

**THE IMPACT OF THE FINANCIAL CRISIS TO THE  
COLLECTIVE INTEREST OF THE EUROPEAN UNION**

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COLLECTIVE INTEREST OF THE EUROPEAN UNION**

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*For our Greek comrades....*

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This thesis is only the beginning of my journey...

Doğa Taşlardan

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European Studies, M.A., Thesis, 2011

Prof. Dr. Meltem Müftüler Baç

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## ABSTRACT

Back in 1950s, the whole construction of the European Union was based on an effort to replace the ruinous and bloody rivalries of European history, with a new logic based around mutual economic interests. By early 1980s, strong neo-liberal pressures in the global economy had further pushed European governments to converge interests under the umbrella of the European Monetary Union (EMU), as qualitatively a new step in European integration. By early 2000s, the single European currency Euro, became the united Europe's proudest achievement and centerpiece of supranationalism. While *externally* EMU and Euro were designed to give Europe a chance in global economy, *internally* they aimed 'politically' cementing Germany to the Community while 'economically' cementing Community to the orthodox monetarist/fiscal policies of Germany. However the unexpected events of the global financial crisis of 2008, global economic crisis of 2009 and the European sovereign debt crisis of 2010, had brutally exposed that the scheme was not working as well as it should. The costs of these crises to Europe were not just financial, but political and social. This thesis attempts to illustrate how the rules of the EMU turned out to be *unrealistic, unsuitable, unmanageable, unsustainable, unreliable, unenforced, unsuccessful* while the ad-hoc cures to save the EMU had been *uncomprehensive, unpopular, unstable and unstabling*, as putting all those different economies at different stages of their developments into one basket; turned out to be a “trap” for all parties involved; be it the most powerful Germany or the weaker economies of the single currency.

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Anahtar Kelimeler: Ekonomik ve Parasal Birlik (EPB), Avrupa Parasal Sistemi (APS), Döviz Kuru Sistemi (DKS), Maastricht Antlaşması, İstikrar ve Büyüme Paktı, Maastricht Mali Yakınsama Kriterleri, Bundesbank, Alman Markı, Fransız Frangı, Euro, Avrupa Merkez Bankası (AMB), Euro Sistemi, Euro Alanı, 2008 Finansal ve Ekonomik Krizi, Devlet Yardımı, Şirket Kurtarma, Yunanistan, İrlanda, Portekiz, Avrupa Finansal İstikrar Aracı (AFİA), Almanya, Fransa, Lizbon Anlaşması, Avrupa Birliği, Devlet Borcu Krizi 2010

## ÖZET

1950’li yılların başında, Avrupa Birliği fikrinin doğuşu Avrupa kıtasında o güne kadar yaşanmış kanlı savaşların tarihini silmek ve karşılıklı ekonomik çıkarlara dayalı bir oluşum yaratmaya dayalıydı. 1980’li yılların başında küresel ekonomide esen neo-liberal rüzgârlar Avrupa devletlerini birbirlerine daha çok iterek ekonomik çıkarlarının, Avrupa bütünleşmesinde yeni bir ever olan Avrupa Parasal Sistemi (APS) çatısı altında bütünleşmesini sağladı. 2000’li yılların başında Avrupa ortak para birimi olan Euro’nun doğuşu, birleşmiş bir Avrupa’nın meydana getirdiği en övünülecek başarısı ve uluslarüstücülüğün odak noktasıydı. Avrupa Parasal Sistemi ve Euro; ‘*dışsal*’ olarak Avrupa’ya küresel ekonomide bir şans vermek, ‘*içsel*’ olarak ise politik anlamda Almanya’yı Avrupa’ya, ekonomik anlamda ise Avrupa’yı Almanya’nın sıkı kamu maliyesi politikalarına bağlamayı amaçlamıştı. Ancak, 2008 küresel finansal krizin, 2009 küresel ekonomik krizin ve 2010 Avrupa’daki devlet borcu krizinin beklenmedik gelişmeleri bu oluşumun gerektiği gibi çalışmadığı gerçeğini çok açık bir biçimde ifşa etti. Üstelik bu krizlerin Avrupa’ya faturası sadece finansal değil, politik ve sosyaldı. Bu tezin amacı; gelişmelerinin çok farklı aşamalarında olan 17 farklı ekonomiyi bir sepet içerisine koyarak aynı kurallarla yönetmeye çabalayan Avrupa Parasal Sistemi (APS) ve Euro’nun kurallarının gerçeklikten, sürdürülebilirlikten, güvenilebilirlikten ve yönetilebilirlikten en denli uzak oldukları, uygulanmalarının zorunlu kılınmamış ya da en hafifinin başarılı olmamış yanlarını, diğer taraftan Avrupa Parasal Sistemi (APS) ve Euro’yu kurtarmak için derme-çatma oluşturulmuş çarelerin bütünsellikten, Avrupa halklarının kabulünden uzak, dengesiz ve dengesizleştirici olduğunu, dolayısıyla da ekonomik olarak en güçlü üyesi olan Almanya’dan başlayarak en zayıf üyelerine kadar bir tür “tuzak”a dönüştüğünü sergilemektir.



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## INTRODUCTION

The first twenty years after the establishment of the European Economic Community (EEC) in 1958, could easily be characterized by much talk and little action in terms of integrating economies among member states. When the Community was set up, the international monetary system was that of Bretton Woods, which provided currency stability with the U.S. dollar as the dominant monetary standard. This system began to show signs of weakness in the late 1950s. By 1968-69, revaluation of the Deutschmark and devaluation of the French Franc threatened the stability of other European currencies.<sup>1</sup> The increasing instability in the international system and the perceived need to insulate Europe from the caprice of the dollar fueled a gradual growth in the interest towards a monetary integration. However, the fact that this need was perceived more by the French than by any other member, who were not keen on a confrontation with the United States, caused the debate fall short of any kind of serious joint action by the Six. (Wallace and Wallace 281) As a result, despite the first calls for a common currency at the Hague Summit in 1969 and the establishment of European Monetary System (EMS) in 1979, the Economic and Monetary Union (EMU) remained to be the biggest non-event in the Community. It took a powerful political catalyst -the breach of Berlin Wall in 1989- to sign the Maastricht Treaty in 1991 which had sealed the principles and timetable of Europe's common currency, once and for all. It all happened, however, in spite of persistent skepticism from economists -for whom European Union was not yet '*optimum currency area*'-, from bureaucrats -for whom European Union was not entitled to policy areas normally reserved for national governments-, and from citizens of Europe -for whom national currency was a crucial symbol of national identity and sovereignty. (Wallace and Wallace 279) The caution of the economists, bureaucrats and publics however, has usually been overcompensated by the enthusiasm of political leaders, who had seen EMU as an economic means to a political end, rather than an end in itself.

In economic terms, the European project itself has been largely Keynesian; accepting the state's role in the economy as an integral part of market correction and using fiscal tools to address social and regional discrepancies.<sup>2</sup> Through the spread of neoliberal policies in 1980s, however, EU's focused had shifted towards 'competitiveness'. In fact the Single Market project emerged against a background of a perceived loss of competitiveness in comparison to Japan and the United States in the mid-1980s. Eliminating fragmentation within the European market through predominantly "negative integration", such as removing trade barriers, was the initial step to compete in the global economy. However, strong neoliberal pressures had further pushed European governments to ignore social policies that had long been a part of the European project while embracing the European Monetary Union (EMU) and the Euro, as qualitatively new steps in European integration and centerpieces of supranationalism.

While *externally* EMU and Euro were designed to give Europe a chance in global economy, (Çarkoğlu and Rubin, 233) *internally* it aimed 'politically' cementing Germany to the Community while 'economically' cementing Community to the orthodox monetarist/fiscal policies of Germany.

In terms of decision-making, EMU and Euro, had considerable resemblance to earlier European integration initiatives. The gradual built-up of the momentum, steady expansion of political support base through coalition-building and isolation of the opponents, combined with functional spill-over effect of the single market program, reached to its peak once a Franco-German agreement had been reached on the subject. From then on the process appeared almost unstoppable, thus becoming a repetition of earlier patterns of European decision-making. (Wallace and Wallace, 293) Initiatives came from the very top and the role of personalities was absolutely crucial. The role of the institutions was essentially supportive, except for the Delors presidency when the Commission succeeded in entering the top league. One can hardly detect an important role played by the pressure groups. As for the public, initially they were not aware of the European integration project, due to lack of knowledge and communication. The first instance where the typical European citizen had felt the impact of the integration process was in 1992 when the borders were removed among the European Union member states. The second visible impact of the process on the ordinary citizen came in 2002 when the European single currency, the Euro, had replaced national currencies within those states in the Eurozone. Once the general public had got the gist of what's going on, however, they provided pessimistic feedback (Danes rejected Euro referendum and French accepted it with the slightest margin, Germans showed little enthusiasm for replacing their Deutschmark with a 'softer' currency), leaving questions of legitimacy unanswered. All in all, European debate on EMU have been set at the highest level, the negotiations of specific arrangements and everyday running of the monetary regimes have been entrusted to a small number of technocrats and central bankers. (Wallace and Wallace, 294)

Against all odds, Euro was successfully launched in 1999, only to become the second most important international currency after the US dollar. With a unified monetary policy and a single currency across the seventeen-country Eurozone, EMU became one of the Old Continent's grandest success stories, according to its supporters.<sup>3</sup> Today, however, the European Union, is going through its most serious crisis since its foundation in 1957. The steady progress towards '*ever closer union*' over the past fifty years was built on win-win logic. The nations of Europe felt that they were growing stronger and more prosperous by merging their fates. The creation of a single currency and the near doubling in the size of the Union between 2000 and 2007 fitted perfectly with the logic of globalization. Economic and political barriers between nations were being torn down. (Rachman 4) By the 2008 crash, the European Union had almost 500 million citizens and -taken as a whole- was the largest economy in the world. (Rachman 6) The Eurozone -alone- was making up one-fifth of the global economy with 320 million citizens, roughly equivalent to that of the U.S. Yet the rosy assessment of the Euro will

not be able to hide the fact that EMU was fundamentally a flawed project whose consequences would haunt Europeans for years to come. Introduced above all for political reasons, EMU has failed to bring sufficient economic convergence among its disparate members. Especially in the wake of the worst recession to ever hit Europe since the World War II, in 2008, the danger of running a single monetary policy for countries at different stages of development became steadily more visible. While the main goal of the decades-long struggle towards monetary union has been to shield Europe from U.S. financial intrusion, it has made Europe more vulnerable to international monetary turmoil. (Marsh 3)

Yet, it is often said that a near-death experience forces one to re-evaluate priorities and values. (Stiglitz 275) The European Union has been going through a near-death experience for nearly three years after the beginning of the recession and four years after the bursting of the mortgage bubble. The financial and economic crisis had presented a big and visible failure for the European project. (Rachman 280) This paper is an attempt to catch the ever faster moving events as they unfold and throw some light on how they had impacted the collective interests, both political and economical, of the European Union members, whether or not they, had and would, impair the ongoing integration process and what would be the expected outcomes borne out of Europe's strategy for tackling the current sovereign-debt crisis within the Eurozone. The first chapter will briefly examine the history of the economic and monetary integration within the European Union, which could be defined as a dialectical process between wider political objectives and market realities. (Wallace and Wallace, 280) It will dwell on the challenges which arose from the transfer of monetary and the exchange rate policies to the supranational level while fiscal policies were maintained at the national level.<sup>4</sup> The chapter will also investigate the interaction between economics and politics in an area where political imperatives often clash with the logic of international markets. This was true of the 1960s, when plans for European monetary integration were mainly used for rallying other Europeans behind the French challenge of the dollar standard. It was also true in the 1970s when the ill-fated attempt to establish EMU as a weapon to fight against possible dilutions of the Community after the entry of the British 'Trojan Horse'. It was even truer in the late 1980s, when EMU was used as the instrument of high politics *par excellence* to tie the German giant more tightly into the Community (Wallace and Wallace 292) after the unification of East and West Germany.

The second chapter will confront the challenge of summarizing the global financial and economic crisis in the midst of fast-moving events, focusing on, the causes of and responses to, those events on both sides of the Atlantic Ocean. The evidence is clear, however, that Europe was in denial about the crisis until Lehman's bankruptcy on September 15, 2008. Interestingly enough, European nations felt safely immune from the financial crises and actually, for a few heady months in the early days of the saga, Europeans felt they were leading the world. The European Union proclaimed itself as the leader of global efforts to combat climate change while being the first to demand and draft the new rules for

global finance. European politicians even announced the death of the “ultra-liberal” Anglo-Saxon economic model.<sup>5</sup> Soon enough, it turned out that the European Union was in even deeper trouble than the United States. Although there has been a chorus of calls for a Pan-European response to the crisis, both from Brussels and some prominent members, they had fell on deaf ears, especially those of Germany -the Union’s leading paymaster- on worries that most of those bills would fall on their shoulders.<sup>6</sup> Meanwhile, debt levels were soaring across the continent, when finally in February 2010 it became clear that Greece, with a national debt of around %115 of GDP, could no longer borrow from international markets. The threat that the sovereign debt crisis would spread across the Union, hitting countries like Portugal, Spain and Italy, forced the members to come up with a joint European approach in May, through creating a massive bail-out fund of almost \$1 trillion dollars that could be drawn upon by countries in an emergency. (Rachman, 184) The most cherished canons of EMU, like the ‘*no-bailout*’ rule and the ‘*independence*’ of the European Central Bank (ECB), “supposed” to be set in stone at the Maastricht Treaty, were all buried to the ground thanks to the makeshift rescue scheme. And, still, the Eurozone's weapon barely deterred the barbarians. (The Economists, 20 November 2010, 37) In early November, barely six months after the Greek bail out in May, a similar story was beginning to emerge in Ireland.<sup>7</sup> At an EU summit in Brussels, by the end of October 2010, German Chancellor Angela Merkel had won an agreement on limited rewriting of the Lisbon Treaty so a 'permanent debt-crisis mechanism' and 'sovereign debt restructuring scheme' could be established to deal with future Greek-style debt crises. Came 2011, the memories of European hubris seemed cruelly distant, thanks to numerous government interventions in the economy, state aids, protectionist reflexes, a terrible recession, three Eurozone country bail-outs, unprecedented social unrest, lurking austerity measures and a treaty revision looming ahead. The chapter -as a whole- will attempt to disclose how the reconciliation of different interests did occurred among the member states, taking into account the “weighted power” of the larger states. The final chapter will dwell on how sudden external shocks, like the 2008 downturn exported by the United States, impacted the collective and individual interests of the European Union member states, how it had highlighted the divergent policy preferences of the European Union member states, and thus, effected the ongoing European integration process, what kinds of structural problems, technical shortcomings, inadequate policies and insufficient mechanisms it had exposed and whether or not they remained to be challenges to the system.

Indeed, having a single currency and monetary integration among the European Union member states, was a brilliant idea. While the Euro was not an explicitly anti-American currency, underlying entire European project had always been a sense of building a genuine rival to the overwhelming power of the United States. No European currency on its own could ever hope to match the power of the dollar - not even Deutschmark and certainly not the French Franc or the Italian Lira. Their economies were simply too small compared with the scale of the United States’. But the Euro had a chance. And right

from the start, it became a natural rival for the dollar. It had allowed European leaders to finally escape from U.S. financial dominance, (Lynn 155) at least for a decade. Despite being a brilliant idea, however, EMU was actually pursued by wrong motivations, which were mostly political. This fundamental flaw, made its' creators missed the point that the whole project, as the name suggests "the economic and monetary union", was supposed to stand on solid economic foundations. Unfortunately, despite Germany's initial insistence over the 'Convergence Criteria' for being a Eurozone member and the 'Stability and Growth Pact' for staying one; were both fiddled with, by founding members like France, Germany, Portugal and Italy, not to mention Greece's continuous frauds. The controversy about the truants from the Stability and Growth Pact, ineffective rules that govern EMU and almost non-existent punishment mechanisms were only one part of the problem; more damaging to its future was the serious questions raised about its appropriateness in meeting the needs of all the members alike. An economic straight-jacket made up of German fabric, carelessly imposed on the divergent economies of the European Union would certainly not sustain a common currency indefinitely. Of course, as long as there were no external shocks, EMU would do just fine, hiding its institutional deficiencies and asymmetries. But in its first real test, provided by the recession of 2008, the whole system appeared to be coming apart, (Stiglitz 322) to prove the difficulty of linking divergent economies, without enough economic integration and a centralized fiscal policy. It may, therefore, be rather unfortunate for leaders of the Union that the markets and economic fundamentals do not always adjust themselves to the exigencies of their high politics. (Wallace and Wallace, 280) Solemn decisions taken at the highest level are usually not strong enough to survive the adverse economic conditions of their times; be it the oil crisis of 1970s, the economic recessions and inflation of 1980s or the financial and economic crisis of late 2000s. Another reason for EMU being a brilliant idea executed badly, was its half-hearted adoption by its protagonist -Germany- at the political, bureaucratic and public levels. Despite having a 'Single Currency' looked like a direct result, a natural functional spill-over, of having a 'Single Market', the whole scheme was actually part of a grand *quid pro quo*, a painful compromise for Germany, tremendously jealous of its central bank and currency.

European integration is surely a difficult idea which has not been tried before, since probably the Hanseatic League, an early example of the principles on which the European Union was founded -that commercial and cultural interchange builds common interests between peoples and that such interchange raises the costs of conflict, facilitates compromise and fosters cooperation. The Hanseatic cities symbolized the principle of '*doux commerce*' about which Montesquieu would later write: '*nations that traffic with each other become reciprocally dependent; and their union is founded on mutual necessities.*' For a long period in the 14th to 16th centuries, the core cities of the Hanseatic League -Lübeck, Hamburg, Lüneburg, Wismar, Rostock, Stralsund- shared a common currency, the 'Lübische Mark'.<sup>8</sup> Today, Eurozone countries are in the *avant garde* of this process. Just like Union's other 'quantum leap's towards supranationalism, the economic and monetary integration has been a

very dialectical process. At the moment, it looks like a failure. But that does not indicate that it would not be healed. As history tells us, European integration is a cumbersome process that routinely stumbles upon crises threatening to destroy it, only to find that the crisis has served to deepen it.<sup>9</sup> Curiously enough, Europe always finds a way out. In the case of EMU, Europe's solutions ranged from the Snake in the Tunnel of early 1970s, to the European Monetary System (EMS) / Exchange Rate Mechanism (ERM) of late 1970s, and the Economic and Monetary Union (EMU) / Euro of 2000s. Thus, one could expect the current financial and economic crisis to either leave European financial integration in tatters or quicken the development of European fiscal capacity. The real test for European governments and institutions comes when faced with the most difficult of circumstances.<sup>10</sup> The evidence so far indicates that, painfully slowly but surely, the 'individual salvation' is not being a real option, dawns on the political and bureaucratic elite. The peoples of Europe, may not be there yet. But they might, in the future, be reappraising the value of cooperation in difficult times, realizing that being together in a large single ship -in an *ever closer union*- is better than sailing on a small vessel in the turbulent waters, to use the infamous seafaring metaphor. It looks like, Europe would get out of this mess by being Europe: by bickering, compromising, doing less than required, doing it slowly<sup>11</sup> and yet, miraculously ensuring that all parties act in a way that serves our common interest.



# CHAPTER 1: THE HISTORY OF THE ECONOMIC INTEGRATION IN THE EUROPEAN UNION

## 1.1. Shielding Europe from the caprice of the US dollar: Initial interest towards EMU

*A continental currency, with a dual metallic and fiduciary base, resting on all Europe as its capital and driven the activity of 200 million men; this one currency would replace and bring down all the absurd varieties of money that exists today, with the effigies of princes, those symbols of misery.*

**Victor Hugo, 1855**

While the Rome Treaty signatories had a monetary union in the back of their minds in 1957<sup>12</sup>, the treaty itself contained very little in terms of binding constraints regarding macro-economic policy, limiting itself to wishful thinking on coordination of policies. (Wallace and Wallace 281) The six founding member states of the European Community (EC) were participants in the Bretton Woods international monetary system, which<sup>13</sup> was erected at the end of the World War II and retained gold as the ultimate source of value. The only currency directly tied to gold was the dollar (at the pre-war parity of \$35 per ounce of gold) while all other currencies were defined in terms of the dollar. Exchange rates were 'fixed but adjustable'. (Baldwin and Wyplosz 303) The main goal of the system was to avoid a repetition of the trade protectionism and competitive currency devaluations of 1930s, which intensified the Great Depression and sowed the seeds of war.<sup>14</sup> Thus, in early 1960s, the creation of a parallel system was deemed unnecessary by the Community, especially at a time when Keynesianism was still at its peak and national governments were zealous in retaining the independence of their monetary and fiscal policies for the pursuit of economic objectives. (Wallace and Wallace 281)

Threatening the entire political balance of Europe, the 1961 revaluation of the Deutschmark set alarm bells ringing in the European Commission since changes in European currency parities risked distorting the farm support prices in the Common Agricultural Policy (CAP), entering into force in 1962. In October 1962, the Commission argued for a permanent fixing of EEC exchange rates, creating the first inclinations towards an economic and monetary union (EMU). (Marsh 38, 39) Not everyone agreed. During late 1960s, however, enormous speculative pressures on both Sterling and Franc, reinforced the need for better cooperation in money matters throughout the Community. In November 1967, Britain's three-year campaign against devaluation of Sterling came to an end when the currency lost its value by %14 against the dollar. (Marsh 46) After Sterling's stabilization, exchange markets sensed a new victim: the Franc which had become overvalued against the

Deutschmark. It had seen an intense attack of selling, triggered by the social unrest erupted following the revolts of May 1968. (Marsh 47) In November 1968, maneuvered into a corner by the Germans, French finance minister reluctantly agreed on a 10% Franc devaluation against Deutschmark, at the meeting of central banks governors and finance ministers in Bonn, only to be blocked by French President Charles de Gaulle who regarded a strong currency as a sign of virility. The European Commission attempted to turn the turmoil into a springboard for a common currency, by suggesting to pool Community foreign exchange reserves, as a means of collecting common ammunition against speculation, could have prevented the crisis. However, Germany's legendarily independent central bank, the Bundesbank, led its peers to contradict the idea. According to Bundesbank president Karl Blessing such an action would require member states to give up sovereignty in other areas, 'for which they were evidently not ready'. (Marsh 48)

However, de Gaulle's generous wage settlement with the unions and his loose monetary policy to boost economic recovery had caused high inflation and a deteriorating balance of trade in France.<sup>15</sup> When his successor Georges Pompidou came to power, currency markets were convinced that the long-delayed parity changes between Franc and Deutschmark were only a matter of time. The result was a run on the Franc, which in August 1969, forced Pompidou's finance minister Valery Giscard d'Estaing to devalue Franc by %11 against Deutschmark. This was the first of three progressively more humiliating currency decisions carried out by Giscard – driving him towards the monetary union. The long-overdue step of the August Franc devaluation increased expectations that a Deutschmark revaluation might follow up, channeling fresh capital inflows into the Deutschmark. On October 1969, the German government under Willy Brandt decided a %9 revaluation of the Deutschmark against the dollar. (Marsh 49) The move confirmed the Bundesbank as the toughest monetary institution on the international scene, in charge of an economy that had re-emerged as Europe's powerhouse. German gold reserves comfortably outstripped those of France and were three times Britain's. For the French it was distressingly evident who was in charge. In a decade-long wrangle with the great powers of international finance, France finished on the losing side. (Marsh 50)

## 1.2. Much Ado about Nothing: Early Plans for EMU

*“After Hitler, Auschwitz and the Postdam agreement (dividing defeated Germany into zones of occupation) the German political class cannot be considered for European leadership”*

Helmut Schmidt

In December 1969, the Heads of State and Government agreed on a crucial breakthrough at the Hague Summit for deeper integration, notably via economic and monetary union (EMU) and enlargement.<sup>16</sup> This was the first time a complete EMU target -directly linked to the first enlargement of the Community- was adopted by political leaders. The Hague summit reached an agreement on both the admittance of the United Kingdom into the Community and the progressive transformation into an economic and monetary union -with little agreement on how to get there. (Wallace and Wallace 281, 282) Germany's new Chancellor Willy Brandt supported Pompidou's idea of closer monetary policy coordination if only to demonstrate Germany's commitment to the Community to weather concerns over his ambitious initiative toward Eastern Europe, known as the *Ostpolitik*. But the chancellor would not consider monetary cooperation in isolation. An ingrained fear of inflation led him also to urge greater economic convergence. (Dinan 59) In an attempt to conceal the differences of monetary approach, surfaced at the Hague, the Community asked Luxembourg prime minister Pierre Werner to convene a high-level committee to construct a detailed blueprint for EMU. The overarching aim was to protect Europe's interests against perceived American indifference or even hostility while striking a counterbalance for Germany's economic and industrial strength. (Marsh 51)

Late 1960s had seen an economic decline for France, while Germany surged ahead. Germans were also politically assertive under Brandt's government. Gone were the days of Chancellor Konrad Adenauer's subservience to the President Charles de Gaulle. Germany's refusal to arrest the declining value of the Franc by revaluing the Deutschmark and the *Ostpolitik*, emphasized the point. The combination of Germany's economic power and rising political confidence made British accession a more appealing prospect for Pompidou, who was in a far weaker position than de Gaulle to veto British membership, since recent economic difficulties (Dinan 57) and political fiascos, like the May 1968 unrest and the “empty chair crisis”, had lowered France's international standing. Thus, after seven years and two consecutive rejections, Britain was suddenly in demand. The Germans believed that a tie-up with the U.K. would prove France that Bonn's attentions were not universally with the East. (Marsh 53) And from the French point of view, Britain's well-known suspicion of supranationalism was a source of comfort, since once in the Community, Britain would surely support French gradualist position (Dinan 60) and counterweight Germany's growing strength. Thus,

abandoning de Gaulle's anti-British blockade, Pompidou launched the Community's first expansion, designed to bring in Britain, Ireland, Denmark and Norway. (Marsh 50)

In May 1970, the Federal Reserve (FED) had switched to the policy of cheap money, (Marsh 56) reducing interest rates in the United States. Maintaining low interest rates was one of the critical ways that countries "managed" their exchange rate (when interest rates were low, capital would flow out of the country to places where it could get a higher return) and many in Europe believed that the United States would be using low exchange rate to get a competitive advantage. (Stiglitz, 2010, 227) And the resulting run on the dollar, in favor of the more stable Deutschmark, (Dinan 64) marked Germany as the target of speculative international capital. (Marsh 51) For Bundesbank, inflows of capital into Germany represented a potent source of inflation. Thus the bank attempted to stop the tide with progressive cuts in interest rates, but with each step the FED cut its own rates further. (Marsh 56) Such aggressive US monetary policy, known as the '*benign neglect*' was provoked and nurtured by wider European-American suspicions and antagonism at the time. (Marsh 51, 52)

In October 1970, the Werner Plan proposed a three-staged plan to create economic and monetary union with a target implementation date of 1980. The plan foresaw the eventual transfer of budgetary and monetary responsibilities to Community institutions, under the surveillance of a reformed European Parliament. The first stage of the process was relatively clear-cut: reduction of permitted currency fluctuations. So was the final stage: irrevocable fixing of exchange rates, convergence of economic policies and establishment of a Community system of central banks. European central banks reacted unenthusiastically. (Marsh 54) France's desire for speedy moves towards currency fixing and reserve-pooling conflicted with a dawning German belief that more currency flexibility was required. Equally, Germany's demands for tightly-coordinated economic policy required much more supranational decision-making than the French taste. (Marsh 53) In January 1971, Pompidou met Brandt to repair divergences. (Marsh 56) He went to great lengths to comply with the German conditions, declaring that Germany could be relieved of its obligations to intervene to support weaker currencies, at times of crisis. Yet, Pompidou -a staunch intergovernmentalist as an apprentice to de Gaulle- was not ready to give up economic sovereignty and permit supranational control of economy. France, together with Britain, also feared being locked to an over-strong Deutschmark, weakening their export competitiveness. In March 1971, EC governments adopted the Werner Plan, yet avoided a firm timetable for monetary union, disregarding the original ten-year time frame. (Marsh 57)

On August 15, 1971, Nixon's unilateral termination of the dollar's convertibility to gold<sup>17</sup> practically ended the Bretton Woods system, followed by a period of flexible exchange rates. The chaotic situation of world's currencies floating violently against one another seriously destabilized European markets by crucifying the manufacturers. European companies had no idea of what they would end up

paying or whether they could make a profit by exporting. There wasn't much point in taking down trade barriers between the countries if they would remain reluctant to trade because of exchange rate uncertainties.<sup>18</sup> In early 1972, the U.S. intensified dollar unilateralism, with deep interest rate cuts to boost the economy. As a result, capital inflows accelerated into Germany, prompting Bundesbank to lower interest rates and enact capital controls to prevent German companies from borrowing abroad. The general instability and American actions once again pushed Brandt and Pompidou towards one another to restore momentum towards EMU, by re-launching the plan for narrower exchange rate fluctuation margins. In April 1972, the response of the two men was to create the "Snake in the Tunnel", as a regional system to limit intra-European exchange rate fluctuations (the Snake) inside narrow limits against the dollar (the Tunnel).<sup>19</sup> Under Bretton Woods, most of the world's currencies were pegged to the dollar and the dollar was pegged to gold. Devaluations were periodically allowed to cope with economic shocks but, in general, currency rates remained stable over long periods. Under the Snake, the EC members attempted to replicate that system; although their currencies floated against each other, exchange rate fluctuations would be permitted to maximum %2.25, by market intervention if necessary. The idea was that while there might be frantic volatility against other major currencies, the EC currencies would never move very much against each other. It would also meant that the different Snake currencies would behave as a single block. If the Deutschmark started to move up against the dollar, then so would the Sterling, the Franc and the Lira because all the different European currencies were in effect linked to one another. (Lynn 16, 17) In May 1972, the prospective EC members; U.K. and Ireland, had joined the Snake only to leave in June 1972, after a wave of international selling of the Pound causing reserve losses of \$2.6 billion in a week, through forced intervention sales to prop up the British currency. (Marsh, 60)

The demise of the Bretton Woods system, followed by worsening oil crisis, coupled with soaring inflation, rising unemployment and yawning trade deficits shook the Community to the core in early 1970s. (Dinan 70) The member states reacted to these economic troubles in different ways, which led to frequent and sharp fluctuations in exchange rates.<sup>20</sup> Worried about the consequences of currency fluctuations for the CAP, Pompidou put EMU high on the agenda of Paris Summit scheduled for October 1972. In response to Pompidou's call for exchange rate stability, Brandt stressed the importance of anti-inflationary measures. (Dinan 65) Two years of wrangling over the dollar had proved a costly distraction from Bundesbank's prime focus, with prices rising at an annual %7.5 in early 1973. In the summer of 1973, Bundesbank stepped decisively on the monetary brakes and proposed a dramatic program of spending cuts and tax freezes. In June 1973, the 'crush the inflation' mentality of the package had the desired effect of curbing Germany's economic overheating and brought about a %5.5 revaluation of Deutschmark within the Snake. (Marsh 65) As Deutschmark pushed through the top, as a result of Germany's low inflation and trade surplus, the Sterling, Franc and Lira fell through the bottom, weakened by their countries' high inflation and large trade deficits.

