

A useful initial examination of the European financial crisis can be based on a stock and flow analysis of critical variables, and on a short and long-term time analysis. The main issues shaping the crisis are: weak actual and potential growth; competitive weakness; liquidation of banks and sovereigns; large debt-to-GDP ratios; and considerable liability stocks (government, private, and non-private sector). The four features (stocks/flows, and short/long-term maturity) are impacted by the problematic structure of the European crisis, and suggested policy solutions for one feature tend to have a negative influence on the opposite feature. Short-term solutions do not favor long-term prospects, and vice versa. Stock rebalancing policies do not favor flow imbalances, and vice versa.

The cycle of austerity, deleveraging and deflation experienced in Europe in recent years has been amplified by excess debt, contagion between sovereigns and banks, and the economic policies chosen by member states. Although the crisis is following a predictable evolution, it is difficult to estimate how long it might last.

This chapter provides a background to the evolution of the European Union as a political entity and to the European financial crisis from its outset to its current status. The first Sect. 2.1 describes the evolution of present-day political Europe, the second Sect. 2.2 analyzes the evolution of the European crisis, by outlining the most basic facts, and the third Sect. 2.3 provides an initial introduction to the causes behind the crisis.

2.1 Evolution of the European Union

The Eurozone (and the European Union in a wider sense) emerged through the unification of the national economies of Europe with the aim of overall economic unification. Balassa (1961, 1976) noted five stages in the process of cross-country unification. In the first stage, custom duties between the participating countries are eliminated. In the second stage, a customs union is established to deal with external economies. In the third stage, an internal market is organized (lifting of trade barriers, elimination of restraints and free movement of capital). In the fourth

stage, synchronization of individual national economic policies is developed. Finally, in the fifth stage, the unification of monetary, fiscal, social and anti-cyclical policies is achieved. In this final stage the decisions of the supranational entity prevail over the decisions of national governments. However, interim provisional union forms may emerge between the fourth and the fifth stage. In these cases the supranational structure undergoes four different phases: Political Union, Transfer Union, Monetary Union and Fiscal Union. This is the situation that the Eurozone has found itself in and it is, to date, dominated by the notion of the Transfer Union. Political union is at an embryonic stage of development, and Fiscal Union is at an even more premature stage. The reformation of the Maastricht Treaty (March 2012) aimed at introducing elements of political and, more particularly, fiscal union.

Sorens (2008) defines five basic characteristics of a Fiscal Union:

1. It is composed of separate entities (sub-central political entities) having autonomous powers in relation to taxes and expenditure.
2. Individual governments are subject to strict fiscal controls, and there are no bail-out procedures (bail-out rule).
3. There is a single market based on the free trade of goods and services, and the free movement of labor and capital, within the fiscal union.
4. There is a specific institutional framework for the operation of the system, ensuring that no government of any member state can change it at will.
5. There is a single currency.

It is hard to distinguish whether the evolution incentives during the first stages of an economic unification are merely commercial, or if they are also political (Sapir 2011). The political character of the unification is established in later unification stages.

The European Union first emerged in its primary form in 1951 (Table 2.1). The European Union was a French-inspired postwar creation, with its main goal being the prevention of future war crises in Europe. The European Union experienced high growth rates from 1958 until 1968, and then entered a period of immobility until the early 1980s (Fig. 2.1). During this period, the “Single Market Program” came about, signaling Europe’s entry into the third stage of unification. The collapse of the Bretton-Woods system in 1971 led to the establishment of the European Monetary System (EMS) in 1979, a mechanism for the stabilization of exchange rates. The fall of the Berlin Wall in 1989, however, changed the character of European unification. To ensure French support for the unification of East and West Germany, Germany agreed to abolish the Deutsche Mark and accept a new single currency, i.e. the euro. The concept of “One Market, One Money” was established in 1990, aiming at tackling the three contradictions inherent between the free movement of capital, stable exchange rates and monetary policy. This concept was incorporated into the Treaty of Maastricht in 1993, and led to the adoption of the euro on 1 January 1999. Throughout this process, new member states were acceding to the European Union, resulting in its enlargement to the South, North and East. Two further treaties contributed to its enlargement: the Treaty of Nice in 2003; and the Treaty of Lisbon in 2009. By virtue of the latter Treaty, the EU became a legal entity.

