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Europe: social democracy's Faustian pact with global finance unravels

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ideas into movement

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The global financial crisis, in the aftermath of which the world is still mired, erupted in Wall Street but it could very well have begun in Europe. For, as in the United States, the financial systems of a number of European countries were teetering on the abyss of collapse, the ingredients of which were financial overextension or high degrees of indebtedness or leveraging, huge holdings of toxic securities like subprime loans by European banks, the rapid inflation of real estate and stock market bubbles, and lax or virtual absence of regulation of the financial sector. There were, however, certain aspects of the European scene that made the evolution of the financial crisis uniquely devastating, and the most important of this was the adoption, by 2008, of the euro as a common currency by 15 countries in the European Union. A symbol of European economic unification, the euro transmogrified into a trap for the less developed economies of the Eurozone over the next few years.

At the beginning of 2008, Europe's financial unraveling was a disaster waiting to happen, and contagion from Wall Street was simply the string that pulled down a house of cards.

From Wall Street the financial panic radiated outwards, mainly towards Europe. The liberalization of financial flows promoted by neoliberal policies ensured that the rise in defaults on US subprime mortgages would have a global impact. American-made mortgaged-based securities spread through the global financial system like a virus, leading it to the edge of collapse. As British analyst Hugh Pym put it,

> 'The US subprime disaster had such a huge impact on financial markets because exposure to vulnerable American borrowers was so widely spread around the international banking system. US lenders sliced and diced the mortgages and packaged them up as sophisticated instruments with names like 'collateralized debt obligations' and 'asset-backed securities'. They were created, sold and resold, and ended up in the balance sheets of US, Asian and European banks. When house prices started to fall and defaults rose, the music in this global financial game stopped. Suddenly everyone wanted out. They scrambled to cut their losses on the subprime mortgages.'[1]

British banks were among those most exposed, owing to their close relationship with US banks. And there was no bank more exposed than the Royal Bank of Scotland. Royal Bank of Scotland had grown from a regional bank to the world's second largest bank through a wave of acquisitions, many of them financial institutions whose assets were overloaded with US-originated subprime-based securities. When the US real estate market plunged and subprime mortgage owners began to default, Royal Bank of Scotland found itself with practically valueless assets, unable to repay the lenders and depositors who had financed its acquisitions. The British government had to step in to inject billions of pounds worth of capital into Royal Bank of Scotland, since its going under would have brought down the country's entire banking system.[2]

British banks were not unique in their exposure to toxic securities from the other side of the Atlantic. At the beginning of the financial crisis, German Chancellor Angela Merkel said she regarded the banking crisis, 'as an Anglo Saxon problem, born in the United States and compounded by the US' failings.'[3] Her advisers were probably late in briefing her, since continental, and notably German, banks had been big buyers of those mortgage-based securities.

These included Societe Generale SA, Deutsche Bank AG, BNP Paribas, Credit Agricole SA, Dredsner Kleinwort Securities, the German Bank IKB, several German *Landesbanken* or regional development banks, and UBS Securities.

Neoliberalism, finance and crisis in Britain

Exposure to questionable US bank securities was, however, probably not as decisive as the adoption of financial reforms that neoliberal economists had promoted both in the US and Europe. This paved the way for the explosive meeting between unfettered finance and scarce real estate.

In Britain, liberalization of the banking sector began with what is now known as Big Bang Day, Oct 27, 1986, when Prime Minister Margaret Thatcher deregulated the London Stock Exchange. Financial market deregulation was aimed at making the City of London a competitive global financial hub on a par with New York. Finance became the cutting edge of economic activity, and its so-called 'social value' became the lynchpin of a new ideological consensus. As Manchester University's Centre for Research on Socio-Cultural Change put it,

> 'In the United Kingdom, after the late 1980s, finance became a domain of high politics where agendas were set by industry leaders, sympathetic technocrats and supportive elite political sponsors. If political participation narrowed, so did intellectual debate as two mystifications supplied what Wright Mills once called the, 'vocabulary of motivation' for elite economic and political practices in finance. The first mystification was a variation on the venerable laissez-faire narrative about self-regulation that helped legitimize a particular regulatory order by conferring financial markets the right to run their own affairs. The second mystification was a more contemporary narrative about the social and economic value of finance in the wider economy. That narrative helped to politically empower finance as a sector by emphasizing the importance of an economic regime and a 'light touch' regulatory regime tailored to the needs of financial markets.'[4]

When New Labour came to power in the mid-nineties, a view of finance as productive became part of Tony Blair and Gordon Brown's 'third way'. As the Manchester University study points out, 'The City was viewed by the New Labour government as both a tax cash cow and as an engine of growth, job creation and innovation in the UK economy'.[5] Gordon Brown bought into the ideology of 'light touch' regulation, and was vocal about his intention to make London a financial centre outstripping New York.[6]

As in New York and Washington, the efficient market hypothesis, which posited that the market price of an asset was the synthesis of all available information and thus constituted its true value, came to govern the thinking of bankers and regulators alike in London. As one study pointed out, 'Financial markets had come to be regarded as inherently stable and financial institutions as just another commercial undertaking, so that no more than light touch monitoring and intervention was thought necessary to ensure system integrity and dynamic stability.'[7]

The precise configuration of reforms differed from country to country, but as Adair Turner notes, whether in Japan, Spain, London or Scandinavia, liberalization had the following commonalities:

1) Removal of restrictions on the quantity of lending in the whole economy or specific sectors.

2) Elimination of the distinctions between retail, corporate and investment banking, and between banking and non-banking activities.

3) Use of interest rates as the only policy lever to manage the economic cycle, with the overwhelming focus on maintaining a low and stable rate of inflation.[8]

As in the US, by the 1990s traditional lending activities to corporations and banks were matched or overshadowed by financial market – or in the American parlance, 'shadow banking' – activities, with institutions that adapted to the new regime, like the Royal Bank of Scotland, becoming the most dynamic players.

This cult of innovation resulted in the proliferation of derivatives produced by allegedly sophisticated financial engineering. Most prominent were mortgage-backed securities, which were similar to subprime securities. As in the US, mortgage-backed securities were created amidst – and helped to create – a frenzied property bubble, which saw residential property prices double between 1997 and 2007.[9] As in the US, a mortgage-backed security was one based on a package of mortgages bundled together and sold off to investors, a move designed to lift the credit risk from the originating bank and transfer it to the buyer. While the securitization of mortgages in the UK was not as widespread as in the US, it was nevertheless a very significant development, with mortgage-backed securities rising from practically nothing in 1995 to over 25 per cent of mortgage lending by 2005.[10]

Northern Rock and the mortgage-backed securities crash

Northern Rock was one of the more aggressive issuers of mortgage-backed securities, securitizing 50 per cent of the loans that it made. Particularly popular was its 'Together Loan', which was the British equivalent of the subprime loan. This loan covered an amazing 125 per cent of the value of a new home and six times the income of a household, compared to the 2.5-3 times income that was usual practice. Some 30 per cent of bank's mortgage book consisted of 'Together Loans'. Not surprisingly, when real estate prices began to plunge in 2007, these loans accounted for 50 per cent of loans in default and 57 per cent of foreclosures.[11]

When the defaults became news, Northern Rock became the victim of a classic bank run, with television footage showing depositors queuing at bank branches throughout Britain. The Bank of England tried to rescue Northern Rock with an unprecedented package of £55 billion (€75 billion) in liquidity assistance and guarantees, but this did not stem the crisis, pushing the government to eventually nationalize it, with the full bill to taxpayers coming to £37 billion (€50 billion).[12]

But it was soon clear that British banks' problems did not just have to do with their exposure to US-based subprime mortgage securities or their homegrown counterparts. The bigger problem, again encouraged by neoliberal 'hands off' or light touch 'regulation', was a banking model that combined the traditional bank formula of 'borrowing short and lending long' – that is, borrowing short-term at low rates of interest and lending long-term at high rates – with the practice of leveraging, or maintaining a high ratio of credit to one's equity or capital.