(Dinan 74) As pressure grew on its foreign exchange reserves, France would no longer maintain exchange rate fixity with the Deutschmark, (Baldwin and Wyplosz 304) thus in January 1974, French Finance Minister Valéry Giscard d'Estaing declared that France was withdrawing from the Snake. (Marsh, 66) In September 1974, in an effort to repair the damage brought about by its departure from the Snake, French Finance Minister Jean-Pierre Fourcade proposed a 'European monetary union re-launch', involving a basket of Community currencies as a new unit of account to counterbalance the Deutschmark. The Fourcade Plan for 'greater symmetry' (the French code word for reduced German influence), had been rejected by the majority of the member states. (Marsh 74) In July 1975, to regain the center stage of European monetary affairs, France returned to the Snake. However, in March 1976, after losing a quarter of its reserves in a week's heavy intervention to protect the Franc, Giscard was forced to announce, for the second time, that France was leaving the Snake. (Marsh 75)

It soon became clear that the Snake, while being the most concrete manifestation of the first stage of EMU, was not equipped to survive the early 1970's hectic conditions, increasingly divergent economic policies and inflation rates. What's left of the ambitious plan for EMU was only an injured Snake, wriggling its way in the chaotic zoo of international exchange markets. (Wallace and Wallace 282) This was the end of the road, for the embattled group of British, French and German leaders who had struggled for four years to reconcile irreconcilable positions on EMU. (Marsh 67) By the end of 1977, only five of the then nine member states (Germany, Belgium, the Netherlands, Luxembourg and Denmark) remained within the mechanism, while others decided to allow their currencies to float freely. The Werner Plan was abandoned the same year. (europarl.europa.eu) Since majority of EC currencies had left the Snake, the system, originally designed as an agreement of Community scope turned into a *de facto* German bloc, in which European currencies were tied to the Deutschmark. This was the first concrete manifestation of the growing importance of Germany in the Community. (Wallace and Wallace 282)

In December 1977, the European Council leaders re-launched efforts towards EMU by asking the Community's finance ministers to make a 'through study' on the issue. In February 1978, Commission President Roy Jenkins's cause to revive interest in EMU suddenly converted Schmidt, as a persistent depreciation of the dollar and a corresponding appreciation of the Deutschmark cut German industrial competitiveness and fed speculation that a US economic recovery was happening at the expense of German prudence and prosperity. What Schmidt had in mind was establishing a quasi-fixed exchange rate regime, later to be called the European Monetary System (EMS), for several reasons: to shield European Community members from 'dollar disasters', to reduce the importance of dollar in world reserves, to safeguard German exports by holding down the rising Deutschmark and to take further steps towards economic and monetary union. (Marsh 79) Also, mindful of past catastrophes, Schmidt believed that playing down Germany's growing economic might by emphasizing currency cooperation

would prevent his country to fall into dreadful isolation. (Marsh 69) Schmidt's crucial collaborator in this grand design was Giscard, frequently torn between his own pro-European leanings and his need to maintain favor with the French Gaullists who were suspicious of Germany's re-acquired economic muscle and jealously opposed giving power to European institutions. (Marsh 72) Both leaders saw large exchange rate movements as a direct threat to the Common Market and were alarmed by the inability to sustain the Snake arrangement. But political sensitivities were still important. Germany would never risk weakening its star currency, the Deutschmark, while France could not be seen to be playing second fiddle to Germany. Plus, Britain was still staunchly opposed to a fixed exchange rate regime while the smaller countries had to be brought along. (Baldwin and Wyplosz 333) Although closer monetary coordination and eventually EMU, were cherished EC objectives, the EMS was not based on the Rome Treaty. Nor did it emerge from a Commission proposal. Yet, in July 1978, with Schmidt's forceful chairmanship of the Bremen Summit, the Franco-German proposal for an Exchange Rate Mechanism (ERM) at the heart of the EMS was accepted. (Dinan 79, 80)

In December 1978, at the Brussels Summit, the Heads of State and Government agreed on setting up the European Monetary System (EMS), aimed to out to establish a zone of relative monetary stability in a world of wildly fluctuating exchange rates (Dinan 77) and thus provide a more solid foundation to the Common Market which remained at the center of European integration. (Peterson and Shackleton 173) They had established a subtle distinction between the EMS, of which all European Community countries were *de facto* members and the Exchange Rate Mechanism (ERM), an *optional* scheme of jointly managed fixed and periodically adjustable exchange rates, resting on four main elements: a grid of agreed-upon bilateral exchange rates with a fluctuation band of +/- %2.25 around central parities, mutual support, a commitment to joint decision of realignments and the European Currency Unit (ECU). EMS/ERM worked in much the same way as the Snake, stabilizing exchange rates between the members, while allowing them to fluctuate against the rest of the world's currencies. (Lynn 18) In March 1979, the EMS became operational, effectively starting the monetary integration in Europe.<sup>21</sup> All the member states joined its only meaningful part, the ERM, except for Britain, fearing to lock itself into the wrong exchange rate. This was an understandable move, as Britain shared neither the economic nor the political goals associated with the EMS. (Wallace and Wallace 283) However after the EMS breakthrough, disillusionment soon set in. The oil price rise caused by the first stirrings of the Iran-Iraq war in 1979 brought higher inflation and a threat of recession. Just as the 1973 oil price tempest wrecked the Snake, the second energy shock six years later severely buffeted the EMS in its opening phase. (Marsh 88) EMS was not a remedy to the currency adjustments within the Community either. In June 1982, France had faced yet another attack of weakness on the foreign exchanges, (Marsh, 97) forcing two consecutive Franc devaluations against the Deutschmark within the EMS. Since departure from the EMS would have robbed France of crucial leverage over Germany, Mitterrand kept France in the EMS as a *quid pro quo* for a substantial Deutschmark revaluation.

(Marsh, 100) On March 1983, his French finance minister Jacques Delors succeeded in browbeating the Germans into a %5.5 Deutschmark revaluation, a move that allowed France to save face with a Franc devaluation of only %2.5. (Marsh, 101) However, it soon became clear that, rather like the Snake, EMS worked only in good times. (Lynn 18)

### 1.3. The Great Bargain: “Deutschmark” vs. “Europe”

*“You will not stop the German people following their destiny”*

Helmut Kohl

In January 1985, the Commission proposed realizing the objective of a market without internal frontiers by the end of 1992. The detailed measures for the removal of physical, technical and fiscal barriers were set out in a White Paper, which specified the precise program, timetable and methods for creating a unified economic area in which persons, goods, services and capital could be able to move freely.<sup>22</sup> The sense of excitement felt for the successes of the Single Market program in moving towards dismantling barriers to trade forged a logical link with a single currency. The resulting support for further integration caused France President François Mitterrand and German Chancellor Helmut Kohl to discuss, for the first time, the notion of a common European currency during the autumn of 1985. Kohl told his counterpart that he agreed with establishing a European currency ‘as the logical conclusion of all that we are trying to construct’. However the chancellor reminded that the Germans would have to give up a great deal: *“Deutschmark is our flag. It is the fundament of our post-war reconstruction. It is the essential part of our national pride; we don’t have much else”* (Marsh 106) In December 1985, the Luxembourg Summit had seen Community leaders agreed on the Single European Act with the ultimate goal of an economic and monetary union. Even Britain’s stridently free-market conservative prime minister Margaret Thatcher, agreed –together with Germany- to inscribe the EMU objective into the Single Market treaty in a compromise to encourage other countries, predominately France, to sign up to a comprehensive liberalization program that would include ending restrictions on capital movements. (Marsh 110)

In March 1986, Jacques Chirac became the French prime minister under Mitterrand’s presidency. Chirac’s appointee as finance minister -effectively No. 2 to the prime minister- was Edouard Balladur, born in Turkey of an Armenian family who immigrated to Marseilles in the 1930s. The new Paris government came under immediate pressure as fresh flows of international funds poured into the Deutschmark, forcing the Franc fell victim to the switch in currency market sentiment. (Marsh 111)



When Balladur proposed a %8 to 9 reduction in the Franc's value against Deutschmark, member governments believed the proposal would give France an unfair boost of competitiveness. After the usual realignment bargaining in Brussels, finance ministers agreed to %3 Franc devaluation and %3 Deutschmark revaluation. But the realignment brought only a brief relief, as news of a further rise in France's trade deficit with Germany abound. In spite of falling consumer prices in Germany (for the first time since the country was established in 1949), Bundesbank maintained interest rates well above %3.5 discount rates, to stop fast-growing German money supply. In January 1987 Chirac and Balladur openly criticized the Germans' 'egoistical' monetary behavior and called for the Bundesbank to cut interest rates. Chirac declared that the currency turbulence was the Germans' fault. (Marsh 112) In June 1987 Balladur, an enthusiast for European monetary initiatives, proposed a European Central Bank as the ultimate means of achieving better European monetary balance. (Marsh 113) A common central bank all of sudden sounded not so bad, thanks to the fundamental asymmetry in the EMS, causing Deutschmark to be explicitly referred to as the 'anchor' of the system. (Wallace and Wallace, 286) During the first ten years of the EMS, inflation rates diverged markedly in Europe. With fixed nominal exchange rates, the result was chronic misalignments. Unsurprisingly therefore, realignments were frequent and usually involved several currencies at a time. Between 1979 and 1987, realignment occurred no less than twelve times, once every eight months on average. This process was a bit too transparent, allowing the exchange markets to easily foresee the next realignment and speculate accordingly. The answer was to reduce the inflation differentials. Germany, the largest country with the lowest rate of inflation, naturally became the example to follow. As the other countries undertook to emulate its monetary policy, Bundesbank gradually emerged as the center of the system. After 1986, each country was trying to anchor its currency to the Deutschmark and realignments became rare. However, convergence to the Bundesbank standard meant that, except for Germany, all countries had in effect lost monetary independence. As a result other countries became eager to move to a monetary union and replace Bundesbank with a common central bank as a way to recover some influence over monetary policy. (Baldwin and Wyplosz 304, 306)

Both the Snake and the EMS/ERM were conceived as zones of European currency stability to protect the continent from the hazards of floating exchange rates. But, as controls over flows of international capital were progressively eased from the 1980s onwards, leading to enormous increases in the mobility of funds, both European monetary arrangements were prone to frequent, increasingly politicized, currency upsets. Additionally, both the Snake and the EMS became ever more dominated by the Deutschmark as the 'anchor currency', in line with the growing strength of Germany's economy. In a world where fixed exchange rate systems were becoming ever more vulnerable to marauding flows of international capital, a succession of currency strains confirmed European governments' view that the EMS was not and could never become a permanent recipe for stability. (Marsh 7) But much more important than the ineffectiveness of EMS system, behind French President

François Mitterrand's quest for rejuvenating EMU ideal, laid both a sharp and long-held prediction of German unity -nearly a decade before the fall of Berlin Wall- and suspicion of how it might misuse its economic power. (Marsh 94) Mitterrand recognized that, although West Germany's economic prowess was growing; the country was still beset by fundamental weakness as a result of diminished sovereignty and national partition. The president's inventive mind started to assemble the ingredients of a political trade-off between Germany's monetary superiority, as symbolized by the status of the Bundesbank and the Deutschmark and France's strength in military and defense matters, as underlined by its ownership of nuclear weapons and position in the Second World War alliance that maintained formal leverage over divided Germany. (Marsh 98, 99) In January 1988, realizing that the 'policy of small steps' had run its course, convinced his German counterpart that high profile action was required. In May 1988, backing French plans for an accelerated European convergence, German Chancellor Helmut Kohl, pressed the Community to launch full-scale EMU preparations. In early June, France agreed to the lifting of controls on movements of investment funds throughout the Community, as a key component of the Single Market program. (Marsh 118) In late June, with Mitterrand's forceful and Kohl's lukewarm support, the European Council in Hanover, charged the Commission President Jacques Delors – a key protagonist in the revival of the single currency project – with developing a plan for Economic and Monetary Union. (Peterson and Shackleton 173)

In April 1989, the Delors Report was delivered to the European leaders whose conclusions would form the basis for the subsequent Treaty on European Union, signed in Maastricht in December 1991. (Peterson and Shackleton 174) The report laid down EMU objectives as combining complete liberalization of capital movements, full integration of financial markets, irreversible convertibility of currencies and irrevocable fixing of the exchange rates. It had proposed a new, federal and autonomous Community monetary institution, possible to be called the European System of Central Banks (ESCB), consisting of a central institution (with its own balance sheet) and the national central banks. The ESCB should be committed to the objective of price stability and stay independent of the instructions of national governments and Community authorities. (Marsh, 120) In June 1989, at European Council's Madrid Summit, the twelve European Community leaders -including Thatcher- endorsed the Delors's three-staged approach to EMU and agreed that Stage I, involving greater coordination of member states' macroeconomic policies, the establishment of free capital movement and membership of all EC currencies in the EMS, should begin by July 1990. (Dinan 114).

Although strong support from Belgium and Italy were readily available, the driving force for the latest re-launch of EMU came from Brussels (Jacques Delors in particular) and Paris. (Wallace and Wallace 293) France was the most powerful proponent. Only if monetary policy decisions were taken on an EC-wide basis, the thinking in Paris went, could France hope to regain some of the influence it had lost to Germany in EMS, because of the Deutschmark's predominance in the exchange rate

mechanism. For precisely that reason, Kohl was equivocal about EMU. (Marsh 130) Thus, initially Germany showed little enthusiasm: since both the government and the Bundesbank were happy with the *status quo* and any move towards monetary union was perceived, quite rightly, as leading to an erosion of Germany's independence in the monetary field. What latter tipped the balance was the perceived need to reaffirm the country's commitment to European integration in the wake of German unification. (Wallace and Wallace 293) Meeting privately, Mitterrand and Kohl sketched out a trade-off between the Deutschmark and Europe. Kohl told the president: *“Abandoning the Deutschmark is a great compromise for the Germans. Opinion is not ready yet!”* Mitterrand retorted: *“You are moving towards German unification. You must continue to show that you believe in Europe”* (Marsh 130)

In the second half of 1989, immediately before the fall of the Berlin wall, Kohl put on the brakes towards monetary union as Germany's own preoccupations -including the unrest in East Germany- took priority. (Marsh 134) Both France and Britain had similar concerns about the speed of German transformation. Mitterrand told Thatcher in early September: *“I believe only the European Union can contain this German power. Without a common currency, we are – you and us – already subordinate to the Germans' will. If they increase their interest rates, we are obliged to follow suit. And you do the same thing even though you are not in the monetary system! So the only way of having the right to speak is to establish a European Central Bank, where one will take decisions jointly.”* Thatcher was not convinced. Three weeks later she took her skepticism to Moscow, attempting to persuade Gorbachev to join U.K. (and France) in preventing unification. Relations between Mitterrand and Kohl turned icy in October 1989 when Mitterrand told the chancellor that he wanted to speed up Economic and Monetary Union and Kohl citing his 'extremely difficult position' at home, said the time was 'not ripe' for the single currency. Exuding cold anger Mitterrand told that the French government would launch the EMU timetable during the European Summit at Strasbourg in December: *“You need to make up your mind”*. In early November 1989, Kohl attempted to explain the president his apparent hesitancy on EMU on the grounds that a political 'campaign' against monetary union was under way in Germany. On 9 November 1989, the East German authorities announced that ordinary citizens could travel across the internal Berlin border. (Marsh, 135, 136) On 18 November at a stormy dinner for Community leaders at the Elysee Palace, Kohl recalled the long-standing NATO commitments to a unified Germany. Thatcher replied that this assurance dated from a time when no one believed reunification was possible. When Kohl told her *“You will not stop the German people following their destiny”*, Thatcher 'stamped her foot in rage' – an outburst of truculence that, Kohl observed, appeared to find Mitterrand's approval. Two days later Mitterrand told the German foreign minister that Germany was no longer a 'motor' but a 'brake' on European integration, thus playing into Thatcher's hands. The sudden prospect of German unification following the breach of the Berlin Wall forced Mitterrand to call on Germany to agree for serious negotiations on EMU before 1990 ends or risk a

'Triple Alliance' between France, Britain and the Soviet Union that could isolate Germany to the eve of the First and Second World Wars. Under this extreme threat, Kohl backed down. (Marsh 137)

On 8 December 1989, European leaders meeting in Strasbourg agreed to start preparations on the EMU intergovernmental conference in summer of 1990. The summit had a 'tense and unfriendly' environment which appeared to push Kohl towards EMU far more rapidly than it wanted. While Dutch prime minister voiced misgivings about German unity, Italian prime minister warned against 'pan-Germanism', and Margaret Thatcher declared: "*Twice we beat the Germans, now they are there again.*" Days after the summit, the chancellor told US Secretary of State James Baker: "*I am supporting EMU even though it is against German interests. But the step is politically important, for Germany needs friends*". (Marsh 138, 139) However, Germany had two important *quid pro quos* for EMU; a central bank modeled after Bundesbank -whose inheritance of 'anti-inflation' and 'political independence' were linked to prevention of the economic waywardness which had promoted the rise of Hitler in the 1920s and 1930s- (Marsh 35) and a close political union among Community members. (Dinan 118, 119) The reasoning was simple; Germany had the most to lose from EMU and most to gain from a political union. By agreeing to EMU, Germany would be giving up the Deutschmark and surrendering control over European monetary policy, which it currently enjoyed in the EMS. In return, Germany wanted an EU with a familiar federal system of government in which a more powerful European Parliament (EP), with a large German contingent, would play a greater legislative role. France, on the other hand, wanted EMU at almost any cost, while holding reservations about political union. French government opposed giving the EP any more power and sought a stronger Council. (Dinan 118, 119) Gradually a *quid pro quo* started to emerge and in June 1990, the Community agreed to start two intergovernmental conferences – on EMU and political union. In October 1990, eager to gain strategic hold over the newly-formed monetary contours of Europe (Marsh 141) Britain entered the Exchange Rate Mechanism, eighteen years after it left the Snake in 1972. (Marsh 133) In early 1991, national delegations gathered in Brussels for the EMU intergovernmental conference.

## 1.4. A Single Currency for a Single Market

*“What are you saying? So you want me to go to Her Majesty the Queen and explain to her that, in a few years, her picture will no longer be on our banknotes?”*

Margaret Thatcher, Prime Minister of United Kingdom, 1990

In December 1991, the signing of the Maastricht Treaty, by the Heads of State and Governments of the member states, had sealed the single currency timetable, marking the end off a three-decade-long road to achieve monetary union. (Baldwin and Wyplosz 380) While its motivations were manifold; EMU constituted the most important and concrete part of the Maastricht revision of the treaty as the Treaty on European Union (TEU). (Wallace and Wallace 280) The main economic benefit was straightforward: the more trade and investment activity across Europe, the more desirable a single currency eliminating the risks to business associated with fluctuating currencies. Actually, the Commission's report *One Market, One Money* stated that 'Indeed, only a single currency would allow the full potential benefits of a single market to be achieved'. (Peterson and Shackleton 172) The part of the Treaty devoted to the EMU, committed members to a transfer of national sovereignty over monetary power to a supranational body, the European Central Bank (ECB) and abandonment of their national currencies for the irrevocable decision to adopt a single currency by 1 January 1999. (Baldwin and Wyplosz 22) However, when the Maastricht Treaty was under preparation, the macroeconomic situation of members differed widely. Germany, deeply attached to price stability, was concerned that EMU would be inflationary if the participating economies were not adequately prepared. (Peterson and Shackleton 174) It insisted that admission to the monetary union would not be automatic. A selection process was designed to certify which countries had adopted a 'culture of stability', meaning that they had durably achieved German-style low inflation. To join EMU, a country had to fulfill the following five economic 'Convergence Criteria', which remain applicable to all future candidate countries: (Baldwin and Wyplosz 381, 382)

1. **Inflation:** should not exceed the average inflation rate of the three best performing EU member states by more than 1,5%.
2. **Long-term nominal interest rate:** should not exceed the average long term interest rates of the three lowest inflation rate countries by more than %2.
3. **Exchange rate stability:** a country must have demonstrated its ability to keep its exchange rate tied to its future monetary union partner currencies. The requirement therefore is that every country must have taken part in the ERM for at least two years without having to devalue its currency. After August 1993, 'normal' seems to be defined as %15, which makes this criterion easy to meet. (Wallace and Wallace 295)

4. **Public debt:** a country's public debt should not exceed %60 of its GDP, simply because it was the average debt level when the Maastricht Treaty was being negotiated in 1991.
5. **Budget deficit:** by far the most important criteria for inflation-sensitive Germany. Since inflation is typically the result of large budget deficits, Germany is budget-deficit-sensitive as well. The interconnectedness of inflation and budget deficit is well known. As government borrows to finance its budget deficits, its debt rises. If the process goes unchecked, eventually the financial markets are likely to ask themselves whether the debts will ever be paid. Their normal reaction, then, is to stop lending to a highly indebted government. The only alternative to borrowing to finance the deficit is to ask the central bank to run its printing press. This is how continuing budget deficits eventually translate into fast money growth, which ultimately delivers inflation. This is why the fifth of Convergence Criterion set a limit on acceptable budget deficit, again based on Germany's standards. Germany had long operated a 'golden rule', which specified that budget deficits are only acceptable if they correspond to public investment spending (on roads, telecommunications, other infrastructure...etc). The idea was that public investment is a source of growth which eventually generates the resources needed to pay for the initial borrowing. The German 'golden rule' considered that public investment typically amounts to some %3 of GDP. Hence the Maastricht Treaty requirement that the general government budget deficits (counting all areas of public expenditure and income) should not exceed %3 of GDP (measuring a country's total economic output).

The Maastricht Treaty also established firm constraints for economic policy among EMU members, priority being sound public finance. The Article 104 of the Treaty provided for an 'excessive deficit procedure' (EDP) to ensure that member states achieve, and maintain that soundness,<sup>23</sup> by encouraging and, if necessary, compelling them to reduce their budget deficits if they exceed %3 of GDP. It had also prohibited both direct financing of public entities' deficits by national central banks and commitments of any member by neither the Community nor any EMU member. (Marsh 147, 148) In other words, Treaty's 'no bail-out' clause prohibited ECB from rescuing member states who find themselves in financial dire straits. ECB was also barred from creating an EU-level financial instrument, such as a European treasury bill, to finance EU expenditures. Instead, the national governments could individually issue their own bonds denominated in Euros. (Peterson and Shackleton, 181) While the ECB's interest rate decisions would profoundly shape the economy, the ECB was prohibited from investing money or lending out funds. (Peterson and Shackleton, 170) The Treaty called for EMU to be achieved in three stages after which it would automatically take place for all members that had to fulfilled economic 'Convergence Criteria' (except for opt-outs). (Tanchev and Nikolov 162) Stage I of EMU, the completion of the Single Market, became a reality by 1 January 1994 when capital markets were liberalized. Stage II of EMU then began and lasted until the introduction of the single currency in 1999. (Lynn 23) The final stage would be comprised of the

creation of ECB and the single currency. However, the starting of Stage III remained subject to a political decision by Community's leaders. The 'Convergence Criteria' were meant to guide that decision, as a necessary concession to those states, most importantly Germany, that feared EMU (Peterson and Shackleton 174) would be destructive to their economic stability.