Table 2.1 Historical evolution of the European Union

1951	European Coal and Steel Community → 1) Preferential Zone
1957	Treaties of Rome European Economic Community EEC → 2) Free Trade Area European Atomic Energy Community EURATOM European Coal and Steel Community ECSC
1960	European Free Trade Area
1967	Merger Treaty: ECSC, EURATOM and EEC merged into European Community EC → 3) Customs Union
1972	Exchange Rate Mechanism (ERM): European Currency Snake
1979	European Monetary System (EMS), including the ECU as a basket currency
1985	Schengen Treaty signed. The Schengen area came into existence 10 years later in 1995
1987	Single European Act First major treaty revision since 1957 Agreement on full removal of all tariff and non-tariff barriers in the European Single Market until 1992
1990	“One Market, one Money” concerns
1993	Maastricht Treaty: → 4) Common market, treaty reform – three pillars: EC (supranational) Common Foreign and Security Policy (CFSP, intergovernmental) Justice and Home Affairs (JHA, intergovernmental) Agreement on 3 stages to European Monetary Union (EMU): 1990: Free capital movement 1994: Convergence of macro policies 1999: Launch of the euro
1994	European Economic Area (EEA): European Free Trade Association (EFTA) plus EU-12 minus Switzerland
1996	Broad Economic Policy Guidelines as a means for economic policy coordination. → 5) Economic Union
1997	Stability and growth pact
1999	Amsterdam treaty: More power for the European Parliament, strengthening the rights of citizens
1999	Third stage of EMU: European Central Bank, Launch of euro as an accounting unit → 6) Currency Union
2003	Treaty of Nice: Amendment of majority rules in the Council. Strengthening the principle of qualified majority, weighing population
2009	Lisbon Treaty: Institutional reforms, qualified majority voting, closer economic coordination between EMU member states, EU becomes a legal entity

(continued)

Table 2.1 (continued)

2010	Euro Crisis: EMU countries agree on support programs for Greece (2 May) and other EMU countries (9 May). Founding of European Financial Stabilization Mechanism (EFSM) and European Financial Stability Facility (EFSF)
2011	Signing of European Stability Mechanism (ESM) Treaty

Source: Deutsche Bank Research (2011)

Note: The organization founded in 1957 originally had six members: Belgium, France, Germany, Italy, Luxembourg and the Netherlands. Denmark, Ireland and the United Kingdom joined EU on 1973, Greece on 1981, Spain and Portugal on 1986, Austria, Finland and Sweden on 1995. On 2004 ten new countries join the EU: Czech Republic, Estonia, Cyprus, Latvia, Lithuania, Hungary, Malta, Poland, Slovakia and Slovenia. The latest stage of evolution to date was in 2007, with the accession of Bulgaria and Romania and in 1st July of 2013 with the accession of Croatia. Iceland, Montenegro, FYROM, Serbia and Turkey are candidate countries, while Albania, Bosnia and Herzegovina and Kosovo are potential candidates

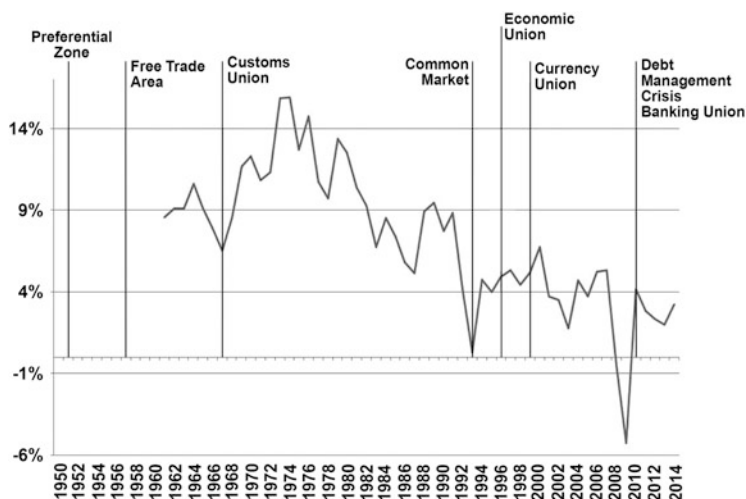


Fig. 2.1 European growth rate and main initiatives (**Source:** AMECO Database. **Note:** The data for the period 1960–1990 relates to the EU-15 [including West Germany] and the data for the period 1991–2014 relates to the EU-27. The data refer to GDP growth rate at current market prices)

The 2010 financial crisis resulted in the amendment of Article 125 of the Treaty of Maastricht. This led to the purchase of government bonds by the European Central Bank (ECB) from the secondary market (initially from Greece, followed by Spain and Italy). This significant move separated the ECB from its fundamental premise, the preservation of price levels. It also implied that national states were no longer exclusively responsible for their public economics. Since then, the European structure has sailed in the uncharted waters of the debt crisis.

