



Crisis in the Eurozone

Financial Management without a Financial Policy

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The rescue of Greece by the IMF and the EU has failed. The strict consolidation programme prescribed in 2010 with the granting of a 110 billion euro loan has had the opposite effect: the recession has deepened, unemployment has increased and tax revenues have fallen. With a national debt of over 150 per cent the prospect looms of Greece sooner or later having to restructure its debt. The bond market is already pricing-in a 30 per cent »haircut« on existing debts. Greek government bonds are trading at yields of over 20 per cent, as a result of which future refinancing of the national debt on the capital market will not be possible.

Portugal, too, is threatened by insolvency. In order to avoid this the country has been granted a loan in the amount of 78 billion euros under the Euro rescue plan. The EU loan to Portugal, as in the case of Greece, is to be accompanied by a rigid austerity programme (cuts in pensions, tax increases and privatisation of state-owned assets). This prescription is the product of an economic policy which neither has a sustainable solution in prospect nor takes account of the overall problems of the Eurozone. The purpose of this article is to address a number of key issues which are being ignored in the public debate.

The Euro rescue scheme is able to refinance in the market on favourable terms (3.2 per cent). However, it lends the money comparatively dearly, as in the case of Ireland and now Portugal, at an interest rate of 5.9 per cent, leaving a credit margin of 2.7 per cent. On this basis, one might ask what the Euro rescue scheme is: a profit-maximising bank or a public institution of the European Union? It is true that on the open market Portugal would have to pay 10 per cent, but even so this cannot be considered truly public financial aid for an EU member state threatened by insolvency. The very term »rescue scheme« would lead

one to expect that the capital would be passed on at the same interest rate. At the end of the day, what is at issue is a rescue, in other words the avoidance of a »life-threatening« situation, and not only for the country in question, but for the whole financial framework of the euro. In light of this it is utterly incomprehensible why an interest rate margin of two per cent is also planned for the European Stability Mechanism (see the draft treaty on the ESM) which supersedes the current rescue scheme in 2013.

But why should only public money be used to rescue Portugal? When insolvency looms, one usually seeks a settlement or restructuring. Figures produced by the Bank for International Settlements (BIS) confirm that the main creditors are European commercial banks (Table 1).

Table 1: Foreign claims on Greece, Ireland, Portugal and Spain by nationality of bank, end of 4th quarter 2010 (billion US dollars; excluding other claims from derivatives etc.)

	DE	ES	FR	IT	GB	US
Greece	34	0.9	56.7	4	14.1	7
Ireland	118	10	29.6	13.5	135.2	50.1
Portugal	36.4	84.6	26.9	4.1	24.4	5.2
Spain	181.9	0	140.6	30	107.2	47.2
Total	370.3	95.5	253.8	51.6	280.9	109.5

DE = Germany, ES = Spain, FR = France, IT = Italy, GB = United Kingdom, US = USA;

Source: Provisional data from the BIS's Consolidated Banking Statistics, 11 April 2011.

German credit institutions alone own government bonds and other claims in the amount of 370.3 billion euros on debtors from Greece, Ireland, Portugal and Spain, the equivalent of more than half of the 750 billion euros of

the European rescue scheme. Other central creditors include Spanish, French, British and US credit institutions. In the event of state insolvencies, in other words, the insolvency of the western creditor banks bailed out in 2009 at taxpayers' expense also threatens, first and foremost German credit institutions. A settlement involving a reduction of outstanding claims would be painful for the banking system. Consequently, the Euro-countries – and primarily Germany – are once more bailing out the private commercial banks via loans to Greece, Ireland and Portugal: bank bailout number two.