To Mervyn King, the Governor of the Bank of England at the time, this process was tantamount to trying to turn metal into gold. Taking riskless, low-interest bank deposits and loans, and transforming them into risky long-term investments on the promise of high profits is always a precarious proposition, and the risk increases exponentially when high leverage, or a high ratio of loans to equity, is glorified because standard accounting allows a bank to show it as proof of profitability. This irreducible gap between riskless deposit and risky investment is the source of the financial sector's instability, and one which cannot be eliminated by derivatives that purport to eliminate or radically reduce risk. As King puts it, 'For all the clever innovation in the world of finance, its vulnerability was, and remains, the extraordinary levels of leverage. Pretending that deposits are safe when they are invested in long-term risky assets is an illusion. Without a sufficiently large cushion of equity capital available to absorb losses, or the implicit support of the taxpayer, deposits are inherently risky. The attempt to transform risky assets into riskless liabilities is indeed a form of alchemy.'[13]

For King, the illusion of eliminating risk from investment that promised high returns, financed by low-interest deposits and loans, was a central factor leading banks to both overborrow and overinvest, becoming larger and larger in the process. And as they grew larger, the more indispensable they became to the system, and the more governments could not allow them to fail. What was perceived as an implicit government guarantee that it would cover their deposits, in turn encouraged people and creditors to place or lend their money to the banks, giving the banks an unfair advantage over other institutions such as non-financial corporations.

All three cases of spectacular UK bank failure, Northern Rock, Royal Bank of Scotland and the Halifax Royal Bank of Scotland, were essentially felled by this model when the market soured on their long-term investments, and their short-term depositors came after them in a panic to retrieve their money. When the price of commercial property or residential property where they were overexposed plunged, they found panicked depositors and creditors demanding their cash. But they were unable to supply the money since their equity or capital was extremely limited, having been dependent on borrowing to make their acquisitions. Bailing out the banks became a massive problem for the state, since the size of the banking sector had increased to the stage, as King points out, 'where it was beyond the ability of the state to provide bailouts without damaging its own financial reputation – for example in Iceland and Ireland – and it proved to be a near thing in Switzerland and the UK.'[14] That the state itself could have gone under financially in the UK is an extraordinary admission for the former Governor of the Bank of England to make, but it was not surprising if one considers that the size of the banks' balance sheets had grown to five times the country's GDP.[15]

The UK government's bailout packages for the ailing banks included equity injections, guarantees and liquidity support from the Bank of England, all of which raised public debt from 44 per cent in 2007 to 92 per cent in 2013. While the government bought huge chunks of shares in the troubled banks, in only two of them – Northern Rock and a smaller mortgage lender, Bradford and Bingley – was the nationalization option exercised, owing to fears that the business establishment would see the Labour government, then headed by Gordon Brown, as going back to its old, 'socialist' ways. Direct monetary support was provided to banks across the board through 'quantitative easing', which was supposed to promote lending and stimulate and raise effective demand, but the bulk of it remained within the vaults of the banks.[16] Most likely, the issue was the same as the one quantitative easing faced in the US: corporations and consumers chose not to borrow during the crisis, preferring instead to reduce their debt. The British government engaged in stimulus spending, with the fiscal deficit rising from 2.9 per cent to 11.3 per cent of GDP between 2007 and 2009, but, as in the US, there was reluctance to go full speed ahead to reverse the recession that came on the heels of the financial crisis. What Adair Turner describes as, 'unnecessarily aggressive fiscal consolidation' appears to have depressed growth.[17]

Interestingly, both Turner, who headed up the Financial Services Authority during the crisis, and Bank of England Governor King might be said to agree with Minsky that the financial sector is inherently unstable. For King, banks are 'inherently fragile', meaning unstable, and the source of instability lies in the banks' propensity to engage in the impossible task of financial alchemy, of making long-term investment from safe deposits equally safe. For Turner, the instability lies in, 'the interaction between the infinite capacity of banks to create new credit, money and purchasing power, and the scarce supply of irreproducible urban land. Self-reinforcing credit and asset price cycles of boom and bust are the inevitable result'.[18] Both King and Turner favoured the nationalization option for the troubled banks in the midst of the crisis.[19] But when it comes to the key lessons of the crisis, Turner pushes for tighter and more comprehensive regulation by government, even flirting with the idea of abolishing the banks, while King flies off to abstract recommendations such as a 'move to a new equilibrium' that will enable economies to regain their pre-crisis path of productivity.[20]

With these views coming from two of the top regulators of the UK finance industry, it is not surprising that the outcome for the banks – nationalization of two banks and virtual state control of another two, along with the dismantling of their top management – was harsher (relatively, that is) in the UK than in the US, where the troubled banks were not only bailed out on very generous terms, but their management was allowed to stay in place. As one foreign observer commented: 'The crisis was a terrible blow to the British Bankers' Association, because they ended up being nationalized ... The entire liberal reasoning was ripped apart ... We never see them taking a stance at international meetings any more.'[21]

A change in government from Labour to the Conservatives in 2010 brought accelerated re-privatization of the troubled banks to the agenda, but so poor was the state of Royal Bank of Scotland that it found no serious buyers for the government's huge stake in it. The entire system remained saddled with the effects of the implosion eight years after it took place, leading to this judgment by one of its most assiduous chroniclers, Hugh Pym:

> 'The untold story of the banking crisis has no ending. It is a story that matters to borrowers, savers and taxpayers. Future generations should be grateful to the politicians, regulators and advisers of 2008 for preventing a cataclysm, which would have crippled the UK economy for years. But they will not thank them for leaving debts and liabilities that could take decades to settle.'[22]

Talk about the social value of finance and good words about light touch regulation went up in smoke after the crash. But neoliberalism plodded on in the form of the Cameron government's austerity – cutting government spending – programme, which was essentially a way of making the public pay for the excesses of the era of financialization. Anger simmered in the electorate and revolt came in the form of the Brexit vote in 2016, which can be interpreted not only as a rejection of the European Union, but also a repudiation of both the Conservative Party and Labour Party elites who were responsible for eight years of crisis, austerity and stagnation.

Ireland: from development miracle to financial nightmare

The marriage of real estate and dodgy finance spelled disaster for British banks. In the case of Ireland, it was a love triangle of real estate, dodgy finance and the euro.

It was not too long ago that Ireland was regarded as the site of an economic miracle, something that was supposed to be an East Asian copyright. How did the so-called Celtic Tiger lose its way and collapse into the financial hole from which it is still digging itself? Interestingly, the reason is pretty much the same as why the East Asian tigers were brought low by the Asian financial crisis: financialization.

