The social roots of the financial crisis: implications for Europe

Jacques Sapir

The financial crisis, which erupted in the mortgage market in the United States in spring 2007 has gradually spread across the entire global banking and financial system. Prompting first a contraction of lending, then the violent crisis in international liquidity witnessed between 15 September and late November 2008, it has turned into a major economic crisis. In specific ways, this crisis constitutes the equivalent of the 1929 crash. Although its effects have been relatively limited for the moment, this is due to the survival of state-controlled mechanisms not yet undermined by the neo-liberal globalisation we have experienced since the 1990s.

It may look like a financial crisis, but in essence this crisis is in fact one of income distribution. The unleashing of the ‘conservative revolution’ instigated by Ronald Reagan and Margaret Thatcher, but imitated by certain strands of European social democracy (from Jacques Delors via Tony Blair to Gerhard Schröder) led to a fall in the proportion of national income represented by earnings. The unleashing of globalisation via international financial liberalisation measures and the introduction of a widespread free-trade system has lent a new and decisive violence to this income distribution crisis. Thus the forms taken by the crisis are closely linked to the very mechanisms of globalisation, and these are likely to be abruptly called into question if we wish to prevent the already perceptible rise in unemployment turning into a tidal wave.

1. Households burdened with debt and struggling to make ends meet

It is now clear that the most immediate and visible cause of the crisis, both in the United States’ economy and within the European Union, has been a steady deterioration in the solvency of households and a rise in
their debt levels. Consumers’ incomes lagged behind rising output in the 1980s and 1990s to a growing extent. Consumption only managed to hold up by virtue of household debt, but the latter could not continue to grow indefinitely. The deterioration in the quality of households’ debt, and their growing inability to cope with the burden of paying back both the principal and interest on these debts is the root cause of the banking crisis.

1.1. The United States: an archetype?

As has been stated many times, the crisis began in the US mortgage market. Yet the US mortgage market crisis is a complex phenomenon, which extends well beyond the confines of this market alone (d’Arvisenet, 2007). It combines a real-estate speculation mechanism, which is fairly traditional in terms of its nature and operation, with a more fundamental imbalance in the distribution of national income in the United States, all in a context of unfettered financial innovation.

In point of fact, the trend in household incomes in the United States began showing worrying signs from the start of George W. Bush’s presidency. For instance, average earnings have increased on average by 3 % per annum, but median earnings by just 0.1 %1. As for the income of the median household, this actually fell in real terms between 2000 and 20062. In fact, if we look at the distribution of households, we find that the poorest quintile saw its income fall by 4.5 % between 2000 and 2006, the second quintile fell by 3.1 %, and the third by 2.5 %. Only the fifth quintile, i.e. the wealthiest one, saw its income increase by 1.0 % over the same period. Over the period 1997-2004, counting deciles from the poorest upwards, the cumulative income of the second decile fell by 12 % in the United States, whereas it rose by 10 % in the case of the 9th. In France, there is an increase of 6.8 % and 12 % respectively, and 8 % for each decile in Germany3.

3. Data supplied by UBS.
This trend reflects a sharp increase in inequalities of wealth, which has become concentrated on a very small minority. In 1980, the wealthiest 1% accumulated 8.2% of the national income, while the wealthiest 0.1% accumulated approximately 2.2%. These proportions had been stable since the mid-1950s. In 2005, they rose respectively to 17.4% and 7.5% of the national income (Piketty and Saez, 2006), a level corresponding to that of the years immediately prior to the 1929 crisis. Thus the Gini Coefficient, which measures the inequality of the distribution of a sample, for incomes rose from 0.415 in 1980 to 0.466 in 2001. This increase in inequality, which has been developing since 1980 also corresponds to a significant trend in the share represented by profits as a proportion of national income (Figure 1). Although compromised for some years by the recession triggered by the Saving and Loans crisis, this trend resumed from 1992 onwards and, following the double blow of the 1998 financial crisis and the terrorist attacks of 11 September 2001, reached a peak in 2006.

Household debt developed strongly, as it was the only way to maintain consumption. It was facilitated by financial innovations, which allowed financial institutions to pursue increasingly aggressive policies. It is economically significant that the level of indebtedness then tended to dissociate itself from that of GDP. This is one of the major differences between the cycle of debt and economic activity witnessed in the United States since 2001 and those observed since the late 1960s. This disconnection has also been mirrored by the way in which mortgage lending has become detached from the growth rate of GDP.

The first of these disconnections has been spectacular. Mortgage lending has traditionally served as a lever for household debt in the United States. In fact we find a strong correlation between the annual growth of mortgage debt and that of non-mortgage debt between 1966 and 1993. On the other hand, from 1993 onwards and especially from 1998, mortgage lending tends to oust non-mortgage lending, i.e. the traditional forms of consumer lending.

