopped lending to European banks and European banks started shifting assets out of the EU.

Therefore the US Fed opened the dollar gates for European banks. Therefore the ECB opened the Euro gates and European banks got unlimited quantities of cheap money (1 per cent interest rate for 3 year loans, no questions about collateral). This gives some relief. But the money pumped into European banks is not going to lending to households and enterprises.[13] It goes to buying up safe state obligations or into speculative investments in commodity markets or 'emerging markets'. For example, buying up Italian government bonds with 6 per cent interest is a risk free investment, guaranteed by the ECB. The same ECB provides money for 1 per cent interest. Insolvent Italian banks borrowed more than 50 billion euro from the ECB. This means a 2.5 billion euro annual present from the ECB (and Italian government) to Italian banks in order to keep up the appearance of solvency.[14]

Dead lock

By early 2012 the Eurozone and the EU look like a card house. In the words of Nobel prize winner Joseph Stiglitz 'Economists do not longer discuss the question if the euro will implode; but when and how it will happen' (*De Volkskrant*, 18 January 2012).[15] One or more countries are faced with possible bankruptcy (it might cause a chain reaction) and the moribund financial system is not only faced with many dis-functional zombie banks that are deemed 'Too Big To Fail', but also with a dysfunctional shadow banking system that disrupts financial markets and brings speculation to the forefront of economic activity. The risk of a new global financial emergency, like in 2008, is increasing.

Policy makers seem to be paralyzed and are being blackmailed by the financial markets. The result is that the state is pushed back across the eurozone and that those who can least bear the burden of the crisis have to shoulder it.[16] In Ireland, a requirement of the IMF/EU bail out was that money out of pension funds be used in order to pay for the debts of banks.[17] In Greece, that has the highest military expenditures in relation to GDP in Europe, there is no cut on military expenditures.[18] Multinational enterprises that avoid paying taxes through affiliated in tax havens are not asked to contribute.[19] It are mainly small and medium sized enterprises that are suffering. Corporate profits as a whole actually rose in recent years.

Still, EU governments profess the possibility and necessity that the PIIGS countries can recover through internal devaluation. But experts assess that, for example, Greece needs a 50 per cent internal devaluation in order to become competitive. The EU disregards the fact that extreme austerity that is nowadays imposed upon the PIIGS countries is killing the patients, not helping them to recover. It appears that austerity leads to decreased revenue and increased social expenditures (more unemployed) that in turn leads to greater deficits. Declining GDP leads to larger external debt in relation to GDP. Despite the evidence that austerity, implemented across the EU, is suicidal, governments continue to implement the same policy. Governments implementing austerity policies, constantly have to review downwards their estimates of budget deficits. PIIGS countries need desperately growth in order to pay off their enormous debts, but are

prevented to do so because of bail out conditions. But socializing private debts in the context of austerity allows creditors to anticipate default. Also, a slow motion bank run is taking place in some southern European countries that allows the wealthy to bring their money in safety. And the ECB is filling the gaps.

Keynes taught that in times of depression, in which household demand and investments are depressed, government expenditures should increase, especially in sphere where multipliers are working, such as infrastructural works. In times of boost, government can decrease expenditures. This countercyclical Keynesian policies has been made impossible by current EU governments. There is now the demand that the golden rule of not more than 0,5 per cent government deficit should be inscribed into constitutions of EU member countries, while budget deficits higher than 3 per cent should be fined (*De Volkskrant*, 20 January 2012).

In this context it is not surprising that popular support for the EU diminishes. The euro crisis has led to an EU political crisis. Everywhere in the EU eurosceptic parties are gaining ground. In the meantime the EU imposes a suicidal economic policy upon debtor nations, in conjunction with an unelected ECB and an IMF that has proved its economic incompetence.[20]

But EU governments want to make a big jump towards fiscal and economic union. It seems an impossible act.

The consensus nowadays is that the euro can only be saved if the EU transforms into a transfer union, that means that you have an effective EU economic government that disposes of a 'treasury' that can move money from one EU country to another. EU President van Rompuy was right when saying that "We can't have a monetary union at the end without some form of economic and political union" (*The Guardian*, 11 May 2010). It means a big jump towards a United States of Europe. But it will be, in the short and medium term, a USE without a demos, without a polity. Polities, that means civil society and political parties, are still organized at the national level and that will remain for some time to come. A forced transition to a United States of Europe will mean a dysfunctional polity where the influence of big corporations and big finance is even bigger than it is now.