The Celtic Tiger

The Ireland that drew the admiration of a whole generation of neoliberal economists and technocrats successfully rode the wave of globalization to become Europe's fastest growing economy from the 1990s to the middle of this decade. In 1988, the *Economist* described Ireland as 'the poorest of the rich'.[23] By 1997, it pitched Ireland's transformation as 'dazzling'.[24] By 2005, the country's per capita GDP was the second highest in the EU, after Luxembourg's.

After the Asian financial crisis brought down Asia's tiger economies in the late 1990s, Ireland remained, along with China, the stars of export-oriented growth, seen by orthodox economists as the road to prosperity in the era of globalization. China learned the lessons of the Asian financial crisis and kept its financial sector on a tight leash. Ireland did not, and paid the price when the Western financial system unravelled in 2007.

Like South Korea and the southeast Asian tiger economies, the Irish economy passed through two phases. In the first phase of export-oriented growth Ireland experienced real growth, especially in manufacturing and services. The growth was foreign investment driven, particularly in high tech. The country became a premier international location for US investment in information technology, with Intel leading the pack with 5,000 employees, Dell with 4,300, IBM with 3,500, Hewlett Packard with 2,500, and Microsoft with 1,200. By the mid-2000s, tiny Ireland, whose population was no more than 4.5 million, had become the world's leading exporter of computer software and the source of a third of all personal computers sold in Europe.[25]

Much of what has been written about the Celtic Tiger – a sobriquet thought up by an investment agent with the Wall Street firm Morgan Stanley – was hype. But not all. By the turn of the century, the boom in the real economy had brought down the country's chronically high unemployment rate to five per cent, and the poverty rate to the same figure.

At that fateful conjuncture in the late 1990s, upgrading the real economy via technological innovation owing to rising costs was the obvious priority.[26] But the challenge went beyond just improving productivity. According to journalist Finlan O'Toole, the Irish, 'had an opportunity that was unique in Irish history. They had the resources to invest in the creation of a decent society, one that would be economically, socially and environmentally sustainable. They had a population that was optimistic, self-confident and ready for a challenge. They had incredibly favourable global conditions.'[27]

Fifteen years earlier the export-led economies of East Asia, then at their apogee, were at a similar crossroads … and took the wrong turn. Tempted by foreign speculative capital knocking at the door of the 'East Asian Miracle', the economies of the region liberalized their financial sectors. Hot money came flooding in, for investment not in industry or agriculture, but in real estate and the stock market. Overinvestment in real estate led to a collapse in property prices, which led to dislocations in the rest of the economy, which in turn led to panicky flight by foreign investors. In the summer of 1997, some $100 billion that had flowed into East Asian economies in the period 1994-97, flowed out of the region. The end result of this toxic cocktail of hot money and volatile property was a three-year recession that brought an end to the East Asian Miracle.

Ireland's wrong turn

Had Ireland's leaders paid attention to the East Asian tragedy of the late 1990s, they would have been more mindful of the dangers associated with financial liberalization and property development. They would have also avoided the second phase of the Asian growth process — paper prosperity. The conjunction of the international recession of 2001 and Ireland's adopting the euro appeared to bring the Irish elite to new conclusion: that there was an easier way to prosperity than expanding the real economy and raising productivity. That was the route of financialization, in which the creation of the euro and its adoption by Ireland played a central role.

In adopting the euro, which was backed by Germany (Europe's strongest economy), Ireland, like other Eurozone countries, found itself regarded by international markets as having a creditworthiness matching that of Germany, a fact that was reflected in the convergence of its sovereign bond yields with German levels. 'With the euro', as *Financial Times* journalist Martin Sandbu writes, 'other countries saw Germany's credibility rub off on themselves'.[28]

The US and Britain showed the Irish capitalist class that real estate was where profitability was highest, leading to an unholy alliance between global funds, Irish banks such as Anglo Irish that aggressively tapped them, and local developers such as the Sean Quinn family. The hothouse atmosphere of the early 2000s was described by *The New York Times thus*: 'Before Ireland joined the euro, its banks tended to do business the old-fashioned way, financing their lending through the deposits they took in. Once in the Eurozone, banks were suddenly able to borrow huge sums of money inexpensively on international markets with nearly no exchange rate risk, an activity that was barely regulated by policy-makers. With easy access to these funds, banks such as Anglo Irish lent huge amounts to prominent Irish developers, leading to a frenzy of overdevelopment.'[29] To use Adair Turner's image, the encounter of finite land with the infinite ability to produce money and credit produced a real estate bubble that seemed to go on inflating indefinitely.

The crisis

In the five years from 2003 to 2008, net foreign borrowing by Irish banks increased from 10 per cent to 60 per cent of GDP. Lending standards were driven down to entice prospective homeowners, many with low or no credit history: much like the subprime phenomenon in the United States. And, as in the US, regulators stood on the sidelines unwilling to take away the punch bowl, probably because so many of the top figures of the ruling party, Fianna Fáil, were tied to bankers and developers. Corruption, it seems, was central to the Irish financial model and, particularly when it came to relations between politicians, the banks and developers, it went well with the neoliberal prescription of light touch regulation, since that provided a justification for regulators not to look too closely at dealings among these key actors.[30]

Ireland's finances were already rotten when the global financial crisis blew in from Wall Street in 2007-2008. The crisis simply exposed the decay. With Ireland's lenders becoming jittery, the country's finance minister guaranteed all debt and deposits in the six main Irish banks and financial institutions, effectively nationalizing the debt and bailing out the country's banking elites. It was a case, however, of David carrying Goliath, since the banks' liabilities totalled €440 billion, a sum that was nearly three times the country's GDP.[31]

The government ended up nationalizing the notorious Anglo Irish Bank and Irish Nationwide Building Society, and injected massive amounts of capital into Allied Irish Bank and the Bank of Ireland. The total cost of restructuring and capitalizing these entities was enormous, and when the budget deficit needed to prop up Ireland's sinking economy was added, it became clear that things had gone beyond the capacity of the government. This led to the government's applying for and getting an €85 billion loan from the European Commission, European Central Bank and International Monetary Fund, which made up the so-called 'Troika'.

The loans did not, however, come without significant costs.

First, the government lost control over the process of restructuring. Before going to the Troika, it had entertained the possibility of having senior holders of the nationalized banks take a 'haircut' on their investments as a penalty for irresponsible lending. The European Central Bank, however, vetoed this, fearing the outrage this would cause among the global financial elite, and to show it meant business, the Bank's head Jean-Claude Trichet warned the Irish finance minister that a 'bomb' would go off if Ireland insisted on the haircut.[32] This meant that the costs of the bailout would be shouldered wholly by Irish taxpayers.

Second, to repay the Troika, the government imposed an austerity programme that severely cut government social expenditures, deepening the recession that swamped the country following the 2008 financial collapse. *The New York Times* characterized the quid pro quo for the bailout as the, 'toughest austerity programme in Europe', involving, 'the loss of about 25,000 public sector jobs, equivalent to 10 per cent of the government workforce, as well as a four-year, $20 billion programme of tax increases and spending cuts such as sharp reductions in state pensions and minimum wage.'[33]

Austerity bites

'Having surrendered sovereignty in 2010,' three of Ireland's top economists assert with little exaggeration, 'the Irish state remained in effect a protectorate of the Troika until the end of 2013.'[34] The country went through a two-year recession in 2008 and 2009, followed by several years of stagnation until 2014. The unemployment rate rose from 6.4 per cent in 2008 to 13 per cent in

2013.[35] Especially hard hit were the young, with development NGO Oxfam reporting that as of February 2013, 30.8 per cent of the country's under-25s were unemployed, and those in chronic long-term unemployment accounted for close to 62 per cent of the total number of those out of work. Inequality was also on the rise, with those with the lowest incomes seeing them fall by more than 26 per cent, while those with the highest saw theirs rise by more than eight per cent. Ireland, noted Oxfam, 'is likely to see rising inequality over the coming years, as it struggles to maintain the redistributive mechanisms in place prior to the financial crisis.'[36] Some 610,000 people left the island between 2008 and 2015, or close to 13 per cent of the country's population of 4.58 million.

