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# Exploring the Global Financial Crisis

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edited by  
Alan W. Cafruny  
Herman M. Schwartz



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## The Crisis of the Eurozone

*Alan W. Cafruny and Leila Simona Talani*

With the successful launch of the third stage of the Economic and Monetary Union (EMU) in 1999, Europe's prospects for closer regional integration and autonomy seemed limitless. In some quarters, to be sure, reservations were raised about the structural and institutional flaws in the EMU design. However, these reservations received very little attention from official Europe and the academic establishment. From a wide variety of theoretical perspectives, scholars anticipated a "European century," spearheaded by a single currency, geographical enlargement, and a Lisbon strategy that would "make Europe the most competitive and dynamic knowledge-based economy in the world" (European Union 2000). Many observers proclaimed that the euro would soon replace the dollar as the principal international reserve currency and that European soft power was destined to challenge a US hegemon in the throes of terminal decline.<sup>1</sup>

Yet the financial crisis that erupted in the US subprime mortgage markets in 2007 leapt across the Atlantic with devastating effects. The first casualty was European banks that, taking advantage of financial deregulation, had made massive, highly leveraged purchases of US mortgage-backed securities (Bernanke 2011). But the banking crisis threw a spotlight on the deeper and more chronic problems and contradictions of EMU—most important the disjunction between a supranational currency and national fiscal policies in the context of uneven development and growing imbalances. More generally, the crisis suggested that Europe's second phase of integration—beginning with the Single European Act (SEA) (1986), and culminating with EMU and its associated Lisbon "competitiveness project" (2001), was not the culmination of a natural or inevitable advance in regional integration, as proclaimed by much of official Europe, but rather a deeply political project that consolidated neoliberal policies, intensified interstate and intercapitalist class rivalries inside the EU, and ultimately served to reinforce Europe's dependence on the US superpower (Cafruny and Ryner 2007). Just one decade into the century that had opened with so much opti-

mism and fanfare, Europe was facing what EU Council President Herman Van Rompuy called a “survival crisis” (*Spiegel* 2010b) that has laid to rest dreams of a superpower status, postmodern or otherwise.

In the first section of this chapter we provide an overview of the proximate and underlying causes of the global financial crisis. Although the crisis erupted in the newly deregulated US financial sector, it ultimately reflected a deeper, systemic crisis in the real economy that served as an essential counterpart to European mercantilism. In the next section we show that the neoliberal aspects of EU integration have resulted in a deepening of the circuits of transatlantic capital and trade, increasing Europe’s exposure to the crisis. The third part of the chapter explores the internal contradictions in the EMU project and how these contradictions sharpened as a result of the global financial crisis. The fourth section describes the EU’s record of crisis management and reform, emphasizing the lead role played by the US Treasury and Federal Reserve Bank in crisis management and the limits and self-defeating aspects of the generalized austerity policies that have been demanded of the peripheral members of the eurozone. The last section explores the broader, geopolitical implications of the crisis for Europe.

### Origins of the Global Financial Crisis

The financial crisis that hit the global economy unexpectedly in August 2007 produced consequences comparable to those experienced during the Great Depression. Unlike the previous financial crises in the 1990s and early 2000s, it originated in the very heart of the global economy, the United States, and spread first and foremost to the most developed countries in Europe and Asia (Stiglitz 2010). Although originating in the US housing markets, the problems found a very fertile terrain in the uncontrolled possibility of newly deregulated financial markets to develop and sell new financial instruments that allowed the banking sector to expand enormously its capacity to extend loans and provide mortgages to the least solvent clients. The speculative bubble exploded when the increase in interest rates made it impossible for subprime mortgages to be repaid and many borrowers defaulted. From that moment onward, the crisis spread rapidly from the housing market to the banking and financial sectors and then into the rest of the economy.

Whereas the immediate causes of the banking meltdown can be ascribed to regulatory failure (see, for example, Financial Crisis Inquiry Commission 2010), much scholarship concerning the underlying causes of the global financial crisis has focused on two analytically distinct but related aspects: widening global imbalances and US macroeconomic policies. Each of these perspectives captures important dimensions of the crisis. The former highlights the problems and conflicts caused by growing Asian (especially Chinese) and northern European (especially German) trade sur-

pluses and the corresponding US current account deficit (Smith 2010; Munchau 2011a; Davies 2010; Stiglitz 2010; De Grauwe 2010; Dumas 2010). Favored, not surprisingly, by the United States as well as other deficit countries, the focus on global imbalances suggests that the resolution of the crisis lies in exchange-rate adjustments of surplus countries (or, in the case of Germany, “internal revaluation”); it seeks to identify the obstacles to currency adjustments arising from domestic political structures and ideological factors (see, e.g., Hung 2009; Bibow 2009; Munchau 2011b). The focus on the US current account deficit, favored by China and Germany, emphasizes the causal role played by rising current account deficits (Woods 2009; Goodhart 2009; Huertas 2010; Gup 2010) and calls for “internal devaluation” by deficit countries. Yet the historical trajectory and depth of the crisis suggest the limitations of interpretations that focus primarily on policy failure, myopia, or domestic structural rigidities and indicate the need for a deeper and more comprehensive analysis. The US subprime mortgage crisis was neither temporally nor spatially an isolated incident, and the permissive interest rate and deregulatory policies that facilitated it served as proximate but not underlying causes.

The twin tendencies toward financialization and growing indebtedness in the United States—the most immediate manifestations of the crisis—resulted from the strategies by which the United States extricated itself from the contradictions of the Bretton Woods system and prolonged the global role of the dollar and US hegemony. The relative stability of the Bretton Woods system derived from the United States’ ability to recycle its own surpluses while the leading states were able and willing to maintain more or less full employment via active macroeconomic management. By the late 1960s, the system was becoming increasingly unstable as a result of the growth of the mercantilist powers of Europe and Japan and their increasing penetration of the US market. The US surplus turned into a deficit just as spending for domestic programs and the Vietnam War soared, resulting in inflation. As the US gold supply hemorrhaged, the purchasing power of the dollar fell and the commitment to pay out gold at thirty-five dollars per ounce became untenable.