With agreement on the goal (EMU) and the conditions (Convergence Criteria), the European Union could now move forward. However, in June 1992, Europe's hopes of a smooth monetary transition were shattered when a wafer-thin majority of the Danish electorate rejected the Maastricht Treaty in a referendum. (Marsh 163) This alarmed the exchange markets which had bought into the authorities' excessive confidence in the monetary union project. (Baldwin and Wyplosz 338) Speculative attacks started immediately, initially targeting the Lira as 'the weakest link in the chain' due to its economic hardships and doubts over its ERM exchange rate competitiveness against Deutschmark. (Marsh 163) The second target was Britain, as the central rate chosen for the newly-ERM member was seen to be overvalued. In response to the speculative attacks, the strong currency central banks initially intervened in support of the embattled Banca d'Italia and Bank of England. By mid-September 1992, the attacks had become massive; a frightened Bundesbank decided that the 'unlimited interventions' clause of ERM was not reasonable and stopped its support. Left to themselves, with foreign exchange reserves rapidly falling, the Lira and Pound had to withdraw from the ERM. As a result, the markets concluded that the ERM was considerably more fragile than hitherto admitted and shifted speculation to Ireland, Portugal, Spain and finally France. (Baldwin and Wyplosz 338) Financial market speculators were borrowing massive quantities of Franc from French banks and then selling them against Deutschmark, in an opportunistic quest to force France away from the 'strong Franc' policy and make profits by buying back the currency later on at a lower level. Despite heavy Franc intervention purchases by Banque de France to defend the currency, (Marsh 162, 163) speculation was growing strong, as market operators bet on more general realignment amongst European currencies. The resistance to realignments of central rates could be justified in economic terms -the use of the exchange rate as an anti-inflationary instrument- but there was much more at stake, namely the prestige and credibility of governments; and this was, perhaps most strongly felt in France. (Wallace and Wallace 289) On the other side of the coin, these currencies became progressively overvalued, with a loss of external competitiveness, which was in turn translated into growing trade deficits. In the end, this acted as a boomerang. The crisis of September 1992 was fundamentally a crisis of confidence for the currencies of countries with higher inflation rates and large trade deficits. (Wallace and Wallace 286) In August 1993, given the size of private funds shifting across national borders and relatively recent dismantlement of the capital controls, European governments were finally forced to give in. In order to uphold the principle of the ERM and save face, the fluctuation margins of ERM widened to %15, which would be little short of floating. (Wallace and Wallace 289) While such wide margins avoided formal devaluations and prevented speculators from making profits, (Marsh 175)

they had effectively suspended the ERM and made the monetary integration seemed like a failure. (Wallace and Wallace 289) Amid the clamor of currency turmoil, governments had little option but to rally anew behind the battered cause of a single European money -as the sole means of curtailing the destructive energy of world financial markets. (Marsh 134)

By late 1993, as a consequence of the previous monetary turmoil, Western Europe was effectively split across a north-south divide of '*hard*' (Germany, Belgium, the Netherlands, Luxembourg and Austria) and '*soft*' (Portugal, Italy, Greece and Spain) currency blocs. France, despite Herculean efforts to maintain German-style economic discipline over a decade, straddled an uncomfortable position between the two blocs. (Marsh, 177) While some countries in the strong currency bloc feared for the contagion from their neighbors' perceived monetary instability, others had the anxiety that exporters from weaker states, if they were not permitted to join EMU, would benefit unfairly from permanently devalued currencies. The weaker bloc of European countries, worried that they would faced economic isolation through exclusion from monetary union. Tension between the blocs was heightened by suspected 'creative accounting' and statistical manipulation by Italy, Greece and other countries to fulfill the Maastricht's 'Convergence Criteria'. Even Germany, in a dramatic reversal of its traditional orthodoxy, at one stage appeared guilty of inflaming accounting procedures to meet the conditions -inflaming worries that the new currency would be inevitably weak. (Marsh, 178)

In December 1995, one of the few issues on which the Europeans could agree was the name for the single currency. The neutral sounding 'Euro' was chosen as against more nationalistic options. (Marsh 177) The first post-Maastricht policy innovation came as the Stability and Growth Pact (SGP), requested by the Germans, building on language in the Treaty regarding 'excessive government deficits', specifying a government whose budget deficit exceeds %3 of GDP or whose public debt exceed %60 of GDP maybe required to correct its situation and maybe subject to sanctions and penalties if it fails to do so. Whenever a member goes on a wild borrowing spree, it would ultimately loose the confidence of the bond markets and could no longer borrow to pay its bills, the ECB couldn't be expected to print more Euros to help it out. Since that would risk inflation and if there was one thing the Germans were determined upon was that Euro to be as stable and secure as the Deutschmark it replaced. Neither could the other member states be expected to bail out the country, with soft loans extended to cover up its deficit. Since that would be unfair if those that were managing their finances responsibly were forced to subsidize the states that had been spending profligately. There would be no incentive for anyone to keep their national books in order. The situation would quickly descend into chaos, with every member living beyond its means, then expecting its neighbors to bail it out or ECB to print the money to finance its extravagance. Thus, there needed to be strict rules to prevent it. The German answer was the Stability and Growth Pact with its increased policy surveillance, specific penalties to be imposed when countries have excessive deficits and the automatic imposition of those



penalties. The trouble was, not everyone in the EU saw it the same way Germans did. (Lynn 26) In December 1996, at the summit meeting held in Dublin, there was a furious debate between Germany and France over the automatic mechanism of this kind while most other countries were reluctant to agree to the German proposal which seemed to impose too strict a limit on their independent action. The governments would no longer be free to set their own fiscal policy. There would be a set of rules, enforced by Brussels, that would decide how much they could and could not spend. It was a huge compromise in national sovereignty that many countries, the French in particular, didn't feel they had signed up for when they embarked on the Euro project. In the end, Luxembourg Prime Minister Jean-Claude Juncker hammered together a compromise. Member states would stick to the Stability Pact, but they could invoke "a severe recession" as an excuse to run a larger deficit. How severe? A drop of 0.75% in GDP, which in the view of many economists would not really be a severe recession at all, but more a normal cyclical dip that a healthy economy can expect to experience every few years. The Commission would automatically launch an inquiry against a country that breached the Pact, except in cases where output fell by more than 2% a year, in which case the country could do pretty much whatever it wanted. But, crucially, the German demand for stiff, automatic penalties for any country that broke the 3% deficit ceiling was dropped. The worst a member state would face was an inquiry from the Commission. (Lynn 27) The 1997 Amsterdam European Council agreed on the rules and responsibilities of the SGP while the European Commission was given the key responsibility of monitoring adherence to it. (europa.eu)

By 1998, the Southern European members managed to bring their inflation rates to within the tolerance margins mandated by the Maastricht 'Convergence Criteria', except for Greece who did not even try and decided to join later. (Baldwin and Wyplosz 381) In May 1998, the Council, taking into account Commission's recommendations on accordance with the convergence procedure, selected eleven (Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Portugal and Spain) out of fifteen members of the EU to participate in the final stage – leaving out UK, Denmark (as per their "op-out" request), Sweden (who used some criteria to remain out) and Greece. (Tanchev and Nikolov 162) In June 1998, the European Central Bank (ECB) began operation, charged with maintaining Europe's new currency, making monetary policy for the participating countries while directing and coordinating the Eurosystem, comprising of the national central banks who together with the ECB which made up the European System of Central Banks (ESCB). (Peterson and Shackleton 170) In December 1998, the conversion rates between the Euro and the currencies of the participating members were irrevocably frozen. On 1 January 1999, both the Euro and the Eurosystem, were introduced for a transitional period of three years. The power to conduct monetary policy was transferred from each member country to the overarching institutional framework for EMU, the ESCB, headquartered in Frankfurt. (Baldwin and Wyplosz 307) The same date had seen the set up of the Exchange Rate Mechanism (ERM) II, a voluntary scheme where the currencies would be

tied to Euro with a fluctuation band of +/- %15. EU countries that have not adopted the Euro were expected to participate for at least two years in the ERM II before joining the Eurozone.<sup>24</sup> The ERM II would function as long as there will be EU member states that have not adopted the Euro (Tanchev and Nikolov 165) as could be seen in Map 1. In 2000, the Council decided that Greece had fulfilled the necessary conditions for the adoption of the single currency and that the country could join the Eurozone on 1 January 2001 when the Euro banknotes and coins were introduced while national banknotes and coins were withdrawn from the market. (europa.eu)

In 2003, France and Germany were identified as having budget deficits above the permitted levels. The Council, on the recommendation from the Commission, set deadlines for each country to take steps to correct the deficit. Those deadlines expired without either country to taking effective measures. The Commission then recommended that the Council to give formal notice to these members to take necessary steps. (Peterson and Shackleton 140) However, EU finance ministers rejected the Commission's recommendations to sanction these countries and voted instead to give them room to make adjustments without fines. The Commission decided to refer the matter to the European Court of Justice to decide if the Stability and Growth Pact was being upheld. In August 2004, the Court's politically sensitive decision was, to condemn the EU's finance ministers for suspending the Pact's recommendations on deficits while upholding the rights of the national governments to ignore the disciplinary procedures attached to them. This decision was viewed by many as suspending the Pact and giving *carte blanche* to flout the rules to two largest actors in Eurozone while their partner states were struggling to meet. (Peterson and Shackleton 182) In September 2004, the European Commission had announced that it had gone back over the figures supplied by Greece for the entry into the single currency and found "significant accounting errors". (Lynn 117) There was a furious reaction from Brussels. Eurostat, the official statistics agency of the EU, promptly began an inquiry into the manipulation of the Greek data. In December 2005, Eurostat report revealed that Greece had understated the size of its budget deficit by an average of 2.1% in every year since 1997. The controversy about how the books were fiddled was just one part of the problem, the more damaging point was that Greece had never qualified for the single currency after all. It was a clear breach of the Maastricht Treaty, to which the country was a signatory. The European Union threatened legal action against Greece. But in the end, there was no meaningful penalty that could be imposed, so there wasn't much point in a trial. It was an embarrassing few weeks for the Greek government. But the EU didn't even contemplate to tell the Greeks to start re-minting the drachma and come back once they were ready to play by the rules. (Lynn 118) Worse, once they were inside the Euro, Greeks still didn't bother to stick to the Treaty. Why no one inside the EU establishment bothered to do anything about it remains a mystery. (Lynn 119)

## CHAPTER 2: HISTORY OF THE FINANCIAL AND ECONOMIC CRISIS

### 2.1. “America's Dream” ruining the “American Dream”

*“In a consumer society there are inevitably two kinds of slaves: the prisoners of addiction and the prisoners of envy”*

The basic outlines of the 2008 Great Recession are well known and often told. For purposes of brevity, one could begin with the burst of the Internet (Tech or Dot.com) bubble in the United States, which was allowed to develop by the Federal Reserve (Fed) and sustained strong growth in late 1990s. When the stock prices of technology companies fell, it was hoped that these losses would not affect the broader economy. But they did. Much of investment, which had been in the high-tech sector, came to a halt with the bursting of the bubble. In March 2001, America went into recession. The Bush administration used this recession as an excuse to push its agenda of tax cuts for the rich, claiming that it would stimulate the economy. It did not. As a result, the burden of restoring the economy to full employment was placed on monetary policy. (Stiglitz 4) Accordingly, from early 2001 through the middle of 2003, Fed Chairman Alan Greenspan lowered interest rates all the way down to %1 and kept them there for 13 months -long enough to flood the market with liquidity. His lethargy in raising rates even as the economy was powering ahead, allowed the housing bubble to inflate.<sup>25</sup> However, even though Fed had raised the rates in 2004-2006 period, long-term interest rates and fixed mortgage rates barely moved. As it turned out, there were plenty of other sources of easy money flowing into the United States. China, Japan and Germany had accumulated massive stockpiles of the reserve currency -dollar- over the course of the past decade, which were lent bank to the United States, financing budget deficits and excessive borrowing by everyone from households to corporations. (Roubini and Mihm 33, 34) The huge inflows of foreign capital, which rose steadily from the mid-1990s and reached record levels for several consecutive years until 2006 (Bergsten 24) meant that the U.S. had sucked in more than \$5 billion a day from the rest of the world. (Marsh 216) The abundance of foreign money allowed Americans to borrow easily and live beyond their means. (Bergsten 23) Cheap money, without a well-functioning and well-regulated banking system, was used to replace the tech bubble with a housing bubble, supporting a real estate and consumption boom.(Stiglitz 4)

A closer look, however, revealed much more fundamental problems underlying the U.S. economy: a decade-long income stagnation in middle-class; growing inequalities (Stiglitz *xxii*) through shifting of the money from those who would have spent it to those who didn't (the super-rich), creating the “weak

aggregate demand” problem (Stiglitz 19); an economy where major sectors -besides finance- were in trouble; a country with unacceptable fiscal and trade deficits contributing to an unbalanced global economy where one part produces far more than it consumes and the other part consumes far more than it produces. (Stiglitz *xxiii*, 1) However, Americans found an ingenious solution to all these ills: borrow and consume as if incomes *were* growing. And borrow they did. A deregulated market flushed in liquidity made everyone happy: while the individuals were able to continue their consumption binge, not having face up to the reality of stagnating and declining incomes, lenders could enjoy record profits based on ever-mounting fees. America, the richest country in the world, was practically living in a dream. (Stiglitz 2) With debt-based profligate consumption, the United States was able to save the world from the global “lack of aggregate demand” problem, by being the world's consumer of last resort. And by 2004, the real estate boom was generating such rapid and broad-based economic growth that George W. Bush got re-elected.<sup>26</sup> Unfortunately, however, these exceptional levels of growth and consumption were supported by debt and thus, were not sustainable. (Stiglitz 20)

## **2.2. The Mortgage Scam: House of Cards Collapsed**

*“We believe the effect of the trouble in the subprime sector on the broader housing market will likely be limited and we do not expect significant spillovers from the subprime markets to the rest of the economy or the financial system.”*

Ben Bernanke, Chairman of the U.S. Federal Reserve, May 2007

The wheeling and dealings of the mortgage industry in the United States will be remembered as the great scam of the early twenty-first century. (Stiglitz 77) As the well-known story goes; when U.S. banks and mortgage companies started offering cheap mortgages, many people rushed to get a piece of the action, causing the housing bubble get out of control sometime around 2005 or 2006. (Roubini and Mihm 35) The flooding of the market with 'exotic' subprime mortgages -like super low teaser rates (temporarily low rates that exploded after a few years), %100 or + LTV (bank would lend %100 or more of the value of the house), interest-only (negative amortization mortgages where borrower pays only the interest until a one big payment at the very end) and option ARMs (adjustable-rate mortgages where the interest rate of the mortgage changes according to the changes in the market interest rate)- had at least two main flaws. First of all, these 'innovative' products were pushed onto poor and poorly educated borrowers, nicknamed NINJA (No Income, No Job and No Assets) (Stiglitz 79) When housing prices soared, homeowners could take out mortgage equity withdrawals -which hit more than %7 of GDP- allowing them to make a down payment on a new car and still have some equity left over for retirement. (Stiglitz 2) Secondly, all of these schemes were based on an economically impossible

assumption that the house prices -which had doubled over the last decade- would continue to go up. This way if the borrowers were to default, the banks could always sell the house to recover their losses. (Stiglitz 86) As the house prices leveled off and a rise in interest rates made variable-rate mortgages more expensive, however, the subprime mortgages issued in 2005 and 2006 began to exhibit unusually high delinquency and default rates. In the first half of 2006, U.S. banks were still reporting record profits; however, both housing starts and home prices stopped rising. The reason was simple enough: the supply of new homes began to outstrip the demand. (Roubini and Mihm 89)

The scale of the problem amplified because banks had sliced and diced, packaged and repackaged these high-risked subprime mortgages to be sold to unwary investors around the globe (Stiglitz 77) through a process called “securitization”. Wall Street had thought that by repackaging the mortgages and passing them on to numerous investors, they were sharing the risk and protecting themselves. While securitization might have an advantage of spreading the risk it had a major disadvantage of breaking the relationship between the lender and the borrower, creating problems of imperfect information. Those buying a mortgage-backed security -pools of mortgages that were bundled together and sold to investors- was, in effect, lending to the homeowners whom they know nothing about. They trusted the banks to have checked it out. The banks trusted the mortgage originators - whose focus was more on the *quantity* than the *quality* of borrowers- to do the same. (Stiglitz 14) And the rating agencies, who were *supposed* to check these toxic instruments, instead transformed them into AAA-rated products, just like alchemists attempted to transform base metals into gold during the Middle Ages. (Stiglitz 6, 7) As a result, these clever and innovative instruments had allowed the banks to hide much of their bad lending, move it off their balance sheets, use assets, whose value had been inflated by the bubble, as collateral and deceive regulators by using extremely complex instruments allegedly for managing risk. (Stiglitz *xviii*) Mean while, far from standing in the way of these get-rich-quick schemes, politicians and policy makers actually encouraged them (Roubini and Mihm 13) by allowing banks to engage in ever-riskier lending. (Stiglitz 8) Regulators by standing back and blessing this cozy relationship between the banks and the rating agencies, (Roubini and Mihm 33) actually let the bubble grow. (Stiglitz 8) But as mid-2006, there were signs that the party was almost over. In May 2006, the hilariously misnamed Merit Financial Inc., a Washington-based subprime mortgage lender which had allegedly spent not more than fifteen minutes to train its loan officers before setting them loose to originate loans to NINJAs, was the first to go under. But Merit Financial was not alone. By the end of 2006, ten mortgage institutions had gone bust. (Roubini and Mihm 89, 90)

### 2.3. The Tsunami that came across the Atlantic

*“If France's political aim was to create the Euro as part of a plan to weaken Germany so as to reduce our supposed economic dominance, then the result has been exactly the opposite. The rise in German competitiveness means that Germany is stronger, not weaker. In a way, that is obvious and inevitable because we are the strongest economy in Europe. We have less inflation and other can no longer devalue.”*

Gerhard Schröder, Former German Chancellor, 2007

On the other side of the Atlantic, the president of the European Central Bank Jean-Claude Trichet and other central bankers were aware of the growing risks. In January 2007 Trichet criticized lack of transparency in some innovative areas of financial markets and warned that there could soon be some 'reprising of credit risk'. (Marsh 216, 217) Just a few months later, by the end of March 2007, the number of non-bank lenders that had collapsed in the United States had soared to fifty or more. In April 2007, New Century Financial, America's second-largest subprime lender, went bankrupt after its funding dried up. At the same time, thousands of small-time mortgage brokers went out of business. The worst was yet to come. (Roubini and Mihm 89, 90) However, the European Union members, were too busy quarreling over the pros and cons of the Economic and Monetary Union (EMU) to pay closer attention to the dark clouds approaching. In May 2007, President Nicolas Sarkozy swept into Elysee Palace with a mixed program, ranging from liberal reforms and pro-American defense policies to a protectionist 'France-first' stance on trade and investment. He tended to regard France as a victim and not a beneficiary of EMU, displaying considerable public resentment about France's failure to establish a '*gouvernement économique*' to provide a political counterweight to the ECB. The Italian Prime Minister Silvio Berlusconi, had led an anti-ECB election campaign during late 2007, joining to Sarkozy about enacting some form of political control over the European Central Bank. (Marsh 219) The main reason behind French frustration at the workings of EMU was Germany's large increase in competitiveness since 1999, which started to become noticeable by 2005. (Marsh 220) Guided in particular by the improvement in German economy from 2005 onwards, the ECB gradually increased interest rates from December 2005 to June 2007, in eight separate quarter-percentage point moves starting from the low point of %2, as could be seen in Chart 1, 'to welcome pick-up in Eurozone's economic activity' as Trichet justified. (Marsh 212) This phenomenon has given an edge to German exports and hence to German economic growth at the expense of France and Italy. They called for bringing down the rise in Euro, blaming ECB to be concerned only with inflation, disregarding growth and unemployment. (Marsh, 220) The depressed French mood on EMU stood in stark contrast to the highly positive sentiments of the German political elite. The German Finance Minister Peer Steinbrück put it: *“Euro is one of the greatest success stories in the history of the European Community. It has produced lower inflation and provided a welcomed disciplinary force. It has been good for the consumers and companies as transfer costs and exchange rate fluctuations have fallen.”* (Marsh 219) The disagreement extended well beyond the Fraco-German axis as there was a widespread perception

that Germany gained more than other countries from EMU membership and was less hurt by the Euro's sharp rise against the dollar in 2007-2008. (Marsh 228)

On the other side of the channel, on 20 June 2007, just days before replacing Tony Blair as Prime Minister, Gordon Brown, gave a rousing speech at the traditional black-tie dinner in Mansion House, brashly predicting “an era that history will record as the beginning of a new golden age for the City of London”. It has been downhill ever since these 'famous last words'.<sup>27</sup> As Chancellor of the Exchequer for 10 years, Brown has played a key role in the City's growth, supporting financial services despite his Labor Party's history of antagonism with the City. Brown sought to convince the financial community that New Labor would be pro-business, non-interventionist and keen to cosset the rich, believing their wealth would trickle down into the wider economy. Brown also led the way for Britain to put in place a new governance system for financial services which was referred to as “light-touch” or “appropriate” regulation.(Gumpel 28) Just like in the United States, “light” regulation in the United Kingdom helped create a real estate bubble.(Stiglitz 22)

During the week of July 16, 2007 Bear Stearns, a global investment bank based in New York, announced the collapse of its two highly leveraged hedge funds which had invested in securities backed by subprime mortgages, triggering a flight from all securities associated with the subprime market. As awareness mounted that exposure to subprime mortgages was ubiquitous, panic spread throughout the global financial system. Thanks to securitization, credit risk was transferred from commercial banks to investment banks and from them to investors around the world. But by the time the crisis hit, this process was incomplete: banks kept some of the toxic assets on their own balance sheets or else stowed them in “structured investment vehicles” that did not show up on official balance sheet until the crisis forced banks to acknowledge their losses. (Roubini and Mihm 34)

Despite the wishful thinking to the contrary, subprime bonds were also sold to the “Stupid Germans,” a phrase coined by top-derivatives trader Greg Lippman working for Deutsche Bank. The “Stupid Germans” were none other than the IKB Deutsche Industriebank (IKB), a medium-sized private bank, which nearly collapsed, marking one of Europe's first and biggest casualties of the subprime crisis. IKB faced the threat of bankruptcy as it had around \$24 billion-worth-of-investments in high risk loans.<sup>28</sup> In 29 July 2007, the German government and financial regulators asked for and were granted approval by the EU Commission to bailout IKB with a €9 billion (\$11.7 billion) recapitalization due to losses suffered for investing in U.S.-subprime mortgage securities. (Walter 1) The revelation of the scale of the problem prompted the head of Bundesbank to repeatedly call for calm in the market.<sup>29</sup> As July turns to August, smaller-scale shock waves continued to reverberate in Germany prompting financial heavyweights like Allianz and commercial property financier Hypo Real Estate struggled to calm jittery investors by insisting they would be unaffected by the U.S. subprime fallout. Investor

confidence was further dented as French insurer AXA had also temporarily closed two subprime funds after sudden losses. (nytimes.com) Share prices on both sides of the Atlantic plunged on July 30<sup>th</sup>; shot back up on July 31<sup>st</sup>; plunged again on August 1<sup>st</sup>; bounced back again on August 2<sup>nd</sup> and endured another savage sell-off on Friday, August 3<sup>rd</sup>, as the latest ramifications of a global financial scare that began in the homes of overstretched Americans struggling to pay the mortgage.<sup>30</sup>

However, a single day, 9 August 2007, would go down in history marking the start of a full-blown liquidity and credit-crunch, in the financial markets. (Roubini and Mihm 93, 94) Even though the financial crisis was originally erupted in the United States, 'the tsunami that came across the Atlantic', as Trichet would like to call it, gained unprecedented virulence when it reached Europe on 9 August, causing the European financial markets to seize up and prompting the ECB for its largest market intervention since the September 11, 2001 attacks. On August 9, France's biggest bank, BNP Paribas closed down two of its funds exposed to subprime lending, claiming that it could not fairly value the underlying assets. While the estimates about BNP Paribas's funds invested in subprime mortgages were to be around \$2.2 billion, what's more frightening was that only a week ago BNP's CEO had said the bank's exposure to subprime mortgages was "absolutely negligible". Famous last words were enough to freeze the entire European interbank money markets,<sup>31</sup> forcing the European Central Bank to take a highly activist stance by pumping more than €96.8 billion (then \$130 billion) in overnight liquidity to ease the balance sheets of hard-pressed banks, within hours of BNP Paribas' announcement. The ECB offered unlimited cash to borrowers at its main lending rate of 4% after overnight rates rose sharply past that level, causing concern and growing fear of a credit crunch in Europe. On August 10, Countrywide Bank, the savings arm of Countrywide Financial, America's largest mortgage lender, became the target of a bank run, as depositors rushed to its branches clamoring for their money, in a way not seen since the 1930s. On 13 August, the European Central Bank made its third consecutive daily injection of cash into the European banking network, bringing its aggregated support for Eurozone banks to almost \$280 billion (£140 billion).(opendemocracy.net)

The month of August, had also seen the difference between interest rates on interbank loans (rates at which banks lend to each other) and T-bills (rates at which government can borrow) spike drastically in the United States. In a "normal" economy, the two interest rates differ little. A large difference meant that banks did not trust each other and for a good reason. They did not know whether what they owed to their depositors and bondholders exceeded the value of their assets and thus gradually became aware of the enormous risks that they faced on their balance sheets. Since many of their complex debt instruments -perceived as revenue-yielding- might turn out to be "non-performing", they could only guess how precarious the position of the other banks were. (Stiglitz 28) Thus, the trust that underlie the banking system evaporated, kick starting the global credit markets meltdown. (Stiglitz 2, 3)



By September 2007, the subprime crisis was in full swing in the United States with rising delinquencies and foreclosures. (Roubini and Mihm 96) On September 10, the German Chancellor, Angela Merkel and the French President Nicolas Sarkozy, called for transparency in international financial markets, exhibiting a united front following an informal meeting at a castle in Meseberg, north of Berlin. Mr. Sarkozy stressed: *"We cannot allow a few speculators to bring down the whole international system."*<sup>32</sup> On 14 September, Northern Rock, a sizable British mortgage lender with a banking arm, suffered Countrywide's faith as most of its funding came from sources other than ordinary depositors. The Bank of England intervened, offering emergency lines of liquidity, but the run did not stop. Just a month ago lecturing about letting bad banks fail, the Governor of the Bank of England Mervyn King found himself in an awkward position; promising to insure all of Northern Rock's deposits and offering additional lines of liquidity to the beleaguered bank. (Roubini and Mihm 99, 100) That blanket deposit guarantee was soon extended to all banking institutions throughout the United Kingdom. Most other countries eventually followed suit, or at the very least, raised the deposit insurance ceiling. These interventions were just the beginning. (Roubini and Mihm 100) The British government ended up nationalizing Northern Rock whose near failure raised serious questions about the effectiveness of U.K. banking regulation. (Gumbel 28) On 15 September, Sarkozy attacked the ECB's handling of the credit crisis by pumping liquidity into the financial markets but refusing to lower interest rates to help businesses, claiming *"They're making life easier for speculators and harder for businessmen"* (Marsh 227) However, central bankers and finance ministers, attending an EU meeting in Portugal, closed ranks behind the principle of ECB independence while Axel Weber, president of Germany's Bundesbank, claimed *"The news value of Sarkozy's critique is zero. And it also has zero influence on the ECB"*<sup>33</sup> In November 2007, Merrill Lynch, an investment bank which had heralded the idea that everyone -not just the rich- should invest in the financial markets, making it one of the pillars of Wall Street since 1914, announced that it would write-down \$8.4 billion in losses associated with subprime mortgage lending. In December 2007, the firm which had survived wars and the Great Depression, announced it would sell its commercial finance business to General Electric and major shares to Temasek Holdings, a Singapore government investment group, in an effort to raise capital.<sup>34</sup> As 2007 turned into 2008, nothing seemed to work. The atmosphere of mutual suspicion started to build up, as banks increasingly refused to trade with one another. (Lynn 95)

## 2.4. The “Black September” (PART I): The United States Goes Belly Up

*"It's only when the tide goes out that you learn who's been swimming naked."*

Warren Buffet

Crisis gained speed in 2008 after more than three hundred non-bank mortgage lenders collapsed in the United States. (Roubini and Mihm 35) As the calls for action increased, President Bush turned to his usual cure-for-all-economic-ills and passed a \$168 billion tax cut in February 2008. Americans, saddled with debt and suffering from tremendous anxiety, chose to save more than half of the small tax rebate. (Stiglitz 28, 29) On 14 March 2008, the Federal Reserve Bank of New York agreed to provide a \$25 billion loan to Bear Stearns, the giant investment bank based in New York, to provide the liquidity for up to 28 days that the market was refusing to provide. But apparently the NY Fed had a change of heart and canceled the \$25 billion loan to Bear Stearns, instead gave a \$30 billion loan to J.P. Morgan who would then buy Bear Stearns.<sup>35</sup> On March 16, in a shocking deal reached to save Bear Stearns from bankruptcy, JP Morgan Chase agreed to pay a mere \$2 a share (or \$236 million) to buy all of Bear Stearns -less than one-tenth the firm's market price on March 14th.<sup>36</sup> On March 24, that offer was raised to \$10 per share (or \$1.1 billion), in an effort to pacify angry shareholders. The U.S. Federal Reserve further rewarded Bear Stearns' shareholders in the deal by taking responsibility for \$29 billion in toxic assets in Bear Stearns' portfolio.<sup>37</sup> All in all, Bear Stearns became Wall Street's first major victim due to big losses on subprime debt and a crisis of confidence in its leadership.<sup>38</sup>

During the month of September, all hell broke on Wall Street. On September 6, both Fannie Mae and Freddie Mac, the two monster housing-finance companies which had issued or guaranteed almost half of all loans to American homeowners<sup>39</sup>, have been nationalized. Between 2005 and 2008, Fannie Mae purchased or guaranteed at least \$270 billion in loans to risky borrowers -more than three times as much as in all its earlier years combined “*We didn't really know what we were buying,*” said Marc Gott, a former director in Fannie's loan servicing department, explaining the collapse “*This system was designed for plain vanilla loans, and we were trying to push chocolate sundaes through the gears.*”<sup>40</sup> During the week of September 8, Lehman Brothers came under severe liquidity pressures, with its survival in question. If Lehman Brothers failed, investors were afraid that the contagion could spread to the other surviving investment banks.<sup>41</sup> On September 14, Merrill Lynch, the venerable bull of Wall Street and “Thundering Herd” of brokers was brought to its knees after \$51 billion of subprime losses (Newsweek, 5 January 2009) and agreed to sell itself to Bank of America. On September 15, as one of the most dramatic days in Wall Street's history, Lehman Brothers declared bankruptcy after government officials could not find a merger partner for it. The fall of Lehman provoked a catastrophic loss of confidence. (Lynn 96) On September 16, stock prices of the insurance giant American International Group (AIG) -which must have somehow thought that insuring debt was

like insuring cars and built up \$440 billion in credit default swaps- (Newsweek, 5 January 2009) dropped by %60, as the company suffered from a liquidity crisis following the downgrade of its credit ratings. On the evening of September 16, the Federal Reserve's Board of Governors announced that they had been authorized to create a 24-month credit-facility from which AIG could draw up to \$85 billion, in exchange for the U.S. government receiving warrants for a %79.9 equity stake in AIG. The bailout was characterized as the nationalization of AIG.