The bailout of the private sector transformed the Irish government from one with a relatively good ratio of public debt to GDP of 25 per cent in 2008, to one with a sovereign debt problem – with the ratio climbing to 123.7 per cent in 2014. In its transformation from a commendable practitioner of budgetary restraint to a government with a sovereign debt problem, owing to the state assuming the liabilities of its failed banks and taking on new debt from official agencies to settle these, the Irish case was similar to that of Spain and Iceland, underlining political economist Mark Blyth's sardonic observation that, 'sovereign debt crises are almost always 'credit booms gone bust'. They develop in the private sector and end up in the public sector. The causation is clear. Banking bubbles and busts cause sovereign debt crises. Period.'[37]

Plus ca change, plus ca meme chose

Ireland exited the European Central Bank imposed austerity program in 2013, with a chorus of technocrats led by International Monetary Fund Managing Director Christine Lagarde painting it as the 'poster child' of austerity. There were, however, doubts that this was the case, or that one could even call what had transpired a success. Unemployment stood at a high 8.5 per cent in 2016. Ireland was the second most indebted industrial country in the world, with a per capita debt of over €43,500. Servicing that debt would absorb a significant volume of financial resources over the next few years, depriving the country's under-resourced public services of much-needed investment.[38] Moreover, in the three years since Ireland exited austerity, it seems that the financialization dragon has not been slain, leading Sean O Riain to assert that what happened was a 'recovery without transformation' and that a process of 'refinancialization' was taking place:

> 'Ireland's ability to move forward is threatened by the same trends that contributed to the crash. While banks are not lending as recklessly as they once did, they have provided little credit to productive businesses … Both finance and property are once again being boosted as growth sectors, and rising rents and prices are putting pressure on households and small businesses.'[39]

Greece: the unending tragedy

Greece's case differs from Ireland in that the massive borrowing financed real estate speculation in the former, and government spending in the latter. But they had a common denominator: lenders who were eager to lend.

Missing in the equation

By most standard accounts, the Greek crisis was triggered by the revelation in 2009 that the government had been cooking the books. Greek accounting had previously been viewed as a 'bit dodgy' by the European Union's statistical agency Eurostat. The Hellenic Statistical Authority had initially reported a projected budget deficit of 3.7 per cent GDP. Then, successively, the estimates ran to 7.8 per cent of GDP, then 9.8 per cent, then 11 per cent, and finally 12.7 per cent. It was at that point that further lending to Greece practically ceased, since lenders realized that the debt to GDP ratio was more than the reported 110 per cent – and actually clocked in at 148 per cent. In April 2009 ratings agency Standard and Poor, which had previously rubberstamped Greek bonds with high ratings, now demoted them to junk bond status, making Greece the first Eurozone country to suffer this fate. Just two months later, the agency pushed it over the cliff by giving it a CCC, the lowest rating in the world.[40]

But what is missing in the standard account is that, as economist Joseph Stiglitz puts it, 'if there is an irresponsible borrower, it means at a minimum that there is an irresponsible lender, who has not done due diligence.'[41] Indeed, by 2007, two years before the statistics scandal, the tango of frenzied lending and addictive borrowing had already pushed Greece's debt to €290 billion, which was equivalent to 107 per cent of GDP.

Why was the fact that half the blame rested with the banks not given even the briefest recognition? The most likely answer is because it was banks from the two pillars of the Eurozone, France and Germany, that were most exposed in Greece. German and French private banks held some 70 per cent of the country's €90 billion debt at the beginning of the crisis. Among foreign buyers of Greek bonds, French banks had over €20 billion worth of claims and more than €80 billion at stake in the Greek economy overall.[42] German banks, as noted in the previous working paper, had been great buyers of toxic subprime assets from US financial institutions, and they applied the same enthusiasm to buying Greek government bonds. Led by Commerzbank, they held some €17 billion of Greek debt. Indeed, the exposure of the German private sector, including pension funds, insurance firms and individual investors, came to as much €25 billion. Martin Wolf of the *Financial Times* was on target when he asserted, 'Germany's focus on the alleged fiscal crimes of countries now in crisis was an effort at self-exculpation: as the Eurozone's largest supplier of surplus capital, its private sector bore substantial responsibility for the excesses that led to the crisis.'[43] This lending was so reckless, as another commentator noted, that what was at stake, 'was not just the solvency of the Greek government but the stability of the German financial system.'[44]

Moreover, had the irresponsibility of the banks been recognized, then the complicity of the French and German states would also have had to be acknowledged. As journalist Martin Sandbu writes, from the French perspective on the relations between the government and the banks,

> 'It is anathema not just to restructure sovereign debt, but to let banks fend for themselves instead of bailing them out at taxpayer expense. In France, credit allocation – even though at the hands of nominally private banks – has always been an affair of the state. This attitude, which it shares with Germany, has resulted in French and German banks being the most highly leveraged in the world, safe in the hitherto unchallenged belief that the state will always stand behind them.'[45]

In short, moral hazard or perverse incentives to engage in reckless lending – owing to the explicit or implicit backing of the state – is central to the reason why banks were left out of the narrative of blame. Not only would the stability of the European financial system be threatened, but the credibility of those states safeguarding that stability would be eroded.

Creditors, European authorities and the business press used the ensuing panic to focus the blame solely on unchecked government borrowing and the Greek government's fudging of its balance sheet, completely suppressing the role played by irresponsible foreign creditors. Equally significant, the same forces used Greece's crisis to create the impression that sovereign debt crises caused by profligate spending had also overtaken Ireland, Spain and Portugal — though these countries had public debt-to-GDP ratios that were rather low. In the case of Spain and Ireland, the ratio was actually lower than Germany's.[46]

The process of heaping blame on Greece acquired ethnocentric overtones. For instance, the German newspaper *Bild* urged that, 'proud, cheating, profligate Greeks' who exploited responsible German taxpayers should be expelled from the eurozone.[47] The stereotype became about lazy southern Europeans versus hardworking abstemious northern Europeans. The impact on European solidarity so painstakingly built up in the post-war years was not inconsequential.

But it was not only Germany that had a stake in perpetuating the image that the Greek government was responsible for the crisis engulfing Greece and its creditors. American conservatives, who were then fighting the Obama administration's spending plans, saw it to their advantage to portray Greece's present as America's future should the government's budget deficit continue to rise.