The collapse of Bretton Woods coincided with an attendant crisis of deepening stagnation and declining rates of growth and corporate profitability (Brenner 2006; Harvey 2007; Gamble 2009; Callinicos 2010; Ivanova 2011c). The rate of growth of real US GDP had been decreasing throughout the post-World War II period. A further indication of stagnation has been the long-range decline of capacity utilization in manufacturing, a reflection in part of the problem of the US domestic automobile industry. Since the late 1970s the rate of return on domestic investments in the United States declined in absolute terms as well as in relation to foreign direct investment (Dumenil and Levy 2011). The decline was especially dramatic for the 1997–2007 period.

The US response to these combined crises was twofold: on the one hand, by closing the gold window, US demand was limited only by the amount of dollars the rest of the world was willing to hold. At the same time, the United States sought to counter the declining rate of profit through the neoliberal offensive: by reorganizing work and breaking worker resistance to capital, ultimately severing the link between productivity and wages that served as the linchpin of the postwar settlement (Harvey 2007). These policies, which originated with the Carter administration but became fully realized in the Reagan years, were sustained through high interest rates, deregulation, tax cuts, new legal restrictions on trade unions, increasing rates of immigration, and subjecting labor to increased global competition through trade liberalization and outsourcing. By failing to address any of the systemic problems that intensified in the post-Bretton Woods era—stagnation, growing US deficits, and corresponding current account imbalances—they set the stage for the present crisis.

Hence, the Volcker shocks of 1979, under which high interest rates imposed harsh monetary discipline on the rest of the world, laid the basis for the emergence of the dollar–Wall Street regime with the dollar as linchpin (Gowan 1999; Sarai 2008), a prolongation of US hegemony based on debt. As a result of global capital market liberalization, US financial institutions could attract massive inflows of capital, greatly enhancing their capacity to restructure US society along neoliberal lines. Financialization gathered steam throughout the 1980s and 1990s as the regulatory framework that had been established during the New Deal was reconfigured by the Clinton and George W. Bush administrations under the close supervision of money-center banks and the US Treasury.

The United States' structural power enabled it to transform indebtedness into a strength by its ability to shape the preferences not only of debtors but also of creditors. So-called financial innovation enabled the United States essentially to tax the resources of the major holders of US debt in Asia and Europe. The United States "sought to avoid undertaking adjustment measures by encouraging foreign governments and private investors to finance these deficits" (Seabrooke 2001, 10; see also Gowan 1999). By 2006 the US current account deficit had reached \$811.5 billion (Bureau of Economic Analysis 2011).

These large dollar inflows enabled the United States to finance trade and budget deficits while dramatically increasing military expenditures. They also contributed to the steep decline in the overall share of manufacturing in US GDP. Much of this capital was used for overseas investment. Most other countries became dependent to varying degrees on the US market while US consumers increasingly became dependent on finance and debt. All of these structural problems were exacerbated by the Asian financial crisis as capital flowed in ever-greater quantities to the United States as a safe haven, fueling the stock market and housing bubbles. Capital inflows

thus served to maintain demand, which was under pressure from stagnant real wages even as the rising dollar further devastated the manufacturing sector.

The following data provide the context for understanding the explosive growth and structural power of the financial services industry, including not only the expansion of existing banks and financial institutions but also the growing involvement of industrial corporations in finance and investment. Between 1990 and 2006 the financial services industry doubled in size, from 4 percent to 8 percent of GDP. In 2006 it produced no less than 41 percent of the profits of the US domestic economy. In the third quarter of 2010 the six largest US banks (J. P. Morgan Chase, Bank of America, Citigroup, Wells Fargo, Goldman Sachs, and Morgan Stanley) had assets worth 65 percent of US GDP, up from 55 percent in 2006. By contrast, in 1995 the assets held by these six banks were 17 percent of GDP. The contemporary crisis and the terms of its resolution suggest that a further "quiet coup" (Johnson 2009) has taken place whereby the structural power of finance capital in the United States has become instrumentalized among a small oligarchy of leading money-center banks that are "too big to fail" and whose interests and outlook now entirely transcend party politics and electoral cycles.

A similar picture can be painted with regards to the British financial sector. At the onset of the crisis in 2007, the financial and professional services sector of the City of London accounted for around 11 percent of GDP, and the United Kingdom enjoyed large surpluses in trade in financial surpluses. The United Kingdom was the world's largest source of international bank lending and accounted for the world's biggest share of cross-border lending in September 2008 (Talani 2011). In 2007 London hosted almost double the number of foreign banks as New York. It was the fastest-growing market for asset management and was also the world's leading market for international insurance. The UK capital markets were thriving as well, and London accounted for over 30 percent of world foreign exchange business. The city has successfully defended its autonomy vis-à-vis national and EU-level regulations; there is little evidence that the financial crisis has put an end to the hegemonic position of the City of London, either in relation to Europe or within the structure of British capitalism (Talani 2011).

The stagnation of real incomes in the United States as a result of the neoliberal offensive reinforced the tendency toward financialization as an expanding pool of investment resources outpaced opportunities available in the real economy (International Monetary Fund 2011a). In the three decades after 1979, real income for the top 1 percent of households rose by 256 percent compared to 21 percent for the middle fifth, and 11 percent for the bottom fifth. Alongside the hyperconcentration of wealth, trade union membership declined from 31 percent of the workforce in 1960 to 11 percent in 2010, and is destined to decrease further as public-sector unions bear the brunt of state and metropolitan fiscal crises. At the same time, as working- and

middle-class households sought to maintain levels of consumption by working longer hours and accumulating rising debt on credit cards, education, automobiles, and mortgages, they were encouraged by a burgeoning shadow banking system seeking to expand credit to progressively less-qualified buyers.

The ability of the Federal Reserve to keep credit flowing was facilitated by the willingness of Europe and Asia to finance the trade deficit and maintain demand for their exports. Continuing high levels of consumption depended on a succession of bubbles, each larger and with more systemic consequences than the previous one, and ultimately unsustainable levels of household debt. As US Treasuries delivered decreasing returns to foreign investors, they sought higher-yielding investments in presumably safe mortgage securities. The big banks obliged by lowering lending standards and devising complex financial instruments to spread risk more widely. In fact, the resultant explosion of debt magnified the risk and ultimately brought the global financial system to its knees as the full-fledged subprime crisis erupted in August 2007, followed by the crash of Lehman one year later.