History has shown that the creation of a single monetary union without agreeing political unification at the same time is a dangerous undertaking. There were two previous monetary unification attempts in Europe, both of which failed. In 1865

France, Belgium, Italy and Switzerland formed the Latin Monetary Union. The four nations were joined by Spain and Greece in 1868, and Romania, Bulgaria, Venezuela, Serbia and San Marino in 1889. It was dissolved in 1914 because of disagreement over the funding of public debts by increasing the money supply. The Scandinavian Monetary Union (Sweden, Denmark on 1873 and Norway on 1875) was formed in 1873, and subsequently dissolved in 1914 for the same reason as the Latin Monetary Union. Their pegged exchange rates system, mainly in the form of a link to the gold standard, prevailed after 1914 and was in place until the Great Depression of 1930. Another monetary management system which previously operated within Europe, the Bretton-Woods postwar pegged exchange rates system, was dissolved in 1973.

Descriptions of such actual or “quasi” monetary unions show that various forms of fiscal vicissitudes (wars) or private explosive deficits led to the establishment of considerable national fiscal deficits. These deficits contributed to the creation of significant disequilibrium in the balance of payments and their monetization, and led to the breaking up of the monetary unions. Such historical lessons are one of the fundamental reasons behind today’s desire to preserve the control of fiscal deficits.

The enlargement of the European Union to include Southern European countries resulted in immediate serious concerns relating to (a) fears that, because of its low competitiveness level, Southern Europe would lose its industry to the benefit of Northern Europe, and (b) fears that high wage earners in Northern Europe would be replaced by cheap workers from Southern Europe, or from Eastern Europe at a later stage. The first concern was upheld to a greater extent than the second mainly because, as is discussed later, competitiveness was greatly shaped by production, prices and non-wage costs. In general both Southern and Northern Eurozone member states enjoyed a prosperous period prior to the financial crisis of 2008. The economic benefits of the single currency were particularly apparent during this period. Peripheral Eurozone countries such as Spain, Portugal, Greece and Italy enjoyed access to international capital markets, low borrowing levels and significant investment opportunities. Eurozone core countries (Germany, France, and the Benelux) experienced increased exports, attributable to the rapid growth of peripheral countries, in addition to high investment returns from companies and assets located in Southern Europe. Therefore, the benefits of the single currency were distributed between the core and the periphery of the Eurozone.

The good years, however, soon came to an end because of key differences in the economic behavior of the peripheral countries to those in the center of the Eurozone. The increase in fiscal deficits, accompanied by a drop in private savings, led to the expansion of the current payments balance deficit. This, in turn, created three deficits: current account deficit, fiscal deficit, and savings deficit in relation to investments.

Imbalances between goods and services and capital transfers (either as investments or in the form of net transfers) were evident, even within the European Union. It is clear that the Eurozone crisis is of a systemic nature. Hence, it is useful to reevaluate the macroeconomic history of European peripheral and debtor countries in the light of this (Fig. 2.2).

The large deficits observed in current account balances were an inevitable result of increased capital flows from the center of the Eurozone, poor fiscal administration,

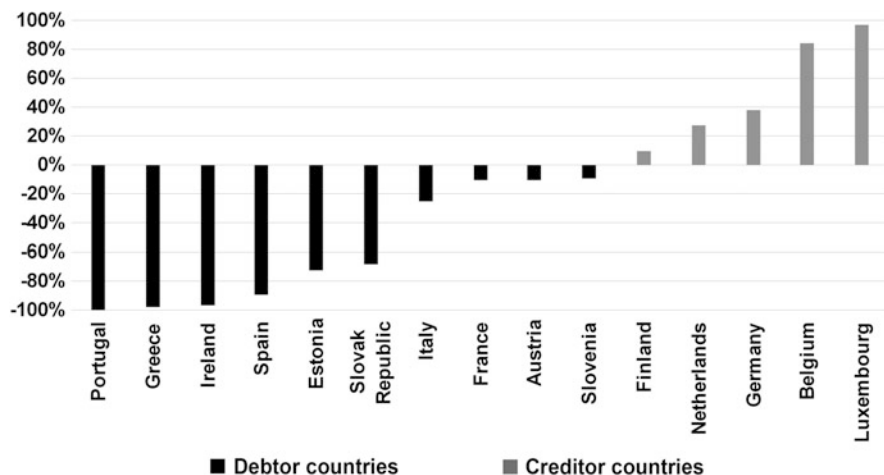


Fig. 2.2 Net foreign asset position 2012 (GDP percentage) (Source: OECD Database)