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Actually, households are no longer using their mortgage loans as an indirect indicator of their solvency vis-à-vis the banks or finance companies to which they apply for new loans. Households are using mortgage lending directly as a global source of financing, relying on the underlying rise in value of the mortgaged property (resulting from the general rise in property prices).

When the value of a property rises, the borrower can harness the difference between its theoretical market value and the amount of the mortgage. This process is known as ‘home equity extraction’. The banks grant renewable loans based on this difference in value (‘Home Equity Line Of Credit’ or HELOC), which explains the explosive rise in the debt levels of US households. However, this rise has also been based on the readiness of organisations providing loans to increase the amount of debt owed by households in return for a given property pledged as collateral security. This behaviour on the part of the loan provider can be explained firstly by a speculation effect (they anticipate a rise in the
potential value of the mortgaged property) and, secondly, by these institutions having the option of using new financial instruments.

The logic of household debt has deeply changed in the United States since the late 1990s. Consumer credit and real-estate credit were mechanisms typical of the so-called ‘Fordist’ accumulation regime. Here, money was borrowed in anticipation of a rise in real incomes and, through its effect on the level of economic activity it helped to make this anticipation self-fulfilling. In the late 1990s, debt became a survival mechanism for households which were no longer seeking to raise their standard of living but simply to maintain it, at a time when real incomes had ceased to grow or even gone into decline for the vast majority of Americans.

This raises the question of the macroeconomic impact of this debt. There are two constraints here: one concerning the repayment capacities of the debtors concerned, and the other linked to asset values in relation to the value of the stock of debts. As long as the value of their assets is on a par with the stock of debt, assuming full liquidity of the assets concerned, the agents involved are permanently solvent. The problem, which arises when assets are primarily constituted by real estate, is that their value may fluctuate sharply, and the degree of liquidity of the assets is dependent on the trend in this value. Thus here we have a pro-cyclical mechanism which keeps households solvent as long as property prices continue to rise, but makes them appear insolvent (they are equity-negative with an excess of debt over assets) in the event of a sharp fall in prices, when the fall in value is accompanied by more serious difficulties in liquidating assets.

This passes on the strain to the capacity of annual incomes to cope with the flow of repayments. Here, the concomitant rise in debt as a percentage of GDP and the decline of earnings as a proportion of national income indicates that this capacity has been weaker since the 1980s. This situation has been masked by America’s distinctive system of mortgage lending, which needs to be explained in detail to permit a better understanding of the underlying dynamics of the crisis.

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5. The Fordist model in the United States was analysed in Aglietta (1976).
In the United States, mortgage lending dominates housing finance, but it has also become an instrument of global lending, taking the place of traditional forms of consumer credit to some extent. The market is structured into several segments, with mortgage loans benefiting from guarantees (Fannie Mae and Freddie Mac), but also a number of much higher-risk segments. The latter include:

- ‘Subprime loans’. These mortgage loans are granted to borrowers whose debt-to-income ratio is over 55% or whose loan-to-asset value ratio exceeds 85%;

- ‘Alt-A’ loans. These loans are granted to borrowers who are below subprime ratios, but for whom only incomplete references are available. Nevertheless, these loans still receive an ‘A’ rating;

- ‘Jumbo’ loans. These are mortgage loans covering large amounts of money (US$ 500,000 and subsequently $1 million).

In March 2007, the value of subprime mortgages was estimated at more than $1,300 billion. Subprime loan agreements, which in 1994 represented approximately 4% of the annual volume of mortgage loans issued, reached levels of around 20% in 2006. Many of these agreements contained interest-rate adjustment clauses (Adjustable-Rate Mortgages or ARM). As early as October 2007, it was estimated that 16% of subprime agreements under ARM clauses were either experiencing payment delays of more than 90 days or were in liquidation, i.e. 3 times more than in 2005 (Bernanke, 2007). This explosion of lending led to a sharp rise in the debt levels of US households, and was accompanied by a spectacular drop in savings.

Household debt levels remained constant in relative terms during the 1960s and 1970s, at between 40% and 45% of GDP. The so-called ‘supply-side’ policies pursued under Ronald Reagan’s presidency resulted, from 1984 onwards, in an initial rise. This gathered pace from 1998 onwards, i.e. under the Clinton administration, before becoming truly explosive under George W. Bush’s presidency from 2001 onwards, when the household savings ratio plummeted to 0.3% of GDP.