Saving the banks, crucifying Greece

From the point of view of the European authorities and the German government, the banks had to be bailed out. At the same time, Greece could not be allowed to go under or leave the Eurozone, since that might lead to the collapse of the Eurozone and unpredictable political consequences. The way out of this dilemma was to bail out the banks by giving the Greek government multibillion euro loans that it would use to pay off the foreign creditors of the government and the Greek banks, and which would be repaid from cuts in the social expenditure of the government. As Karl Otto Pöhl, a former head of Germany's Bundesbank, admitted, the draconian exercise in Greece was about, 'protecting German banks, but especially the French banks, from debt write-offs.'[48]

The first loan, put together by Eurozone members, the European Central Bank and the International Monetary Fund, was a €110 billion loan, the bulk of which went to pay off foreign banks, and most of the rest to restructure Greece's private banks. The quid pro quo was a savage austerity programme that would radically cut back government social expenditure, including wage and pension cuts. As a result, GDP fell by a cumulative 20 per cent until 2012 and was projected to fall another five per cent until 2014. Unemployment rose to 28 per cent, with youth unemployment above 60 per cent.[49]

A second bailout package was given in February 2012; its terms for Greece were even more cuts. This time, however, there was a haircut or a cut in expected returns for the banks, something the

Germans agreed to only grudgingly. Investors holding 60 per cent of Greek debt saw the face value of their bonds, which came to roughly €200 billion, cut by half; the length of the loans stretched out over decades; and interest payments reduced. The rapid collapse of Greece triggered by the austerity programme had forced through the painful realization that without some cuts in the massive repayments it owed to the banks, Greece would be further away from recovery than ever. As one analyst put it:

> 'The more the government cut, the worse the economy suffered; the International Monetary Fund was later forced to conclude that the damage to economic activity from deficit cuts had been badly underestimated. With no recovery for sovereign debt, and with the downturn eroding private borrowers' ability to service their loans, Greek banks sat on growing unrealised losses. They were unable to channel credit to those private sector companies that might have expanded, so a credit crunch compounded the fiscal austerity to depress the economy further.'[50]

Thus, more than €100 billion of Greek debt was 'vaporized.'[51] The taboo against sovereign debt restructuring had been broken, but no sooner was this done than the, 'Eurozone's policy-making class quickly reinstated it, by insisting that Greece was a unique case and smothering any other Eurozone sovereign's debt.'[52]

Since there was no way an economy geared to austerity could miraculously go back to a growth path that would provide the money Greece needed to pay back its debts, it was not long before the country required a third loan from the European Central Bank and the International Monetary Fund, this time to pay back not only private lenders, but the European Central Bank and the International Monetary Fund itself.

The price of membership in the euro club

Negotiations for this third loan proved to be the most contentious. Greek Prime Minister Alexis Tsipras broke off negotiations because he thought the conditions imposed by Germany condemned his country to permanent austerity. The Greeks voted to reject the new deal, but Tsipras went back to the negotiating table because accepting the deal was the only way Greece could remain in the Eurozone. Why Tsipras walked away initially is understandable, if one considers in detail how the Eurozone authorities wanted to break down the loan and the conditions that would accompany it. Of the €86 billion provided by the loan, plus an expected €8 billion from the sale of Greek assets and the government's income:

- €54 billion would be spent on debt payments by the government
- €15 billion would be devoted to debt payments that Greece defaulted on in the summer of 2015, primarily to the International Monetary Fund, and to increasing the Greek government's currency reserves
- €25 billion would be used for 'recapitalization' of local banks.[53]

The conditions included further cuts in pensions and raising the retirement age from 65 to 67, further cuts in social welfare spending, a review of labour legislation with a view to loosening it, and the sell-off of €50 billion worth of Greek assets, including the privatization of the ports of Piraeus and Thessaloniki. The last condition was the most controversial. According to one account:

> 'The demand to sell off certain industries and assets by a given date [leaves] the Greek government with little room to bargain, as potential buyers know it is being forced to sell, a true fire sale. Nowhere in the Eurozone demands do they consider whether industries targeted are best run in the public or private sector, nor do they take account of the fall in Greek government income from no longer owning profitable enterprises.'[54]

The prospect of the country being locked into debt slavery, austerity and stagnation for at the very least 15 years was evident in figures collated by the Jubilee Debt Campaign:

> 'With the new loans Greek government debt is now projected by the International Monetary Fund to be 196 per cent of GDP by the end of 2015, €330 billion. By 2020, the International Monetary Fund predicts debt will still be 183 per cent of GDP (an increase in absolute terms to €367 billion), based on the recession continuing in 2016, then growth of 2.5-3 per cent from 2017 to 2020. The European Commission predicts that debt will be 175 per cent of GDP by 2020 and 122 per cent by 2030, again based on relatively high economic growth from 2017 on.'[55]

The International Monetary Fund, it has been noted by many, has proven to be more accommodating to the Greek government's pleas for a less harsh adjustment programme, perhaps mindful of the disastrous impact of its policies during the Asian financial crisis. The European Central Bank and the German government were, however, determined to squeeze the Greeks, motivated mainly by a stern desire to make Greece serve as an example of irresponsible borrowers while hypocritically ignoring irresponsible lenders. As one high-ranking German official told former Greek Finance Minister Yanis Varoufakis: 'A debt is a debt is a debt.'[56]

Eurocross

Financial liberalization promoted by neoliberal thinking was one of the major drivers of the European financial crisis. The two other key drivers were the euro and Germany's low-wage, export-export oriented political economy.

The euro once represented Europe's gleaming future. Now it stands for what went wrong with the European project. In the standard history of the creation of the euro, the common currency of 17 countries in Europe, the noble goal of deepening European integration is often stressed as the motive. Realpolitik, however, accompanied this process, and it was realpolitik that trumped that noble goal of European solidarity in the end.

In Greek Finance Minister Yanis Varoufakis' wide-ranging account of the European financial crisis, the euro stemmed from the project of French leaders to harness German economic power to European integration under French political and administrative leadership. The euro project began as a 'French plan to usurp an institution cherished by the German people – the Bundesbank – subsume it into a French-dominated central bank and extend into Germany and the rest of Europe policies close to Paris's heart.'[57] Germany, or specifically, the German Bundesbank or Central Bank, was a reluctant bride, but when the folly of merging currencies without a political union exploded in crisis, Germany, on whose economic might and financial stability the euro rested, became the stern taskmaster whose idea of disciplining errant members of the Eurozone was to subject them to permanent austerity.

Putting the cart before the horse

In Varoufakis' account, money and the cost of money, that is, the interest rate, are not neutral; they are intensely politicized. And the essential problem of the creation of the euro was the decision of Paris and Berlin to create a common currency before achieving a political union, which would have been accompanied by institutions that would perform the tasks of taxation, spending, investment and recycling financial resources. The European Central Bank, whose principal tasks were to douse inflation and manage the issuance of the common currency, was simply one piece in a much bigger economic structure that was absent. The original Franco-German project rested on a key assumption, and it was a dubious one: that a common currency would pave the way for a political union because the problems created by the use of the currency would force different governments to push forward to a higher stage of institutional unification. While this might not have been exposed as essentially wishful thinking when there was growth and financial stability, it could not but be a tragic illusion that would be ripped apart when the pressure building down below came to the surface. Varoufakis poses the question:

> 'How could so many top journalists, academics, functionaries and politicians believe that they could sustainably bind together the French franc and the Deutsche mark, let alone the Italian lira, the Spanish peseta and the Greek drachma, without a political mechanism for recycling German and Dutch surpluses and managing private and public sector deficits? Did they not see that German surpluses, left to Frankfurt and Parisian bankers to scatter throughout Europe's periphery, would flood the deficit regions, causing massive bubbles? How did they expect the Eurozone, bereft of any mechanism for coping, to handle the preordained bursting of these bubbles?'[58]

The Bundestag 'guarantee'

Aside from the absence of the key institutions necessary for the euro's proper functioning, the system had two other fatal flaws. One was that a common currency encouraged bankers to view credit extended to households and enterprises in weaker economies as carrying the same or close to the same risk as credit extended to those in stronger economies. With the euro, Spanish, Greek or Italian banks now found it easier and cheaper to get loans from German or French banks, because the latter fell under the illusion that the loans would be guaranteed by Germany's Bundesbank. In other words, risk was artificially eliminated by the euro, whereas in reality many of the private and public debtors in the Eurozone's 16 other member countries did not have the same capacity to pay as German debtors.

