

Causes of the Sovereign Debt Crisis

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ANNEMARIE DETLEF, APR 16 2012

In the immediate aftermath of the financial meltdown in 2008, the global crisis has made an important shift. By then not the private banking sector, from where the financial crisis originally emerged from, but sovereign states face the risk of default. In order to analyse the multifaceted character of the European sovereign debt crisis, this essay focuses on its *systemic* causes. Contrary to the argument of popular Northern European politicians and journalists that blame the inability of Southern European states to manage deficit spending, the Eurozone crisis is firstly determined by imbalances in the European Monetary Union, and secondly by imbalances in the global political economy. This paper argues that the vast amount of sovereign debt is therefore not the result of weak Southern European nations, but of inherent structural illnesses that ultimately led to the current crisis. This essay is divided into two sections. The first section examines the problems of the design of the European Monetary Union. In regard to the theory of an 'Optimum Currency Area' by Robert Mundell, it analyses the extent to which the EMU has failed to meet the criteria of optimised efficiency. In the absence of an adjustment mechanism for unequal development in Euro member states, the dominance of Germany as leading export nation created severe inequalities. The second section then focuses on the role of the global political economy and imbalances that were created in the 'era of financialisation' following the demise of Bretton Woods. The shift to neoliberalism and consequently the liberalisation of finance have led to an increase in speculation with financial assets. The 'Global Surplus Recycling Mechanism' – the recycling of surpluses from successful export countries such as Germany and Japan in Wall Street – has massively increased the amount of money available to households in form of debt and thus created speculative bubbles that burst during the financial crisis. The vast debt of Southern European states is therefore determined by systemic failures.

Beginning with an analysis of the systemic issues in the European Monetary Union, the design of the EMU differs significantly from Robert Mundell's and Ronald McKinnon's criteria of an 'Optimum Currency Area' (Manolopoulos, 2011). The unequal development in Eurozone member countries requires an adjustment mechanism that smoothens out imbalances between surplus- and deficit nations (Grahl, 2011). This mechanism would replace the 'usual' adjustment in form of currency devaluation in deficit countries against currencies in surplus countries. Because a fixed exchange rate automatically fixes competition between economic sectors of member-states (Conquest & Bruges Group, 2011), the following five criteria need to be ensured in order to adjust imbalances (Mundell, 1961).

Firstly a currency union needs to have a flexible labour market. Labour from deficit countries cannot be restricted to move to areas with more successful industries. This factor prevents unemployment to rise in deficit areas and skill shortages to occur in surplus countries with faster growing economies. Within the European Union however, labour mobility was relatively low. According to a report by the European Central Bank, "in 2000, only 0.1% of the total EU-15 population (or 225,000 people) changed official residence between two member countries" (Heinz & Ward-Warmedinge, 2006). Furthermore most of labour mobility was due to an influx of workers from Eastern Europe rather than from Southern European countries, which are now part of the Eurozone. In contrast, labour migration between US counties was 5.9 % of its total population in 2000 (Heinz & Ward-Warmedinge, 2006).

The second mechanism for an optimum currency union is the establishment of fiscal transfers to counteract asymmetric imbalances (Manolopoulos, 2011). This includes international transfers to balance out surpluses and deficits of successful and less successful regions by a strong central government with a federal taxation system. In the EU however, only 1.24 % of its total GDP has been used for fiscal transfers (Macdougall, 1992). In the dollar

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zone on the contrary, the central government compensated about 40% of falls in any state's GDP with fiscal transfers (Callinicos, 2001).

Thirdly, Mundell emphasises the importance of flexible capital and product markets (Manolopoulos, 2011). Wages and prices have to be flexible and responsive to competitive market forces. In the European Union however, especially German wages have been politically repressed for the benefit of German business with the Agenda 2010. There was an artificial redistribution from the German and European citizenry to the German business class. Most of Germany's 'export miracle' was not due to intensive increases in productivity rates, but the result of extensive wage (and demand) repression. The high competitiveness of German unit labour costs compared with Spain, Italy or Greece thus created another imbalance in the European Monetary Union (Conquest & Bruges Group, 2011). Within the Eurozone however, the adjustment of labour costs is an important factor for outbalancing any productivity rise in other nations. Germany, which has been the most successful surplus-generating country of the EU anyhow thus applied a mercantilist policy and restored its own 'productivity' through wage repression.