1.2. The phenomenon spreads to Europe

While the explosion in household debt in the United States, in the wake of the stagnation of incomes among the majority, is undeniably spectacular, this phenomenon is also to be found, to greater or lesser degrees, in several European Union countries. Thus, on the basis of 2006 data, we find a marked difference between the household debt situations in the European Union major countries.

The United Kingdom and Spain actually have debt levels very comparable to those of the United States. Ireland was reaching similar levels. In these countries, we see the introduction of financial mechanisms very similar to those across the Atlantic, notably where the borrower has the option of using the rise in the market value of his property to increase the level of his debt. This mechanism, known as the ‘rechargeable mortgage’, opens up very high debt-carrying capacities for households during the expansion phase of a property bubble. Its effect is clearly apparent in Spain, where property prices rose by 247 %
between 1997 and 2005\(^7\). As a result the Spanish households debt level leapt from 84 % to more than 100 % of GDP between 2006 and 2007. However, as soon as prices start to stagnate, or even to fall, households come under increasing pressure as they are required either to make an early repayment of some of the additional tranches of the mortgage loan, or to deposit a sum offsetting the fall in value of the mortgaged property with the bank, which issued the loan. The phenomenon may be aggravated by variable-rate mechanisms (which apply to 97 % of Spanish agreements)\(^8\) or delayed interest-rate mechanisms (where the borrower pays interest only for the first 24 or 36 months of the loan, then faces a sharp rise in repayments when he starts to pay off the principal).

Table 1 Household debt as a % of GDP for 2006

<table>
<thead>
<tr>
<th></th>
<th>France</th>
<th>Germany</th>
<th>Spain</th>
<th>United Kingdom</th>
<th>Italy</th>
</tr>
</thead>
<tbody>
<tr>
<td>House</td>
<td>45 %</td>
<td>68 %</td>
<td>84 %</td>
<td>107 %</td>
<td>39 %</td>
</tr>
</tbody>
</table>

Source: National data.

While the British mortgage market has been better regulated than in the United States, the mechanisms here are the same. Household debt stands at 107 % of GDP, and ‘home equity loans’ play the same role as ‘home equity lines of credit’. The mortgage crisis in the UK unfolds in parallel to the figures for the US (IMF, 2008a: 8). Likewise, the household savings ratio is very low and cannot be reduced any further. British households, with their position weakened by liberal policies and much of the population deprived of social protection (Brewer et al., 2005; Paxton and Dixon, 2004), are in fact particularly vulnerable.

Unlike those countries imitating the US system, in both France and Italy we find that household debt remains at much more moderate levels. Nevertheless it should be pointed out that in these two countries, inequality has increased less markedly than elsewhere, and they do not have the strongly ‘pro-cyclical’ mortgage systems based on the US

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model; systems which have proved to be real ‘debt traps’ for the lowest-income households. Here, it should be borne in mind that as UMP president, Nicolas Sarkozy established himself as the champion of the principle of rechargeable mortgages in France.9

However, while household debt levels remain low, we are witnessing an undeniable upward trend, demonstrating that a weakening of the financial position of households is a reality here too, even though it is less marked than in those economies, which have adopted a blatantly very inegalitarian model. The case of France is instructive here. Household debt, which was around 33 % of GDP until 1998, leapt by 12 points in 7 years, to 45 % of GDP in 2006. This degradation in the situation of households in France is also reflected in growing anxiety on the part of the middle classes, who now view their situation as increasingly comparable to that of the underprivileged classes (Bigot, 2007).

Table 2 Trend in the breakdown of added value in France

<table>
<thead>
<tr>
<th>Year</th>
<th>Gross wages and salaries</th>
<th>Gross operating surplus</th>
<th>Operating surplus less tax on production plus operating subsidies</th>
</tr>
</thead>
<tbody>
<tr>
<td>1982</td>
<td>46.5 %</td>
<td>22.7 %</td>
<td>20.3 %</td>
</tr>
<tr>
<td>1987</td>
<td>42.4 %</td>
<td>29.1 %</td>
<td>27.0 %</td>
</tr>
<tr>
<td>1992</td>
<td>41.7 %</td>
<td>30.4 %</td>
<td>27.4 %</td>
</tr>
<tr>
<td>1997</td>
<td>41.9 %</td>
<td>30.4 %</td>
<td>26.5 %</td>
</tr>
<tr>
<td>2002</td>
<td>43.0 %</td>
<td>30.3 %</td>
<td>26.9 %</td>
</tr>
<tr>
<td>2007</td>
<td>42.3 %</td>
<td>31.7 %</td>
<td>28.3 %</td>
</tr>
</tbody>
</table>

Source: INSEE.