and the phenomenon of overconsumption. In addition to high levels of inflation and the drop of competitiveness, which constituted indicators of ineffectiveness in the job market and the fiscal tax policies, the appreciation of the actual exchange rates was inevitable.

From the moment the countries of the Eurozone adopted the euro, certain forces were born, laying the foundations of a possible financial crisis. This situation seemed inevitable, irrespective of peripheral country governmental policies. Peripheral country policies certainly contributed to the Eurozone crisis, but only to a limited extent. The primary reason lies within the existence of the single currency.

The shaping of the Eurozone led to the formation of a supranational entity with imperfect supervision and without formulated plans relating to: macroeconomic imbalance management; crisis management; institutional production of solutions; and satisfactory banking supervision. During the current financial crises with such weaknesses to the fore, the Eurozone has operated an ad hoc intervention approach that has proved insufficient, and has given rise to multiple levels of moral hazard.

It is important to note here that the situation that has emerged in the Eurozone has exceeded the strict characteristics of a fiscal union, given that during the crisis of 2008–2012 it intervened with bail-out programs in Greece, Portugal, and Ireland.

The real question to be posed is, whether such interventions have triggered moral hazard bursts. This would imply to member state governments that, no matter what happens, there will be a plan for their bail-out. If this is the case it would sooner or later cause the collapse of the European Union as we recognize it today, or significantly impact on its conversion to a new structure with special “made in Europe” characteristics. Hence, for European unification to successfully continue, the union itself will have to develop its ability to learn from and adapt to changing economic and political circumstances.

A survey on the evolutionary conversion of European member states (Bordo et al. 2011) showed that global economic crises played catalytic roles in their transformation. A distinctive example is that of the Great Depression of 1930. During the

crisis, and after it ended, federations underwent a process of centralization. This centralization made it easier for federal governments to introduce, or extend, measures aimed the equalization of incomes across regions. Thus, expenditure distribution before the crisis was 50 % local, 20 % state and 30 % federal government, whereas after 1940 the respective percentages were 30 %, 24 % and 46 %.

The 2008 economic crisis has a determinative impact on the direction and the quality of European unification. To put it in Jean Monnet's (1976) words, "*Europe will be forged in crises and will be the sum of the solutions adopted for those crises*". "*Crisis represents an opportunity. I'm not saying that I enjoy being in a crisis. But I'm not worried. Europe always moved forward in times of crisis. Sometimes you need a little pressure for certain decisions to be taken*" (Schäuble 2011).¹

2.2 The Historical Evolution of the Crisis

The US subprime crisis of 2008 laid the foundations for a wider global crisis. The starting point of the crisis in Europe was in October 2009, when the new Greek government revealed that the size of the fiscal deficit was much larger than the previous government had claimed, with fiscal holes being greater than 10 % of GDP. Two weeks later the fiscal deficit was officially estimated at 12.7 % of GDP. This immediately impacted on investor confidence in the fiscal sustainability of the Greek economy, and a call for higher interest rates on government debt. In December 2009 the three credit rating agencies – Fitch, Moody's and Standard and Poor's – downgraded Greece's sovereign credit rating. The lending rate of the Greek economy reached 8.7 % in April 2010, an increase of 270 base points over the previous month. The need for the country's bail-out by the European Union and the International Monetary Fund (IMF) subsequently became obvious in May 2010. The sum of the 3-year bail-out package for the Greek economy amounted to €110 bn: initially comprised of €80 bn in bilateral loans and €30 bn from the IMF.

During this period, European Finance Ministers announced the establishment of the European Financial Stability Facility (EFSF), a fund of €500 bn, and the ECB launched the Securities Market Program (SMP).