Way out

Why some many parties on the Left are supporting the emergence of a fiscal and economic union in order to save the Euro? Because they see the euro as an achievement, something to embrace. They assume that more Europe in the present context can mean more democratic Europe. They also assume that the end of the Euro might mean Armageddon, even war within Europe. Opposing the euro is equated with populism. They also cannot conceive an orderly abandoning of the euro (on such a scale it never happened before, the dissolution of the SU and the abolishment of the ruble in 14 successor states is not such a good example).

But what if present policies will lead to depression, even higher structural unemployment and a lost generation in a large part of the EU? Is this not a high price to pay? What if present policies, that imply a continuation of a casino capitalism, may lead to the Latin Americanization of Europe? What guarantees we have that we can get a democratic and affluent Europe and not a bankocracy that will abolish all achievements of post-war Europe? Could a boom in the property market, as happened for example in Ireland and Spain, have been prevented if a fiscal union would have been in place? Could the speculative lending that took place to banks in Ireland have been prevented with a fiscal union? Can fiscal union prevent diverging current account balances?

The current strategy allows the emergence of new speculative bubbles with no end in sight for bail outs with tax payers money.

The EU has since the early 1990s increasingly aligned with the interests of larger banks and European multinationals and has propagated the Anglo-Saxon model. European trade unions are complaining that the EU Commission wants to keep wages low and reduce public services, to decentralize collective wage bargaining and to make labor markets more 'flexible'. But, as Jan Willem Goudriaan, the head of the European Public Service Union has said, "the suggested EU proposals do nothing to get the many banks and their CEOs who engaged in speculation and short term greed". He called the EU plan "a power grab by conservatives, neo-liberals and above all corporate interests to bury social Europe for good." (*EU Observer*, 2 March 2011)

The Nordic countries that do not have the euro (Norway, Sweden, Denmark) and where deregulation of the banking system went less far, did far better than the eurozone countries.[21] How can these countries prosper with their high levels of taxation, wages and public expenditures? Why do they have the highest overall employment rates among the OECD countries?

The absurdity of the current conundrum is that with the Great Financial Crisis market fundamentalism has proved bankrupt but that a slightly modified market fundamentalism, with socialism for the bankers, has still survived. To stick to the euro in this context means the end of social Europe and the disintegration of the European Union.

Haarlem, 31 January 2012

Notes:

[1] When the EMU started there was a warning by the EU's own economists and the Bundesbank that the undertaking was not workable without fiscal union and probably catastrophic if extended to Southern Europe. 68 economists signed 13 February 1997 a letter against EMU (*NRC* 20 February 2010). These warnings hardly appeared in the press.

[2] This does not apply to Italy. During 2000-2011 the Italian economy hardly grew.

[3] A 2008 OECD survey of Ireland written just before the bust, concluded 'that the economy had performed remarkably well over the past decade', and that 'the economic fundamentals remain strong'. Irish banks were 'highly profitable and well capitalized, so they should have considerable shock absorption capacity' (*New York Times*, 29 December 2010).

[4] Greece lied about the government budget deficit that was not 6 but 12 per cent . Goldman Sachs had cut a secret deal with the Greek government in power then. Their game: to conceal a massive budget deficit. Goldman's fake loss was the Greek government's fake gain. Goldman got 300 million dollars fee for these services. (Greg Palast, *In These Times*, 8 November 2011)

[5] Guarantees provided by U.S. lenders, i.e. 5 large US banks, on government, bank and corporate debt in PIIGS countries amount to $518 billion, according to the Bank for International Settlements.US banks have 181 billion $ exposure to the PIIGS. Banks that issued Credit Default Swaps on PIIGS debt, often insured these CDS deals as well with counterparties. Therefore a default could trigger a chain reaction of claims that could bring down the whole financial system. Therefore the EU and Greece are insisting on a voluntary debt reduction of Greek debt by private creditors that would not trigger CDS claims (*Bloomberg* 1 November 2011).