This phenomenon is part of a downward trend in the proportion of global added value represented by earnings. In this sense, the experience of France from 1983 onwards, when Finance Minister Jacques Delors imposed the ‘austerity policy shift’ on the socialist government of the day, can be compared very closely with that of the United States under Reagan. Delors, a pro-European socialist, imposed a policy shift on France identical to that which the hard-line conservative Reagan had imposed on the United States, and whose

9. See his declaration at a UMP meeting on 17 March 2005 (http://www.u-m-p.org/site/index.php/umd/s_informer/discours/intervention_de_nicolas_sarkozy_president_de_1_ump).
consequences – in terms of dampening demand and hence increasing unemployment – were felt for many years to come.

Thus between 1982 and 2007, the gross operating surplus rose by 9 points, of which 5.4 are accounted for by the period 1982-1987 alone. A second, less spectacular rise occurred between 1987 and 1992. While the statistical aggregates are not fully comparable between France and the United States, the similarity of the changes taking place over the same period is striking.

We therefore find that in the main industrialised countries, the situation of the majority of households, and especially those with the lowest incomes, has deteriorated. The degradation was first of all relative, in the 1980s, under the influence of ‘supply-side policies’ and the US example. It then became absolute in a number of countries from the late 1990s onwards. This led to an explosion in household debt which, coupled with growing insolvency among households, produced chains of poor quality or ‘toxic’ debt. These then contaminated the balance sheets of banks and financial institutions. Thus it is important to understand what provoked the sudden deterioration witnessed in the late 1990s, which transformed a latent crisis into an open crisis during the course of 2007.

2. **The crisis, an effect of globalisation**

The change experienced in the 1990s, which unleashed all its consequences at the end of the decade, has a name: globalisation. This word conceals two important realities: the spread of free trade and the financialisation of economies, made possible by a liberalisation and deregulation of the financial markets now taking place in the main developed countries.

2.1. **The role of free trade**

The contraction of wage incomes in industry, which used to act as a benchmark for global trends in earnings, is linked to wage deflation imported via free trade. This process has played an important role, as pressure on wage levels is much stronger in sectors open to competition
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from the developing countries (mainly China and the Far Eastern countries, but also the ‘new Member States’ in the context of the EU, and Mexico within NAFTA) (Bivens, 2007). The correlation between downward pressure on wages and free trade is now well established. Even Paul Krugman, who only a few years ago was still telling us that ‘globalisation is not guilty’, now has to admit it (Krugman, 2007).

Clearly, the most spectacular form is the phenomenon of industrial activities relocating to countries with low wage costs and light-touch social or environmental regulations. Even so, this spectacular form is not the most significant one. Pressure on wage levels in companies, which have not relocated, and blackmail applied to workers and their unions in an attempt to force them to give up social gains, constitute the most significant forms of wage deflation.

The origin of this deflation lies in predatory policies in international trade, which have been implemented in the Far Eastern countries since 1998-2000. These policies, via the context of widespread free trade promoted by the WTO – and which the G-20 summit participants just plan to maintain – have triggered a powerful effect of wage deflation in the developed countries. Imported wage deflation has also taken on a particular dimension in the context of the EU, with the enlargement process. The countries newly admitted to the EU are characterised by less restrictive social and environmental systems, and low levels of pay, which are frequently lower still due to the under-valuation of their currencies in relation to the euro.

In point of fact, even before it was completed, the accession process gave rise to significant inward investment in these countries, enabling them to achieve major productivity gains. In these circumstances, and in the absence of alignment with the social and environmental standards of the countries making up the EU’s ‘historical core’, the convergence between productivity levels in industry generated by the direct investment flows before and after the accession process has been accompanied by a phenomenon of social and environmental dumping on a massive scale. This has a particularly severe effect in terms of exacerbating wage deflation.

This wage deflation has also been strongly exacerbated by the sudden emergence and domination of financial logic within companies making
up the real sector of the economy, via leveraged buy-out (LBO) procedures. These procedures have seen financial logic, with its requirement for very high rates of return, take precedence over other criteria within the real economy. Companies subject to LBOs find themselves under pressure to achieve profitability levels of 10% or more per annum. However, other than in exceptional circumstances, it is impossible to secure such high returns in industry without exerting growing pressure on the wage levels and working conditions of employees. This has significant consequences for the trend in both direct and indirect earnings, as well as for the health and well-being of employees.

One of the effects of wage deflation, whether due to the effects of free trade or financialisation, is in fact an increase in the number of illnesses caused by stress in the work-place, resulting from employees coming under growing pressure, exerted via a combination of financial logic and blackmail based on the threat of relocation (DARES, 2000 and Legeron, 2001).