In October 2010 the credit rating agency Fitch downgraded the sovereign credit rating of Ireland. Furthermore, the Irish government announced that to achieve its deficit goals by 2014, funding of €15 bn over a 4 year period was required, i.e. almost 10 % of the Irish GDP. A direct impact was the increase of the 10-year government bonds by 250 base points, reaching levels in excess of 9 %. In November of the same year, Ireland too had to accept aid through the bail-out mechanism, amounting to €85 bn. Concerns over the high cost for the bail-out of the Irish banking system created a run on Irish sovereign debt. In December of the same year both Moody's and Standard and Poor's credit rating agencies downgraded the country's sovereign credit rating.

¹ Quoted in Reuters (2011).

In March 2011 the Eurozone leaders agreed to lower the interest rates on Greek loans to 5 % and to increase the length of program loans to 7.5 years, in exchange for the swift completion of a €50 bn privatization plan. They also agreed to make the EFSF's €440 bn lending capacity fully effective, to include debt buybacks, bank recapitalizations and pre-emptive loans. Finally, they agreed to allow the EFSF and the European Stability Mechanism (ESM) to intervene in the primary sovereign debt markets as an exception, and only in the context of a financial assistance program.

During the same period of time, the three large credit rating agencies downgraded the sovereign credit rating of Portugal. Exactly 1 year after the Greek bail-out, Portugal became the third member state to avail of the bail-out mechanism. The 3-year program amounting to €78 bn: of this €26 bn was to be provided by the IMF.

The wider European economic situation started to worsen in the summer of 2011, with intense market worries relating to rumors of Greece exiting the Eurozone and the implementation of a second program of fiscal adjustment in that country. The direct outcome was a large increase in the yields on Spanish and Italian sovereign bonds, with the Italian president green-lighting the government's austerity package in July 2011. As a result, Greece accepted a new assistance package amounting to €109 bn including: maturity extensions (from 15 to 30 years); some private-sector involvement (with a net contribution corresponding to a 21 % haircut); a secondary market debt buy-back program; and the lowering of the interest rate on assistance loans (to approximately 3.5 %).

Furthermore, significant problems within European banking systems emerged around the same time. Banks faced significant difficulties relating both to lack of liquidity, and relationships with their sovereigns. Such difficulties arose because significant amounts of government bond-funding came from banks within the Eurozone, while it was apparent that the banks in the Eurozone were correlated. It was clear that a bank failure, or a sovereign default, could lead to a huge systemic crisis. In late August 2011 the IMF claimed that losses for European banks from exposure to sovereign bonds could potentially reach €200 bn.

In an attempt to tackle these problems, the ESM was established, as a follow-up to the temporary EFSF, with a capacity of €500 bn. However, this mechanism did not seem able to support the restructuring of larger economies, such as those of Italy and Spain. In August 2011 the ECB extended the SMP by purchasing Italian and Spanish bonds in the secondary markets, to suppress their borrowing costs. Such moves offered little more than short-term relief to the troubled economies because they took place on a sterilized basis and under the condition that the EFSF would eventually take over responsibility for secondary purchases. In September 2011, the European Council, the European Commission and the European Parliament concluded the agreement on the "six-pack" legislation on macroeconomic surveillance (which entered into force in December 2011).

The credit rating agency Standard and Poor's downgraded the sovereign rating of Italy in September 2011 thus highlighting its negative growth prospects and the country's fragile political environment. One month later, Italy and Spain, were further downgraded by the three big credit rating agencies.

In November 2011, contagion had spread to France. Furthermore, sovereign yields in Italy and Spain had reached the highest levels in Europe (almost 7 %), and

pressure on the banking system was enormous. In the same month, the European Commission proposed a “two-pack” of budgetary surveillance and monitoring. Furthermore, it launched “Stability Bonds” among the euro member states.

In December 2011, EU leaders agreed on the establishment of a European Fiscal Compact, setting a deficit limit of 0.5 % of GDP, and including a requirement to reduce public debt in excess of 60 % of GDP by one-twentieth per year. The only country that did not agree on the establishment of the European Fiscal Compact was the United Kingdom. This did not pose a significant difficulty as the consent of 12 out of the 17 Eurozone countries was required by January 2013 for the treaty to come into force.

One positive intervention was the 3-year Long-term Refinancing Operation (LTRO) provided by the ECB on 21 December 2011. Through these, the ECB provided approximately €1 tr in cheap funding to many European banks. Five hundred and twenty three banks participated in the first 3-year LTRO (€489.2 bn), primarily from Italy and Spain. This had positive impacts on bank funding, sovereign and corporate bond yields and the climate of the markets. Hence, in early 2012, overall the European banks managed to cover their finance needs, and the yields on the Italian and the Spanish 10 year sovereign debt dropped to between 5 % and 5.5 %. Furthermore, the Credit Default Swap (CDS) values of peripheral countries dropped to half their peak level. However, the bank-sovereign nexus was reinforced by the banks operating in peripheral countries, as they were enticed to buy even more of their governments’ debt.