### **Eurozone in Crisis**

The collapse of the Bretton Woods system constituted a fundamental challenge to the Fordist mode of regulation in Western Europe. The stability of the dollar-gold standard was essential to Fordism. US trade surpluses could be recycled, and capital outflows would return as demand for US goods and services. Two European countries in particular, Germany and Italy, achieved large export surpluses with the United States. As US industry lost its competitive edge and military and social spending increased, the purchasing power of the dollar fell. Western European countries experienced growing instability in the form of inflation and, especially after 1971, currency fluctuations. While the catalyst for regional monetary cooperation was the danger that France's post-1968 inflationary policies posed to the Common Agricultural Policy (CAP), the broader objective of these cooperative attempts throughout the 1970s was to preserve the terms of the Fordist settlement at both the national and intraregional levels by insulating Europe—Germany in particular—from the disruptive effects of dollar instability (Parboni 1982; Carchedi 2001). These embryonic but ultimately unsuccessful attempts at monetary cooperation in the form of the “snake in the tunnel” and EMS, which attempted to limit currency fluctuations, of course, predated the single market. But the failure to construct a zone of regional monetary stability on an intergovernmental basis demonstrated the difficulties of maintaining fixed exchange rates within the relatively more consensual framework of the postwar social settlement, when the costs of adjustment arising from uneven development could not readily be passed on to strongly entrenched working classes.

The Maastricht treaty was signed in a very different sociopolitical climate. After the failure of France's nationalist strategy from 1980 to 1982, European capital as a whole sought a decisive departure from the postwar settlement. By this time, working-class power had steadily eroded as a result of growing unemployment, globalization, and the nascent incorporation of the former Soviet bloc economies into transnational capitalism. Already in 1985 the highly influential European Round Table (ERT), representing the interests of big European capital, had called for a single currency. Its proposal, *Reshaping Europe* (1991), bore remarkable similarities to the Maastricht timetable for the EMU (Van Apeldoorn 2002; Carchedi 2001).

If the decision to adopt the EMU as enshrined in the Maastricht treaty was a result of a multiplicity of factors operating in both the geopolitical and economic spheres, the project ultimately expressed the strong turn toward finance-led growth and neoliberalism, not the least in Germany. In contrast to the Werner Report as well as the McDougall Report of 1977, both of which bore the imprint of the postwar settlement and envisioned a monetary union buttressed by a substantial community budget and macroeconomic policies designed to promote full employment, the Maastricht criteria and successive fiscal pacts firmly subordinated macroeconomic policy to the performance of short-term global financial markets. The “straitjacket” served as the handmaiden to the full range of neoliberal policies; it was, for instance, attractive to Italian capital as “Europe” became a rallying point for fiscal austerity (Talani 2003). Given the monetarist design of the ECB, flexible labor markets and other structural reforms—now identified as “internal devaluation”—were offered as the cure for “eurosclerosis” and the only means of averting the breakup of the eurozone. Spurred on by a Commission-led project of competitiveness, the European Union increasingly sought to emulate the Anglo-US model of labor flexibility and capital market liberalization, even as it rejected its emphasis on macroeconomic promotion of growth. Yet flexible labor markets and capital mobility exacerbate low growth and high unemployment through “competitive austerity” (Albo 1994; Bellofiore et al. 2010) among the constituent units; each unit reduces domestic demand as part of its export-oriented production strategy wherein wage increases and benefits are kept below productivity growth.

The uneven nature of this dynamic is important. Some countries and regions, for some of the time, have been able to experience considerable economic growth. This includes small, export-oriented economies, based on high value-added niche products and services, such as the Netherlands in the latter part of the 1990s and Sweden and Finland in the late 2000s, although it should be said that periods of crises have also punctuated their success. Other countries, most notably some of the now infamous PIIGs (Portugal, Ireland, Italy, and Greece), who were (with the partial exception

of Ireland) unable to exploit any competitive advantages to overcome the negative effects of renouncing exchange rate and monetary autonomy, followed the logic of finance-led growth par excellence. They could only utilize the reduced exchange rate risk the euro membership entailed, to attract speculative foreign investment into the housing sector on the basis of high rates of growth in asset values. In the wake of a financial crisis, no wonder these countries found themselves in the eye of the storm.

The contrasting trajectories of Germany and Italy over the last decade illustrate with great clarity the chronic problems and imbalances that emerged in post-Bretton Woods Europe and which the EMU has exacerbated. Germany has pursued a strategy of relentless cost-cutting, and its modest record of growth since the late 1990s has been achieved largely on the basis of exports. A succession of reform programs and “employers’ offensives” (Kinderman 2005), undertaken by both Christian and Social-Democratic governments, dramatically decreased unit labor costs, especially after 2002 in conjunction with excessive budgetary rigor and ensuing Hartz IV labor reforms, which greatly reduced trade union power. Agenda 2010 resulted in sweeping changes in unemployment protection and social assistance. Alongside these initiatives, German corporations have pursued extensive outsourcing strategies, resulting in increased levels of poverty, inequality, and part-time and precarious work (OECD 2010; Weinkopf 2009). As a consequence, the link between export-led growth, wages, and the expansion of the internal market that characterized Germany’s postwar phase has been severed (Hugh 2007; International Monetary Fund 2007; see also Bibow 2009; Dumas 2010). By 2009, Germany’s current account surplus with the rest of the world reached \$235 billion, representing 6.4 percent of GDP, of which 85 percent was with the rest of the European Union. In contrast, Spain’s current account deficit was \$154 billion, equal to 10 percent of GDP. Greece and Portugal had even larger current account deficits in relation to GDP (Lund and Roxburgh 2009).