While it has been confirmed that these illnesses have a medical cost of 3% of GDP\textsuperscript{10}, the link between the logic of wage deflation – derived from a combination of the effects of free trade and financialisation – and the deterioration in the social accounts of France and the main European countries appears to be well established. This has a major macroeconomic dimension. In point of fact, it is the drift (or apparent drift) in the social accounts which various governments have used as a pretext to row back on a number of rights, thus transferring the costs onto employees. Hence demand is squeezed even further and the conditions for depressed levels of economic activity are reproduced.

\textsuperscript{10} The figure put forward for Sweden and Switzerland on the basis of extensive epidemiological investigations (which are tragically lacking in France): Niedhammer et al. (1998). As far as France is concerned, a limited investigation provides convincing results regarding the scale of the phenomenon: Bejean et al. (2004).
2.2. The specific role played by financialisation in the crisis

The financialisation of economies has not just been a national-level phenomenon. In essence, it has been a global change in the rules of the game at international level imposed by the United States, to which the European Union has capitulated, via European directives on financial services, with astounding ease. The EU, far from being a protective mechanism, has been an aggravating factor here.

It was the United States which put pressure on the IMF to include in its Articles of Agreement an obligation covering capital account convertibility (Polak, 1998), where previously there had only been current account convertibility – which Keynes had fought with all his failing strength to defend. Yet the difference between the two notions is a critical one. In the second case, the emphasis is placed on currency flows covering genuine transactions, trade in goods and services, flows relating to tourism or corresponding to the repatriation of migrants’ income. Under the first notion, all portfolio operations and all possible speculative instruments become authorised. The IMF now acknowledges that these financial flows do not in any way favour the growth of developing countries (Prasad, 2007).

Ten years earlier Dani Rodrik, whose voice was neither heard nor even listened to (Rodrik, 1998), demonstrated it. Similarly, the IMF promoted the idea of opening up all financial markets to financial innovations, which in its view justified the total liberalisation of capital movements recently blessed once more by the G-20 summit held on 15 November. In 2008, here too, the IMF acknowledged its error – somewhat late in the day – and its annual report on the stability of the financial system states the following: ‘... certain complex and multi-level products have added little economic value to the financial system. What is more, in all likelihood they have exacerbated both the depth and the length of the crisis’ (IMF, 2008b: 54).

In the United States itself, financial liberalisation played a key role in the development of subprime and Alt-A mortgages, which, as we have seen, were the products that triggered off the crisis. The role played by these ‘at risk’ segments in the US financial structure has developed strongly because of one particular financial innovation: the Credit Default Swap or CDS. The purchaser of a CDS pays a regular (annual or
monthly) premium in return for a guarantee covering a credit risk on a given amount. The seller thus assumes the risk, in return for income, and bears a loss in the event of default on the loan, which he has agreed to insure. Thus the CDS is akin to an insurance policy, but it may be provided by other financial entities than insurance companies, as technically it is a financial instrument comparable to an option contract. It corresponds to a securitisation of a risk outside the normal framework of insurance markets.

CDS lead to a marked reduction in agents’ perception of risk. Their rapid development was accompanied by that of financial instruments based on a similar logic, such as Collateralised Debt Obligations or CDO, and Collateralised Loan Obligations or CLO, which associate a debt with a particular item of collateral security and thus reduce the credit risk, to the extent that the asset used as security is reliable. These instruments have enabled banks and various financial operators to accept increasingly high-risk positions within their portfolios. The development of Mortgage Based Securities or MBS has made a powerful contribution to the development of the mortgage market since 1998, but also to growing risk-taking. In 2007, the risks ‘insured’ by CDS reached the equivalent of $45.5 trillion, with an increase of 9 to 1 for the past 3 years\textsuperscript{11}. The role played by rating agencies, which were very lax in the way they awarded an AAA rating to these instruments, also enabled the latter to be disseminated extremely rapidly. The explosion in credit derivative instruments has been spectacular indeed\textsuperscript{12}. From a virtually non-existent level in 1998, they reached 1,500 billion in 2002, 8,500 billion in 2004, 17,000 billion in 2005 and 34,500 billion in 2006. They reached a level of around 46,000 billion in 2007.

CDS were used on a massive scale to ‘insure’ risks in the subprime, Alt-A and Jumbo segments, and as a result the mechanics of mortgage lending raced out of control. In order to meet the demands of their customers, the banks developed CDO (with real-estate products as collateral covering securities operations). The result was a ‘transformation

\textsuperscript{11} JP Morgan Corporate Quantitative Research, Credit Derivatives Handbook, JP Morgan, New York, December 2006, p. 6

of base metal into gold’, or more precisely high-risk loans into financial instruments which were ostensibly risk-free and offered high rates of return. This created an acute lack of transparency between the initial risk-taking (mortgage lending to borrowers on relatively low incomes) and the ultimate owner of the financial instruments.