In January 2012 the agency Standard and Poor’s downgraded the sovereigns of nine European countries, namely Austria, Cyprus, France, Italy, Malta, Portugal, Slovakia, Slovenia and Spain. Austria and France were stripped of their triple-A status at that time, with Finland, Germany and the Netherlands being the only European countries to retain their triple-A rating. This suggests the inability of European leaders to confront the crisis and the failure to recognize that not all of the problems stemmed from fiscal profligacy in particular countries.

On 3 February 2012 the Spanish government adopted a series of new measures aimed at reforming and strengthening its banking sector. These mainly included cleaning-up balance sheets and the creation of incentives to continue the banking sector restructuring through mergers and acquisitions.

On 21 February, European leaders agreed on the terms for a second rescue program for Greece, with a marginally higher contribution from the private sector (53.5 % haircut instead of the 50 % agreed in October 2011). The official acceptance of the second program was delayed for a few days until the completion of a Private Sector Involvement (PSI) operation,

Additionally, on 28 February 2012 the second 3-year LTRO (€530 bn) was conducted, to which 800 European banks participated.

In March 2012 following a positive report from the Troika on the implementation of previously agreed actions and the high private sector participation in the debt exchange offer, the Eurogroup (the finance ministers of the Eurozone) decided to move on to the second adjustment program for Greece. In the same month, the Spanish government finally presented a budget for 2012, including €27.3 bn of new austerity measures.

In April 2012, the agency Standard and Poor's downgraded the credit rating of 16 Spanish banks, including two large international banks. To relieve market anxiety, the Spanish government adopted a comprehensive new package of measures to strengthen the banking sector. Spain was the first country to request financial assistance to recapitalize its banking system within the framework of a €100 bn program focused solely on the banking sector. Concerns were raised over rumors that the assistance would not be solely destined for the recapitalization of banks. Ultimately, on 11 July 2012 Spain was given an additional year to correct its excessive deficit, with the deadline for returning below 3 % being pushed back until 2014, and the goals for 2012 and 2013 being adjusted accordingly.

On 9 October 2012 Portugal was also given an additional year to correct its excessive deficit, owing to downward revisions to the country's growth prospects. In the same month, the IMF admitted for the first time that the fiscal multipliers measuring the effects of fiscal consolidation on growth had been grossly underestimated since the beginning of the crisis.

In December 2012 the agency Moody's downgraded the creditworthiness of the ESM and the EFSF from Aaa to Aa1. Furthermore, the agency Standard and Poor's downgraded Greece from the high risk category (CCC) to a state of selective default, because of the upcoming repurchase of the debt: however, just 13 days later the same credit rating agency upgraded Greece to B-.

Finally, in December 2012 the presidents' of the European Council, the European Commission, the Eurogroup and the European Central Bank released a report relating to the achievement of a genuine Economic and Monetary Union (an issue first tabled in June 2012). They presented a specific and time-bound roadmap towards deeper EU integration, by identifying "four essential building blocks" for the future of the EMU – an integrated financial framework, an integrated budgetary framework, an integrated economic policy framework, and strengthened democratic legitimacy and accountability.

2.3 An Initial Approach to the Crisis

The global crisis was triggered by the subprime mortgage crisis in the United States, leading to it being initially known as the Subprime Crisis (Cecchetti 2007). Later it was defined by the collapse of Lehman Brothers (Eichengreen et al. 2009). It took its current form as the Eurozone crisis in 2010 (De Grauwe 2010). Eight hundred years of crises experience, as analyzed by Reinhart and Rogoff (2009), classified two crises types: financial and non-financial. The present crisis falls into the first group. Financial crises can be further separated into four sub-categories (Claessens and Kose 2013): currency crises, sudden stops (in capital flows), debt crises, and banking crises. However, this typology does not contribute towards an understanding of the current crisis, and we examine instead its basic characteristics.