This resulted in a virtual orgy of lending by French and German banks that were flush with cash, with preferred customers being households and enterprises in southern Europe which had not been trawled in pre-euro days by the banks as intensively as those in northern Europe, owing to their lower levels of private indebtedness. In 2009, the exposure of German banks to the so-called PIIGS (Portugal, Italy, Ireland and Greece), was a mind-blowing €704 billion. This was more than the total capital base of Germany, leading Varoufakis to claim that if, 'Greece went under, and contagion brought down some of the other peripheral banks, Germany's banking system would be toast.'[59]

Eurotrap

The second major glitch associated with the adoption of the euro was a country's loss of any room for maneuver if it fell into a severe debt crisis. Having an independent currency, say the peso, would allow one to devalue it relative to the euro, and bring about a more favourable balance of trade that would yield a rise in income that could pay off the debt. This is, of course, in theory, since as political economist Mark Blyth has pointed out, 'The problem with keeping up with the Germans is that German industrial exports have the lowest price elasticities in the world, meaning Germany makes really great stuff that everyone wants and will pay more for in comparison to all the alternatives.'[60] But assuming devaluing would have some impact, having a common currency precluded the devaluation solution. Indeed, this was not an option for a very practical reason: even if one decided to withdraw from the euro and create one's own currency, the process would take a minimum of 12 months. This meant hinting one would take this option would be to trigger a ruinous panic. In Varoufakis' words, people, 'will rush to liquidate whatever wealth they have, convert it to euros, take their euros out of the banking system and either stash them under the bed or carry them across the border to Germany or Switzerland for safekeeping. Before you can say 'panic', banks fail, the country is drained of all value, and the economy collapses.'[61] The euro then was 'a Hotel California. You could check in, but you could never leave'.[62]

In the end monetary union, which had been intended to end in a political union based on intra-European solidarity, ended up promoting discord, the subjugation of one group of countries by another, and a deeper democratic deficit as the unelected technocrats of the European Central Bank, working with a powerful German government, made life and death decisions for millions of people. With unending austerity and no counterbalance to the power of Germany, the project of monetary union as it stands would be best disbanded, says Nobel Prize winner Joseph Stiglitz:

> 'Many within Europe will be saddened by the death of the euro. This is not the end of the world: currencies come and go. The euro is just a 17-year-old experiment, poorly designed and engineered not to work. There is so much more to the European project, the vision of an integrated Europe, than a monetary arrangement. The currency was supposed to promote solidarity, to further integration and prosperity. It has done none of this: as constructed, it has become an impediment to the achievement of these goals…'[63]

Germany beggars its neighbours

As in the case of the US, financial factors interacted with structural factors to create the crisis. In the US, the current account deficit created by massive imports of cheap manufactured goods from Asia, and in particular from China, led to the creation of reverse financial flows that played a central role in fostering consumer indebtedness. In Europe, labour market reforms in Germany, and the trade and financial circuits, created the conditions for the creation of deep indebtedness for Germany's neighbours.

Structurally, the central problem that emerges here is Germany. Once seen as the sick man of Europe, Germany underwent painful neoliberal reforms in the late nineties and the first years of the 21st century under the leadership of Chancellor Gerhard Schroeder. Agenda 2010, which was put together by Peter Hartz, a former personnel director of Volkswagen, was essentially an employers' programme of economic restructuring to regain profitability that was implemented by a social democratic government. The Hartz reforms were, as economist George Zestos points out, neoliberalism at its most punitive:

> 'The Hartz reforms created incentives for workers to search for work and find employment because it was no longer in the workers' interest to remain unemployed, since liberal long unemployment benefits were drastically cut. The German agenda restructured the Federal Employment Agency and modernized the welfare system. Wages and other benefits, such as pensions and healthcare for workers, were substantially reduced as new types of employment were introduced. Wages under these new types of employment were set outside the contracts that customarily were agreed and signed through negotiations between trade unions and employers' associations.'[64]

'Precarious employment' favoured by the reform package proliferated in the form of fixed-term contracts, agency work and temporary work, since high unemployment 'tilted the bargaining power of labour away from trade unions towards companies, which imposed their conditions under the threat that they would invest abroad and close factories in Germany.'[65]

By making German labour cheaper, the Hartz reform made German products much more competitive than the products of its neighbouring countries in the European Union, thus allowing German products to increase their market share in these economies. The lower disposable income of German workers also made them less likely to consume higher priced foreign goods. Heiner Flassbeck and Costas Lapavitsas provide a good description of what happened next.

> 'With German unit labour costs undercutting those in the other countries by a rising margin, German exports flourished while imports slowed down. Countries in southern Europe, but also France and Italy, began to register widening trade and current account deficits, and suffered huge losses of their international market shares. Germany, on the other hand, was able to preserve its share despite mounting global competition from China and other emerging markets. In a nutshell, Germany has operated a policy of 'beggar thy neighbour' but only after 'beggaring its own people' by essentially freezing wages. This is the secret of the German success over the last fifteen years.'[66]

The effect of the Hartz reforms on Germany's relations with its trading partners was evident in the statistics. Whereas real GDP growth in the 1960s, 1970s and 1980s was mainly driven by domestic demand, the share of exports in GDP went from 24 per cent in 1995 to 51 per cent in 2013, and the share of imports from 23 per cent to 44 per cent. As analysts Daniel Dexter and Eckhard Hein point out, 'Growth was thus increasingly driven by net exports, and the relevance of domestic demand declined dramatically. This was equally true for private consumption and investment.'[67]

Threatened by mounting deficits, Germany's weaker partners in the Eurozone were, however, caught in a trap owing to their being part of the European Monetary Union. As noted earlier, had they had their own currencies, a solution to their increasing trade deficits vis-à-vis Germany would have been to devalue their own currencies, thus making German goods more expensive locally and their goods more competitive in the German market.

Unable to do so, these countries borrowed heavily from international financial markets, including German banks, to cover their rising deficits, as well as to provide social security support to workers being displaced by German exports. The massive rise in the lending of German banks to southern European countries was, in this sense, related to the rise in Germany's trade surpluses to these same countries.