What the banks are doing here or are able to do is based on the logic of double-bottom trading. Ten per cent interest is available only at high risk. Nevertheless, German banks have stepped up their purchasing of the bonds of these insolvency-threatened Euro-states. It's great business. The banks receive cheap money from the European Central Bank (ECB) at one per cent (in future 1.25 per cent) and lend it to Portugal at between seven and 10 per cent. There is no risk of default because the Euro-states cannot allow Portugal to go under without putting their own banking systems at risk once more. The German commercial banks are perfectly aware of this, of course. The banks are speculating on the likelihood that, under threat of the insolvency of creditor states the EU member states will step in to ensure the economic survival of their own national banking systems. Only on that basis can risks on this scale be taken. What politics and the media are presenting to the public as a »euro crisis« is first and foremost a structural defect of the European banking and financial system.

What happens now? After three austerity programmes which the Portuguese have managed themselves they now have to deal with a fourth, this time under external supervision (the EU and the International Monetary Fund). As in the case of Greece, the austerity measures will not work in Portugal. Economic growth will not emerge from rigid budget austerity, either in Portugal or in Greece, of the kind needed to enable them to service their debts.

For this purpose, growth momentum is needed from infrastructure programmes, investment in education and other economic policy measures which incur costs before, over the long term, they result in stable economic growth. In the OECD's 2010 education report Portugal comes bottom in almost every category. Only 28 per cent

of Portuguese between the ages of 25 and 64 have completed a secondary education (85 per cent in Germany). In Portugal the proportion of those leaving school without graduating is 37.1 per cent (2.8 per cent in Germany). Portugal's problems in this respect are fundamental and cry out for extensive public investment in education, which will pay off only in the long term. Of course, long-term investments must be financed over the long term, too. An EU loan in the amount of 79 billion euros with a three year term and at six per cent interest, the main purpose of which is the refinancing of existing debts and the capitalisation of Portuguese commercial banks, is no solution here. The prescribed austerity programme will only lead Portugal's education system from bad to worse.

We Need a European Economic Policy

If the crisis of the monetary union is to be solved a change of policy perspective is needed. The Eurozone is a »state« with a common currency, consisting of 17 euro-countries. In 2010, the budget deficit of this »state« was six per cent and its debts amounted to 79.3 per cent of annual economic output (Eurostat April 2011). The Eurozone's debt level therefore does not present a serious problem and threatens neither the creditworthiness of this »state« nor the stability of the euro. Taking an overall view, the debt problems of Greece, Ireland and Portugal can be put into perspective.

However, the unequal distribution of debts in relation to economic output between the 17 Euro-countries poses a problem, calling for a European economic policy with a long-term perspective. The inequality of the debt burden is the result of a historical economic imbalance in trade flows. While Germany has for years registered export surpluses in trade with its Euro-neighbours, the latter have experienced trade deficits. In a currency area, in which the exchange rate is no longer available as a compensatory mechanism, wages must be flexible enough to correct this inequality. While German wages would have had to rise much more strongly in comparison to inflation in recent years, in the neighbouring countries a disproportionately low wage development in relation to inflation would have been required. Wage dumping in Germany has reinforced export surpluses so that German banks are now financing trade deficits and thus the debts of its neighbours. The financial crisis was only the trigger of

the Eurozone crisis. What is lacking, therefore, is a European economic policy or economic government whose task would be to take preventive countermeasures with regard to differences in real wages.

This is precisely where a sustainable solution to the crisis in the common currency area must begin. In Germany, wages must rise disproportionately in the coming years so that German domestic demand can offer the neighbouring countries growing export opportunities. In this way another outrage would also be corrected: the extremely unequal distribution of income and wealth between labour and capital in Germany. Such a measure could count on the political support of a large part of the population. In the European neighbours, by contrast, wage development must be moderate. In Greece, Ireland and Portugal economic growth must also be stimulated by public investment in infrastructure and education. It is high time Europe had economic government, rather than relying on a make-do-and-mend approach shaped by national interests.

We Need a European Fiscal Policy

To save the Portuguese economy much higher volumes of »genuine« public financial assistance and long-term loans from the Euro-states are needed. State financing of Euro-countries threatened by insolvency cannot remain at the mercy of daily speculation on the capital markets and their rating agencies, but has to be established on a stable footing. The Euro-rescue scheme has already created a transaction platform which, due to guaranteed creditworthiness, can raise capital in the market on favourable conditions and pass it on with the same loan conditions to the affected countries. De facto this entails the introduction of Euro government bonds or a common European fiscal policy.