In the second half of 2011, Italy experienced an increasing pressure on its sovereign debt from financial markets. From July to November 2011, the spread between the Italian BTPs (Italian 10-year treasury bills) and the German Bund, a common measure of such pressure, surpassed 400 basis points on many occasions. In the same period, the interest rates of Italian government long-term debt bonds increased steadily to reach quota 6.99 percent in November 2011. Overall, the EMU has aggravated Italy’s already serious economic problems, and it greatly impedes Italy’s future growth prospects. Italy’s relative labor cost competitiveness has seriously deteriorated since an essentially political decision was made to join the EMU. Italy’s effective overvaluation, at approximately 35 percent, and trade deficit are the mirror opposite of Germany’s effective devaluation and trade surplus. Since 1991 the Italian economy has essentially remained stagnant,

registering a zero increase in productivity gains and real GDP growth. During the first three months of 2011, Italian output was 17.8 percent below precrisis levels (*La Repubblica* 2011). Such a result could hardly have been surprising to German proponents of monetary union.

Yet, given the depth of its competitiveness crisis, even a steep euro devaluation would have little impact on Italy. Rather, recovery of export competitiveness would require a substantial internal devaluation coupled with the harsh austerity program inaugurated by the new administration of Mario Monti in the immediate aftermath of the markets’ attack on Italian debt. Indeed, Charles Dumas (2010, 144) concludes that a return to competitiveness is “irretrievable. . . . In any normal view of the euro’s future exchange rate, the unemployment needed to get labor costs competitive will be pure sadism and ensure nil growth for a full decade.” Yet if Italy’s future in the eurozone can be described as sadistic, it is also the case that Germany has experienced neither significant growth nor productivity gains in terms of output per worker over the last decade. Germany’s modest economic recovery in 2010, based largely on exports, came on the heels of a massive downturn in 2009 as world trade declined. Moreover, between 2001 (the end of Europe’s previous recession) and 2009, Germany registered 3.5 percent cumulative growth (less than 0.5 percent per year) in comparison with 11 percent in the United Kingdom and 10 percent in France. Real consumption growth was 0.5 percent in Germany compared to 3.5 percent in Italy (Dumas 2010). Germany must compensate its eurozone partners for its massive trade surplus by either lending or granting transfers to deficit countries, neither of which appears to be a sustainable policy. But Germany’s relative export competitiveness is declining, and its export-based strategy thus faces significant limits. Neither China nor the United States can reliably serve as a destination for Germany’s exports. At the same time, China is rapidly becoming a competitor in high-value areas of manufacturing that Germany has long dominated (Bellofiore et al. 2010; Schafer 2011).

Therefore, as they have generated growing imbalances within the eurozone, the mercantilist strategies of the large European states, and most decisively, Germany, have also reproduced Europe’s dependence on the United States, especially within the context of the slow-growth eurozone regime. As Bellofiore et al. wrote, ‘

Crucially, the United States functions as the market where the net neomercantilist position of Europe is consolidated. . . . For the European countries, the deficits with Germany weigh heavily on their overall external account balance. Thus, attaining a surplus with the United States has become a necessity, to compensate for those persistent deficits as well as for the deficits with dollar-based raw materials and energy-exporting countries. The United States has remained the largest, richest, and most durable market for the realization of net surpluses for the EU, and for the eurozone in particular. (2010, 121)

Neomercantilism is thus both a cause and effect of stagnation, as deficit countries are compelled to adjust through recession or (following the EMU) internal devaluation. Wage stagnation and growing inequality along with the more regressive tax policies that have gradually been introduced throughout much of the eurozone (see, e.g., European Commission 2010; OECD 2010; Stancil 2010) depress demand and consequently draw European capital into the US financial sector in the search for profits. Europe's integration into Atlantic circuits of capital was facilitated by the European Commission's Financial Services Action Plan of 1999, which established a unified market for financial services. It reflected an active process of emulation of, and linkage to, the US model, which was at the time generating higher growth and productivity rates (Grahl 2011). Emulation played out most strikingly in Germany, where capital markets have become increasingly important for German firms as the shift toward investment banking has weakened traditional ties between banks and industry. Hedge funds, insurance companies, and foreign investors have gained influence as Anglo-Saxon shareholder value increasingly challenges the Rhineland model. Moreover, rather than relying on their traditional house-bank linkages at home, German and European corporations increasingly turned to the US stock market to raise capital (Sablowski 2008).

As European capital poured into the US economy in the decade preceding the crisis, the volume of financial transactions between the United States and Europe increased exponentially. At the end of 2007 the share of EU securities in foreign holdings by US individuals amounted to 42 percent for equities and 53 percent for asset-backed securities, totaling, by the end of 2006, \$1.8 trillion of equity holdings and 87 percent of debt holdings. Similarly, the share of EU investments in US equities amounted to 39 percent of total foreign investments, while that of asset-backed securities was 32 percent. By 2007 the United States accounted for 40 percent of global stock market capitalization; 26 percent of European asset price variation was due to developments in the United States (Deutsche Bank Research 2008; International Monetary Fund 2007).

European banks were hit hard by the collapse of the US subprime market and the ensuing crisis. Not only British, Swiss, and French but also German banks were heavily exposed. At the start of the crisis, German banks had the largest leverage rates among OECD countries. Many German banks, including not only Deutsche Bank, which listed fifty private Goldman Sachs deals for subprime bonds mostly issued through the Cayman Islands, but also the Landesbanks suffered substantial losses (Gordon 2009). At the end of 2009, European banks were estimated to hold more than \$1 trillion in toxic assets, more than two-thirds of which were held by German banks (Carrington 2009), and a large proportion of these in the PIIG states (Bank for International Settlements 2010b). In July 2010 the EU conducted stress tests that served to conceal the precarious condition of

the European banking system, as exemplified by the fact that the tests gave Anglo-Irish and Allied banks a clean bill of health.<sup>2</sup>

### EU Response to the Crisis

Thus, the global financial crisis erupted in the United States, but it immediately crossed the Atlantic and, in important respects, was transformed into a crisis of the transatlantic order. Linkage to the precarious but still growing US economy had made it easier to ignore the underlying problems and contradictions in Europe's second project of neoliberal integration. Given the vulnerabilities of the United States—most notably an unfolding fiscal crisis linked to the international role of the dollar that in the aggregate surpasses that of the eurozone as a whole—it is very doubtful that the European economy can continue to rely on the US growth-and-profits locomotive.

