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Europe in Crisis: Introduction

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Europe in Crisis: Introduction

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The economies of the Euro area (EA) are in crisis. According to the European Commission, EA GDP remains 2.1% below pre-crisis levels. However, these aggregate figures mask substantial cross-country divergence. While there has been a weak recovery in Germany (up by 2.9% of GDP since 2009), southern European countries are in much worse shape. Real GDP in Greece has declined 23.3%; in Spain the decline has been 6.4%, in Italy, 7.1% and in Ireland, 2.9%. The social costs of this crisis are enormous. Greece and Spain suffer from unemployment rates above 25%. This crisis poses profound questions about the nature of European integration, its macroeconomic policy regime and, possibly, the future of the common currency itself.

The crisis originated in the USA—in particular, in the market for derivatives on subprime mortgages. Initially, the crisis threatened to bring down the major financial institutions because liquidity dried up as the interbank market froze and banks stopped lending to each other. These events threatened the very existence of the major financial institutions and could only be averted by massive state intervention in the form of central bank lending and a government-sponsored bank rescue package.

The crisis had two effects in Europe. First, there was a sharp recession and rising unemployment, as well as large government budget deficits, in most countries. Second, there was a general re-pricing of risk, which began in the market for private financial assets and then moved to the market for public debt; by the spring of 2010, government bonds in all the peripheral European countries were adversely affected (Shambaugh, 2012; Sotiropoulos *et al*., 2013). The Greek debt crisis had powerful effects on economic policy across the continent as it enabled orthodox policy makers in Berlin, Brussels and Frankfurt to frame the crisis as one related to sovereign debt. However, the Greek situation was the only one in which the sovereign debt crisis was not the result of an oversized financial sector. The other peripheral EA countries that were hit by the sovereign debt crisis had experienced exceptionally high growth of *private*

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debt (de Grauwe, 2010; Hein, 2012). They had either budget surpluses (Ireland and Spain) or a sustainable debt level at normal interest rates (Italy).

The crisis in Europe had international as well as European origins. The process of European monetary integration not only allowed Germany to pursue an aggressive neo-mercantilist policy through nominal wage suppression, it also led to persistent current account deficits in the peripheral countries via capital inflows, which helped fuel unsustainable asset and housing price inflation (Bibow, 2012; Stockhammer, 2011). The resulting trade imbalances and high household debt levels provided the basis for the unfolding of the crisis. This is the subject of the paper by John Weeks (2014) that follows.

The crisis took a unique turn in Europe. While the USA experienced a weak recovery characterized by a massive household debt hangover, which was fuelled by government expenditures and aggressive quantitative easing, things got worse in the southern European countries. This is due to the particular policy set up of the EA. First, the common currency prevents southern European countries from pursuing a monetary policy that would support an appropriate fiscal policy, thereby by creating an exceptional situation in which an advanced economy is facing a problem akin to debt in a foreign currency. Second, because of the lack of European fiscal policy, there has been no automatic support from the richer region of the common currency area to the poorer ones. Worse, the countries in crisis have had to submit to structural adjustment programmes to promote neoliberal reforms (for a neo-Austrian defence of these policies, see Huerta de Soto, 2012). In short, they were pushed into austerity policies in the face of the worst economic crisis in two generations.

Monetary policy in Europe has been a good deal more conservative than in the USA, the UK or Japan. The European Central Bank has been hesitant to pursue Quantitative Easing policies. It has tried not to support national governments; instead, it has sought to use financial market pressures on these countries to discipline fiscal policy. Only when the Greek sovereign debt crisis threatened the stability of the private banking sector across Europe did the European Central Bank change course. It has thus reluctantly accepted downgraded Greek government bonds as collateral. While the European Central Bank has famously committed to do everything necessary to save the Euro, it does not show the same commitment to helping national states or fighting unemployment. The paper by Daniela Gabor (2014) discusses monetary policy in more depth.

European economic policy does not have much to offer southern European countries other than sweat and tears. Its main aim is fiscal consolidation and, for countries in crisis, 'internal devaluation'. This is pretty much the old orthodox recipe of cutting wages to fight unemployment. Never mind that there is no evidence that high wages were the cause of the crisis. In the present situation, furthermore, wage cuts will not only undermine domestic demand, they are also likely to worsen the problems in servicing the high levels of household debt. The paper by Stockhammer & Sotiropoulos (2014) discusses the costs of the internal devaluation strategy.