2.3. The logic underlying the crisis

We can now establish the link extending from international chaos to the deterioration in the situation of employees in the developed countries (wage deflation), and from there to the international financial crisis, which was to result, sadly, in a further worsening of the social situation.

The 1997-1999 crisis, which ravaged emerging countries, from Korea via Russia to Brazil, was one of the consequences of financial liberalisation at global level. It was the outcome of the application of neo-liberal policies derived from the United States to the international financial system, and marked a regime change in the international financial order (Sapir, 2008).

The IMF’s inability to deal with the crisis left many countries powerless. This led them, especially in the Far East, where the crisis hit particularly hard, to build up excessive hard currency reserves in order to protect themselves against this instability. This policy has a significant internal cost, which could be avoided if we had a less dysfunctional international financial system (Rodrik, 2006). The growth of the countries committed to this strategy could have been balanced more effectively, on both a social and environmental level. However, there is also a cost to the system as a whole, and it is this that leads us to the present crisis, as can be seen in Figure 3, summarising the series of interlinked factors which produced it.

To enable them to accumulate hard currency in the desired quantities, these countries would develop predatory policies in international trade, implemented by way of drastic devaluations, competitive deflation policies and by limiting their domestic consumption. In so doing, they set in motion the process of wage deflation in the developed countries and suddenly worsened the American trade deficit.
Figure 3: The international crisis: a series of interlinked factors
As with the trend in mortgage debt, 1998 marks a turning point between two distinct ways of economic thinking. The trade deficit, which on average used to be -1% of GDP, suddenly leapt to -5.5% of GDP on average between 2003 and 2007.

Table 3 Exchange reserves at 31 August 2008

<table>
<thead>
<tr>
<th>Amount in $ billions</th>
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<tbody>
<tr>
<td>People’s Republic of China</td>
</tr>
<tr>
<td>Hong Kong (*)</td>
</tr>
<tr>
<td>Taiwan</td>
</tr>
<tr>
<td>South Korea</td>
</tr>
<tr>
<td>Singapore</td>
</tr>
<tr>
<td>Total Far East emerging countries</td>
</tr>
<tr>
<td>Japan</td>
</tr>
<tr>
<td>Total Far East</td>
</tr>
<tr>
<td>India</td>
</tr>
<tr>
<td>Brazil</td>
</tr>
<tr>
<td>Russia</td>
</tr>
<tr>
<td>Total BRIC</td>
</tr>
<tr>
<td>People’s Republic of China</td>
</tr>
</tbody>
</table>

* Hong Kong is accounted for separately from the PRC here. Source: IMF.

The strategy of growth powered by internal debt thus logically generates external debt as a consequence. The circulation of US debts among non-resident players becomes the operating condition on which the system relies: it speeds up the process of spreading the risks contained in these debts. The US trade deficit constitutes one of the foundations on which the surplus of the Asian countries is built. The inflow of hard currency should prompt a rise in the exchange rates of the currencies of the countries concerned. In order to maintain their predatory policies, these countries have no alternative but to sterilise many of their gains. The central banks of the countries in question then purchase dollars (and euros) on a huge scale and their hard currency reserves increase massively (see Table 3), which was indeed the initial objective.

Thus the exchange reserves in place on the eve of the shock caused by the international liquidity crisis of September-October 2008 were substantial. China held 69% of the total reserves of the emerging economies of South-East Asia and 3.4 times the reserves of the euro zone. Some of the other gains would be sterilised through taxation. The budget surplus would then fuel the emergence of sovereign funds.
The pressure of wage deflation has also been felt in Europe. Here, for the countries of the euro zone, it was combined with the high-interest-rate policy pursued by the ECB, which added its weight to the imported forces depressing the economy (Bibow, 2007). Faced with this situation, we see a fragmentation of the European ‘model’ around three directions, which we shall call here the eurodivergence process.

Some countries followed the US example (Spain, United Kingdom, Ireland). They adopted the neo-liberal model of an open financialised economy, and tried to maintain growth through recourse to high levels of household debt. In 2007, this exceeded 100 % of GDP in Spain and the UK. This economic model triggered a sharp rise in social inequality. This model was just as unsustainable in the long term as the US model, and countries one can regard as ‘clones’ of this model are now suffering from the same ills. The United Kingdom and Ireland have experienced a mortgage crisis whose violence was comparable to that of the US crisis, and this crisis immediately contaminated the entire banking system of these countries. The UK was forced to nationalise some of its banks in order to prevent a collapse. These two countries look set to experience a very severe recession in 2009 and probably 2010.