[6] As a matter of fact, most heavily indebted countries that went bankrupt, did quite well after a short period of decline. When Argentine declared bankruptcy in 2001, recovery started on year afterwards and since 2002 Argentine is the fastest growing economy in Latin America. By 2009, GDP was twice that in 2002, during the low point of recession (*The Guardian*, 3 January 2011).

[7] Not addressed have been the separation of investment and retail banking, taxation of financial transactions, trade in financial derivatives and high frequency trading, shadow banking and dodgy accounting practices, the regulation of hedge funds and speculative trading in currencies.

[8] German banks have loans about 170 per cent of their total equity capital to governments in the PIIGS, French banks 200 per cent. US banks hold 700 billion dollar of government debt from PIIGS (D. McNally, in *Information Clearing House*, 23 September 2011).

[9] The IMF estimated the total value of toxic assets at 4 trillion dollars (*Huffington Post*, 8 April 2009)

[10] *The Independent*, 18 November 2011.

[11] Irish banks that failed shortly after the European banking Association gave them the green light in their stress test (*The Guardian*, 17 July 2011). Belgian/French Dexia passed without problems the second and 'improved' stress test of the EU (October 2011). Only a few days later Dexia had to be dismantled and got huge state injections.

[12] Often, it is maintained that the total amount of bonuses paid out is tiny compared to national product. This is wrong. Gordon Brown wrote: 'We now know that, if British bankers had paid themselves 10% less per year between 2000 and 2007, they would have had more capital, some £50bn more, to help them to withstand the crisis'(*The Guardian*, 7 December 2010).

[13] Not that big enterprises need money. They are generally quite profitable and the 446 biggest European companies are sitting on 445 billion £ on cash. This is 16 per cent higher compared to 2007. Their strategy is to reduce their debts (*The Guardian*, 30 November 2010).

[14] "At over 170 per cent of GDP; Irish domestic banks currently depend almost entirely on the ECB to refinance expiring market debt", said Standard & Poor's sovereign credit analyst Frank Gill (*The Independent*, 2 February 2011.)

[15] Remarkable is also the outcome of a straw poll in the packed congress auditorium in Davos during the World Economic Forum, where the vast majority said they thought the sovereign debt crisis would end in a blow-up of some kind. A similar number thought the financial system was no safer now then after the 2008 collapse of Lehman Brothers (*Financial Times*, 26 January 2012).

[16] According to EuroMod, the lowest income deciles representing 6 per cent of total national income are shouldering a disproportionate 10.5 per cent of the total austerity package (*Social Europe*, 20 December 2011).

[17] The IMF and the EU insisted that Ireland pay 17 billion out of the state pension fund to shore up the country's banks (*The Guardian*, 29 November 2010). EU interest rates for loans to Ireland are more than 5.8 per cent.

[18] The Greek government bought for 2.5 billion weapons in France (2010). Germany sold 2 submarines to Greece for 1.3 billion (2010). During the last decade Greece has signed arms deals amounting to 16 billion euro (*World Socialist Web Site*, 15 July 2010)

[19] A stimulus package could be financed by a financial transaction tax and tackling tax evasion. The European Commission estimates annual revenue of the tax in the order of 57 billion euro (tax rate of 0.1 per cent). A comprehensive source puts the tax gap at 8 per cent of Europe's combined GDP. If half the tax gap is closed, it will bring a revenue of 500 billion euro a year (George Irvin, *Social Europe*, 24 January 2012).

[20] The IMF failed to notice the bubble that led to the Great Financial Crisis. In 2007 the IMF board stated that 'The financial system has shown impressive resilience, including the recent difficulties in the subprime mortgage market.' (Walden Bello, 31 March 2009, "Foreign Policy in Focus"). The IMF deserves a substantial share of the blame for this crisis because it advocated the deregulation that lies at the root of the crisis. Strangely, the IMF belongs, with the financial sector, as one of the winners of the financial crisis.

[21] Between 1994-2007 Finland, Sweden and Denmark grew by 85 per cent, the US by 76 per cent (*Social Europe*, 9 June 2011)