Eventually, by late September 2008, following the demise of Lehman Brothers, the nationalization of Fannie Mae and Freddie Mac and the bail out of AIG, it became clear that the problem started to become one of the system's solvency as well. The economy was not healing itself. If credit markets were to stay blocked, consumers and firms would enter a vicious spiral. And the market had lost faith in a strategy that saved finance one institution at a time<sup>42</sup> through the "hidden" bailouts of the Fed (Stiglitz 123). Thus, in the waning days of his administration, Bush rushed to throw money at the banks with a massive \$700 billion bail out package (Stiglitz 30) extending the "corporate safety net" from commercial banks to investment banks while refusing to help millions of homeowners going into foreclosure and the unemployed. (Stiglitz 38) On September 23, the U.S. Treasury Secretary Paulson and the Chairman of the Federal Reserve Ben Bernanke went to Congress and presented a three-page "Troubled Asset Relief Program" (TARP) bill asking for a blank check for \$700 billion, with no congressional oversight or judicial review, (Stiglitz 123) for the government to buy toxic mortgage-related assets. Under the TARP scheme, which the critics called "cash for trash", the government would buy the toxic assets, injecting liquidity and cleaning up the banks' balance sheets at the same time. Paulson and Bernanke also hoped that the government would overpay for the junk which would be a hidden recapitalization of banks. (Stiglitz 123)

## **2.5. The "Black September" (PART II): Europe catches on Fire**

*"The financial crisis is above all an American problem. Other G7 financial ministers in continental Europe share this opinion"*

Peer Steinbrück, German Finance Minister, September 2008

The fact that the global financial crisis bore a "Made in USA" label has led many Europeans to believe, once again, that their economic and social model were morally superior to America, sparking a new wave of anti-Americanism, where the intensity of America-bashing in some countries had reached levels not seen since the United States invasion of Iraq in 2003. Yet it soon became clear that

many of the problems facing European banks also stemmed from; bad credits, too much risk and hooking on to easy profits from subprime mortgage debt and that greed was hardly unique to America.<sup>43</sup> In the beginning, however, the thinking was that only the United States had practiced *le capitalisme sauvage*, as the French disparaged, and it alone would suffer the consequences.<sup>44</sup> In reality, in the first twelve months of the credit crisis after August 2007, EMU area banks did not need to raise additional capital from sovereign wealth funds and other foreign investors as Citicorp, Merrill Lynch and Morgan Stanley in the United States, Barclays in the United Kingdom and UBS in Switzerland. Nor were there any spectacular collapses in investment banking equivalent to Bear Stearns, Lehman Brothers or Merrill Lynch. However, shortly after the Lehman and Merrill Lynch shocks, this perception was dramatically changed as the tide of financial markets convulsions washed through Europe with full force. (Marsh 233) Confidence collapsed, investors massively liquidated their positions and stock markets went into a tailspin. From then onward the EU economy entered the steepest downturn on record since the 1930s. The transmission of financial distress to the real economy evolved at record speed, with credit restraint and sagging confidence hitting business investment and household demand, notably for consumer durables and housing.<sup>45</sup> As it turned out Europe's bankers and mortgage providers have been just as stupid and greedy as their American comrades-in-harm and this was in countries that prided themselves on having tamed the capitalist beast in the name of equality and social justice. (Joffe 23)

On September 22, German Chancellor Angela Merkel issued an angry attack on the U.S. government for its failure to avoid a financial crisis, accusing it of mismanagement and stubborn refusal to apply virtually any controls over its banking industry. Merkel said that taxpayers "far beyond the United States and Britain" would be carrying the burden of a crisis which could have been prevented had the U.S. and Britain acted more prudently. The chancellor criticized the fact that the U.S. government had dragged the industrialized world into credit crisis by allowing financial markets to operate in a "free-range way" despite impending dangers. (guardian.co.uk) On September 25, French President Nicolas Sarkozy, referred to as '*Sarko l'american*' because of his frank and un-French admiration of the U.S., retreated to a more traditional Gallic position, claiming that "*The laissez-faire capitalism is over. The all-powerful market that always knows best is finished*". Sarkozy's rally against the 'dictatorship of the market', were just a taste of the international assault on the free-market beliefs that, to a great extent, all the world's major powers had subscribed to over the previous thirty years. (Rachman 186) On September 28, the Belgian, Luxembourg and Dutch authorities partially nationalized Belgian-Dutch bank Fortis through €11.2 billion in government bailout.<sup>46</sup> On September 29, the U.S. House of Representatives' rejection of the TARP bailout plan (Stiglitz 123) sent shock waves through European financial markets, spreading the domino effect of bank failures throughout Europe.<sup>47</sup> On that very same day, German Finance Minister Peer Steinbrück had to seal a rescue package of €35 billion (\$69 billion) for Hypo Real Estate Holding (HRE), Germany's second-biggest commercial-property lender,

to save it from potential collapse. Followed by British government's nationalization of Bradford & Bingley Plc, a British bank headquartered in West Yorkshire. (bloomberg.com) On September 30, Belgium and France stepped in to help the Franco-Belgian financial group Dexia with a capital injection and Ireland pledged up to €400 billion to guarantee to all bank deposits.(uk.reuters.com) Ireland's unilateral measures against financial panic quickly followed by Greece and Germany, (Marsh 233) as Berlin had also guaranteed all private accounts to the tune of \$1.37 trillion. (Joffe 23) Much of the European banking system effectively collapsed (Roubini and Mihm 116) in a week's time, when mega-banks had to be saved with spectacular private and public sector rescue packages. Following the onset of Black September, Europeans realized that they were in the same boat with the Americans while Germans realized that they were in the same boat with the rest of Europe.

## **2.6. Much Ado about Nothing: Early Efforts for a United European Front against the Crisis**

*"If by economic government, you mean a federal Europe ...  
that's not what I would be saying."*

Nicolas Sarkozy, French President, November 2008

The mess caused by fast-and-loose mortgage lending in the United States has blown into a global crisis of confidence where 'trust' has been replaced by 'fear': fear among depositors over the safety of their money, fear among banks over lending to one another and fear among politicians, central bankers and regulators over not possessing adequate tools to fix the problem. (Gumbel 19, 22) The panic presented an opportunity for the French President Nicolas Sarkozy to showcase his leadership skills, profiting from France's European Council presidency. He had hosted emergency crisis meetings on two consecutive weekends, in October 4 and 12, pointedly inviting the leader of the EU's second biggest economy, U.K. Prime Minister Gordon Brown to both (despite Britain's non-membership of the Euro).

On October 3, the revised TARP bill passed by both houses of the U.S. Congress's with a clear *quid pro quo* that its special tax provisions should contain \$150 billion for the constituents of those congressmen who had changed their votes from "Nays" to "Yeas" in the second round of voting; revealing how cheap it was to buy out congressmen. (Stiglitz 123) On October 4, Nicolas Sarkozy was joined by his German, Italian and British counterparts in Paris, for his first mini-summit on the financial crisis where German Chancellor Angela Merkel refused his proposal for a \$409 billion Europe-wide rescue fund where Germany, as the biggest European economy, would contribute the

most. The fund would then bail out banks -perhaps in Ireland, the country that helped German companies to avoid paying taxes in Germany- with money that might well be needed to prevent the next crisis at home. Politicians, who were handing out tax-payers' money to bail out highly unpopular bankers -blamed for earning tons of money, forcing companies to cut jobs, resisting regulation and now asking for the society to pay the bill- would seriously had to worry about next elections. Thus, no money for greedy fools of other lands, Merkel seemed to say, only after guaranteeing German private bank accounts and save Hypo Real Estate. (Joffe 23) She was also critical about the idea of forming national rescue funds. As soon as they were up and running, bank managers might be tempted to make use of these funds even before their institutions run into trouble. The Hypo Real Estate lesson that Merkel wanted to teach to the financial community was: the government might help, but would always look for the cheapest possible solution.<sup>48</sup> Britain's Gordon Brown was also reluctant to see Brussels lay its regulatory hands on London's City, as his recapitalization of Britain's banking sector was no less unilateral than Merkel's actions. (Joffe 23)

On October 6, the U.S. government's vaunted \$700 billion rescue plan barely slowed the market meltdown, providing historians with the clue on when the Panic of 2008 began.<sup>49</sup> On October 7, EU finance ministers at least came to a rhetorical agreement to prop up "system relevant" banks. But which were they and how many billions did Europe had to deploy? We'll cross that bridge when we get there, meanwhile we will wait for the EU's summit on October 15, the ministers seemed to mumbled. Share prices of course, did not wait to plunge even further. By market close on October 7, the Dow Jones Industrial Average had dropped by %27.5 while the FTSEurofirst 300 Index of European shares were down by %32.5. The pattern continued for a long while. The moral of the story for Europe was that you can try to hide but you can't run. There was no "decoupling" -that Europe and Asia would be able to grow even if America sank into a recession- as the Europeans had hoped when the global crash was still a stumble back in January 2008. (Joffe 23)

On October 8, the governments on both sides of the Atlantic carefully coordinated their actions for maximum effect. First came an early-morning announcement by the British government that it had crafted an emergency \$88 billion recapitalization package for its banks. Announcing Britain's plans Prime Minister Gordon Brown didn't mince words: *"This is not a time for conventional thinking or outdated dogma but for fresh and innovative intervention that gets to the heart of the problem."* Following the statement, five central banks from around the world, including the U.S. Federal Reserve and the European Central Bank, announced a cut in interest rates. Under normal circumstances, such measures would have bucked up moods and stock prices in financial centers across the globe. Instead, the big concerted action passed with barely a shrug as stock markets worldwide continued to roil and banks everywhere remained in firing line. The big yawn with which global stock markets greeted the

move said it all: given the beaten-down state of the financial system and questions that continue to swirl around it, far more concerted action is needed if confidence is to be restored.(Gumpel 19, 22)

On October 9, Iceland became the first developed country in more than thirty years to turn to the IMF for help, following a dramatic collapse in its banking system. As a country of 300,000, Iceland had three banks, which had taken on high leverage totaling some \$176 billion, eleven times the country's GDP. When financial markets realized the risk and started pulling money out, these banks lured money from depositors in the U.K. and Netherlands by offering them "Icesaver" accounts with high returns. The depositors thought that there was a "free lunch": they could get higher returns without risk. However, as the bitter reality that Iceland could not afford to pour hundreds of billions of dollars into its weakened banks, gradually dawned on the depositors, a run on the banking system became only a matter of time. Unlike the United States, the government of Iceland knew that it could not bail out the bondholders or shareholders. The only question was whether it would bail out the Icelandic corporation that insured the depositors and how generous it would be to the foreign depositors. The U.K. government went as far as seizing Icelandic assets using anti-terrorism laws and insisting that Icelandic taxpayers bail out U.K. and Dutch depositors even beyond the amounts the accounts had been insured for. (Stiglitz 23) The whole country was forced into something close to national liquidation by the wild, reckless risk-taking of a small clique of well-connected speculators. (Lynn 97)

On October 12, following announcements by Britain and the United States that they would move to take ownership shares in failing banks, Sarkozy had hosted the first ever Eurogroup summit in Paris, looking for a collective response to avoid tit-for-tat actions by individual countries that might harm their neighbors. In contrast to the first meeting, this time the leaders seemed to be reading from the same script, agreeing on measures such as guaranteeing interbank loans for up to five years and buying stakes in banks. But this show of unity was missing a Europe-wide solution. Proposed measures were simply guidelines for member states to follow in the development and implementation of their own independent solutions.<sup>50</sup> Contrary to Britain's \$255 billion and the United State's \$700 billion bailout plans, however, Eurozone leaders did not put a price tag on any of their promises. The idea, they said, was that governments faced different challenges and needed to act quickly. "*Each country will announce concrete figures for the measures they expect to take individually. There is no question of setting up a European fund*" said the Belgian Finance Minister Didier Reynders. And when the summit ended, Sarkozy proclaimed: "*This crisis needs concrete measures and unity – and this is what we have today*".<sup>51</sup> One result of the Sarkozy's emergency crisis meetings was an effective suspension of the EMU area's Stability and Growth Pact as a means of offsetting recessionary risks – opening the way to a further expansion of Europe's debt and deficit levels. (Marsh 234)

On October 13, main European economies quickly started putting the agreed-upon measures into action by offering concrete proposals for infusing liquidity directly into banks. This would be done either by injecting capital straight into the banks or by setting up interbank loan guarantees. (istockanalyst.com) Chancellor Angela Merkel has announced a huge rescue package worth up to €500 billion to inject movement into Germany's stricken banking and insurance sector. The bail-out amounted to the biggest state intervention in German economy since the end of the Second World War. It included €400 billion in guarantees for interbank lending to restore liquidity and €100 billion in fresh capital. The bail-out package marked a change in direction by the German government, which had resisted taking stakes in the country's troubled banks. Berlin had been forced into a U-turn due to the shortage of liquidity held by German banks, resulting from the slump in markets and the difficulty in securing short-term lending. The German government said the package had ruined its hopes of having a balanced budget by 2011 for the first time in years.<sup>52</sup> The British government effectively nationalized Royal Bank of Scotland (RBS), Lloyds TSB and HBOS by pumping a total of £37 billion. Trying to justify the bail-outs, Prime Minister Gordon Brown proclaimed: *"In extraordinary times, with financial markets ceasing to work, the government cannot just leave people on their own to be buffeted about"*.<sup>53</sup> On October 17, the German Parliament and the Chamber of German States had passed the German Financial Market Stabilization Act to establish the Financial Market Stabilization Fund to be managed by the Financial Market Stabilization Agency. The EU Commission has provided its support to this plan. On October 20, the Federal Government enacted the regulation to be effective until 31 December 2009. The rescue package, totaling up to €480 billion, consisted of a re-capitalisation scheme, providing new capital to banks and insurance companies in exchange for shares, a guarantee scheme covering new issuances of short- and medium- term debt to support the banks which are unable to access interbank funding, a temporary acquisition of assets under the condition that these assets are bought back after 36 months maximum without the state making a loss.<sup>54</sup>

On October 22, articles appeared both at the French daily *Le Monde* and the Austrian newspaper *Kurier*, about the possibility of extending the France's omnipresent EU Presidency<sup>55</sup> until 2010, which would originally to be held from July 2008 through December 2008. However, the European Council President Nicolas Sarkozy, proven to have more energy than that drum-beating rabbit on TV and not shy to lead, made it clear that he did not want to step down<sup>56</sup> from the rotating six-month presidency, based on the rationale that the EU needs a strong presidency and a much more united front to respond adequately to global challenges, such as the current financial meltdown.<sup>57</sup> He had suggested that countries belonging to the Euro, with an invitation extended to Britain, should form an informal emergency "economic government" with himself at its head.<sup>58</sup> During France's first three-month at the helm of the EU, Sarkozy imposed himself upon European and global affairs and managed to shift global perception of the EU from that of a slow bureaucracy to a major player on the world stage. At last, the EU was seen to be "proactive, constructive and effective" power. The widespread satisfaction



with the French Presidency culminated in speculations that all these were set to change in January, when the Czech Republic took over the rotating presidency, as a country which had failed to ratify the Lisbon Treaty and whose president, Vaclav Klaus, refused to fly the EU flag above his official seat at the Prague Castle. At a time when Europe needed to maintain its fragile unity in the face of an economic crisis, speculations on not to expect “incredible initiatives” under Czech leadership<sup>59</sup> angered the country's political elite. Alexandr Vondra, the Czech vice-prime minister, has criticized Mr Sarkozy's plans to extend his time at the head of the EU: *"Any speculations on extension of the current presidency are groundless and unacceptable. Nobody can take the presidency away from the Czech Republic. There are formal rules of the game which cannot be changed without the consent of everyone. No such new rules in the EU primary law have been approved."* (telegraph.co.uk )

On October 28, the European Commission has concluded its investigation on German government's IKB bailout, to determine whether the rescue measures contravened with EU's “State Aid” regulations. According to the regulations, state support had to be capable of restoring the long-term viability of the company, must be limited to the minimum necessary and the beneficiary had to make a substantial contribution to the restructuring and to accept compensatory measures to limit distortions of competition induced by the aid. The Commission decided that the €9 billion restructuring package was compatible with the EU's “State Aid” rules to companies in difficulties. The package would allow for the restructuring of the bank, while the significant scaling back of IKB's activities would limit the distortion of competition created by the state support.<sup>60</sup>

## **2.7. The Great Bargain: “Frau Nein” vs. “Europe”**

*“We are not going to participate in this bidding war over who can do the most”*

Peer Steinbrück, German finance minister, December 2008

All in all, throughout the fall of 2008, the world's financial system had been shaken to its foundations. Over a few nervous weeks banks were collapsing by day and governments around the world have been throwing billions at them in a desperate effort to keep their economies simply freezing up. (Lynn 78) In Washington, London and Beijing, governments were taking the line that this downturn requires extraordinary policies and had passed a plethora of spending programs that they said would help their citizens and companies weather the recession. In Europe, the biggest pressure to do more, had come upon the Germans. As leader of the world's fourth most powerful economy, Angela Merkel had resources few of her peers could match. Germany's slow-and-steady economy might have seemed

boring in the global boom years, but during the crisis Merkel's country looked like a rare island of stability. The country was, relatively speaking, in a sweet spot: it had no credit or housing bubble, employment has been astonishingly well, government budgets were balanced and the savings rate had put America to shame (%11 versus near zero in 2008). (Newsweek, 29 December 2008) Accordingly, the Germans thought that they were being punished for having balanced their budget when deficit spenders like Italy and France came to them for aid. Thus, German political elite was pushing back against this strategy.<sup>61</sup> While other leaders talked up big government and boasted about the way they were saving the global economy from ruin, German Chancellor Angela Merkel was the only major world leader to question the prevailing wisdom. (Lynn 78) As critics at home and abroad were lashing out at her for what they saw as a slow and timid response by Europe's most powerful economy to the worst global recession in decades (Theil 25), her argument was that the crisis, caused by a tidal wave of borrowed money of the past decade, could not really be fixed by borrowing more and more. However, the whole saga wasn't just a dispute over the effectiveness of policy. It had turned into a fight over influence and money, pitting Merkel against the leaders of France, Britain and Italy, who were calling for German help (and treasure) for a more muscular European response. Plus, there was the leadership question. In the minds of many European leaders, the global crisis of capitalism ought to be a golden age for the continent's less market-driven, more social-democratic model. However, Europe once again seemed to be fighting with itself. Germany, by its sheer economic heft and role as the world's biggest trading power, seemed best placed to help unify in this crisis. Like few other major powers, it had an existential stake in the health of the global economy, stable financial systems and liberal markets. So far, there was little indication that Germany was ready to lead, as it craved for a more measured, less hectic response to the crisis. *"No one—not Merkel, not Steinbrück, not Steinmeier—is going out and saying, this is what we should do, as one might expect in a crisis,"* said Jan Techau, political analyst at the German Council on Foreign Relations. (Theil 25)

On November 4, President Nicolas Sarkozy unveiled a €26 billion stimulus plan for the faltering French economy, targeting investment projects rather than directly aiding consumers. *"Our answer to this crisis is investment because it is the best way to support growth and save the jobs of today, and the only way to prepare for the jobs of tomorrow"* said Sarkozy in a keynote speech in northern France.<sup>62</sup> On November 7, after chairing an unofficial emergency EU summit devoted to the economic crisis in Brussels, French President declared that the European leaders have agreed to coordinate economic policy-making, for the first time, as part of their effort to combat looming recession. The European Commission would come up with proposals on a coordinated economic strategy for Europe by next month. Sarkozy's statement alarmed Eurosceptics who feared the EU was moving towards a common tax policy, while such calls have always been strenuously opposed by Germany and Britain. But Gordon Brown, while not going as far as a common economic policy-making, also said the 27 countries of the EU should coordinate their fiscal policies to fight recession and encourage growth.

*"There's a role for fiscal policy to support monetary policy across Europe".* He added that EU member states should pursue a similar track in their taxation, public borrowing and spending policies. On November 13, despite its low borrowing costs and broadly balanced budget, Germany announced a modest stimulus package of €12 billion (\$15 billion) -roughly 0.25% of GDP- to be spent over two years<sup>63</sup> and apparently without consulting with its European partners.<sup>64</sup> On November 15, at its Washington Summit, the G-20 committed to a self-imposed standstill in terms of new barriers to investment or to trade in goods and services.<sup>65</sup> Their communique had forsaken protectionism and pledging "economic stimulus" programs. Yet much of the "cooperation" was left on press releases, as countries agreed on broad principles but went their separate ways. (Samuelson, 39) On November 20, roughly five days after the G-20 pledge and a month after his call for a 'new balance between market and the state', Sarkozy, introduced a "strategic national investment fund" of €20 billion (\$25 billion) to take stakes in French companies to protect them from foreign predators.<sup>66</sup> Sarkozy said the fund stood ready to take stakes in large and strategically important companies vulnerable to takeovers because of falling stock prices: *"I won't let foreign funds get bargains thanks to the current levels of the stock market."*<sup>67</sup>

As the financial crisis continued to spill over into the "real" economy and push more and more countries into recession, a growing number of industries were lining up for their share of the state aid. By late November, it was the car companies' turn, with the U.S. Congress debating an immediate \$25 billion cash infusion for Detroit's "Big Three" automakers, General Motors, Ford and Chrysler. European automakers called for a \$50 billion aid package of their own. But unlike the bank bailouts, which could be argued to be necessary to avert a global financial meltdown, auto aid had the risk of turning into an old-fashioned subsidy race. In Europe the question was not just whether to help car makers but what strings to attach to any bailout so that it didn't just prop up zombie companies, their subsidized products depressing market prices -as was the case with the European coal mines and shipyards that spent decades on life support before dying. Since politicians lacked the knowledge to decide which companies to support and usually prop up the losers, the EU Commission and several European governments had chosen a smarter policy alternative where they would be propping up the market by subsidizing car buyers instead, letting them decide which models and companies to survive. The Commission was insisting that any aid package be implemented on a Europe-wide, not on national levels. Otherwise, EU Competition Commissioner Neelie Kroes has warned, the explosion of bailouts risks turning into a destructive round of "beggar-thy-neighbor" policies, akin to the tariff wars in the 1930s that prolonged the Great Depression. Also, EU Commission president José Barroso has threatened to take the United States to the World Trade Organization if it props up Detroit with aid.<sup>68</sup> On November 24, however, Nicolas Sarkozy and Angela Merkel agreed to unilaterally support the crisis-stricken automobile industry in France and Germany.<sup>69</sup>

On November 25, the U.S. Federal Reserve had announced another \$800 billion stimulus package, since banks were still reluctant to lend despite the previous \$700 billion plan.<sup>70</sup> “*Key lending such as credit cards, car loans and student loans had essentially come to a halt in October. The new measures are aimed at getting these types of lending back to more normal levels.*” said U.S. Treasury Secretary Henry Paulson. Under the latest rescue plan the Fed would buy up to \$100 billion in debt from the troubled mortgage giants Fannie Mae and Freddie Mac and buy another \$500 billion in mortgage-backed securities over a number of months.<sup>71</sup> On November 26, long criticized for doing 'too little too late' to tackle a European recession, the European Commission proposed the European Economic Recovery Plan (EERP), a coordinated fiscal stimulus package, worth €200 billion (\$258 billion) or 1.5% of the European Union's GDP. (globalissues.org) It set out policies -temporary cuts in employment and sales taxes, spending increases like more generous state support for the low-paid and jobless...etc- to be implemented by the European Union members over the next two years to give the economy a short-term lift. (The Economist, 29 November 2008, 71) The Commission's proposals, unveiled as the European Union's answer to the swelling financial and economic crisis, has not been taken up enthusiastically by member states since the proposed package left the bulk of spending and fiscal stimuli to the member states. According to the plan, 27 members would have to provide €170 billion of the €200 billion -or 1.2% of European GDP- while only the remaining €30 billion would come from Brussels' coffers in the form of European Investment Bank (EIB) loans and accelerating payments from the cohesion and structural funds which mainly went to the new members in central Europe. What's more, the package did not specify how the "burden" of meeting the 1.2% of GDP target would be shared amongst members with quite different economic performances,<sup>72</sup> as some were in recession while others were experiencing 4% growth).<sup>73</sup> Although Germany's role naturally looked like to be bigger, Angela Merkel hit out at those who say Germany should do more and criticized the loosening by other countries. (Economist, 29 November 2008) She had told the German parliament: “*Excessively cheap money in the U.S. was a driver of today's crisis*” (Lynn 78). Since the economic conditions and budgetary policies wildly varied across the union, Commission President José Manuel Barroso emphasized that there could be no "one-size-fits-all" formula. As a result, apart from new EIB loans and cohesion/structural funds, EU's fiscal stimulus package was concentrated on coordinating national schemes and represented a "tool-box" for members to use as they saw fit. The Commission also announced that the prospect of a deep recession meant the rules that cap budget deficits at 3% of GDP for Eurozone countries were being temporarily relaxed. That gave France and Italy, which were close to the limit, some room for maneuver. (Economist, 29 November 2008) Barroso also proclaimed that they preferred increased public spending over tax cuts to keep the recession as short and shallow as possible. (guardian.co.uk) The Commission's proposals were left to be discussed at an EU summit in December 2008.