Focused primarily on inflation-targeting and competitiveness reforms, both the ECB and the European Commission were caught unaware by the depth and breadth of the crisis. In marked contrast to the US Federal Reserve Bank and the Treasury, they were very slow to recognize the threat posed to the eurozone, and subsequent policies have been largely reactive and incremental. Following the US-linked modest recovery of 2003–2005, the ECB had embarked on a program of interest rate increases that served to reinforce the German employers' offensive. Indeed, as late as July 2008, long after the crisis had erupted, interest rates were raised from 3.75 percent to 4.25 percent, and under the terms of the Stability and Growth Pact (SGP) public deficit reductions were enforced. After the crash of Lehman Brothers Bank in August 2008 the ECB moved to provide massive liquidity to troubled banks, which, as noted above, were highly exposed to the US market and offered guarantees for interbank lending. Governments became major shareholders of large banks while others were nationalized. The government of Ireland, which (along with Spain) was running a budget surplus before the crisis erupted in 2008, moved to guarantee the liabilities of its banks. European states thus effectively socialized bank losses, converting them into public debt. The immediate manifestation of Europe's crisis was bank debt resulting from deregulation; this was converted into a succession of sovereign debt crises.

The lead role in crisis management initially fell to the US Federal Reserve and Treasury. They recoiled at the specter of global depression and, despite the massive US current account and budget deficit, made the United States serve as lender of last resort. In the six weeks following Lehman's collapse, the Fed injected \$3.3 trillion in reserves; a \$787 billion stimulus package equal to 3 percent of US GDP in 2009 and 2010; and unprecedented, massive amounts of liquidity to commercial banks. European banks were among the largest recipients of the Federal Reserve Bank injections

(Tett 2010b; Chan and McGinty 2010). In addition, the Fed carried out swaps to the ECB, Japan, and emerging markets totaling \$585 billion. It was possible to argue that the United States had become effectively the “central bank of the world” (Bloomberg 2010) and that “in a sense the Fed became the market in 2008 and 2009, not just in the United States but in parts of Europe too” (Tett 2010b). Following the outbreak of the Greek crisis in May 2010, it was US pressure—reputedly in the form of Obama’s personal intervention with Angela Merkel (Willis 2010)—that finally persuaded European capitals to establish a €440 billion European Financial Stability Fund (EFSF) alongside \$250 billion from the IMF, further indication of the limits of European policy autonomy. Greece was provided with €110 billion of emergency support, at 5 percent interest, with a further IMF contribution of €30 billion.

The onset of the banking crisis, in the context of asymmetries that have haunted Europe since the last days of the Bretton Woods system and greatly increased following the adoption of the single currency, thus posed an enormous challenge to European crisis management capacities. Membership in the EMU had insulated debtor countries from currency crises even while keeping their borrowing costs artificially low. At the same time, of course, it precluded devaluation as a means of regaining competitiveness. As a result of a one-size-fits-all interest rate structure, household debt in Greece, Spain, and Portugal skyrocketed to offset the structural current account deficit arising from German export success, while German and other core-nation banks became massively overexposed. At the end of 2009, French and German bank exposure to Greece, Ireland, Portugal, and Spain was 16 percent and 15 percent of their GDP, respectively. French bank exposure to Greece totaled \$138 billion (of a total of \$392 billion) while German exposure was \$84 billion (Bank for International Settlements 2010). Former Bundesbank head Karl Otto Pohl characterized the rescue package for Greece in the following terms: “It was about protecting German banks, but especially the French banks, from debt writeoffs. On the day that the rescue package was agreed on, shares of French banks rose by up to 24 percent. . . . You can see what this was really about—namely, rescuing the banks and the rich Greeks” (*Spiegel* 2010a).

Swedish and Austrian banks also experienced similar levels of exposure in the Baltic states and eastern Europe, as member states remaining outside the eurozone faced their own problems with debt and deflation. The collapse of the housing and construction markets in Ireland, Spain, and Portugal, where construction accounted for more than 10 percent of all employment, threatened core state banks but also provided new opportunities for profit seeking through government bailouts.<sup>3</sup> As the recession deepened throughout late 2008 and early 2009, Europe’s ailing banks and hedge funds realized that peripheral eurozone states were in danger of default and, taking advantage of the ECB’s effective zero-interest-rate policies, began to attack the weakest links in the chain. These attacks could not, of course,

trigger currency crises—as with the European Monetary System and Exchange Rate Mechanism—but rather provoked massive speculation on sovereign debt.<sup>4</sup>

As the spread between German and peripheral bonds rose, savage austerity plans—effectively channeling public funds to the banks—were introduced as the price of emergency injections of capital to be repaid at punitive rates. As the threat to the eurozone resumed with the Irish crisis in November 2010, emergency lending was once again provided alongside similar austerity measures and repayment terms, including EFSF loans at 6 percent interest, and the ECB stepped up its bond market purchases. In 2011 and 2012, Greece was the recipient of two bailouts, the second of which involved significant debt writedowns and “haircuts,” imposing losses on bondholders. However, the common denominator of these rescue operations—and similar ones held in reserve for Spain and Portugal—was internal devaluation. The long-term prognosis must inevitably be debt deflation and instability amid persistent demands for debt restructuring. The specter of default in the context of popular resistance to crippling austerity threatens to destabilize Europe’s already precarious and overextended banks, although the Greek bailouts have succeeded in transferring two-thirds of Greek debt to the IMF and EU.

Amid predictions of eurozone collapse at the end of 2010, the European Council formally began discussions on the institutionalization of a permanent rescue vehicle, the European Stability Mechanism, to succeed the EFSF, which was set to expire in 2013. Given the likelihood of further crises and efforts to restructure existing agreements, discussions were held on longer-term solutions, which included expansion of funds for the EFSF, and broadening its powers to include creation of European bonds (E-bonds); recapitalization of banks; setting interest rates for borrowers; and establishing short-term lines of credit. In March 2011 the European Council signed the Euro-Plus Pact, giving the European Commission greater control over member-state economic policies.