Another important factor is that most of the members have shared business cycles to prevent asymmetric shocks and imbalances (Manolopoulos, 2011). This includes similar inflation rates, which are furthermore closely connected to the degree of integration of member countries. The problem in the EMU is that the inflation policies of the European Central Bank are largely influenced by the imperative of the former German Bundesbank. With the conditions of the Growth and Stability Pact many member states adopted strategies to adapt to the proposed inflation rates at the expense of high unemployment rates (Baimbridge, Burkit, & Whyman, 1998).

Finally, the degree of diversification of the member economies is positively correlated to the optimisation of currency union (Manolopoulos, 2011). Due to the fact that during recessions a region that relies on a few economic sectors can be affected more severely, this criterion needs to be ensured. Though all industrialised member states of the European Union fulfil this criterion, Greece's economy was relatively undiversified.

The EMU is thus far from Mundell's concept of an optimum currency union. With low labour mobility, the lack of fiscal transfers, artificial repression of German unit labour costs, inflation policies that serve the interest of surplus countries and a low degree of diversification of the Greek economy, the adoption of a single currency in the 1991 Maastricht Treaty seemed to be a fairly irrational decision. Because most of Germany's surplus is generated by the export to other EMU member countries, those countries consequently have to run a deficit in the zero-sum-game of balance sheets. According to Eurostat, the intra-EU27 trade balance of Germany made up a surplus of 61912 euro in 2010[1]. Spain and Greece on the other hand run deficits of roughly -11000 and -15000 euro in the same year. Because the *normal* adjustment mechanism of exchange rate devaluation however was not possible anymore, and because the criteria of the optimum currency area have not been implemented, the European Monetary Union itself entails significant systemic issues that determined the Eurozone crisis.

In addition, the role and policy preferences of Germany during the crisis have exacerbated its severity. The popular press and politicians in Germany have not recognised the systemic failures of the EMU and blame Southern European states for their inability to deal with deficits on the contrary. It is however logically impossible for all member states of the European Union to adopt the same policy preferences as Germany – if every country in the Eurozone relied on mercantilist imperatives, the system could not work. The Eurozone did not base on fair multilateralism between its members, but on a national hegemonic project of Germany (and France). Nationalism in the EU is persistent and still dominates decision-making processes. The role of Germany as an export country and the simultaneous lack of an adjustment mechanism have created significant imbalances within the Eurozone that ultimately determined the current crisis.

Having analysed the systemic issues in the construction of the Eurozone and the consequences of Germany as an export country, the solution of austerity does not seem to be a sustainable long-term orientation for Southern European countries such as Greece. This is the case firstly because the crisis is not primarily caused by weaknesses of corruption in Southern countries and does thus not require a mechanism to remove those supposed origins, and secondly because the negative effects of austerity – the loss of jobs and demand – seem to exacerbate the crisis rather than to resolve it: "with austerity, the automatic stabilizers in the economy that cushion an economic downturn

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are over-ridden and growth falls" (Carlin, 2011). As recognised by the World Economic Forum in Davos, the German-Franco axis should thus rethink those measurements and focus on long-term growth stabilisers rather than austerity. The bailout agreements signed by Greece however entail the conditionality of those policies.

Next to the imbalances created by the construction of the European Monetary Union and the role of Germany as mercantilist country there are further imbalances in the global political economy that determined the sovereign debt crisis in Europe. In the demise of the Bretton Woods system and the age of neoliberalism that emerged after, the increasing amount of global wealth that was used in the financial sector created speculation and ultimately determined the financial crisis of 2007-2009. Most of the surpluses of successful countries such as Germany and Japan were channelled into Wall Street and then bundled to cheap credit. This 'Global Surplus Recycling Mechanism' (Varoufakis, 2011) in fact actively looked for vast amounts of debtors. This paper therefore argues that the imbalances created in the 'age of financialisation' present the second systemic illness that determined the Eurozone crisis.