On December 2, speaking at a national congress in Stuttgart, Merkel rejected a growing faction within her party, in the German media and among the country's economists calling for a heftier round of tax cuts and government spending. (Theil 25) She had admitted that the financial crisis had hit the German banking industry almost as hard as the American or the British. Sounding extraordinarily Thatcherite, however, she told her audience: *"You cannot live beyond your means in the long run. Governments had a responsibility to future generations of taxpayers. We are not going to participate in this senseless race for billions"*. (Lynn 75) She was not finished. *"We have to have the courage to swim against the tide."* While Merkel has become known as "Frau Nein", or Mrs. No, for her refusal to act,<sup>74</sup> her course was entirely understandable. With national elections in September 2009, a big tax cut or spending boost would ruin her administration's proudest major accomplishment: balancing Germany's budget. If she were to cut taxes, she would risk looking ineffectual once the predicted rise in unemployment would hit well before the election. Any additional stimulus passed would also risk disappearing in voters' minds especially once Barack Obama's planned \$700 billion spending spree, which dwarfed anything the Europeans were discussing, hits the German tabloids. What's more, her steady-handed, no-panic course was popular with German voters as her approval ratings remained the highest of any major Western leader. (Theil 25)

On December 4, the heads of Detroit's "Big Three" automakers, General Motors, Ford and Chrysler traveled from Detroit to Washington in hybrid vehicles packed with action plans a month after being mocked for coming to earlier congressional hearings on private jets without detailed plans to revitalize their companies. They agreed to work for \$1 a year if lawmakers were to approve their bids for emergency government aid totaling \$34 billion.<sup>75</sup> On December 8, Gordon Brown, Nicolas Sarkozy and the European Commission president José Manuel Barroso met for an informal summit in London. The leaders were hoping for a German economic package early next year to minimize the impact of the recession. They all spoke separately with Merkel on the phone, to reassure the chancellor that their London get-together was not an effort to undermine her. Sarkozy said Merkel had realized 'the position was very serious' and there was no requirement for every leader or country to use the same tool from the toolkit. The French president rejected suggestions that Britain and France were on fighting terms with Germany. In a sign that he expects more from Germany, Barroso said *"I have full confidence in the measures Germany is making and will make. Germany is the most important European economy and so it would be completely unreasonable to think about any plan without the active cooperation of Germany"* as the motor of the European economy has been accused of being far too timid in its response to the downturn so far. (guardian.co.uk 9 December 2008) On December 12, hijacking much of the Lisbon Treaty debate, the Commission's European Economic Recovery Plan had been agreed on at the summit of European Union leaders in Brussels, in hopes to ease the economic downturn. But leaders had watered down the original proposal by pledging "around" €200 billion, instead of "at least", to the package. The proposal ironically read: *"The EU will act in a united,*

*strong, rapid and decisive manner to avoid a recessionary spiral and sustain economic activity and employment" while Gordon Brown said "Europe is fully united", downplaying a division between Germany and Britain on how they should spend.<sup>76</sup> On December 15, German Finance Minister Peer Steinbrück, leading the German defense on fight against the tremendous pressures to deliver what he mockingly calls the "Great Rescue Plan" talked to the press: "Brussels and a few other countries have been setting up large-scale spending programs, without questioning their real effects. The speed at which proposals are put together under pressure that don't even pass an economic test is breathtaking and depressing. And since the amounts are so high, they thought 'Well, lets get the Germans to pay because they can'. Ms.Merkel and I are trying to calm them down a bit just now"<sup>77</sup>*

Since the beginning of the financial and economic crisis in the autumn of 2008, the EU Commission had issued a number of Communications on the criteria for the compatibility of member states' support to banks and non-financial firms with the requirements of Article 107(3)(b) of the Treaty on the Functioning of the European Union (TFEU). But more crucially, on December 17, the Commission adopted a "Temporary Framework" (Temporary Community Framework for State Aid Measures to Support Access to Finance in the Current Financial and Economic Crisis), to provide member states with the possibility of adopting additional State Aid measures to facilitate companies' access to finance.<sup>78</sup> On December 19, the *Der Spiegel-Online* reported that Chancellor Angela Merkel would pump a second package into the struggling economy, amounting to €40 billion, or almost four times the first €12 billion stimulus package which was much ridiculed by Germany's EU partners. The new package, would give a fiscal stimulus of up to 2% of GDP compared with the average of 1.5% sought under the EU's €200 billion stimulus package endorsed at the EU summit. With German business confidence at a 25-year low and a predicted 3% contraction in 2009, Merkel admitted her government would be forced to borrow more money to meet 'extraordinary challenges'. Peer Steinbrueck, the fiercest opponent of increased spending to reboot the economy, acknowledged that the economy would sink deeper into the swamp that quarter, as exports withered and unemployment was set to rise.<sup>79</sup>

On December 19, the U.S. announced a \$17.4 billion lifeline to Detroit car makers from the \$700 billion Troubled Asset Relief (TARP) program. GM was to receive \$13.4 billion and Chrysler \$4 billion. Ford said it did not need a loan.<sup>80</sup> On December 23, the European Commission rushed through approval of proposed changes to Britain's bank guarantee scheme, only four days after its submission to the Commission. The U.K.'s banking sector rescue package, worth £500 billion, brought the total changes endorsed by the Commission to around three dozen since the beginning of the crisis. The British government, however, had to wait until well into 2009 to get a final settlement with the Commission of its bail-out, and subsequent nationalization, of Northern Rock which had been put aside as more urgent cases overwhelm the 50 Commission staff dealing with bank rescues.<sup>81</sup> As 2008

turned to 2009, world leaders have spent trillions on confused rescue plans which were both unprecedented in scope and creativity. In the United States alone, Ben Bernanke and Hank Paulson have orchestrated a dozen rescue measures throughout the year. However, it was becoming frighteningly clear that the world's dramatic financial rescue efforts were wholly inadequate. Despite the around-the-clock labor by officials on a number of continents, the world stood on the threshold of a disaster that goes well beyond the deepening of a global recession, but one that could lead to major political instability and conflict.<sup>82</sup>

## **2.8. The Eurozone: Noah's Ark in the midst of Turmoil**

*“Since the introduction of Euro, fellow Europeans have enjoyed a level of price stability which previously had been achieved in only a few of the Euro area countries. This price stability is a direct benefit to all citizens. It protects incomes and savings, and it helps to bring down borrowing costs, thus promoting investment, job creation and prosperity over the medium and long term.”*

Jean-Claude Trichet, President of European Central Bank,  
Celebrating the 10<sup>th</sup> anniversary of the Euro, Strasbourg, January 2009

On January 13, Jean-Claude Trichet, President of the European Central Bank, on the tenth anniversary celebrations of the Euro, pointed at key achievements of the first decade since the single currency was introduced. First of all, the Euro had sailed through the crisis unscathed. Second, the primary goal of the economic union, being the ‘price stability’, had been achieved. (Lynn 9) Inflation was low and steady right across the vast continental economy. Government bond markets functioned smoothly: Portugal could borrow money just as easily and almost as cheaply as the Netherlands or Germany, despite vastly differing credit records. (Lynn 14) Finally, the Euro coverage was getting bigger. Despite the British, the Swedes and the Danes rejections to take part at the beginning of the grand experiment, it was turning into a club that everyone wanted to join. (Lynn 9) As the crisis deepened, by late 2008, Euro, depicted as an unsinkable safe haven, became ever more attractive to EU countries opted out of the Eurozone.<sup>83</sup> The “*L'euro protecteur*”s had argued countries like Hungary, Iceland and Denmark whose national currencies have come under attack had “only one dream”: to get into the Euro and shelter from the storm. Membership to Euro did seem to have protected small, open economies with big banking sectors, such as Belgium, Luxembourg and Ireland, from potential runs on their currencies- a lesson that outsiders were beginning to draw. Boosters of Eurozone enlargement have also called for the rules on admission to be loosened, so that countries could climb aboard the Euro-ark sooner. The European Commission has also been flooded with calls to ease requirements for Euro entry but would not consider it. Denmark, forced to raise interest rates above the Eurozone's, due to global downturn and speculative attacks, might be an exemption. However, in contrast to the Danes,

Icelandic ministers visiting Brussels have been firmly told that Euro membership could not happen unless they join the EU first, a process that would take considerable amount of time, especially considering the Eurozone governments' wariness of enlargement at the time. The new members in Eastern Europe were gearing up to meet the strict conditions for adopting the currency, while even among the Brits, there were hints of loosening Euro hostility. The continent-wide change of heart was no mystery. Smaller nations outside of the Eurozone have found themselves exposed to speculative attacks on their currencies and weaker economies like Hungary had seen their currencies plunge. The ECB has won favor with Eurozone members by sidelining the fight against inflation.<sup>84</sup> While the Fed basically dozed through the subprime mess -it had continually surprised as one domino fell after another like Fannie Mae, Freddie Mac, AIG, Lehman Brothers and the whole economic system, despite having responsibility for overseeing the financial sector and employing hundreds of economists-<sup>85</sup>, EBC has been quick to cut interest rates<sup>85</sup> and pump cash into the money markets to help out the liquidity-starved banks. (Newsweek, 15 November 2008). There was also the growing importance of the Euro in the capital markets, as the global importance of the dollar declined due to U.S.'s evermore reckless fiscal policy and failure to hold the line against inflation. As a result, governments had started looking for a safer alternative for the world's reserve currency. As the Euro established itself and gained credibility, OPEC, the powerful cartel of oil produces, started to make noises about pricing oil in Euros rather than dollars. The Chinese, who accumulates vast trade surpluses, started to talk about holding more of their assets in Euros rather than dollars. Whichever way you looked at it, the European currency was gaining ground over the American one. (Lynn 13) All in all, the single currency's successes were making its founders proud of their creation. (Lynn 14)

## **2.9. The Great American Robbery: Corporate Welfarism**

*“We’ve seen money go out the back door of this government unlike any time in the history of our country. Nobody knows what went out of the Federal Reserve Board, to whom and for what purpose. How much from the FDIC? How much from TARP? When? Why?”*

Senator Byron Dorgan, North Dakota Democrat, February 2009

On January 20, 2009 Barack Obama took office, inheriting two unfinished wars and a financial mess. At the time, the downward momentum was so solidly in place that there was nothing he could do to reverse it immediately. (Stiglitz 59) The main question was, would he continue with the corporate welfarism of George W. Bush or not. (Stiglitz 38) Remarkably, President Obama, campaigning on the promise of “*Change You Can Believe In*”, only slightly rearranged the seats of the economic team in Washington. (Stiglitz 46) He had choose to stick with the old team who had vested interest in the past



-either in the deregulatory movement that pulled the U.S. into this mess or in the faltering rescues that had marked 2008. The champions of deregulation had pressed for making sure that their ideas prevailed - even in the face of overwhelming evidence to the contrary. The champions of government assistance, continued to claim that making banks pay for the mess would impede their recovery. Thus, on the question of who bears the costs? Obama administration signaled the 'American taxpayer' rather than the 'Wall Street', sticking with the course of the Bush administration. (Stiglitz 38) The government claimed that the banks were '*too big to fail*' -indeed so big that the ordinary rules of capitalism were suspended to protect their bondholders and shareholders- and yet did not propose to break them up or tax them or impose additional restrictions on them so that they would no longer be '*too big to fail*'. America has long had a suspicion of banks, especially big banks -and for a good reason. In this episode of the old conflict between Wall Street and the rest of the country, the banks held the gun to the heads of the American people and threatened: "*If you don't give us more money, you will suffer. There is no alternative. If you impose constraints -if you stop us from paying dividends or bonuses, or if you hold our executives accountable we will never be able to raise capital in the future.*" Bankers took advantage of the panic and used the 'fear of an economic collapse' to redistribute wealth -to extract enormous amounts of money from American taxpayers to enrich their own. (Stiglitz 41) And in each instance of money pumping, taxpayers were told that the government had to recapitalize the banks if the economy was to recover. (Stiglitz 41) No one was surprised when Bush sided with Wall Street and gave in to its blackmail. But many had hoped that Obama would take a different path, (Stiglitz 51) instead of risking the sense of fairness and social cohesion in the long run, as the financial sector, which had used its out-sized profits to buy the political influence first to free itself from regulations and then to secure a trillion-dollar bailout, became the target of public outrage. It was not clear how long the public would tolerate the hypocrisy of these long-time advocates of fiscal responsibility and free markets continue to agree against help for homeowners on the grounds of 'moral hazard' -that helping them out would simply lead to more bailouts in the future and reduce incentives to repay loans- while making unbridled requests of money for themselves. (Stiglitz 39)

By the end of January 2009, the total U.S. bailout had reached \$9.7 trillion. The Federal Reserve, Treasury Department and Federal Deposit Insurance Corporation have lent or spent almost \$3 trillion over the past two years and pledged up to \$5.7 trillion, in order to rescue the financial system after the credit markets seized up about 18 months ago. Pledges only, amounted to almost two-thirds of the value of everything produced in the U.S. in 2008. The \$9.7 trillion in bailouts would be enough to send a \$1,430 check to every man, woman and child alive in the world. It was 13 times what the U.S. has spent so far on wars in Iraq and Afghanistan and enough to pay off more than %90 of America's mortgages, calculated at \$10.5 trillion by the Federal Reserve<sup>86</sup> (although this bailout barely helped homeowners).<sup>87</sup> The Federal Reserve, however, refused to disclose loan recipients from the TARP which was approved by the Congress on October 3. (bloomberg.com)

## 2.10. Europe's Economic Integration: from “tearing down” to “building up” barriers to trade

*"If every country acts according to 'my way or the highway', the banking sector as a whole - and with it the entire world economy- will suffer for many, many years to come."*

Neelie Kroes, EU Competition Commissioner, February 2009

The start of 2009 had seen Europe get protectionist as the recession bite deeper. The rescue of finance sectors quickly bleed into other industries. While some European leaders have expressed concerns about the region's protectionist reflexes, others were talking about ways to fence in their economies. In a few special cases, leaders appeared to be doing both. There was, however, at least some reversal of the relatively free-flowing trade and workers of the past few years.<sup>88</sup> The most remarkable u-turn was that of the government in Berlin which had gone through an astonishing change of heart. Only a few weeks back, Angela Merkel spoke out against "arbitrary, unfocused economic stimulus programs" and large-scale government intervention in the economy. But, suddenly, on January 13, she had introduced the biggest economic stimulus program in German post-war history, amounting to €1.5 billion, as well as giving her blessing to a series of government interventions into companies and industries, the likes of which the country has not seen since German reunification. The government has acquired a %25 share of Commerzbank and planed to purchase a majority stake in the ailing Hypo Real Estate. It was looking into assisting the highly leveraged Schaeffler Group and has made several hundred billion Euros in additional guarantees available to companies. Merkel's government hoped to stimulate the auto industry with a so-called "scrap premium" to encourage drivers to take old vehicles off the road,<sup>89</sup> as the aid package, included €2,500 incentives for new car purchases.<sup>90</sup>

It was hard to stay loyal to liberal markets when voters were demanding action in the middle of an economic meltdown. Ironically enough, this phenomena had been more evident in the U.K., European Union's most enthusiastic cheerleader of American-style deregulation and free trade. As early as 2007, British Prime Minister Gordon Brown promising that his government would impress upon businesses the need to create *“British jobs for British workers”*. On January 27, when British unions were protesting a decision by Total, a French-owned oil plant, to bring in 300 Italian and Portuguese contract laborers, British workers asked the prime minister to stick to his 2007 pledge. They wanted jobs to go to locals, not to cheap foreign workers. Officials have come under similar pressures in Ireland where Irish workers wanted construction companies to give precedence to Irish laborers over foreigners, pointing at the 300.000 Polish workers who had flocked once booming building sector of the country after Poland had joined the EU in 2004. But calls for labor protection run counter to EU rules that ensure the free flow of goods, services and workers while risking a chain reaction of protectionism.(time.com) On January 29, more than one million people have taken to the streets in France, as the first general strike to hit a major industrialized nation since the start of the global

financial crisis. Unions said million of workers had rallied to protest the handling of the economic crisis and demand action to protect wages and jobs, causing disruption to rail and air services.<sup>91</sup>

On February 6, Italy unveiled a \$1.7 billion package of measures to help its car sector, including a scraper incentive similar to Germany's. (reuters.com) On February 9, Nicolas Sarkozy announced that the French Government would provide up to €7 billion (\$8.9 billion) in emergency financing to<sup>92</sup> its struggling car industry, as the head of Renault warned that the European auto industry needed quick action to save it from collapse.<sup>93</sup> Non-French carriers could benefit from the scheme as well, however, the clear aim was to favor national companies. The two leading domestic car companies, Renault, partly in state hands, and Peugeot Citroën, which had already been handed more than €1 billion to boost lending by their finance/leasing arms, would enjoy the bulk of €7 billion package,<sup>94</sup> in the form of low-interest loans. The loans would have a five year life at 6% interest, which was well below the current global interest rates at the time. One of the conditions of these loans was that both automakers must pledge to retain employment in the region and ensure to buy from French component makers (keeping the money at home) in return for the funding. Nicolas Sarkozy's take on the matter was "*We want to stop moving factories abroad, and perhaps we will bring them back. If we are to give financial assistance to the auto industry, we don't want to see another factory being moved to the Czech Republic*" (hubpages.com) while French Prime Minister Francois Fillon warned that in return for the loans car makers must keep jobs in France and that "*there is no question of the state helping a manufacturer that decides to simply close one or several production sites in France*".(indianexpress.com) While both speeches sparked anger from other EU members, the conditions attached have already raised anti-protectionist eyebrows in Brussels. Especially those of Neelie Kroes, EU Competition Commissioner. The terms of the bailout clearly enjoin the car makers to save French jobs and factories at the expense of other Europeans.(buzzle.com) Financing still needed to be approved by the EU Competition Commission in Brussels, to insure that the loans do not break EU rules. However, Fillon has said he would not accept a three-month delay while Kroes considers the scheme, claiming that "*This is an emergency.*" (hubpages.com) On February 13, Spain approved a €4 billion package that included €1.2 billion in credit for car purchases during 2009 and 2010 along with aid to help parts makers upgrade plants. (reuters.com) However, especially the new member states from Central and Eastern Europe, could not get over France's protectionist impulses. The EU Council President Czech Republic has decided call the EU leaders for a special summit on March 1, to discuss recent "protectionist steps and statements" by member states. This was especially a response to moves and calls by Sarkozy to repatriate production of French cars from Eastern Europe.<sup>95</sup> The new member states, meeting at Poland's initiative on the day of the summit, voiced support for adherence to Community legislation on the functioning of the internal market, objection to protectionist measures and highlighted the European Commission's role as the "guardian of the Treaty". Eventually, France has given up on the most controversial elements of the plan.<sup>96</sup>

## 2.11. Sovereign Sorrows

*“Only government can break the vicious cycles that are crippling our economy -- where a lack of spending leads to lost jobs which leads to even less spending”*

Barak Obama, President of the United States, January 2009

On April 2, the leaders of the Group of 20 industrial nations (G-20) met in London to discuss the crisis that was engulfing the global economy for the last year and a half. This was the first major foray that the new, exciting and dynamic U.S. President Barack Obama had made into global summitry. (Lynn 93) Obama, like the British Prime Minister Gordon Brown, believed that the government could spend its way out of this recession. Thus, joined by France’s Nicolas Sarkozy, both leaders put together an agreement for a massive coordinated attempt to use the power of government spending to float the global economy off the financial rocks. The official communiqué was a hymn to the power of government to boost demand. (Lynn, 94) Fourteen years after U.S. President Bill Clinton had announced that the “era of big government is over”, big government was back with a vengeance.<sup>97</sup> There was some resistance to the package, however, most predictably from Germans. Yet few leaders wanted to stand up to Barak Obama, America's most glamorous president since Kennedy, who was also a hugely popular figure globally. There was not much point in getting on the wrong side of Obama since he looked like to be in power for along time. (Lynn, 94) Thus, the G-20 leadership agreed that they would boost their own economies with higher public spending and that an extra \$1 trillion would be made available to the International Monetary Fund (IMF) to ride to the rescue of any country that might find itself in financial trouble. Leaders around the world had bought into the idea that a depression could be fought by massively boosting spending. Governments would be moving where the markets have failed and banks have collapsed. Thus, the G-20 meeting provided cover for leaders to spend their way out of the slump. They could go back home, explain that the whole world was doing the same and hope to secure support for piling up public debts on a scale that had seldom been seen before. (Lynn 95) As a direct result of this spendthrift atmosphere, governments were extending emergency credit to their financial sectors on an unprecedented scale. It was without question the greatest coordinated government rescue effort ever mounted. Nor was it to end there. If the credit crunch had merely been restricted to the banking industry, that would have been bad enough. But finance was more than just a profitable occupation for sharp-suited young men in gleaming glass-and-steel skyscrapers. It was also the lifeblood of an economy. In the wake of the collapse of the banking system, global trade and with it global manufacturing, suddenly fell off a cliff. In the final quarter of 2008, global trade dropped by %15. (Lynn 97) Not surprisingly, by the start of 2009, the crisis was feeding through to the GDP numbers. As trade collapsed, economies went into recession. The impact was sudden and brutal. For the first quarter of 2009, the annualized rate of decline in GDP

was %14.4 in Germany, %7.4 in U.K., %9.8 in the Eurozone as a whole and %6 in the United States. (Lynn 98)

The crux of the matter was; debt was trying to be cured by spending. At the heart of the credit crunch was a debt crisis. And governments were choosing to fix it with even more debt. (Lynn 98) Over the years, debt was seeping into every corner of major economies. By 2008 everybody was drowning in debts; whether it be through credit cards and mortgage lending for individuals, private equity in companies or sovereign bonds to governments. The economies had been turbocharged, using the power of debt to boost spending, increase consumption and, at least for a time, make everyone feel that the economy was growing a lot faster than it really was. The financial system, having free rein to do pretty much whatever it wanted; had sliced and diced the debts, finding smarter and smarter ways to wrap them up, put them inside new packages and find new balance sheets to park them on. (Lynn 99) Lots of money had been lent to people who couldn't really afford it and weren't ever likely to earn enough money to pay it back. It was a catastrophe in the making. At root, far more debt had been taken on than could ever realistically be repaid. When the crisis hit, however, governments felt that they had no choice but to respond to it with even more debt. (Lynn 100) In fact what's happening was, debt has simply being transferred from the private and corporate to the public sector. Between 1970 and 2007, total public debt in the advanced economies had steadily risen from 40% to 76% of GDP. By 2011, it had passed %100. The last time public debt had exploded on anything like that was during the Second World War, when it reached %120 of GDP in the United States and %275 of GDP in Britain. (Lynn 107) Ironically enough, the way that governments were fixing the credit crunch, was paving the way for the next crisis, this time revolving around the Euro and sovereign debt. (Lynn 104)

Over the course of 2008, interest rates were slashed to close to zero in all major economies in a series of coordinated rate cuts. But it soon became clear that would not be enough to bring the global economy back to life. So instead central banks embarked on massive, direct interventions in the money markets to buy assets for which there would otherwise be no buyers. The phenomenon, led most enthusiastically by the Federal Reserve and the Bank of England, was called *quantitative easing*, simply because it sounded a lot better than *printing money* or *creating inflation*. (Lynn 102) Once *quantitative easing* was underway, the bond holders had lost their power. They were like tigers with their teeth pulled off: They couldn't bite anymore. Since the central banks were buying all the government bonds nobody cared what the money managers thought. Thus, the discipline on governments had been practically removed. They could spend just about whatever they wanted because central banks were simply printing money to finance their deficits. (Lynn 104) The European Central Bank, however, stopped short of both Fed and the Bank of England on *quantitative easing*. It had too much of the old Bundesbank stamped into its DNA. Printing money was just not the kind of thing it did. German central bankers had tried that in the 1920s and the result -World War II and

Holocaust- were not so desirable. Thus, the ECB printed money by the back door. It provided unlimited loans to the main European banks and allowed them to buy up the bad assets instead. So, in effect what happened was this: A bank could borrow unlimited sums of money from the ECB, at a rate around %1. It could then use the money to buy Greek government bonds which paid %4+ in interest. There was no risk to the trade, because the ECB would accept the bonds of any Eurozone government as collateral for yet more loans. (Lynn 105) It was perfect. Free and easy money in unlimited quantities. Why should the bankers resist? The trouble was, it created a false sense of security. European banks were recovering because of the easy money coming from the “carry trade” of borrowing from the European Central Bank and passing the money on to the governments. At the same time, the governments were finding it very simple to finance their ballooning deficits. The artificial demand for higher-yielding government bonds, like that of Greece, sent a message to the governments that high fiscal deficits, which had swollen due to governments' response to the recession, weren't a problem for the markets. The lucrative “carry trade” meant that all those inconvenient truths could be conveniently swept under the carpet. As deficits rose, the markets didn't murmur and the banks just kept on buying the bonds as if everything was okay. (Lynn 106)

Starting with the second quarter of 2009, there had been indications that the global economy was recovering. By the summer of that year, the markets were already in the '*crisis is over*' mode.<sup>98</sup> The wide-ranging measures undertaken in many countries as well as a strong performance in Asia were important factors of this 'rebound' in global economic activity.<sup>99</sup> On September 25, the leaders of the G-20 gathered in Pittsburgh mostly for self-praise and adoration, while a tiny voice of caution squeezed between the lines. The leaders' statement of the summit read as such: *“When we last gathered in April, we confronted the greatest challenge to the world economy in our generation. Global output was contracting at pace not seen since the 1930s. Trade was plummeting. Jobs were disappearing rapidly. At that time, our countries agreed to do everything necessary to ensure recovery, to repair our financial systems and to maintain the global flow of capital. Our national commitments to restore growth resulted in the largest and most coordinated fiscal and monetary stimulus ever undertaken. It worked. But a sense of normalcy should not lead to complacency. The process of recovery remains incomplete. We pledge today to sustain our strong policy response until a durable recovery is secured. We will avoid any premature withdrawal of stimulus. At the same time, we will prepare our exit strategies and, when the time is right, withdraw our extraordinary policy support in a coordinated way.”*<sup>100</sup> On October 4, at the IMF's International Monetary and Financial Committee's meeting held in Istanbul, German Finance Minister Peer Steinbrück asked world leaders to consider coordinated “exit strategy” from trillions of dollars' worth stimulus programs enacted in the past year, to strengthen sustainability and fair competition. To varying degrees the U.S., U.K., France and other major nations have also exhorted the world to start thinking about how to end the loose-money policies of the past year that kept interest rates low and handed free cash to consumers.<sup>101</sup>

The European Commission President Jose Manuel Barroso claimed that: *“The current fiscal stimulus cannot go on indefinitely. Too much stimulus over too long a period would saddle future generations with unsustainable debt. Yet, no one really knows when the right moment will come to insist that the banking sector once again stand on its two feet”*.<sup>102</sup>

By mid-November, British Eurosceptics started talking about the break-up of the single currency, after the gap widened dramatically between Germany’s bond yield and those that Italy and Greece were offering on government debt. The markets seemed to be saying that Italy and Greece could not be trusted to share a currency with Germany. Their argument was for these weaker Eurozone countries to either default on their debts or crash out of the single currency or (most likely) both. But some saw these widening spreads as a positive phenomenon; as the markets started sending useful signals to uncompetitive or profligate countries. A year ago the markets simply did not pay close attention to such things. Now they are warier of risk and hunting for assets that could be turned into cash without the danger of suddenly losing value. (Newsweek, 15 November 2008). As 2009 turned into 2010 as fears of another depression eased, the markets slowly started to worry again over whether or not the built up of sovereign debts could ever possibly get repaid. The cure was suddenly looking even worse than the disease, (Lynn 2) as the GDP decline and government debt increases summarized in Table 2.