As bond yields in Spain, Portugal, Italy, and Greece soared in the fall of 2011, the European Union implemented novel monetary and fiscal policies. Central bank policies are usually characterized in terms of conventional measures, such as interest rate cuts and, in the case of a liquidity trap (when interest rates are effectively zero), quantitative easing or nonstandard measures, including enhanced credit support and securities markets programs. By effectively implementing quantitative easing, the Long Term Refinancing Operation (LTRO) enabled the ECB to act as a hidden lender of last resort. Through the LTRO, a three-year lending program, the ECB provided virtually cost-free liquidity to banks, thereby allowing them to acquire the sovereign debt of countries under attack. Finally, on March 2, 2012, the European Council approved the so-called fiscal compact (officially the Treaty on Stability, Coordination and Governance [TSCG]).<sup>5</sup>



However, the fiscal compact and the LTRO have not resolved the underlying structural crisis. The fiscal compact falls short of being a real fiscal constitution for the European Union, not only because the decision by the United Kingdom not to sign it made it impossible to incorporate it into the EU treaties. In essence, the fiscal compact is an intergovernmental agreement. Indeed, compared to the declaration made in December 2011, two things stand out in the latest treaty draft: First, there are no provisions for automatic sanctions. Second, the pact allows countries to temporarily deviate from the requirements of having their budgets in balance or in surplus in case of an unusual event outside the control of the government concerned or in periods of severe economic downturn. Notwithstanding the rhetoric, the fiscal pact represents little more than a replay of the Growth and Stability Pact.

The LTRO allowed the ECB to flood the banking system with cheap money, thereby allowing Spanish and Italian banks to engage in the highly profitable carry trade. Between December 2011 and February 2012, Spanish banks bought €67 billion of sovereign debt while Italian banks acquired an additional €54 billion. However, if the LTRO temporarily prevented a wholesale meltdown, it not only failed to resolve the underlying problems but arguably exacerbated them. By April 2012 austerity generated new crises of confidence, and bond yields began to increase into the danger zone. As a result, the underlying insolvency problems of banks reappeared, and indeed became more acute, as did the exposure of the ECB itself. The German government has continued to prevent the ECB from transferring risk to its own balance sheet, as the Federal Reserve Bank has done. Moreover, whereas at Copenhagen in March 2012 the ESM was increased to €500 billion, with significant new commitments from the IMF, these sums would still not be sufficient to resolve a full-blown crisis arising in either the Spanish or Italian bond markets.

These crisis resolution plans have been presented in terms of “economic governance” that would “take European cooperation to a whole new level” (*Spiegel* 2011). Yet, these plans reflect bilateral Franco-German negotiations, the results of which are essentially dictated to the Commission and the rest of the member states. They offer the prospects of limited fiscal transfers but stop well short of a genuine fiscal union or European Treasury with a common budget and powers of taxation and redistribution. The common denominator is austerity:

Within the new framework of the European semester, the European Council endorsed the priorities for fiscal consolidation and structural reform. It underscored the need to give priority to restoring sound budgets and fiscal sustainability, reducing unemployment through labour market reforms, and making new efforts to enhance growth.

Outside the eurozone the crisis has been no less severe. On the eve of the crisis the new member states already were struggling with a model of development based on foreign direct investment in search of cheap labor and trade dependence on Western Europe, especially Germany (Bohle 2006; Ivanova 2007). Central and Eastern European countries, for example, depended on Western Europe for 80 percent of exports. Strategic sectors of the Central and Eastern European economies, including banking, telecommunications, and utilities, had been privatized and sold to Western firms. Many Central and Eastern European economies were heavily exposed to borrowing in foreign currencies and struggling with large current account deficits. By 2004, for example, debt service payments accounted for 25 percent of Hungary's, 27 percent of Croatia's, and 35 percent of Poland's exports. Western and European banks, especially Austrian, German, Italian, and Swedish, were heavily exposed by virtue of their participation in property bubbles (Raviv 2007). With the exception of Poland, Eastern and Central European member states suffered massive decreases in GDP and large spikes in unemployment after 2007. The European Union deployed the IMF as the key arbiter of emergency funding (Verhofstadt 2009), eventually concluding agreements with eleven countries in the region, starting with Latvia, Hungary, and Ukraine. Yet these agreements were essentially procyclical structural adjustment programs. As with the situation in Greece and Ireland, they were designed primarily to bail out heavily exposed Western European banks (Weisbrot 2011). Most CEE countries returned to growth in 2010, but they continue to face massive problems of slow growth, large current account deficits, and high unemployment.

## Europe of Capital

While a regime of ad hoc emergency loans, bond purchases, and austerity programs has thus far averted collapse, it has not addressed the eurozone's pressing problems resulting from structural imbalances and the slowing US growth locomotive. At the same time, this approach has plunged much of Europe's periphery into near-depression, almost certainly condemning it to years of harsh austerity and political instability.

Notwithstanding Germany's own export-led recovery, at the beginning of 2012 the EU27 had 24.5 million people unemployed, with millions more who do not qualify for benefits and 84 million living at the risk of poverty. In Ireland, output per person declined by more than 20 percent since 2007, and unemployment rose from 4.3 percent in 2006 to 14.7 percent in 2012. Greece's unemployment rate jumped from 7.5 percent in 2007 to more than 21 percent in December 2011 (Eurostat 2012). By the beginning of 2012 youth unemployment in Greece, Spain, and Portugal exceeded 50 percent.

As noted above, Italy has endured years of stagnation and diminishing export competitiveness. Not surprisingly, the crisis has greatly damaged the already tarnished legitimacy of the European Union, not only in the periphery but in Germany itself where resistance to bailing out southern “profligacy” is strong.<sup>6</sup> French and German leaders have expressed unequivocal support for the EMU, rejecting calls for alternatives that include managed default or radical restructuring of debt, the transition to two or more currencies, or as discussed below, more progressive solutions that are not austerity based. Yet any form of transfer union would provoke conflict in the context of a German political culture that, like an amputee, still senses the lost limb of the deutsche mark and has undertaken to balance its own budget by the end of 2016.

Is there no alternative, then, to the construction of a fiscal union that would finally fulfill the neofunctionalist prediction, the Federalist dream, and the German nightmare? In 1997 Hans Tietmeyer, then-president of the Bundesbank and no friend of political union, asserted, “Any split in real economic trends would, naturally, exert pressure in the direction of a transfer and social union, or even of a European ‘superstate’” (quoted in Phillips 2010, 2). Abstract statements in support of a putative but undefined fiscal union have come from French finance minister Christine Lagarde, ECB president Jean-Claude Trichet, former IMF managing director Dominique Strauss-Kahn, and even German finance minister Wolfgang Schauble, while correspondingly, Bank of England governor Mervyn King has expressed alarm over such a development (Willis 2010).