'Internal devaluation', or cuts in wages and social security benefits, was, of course, the other option, and this was undertaken in most cases after the outbreak of the financial crisis, as the price for getting financial assistance to prevent economic collapse. Internal devaluation should have had a positive effect, since it should have made cheaper exports from the deficit countries more attractive in the surplus country, resulting in more foreign exchange to pay off loans and triggering more intensive economic activity. But it has had little effect in getting distressed economies to grow and in bringing down unemployment. While the trade balance was achieved in some instances, as in Greece, this was mainly because of a reduction in imports, not a rise in exports.[68] The weak performance of exports could not make up for the negative effects of austerity in the non-traded sector. As Stiglitz notes:

> 'Internal devaluation increases economic fragility by bringing more households and firms to the brink of bankruptcy. Inevitably, they cut back spending on everything. The cutbacks in imports were one reason that trade balance was improved; the cutback in domestically produced goods is one reason that GDP declined so much.'[69]

In sum, the mix of financial liberalization, the euro and Germany's structural adjustment proved to be a highly toxic one. Germany's 'beggar thy neighbour' political economy made it an export-led powerhouse that converted its neighbours into deficit countries. To cover their current account deficits, Germany's neighbours needed financial resources. Financial liberalization transformed the cross-border flow of northern European bank assets into a deluge, a process that was facilitated by the adoption of a common currency, which gave the banks the illusion that lending to governments, enterprises and households in southern Europe was practically riskless, since they assumed that the Federal Republic's Bundesbank would stand behind the multibillion dollar debt of recipient countries. When the thunderbolt from Wall Street illuminated financial realities in 2008 and showed that all of the bankers' key assumptions were groundless, the process of European economic integration went sharply into reverse, ending up in today's dismal picture of a continent in permanent crisis.

Social democracy in crisis

An account of the economic crisis in Europe from a progressive perspective would not be complete without touching on the role of social democracy in both the crisis and the developments leading up to it. Why? Because social democratic parties were not only the main party on the left, but in key countries – notably Britain, France and Germany – they were in power at various times during this period, and were key to forming and executing policies.

New Labour's Faustian bargain

In an effort to move beyond its traditional working class base, the UK's New Labour under Tony Blair and Gordon Brown struck up an alliance with finance capital, that is, The City. The deal was to make London a prosperous global centre for finance, recycle some of the profits for New Labour's social programmes for its traditional working class base, and woo the middle classes with the low mortgages that the financial inflow made possible. Gordon Brown, first as Chancellor then as Prime Minister, became the ideologue of 'light touch' regulation of finance, and for this and his ambition to make London outstrip New York as a financial centre, he was 'lionized' by bankers.[70]

The centre of New Labour's paradigm, or its bet, was that financial services, 'would power a new service-based economy' that would compensate for the decline of the manufacturing sector that had been the base of its traditional working class clientele. The new white collar class associated with the rising dominance of financial services would be enrolled in the voting lists of 'forward looking' New Labour, while monetary contributions would come from the City's financial elite. A good account of Labour's comprehensive transformation from a working class- based party is provided by the Centre for Research on Socio-Cultural Change of the University of Manchester:

> 'The New Labour project was based on enthusiastic acceptance of Conservative doctrine about economic transformation and private sector enterprise that follows from flexibilized labour markets and lower income and corporation taxes. Politically, New Labour distanced their party from the trade unions and thereby made Labour financially dependent on, and sympathetic to, City donors and other high-wealth individuals. A new style of politics had also emerged whereby business supports not the centre right, but whatever side is winning, in the hope of sympathy after the election...[I]n 1999, at the height of New Labour triumphalism, for example 60 per cent of Labour's income came from individual donors (20 per cent from donors over £5,000). The trade unions, which once generated 90 per cent of the Party's income, by then provided only 30 per cent...'[71]

The curious partnership of austerity and French socialism

As for the French socialists, the turning point appears to have been the economic crisis of the early 1980s, which was provoked by Federal Reserve Chief Paul Volcker's steep interest rate policy. With the budget deficit growing, capital fleeing and the franc being repeatedly devalued, Francois Mitterand pulled back from his ambitious programme of nationalization and aggressive government spending and loosened capital controls to avoid further devaluations of the franc.

As commentator Paul Cohen notes, ‘the most striking shift of the post–Mitterrand era was the French left’s rallying to the privatization creed.’[72] In spite of a joint socialist-communist campaign promise to halt privatizations, the socialist-communist-green coalition led by Lionel Jospin that reigned from 1997 to 2002 privatized the bank Crédit Lyonnais and other corporations, as well as selling minority stakes in Aérospatiale, Air France and France Télécom.[73]

In place of nationalization and a more socialized economy, the priority of Mitterand and his successors on the left became the creation of the European Monetary Union. The curious logic in prioritizing the establishment of monetary union, from the socialists’ point of view, was that austerity or neoliberalism could only be defeated at the European level, and this could only be done if the French could prove to their German partners – Europe’s moneybags – that they could impose a successful austerity programme on themselves. It seems to have escaped the French socialists that the Maastricht Treaty of 1992, the agreement that led to the euro’s creation that they were instrumental in bringing about, was an extremely neoliberal free market document that would have made it very difficult for a future socialist government in France to move towards greater state control. As Varoufakis saw it,

> ‘President Mitterand’s government abandoned anti-austerity policies on the dubious grounds that austerity could only be defeated Europe-wide once the French economy was subjected to doses of austerity sufficiently large to placate the money markets and convince Germany’s elites to bow to the superior wisdom of French economic policymaking. French ‘socialist’ austerity would, according to this ill-fated plan, lull the Bundesbank into a sense of security [that would allow] French bureaucrats to erect a European Central Bank in France’s image. From there the single European currency would spread Mitterand and Delors’ expansionary growth-oriented anti-austerity policies – the same ones they had just abandoned at home – throughout the union.’[74]

‘Or so the fairy tale went’ is Varoufakis’ sardonic comment, since how the Germans could be fooled and how the strict Maastricht criteria could be evaded at a European level remained a mystery, except, of course, to the French socialist elite.

When the financial crisis broke in 2008, and country after country was driven to take loans from the Troika on condition they would impose crushing austerity, progressives in the deficit countries had little faith in the French socialist technocrats and other social democrats in Brussels and Frankfurt, owing to the contradiction between their seeming sympathy for anti-austerity but actual support for austerity. As an Irish economist acidly put it:

> ‘Contrary to common perceptions. Balancing budgets has not been a tactic of Europe’s economic liberals, but of the EU’s social democrats. They have sought social solidarity in a social contract based on high employment, strong social services and egalitarian wages – all wrapped in a protective shell of prudent finances. The Irish and European approaches today emphasize only the shell, including precious little of the social protection. The rediscovery of an older social democratic project involving prudence, protection and economically productive activity – an approach too long marginalized within EU policy debates – is long overdue.[75]

Preparing Angela's lunch

To many observers, Germany is one of the main reasons for the eurozone's problems, and they specifically point to the Hartz reforms, which were put in place in the early 2000s by the Social Democratic Party-led government of Chancellor Gerhard Schröder. As noted earlier, the reforms, packaged as 'Agenda 2010', were a Thatcherite package that relied on cutting medical benefits, slashing pension and unemployment benefits, raising the age of retirement from 65 to 67, outsourcing health insurance and abolishing craft requirements. Political essayist Perry Anderson described this package as, 'a more comprehensive bout of neoliberal legislation than [Britain's] New Labour, a much invoked model, was ever to do.'[76]

A conservative government could not have carried them out without evoking massive resistance. Only a labour government could discipline labour. But the price paid by the social democrats was high. Some 100,000 members, including former Finance Minister Oskar Lafontaine, split from the party, with many joining the former Communist Party of East Germany (renamed the Party of Democratic Socialism, or PDS) to form the 'Die Linke' party, or 'The Left'. Trade union members also withdrew their allegiance to the party *en masse*, and the loss of their support was a key factor in the party's rout in the 2009 elections, when it suffered the heaviest losses in its history and saw its seats in the Bundestag reduced to 23 per cent. Achim Post, head of the SPD's (Germany Social Democratic Party) International Politics Department, saw the Hartz reforms, 'as a case of the party doing something that was for good for society but not in the party's best interests.'[77] However, there is strong feeling in the party that the SPD ended up doing the dirty work for German capitalism, only to be sidelined and to see Angela Merkel reap the political rewards.