## **2.12. The Greek Tragedy: How did the “Europe's Spoiled Child” spoiled “Europe”**

*“Peoples of Europe, Rise Up”*

Communist Party of Greece (KKE)  
banner on Acropolis, May 2010

Ironically enough, the Greeks who had given one of their letters, “€”, as the symbol of Euro, would be the ones wracking the single European currency, nearly a decade later. The whole story, mounting up over the past year, tipped off on December 7, when the credit rating agency Standard & Poor’s, downgraded Greece’s sovereign debt rating to “A-”. As it turned out, that was the last thing the investors wanted to hear. The Greek government's debt had seen a heavy sell-off in the markets, amid loose of faith in country's ability to pay it back. That same day, the European Central Bank President Jean-Claude Trichet said that the Greece was facing a “very difficult” situation and needed to take “courageous” decisions to bring its budget deficit under control, when asked about the situation. (Lynn 127, 128) On December 8, a massive sell-off of Greek government bonds followed Fitch Ratings' lowering of the country's grade to “BBB-plus”. On December 10, as the EU leaders gathered in Bonn

for a routine summit, the markets looked for reassurance that the rest of Europe would stand behind Greece if necessary. *“If something happens in one country, then all other countries are affected since we have a common currency and a common responsibility”* said German Chancellor Angela Merkel. That sounded good enough. Yet the chairman of the Bonn summit, Swedish Prime Minister Fredrik Reinfeldt seemed to think differently: *“What we now are seeing in Greece is of course problematic, but it is basically a domestic problem that has to be addressed by domestic decisions. I am not sure it will actually come up tonight”*. And that didn’t sound like a man who was in a great hurry to help out the Greeks. (Lynn 129, 130) Markets responded with yet another round of Greek-debt-selling. On December 14, after admitting that the previous government has cooked the books for years, Greek Prime Minister Georges Papandreou announced radical plans to cut the country's deficit by %4, in 2010-2011. (guardian.co.uk, 15 December 2010) Nobody seemed to care. On December 16, Standard & Poor’s continued to downgrade Greek government bonds to “BBB-plus” while Angela Merkel assured the German Parliament: *“With a view to some countries with very high deficits, let me say that each member state is responsible for healthy public finances.”* (Lynn 132) On December 17, European Central Bank Vice President Lucas Papademos was hammering home the same message. It was up to the Greeks to sort this mess out with cuts, cuts, cuts and more cuts. As Christmas 2009 approached, a pattern was starting to emerge. One of the big rating agencies would downgrade Greek debt, the markets would panic, a sell-off would follow and finally the government would step in with another revamped austerity package, none of which was convincing investors that Greece would be able to solve the problem alone, (Lynn 133) as the European Union had shown no signs of offering a helping hand. On January 6, the Bundesbank's Jürgen Stark had told the press that: *“The Treaties set out a 'no bail-out' clause and the rules will be respected.”* (Lynn 142)

Over the course of February, Georges Papandreou, continued to fulfill his promise of disclosing problems in government’s accounts, by announcing that Goldman Sachs, an American investment bank, had used a series of elaborate swap arrangements and derivatives to disguise the amount of money the Greek government was borrowing, in order for Greece to meet the Convergence Criteria to join the Euro. (Stiglitz 324) *“It is a scandal if it turned out that the same banks that brought us to the brink of the abyss helped fake the statistics”* said German Chancellor Angela Merkel in a speech. Her government's financial affairs spokesman Michael Meister argued that the Goldman’s swap arrangement ‘broke the spirit of the Maastricht Treaty’. (Lynn 120) Meanwhile, the financial markets opted not to reward Papandreou’s honesty; instead, they punished Greece with a vengeance (Stiglitz 324) through unprecedented sell-offs. On February 24, a general strike was called to protest the latest package of cutbacks in spending. *“We refuse to pay the price for a crisis that we didn’t create”, “Tax the rich”, “Hands off our pension funds”* read the banners. (Lynn 134) On that same day, the Greek Deputy Prime Minister Theodoros Pangalos, gave an interview to BBC blaming Nazis to take the gold from the Bank of Greece and never give it back. The idea that a bailout was a much-delayed war



reparation was a hard hit, prompting the German Foreign Ministry to claim that Germany paid 115 million Deutschmarks in restitution for Greek victims of Nazi crimes under a 1960 treaty. (Lynn 139) On March 1, Angela Merkel was still pushing for a no-bailout stance: *“We have a Treaty under which there is no possibility of paying to states in difficulty.”* Her economy minister Rainer Brüderle added the same day: *“Papandreou has said that he didn’t want one cent. The German government will not give one cent, anyway.”* (Lynn 142) On March 3, Greece unveiled a radical austerity package, announcing a third round of tax rises and spending cuts. Relations with Germany reached a low point when two German MPs suggested that Greece should sell off some islands, the Acropolis or the Parthenon to finance its debts. (guardian.co.uk, 15 December 2010) On that same day, realizing that there was very little sign of any concrete help from the rest of the European Union, Papandreou mentioned getting help from Washington-based International Monetary Fund instead: *“If markets don’t respond as we would like them to, due to their speculative behavior, then the final resort would be the International Monetary Fund”*. The very next day, ECB President Jean-Claude Trichet argued that calling on the IMF would not be “appropriate”. (Lynn 142, 143)

Slowly but surely, it was becoming clear that the crisis wouldn’t be resolved until the European Union demonstrated its willingness to offer some assistance. The earlier line that it was purely a ‘domestic matter’ couldn’t hold any longer. Thus, EU leaders were starting to raise the possibility of some kind of rescue package for the Greeks. On March 5, Luxembourg’s Prime Minister Jean-Claude Juncker, who headed the Eurogroup -representing the finance ministers of the Eurozone countries- tried his luck at assuring the markets: *“Greece won’t be left alone. We are telling financial markets: Look out, we are not abandoning Greece. The Eurozone stands ready to guarantee financial stability in the Euro region.”* The trouble was, it was just words. And the markets had plenty of those already. (Lynn 135) What’s even worse, the German street was diametrically opposed to such ideas, no matter how half-hearted and vague they were. On March 6, *Bild*, a German tabloid published an open letter to the Greek Prime Minister Georges Papandreaou, on his visit to Berlin: *“You are in Germany, a country very different from yours. Here no one has to pay thousands of Euros in ‘special gratuities’ to secure a bed in a hospital. Germany has high debt but pays it off as we wake in the morning and work all day. Our petrol stations have cash registers and our farmers don’t swindle EU subsidies with millions of non-existent olive trees...We want to be friends of the Greeks, that’s why we’ve given to your country 50 billion from the moment you enter the EU, but friendship also means that we remain honest.”* Another headline of the same paper screamed: *“Sell your islands, you bankrupt Greeks! And sell the Acropolis too!”* Another one suggested: *“We give you money, you give us Corfu!”* (Lynn 137) The mood was getting worse. Whipped up by *Bild* and the rest of the press, there was growing German hostility to the prospect of having to rescue Greece. While Greeks were resentful about having to go, cap in hand, to their richer neighbor who had sacked the country during Second World War. (Lynn 139) On April 3, Markus Ferber, a German European Parliamentarian revealed the unbearable truth once again: *“We’ll*

*be happy to give the Greeks anything, just not money*". (Lynn 142) On April 5, Greece's Deputy Prime Minister Theodoros Pangalos, told the Portuguese newspaper *Jornal de Negocioas* rather undiplomatically: *"You are the next victims"* (Lynn 187) On April 9, Fitch Ratings had hammered another nail into country's coffin by downgrading its debt to "BBB-minus". It was now on the same investment grade with Bulgaria and Panama. (Lynn 140) That same day, French President Nicolas Sarkozy told the press: *"The officials are ready to intervene at any moment"*. (Lynn 141)

On April 11, a deal was finally struck between Greece, EU and the IMF, to offer the country an emergency loan worth €45 billion, out of which €30 billion coming from the EU and the rest from IMF. The Germans insisted on loans to be charged at market interest rates so that there wouldn't be any kind of subsidy for the Greeks. That, however, defeated the point of the package. The reason why Greece had found itself in this mess, was because it couldn't afford the market rate. Merkel had to compromise to charge Greeks at %5, less than the %7+ that the markets were demanding at the time. (Lynn 144) The €45 billion would help, but Greece's total government debt totaled to more than €300 billion and it couldn't survive on that package alone. (Lynn 145) On that same day, while Luxembourg's Prime Minister Jean-Claude Juncker, proudly played the solidarity card: *"This is a problem of the Eurozone and we have to deal with the problem as the Eurozone"*, (Lynn 143) the German Deputy Finance Spokesman Hans Michealbach raised worries over "opening the doors to contagion": *"It's an invitation to spectaculars to make a killing on other Euro-region bonds and a bailout spiral"* (Lynn 145) On April 22, the Eurostat had revealed that Greece's budget deficit had hit %13.6 of GDP in 2009, higher than all previous estimates. On April 23, George Papandreou formally asked for the release of the EU-IMF package agreed earlier in the month, (Lynn 147) at a rather unfortunate time, coinciding with the regional elections in Germany. As her country still hadn't come to terms with the deal, Merkel found it impossible to ignore the pressure. On April 24, speaking in the town of Soest in North Rhine-Westphalia, the chancellor thundered: *"I've said for weeks that Greece must do its homework first"*, drawing endless applause from an audience, looking for a leader who would stand up for German interests. Merkel told the rally that she wanted Greece to agree to several years of budget cuts before releasing any German aid. The message was loud and clear: the Greeks hadn't done enough yet to prove they changed. (Lynn 148) On April 27, Standard & Poor's had lowered Greece's rating to BB-plus, the first time any Eurozone country had been downgraded that low by any of the major rating agencies. The country's debt had, in the view of the agency, reached "Junk" bond status, on a par with Egypt and Azerbaijan. It was possible to go lower -Zimbabwe, for example- but not by much. The sell-off was immediate and brutal. (Lynn 146) On April 28, just to add salt to the wound, S&P also cut its rating on Portugal. The Greek crisis was spreading across the Eurozone. (Lynn 146) On that very same day, the *Bild* thundered: *"Supposedly we have no money for*

*tax cuts, no money for school upgrades, no money to maintain parks, no money to fix our streets, but suddenly our politicians have billions of Euros for the Greeks who had deceived Europe".* (Lynn 145)

On Saturday May 1, the street had entered back to the scene in Athens, as Labor Day rallies marched through the city. Nineteen people were arrested in scuffles with the police while the former president of the Greek Parliament, Apostolos Kaklamanis, was attacked by an angry crowd. (Lynn 3) On Sunday May 2, far away in Brussels, Luxembourg Prime Minister Jean-Claude Junkcer had called an emergency meeting of Eurogroup around 05.00 pm in the evening. Their task was to endorse whatever deal the *troika*, -the representatives of European Union, European Central Bank and IMF officials- had managed to hammer out with the Greek government over the course of the weekend. (Lynn 5) On Monday May 3, the Eurozone finance ministers have agreed on a rescue package worth €110 billion to help the pressured Greek economy. In return for this unprecedented rescue package, the Greek government has announced a further set of austerity measures, including government spending cuts on a massive scale, large increases in the value-added tax rate and further cuts in public sector wages, worth €30 billion, amounting to %13 of GDP.<sup>103</sup> To keep her own electors happy, German Chancellor Angela Merkel had played up the fact that her government had toughened up the conditions attached to the loan: *"Three months ago it would have been unthinkable that Greece would accept such tough conditions"* (Lynn 4) For some Greeks, however, the idea of Germany imposing painful austerity measures on their country was intolerable. After all, Greece had suffered terribly under German occupation during World War II. There hundred thousand people had died of starvation in Athens during the winter of 1941-1942 as the Nazi occupying regime requisitioned food and fuel send back to the Third Reich. And in towns such as Kalavryta, German troops had executed almost the entire adult male populations. (Lynn 5) On May 4, as the protests over the austerity package gathered speed, members of the Greek Communist Party draped a huge banner across Acropolis's famous stones that read: *"Peoples of Europe, Rise Up"* along with the *Hammer & Sickle*, which were formally adopted as the official flag of the Soviet Union way back in 1924. (Lynn 1) On May 5, as the scale of the pain about to be inflicted on the Greeks became clear, people rush to the streets protesting the package being imposed on them by the outsiders. (Lynn 6) Demonstrators storm the parliament, rushing up the steps of the building while shouting *"Thieves!"* (Lynn 7)

### 2.13. Sarkozy's Ultimatum: France out of Euro, unless Germany agrees to the rescue plan

*“If at a time like this, with all that is happening, Europe is not capable of a united response, then the Euro makes no sense.”*

Nicolas Sarkozy, French President, 8 May 2010

The hell let loose in the world markets, causing a steady erosion of confidence in the single currency. On Thursday, May 6, there was a sudden drop of nearly %9, on the benchmark Dow Jones Index on Wall Street as investors worried about contagion from the Greek mess. On Friday, May 7, CAC-40 in Paris was down by %4.6 while German DAX dropped by more than %3, as the European Central Bank failed to calm the markets. The yields on LIBOR, the London Interbank Offered Rate, which measured the interest rates at which banks were willing to lend to one another, was on the rise. At the height of the credit crunch it was the refusal of the banks to lend money to one another -fearing there were huge losses tucked inside their rivals' balance sheets- that had led to the collapse of so many financial institutions. Now banks were refusing to lend one another once again, nervous over losses from sovereign debt. (Lynn 150) The events were worrying enough for European Commission President Jose Manuel Barroso to call Angela Merkel, that Friday morning. When he got hold of the chancellor, to discuss a “worrisome development in the markets” (Lynn 152) she was already well aware of the situation. They agreed that the current rescue package, was not in itself going to calm the markets. After all, , the money was ready to be transferred to Athens and yet the threat of contagion was growing worse by the hour. All they could decide was to discuss the issue at the summit of the 16 Eurozone countries, scheduled to start in Brussels that very evening. (Lynn 153) The summit, originally called to rubber-stamp the €110 billion rescue package for Greece, was about to turn into one of crisis management amid market turmoil, as Spain and Portugal began to suffer similar financial problems to Greece, with both borrowing costs and talk of speculative attacks increasing.<sup>104</sup>

On that same Friday, ECB's President Jean-Claude Trichet, made a short journey from Frankfurt to Brussels, with charts showing the plunging bond prices issued by the Spanish, Greek, Portuguese and the Irish governments, (Lynn 149) for delivery to the German Parliament, the Bundestag, which was still debating the whether the German funds should be released towards a rescue package for Greece, as soon as the German government was convinced that Georges Papandreou and his colleagues had done enough to get the deficit under control. Plenty of German politicians, both in government and opposition, were instinctively opposed to the rescue package. It went against the principles around which the German state had been reconstructed and it was hard not to feel nervous about what it predicted for the future, as endless rounds of bailouts lurking ahead. (Lynn 150, 151) German Finance Minister Wolfgang Schauble, speaking for the government, argued that the rescue package was

essential for Euro's stability and the future of the whole European Union: “*We have no better alternative. Any other way would be more expensive and more dangerous*”. Frank Schaeffler, leading the opposition to the bailout, roared “*We have put the Greek patient on a drip and let his creditors off the hook*”. When it came to a vote, the legislation passed by 380 votes to 72, hiding the extent of opposition as there were 139 abstentions in the 622-seat Bundestag. (Lynn 152) Meanwhile, in Washington, both the White House and the International Monetary Fund, were watching with growing horror as the European Union failed to come up with anything that looked like a coherent response to the crisis. (Lynn 153) By 2.00 pm Central European Time, and early morning over in Washington, the U.S. Treasury Secretary Timothy Geithner, hold a teleconference with the finance ministers of the seven largest industrial nations, making his point clear that the situation was getting out of hand and that the European Union had to make it clear to the markets that they were willing to do whatever it took to make sure the Euro survived. The time for dallying was over. (Lynn 155)

French President Nicolas Sarkozy was the first politician to arrive for the summit of EU Heads of State and Government gathered in Brussels. Insofar, the Euro had largely been a French idea, pushed for the ideal of an ever-closer union among European nations. In French view, the single currency had been a stepping stone to an economic government, with harmonized tax rates, a coordinated fiscal policy and in time a single welfare system. The country has long railed against harmful tax competition within the EU, which made it a lot harder to maintain high-tax, big government, generous welfare version of the French capitalism. For Sarkozy, if there ever was a moment both for devising a step toward a single economic government, this was surely it. Accordingly, a “French Plan” for resolving the crisis had already been sketched out. (Lynn 156) The instrument this time would not be Euro, but *Eurobond*, a new type of debt issued jointly by all the Eurozone governments. If Greeks or Spanish couldn't pay off their debts, then the rest of the Eurozone would be liable for them. It would definitely fix the crisis of confidence problem in the markets while being a huge step towards closer integration. After all, if the Germans and the French were to take on responsibility for all the debts of the rest, then they would also demand a say in the way their economies were to run. Thus, the *Eurobond* would effectively mean common fiscal and tax policies. (Lynn 157) Before joining the rest of the leaders, Merkel arranged a short one-on-one session with Sarkozy. Both leaders, by now recognized that they had been too slow in their initial responses to the sovereign debt crisis, which would have been prevented turning into the catastrophe it became had they acted earlier and more decisively. They should not repeat the same mistake. The French president had told the German chancellor that he wanted to establish a separate bailout fund, taken out from the EU budget. The issue had gone beyond just Greece. EU had to show it stood behind all the high-deficit countries. If not, they could rescue Greece but the markets would just move on to the next victim. They kicked around some numbers between €35-70 billion for the fund. Sarkozy kept pressing that the time was of essence. An impression of decisiveness had to be created to convince the markets that *they* were in charge of the

events, not the bond dealers of the City of London or hedge funds of New York City. (Lynn 159) Sarkozy's insistence represented his personality; for him decisiveness was everything, without much thought being given to what the decisions actually were. Merkel, on the other hand, was a much more cautious leader. By nature she preferred to plan each policy carefully rather than sign up to one of Sarkozy's back-of-the-envelope wheezes. Even so, this time around she was forced to concede that decisiveness was what was needed. However, being well aware that European Union funds had a tendency to disappear into the black hole of extravagance and that the standards of bureaucratic honesty might not be even throughout the continent, Merkel had questions on who would distribute the money from the fund. By the end of the short meeting, there was still no clear agreement between Merkel and Sarkozy, except for the fact that something needed to be done. (Lynn 160)

The leaders' dinner of asparagus and turbot was followed by Trichet's infamous charts, showing the graphs of plunging bond prices of Greece, Spain and Portugal. He had told them that inter-bank lending between main European financial institutions had ground to a virtual halt over the previous 24 hours. Panic was spreading through the markets. (Lynn 160, 161) The mood was tense and nervous. Everyone present knew what was at stake; the survival of the Euro and with it the survival of the European Union itself. (Lynn 149) By 11.30 pm with Merkel was still digging in against a rescue fund, to which Germany would need to contribute the most.<sup>105</sup> It was well past midnight and the leaders were getting nowhere fast. Greece might be saved. But Portugal? Ireland? Spain? Even Italy? Sarkozy said he had had enough and forced Merkel to face her responsibility.<sup>106</sup> It was a stand-up argument where he was shouting, bawling ([guardian.co.uk](http://guardian.co.uk) 14 May 2010) and going as far as banging his fist on the table and threatening to leave the Euro, unless the German chancellor backed the plans. Sarkozy demanded "a compromise from everyone to support Greece ... or France would reconsider its position in the Euro" according to *El País*, quoting Spanish Prime Minister José Luis Rodríguez Zapatero.<sup>107</sup> In the confrontation between Europe's two most powerful politicians, Sarkozy had Spain, Italy, Portugal and the European Commission lined up behind him. While the Dutch, the Austrians and the Finns, were all quietly hoping Merkel would prevail. Sarkozy said he would walk out of the talks and warned of lasting damage to the traditional Franco-German axis in the European Union. Sarkozy's ultimatum obliged Merkel to bend as she proposed using the weekend to find a solution. A meeting of finance ministers had been scheduled for Sunday, May 9. The summit was over. France had won. Germany had lost. At 12:30am in the morning, Sarkozy stormed into the French delegation's media room to stage a triumphant press conference, announcing a radical breakthrough. ([guardian.co.uk](http://guardian.co.uk) 14 May 2010) Sarkozy declared that the European Union would have an "intervention unit" in place to fend off speculative attacks against Euro members: "On Monday, when the markets reopen, Europe will be ready to defend the Euro. We can't let the Euro fall. We cannot leave it to speculators. We will not let others undo what generations have created. The Euro is Europe and

Europe is peace” There was a minor issue; however, the “intervention unit” had no money, no staff, no offices and no plan of action. (Lynn 161)

#### **2.14. The Great Bargain: “1 trillion \$” vs. “Europe”**

*“The message had gotten through: The Eurozone will defend its money”*

Christine Lagarde, the French Finance Minister, May 10, 2010

Even before the Eurogroup had gathered for their special meeting that Sunday, the tone had in effect set by a statement released by the European Commission. Under its draft proposal for the rescue package offered to the high-deficit countries; there would be a time limit, the consent of all member states would not be required for approval, the loans would be financially backed by all the members of the Eurozone, a Eurobond would be created to raise the money and the International Monetary Fund's involvement would be ruled out in the future. *“The document read as if it had been written at the Elysee Palace”* commented the *Der Spiegel*. (Lynn 166) By a strange coincidence, that weekend was also the anniversary of Russia's victory over Germany in Second World War. While other European leaders canceled their visits to Moscow for celebrations, citing that the threat to the future of Euro as a more pressing call, Angela Merkel felt it would be an unforgivable slight not to attend the sixty-fifth anniversary of her country's defeat. The trouble was it took her away from the negotiations for most of the Saturday. While the package to rescue the Euro was being put together, the German chancellor, the most important actor in the drama, was watching soldiers march up and down Red Square. She was out of the loop for the crucial hours and it was going to be hard to regain control of the negotiations from the French. (Lynn 164) It was about to get even worse for the German delegation as their finance minister Wolfgang Schauble, was taken to emergency before the meeting started. (Lynn 166) At 04:00 pm that afternoon, the German Interior Minister Thomas de Maiziere, residing in Dresden, got a call from Mrs. Merkel to replace Schauble at the most important meeting since the launch of the Euro. (Lynn 167) By 08:30 pm, de Maiziere, who was neither an economist nor a financial expert, sat on the negotiation table in Brussels, with Merkel's full authority. (Lynn 169)

Over the course of that afternoon, President Barak Obama had phoned both the French president and German chancellor to stress how seriously the Americans took the crisis. According to *Der Spiegel's* report Angela Merkel promised the president that the Europeans would make a “decisive response”, with a number attached to the package that was big enough to convince the markets the issue had been

settled once and for all. In return, she wanted Obama to make sure that the International Monetary Fund would agree to play a role in the rescue (Lynn 168). While Sarkozy and Merkel had been talking about a fund of around €35-70 billion, the night before, on Saturday it became clear that a much bigger sum would be needed. The EU had already made timid responses and none of them worked. What they needed now was something that would blow the markets out of the water. (Lynn 163) De Maizeiere, made it clear, however, that he could not accept the Commission's proposal for a common European bond. Leaving aside the fact that his government didn't like the idea, he argued that it would be unconstitutional in Germany. Over the next hour there was a heated discussion on the issue as the Eurobond was central to the French plan who had signed up plenty of other countries. But the German interior minister was adamant. He wouldn't accept it. Now there were just two-and-a-half hours left until the trading opened in Sydney. If they didn't have a deal in place by then, despite the promises of Friday night, the response of the markets could be swift and brutal, if not fatal. (Lynn 169)

On 10:30 pm that afternoon, Axel Weber, the President of Bundesbank, updated his executive board by phone over the events unfolding in Brussels. For the men who regarded themselves as custodians of Germany's postwar monetary orthodoxy, the news were not good. The European Central Bank might start to buy the bonds of countries that needed credit, as early as Monday morning Weber told. It was a direct breach of the Maastricht Treaty which explicitly stated that no country and neither the ECB would be liable for the debts of any other. If the ECB was buying bonds directly in the market, then the Eurozone was now jointly liable for the debts of its members, including the profligate ones. And it also meant that the ECB had compromised its independence, bucking to political pressure at its first test. One of the board members asked Weber is the chancellor had been made aware of the consequences of this decision. Surely the chancellor wouldn't sign up to this if she understood what it actually meant. No economist herself, maybe she'd been bullied into it by the French and the Italians? Once she understood that this meant Germany was abandoning everything regarding its postwar success, then she would change her mind? Weber chose his words carefully and refrained himself to say that he had voted against the decision, at the governing council of the ECB. (Lynn 170, 171)

Back in the heated conference room in Brussels, a compromise proposal had been drafted, that ran 10 paragraphs or one-and-a-half pages. But the deal was still deadlocked on the issue of the *Eurobond* as the Germans were pushing for 'bilateral assistance': where one nation would help another with emergency loans rather than all the Eurzone countries issuing bonds jointly. It might seem a minor point, but the distinction was crucial. Emergency loans were temporary and could be unwound. The *Eurobond* was permanent, irreversible step towards a single economic government. The Italians were objecting that the emergency loans would require special legislation to be passed by the Italian Parliament. It would take months. Several of the smaller countries agreed with that point. Only a few more minutes remained before the Sydney markets opened. A deal clearly wasn't going to be reached



by then. The EU's increasingly exhausted officials decided to forget about Sydney and instead focus on the opening of the Tokyo market at 02:00 am. That gave them another hour and a half. But the trouble was the more they talked, the more objections emerged. The Spanish and Portuguese delegations refused to be mentioned in the statement as 'highly-indebted countries', even though they clearly were. While, they won that one it was past midnight. (Lynn 172) Outline agreement had been reached on the European fund of €500 billion. But who would control it? The Germans insisted it had to be national governments, not the European Commission. They won that argument. (guardian.co.uk 14 May 2010) The British, rather cheekily for a country that wasn't even a Euro member, created some last minute trouble. They had demanded guarantees that the Britain would not be held liable for the defaults of Euro countries, either now or in the future. *“This is completely unrealistic. The City of London would be the first to suffer from the collapse of Euro. The British economy would be as hard hit as any. Why wouldn't they pay their share?”* asked the Swedish Finance Minister Anders Borg. The French joined in with some comments on how the British didn't understand the single currency and never had. To British, however, they had understood it well enough to stay out of the mess to begin with and they wanted to keep out in the future. But there was no time to debate the issue. Thus the question of whether the non-Eurozone members of the EU would be responsible for the debts of the Euro countries remained undecided. By 01:45 am, just 15 minutes before the Tokyo market opened, another draft statement was ready. Both the *Eurobond* and the 'bilateral assistance' idea were dropped. But there was a new institution backed by the members, charged with rescuing the high-debt nations. De Maiziere insisted on imposing a three-year time limit on the bailout package, and by then everyone was too exhausted and too aware of the looming deadline to fight the proposal. At the last minute, the Finnish Finance Minister Jyrki Katainen proposed to have a tax on financial transactions to fight the speculators. While the pro-business government in Berlin was firmly opposed to a tax of that sort, the Germans were in no mood to deal with the last-minute grandstanding objections at that time of the night. Thus the document included a nebulous statement that the European Union would “examine the possibility of a global transaction tax”. With only two minutes before the Tokyo market opened the deal, totaling to €750 billion (\$1 trillion), was done. (Lynn 173, 174)

As the markets tried to digest the scale of the package, the crisis had eased for a short while. (Lynn 174) The €500 billion of the package would come from the Eurozone and while the rest would be provided by the International Monetary Fund, if necessary. The funds would be made available to high-deficit countries for the next few years regardless of whether the markets were willing to support them or not. (Lynn 175) The rescue package would have three main elements. The first was the *“European Stabilization Mechanism”*, through which the Commission was allowed to raise up to €60 billion through issuing bonds on the money markets, using the EU's €140 billion budget as collateral. It could then lend the money to Eurozone states in trouble, at much lower interest rates than the struggling countries could have found by themselves. The decision on who would qualify for the loans

would be made by Qualified Majority Voting, on a proposal by the Commission, meaning that no individual member would have the veto right. Since the EU budget would be used as collateral, every member state in the EU would actually contribute to the scheme, including those that don't belong to the Euro. Whenever a country that has received loans defaulted on them, every European Union member state was required to cover that loss by giving extra money, depending on its share of the total contributions to the EU budget. Wasn't that actually a *Eurobond*? Well, since it involved the EU borrowing collectively using its budget as collateral, it was very close to it. The difference, was semantic than financial. If that €60 billion were to run out, the "*European Financial Stability Facility*" (EFSF) would kick in, providing an extra €440 billion in loans and guarantees. Under this mechanism, the Eurozone countries would establish a Special Purpose Vehicle (SPV) which could issue bonds and use that cash to buy the debts of the financially-troubled member states. The third leg of the package, and the one Bundesbank objected most fiercely, was the decision by the ECB to start buying government bonds directly in the market. (Lynn 178, 179) The ECB would practically become the "buyer of last resort": if no one else would buy Greek, or Portuguese, or Spanish government bonds, ECB would intervene in the market and buy them itself. (Lynn 176)

## **2.15. The Contagion: Oh, no, here we go. It's Greece all over again...**

*"The markets are very nervous because they can see that there is a fatal flaw in the system and no clear way out. It could be the end of Euro as we know it. The long term implications are at best a split in the Eurozone, at worst a destruction of the single currency".*

Theodara Zemek, head of fixed-income investment at Axa, May 2010

On May 12, seeking to build on last weekend's breakthrough, the European Commission President José Manuel Barroso, went further and proposed even stronger measures to shore up the Euro. The safety net agreed, was temporary -for three years. Barroso said it should be permanent. He wanted member states' budgets to be "peer reviewed" by his boffins and European finance ministries, before they went before national parliaments. A direct assault on national sovereignty and parliamentary democracy. Barroso's argument was for full-fledged harmonisation of tax and spending policies in Eurozone, otherwise the Euro had no future: "*Let's be clear. You can't have a monetary union without having an economic union. Member states should have the courage to say whether they want an economic union or not. And if they don't, it's better to forget monetary union altogether.*" On May 13, Merkel started talking about "the Pound, the Deutschmark, the Franc, and the Drachma". Despite Euro's rally on the markets following the launch of Europe's grand rescue plan, the single currency has

slid to an 18-month low against the dollar on fears that the Eurozone bailout would fail and reports that Sarkozy threatened to pull his country out of Euro. (guardian.co.uk 14 May 2010)

On May 21, with the implications of Europe's giant leap in the dark beginning to dawn, Berlin tabled a nine-point plan, rewriting the Euro regime to include legally enshrined budget deficit ceilings, draconian penalties for the profligate -like not having to vote in EU for at least a year- and kicking out those that persistently flouting the rules. The plan proposed debt-crippled countries of Eurozone to be able to restructure their debt or default "in a managed way". Also, national budgets should be reviewed by specialists at the European Central Bank or "independent" experts to ensure budgetary rigor and adherence to a revamped Stability and Growth Pact. Some of the new rules could mean reopening the Lisbon Treaty, which only came into force in November 2009, after eight years of negotiations.<sup>108</sup> Although Lisbon permits emergency aid under exceptional circumstances, it also had a no bailout clause.<sup>109</sup> On May 25, the Commission head José Manuel Barroso launched a strong attack on the German Chancellor Angela Merkel's handling of the Euro's crisis of confidence, claiming that the bill for rescuing Greece and shoring up the Euro would have been much cheaper had Berlin acted more swiftly and accused the German government of failing to lead public opinion in defense of the beleaguered single currency: *"We won't be tabling any proposals for changing the treaty"* Barroso said, describing the quest for Lisbon as *"a traumatic experience. It would be naive to think that you can reform the treaty only in the areas important to Germany. Of course, then the British and others would come with their wishes."* All of the key points proposed by Berlin were opposed by Barroso. Contradicting Merkel, he said it was not possible to expel chronic sinners from the Eurozone, as demanded by Berlin. *"Germany has a strong interest in keeping the Euro stable, indeed not just out of European solidarity but in its own interest. Until now Germany has been one of the big winners from the Euro. More politicians in Germany should say that clearly. By the way, it was not Greece, Ireland or Spain who invented the Euro. It was a German-French project."* said Barroso.<sup>110</sup> On May 28, only two weeks after the assembling of the "shock and awe" rescue program to save the Euro and put a decisive end to sovereign debt crisis, the ratings agency Fitch downgraded Spanish debt, citing worries about the size of its budget deficit and the credibility of the government's plan to get its spending under control. What the grade markdown revealed was that it wasn't specifically a Greek problem, a smallish and not historically insignificant country running into debt crisis, at the far corner of the European Union. It was turning to be an issue of the Euro. (Lynn 183)

After loosing its political independence with the trillion-dollar rescue package, the European Central Bank, initially and outrageously, refused to publish details about its bond purchases. On June 4, it had decided to reveal the €40-billion-worth purchase of debt, mainly issued by the Greek, Irish and Portuguese governments. If Greece, Ireland and Portugal were to default on their debts, the ECB would have to finance its lost through increases in contributions to the ECB by member states, mostly

from Germans, or through printing money. Either way would feed into more instability and inflation. (Lynn 180) On June 7, the *European Financial Stability Facility* (EFSF), has been established as a limited liability company under Luxembourg law.<sup>111</sup> On June 14, Moody's had reduced Greece's sovereign rating by four steps from A3 to B1, which would be summed up in a single word: *Junk*. The message was clear, Greece had been expelled from the ranks of credit-worthy nations, amid fears on its progress towards cutting its budget deficit and the chances that investors would ever get back €300 billion+ they had lend to the Greek government. It could no longer count itself alongside Germany, Britain and Switzerland as a safe and reliable home for investors' money. Instead had to take its place among nations like Colombia, Morocco and Azerbaijan, where one would invest if brave enough. (Lynn 207) On June 23, Wolfgang Schauble, the German Finance Minister, raised the possibility of a country leaving the Eurozone, in a *Financial Times* article: “*Should a Eurozone member ultimately find itself unable to consolidate its budgets or restore its competitiveness, this country should, as a last resort, exit the monetary union while being able to remain a member of the EU.*” (Lynn 225) On June 28, Nouriel Roubini, the U.S. economist born in Turkey to Iranian parents, argued in a *Financial Times* article that “*The €110 billion bail-out agreed by the European Union and the International Monetary Fund in May only delays the inevitable default.*” (Lynn 218) On July 13, Portugal had its ratings cut two levels to A1 by Moody's. (Lynn 188)

## **2.16. Merkel's Ultimatum: Germany would be out of Euro, unless Europe agreed to new Euro regime**

*“You’ll see. We’ve been invaded many times before, but never owned.”*

Micheal O’Doibhilin, a retired Irish man on the IMF and the EU’s bailout of Ireland, a country wary of international interferences due to its long history of British rule.