The crisis has sharply shifted the balance of power within Europe. While the European Union has been shaped by a neoliberal agenda for three decades, in the past this has been rhetorically balanced with a commitment to a European Social

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Model. However, in the context of the crisis, fiscal policy and labour market reforms have come into direct conflict with Social Europe. The sovereign debt crisis in southern Europe has also shifted power in favour of Germany (relative to other European countries) and it has further strengthened the European Central Bank (relative to nation states). It has thereby tilted the power balance in favour of capital and at the expense of labour.

The symposium papers that follow were originally presented at an April 2012 Workshop 'Europe in Crisis'. The workshop was organized by the Political Economy Research Group (PERG) at Kingston University London, UK. The three papers address issues of fiscal policy, monetary policy and wage policy in the EA.

In 'Euro Crises and Euro Scams: Trade not Debt and Deficits Tell the Tale' John Weeks (2014) dispels the argument that the crisis is due to fiscal policies and public debt. This debt and deficit diagnosis has been applied most notably to Greece and Italy, but also to Portugal and Spain (the 'PIGS'). Implicit in the orthodox analysis, and occasionally explicit, is the suggestion that these were not only profligate but also lazy PIGS that spent beyond their means and abandoned a commitment to international competitiveness. Weeks demonstrates that the German export-led growth strategy generated large trade and current account deficits throughout the EA in the 2000s. When the global financial crisis struck the continent in 2008, these trade-based deficits proved unsustainable. With the exception of Greece, neither public debts nor fiscal deficits represented a major problem among EA countries prior to 2008. The analysis leads to a consideration of measures that could have avoided the crisis of sovereign debt entirely, as well as correcting the unsustainable trade balances in the EA. These policies were not seriously considered, with the result that in the second decade of the 21st century the future of the common currency is still in doubt.

In 'Learning from Japan: the European Central Bank and the European Sovereign Debt Crisis' Daniela Gabor (2014) analyses monetary policy in Europe. She argues that both economic ideas and organizational interests shape central banks' policy. New Keynesian ideas led central banks to interpret Japan's experience with quantitative easing through the impact on risk spreads, although the Japanese central bank never intended such effects. Scholars and policy-makers alike ignored one critical lesson: successful policy innovations depend on bank funding models. Gabor argues that there was a shift to market-based funding, which impairs the effectiveness of the traditional crisis toolkit. Central banks must intervene directly in the asset markets of systemic importance for funding conditions, as the Bank of Japan did when it bought government bonds. Market-based finance thus creates a trade-off between financial stability and central bank independence. During critical periods, central banks cannot preserve both. The European Central Bank illustrates this trade-off well. Early in the crisis, it outsourced financial stability to a (largely) market-dependent banking system to protect its independence. With the introduction of Outright Monetary Transactions in September 2012, the Bank recognized that the market-based nature of European banking required outright purchases of sovereign bonds. This new instrument gave the European Central Bank additional powers to

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shape national fiscal decisions in the name of an independence that no longer has theoretical justification.

In ‘Rebalancing the Euro Area: the Costs of Internal Devaluation’, Stockhammer & Sotiropoulos (2014) investigate the economic costs of rebalancing current account positions in the Euro area by means of internal devaluation. Internal devaluation relies on wage suppression in the deficit countries. Using an old Keynesian model a current account equation, a wage–Phillips curve and an Okun’s Law equation are estimated. All estimations are carried out for a panel of 12 EA members. Their estimation results enable them to calculate the output costs of reducing current account deficits. Greece, Ireland, Italy, Portugal and Spain (GIIPS) had, on average, current account deficits of 8.4% of GDP in 2007. To eliminate these current account deficits, a reduction of GDP by some 47% would be necessary. Trade imbalances can be resolved in only two ways—deflationary adjustment in the deficit countries or inflationary adjustment in the surplus countries. The economic costs of deflationary adjustment to those countries are equivalent to the output loss of the Great Depression. An adjustment of the surplus countries would increase growth and it would come with higher inflation, but it would allow rebalancing without a Great Depression in parts of Europe.

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