The fiscal compact, however, is certainly not based on an expansionary and Keynesian logic. Nor does it represent an improvement on the present system of crisis management, with all of its limitations and dangers. Nor, in the final analysis, does it take Europe in the direction of an ever closer union based on democratic legitimacy and genuine supranational governance. Rather, it institutionalizes a highly coercive and undemocratic regime under which limited transfers are conditioned on fiscal orthodoxy and internal devaluation—in brief, a European structural adjustment program supervised by Berlin.

The fiscal pact, moreover, was advanced within the more general framework of the neoliberal competitiveness agenda with all of its attendant problems and limitations. Europe 2020, the European Commission’s strategic growth plan for the coming decade, contains no reflections on how or why the growth and employment targets of the Lisbon Strategy were never reached, even as its proposals replicate the Lisbon Agenda’s emphasis on labor flexibility while ignoring the problem of imbalances. Nor has the European Commission addressed key problems of financial regulation. The transformation of the existing European supervisory committees on January 1, 2011, into the European Banking Authority (EBA) based in London, and the establishment of the European Securities and Markets Authority

(ESMA) in Paris and of the European Insurance and Occupational Pensions Authority (EIOPA) in Frankfurt to create the new European Supervisory Authorities (ESAs), to be inserted in the European System of Financial Supervisors (ESFS), does not address the issue substantially.

National authorities remain responsible for the day-to-day supervision of individual firms, with the new European architecture only providing an overarching framework for financial supervision. The new agencies employ around sixty people each (as compared to the 3,000 of the UK Financial Services Authority) and need the help of national supervisors. Moreover, the ESAs themselves comprise high-level representatives of all of the member states’ supervisory authorities under permanent chairmanships. They will have the power to temporarily ban certain high-risk financial products and activities, such as naked short selling, as well as instructing banks and other financial actors in crisis situations, drawing up standards for national regulators, and settling disagreements between them. However, this authority will be possible only in situations of emergency to be defined by the council, and it is limited by a safeguard clause attributing to the member states the power not to abide by the decisions of the ESAs.

The ESA is complemented by a group connected to the Frankfurt-based European Central Bank called the European Systemic Risk Board (ESRB), which monitors the risk of major threats to the economy, such as problems at major banks or asset bubbles. Although connected to the ECB, the ESRB seems to be mainly a consultative body, which does not appear to activate the idle clause in the Maastricht treaty that gives the ECB a formal role in banking supervisory policy (Art. 105[6]). In sum, while the European banking system has become even more concentrated and in some respects re-nationalized as a result of the crisis, EU banking and financial supervision remains largely in the hands of national authorities.

## Geopolitical Dimensions

What, then, remains of the broader European political project? Europe’s relaunching inspired conceptions of an emergent post-Westphalian Europe that greatly influenced EU studies on both sides of the Atlantic. Mainstream theorists advanced concepts such as a “European polity” (Hix 1999) and “multilevel governance” (Marks 1993). One strand of critical theory proposed the emergence of a nascent “transnational capitalist class” (Van Apeldoorn 2002). This latter formulation presupposes not simply a common agreement among national capitalist classes over a given regulatory mode or “comprehensive concept of control” (van der Pijl 1984) but rather the transcendence of national capitalist class power and interest on the basis of European-level corporate linkages (see also Holman and van der Pijl 2003). At the same time, EU institutions are assumed to displace national sover-

eighty by articulating and in some respects at least implementing a project of an embryonic European capitalist class.

Yet while EU crisis management has consolidated neoliberalism in the form of austerity, it has also thrown into sharper relief the further development of interstate and intercapitalist class rivalry. This has been evident not only in the more or less covert mercantilism that has characterized Germany's policy throughout the crisis, but also in the abandonment of Franco-German industrial projects in the nuclear and military industrial arenas; the growing subordination of the European military-industrial complex to US corporations (Cafruny 2008); and the complete surrender of European energy policy to national energy champions (Abdelal 2010). The Franco-German directorate that has dictated crisis resolution policies to the Commission and the rest of the member states is dominated by Germany. France fared relatively well in the crisis thanks to the specificities of its labor market and a social protection net that allowed its shock absorbers to contain the recession. At the same time, national industrial policy served to boost demand and maintain employment. In the longer term, however, France faces many of the same issues of productivity and competitiveness as Europe's southern flank.

The crisis has raised more fundamental questions in Berlin about the basic European and Euro-Atlantic political structures. In this context, does Germany's economic weight and virtually unchallenged political primacy within the eurozone lay the basis for a second Rapallo, implying the potential transformation of the European geopolitical order (see, e.g., Wallerstein 2009)? To be sure, Germany faces novel challenges not only because of its export-oriented profile but also because of its energy dependence on Russia. In 2009 Germany imported 32 percent of natural gas and 35 percent of crude oil from Russia (Abdelal 2010). At the same time, Russia has become an increasingly important market for German exports and foreign direct investment (FDI), especially in the energy sector. Prior to the crisis Russia was the fastest-growing market for German exports. In 2009 Germany was Russia's second-largest source of FDI, after the United Kingdom (Eurostat 2010). Deutsche Bank is the leading foreign bank operating in Russia, with extensive participation in equity, capital, and bond issuance (Deutsche Bank 2009). These dependencies have served to deepen Germany's diplomatic and commercial links to Moscow and its more or less consistent policy of equivocation between Washington and Moscow. Within the energy sector, German E.ON and BASF along with French EDF and GDF Suez A.A. have invested heavily in Gazprom but also in pipelines, especially Nordstream, that compete directly with Washington- and Brussels-sponsored initiatives, including the proposed Nabucco pipeline, to reduce EU and eastern European dependency on Russian energy. Together with Italian ENI, the key investor in South Stream, they have effectively "dis-intermediated" Ukraine while bypassing the Baltic states and Poland (Abdelal 2011, 35).