Throughout the evolution of the European financial crisis there are two basic sectors of reference: the public sector and the banking sector. The crisis influenced each of these two sectors separately, by refueling itself. An ineffective and expensive public sector resulted in the creation of deficits in many Eurozone countries, such as

Greece and Portugal. Additionally, the banking system – infected by doubtful titles – faced survival issues. State interventions for rescuing the banking sector were considered imperative. Hence, private debt was converted to public debt, which caused the national debt crisis in Europe. At the same time, the debt crisis in Europe is the outcome of the low competitiveness of peripheral member states, fueling deficits and increasing national debt.

Managing the banking crisis included a series of priorities: ensuring fiscal and banking liquidity, ensuring adequacy of banking capital, and encouraging state intervention with a possible privatization of banking institutions. Each of these elements is intrinsically linked to the national debt crisis.

The fiscal crisis increased lending rates. It led investors to abstain from the public debt market and, ultimately, to the establishment of bail-out packages. This resulted in the emergence of problems relating to banking viability. Therefore, the spillovers from the banking system to sovereigns played important roles. Mody and Sandri (2011) consider that government bond spreads reflect the weaknesses of the domestic national banking system, and this feedback loop has a wider impact on countries with high debt-to-GDP ratio. Acharya et al. (2011) believe that the financial sector bail-out is translated into fiscal aggravation and the simultaneous decrease of sovereign creditworthiness.

In actual fact, the trust crisis that emerged with regard to fiscal credibility resulted in the loss of the advantage created after 2000 by the convergence of the public lending rate of the various economies of the Eurozone.

The refueling of the crisis drove the need for a series of actions and policies aimed at safeguarding financial stability in the Eurozone. Overall financial stability and, consequently, the stability of the euro were both under threat.



The problems that emerged in the Eurozone can be depicted on the basis of two criteria: their time-frame and their nature, i.e. depending on whether they refer to flow or stock variables (Table 2.2) (Roubini 2011). They can also be categorized by their cyclical or structural nature.

Short-term flow problems mainly include three phenomena: weak actual and potential growth, weak competitiveness in relation to the role of monetary, fiscal and exchange rate policies, and lack of liquidation in the capital markets where banking and sovereign bonds are traded.

Short-term stock problems include the high debt-to-GDP ratio. Long-term flow problems include: growth rate asymmetries in the EU; weakness in long-term competitiveness (resulting in loss of shares in international markets, particularly in EMs); an emphasis on labor intensive low valued-added sectors; and the real appreciation level (attributable more to wage growth than productivity). Long-term stock problems include the huge stock of liabilities (Governments, private non-financial sector, banking and financial systems, and external debt).

Short-term problems lead to long-term problems: accumulated flow problems lead to stock problems. The distinctions are useful, particularly when they illustrate alternative confrontation policies. Hence, if a policy is identified that deals with a stock problem only without considering any flow issues, it has a limited effectiveness range even on a long-term basis. Furthermore, when a policy is aimed at addressing flow problems without also remedying stock problems, then it does not

Table 2.2 Flows and stocks versus short and long-term problems

	Short-term 	Long-term
Flow problems 	Weak actual and potential growth	Chronic slow potential growth in some areas versus other areas of the EU
	Competitiveness weakness (Monetary policy, Fiscal policy, exchange rate appreciation)	Long-term competitiveness weakness
	Lack of liquidation (banks + sovereigns)	Loss of market share to emerging markets (EM)
		Labor intensive low value-added sector
Stock problems		Real appreciation from wage growth over-productivity
	Large debt/GDP ratio	Huge stock of liabilities
		Government
		The private non-financial sector
		The banking and financial system
		External debt

set the necessary requirements for achieving a level of trust for the policy to prove effective. Examining the short-term and long-term nature of problems is of particular importance. Certain structural measures can have a positive impact on growth, while also having short-term negative repercussions. Thus, the time dimension of problem repercussions is of particular importance.

Three basic problems can be observed when confronting short-term flows: a) growth rate decrease, particularly in peripheral countries, b) credit tightness and exchange rate appreciation leading to a competitiveness drop, and c) lack of bank and sovereign liquidation (becoming insolvent as a self-fulfilling bad equilibrium). Increased market uncertainty and lack of liquidity led to restrained public debt purchase by the private sector. This fact proved prohibitive for Eurozone member states access to the bond markets.