In the early 1970s, the global political economy experienced a major downturn due to global overproduction in relation to global demand (Brenner, 2002). The fixed exchange rate system of the Bretton Woods era began to unravel as a result of massive US debt and speculative attacks on the US-dollar. Many governments that had interlocked their financial positions with the dollar lost trust in the pillars of Bretton Woods: "by the end of the 1960s many governments began to worry that their own positions (...) were being undermined. By early 1971, (US) liabilities exceeded \$70 billion, while the US government possessed only \$12 billion of gold with which to back them up" (Varoufakis, 2011). After President Nixon's closure of the gold window, the US government had to attract global surpluses to finance their balance of payment deficit (Schwartz, 2010). This 'Global Surplus Recycling Mechanism' thus recycled capital from the world (most notably Germany, Japan and China from 2003 onwards) in Wall Street.

These asymmetric inflows of surpluses furthermore massively increased liquidity and the availability of credit. With the era of neoliberalism and the liberalisation of finance those surpluses were then channelled into cheap credits and new financial instruments. For example, a vast amount of credit created real estate bubbles in Ireland (Finn, 2011) and Spain. Those bubbles made up an artificial stimulus by the neoliberal regime to boost employment. Debt therefore was generated in the private sector: it was thus not *public* debt that determined the crisis for those countries, but *private* debt as the result of financialisation. According to Martin Wolf, "Estonia, Ireland and Spain had vastly better public debt positions than Germany" (Wolf, 2011).

The era of financialisation – the value extension of financial means in relation to production, the increasing scope of financial institutions in regard to financial liberalisation, and the increasing range of financial instruments – determined the financial crisis and consequently the European sovereign debt crisis. The collateralised debt obligations, repacked in the process of 'Global Surplus Recycling', channelled to US households and sold to financial institutions and actors all over the world, represent an era of free-market capitalism. Sovereign actors, which then bailed out private banks, make up the final stage of debtors in the recent crisis. The contagion of debt thus spread from households to banks to governments.

Moreover some politicians have accused financial markets themselves of worsening the crisis by panic and speculation about sovereign debt. The EU parliament tried to decrease speculation with sovereign debt through banning the purchase of credit default swaps (CDS) without already holding government bonds. According to a publication of the European Parliament in November 2011, "this is one of the key regulations pushed through by the Commission to tackle the financial crisis. Both short selling and CDS trading are accused of having fuelled the market volatility, with CDS trades moreover having been widely blamed for potentially aggravating Greece's troubles" (European Parliament, 2011).

The problem with such accusations is they do not focus on the broader picture. It is indeed true that speculation with sovereign debt has worsened the situation in Greece to a certain extent. However, the actual origin is the contagion of debt in the whole economic system. One has to ask why such speculation occurs – and narrowing the answer to that question to the mere greed of some speculating actors is wrong. It is the system that lies behind such speculation, the construction of the Eurozone, and the whole global political economy.

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In conclusion, this paper argues that contrary to popular press and politicians that blame Southern European states for weakness and corruption, the origins of the current Eurozone crisis are to be found in two broader systemic issues: firstly the construction of the European Monetary Union, and secondly the global political economy and the age of financialisation. This paper shows that the adoption of the euro was built on unsustainable pillars and far from the theoretical principle of Mundell's optimum currency area: labour mobility was low in the EU; there were neither fiscal transfers from surplus to deficit countries, nor a federal taxation system; wages have not been subject to EU-wide market forces, but have been artificially repressed by Germany; and inflation policies have favoured the interest of the strongest members. Further imbalances were created by Germany as mercantilist country and surplus generator at the expense of other EU members. Austerity thus does not seem to be the right policy solution, as it oppresses demand and thus creates more sovereign debt. Furthermore, this paper argues that the second systemic issue lies in the construction of the global political economy and the imbalances created in the era of neoliberalism. The contagion of debt that spreads through the Global Surplus Recycling Mechanism – from surplus countries to households, to banks, to sovereign states – has afflicted the whole system. The massive amount of debt in Southern European countries is thus not determined by weakness, corruption, and inability to deal with public deficits, but by systemic failures and illnesses. Therefore, to prevent such crisis from emerging it is the system itself that needs to be changed.

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[1] Retrieved from http://epp.eurostat.ec.europa.eu/portal/page/portal/external_trade/data/main_tables

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