These economic developments have geopolitical implications. Since 2008 Germany has undertaken several diplomatic initiatives with regard to Russia on a unilateral basis. Most important in this respect has been the joint proposal for cooperation in security arising from bilateral discussions between Merkel and Dmitry Medvedev, arising out of the 2008 war in Georgia—when Germany (and the Russian army) compelled the United States to abandon plans to bring Ukraine and Georgia into NATO. Within the G-20, Germany has aligned with China, its leading market for exports and an increasingly important investor in European peripheral bond markets, over the issue of global current account imbalances. In March 2011 Germany joined Russia and China in the UN Security Council in abstaining from the Anglo-French proposal to establish a no-fly zone in Libya.

These initiatives in themselves could probably not persuade Germany now to abandon its commitment to the economic and political-military structures of Atlanticism and, ultimately, continuing subordination to the United States. While Russian and Chinese capital and export markets are important to Germany, they are far less significant than the European Union and United States both in terms of export markets and destination for FDI. A breakup of the eurozone would be catastrophic for Germany, not only because wholesale debt default would entail massive losses for its still-fragile banks, but also because it would greatly impinge on Germany's basic mercantilist strategy. Moreover, by removing Germany's anchor to Western Europe, a breakup would have unpredictable consequences for Franco-German relations and so for the European Union as a whole. Germany and France have ultimately treated the defense of the euro—alongside the rescue of their banks—as a core national interest. The Lisbon Summit of December 2010 confirmed the centrality of the alliance to the European Union, including the establishment of a pan-European antiballistic missile (ABM) system, the expansion of the North Atlantic Treaty Organization (NATO) to embrace "a wide network of partner relationships with countries and organizations around the globe" (NATO 2010), and the call by Herman Van Rompuy to "break down the remaining walls" between NATO and the European Union (European Council 2010).

## Conclusion

It has long been axiomatic in the study of EU foreign policy that the analysis of crises provides the only reliable standpoint for assessing genuine European political cooperation (Hill 1983). The global financial crisis has certainly been no exception to this rule. What is true of the economic sphere also applies to the geopolitical: Set against this rather obvious benchmark, it is apparent that the high point of European influence and autonomy from Atlantic structures has not been the post-Maastricht era, but rather the

1960s. Indeed, the European powers arguably achieved their greatest—albeit still very limited—degree of autonomy long before Europe’s relaunching. Coming on the heels of France’s recognition of the PRC in 1964, President Charles DeGaulle’s assertion of state supremacy—and not supranational integration—paved the way for the expulsion of US forces from France and withdrawal from the military wing of NATO in 1966, challenges to the dollar-gold standard, and the attempt to forge an independent policy in the Middle East. Germany’s *ostpolitik* followed a similar logic of relative autonomy from the United States. At the present time, by contrast, the Franco-German project has withered under the pressure of competitive austerity. And as Europe’s military-industrial complex has merged into Atlanticism, ironically it was left to the Gaullist Nicolas Sarkozy to ratify the hub-and-spoke relationship with a beleaguered US superpower that was consummated through France’s reentry into NATO military structures on US terms, and its increasing participation with the United States in the Middle East, Africa, and Asia under the NATO flag. Europe is arguably more divided and subordinated than at any time since 1991 and perhaps even the 1960s.

Attempts to resolve the present crisis on the basis of neoliberalism foreclose closer integration and reinforce a dynamic whereby austerity is limited only by political mobilization from below and pressure on Germany from other member states, hardly a recipe for closer unity or regional autonomy. To be sure, there is no shortage of alternatives. Given the relatively small amount of Irish and Greek debt in relation to the size of the European economy as a whole, European authorities might, for example, have guaranteed medium-term borrowing needs—allowing for temporary fiscal stimulus while Germany and other northern surplus countries could expand consumption—and avoided imposing punitive interest rates on ESFS loans (Weisbrot 2011). The European Trades Union Confederation (2011) has proposed a program whereby the ECB would hold euro bonds of member states while attracting purchases of these bonds by the central banks of surplus economies, coupled with a dramatic expansion of the lending capacities and remit of the European Investment Bank, funded in part by a financial transactions tax. Notably, most of these policies would require neither fiscal federalism nor treaty changes. They would, however, need to be combined with genuinely pan-European banking regulations designed to restrict the size and power of banks, the restoration of progressive tax rates, greatly expanded public investment, and the reduction of imbalances by increasing consumption in Germany and other surplus member states rather than austerity in debtor states. That these alternatives to neoliberal crisis management have gained so little traction in the face of massive economic instability points rather to the underlying power realities of the contemporary European project and the corresponding crisis of social democracy.

## Notes

1. A comprehensive list of these academic works can be found in Cafruny and Ryner 2007 (1–2). For a broader critique of the underlying assumptions informing these optimistic accounts, see Cafruny and Ryner 2011.

2. Wolfgang Munchau (2011a, 8) called these tests “a deliberate attempt by Europe’s regulatory authorities to misrepresent facts and mislead the public.”

3. Pohl’s comments concerning Greece applied with equal force to Ireland, whose banks were not systematically involved in the Irish economy. The decision to guarantee their liabilities reflected the interests of German, French, and UK banks. As Michael Lewis (2011) observes, “In retrospect, now that the Irish bank losses are known to be historically huge, the decision to cover them appears not merely odd but suicidal. A handful of Irish bankers incurred debts they could never repay, of something like 100 billion euros. . . . Their debts were private—owed by them to investors around the world—and still the Irish people have undertaken to repay them as if they were obligations to the state.”

4. For an early analysis of how uneven development led to the abandonment of the original terms of the Stability and Growth Pact (SGP), and that the next stage of crisis would reveal itself in the increased spread of bond yields, see Cafruny and Ryner 2007 (35).

5. For the full text, see [http://www.europecouncil.europa.eu/media/639235/st00tscg26\\_en12.pdf](http://www.europecouncil.europa.eu/media/639235/st00tscg26_en12.pdf).

6. The percentage of Germans who respond that they have no confidence in the European Union has increased from 51 percent before the crisis to 63 percent in January 2011, according to a poll by the Allensbach Institute (*Frankfurter Allgemeine* 2011).