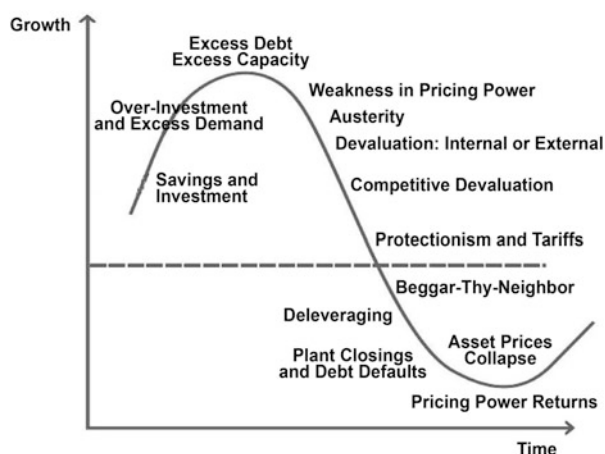
The high debt-to-GDP ratio is important when examining short-term stock problems: this was a critical factor determining the behavior of investors in many European countries. The climate of uncertainty prevented public investment, both with regard to the purchase of government bonds and to the undertaking of entrepreneurial actions.

Long-term stock problems can be traced to historical peak liability stocks, either in the public sector (Greece) or the private sector (Portugal).

By examining the European crisis from a different perspective, it has all the typical traits of a deep recession, characterized by the existence of austerity, deleveraging and deflation procedures (Fig. 2.3).

Figure 2.3 shows that the normal levels of savings and investments that are initially dominant in an economy, lead to an increased level of investments and excessive demand. This in turn leads to excessive debt, excessive investments and excess capacity. At this point, the price mechanism function is weakened. Under austerity conditions, the resolution can come from the invigoration of exports, brought in by either internal or external devaluation. A process of synchronized devaluations, however, weakens the effectiveness of the policy in question and may

Fig. 2.3 The cycle of austerity, deleveraging and deflation (**Source:** Comstock Partners Inc. 2012)



lead, at least in theory, to investment disorientation. Strangely, in the crisis to date there has been no explosion of protectionism aimed at protecting domestic employment. This can be attributed to the existence of the negative (in this instance) global institutional framework (Krugman 2013), depicted to a certain extent in G20 agreements since 2008. At this point in the graph there is a wave of bankruptcies in the private sector. Depending on the concurrence, this is also the point where entire countries can default (economies without the ability to print money), and the price of all assets (shares and real estate) collapses.

When the deleveraging process is completed in the private sector and the debt-to-disposable-income ratio has decreased to healthy levels, i.e. when the private portfolios have been purified, consumers return to the markets and increase their consumption. The power of the price mechanism is reinstated and, ultimately, the recovery of economic activity is realized at the end of this painful procedure.

For many, the 2008 crisis is known as the “Minsky moment”, because its entire evolution corresponds to the theoretical description of the explosion of financial bubbles. Minsky (1986) claimed that after long periods of economic stability, endogenous destabilizing forces start to emerge in an economy, leading to economic instability. He maintained that this occurs when high leveraging reaches dangerous levels. The Minsky moment comes after a long period of prosperity and increasing investment values has encouraged large amounts of speculation using borrowed money. It is a situation in which investors who have borrowed large amounts of money are forced to sell good assets to pay back their loans, and concerns the period in the credit cycle (or the business cycle) where investors are facing liquidity problems because of spiraling debt incurred by financing speculative investments. At this point, a major sell-off begins. As no party can be found to bid at the high-asking prices previously quoted, this leads to a sudden and precipitous collapse of the market, wiping out asset prices and hugely decreasing liquidity in the market.

Recovery necessitates the consolidation of private portfolios through the decrease of debt. Consolidation can be achieved in three ways: (1) through paying off, or relatively paying off, the debt (growth, inflation), (2) through transferring the debt to

the public sector: however, this requires either swelling Central Bank balance sheets through quantitative interventions increasing the monetary basis, or the exercise of a fiscal policy, and (3) through transferring the debt externally (bail-out interventions), primarily to institutions of the European Union (EFSF, ESM) and to bodies such as the IMF. In theory, all three alternatives can lead to a restart of consumer demand. The direction of the debt rollover will also depend on how it is allocated among the three basic economy sectors, public, financial and non-financial.

Figure 2.3 includes an additional and valuable lesson: it clearly shows that in the upcoming stages of the crisis (in early 2013), with the exchange war (Beggars-Thy-Neighbor) and the debt defaults, Europe is reaching the last stages of the great cycle. The duration of these stages, however, is a different issue and is one of the subjects of this book.

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