The starting point here should be a restructuring of public debt. The best thing would be the conversion of these countries' short-term debts into long-term Eurozone government bonds at a significant discount. Private creditors must shoulder the burden just like public creditors. Even though the ECB warns of unforeseeable consequences for the European banking system in the event of a debt reduction, nevertheless, one cannot demand wage and pension cuts and tax rises from Greece and Portugal,

while subsidising private banks and their shareholders with taxpayers' money.

We Need a European Regulatory Policy

Restructuring is intrinsically linked to a solution of the structural defects in the European financial sector. Financial reforms to date are little more than »repair« measures within the existing system and do not touch on the core problems. The main task of commercial banks is the financing of the real economy: this is the only reason they are granted the privilege of favourable refinancing by means of central bank loans. Today, banks largely operate detached from the real sector. Only a fraction of a bank's daily transactions interface with the real economy. This has to change, and this calls for a European regulatory policy. Comparable to the US Glass-Steagall Act of 1933 there must be an institutional separation between banks' deposit and credit business and their securities business. Only banks involved in financing the real economy should receive access to preferential central bank funds.

Critics will object that without the securitisation of loans in tradable securities the financing of large-volume projects would not be possible. But it is possible. The banks themselves demonstrated it by establishing off-balance sheet transaction platforms. We could simply take this path and promote web-based capital intermediation via internet platforms. The fact that web-based peer-to-peer lending works and, indeed, is successful is evident from credit platforms such as *smava* in Germany, *Prosper* in the USA and *Zopa* in the UK.

Peer-to-peer lending is attractive for both the lender and the borrower, because they can share the margin between deposit and lending rates previously taken by the bank. The platform receives merely an intermediation fee. These fees are much lower than the bank margin, because there is no need to fund gleaming skyscrapers in the best locations or the bonus payments of investment bankers. The platform merely mediates; it does not take contract positions of its own. This means that there is no systemic risk since the risks are now shared in a decentralised way among the users. The lenders, in turn, can spread the risk of default by investing in a range of financing projects, committing only small amounts, or by joining together in investor groups via the internet.



The financial market of the future will consist of a network of regional banks which execute payment transactions and grant loans to regional customers. In parallel with this, there will be a multitude of web-based transaction platforms for capital intermediation. This global financial world, by contrast, will function without banks because no local »player« is needed merely for capital intermediation.

None of This Is Possible without a Vision of Europe as a Political Entity

The solutions outlined here could be realised only if there were actors with a clear vision of a politically unified Europe and ready to subordinate short-term national interests to this goal. In the everyday debates on the crisis in the Eurozone the real value of an economically and politically united Europe has become lost from view: the peace which we have enjoyed in Europe for 66 years is beyond price. The best way of ensuring peace is Europe's political unity.

Further reading

Annelie Buntentbach, David Begg, Erich Foglar, Agnes Jongerius, Wanja Lundby-Wedin, Yannis Panagopoulos, Joao Proenca, Jaroslav Zavadil (2011): Solidarity in the Economic Crisis: Challenges and Expectations for European Trade Unions, <http://library.fes.de/pdf-files/id/ipa/08073.pdf>

Toralf Pusch (2011): Wage policy coordination in the Eurozone: A Robust Concept for Greater Macroeconomic Stability?, <http://library.fes.de/pdf-files/id/ipa/08072.pdf>

Klaus Busch and Dierk Hirschel (2011): Europe at the Crossroads: Ways out of the Crisis, <http://library.fes.de/pdf-files/id/ipa/08066.pdf>

Werner Kampeter (2011): International Financial Crises in Comparison: Lessons for Managing the Current Crisis, <http://library.fes.de/pdf-files/id/ipa/08081.pdf>

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