Contrary to Post, however, progressives, including many among the social democrats, disagreed that the reforms were for the 'good of society'. They said that what orthodox economists saw as a 'new resiliency' in the German economy had to be balanced against the emergence of new social inequalities. Inequality and poverty increased more rapidly in Germany in 2000-2005 than in any other OECD country. While unemployment stands at a relatively low 2.7 million at present, a large number of those employed do not earn enough to meet their basic needs, and have to resort to state subsidies.

Moreover, the impact of the reforms was devastating to Germany's neighbours. As noted earlier, by significantly reducing the cost of German labour the reforms beggared many other countries in the eurozone, forcing them to borrow to cover the resulting deficits. Not only did Germany's firms benefit from their exports, but German banks profited from the loans they made to other countries to cover their deficits. The end result was these countries' virtual bankruptcy and their having to be bailed out under very austere conditions.

Germany's reduction of its neighbours into virtual vassals has troubled many party members, not least former German Chancellor Helmut Schmidt. At the party Congress in 2012 Schmidt, now the party's 'grand old man', summed up the troubled relationship of Germany, which straddles the geographical centre of Europe, with the rest of continent thus: 'When the centre is weak, the periphery moves into the centre. When the periphery is weak, the centre expands to the periphery.' The key to a stable Europe is a balanced relationship and that balance has been disrupted by recent developments, he implied. The centre has become too strong, and nations now fear their economic governance being dictated by Germany and its preferences for fiscal and monetary tightness, strictures against debt, and obsession with inflation. Moreover, the fear of economic supervision by Germany is coupled with the fear that the austerity measures the Merkel government is promoting might provoke recession or depression – and he reminded his audience that it was deflation and depression, not inflation, that ended the Weimar Republic, the first attempt at democracy in Germany, and brought Hitler to power.

Schmidt went on to assert that Germany's neighbours' fears had a basis in the past wrongs Germany had inflicted on its neighbours. Their fears were justified. More importantly, Germans had to relearn that their political and economic success in the last 60 years would not have been possible without the 'support and solidarity of others', and that it was now Germany's turn to 'show solidarity with our neighbours'. Otherwise, Germany might 'risk isolation in Europe.'[78]

Many in the party have pushed to get the SPD to take a stronger stand against the permanent austerity to which Merkel, so as not to offend the Bundestag, is foisting on deficit countries. So far, however, the SPD has gone along. With the party suffering another major defeat in the 2013 elections, it joined Merkel's Christian Democratic Union in a Grand Alliance. Merkel agreed, but the price was high: she placed SPD leaders in key sensitive positions, where they had to take a lot of the flak for imposing austerity. These included the foreign affairs and economy and energy ministries. When Greek Prime Minister Tsipras temporarily pulled out of the talks for a third bailout in 2013 and sought his country's vote on what was on offer, SPD party leader Sigmar Gabriel, who served as economy and energy minister in the coalition government, lashed out at Tsipras, saying the Greek leader had, 'torn down the last bridges,' leaving, 'hardly any chance ... for a compromise' between the eurozone leaders and Athens.[79] This led to the perception that he was trying to 'out-Merkel Merkel'.

The social democratic debacle

British Prime Minister Margaret Thatcher is the figure most identified with the advent of neoliberal policies in Europe. After her, however, it has been figures from Europe's key social democratic parties that have played the main roles in promoting neoliberalism: Tony Blair and Gordon Brown in the financialization of the British economy, Francois Mitterand in pushing the Maastricht Treaty, the free-market oriented agreement that led to the establishment of the euro, and Gerhard Schröder in imposing the Hartz reforms that led to Germany's pushing its neighbours into crisis, and eventually financial vassalage. Blair and Brown, Mitterand and Schröder made their compromise with neoliberalism with the best of intentions, which was to achieve economic growth so that some of it could be siphoned off to serve as social expenditures for the working class. That proved to be a tragic illusion. True, there appeared to be a few good years in the 1990s. But, ultimately, the Faustian bargain led in each case to a severe crisis that outweighed whatever economic benefits they had managed to bring about.

Thus one of main casualties of the financial crisis in Europe has been social democracy. The collapse of financialization in Britain led to Labour's irreversible crisis even before the Brexit debacle. One might say that the eurozone mess that has dragged so many countries deeper into permanent stagnation, while subjugating them to Berlin, has led to the increasing irrelevance of social democratic parties as vehicles for people's aspirations for economic emancipation. The unravelling of its historic compromise with neoliberalism and finance capital, to pirate the words of the Italian Communist leader Enrico Berlinguer in a different context, has left social democracy with little moral capital. Varoufakis, expresses social democracy's crisis most eloquently, and it is worth quoting him in full:

> 'With paper profits mounting, European social democrats and American democrats were lured into a Faustian bargain with the bankers of Wall Street, the City of London, Frankfurt and Paris, who were only too pleased to let reformist politicians take a small cut of the loot as long as the politicians consented to the complete deregulation of financial market[s] … Bankers were unshackled and centre-left politicians no longer had to wrestle the captains of industry to fund their social programmes. Financiers had only to feign displeasure at handing over some crumbs from their substantial table for the politicians to acquiesce in the logic and the ethics of financialization, suspend their critical attitude to capitalism and believe deeply that the financial sector knows best how to regulate itself … And so, when in 2008 the vast pyramids of financial capital came crashing down, Europe's social democrats did not have the mental tools or the moral values with which to combat the bankers or to subject the collapsing system to critical scrutiny … Lacking the ethical, intellectual and financial weapons that they and their predecessors had willingly retired or refused to create some years before … Europe's social democrats were ready to fall. Ready to retreat. To bow their heads to the bankers' demands for bailouts to be purchased with self-defeating austerity for the weakest. To shut their eyes to the transfer of the costs of the crisis from those responsible for it to the majority of citizens, Germans and Greeks alike, the very people that social democrats were supposed to represent.'[80]

Varoufakis sadly concludes, 'European social democracy went to ground, leaving the way open to racist ultra-rightist thugs all too happy to act as the protectors of the weak – as long as the latter had the right blood, skin colour and prejudices.'[81] Except for the part about the thugs – at least not yet – the parallel to the US situation with the triumph of Donald Trump is all too obvious.

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This paper by Walden Bello focuses on how the global economic crisis unfolded in Europe, where a toxic mix of financial liberalization, highly-leverage banks, a poorly-planned euro and Germany's years of structural adjustment created a deeply unbalanced and highly indebted European economy, that was brought into sharp focus as Wall Street banks collapsed. The result was the reversal of Europe's economic integration and a state of permanent crisis that continues to this day.

This is the second part of a broader study on global finance, conducted under the auspices of the Transnational Institute (TNI) and the Center for Southeast Asian Studies (CSEAS), Kyoto University. The previous paper focused on the dynamics of the United States' economy during the current global economic crisis. Future papers will examine China's role and also explore possibilities for an alternative global financial architecture.

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