For the past six months, since the formation of unprecedented €750-billion-crisis-fund, EU leaders have been drawing up plans for meaningful responses to the sovereign debt crisis flared up in Greece and nearly destroyed the Euro. Insisting that the Greek disaster must never be allowed to repeat itself, they stressed for new disciplines in Eurozone. Under the Commission's proposed law, countries would face fines of 0.2% of GDP for flouting the Stability and Growth Pact. The penalties would come automatically and could only be stopped subsequently by a qualified majority vote of EU governments. Germany, as the EU's fiscal disciplinarian, was the strongest supporter of the automatic fines. Sarkozy led the opposition, arguing for the primacy of elected governments over national budgets. On October 18, however, there had been a sudden Franco-German hijack of the efforts. At a EU summit held in Normandy coast, Sarkozy yielded to German pressure to re-open and change the

Lisbon Treaty in order to force crisis-stricken countries declare insolvency and to forfeit their voting rights in EU councils, as a *quid pro quo* for Berlin dropping its insistence that sanctions for Eurozone's fiscal sinners be automatic. The Franco-German agreement said any sanctions applied would be "automatic", but the decision to fine would be made by EU finance ministers and not the Commission, increasing the likelihood of political deal-making. The Commission conceded that there had been a Franco-German stitch-up to weaken the new Euro regime, leaving it more vulnerable to political horse-trading.<sup>112</sup> As a result, the joint statement of Sarkozy and Merkel at the seaside resort, demanded two treaty changes: one permitting the establishment of a permanent crisis mechanism and other allowing the suspension of a country's voting rights if it persistently violates Eurozone rules. (Financial Times, 28 October 2010)

On October 28, the EU summit in Brussels, attended by 27 EU Heads of Government or State, the Presidents of the European Commission, Council, and the European Central Bank, was dominated by the Euro crisis and wrangling over whether to bail out Ireland. The German Chancellor Angela Merkel, has warned, for the first time, that her country could abandon the Euro if she were to fail in her contested campaign to establish a new regime for the single currency. Merkel's central aim, was to re-open the Lisbon Treaty so a 'permanent debt-crisis mechanism' and 'sovereign debt restructuring scheme' could be established to deal with future Greek-style debt crises. She argued that under the Lisbon Treaty, EU member states could have their voting rights suspended if deemed guilty of gross human rights violations. *"If this is possible for human rights infringements, the same degree of seriousness needs to be awarded to the Euro"*. Merkel also called for bailed-out countries to lose voting rights in EU councils, causing the Greek Prime Minister George Papandreou accuse her of tabling proposals that were "undemocratic". *"If this is the sort of club the Euro is becoming, perhaps Germany should leave,"* Merkel replied. At the end, she had to shelve the demand for suspension of voting, however, won the argument on a limited change of the Lisbon Treaty to enable a 'permanent debt-crisis mechanism' to be established from mid-2013 when the €750 billion fund expires<sup>113</sup> and to put more of a burden on investors so that they shoulder more of the costs of future sovereign debt crisis.<sup>114</sup> No longer, Merkel declared, would European taxpayers have to bear the risks of protecting their financial systems alone; she would extract a price from speculators too. If borrowers were unable to repay their debts then it would be their creditors who ought to bear the losses. The ECB President Jean-Claude Trichet, warned the leaders that the new rescue system,<sup>115</sup> signaling to markets that private investors would be more at risk in restructuring, could spook the bond markets, drive up short-term borrowing costs for highly-indebted countries like Ireland and Greece, struggling to regain investor confidence. However, Trichet's warnings, first meeting with bitterness by Nicolas Sarkozy who complained that he did not understand the challenges facing heads of state, (Spiegel) then practically ignored.

The European Central Bank president turned out to be right. Investor confidence was just beginning to return to the continent, in the months following Greek rescue. Big institutional investors -like pension funds, Asian and Middle Eastern central banks- were tiptoeing back into government bond markets in countries like Portugal, Spain and Italy. It all changed after German chancellor's statements. The markets thinking that they had been given a blanket guarantee in May, after the formation of a European bailout fund and now fretted that it was being pulled away. *"The statement removed some uncertainty, but not in a good way."* said an investor.<sup>116</sup> Within days, the Euro countries cantered into a new ambush. Yields on the bonds of weaker countries broke new Eurozone records. (The Economists, 20 November 2010, 37) On November 11, at Seoul G-20 summit, however, Mrs. Merkel was still in combative mood: *"Let me put it simply: in this regard there may be a contradiction between the interests of the financial world and the interests of the political world"*. But a day later, the finance ministers of Eurozone's five biggest countries explained that they had been misunderstood. The debts of Eurozone members were protected by their bailout fund until 2013 and any notion of imposing "haircuts" on bondholders would apply only to new debt issued thereafter. On November 15, the Greek Prime Minister George Papandreou, blamed Germany for setting off the latest round of panic in the markets by<sup>117</sup> pressing for investors to share the pain of any Eurozone sovereign debt default in the future. The prime minister claimed that the decision was placing greater burdens on countries already in trouble: *"This could break back. This could force countries towards bankruptcy"*. The German Finance Minister Wolfgang Schauble, replied back that the Greeks were being ungrateful for the help they received earlier in the year. (The Economists, 20 November 2010, 37) Although the decision was to take place only from 2013, the markets took fright at the scale of potential bond losses and pushed Ireland's borrowing costs ruinously high, forcing the bailout of the country.<sup>118</sup>

After Ireland and Greece, financial markets have lined up Portugal as the next domino to be toppled in the Eurozon's sovereign-debt crisis.<sup>119</sup> Germany's insistence over sovereign-debt default schemes, coupled with Ireland's ballooning debts, rotten banks, crony capitalism and uncertain prospects, easily pushed unnerved investors to selling of its' bonds. (The Economists, 20 November 2010, 11) On November 16, Eurozone finance ministers said there would be a "short and focused consultation", involving the European Commission, the European Central Bank and the International Monetary Fund, to assess how much help Ireland might need and how soon. (The Economists, 20 November 2010, 73) Interestingly enough, while Greece pleaded for money from a reluctant Mrs. Merkel in May, the Irish, insisting that they did not need any bailout, was being courted by large Eurozone countries - dying to see an end to uncertainty- that they must take one. (The Economists, 20 November 2010, 11) On November 18, as senior IMF officials were photographed arriving in Dublin for talks, Ireland's central bank governor confirmed that he was expecting "a very substantial loan" while *The Irish Times* talked of ignominy: *"Having obtained our political independence from Britain ... we have now surrendered our sovereignty to the European Commission, the European Central Bank, and the IMF."*

On November 21, European finance ministers agreed to a request from Ireland for a multibillion-euro bailout. On November 28, Ireland became the first country to tap into EU's emergency fund for €85 billion. Of that, €10 billion would go straight to the crippled banks while €25 billion was earmarked for future bank support. The remaining €50 billion was to be used shoring up the public finances, allowing the government to keep making welfare payments and covering other expenses such as health and education. (guardian.co.uk, 15 December 2010) The EU authorities hoped that the Irish bailout would draw a line and halt the threat of Spain and Portugal needing international assistance.<sup>120</sup> However, on November 30, confidence in the Eurozone was further eroded as the cost of insuring government debt rose sharply to record levels and the Euro hit a 10-week low. The financial markets continued to punish the peripheral members of the Eurozone, with Spain, Italy, Portugal and Ireland all seeing their borrowing costs increase. Spanish and Italian bond yields showed the sharpest rises that morning. The market reaction to the €85 billion Irish rescue proved that investors remained unconvinced over the Eurozone debt crisis could be stabilized. They were unwilling to buy European sovereign debt either: *"It's clear that there is extremely low appetite to take fresh peripheral exposure. There are an increasing number of investors who will not touch these assets at any price for now, given all the uncertainty"* said Jim Reid of Deutsche Bank.<sup>121</sup>

On December 6, Merkel opposed to the IMF's call for a larger emergency fund for the Eurozone, saying that the "existing €440 billion fund was enough". (guardian.co.uk, 15 December 2010) On December 7, figures released in Iceland showing that the country's GDP rose by %1.2 in the third quarter. Iceland's recovery offered a big lesson for troubled Eurozone countries: that the benefits to a small country of being part of a big currency union were not all that great. When panicky investors were rushing out of small currencies in the autumn of 2008, Euro seemed a haven. There was much talk about Iceland's fast-tracked membership of the European Union and, ultimately, the Euro. Two years on, the Euro looked more like a trap for countries struggling to regain export competitiveness, like Ireland and Greece.<sup>122</sup> On December 15, Moody's had announced that it was putting Spain's Aa1 rating on review for a possible downgrade, citing concerns about the nation's ability to service its borrowings in 2011. (guardian.co.uk, 15 December 2010)

The air of rancor and pessimism was pervasive. Bitterness was widespread, particularly among the smaller EU countries who felt they were being bullied by the powerful. Jean-Claude Trichet, president of the ECB, José Manuel Barroso, president of the EC, and Jean-Claude Juncker, chairman of the Eurogroup countries and prime minister of Luxembourg, have all separately attacked Merkel in recent months, calling her "naive" and "simple". In the WikiLeaks cables, the US ambassador in Berlin characterized the chancellor as "risk-averse and seldom creative". But there was no doubt Merkel is calling the shots, however ambivalently.<sup>123</sup> On December 16, the government leaders of 27 countries, as well as the heads of the European Commission and the European Central Bank, gathered in

Brussels for their seventh EU summit in 2010, all consumed by the crisis surrounding the single currency. The summit capped a year of unprecedented trouble, with the leaders agreeing on initial steps for establishing a permanent financial crisis mechanism, *The European Stability Mechanism* (ESM), to replace May's ad-hoc Euro rescue scheme, beginning in 2013. The summit participants agreed to supplement the Lisbon Treaty with 'two sentences' overriding the existing prohibition against mutual financial assistance. The German government insisted that financial aid be given only where strict conditions are met and the crisis mechanism applies only if the Eurozone as a whole is threatened. For a country to receive protection against speculative attacks, it must unconditionally submit to the austerity diktats of the European Commission, European Central Bank and the International Monetary Fund, as Greece and Ireland have already done.<sup>124</sup> But for Berlin, that was not enough. *"The issue of last resort could be strengthened,"* said a senior German government source. (guardian.co.uk, 15 December 2010) The original proposal, whereby private bond holders would automatically be asked to share the financial pain should a state run into payment difficulties, was buried at the Brussels summit. (wsws.org) Europe's year of agony was closing just as it was opened, with fear and hesitation.

## 2.17. The Great Bargain: “Competitiveness Pact” vs. “Euro”

*“We want to send out a clear message that as the European Union, as a political union, and as the euro area, we intend to grow together, which is to say closer economic co-ordination.”*

Angela Merkel, German Chancellor, February 2011

For a few weeks over the Christmas holidays, Europeans put their sovereign-debt crisis on hold. But, a tense start to the year, came in first week of January, making them face the grim reality once more.<sup>125</sup> On 1 January 2011, Estonia became the 17th country to join the currency union while Poland still not changing its mind: *"We have to wait and see if the euro plan will work"* said Mikołaj Dowgielewicz, the Europe minister. The Slovaks who had only joined the Euro club in 2009, however, appeared to be kicking themselves. *"We were guided by promises of a stable currency and solid rules. We need to stop believing blindly in the governors of the Eurozone and start preparing plan B, a return to the Slovak crown"* complained Richard Sulík, the parliament speaker in Bratislava. (guardian.co.uk, 15 December 2010) On January 5, the European Union, under the *European Financial Stabilization Mechanism*, issued a bond to raise money for bailing out Ireland. There was a strong demand for the sale of €5 billion in five-year debt.<sup>126</sup> On January 6, *El Pais* reported Chinese vice premier Li Keqiang



telling Spanish officials that China has confidence in the Spanish financial market and will continue to buy Spanish public debt.<sup>127</sup> On January 11, amid growing concern that Portugal would be following Greece and Ireland to seek financial help from its fellow European countries and IMF, Portuguese Prime Minister José Sócrates had to announce that they would not seek a bailout, “because it is not necessary”.<sup>128</sup> Bond yields, however, were climbing in an ever broader not-quite-that-peripheral countries like Spain, Italy and Belgium. Especially, neighboring Spain was painfully aware that it would immediately become the main focus of markets, if Portugal should fall. (guardian.co.uk 9 January 2011) On January 25, following similar events in Tunisia, a popular uprising began in Egypt which featured a series of demonstrations, marches, acts of civil disobedience and street-fights. Millions of protesters from a variety of socio-economic and religious backgrounds demanded the overthrow of the Egyptian President Hosni Mubarak.<sup>129</sup> The unrest in Tunisia and Egypt has spread like a wildfire throughout the Middle East, influencing and encouraging angry crowds in Yemen, Bahrain, Jordan and Libya protesting against their governments. On January 27, America's Financial Crisis Inquiry Commission produced its final report into the events that led to the banking system's meltdown in 2008. It concluded that the crisis was “avoidable” and spread the blame far and wide among policymakers and bankers.<sup>130</sup>

On February 4, at the EU summit in Brussels, Angela Merkel and Nicolas Sarkozy tried to push their “Competitiveness Pact” -which would commit all 17 countries in Eurozone to coordinate their economic policies- onto others. By inviting all to join the “competitiveness pact”, Mrs. Merkel was actually promoting a Franco-German plan for closer economic governance, including six elements that members would have to implement within 12 months:

1. Abolition of wage/salary indexation systems (automatic indexation of wages to prices)
2. Mutual recognition agreement on education diplomas and vocational qualifications for the promotion of mobility of workers in Europe
3. Foreseeing the creation of a common assessment basis for corporate income tax
4. Adjustment of the pension systems taking into account the demographic developments (ie, average age of retirement)
5. Obligation for all member states to inscribe the debt alert mechanism into their respective constitutions
6. Establishment of a national crisis management regime for banks.<sup>131</sup>

Over a long and bad-tempered lunch, almost every other EU prime minister railed objections to the Franco-German plan. Some leaders, anxious to defend their national economic, labor and welfare policies, had expressed resentment at the attempt by the Eurozone's two largest economies to establish a new binding agreement on pension, tax and budget policies. The Belgium Prime Minister Yves

Leterme said he was “absolutely not in agreement” with the plan; Belgium is one of several Eurozone countries that index their pay raises to inflation.<sup>132</sup> Italy have expressed reservations over plans to do away with wage indexation, write deficit limits into national law and seek greater harmonization on tax and the retirement age in European countries.<sup>133</sup> Ireland rejected the idea of aligning EU corporate taxes as a danger to its low-tax growth model. Luxembourg resisted calls to abolish their system of index-linked wages. The Baltics said they could not raise their pension age as fast as west Europeans because their people tend to die younger.<sup>134</sup> Overall, more than half the EU's 27 countries, including traditional German allies like Austria and the Netherlands, criticized the initiative's attempts to reach into policy areas normally reserved for national parliaments. Sarkozy said, Paris and Berlin chose “not to put a paper on the table” outlining specifics of their proposal, in the face of fierce opposition. Instead they tasked Herman Van Rompuy, president of the European Council, to find out if a compromise could be reached. (Financial Times, 4 February 2011) The differences over the “Competitiveness Pact”, which was a *quid pro quo* for Berlin's acceptance of an increase in the lending ceiling of the EFSF, were hoped to be ironed out in EU's next summit in late March.<sup>135</sup>

On February 20, Merkel's Christian Democratic Union (CDU) had suffered a humiliating election defeat in the city of Hamburg, with Social Democrats seizing control of the local parliament.<sup>136</sup> While there would be six more state elections throughout 2011 to test her “Christian-liberal” coalition, an opinion poll suggested that Merkel's government could be voted out of office in a federal election, despite buoyant growth -3.6% in 2010, the fastest rate since unification- and falling unemployment. One cause might be the unease in Euro, which threatens either to fall apart or to require yet another German-backed rescue. So far Germans have grudgingly paid the bills she has presented as the price of saving the currency. Although 62% of voters opposed further bailouts of weak Euro members, 61% supported her handling of the crisis, according to a poll published in January. But more sacrifice may be demanded. Along with financial support, Germany may have to yield some sovereignty to construct Euro-wide economic government.<sup>137</sup> On February 21, yields on the five-year sovereign debt of Portugal rose over 7% as markets lost faith once again in the nation's ability to right its economy. Even though the relationship between the fear of contagion of European debt and political trouble in the Middle East, seemed bleak at the first sight, a deeper looked proved opposite, especially considering the fact that not a single EU nation was among the top 40 oil producers in the world. Italy and Germany were in the top 50, with miniscule reserves compared to those of Saudi Arabia, Libya and Iran. The world could face potential shortages of crude oil if Middle East unrests, especially the current civil war in Libya, were to undermine exports. On the other hand, economic growth of nations like Portugal would be badly hurt by higher oil prices.<sup>138</sup> On February 22, it had become clear that the situation in Libya was not going to be resolved easily or without bloodshed. Muammar Qaddafi has vowed to fight to remain in power while hundreds of Libyans have been reported killed. Meanwhile,

protests continue to mount in Bahrain. The situation remained uncertain. Amid the headlines from the Middle East, the Eurozone debt crisis was far from resolved and growth expectations<sup>139</sup> for financially struggling Eurozone countries continued to look dim. In such uncertainty, whether or not Portugal could avoid becoming the next domino to fall may no longer be in its hands. If European leaders fail to present credible plans to resolve the sovereign-debt crisis at their summit in March, that may well seal Portugal's fate. (The Economist, 24 February 2011)

# CHAPTER 3: THE EFFECTS OF THE FINANCIAL AND ECONOMIC CRISIS ON THE ONGOING INTEGRATION PROCESS OF THE EUROPEAN UNION

## 3.1. The Crisis destroying the almighty image of “Europe”

*“The economic crisis shows once again that Europe has a leadership problem. Europe is difficult to coordinate.”*

Peer Steinbrück, German Finance Minister, December 2008

The global financial crisis of 2008, the global economic crisis of 2009 and the European sovereign debt crisis of 2010 had been catalysts to cruelly expose the inherent flaws in the economic, political and social integration of the European Union. Indeed, having a single currency and monetary integration among the European Union member states, was a brilliant idea. However, its clumsy execution had almost destroyed all that’s been done so far, in the name of European unity and solidarity. For the author of these lines, the most damaging and irreversible hit had been to the image of “Europe”. Throughout the centuries, the Europeans took enormous pains to construct “Europe”, as an invincible and omnipotent notion. The concept of “West”, despite being a moving target with geographical, historical, political and cultural inconsistencies, was first successfully linked to “Europe” and then concretely tied to “European Union” as an institution. In a way, the European Union became the embodiment, the flesh and bond, of the vaguest term on earth; “Europe”, through a series of ingeniously designed rhetoric and linkages to past accomplishments for legitimacy boost. Borrowing from Gerard Delanty, the brand of “Europe” was actually nothing more than a *historically fabricated reality of ever-changing forms and dynamics*.<sup>140</sup>

While the Western civilization almost never came even close to a political unity, in time it had certainly developed certain coherences in terms of shared values and social patterns. A quick survey of those pillars that make up a *real* or *imagined* “West” could be summarized as; the Athenian democracy (which actually had little resemblance to the modern-day one), the Roman Empire, Christianity (which actually did not possess much unity as it was divided into three sects; Orthodoxy, Catholicism and Protestant), the feudalism, the encounters and fights with Islam, the Crusades, the Renaissance and the Reformation, colonization of North America, Asia, Africa and Middle East and the extermination of races in colonial lands, age of economic imperialism, slavery, court culture, Enlightenment, French Revolution, Industrial Revolution, modernism, racism and eugenics, World War I, totalitarianism, authoritarianism, fascism, World War II, genocides (Jews in

Germany, Bosnians in former-Yugoslavia), Europe divided with the Berlin Wall, Europe squeezed between superpowers during the Cold War and finally the European Union (a *avant garde* attempt to heal the dark sides of the continent). While a sizeable majority of these concepts could be classified as “Western evils”, this “politically in-correct” body called Europe, somehow managed to be perceived as the epicenter of “politically correctness”, justice, human rights and democracy. How could the Europeans build such an almighty image of themselves, despite their wrong-doings? How could they monopolize these concepts like human rights, democracy, equality which they had grossly violated in the past and to an extent still today? One answer might be formulated through Europe’s natural talent in “branding”, to turning the reality around and selling it for something that it is not, which might look righteous to untrained eyes. They know how to create *notions of normality*. Their last major branding activity was the formation of “The European Union”. Hiding behind a web of institutions, rules, images and rhetoric, they crowned themselves with the imagery of an “*indispensable, indisputable and indivisible*” unity. The reality, of course, was a lot different. Members of this so-called union, were continuously in fight with one another -this time in a much more civilized manner through hard-core bargaining at the table. There were numerous divides within its members, ranging from purpose (i.e. a supranational end vs. intergovernmental end to the Union) to collaboration fields (i.e. Schengen Europe, Euro Europe, Social Charter Europe, Defense & Security Europe), from geography (i.e. many European states are not even members yet) to democracy (i.e. majority of the European citizens do not view Brussels as legitimate as their national governments to dictate crucial mandates). Against all the odds, however, Europeans had worked meticulously. Bit by bit. Word by word. Negotiation by negotiation. Until they gained considerable ground in bringing everything in line, from marmalades to aviation regulations, to form a Single Market and a Single Currency, providing them with further images of “unity”. What had severely destroyed this image of ‘invincible’ union, was the fact that when crisis strikes Europe could almost never act like a true union. (Joffe 23)

A few examples could be extracted both from recent financial and economic crises. When the going got really tough in financial world by mid-September 2008, Washington was able to act swiftly. While the “effectiveness” and “fairness” of their policies could be fiercely debated, both the U.S. Treasury Secretary and Federal Reserve Chairman were able to devise and present a rescue plan and Congress - after being bought to a relatively cheap price- could act on it within a few weeks time. Europe was lacking such speed. Since financial regulations were enforced both at the European and the member state level within the European Union; finding and implementing effective remedies for the causes of the financial crisis have been slower, different and *difficult* than the United States.<sup>141</sup> First of all, the European Central Bank was prohibited by the Maastricht Treaty to play the lender of last resort, as the FED did by loaning \$85 to prop up the U.S. insurance giant AIG, which has allowed the governments to act individually until some sort of a common European plan emerged. (Joffe 23) As the European Union institutions and common wisdom seemed to be paralyzed at the time, European policy measures

remained individualistic and limited -to a small number of countries, like Germany, France, Spain and Italy- for a relatively long time. As a result *each sheep was being hanged from its own feet*, as the infamous Turkish saying goes. No doubt, a collective and early commitment by those who could afford it, would definitely have a much more powerful and lasting effect on remedying the ills of the downturn, than individual initiatives taken by member states. Yet, there were two major difficulties in all this for Europe. First of all, it would take time. The art of brokering an agreement of some sort, among 27 countries has always been a messy business, even in normal times. Reaching a compromise became increasingly difficult and time-consuming in the face of unexpected speed that the events had unrolled starting from the second half of 2006. In the eye of the storm, the cooperative solutions looked less and less attractive. As urgency fades and negotiators drawn in complexity, national interest might have been lost at the expense of collective interest. Such stresses and strains have led some to conclude that unilateralism represent the best hope for addressing pressing problems of the crisis. Supranationalism was remarkably quick to fell out of favor. The second was Europe's *original dilemma*: whether or not to surrender more to the supranational entities at the expense of sovereignty-demanding nation-states. The conflict between sovereignty and safety was not easy to disentangle<sup>142</sup> as with any other major supranationalist crisis of the Union, especially considering the fact that, this time the "Streets" of Europe were also involved in the debate. As the European Council President Herman Van Rompuy argued in a *Daily Telegraph* article on May 25, 2010: "*We are clearly confronted with a tension within the system, the infamous dilemma of being a monetary union and not a full-fledged economic and political union. This tension has been there since the single currency was created. However, the general public was not really made aware of it*". (Lynn 227) At the very end, what the global financial and economic crisis had boiled down to was, a shattered image of "European Union" as having: no will, no purpose, no power.<sup>143</sup>

As far as the European sovereign debt crisis of 2010 goes, the Eurozone leaders had actually choose to ignore the crisis brewing in Greece for year after year. The occasion to remedy the 'institutional deficiency' present since the Euro's birth, was wasted especially by Germany, which had insisted on there being no bailouts and was reluctant to come to Greece's assistance. To many observers, both in and outside of Greece, Europe's stance was peculiar: it had already come to the rescue of the big banks and companies. Saving corporations was evidently acceptable; saving a country of 11 million was a taboo. And saving a country would not be, in some sense, a bailout. As with the assistance that the IMF provided a decade earlier to Brazil, if Greece were given access to funds at a reasonable interest rate, it would highly likely meet its obligations. (Stiglitz 324) The sad thing was, most probably if its neighbors, friends, peer member states in the EU had uttered a few supportive words about paying off the debts, then Greece would not have such grave problems. But even the rhetoric of solidarity had been deemed too much for Greece. While the Greek Prime Minister George Papandreou gave every promise possible to fix the economy, what the markets hopelessly waited for was a

promise of help from his fellow Euro states. (Lynn 132) *“If we had been able to address it right from the start, say in February, I think we would have been able to prevent it from snowballing the way it did”* confessed French Finance Minister Christine Lagarde in an interview with the Washington Post in June 2010. That was certainly true. (Lynn 180) At first, European leaders tried to pretend it wasn't their problem, but Greece's alone. Then, they searched for the problem in the wrong places and blamed everyone else. The Greeks had borrowed far more money than they could possibly pay back, which was obvious to anyone who cared to look at the numbers. However, it remained an article of faith to many European politicians that it was the markets or the speculators who had created the problem, not the inherent deficiency in Euro itself. (Lynn 173, 174) As the threat of contagious debt crisis marched across Europe and looked likely to overwhelm them, the well-to-do countries like Germany begun to worry about being dragged down by their neighbors. (Rachman 4) A serious economic crash in one member of the European Union would eventually threaten the entire European single market, the stability of the single currency – and even the survival of the European Union itself. (Rachman 262) Just like regular waves of plague roamed around Europe throughout the Middle Ages, the panic had spread around the continent, provoking bitter recrimination within the Union. Greek leaders, under pressure from Germany to cut spending, made dark references to the Nazis' occupation of Greece during the Second World War - precisely the sort of terrible memories that European unity was meant to banish. (Rachman, 8) Even after it had finally dawned on them that Greece might not be an outlier and following their first summit to discuss remedies on 11 February 2010, the Europeans had been prevaricating, agonizing, and quarreling. Prompt action in an emergency was not the strongest suit of the 27-membered-union.<sup>144</sup> Institutionally, the painful process of brokering an acceptable deal for all of its members; politically the Medici-like chronicle of rivalry, jealousy, bluff, threat and intrigue among European leaders (Marsh, 136) and socially, the lack of empathy amongst its peoples helped create an image of the “European Union” as having acute deficiency of solidarity.