Germany, for its part, reacted with a neo-mercantilist policy, characterised by a massive relocation of subcontracting, while maintaining assembly work in Germany. Thus the opening up of the European Union to the countries of Central and Eastern Europe has resulted in a transition from the logic of ‘Made in Germany’ to that of ‘Made by Germany’. At the same time, the German government has transferred some of the charges burdening companies onto households (via VAT).

This strategy has made it possible to maintain a large trade surplus at the cost of low growth, due to depressed domestic demand. Germany’s growth would have been lower still without a worrying rise, here too, in household debt, which reached 68 % of GDP. The German ‘model’ thus combines elements of the US model (pressure on household incomes and a significant degree of financialisation of the economy) and elements of the Asian model (a mercantilist approach based on cutting costs and domestic demand). It is by no means certain that this combination will actually be coherent in the medium and long term. Germany, as we now see, has suddenly been caught up in the crisis. German banks are among those suffering the most in Europe from the
financial crisis and incurring the heaviest losses. The contraction in economic activity looks set to be severe, as heralded by the collapse in business leaders’ confidence since spring 2008.

This explains why debt structures differ so much in Europe, with those of Spain and the United Kingdom being comparable to the United States, while those of France and Italy are significantly different, and Germany occupies an intermediate position.

Figure 4 Comparison of European and US debt models
(2006 data as a % GDP)

Clearly, in these circumstances, seeking to devise a common policy at European Union level is to attempt the impossible. The fact that the process of eurodivergence is gaining ground, even and including within the euro zone (Angeloni and Ehrmann, 2007: 31; Gali et al., 2001; Conrad and Karanasos, 2005), should prompt us to think seriously about the effectiveness and pertinence of the European institutions, in their current state. While joining the EU has permitted some forms of convergence primarily triggered by capital movements, the economic dynamics of the countries in question often remain sharply divergent.
Table 4 Comparison of total debt in 2006

<table>
<thead>
<tr>
<th>Country</th>
<th>Total debt as a % of GDP</th>
<th>Including public debt as a % of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>France</td>
<td>181 %</td>
<td>63 %</td>
</tr>
<tr>
<td>Germany</td>
<td>192 %</td>
<td>67 %</td>
</tr>
<tr>
<td>Spain</td>
<td>227 %</td>
<td>39 %</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>224 %</td>
<td>39 %</td>
</tr>
<tr>
<td>Italy</td>
<td>208 %</td>
<td>106 %</td>
</tr>
</tbody>
</table>

Source: ECB and national accounts.

Thus the euro is not eliminating national divergences (de Lucia, 2008), nor is it slowing down the disintegration of the European social model. This is not because the euro was a bad idea in itself right from the outset, but above all because it was a mistake to apply the principle of the single currency to a group of economies with widely differing structures – and hence economic situations – without having the means to rapidly harmonise these structures (Sapir, 2006). In point of fact, no such means exist. It follows that there cannot be a single monetary policy for all of the countries concerned. Thus, the strong euro is already heavily penalising the French economy, a situation confirmed by a recent INSEE study which estimated the net cost of the overvaluation of the euro at 0.6%-1% of GDP growth (Cachia, 2008).

In the context of the current crisis, the euro has prevented erratic exchange rates fluctuations in Europe and, as a consequence, equally erratic movements in interest rates. It is clear that if the euro had not existed in a context of total liberalisation of capital flows, the acute phase of the autumn 2008 financial crisis would have been accompanied by violent speculation on exchange rates. To combat this, the monetary authorities in some countries would have been forced either to raise interest rates in a way which would have been at odds with the needs of banks and the real economy, or to accept substantial falls in exchange rates. The advocates of the euro are right about this point. However, the euro’s advocates should acknowledge that a similar result could have been obtained by policies implementing exchange controls.

and control over short-term circulation of capital. The current means of supervising electronic settlement and transaction operations provide much more effective control than was the case a few decades ago. Moreover, the regulations and legislation aimed at combating organised crime and money-laundering have created a legal framework which strictly limits any transactions taking place outside the scope of electronic systems which can be placed under supervision. We must therefore conclude that an alternative institutional framework could have played the very protective role euro played.

The view should also now be taken that the absence of flexibility implied by a single currency, which denies participant countries the option of devaluation even when the dynamics of inflation are excessively divergent for structural reasons, could prove to be an insurmountable obstacle if the recession were to deepen during 2009 and early 2010. The euro single currency system implies that the global inflation rate should be low, in order not to provoke excessive distortions between member countries. In this sense, the obsession of the ECB and its president with combating inflation is not without justification. If the economies of the euro zone were to switch over to a more inflationary logic than is the case today, the inflation differentials between member countries would certainly be greater and might become intolerable. The lower inflation is overall, the more any potential differentials are reduced, limiting the risk of damage to competitiveness.