Once the whole system was threatened, Europeans rushed into a solution within a few hours in early May. The trillion-dollar weekend was a violation of the existing EU treaties and a rewriting of the ECB's mandate. (Lynn 180) Even if that wasn't scandalous enough, the plan only bought some time, at huge cost. In an attempt to fix the immediate problem at hand and not deal with the fundamental issues underneath, the Union actually store up new problems a little further down the road. (Lynn 182) The whole saga, cracked open yet another whole in the invincible Europe image, as the dependability of the way the European Union conducted its business had been questioned with such last-minute, makeshift, ad-hoc remedies. But, what's even more outrageous was for the European Union to let its members plea for help from the International Monetary Fund (IMF), an international organization based in Washington, and although usually run by a European, generally regarded as, to put it mildly, susceptible to pressures from the White House. (Lynn 168) The first instance when Greece -hopeless to get a hand from its European Union peers- first asked IMF's support must be one of the most

humiliating moments in Eurozone's existence. (Lynn 207) At the end of the day, the whole EMU project was originally designed to shield Europe from the caprices of the United States and the dollar. But in a second thought, Germany found relief in this escape to IMF, which would mean financial burden-sharing. Thus, Merkel quickly got into the habit of asking Obama for IMF assistance for every single bailout package designed for European Union members, from then on. Shame had long gone out of the equation. This, of course, does not suggest that Greece should go unpunished. On the contrary, the country which had fiddled with the rules the hardest and longest should have made to face its consequences. However, a genuine "Union" would not let this punishment and/or rescue, conducted by an external party. To save both face and credibility, a true Union would swiftly help out its disobedient member, to exhibit genuine solidarity. But, once the firefighting had turned down the immediate fire and the markets have cooled down, it would turn around and punish the naughty, *itself*. By doing diametrically opposite and revealing its helplessness to seek help from foreign entities, the European Union had further spoiled its image of being invincible.

The whole construction of the EU was based on an effort to replace the ruinous and bloody rivalries of European history, with a new logic based around mutual economic interests. But in the aftermath of the crash of 2008, rising public debts in countries like Greece and Spain have cast doubt on the future of a united Europe's proudest achievement - the single European currency. However, the cost of the economic crisis to Europe was not just financial (Rachman, 184) or economical: By 2010, European Union was witnessing erosion in its political power as well. The Union, which has long regarded itself as a model of international cooperation, was now struggling to contain tensions within its ranks. (Rachman 280) European leaders have also taken to agonizing publicly about the continent's declining importance in a world that looks set to be dominated by Asia and the Americas. (Rachman, 8) As a result, Europe lost respect in the world and confidence in its own future, as the suspicion grew that the much-vaunted 'European social model' - with its well-funded social services and generous state benefits for the poor, was simply unaffordable. The climate of austerity and debt raised tensions both within and between European nations. In Greece, one of the first countries to experience major cutbacks in wages and social benefits, there were deadly street riots in May 2010. From Spain to Britain, European nations contemplated a future of cutbacks and austerity, as summarized in Table 1, and worried about the social and political consequences. (Rachman, 184) All of this was causing the European Union, as an institution, to lose confidence,<sup>145</sup> further ruining its all-powerful image.



### 3.2. The Crisis “Un-doing” Europe

*“The €440 billion mechanism was nothing less than the importation of NATO's Article 5 mutual defense clause applied to the Eurozone. When one member is under attack the others are obliged to come to its defense. It is an enormous change. It is expressly forbidden in the treaties by the famous no bailout clause. De facto, we have changed the treaty.”*

Pierre Lellouche, French Europe Minister, May 2010

As Europe approaches to the 20<sup>th</sup> anniversary of the 1992 deadline for the “completion” of the EU single currency, the unexpected events of the recent crises had brutally exposed that the scheme was not working as well as it should, as Europe's economic integration had moved on from the “Mountains of Butter” to the “Mountains of Debt” throughout the last fifty years. But a crisis is a terrible thing to waste. Thus, Europe must identify missing links within EMU, as its rules turned out to be *unrealistic, unsuitable, unmanageable, unsustainable, unreliable, unenforced, unsuccessful* while its cures were *uncomprehensive, unpopular, unstable and unstabling*, since putting all those different economies at different stages of their developments into one basket; turned out to be a “trap” for all parties involved; be it the most powerful Germany or the weaker economies of the single currency.

The rules of the Eurozone were *unrealistic* to begin with, since Eurozone has never really been an ‘optimal currency area’ – a geographic region where economic efficiency was optimized by having a single currency. For example, it was easy to imagine that Netherlands and Belgium to form a currency union since their economies are very similar. But if you were to throw in relatively weaker economies of the Eurozone, like Portugal, Spain, Greece and Italy, into the mix, the currency club would not be as ‘natural’. And as a natural result of having a common currency and monetary policy, weaker economies had to give up an important instrument for adjustments to downturns: monetary policy. Had they not done so, they would have responded to the crises by lowering interest rates to stimulate investment. If lowering interest rates would not have worked in a recession, which is possible, they would have the freedom to rectify their economy through devaluations of their currencies, which would increase exports. But, their hands were tied, by Eurozone rulebook. Plus, the Eurozone was lacking both a special fund to help those facing adverse problems –to make up for the losses of vital economic adjustment tools- and a strong central government to iron out the differences between the countries, through allocating these special funds. If the Eurozone were to build an authority to transfer the tax revenues from relatively-well-to-do states such as Germany or the Netherlands to high-deficit countries, the crisis would be remedied a lot easier. This is roughly what happens in the United States, which is a ‘optimal currency area’. If Florida were to run into a depression, federal funds can be diverted toward that state. When unemployment rates go up in California, a large part of the costs are borne by the federal government. Economic differences between the regions evened out by a big-

spending central authority. (Lynn 228) Europe, on the other hand, had no way of helping countries facing severe economic problems. No longer rectified by such measures, weaker economies had to be corrected by painful long-term adjustments, through lower wage rises, increased working hours and job losses in uncompetitive businesses and sectors. (Marsh, 4)

The Eurozone's 'one-size-fits-all' type of monetary policies had turned out to be *unsuitable*. For example, a slow-growth Germany would benefit from lower interest rates that the ECB has set, while a sizzling Irish economy of mid 2000s with inflationary pressures would probably warrant higher rates than those set by the ECB. (Peterson and Shackleton, 180) Especially the needs of periphery countries -Portugal, Ireland, Italy, Greece and Spain- all suffering from a similar disease of Euro-fueled low interest rates, poor credit records, very high and rising debt, critical dependency on artificial lending booms, all kinds of inflated-bubbles and most significantly, being locked into a single currency where they could not devalue their way out of trouble, were not met. (Lynn 200) Take Ireland, for example. Ireland was the first poor country to join the EU. Theirs was a fairly clear case of integration-induced investment-led growth where membership reduced uncertainty concerning the nation's stability, making it a better place to invest and this extra investment bringing in more tools per worker and thus raising the output per worker. (Baldwin and Wyplosz, 165) Ireland's growth has been downright brilliant. Between 1988 and 2002 the Irish went from an income level that was just %64 of the EU15 average to being the second richest EU nation. (Baldwin and Wyplosz, 232) Ireland looked attractive to American firms seeking a foothold in the EU ahead of the removal of barriers to trade in 1992. It offered an educated, English-speaking, young, skilled and cheap workforce, as well as state grants and a low corporate-tax rate of %12.5. Intel, a giant maker of semiconductors arrived in 1989 and started production near Dublin the following year. That landmark investment encouraged other firms in. The economy grew by an annual average rate of %6.5 between 1990 and 2007. However, this long expansion had two phases: a healthy boom and an unhealthy bubble. The switch between the two phases was hard to spot, but probably happened somewhere between 2001-2002<sup>146</sup> after the country had joined the Euro. The reduction in interest rates, that followed the single currency, blew up a massive housing bubble (Lynn 192) and Ireland became dangerously dependent on the revenues that flowed from it. The country's financial regulators were incompetent at best, cronies at worst. (The Economist, 20 November 2010) When the bubble burst in 2007, enormous damage was inflicted upon the Irish economy, from which it may take generations to recover. (Lynn 192) The meltdown of its banking system back in 2008, reduced the difference between Iceland and Ireland to only one letter and six months, as the joke went among the City of London dealers. (Lynn 189) As a matter of fact, Ireland was not in need of Euro to modernize either, like Greece or Spain. It was doing brilliant on its own. Nor did it need to share a currency with France and Germany to build export industries: it was already a hub for global manufacturers.<sup>147</sup> Thus, it has been very hard to conclude that Euro had been good for Ireland. In reality all it got from monetary union was a monetary policy that was completely

unsuitable for its own situation. (Lynn 192) Another example would be Italy. No one had been more enthusiastic about the single currency than the Italians since their postwar experience with the Lira was not a happy one. The currency had to be devalued numerous times. (Lynn 193) A decade to its existence, it was becoming painfully clear that the Euro membership had not proved any kind of panacea for Italians. The discipline of the Euro membership meant that Italy could no longer regularly devalue its way out of trouble. The impact on the competitiveness of its factories and workplaces was catastrophic. (Lynn 194) Another example could come from Spain with an unemployment rate of %20, with %40 to 50 of young people unemployed. It had a fiscal surplus before the crisis; after the crisis; its deficit exceeded %11 of GDP. But under the rules of the game, Spain must now cut its spending, which will almost surely increase its unemployment rate still further. As its economy slows, the improvement in its fiscal position may be minimal. Spain may be entering the kind of death spiral that afflicted Argentina just a decade ago. It was only when Argentina broke its currency peg with the dollar that it started to grow and its deficit came down. At present, Spain has not been attacked by speculators, but it may be only a matter of time. (Stiglitz 323)

The rules of the Eurozone were *unmanageable*, as the specific construction of EMU rested on two pillars -economic and monetary. The monetary pillar was supranational. There was only one currency, monetary policy, and central banking system -the Eurosystem. On the other hand, the economic pillar was organized at the national level, and thus more decentralized, with responsibility for fiscal and economic policies in the hands of individual countries. These national economic policies should have been steered by keeping in mind the fact that Europe had a single currency without having a political federation. When it was working properly, this structure balanced the independence of nations and their economic interdependence. At the heart of EMU was shared-sovereignty, meaning that it was neither exclusively national nor exclusively European.<sup>148</sup> Which also meant that European Central Bank was deprived of two tasks, traditionally vital to national central banks, leading to not having full control of the economy -fiscally and monetarily. Neither the sovereignty of the member states, nor the responsibility of the supranational institution alone would be enough to create a healthy functioning economy. As long as the current situation remains, the EMU will remain to be a 'crippled man' with one leg at the national level, the other at the supranational, as the famous Turkish saying goes; "*The drum is with me but the beetle is not*".

The rules of the Eurozone have turned out to be *unsustainable*. When Euro was being put together in early 1990s, two views clashed over whether or not it needed to be backed by an effective central government in Brussels. Some said that the central authority would come in time, with Euro being an instrument that would summon a single European super-state into being. The chief economist of German Bundesbank, Otmar Issing rightly argued that "*There is no example in history of a lasting monetary union that was not linked to one state*". Actually, monetary unions were always and

everywhere linked to a strong and unified central government: one that could raise taxes, distribute wealth between regions, borrow money on the global capital markets and authorize a central bank to print money, if necessary. They weren't based on loose, optimistic confederations, with no significant revenue-raising powers, no ability to move funds around the region and when you look at it closely, no genuinely popular mandate. Of course, that wasn't to say it wasn't possible. It was just that it hadn't been tried before. (Lynn, 21) Meanwhile a fierce battle was being fought for the type of Euro; would it be a hard, stern, disciplined, anti-inflationary currency modeled on Deutschmark and with a central bank built after the Bundesbank, independent of any form of political interference? Or would it be a soft, political bank, much closer to the old Bank of France, firmly under the control of the politicians? (Lynn 24) Behind the theoretical-sounding language lay a persistent Franco-German gap in economic culture and philosophy that persisted for half a century. (Marsh 40) Germany won over. Their rulers were clear. Euro members were to limit their budget deficit to just %3 of GDP. And there would be no bail-outs between member states. A country with its own currency and its own central bank could, if it wanted to, run just about any kind of budget deficit it happened to feel like. If it found out that it could no longer borrow the money it needs to fund itself, then it could just order the central bank to print some more. This was not a completely cost-free exercise as it might appear at first glance. Printing too much money would create hyperinflation and your currency would collapse in value. This was what happened in Germany back in 1920s and in Zimbabwe back in 2007. But it was still an important freedom. (Lynn 25) However, Germany's strict EMU rules had left no flexibility and room for maneuver for other members of the Eurozone. They were no longer free to set their own fiscal policies. Rules would be enforced by Brussels on how much they could or could not spend. It was a huge compromise in national sovereignty and one that many countries, the French in particular, didn't feel they had signed up for when they embarked on the Euro project. (Lynn 27) So what would happen if one member ran up big debts? Say it went on a wild borrowing spree, running up bills it could never meet, until ultimately it lost the confidence of the bond markets and could no longer pay its bills? The ECB couldn't be expected to print more and more Euros to help it out. That would risk creating inflation and if there was one thing Germans were determined upon, it was that the Euro should be as stable and secure as the Deutschmark it replaced. But neither could the other member states be expected to bail out that country with soft loans. That would be grossly unfair if the fiscally responsible states were forced to subsidize the states that had been spending profligately. There would be no incentive for anyone for anyone to keep their national books in order. The situation would quickly descend into chaos, with every member living way beyond its means, then expecting its neighbors to bail it out or the ECB to print money to finance its extravagance. (Lynn 26) Furthermore, thanks to having a single currency, countries weren't going to be able to devalue their way out of trouble the way they did in the past. They would have to compete with the ruthlessly efficient Germans on quality and productivity. Their workers would have to hold down wages to make sure they remained competitive. (Lynn 28) The single monetary policy put everyone to a dead-end.

The rules of the Euro area have turned out to be *unreliable*. Maastricht Treaty had promised that there would be no bailouts between member states. It had guaranteed that the European Central Bank wouldn't buy government bonds in the market. A few years later, the members agreed on tougher surveillance under the Stability and Growth Pact. (Lynn 181) The founding principals of the single currency have been betrayed by the founding members, at their first real test, provided by the sovereign debt crisis of 2010. Economically troubled countries had been bailed out. The Eurozone countries issued joint bonds, through a special purpose vehicle and the European Central Bank ended up buying the government bonds issued by its members. Plus, if the rules of the Euro could be rewritten on a Sunday night in Brussels once, they could always be rewritten next time there is a crisis. (Lynn 183) They had already been torn up once during the crisis. There was no reason to suppose they couldn't be torn up again. (Lynn 221)

The rules of the Euro area have turned out to be *unenforced*. The crisis arose because the Eurozone didn't enforce the Stability and Growth Pact, which limited budget deficits to %3 of GDP in all but exceptional circumstances. If the Pact had been rigorously enforced, Greece would not be survived in the Euro, once it had cheated its way into the club. Once in, it would have been disciplined for not allowing its deficits to balloon even when the economy was booming. There were no meaningful constrains to avoid future trickery. The package talked about tougher disciplinary measures, but nobody said what they might be. Were tanks going to sent to Dublin? Or Portugal would be kicked out to the Euro? Of course not. The only credible deterrent was letting Greece default. By saving Greece, the EU had left with no ammunition. (Lynn 181)

But probably most import of all, the rules of the Eurozone have turned out to be *unsuccessful*. The Euro had been designed as a catalyst of modernization. It was meant to be a tool for dragging nations out of the past, polishing them up and transporting them into the 21<sup>st</sup> century. Instead of being an agent of modernization, however, the single currency had served as an agent of destabilization.

On the other hand, the cures for the Euro area have turned out to be *uncomprehensive*. The rescue package didn't address the issue of how the heavily indebted countries would grow again. The problems in Greece, Portugal, Spain, Ireland, Italy and potentially France, were not be solved by governments managing to push through brutal austerity programs. The fact that they would not be able to devalue their currencies to provide some relief to their economies, along with the austerity measures, there would not be much hope for future growth. One cannot run an economy, just with sticks, not in a democracy, anyway. The carrots are also needed, (Lynn 182) especially in high-deficit countries that faced years of grinding deflation. Government spending was being cut. Consumer demand, now that cheap and easy credit had been turned off, was stagnant. Exports were not likely to

revive soon because their industries had been made uncompetitive by the Euro. (Lynn 228) It would involve years of zero growth and stagnant wages. Unemployment would soar. (Lynn 230)

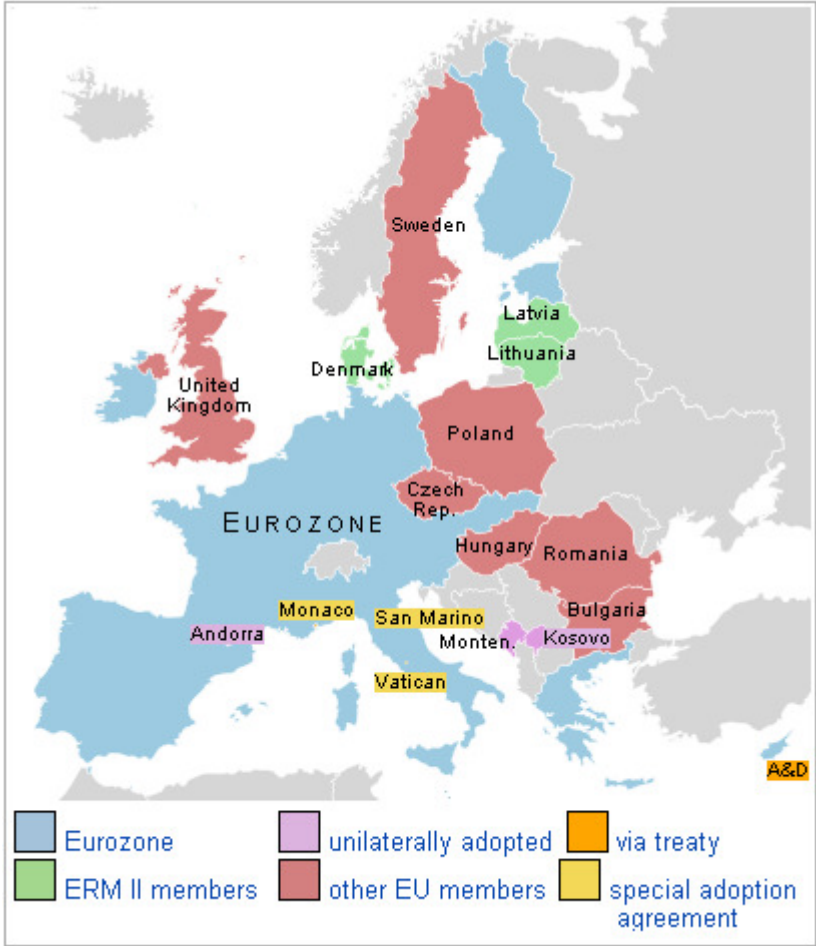
The cures for the Euro area have also been highly *unpopular*. It should be underlined that the financial assistance provided to Eurozone members in distress was not a fiscal transfer, only a loan to be repaid fully with interest. Taxpayers would actually not paying anything. Furthermore, they come with strict conditions, detailed and demanding policy programs, which ensure that, while assistance is being provided, the proper fiscal and structural adjustments are being set in place to ensure solvency in the long run.<sup>149</sup> Outsiders are often amazed to hear that all the bailouts so far -the loan to Greece and Ireland and the set-up of the European Financial Stability Facility- have not yet cost the taxpayer a penny. These are loans backed by guarantees. (Münchau 2011) However, this simple fact was not been able to conveyed to the greater public around Europe.

The cures for the Euro area have turned out to be *unstable*. Greece, Ireland and Portugal had been relatively minor problems for Eurozone. They could be contained. European Union could always afford to them all bail out and put them in life-support just about indefinitely, if it had to. But the collapse in confidence in sovereign debt spread to larger European nations, the implications would be far more worrying. (Lynn 197) Take Spain, for example, which was slightly smaller than Britain or France or Italy, with a population of 40 million. (Lynn 184) Or remember Italy, with its economy seven times the size of the Greek. (Lynn 196) Perhaps, most importantly, the European banking system could easily be tipped into a fresh crisis if the sovereign debt crisis were to continue. One consequence of monetary union was that banks had become a lot more relaxed about holding debt across borders. French banks bought a lot of Spanish debt, German banks bought Italian debt and so on. This was, indeed, a mark of single market's and single currency's success. But what was a strength when times were good, turned out to be weakness when crisis struck. (Lynn 197) A default by any of the highly indebted Eurozone countries would put the whole banking system at risk. The Eurozone countries had discovered, rather painfully, that their financial systems had become so interconnected that it was impossible to let one or two members collapse without paying a very high price in their own economies. (Lynn 198) The financial distress in one member state could have a serious impact on the macro-financial stability of the Eurozone as a whole. (ec.europa.eu) This was not a Greek, Spanish, Irish or Portugese problem. It was a problem for the whole of Europe. (Lynn 198)

The cures for the Euro area have turned out to be *unstabling*. Angela Merkel's idea of having the countries restructure their debts was a good idea with a timing issue. Investors should indeed bear some of the pain, but she would have done better to venture into this territory, a little later, once markets had calmed down. Part of the market turmoil at the time was caused by the 'unforeseen consequences' of the German move. (The Economists, 20 November 2010)

# FIGURES

**Map 1:** Direct and Indirect Usage of Euro



(Source: <http://en.wikipedia.org/wiki/Euro>)

**Table 1:** Summary of Austerity Packages in European Union Member States

COUNTRY	SELECT PLANNED AUSTERITY MEASURES
Greece	Retirement age increase to 63.5 from 61.4
	Public sector salaries and pensions freeze for three years
	Pensions reduced by 7 percent between 2010 and 2030
	Civil servants earning 36,000 euros annually lose two bonus salaries
	Public sector allowances cut by 20 percent
	Fuel, alcohol, tobacco taxes up by 10 percent
	VAT increased by 4 percent
Ireland	Public sector salaries (expected to) decline by 6 percent
	Public sector pensions over 12,000 euros (annual) cut by 4 percent
	Ten percent pay cut for entrants to public service
	Cuts to social welfare and unemployment allowances
	Tuition costs up from 500 to 2,000 euros
Portugal	Income tax bands lowered by 10 percent, bringing 139,500 people into tax net
	Capital gains and capital acquisition taxes increased by 25 percent
	Public sector salaries cut by 5 percent
	VAT increased by 3 percent
	Tax hikes for those earning more than 150,000 euros, to 45 percent by 2013
	Military spending cut by 40 percent, infrastructural projects delayed
Italy	Income taxes increased by 2 percent
	Corporate taxes increased by 5 percent
	Funding for city and regional authorities cut by 13 billion euros
	Freeze in public sector pay and cuts in hiring for three years
	Progressive pay cuts of up to 10 percent for high earners in public sector
	Retirement delayed by six months for those who reach retirement in 2010
	Provincial governments serving fewer than 220,000 inhabitants to be scrapped
All ministries to cut spending by 10 percent	
France	More road toll taxes
	Three-year freeze on public spending is under consideration
	Pension contributions from employees increasing to 10.55 percent from 7.85 percent
	Income tax for highest income group increased by 1 percent
	One-off corporate tax breaks – introduced as stimulus – eliminated
Belgium	Capital gains tax increased by 1 percent
	Most fiscal stimulus measures ending.
Germany	None yet announced because the government has not been formed
	Suggested: 2 billion euros worth of measures including pension cuts, freeze in healthcare spending, carbon dioxide emission taxes and a banking "crisis tax"
	Cost cutting measures of 80 billion euros by 2014
	Air travel surcharge of 8 to 45 euros a ticket, depending on destination
	Tobacco tax increased
	Retirement insurance for longtime unemployed will end
	Housing benefits will end, specifically heating allowances for some on unemployment benefits
Parent benefit for children will end for richest recipients and will be reduced for the poorest	
	Insurance rates for healthcare will go up by 15.5 percent for most Germans

(Source: <http://www.stratfor.com/analysis/20110115-how-austere-are-european-austerity-measures>)



**Table 2:** Economic Indicators for Selected Eurozone Countries

	GDP CHANGE (PERCENT)	BUDGET BALANCE (PERCENT OF GDP)		GOVERNMENT DEBT (PERCENT OF GDP)	DEBT INCREASE (PERCENT GDP)	INTEREST EXPENDITURE (AS PERCENT OF GDP)
	2009	2009	2010*	2010	2007 - 2011	2011
<b>Ireland</b>	-7.5	-11.7	-11.6	82.9	71.1	4
<b>Greece</b>	-1.1	-12.7	-9.1	124.9	39.8	6.1
<b>Spain</b>	-3.7	-11.4	-9.8	66.3	34.4	2.9
<b>France</b>	-3	-7.9	-8.2	82.5	23.8	3
<b>Portugal</b>	-2.9	-9.3	-8.3	84.6	27.5	3.5
<b>Belgium</b>	-2.9	-5.9	-5.8	101.2	19.8	4.1
<b>Austria</b>	-3.7	-3.5	-4.7	73.9	17.5	3.2
<b>Italy</b>	-4.7	-5.3	5	116.7	14.3	5.1
<b>Eurozone</b>	-4	-6.9	-7.5	84	22.2	3.4

(Source: [http://www.stratfor.com/analysis/20100205\\_eu\\_economic\\_uncertainty\\_continues](http://www.stratfor.com/analysis/20100205_eu_economic_uncertainty_continues))

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