Any such damage will be all the greater in that the economic structures of the euro zone countries vary significantly and, as already indicated, are experiencing a phenomenon of divergence. Contrary to the hopes of its promoters, the euro has not succeeded in harmonising economic structures. Even advocates of the euro should acknowledge this fact.\(^{14}\)

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14. It should be emphasised here that Michel Aglietta is one advocate of the euro who has had the courage to acknowledge that the single currency has not led to an alignment of the member countries’ economies (Aglietta, 2004: 237 and 240).
Conclusion

There should consequently be no doubt that the crisis we are passing through will be a profound one. It is illusory to believe that we will be able to emerge from it simply by cutting interest rates – a move that is necessary but not sufficient – and through limited recovery plans. Both in Europe and in the United States, unemployment is set to rise sharply.

Table 5 Trend in unemployment rates as a % of the working population

<table>
<thead>
<tr>
<th></th>
<th>Germany</th>
<th>France</th>
<th>Italy</th>
<th>Spain</th>
<th>United States</th>
</tr>
</thead>
<tbody>
<tr>
<td>2007</td>
<td>8.38 %</td>
<td>8.31 %</td>
<td>6.15 %</td>
<td>8.26 %</td>
<td>4.70 %</td>
</tr>
<tr>
<td>2008 (estimates)</td>
<td>9.10 %</td>
<td>8.90 %</td>
<td>7.10 %</td>
<td>11.40 %</td>
<td>7.20 %</td>
</tr>
<tr>
<td>2009 (forecasts)</td>
<td>10.40 %</td>
<td>9.50 %</td>
<td>8.10 %</td>
<td>15.00 %</td>
<td>9.50 %</td>
</tr>
<tr>
<td>Estimated increase from 2007 to 2009</td>
<td>24.10 %</td>
<td>19.20 %</td>
<td>31.70 %</td>
<td>56.10 %</td>
<td>102.10 %</td>
</tr>
</tbody>
</table>

Sources: Eurostat, US Dptmt of Labor and ECB data for 2007; estimates published by the authorities in November and December 2008 for 2008, except for the United States, where the figure is that given on 9 January 2009 by the US Bureau of Labor Statistics; ‘pooling’ of forecasts among a panel of experts for 2009. Note: In the case of Italy, Spain and the United States, the existence in 2007 of a substantial amount of undeclared labour, especially in the construction sector, means that the rise in unemployment is underestimated. It is a fact that ‘undeclared’ workers are the first to lose their jobs during the crisis, but this cannot be taken into account in the official data.

The international monetary and financial chaos, which resulted from the breakdown of the framework derived from Bretton Woods thus bears a significant degree of responsibility for the accumulation of factors bringing about the current crisis. From the switch made by the Asian countries (referred to in Figure 3 as the ‘Asian mercantilist bloc’) to predatory policies in reaction to the 1998 crisis, to the deployment of a purely speculative approach to finance in the United States and finally to the process of eurodivergence provoked by the impact of wage deflation, interlinked events are both unfolding in parallel and tending to reinforce one another.

The crisis we are living through is like a mutant virus. It was the product of a crisis in wealth distribution in the developed countries, and in the first instance within US and UK neo-liberal capitalism, and it then mutated into a banking crisis. This in turn mutated into a financial crisis and subsequently into a liquidity crisis during the crazy weeks of autumn 2008. The crisis then underwent a further mutation, as it evolved into a serious crisis for the real economy, notably in the
construction industry and the car industry. From the real economy, this crisis is set to mutate once more and return to the world of finance. As major companies go into bankruptcy, chains of credit default swaps will be activated, and those companies’ debts will lose their value. This development will further weaken the situation of the banks and financial institutions purchasing and securitising those debts.

We shall only emerge from the crisis by putting an end to factors generating the wage deflation, i.e. by re-establishing modes of distribution more favourable to employees. This means re-introducing protectionist measures and banning social and environmental dumping practices within the EU, and if necessary re-introducing monetary compensatory amounts to deal with countries which have such practices. However, to ensure that predatory practices are no longer needed in international trade, we shall have to put an end to the systemic instability of the international monetary system. Doing so will inevitably involve the re-instatement of measures to control capital movements and exchange controls. Any other policy would be either feckless or hypocritical.

References


World Economy: Global Player or Global Drag?, New York (NY), Palgrave Macmillan, pp125-147.


