

THE EUROPEAN SOVEREIGN DEBT CRISIS (2009-2010): THE ROLE OF CONFIDENCE AND OTHER SOCIAL FACTORS

LA CRISIS DE LA DEUDA SOBERANA EUROPEA (2009-2010): EL PAPEL DE LA CONFIANZA Y OTROS FACTORES SOCIALES

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ABSTRACT

In this paper I analyze the second phase of the current financial crisis or the events that rocked the European economies in 2009-2010. These events were set off by Greece's declaration in October 2009 that its deficit would be much higher than what had previously been announced; and it culminated in the May 2010 crisis, when EU put together a fund of a trillion dollar in order to calm the markets. The crisis is currently ongoing (and my paper takes it up till November 2010). The European sovereign debt crisis is primarily analyzed with the help of a sociological theory of confidence. The argument is (drawing on Bagehot) that financial crises may be unleashed by the sudden disclosure of hidden losses - in this case (as I document) the disclosure of Greece.

KEYWORDS

Financial crisis, Eurozone, sovereign debt crisis, Greece.

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1. Introduction. 2. The role of confidence in finance. 3. The trigger of sovereign debt in Europe: The hidden losses of Greece. 4. How EU managed the Greek crisis. 5. The peak of the European debt crisis (late April - early May 2010). 6. Concluding Remarks. References.

RESUMEN

En el presente trabajo analizo la segunda fase de la actual crisis financiera o los acontecimientos que conmocionaron a las economías europeas en el período 2009-2010. Estos hechos tuvieron el punto de inicio con la declaración sobre Grecia en octubre de 2009 en la que se decía que el déficit sería mucho mayor de lo que había sido anunciado previamente, y que culminó en la crisis de mayo de 2010, cuando la UE creó un fondo de un trillón de dólares con el fin de tranquilizar a los mercados. Actualmente, la crisis sigue su curso (aunque aquí se trata hasta noviembre de 2010). La crisis de la deuda soberana europea es principalmente analizada con la ayuda de la teoría sociológica de la confianza. El argumento es (basándome en Bagehot) que las crisis financieras pueden ser desencadenadas por la revelación súbita de pérdidas ocultas - en este caso (como trato de documentar) la divulgación de Grecia.

PALABRAS CLAVE

Crisis financiera, eurozona, crisis deuda soberana, Grecia.

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1. INTRODUCTION

The financial crisis started in the United States in the fall of 2008 and quickly spread abroad. While the center of the crisis was initially in the United States, severe damage was soon also done to the financial systems in many other countries. This is especially true for Europe which in early May 2010 experienced a systemic crisis that threatened to spread globally. EU quickly put together a one trillion dollar facility (750 bn EURO) - and the situation was saved for the moment. During the rest of 2010, however, the situation worsened for countries such as Greece and a few other countries which today are close to bankruptcy (November 2010). Since these countries are also members of the so-called Eurozone, which has sixteen member countries all in all, their troubles can quickly spread to Europe as a whole.

While the first phase of the financial crisis involved banks and other financial institutions, primarily in the United States, the later phase is centered around states, primarily in Europe. Both phases also involve *confidence*, in the sense that in both of these crisis investors suddenly lost confidence in the capacity of financial institutions and state to honor their economic obligations, with devastating results. In both the United States and Europe the post-crisis situations have similarly been centered around reestablishing confidence, and in this way get their respective economies going.

In this paper I try to investigate exactly which role that confidence has played in the second phase of the financial crisis, which is also known as the European Sovereign Debt Crisis. I have earlier analyzed the role that confidence played in the first or American phase of the financial crisis; and this paper is to be seen as a further exploration and deepening of that analysis (Swedberg, 2010a). Confidence, I argue, plays a key role in economic life; and what characterizes financial crises is, for one thing, that confidence suddenly evaporates. Confidence, in other words, is of importance for an understanding of the dynamic of financial crises. This goes for confidence in financial actors (explored in Swedberg, 2010a) as well as in states (explored in this paper).

2. THE ROLE OF CONFIDENCE IN FINANCE

When one looks at the role of confidence in economic life, it soon becomes clear that there does not exist one generally accepted theory of confidence, be it among scholars in sociology or in economics (Swedberg, 2010b). Nonetheless, scholars such as Simmel in sociology and Keynes in economics have strongly argued that confidence plays a crucial role in economic life (Simmel, 1978:178-79, 480; Keynes, 1936: Ch. 12). Recently there has also been somewhat of a surge of interest in the topic (Swedberg, 2010b). The key idea is that many economic actions leave the actor vulnerable to other actors; and that unless there is confidence, there will be no interaction in many cases.

This is more of a description of the role of confidence than an analytical take on the subject, but it can suffice for the moment. I also want to emphasize that certain economic actors are active in what may be called confidence intensive areas of the economy. One such area is deposit banking; and the reason is that this type of bank borrows its resources in the form of deposits, without specifying the time when these can be withdrawn, while they lend them out with a specific deadline. The depositors, in brief, can withdraw their resources at any moment, say when their confidence in the bank is low. Something similar is also true for many modern financial institutions, including investment banks of the U.S. type. Also these modern financial institutions borrow funds on a short-term basis, and invest them on a long-term basis, making them vulnerable to sudden demands by their creditors.

In the empirical case of this paper, some of the main economic actors, besides banks and other financial institutions, are states; and while these are not confidence intensive institutions, they similarly rely on confidence in their economic activities. But there exist important differences. It is, for example, hard for market actors to determine when a state is worthy of confidence and when it is not. How is one to decide the value of a bond issued by a state, such as a member of the Eurozone? Shall one look at the rate of debt in relation to the budget of the state, in relation to the country's GDP or what? How do protests by the population affect the valuation? What difference does it make if the Eurozone countries operate as a unity and back up the debts of a member country or if countries like Greece or Ireland are left to fend for themselves?

Looking at the role of states, it is also clear that the way that confidence is *managed* becomes an important topic. When Trichet, the powerful head of the European Central Bank, makes a public statement about the situation, say, of the banks in Greece, is he describing their economic situation or is he managing confidence? Depending on the answer, investors may wish to buy or sell. The blatant way in which the notion of confidence has been used to justify the attempts to fight the financial crisis through budget cuts, has also made some economist refer disparagingly about a belief in some mythical "confidence fairy". All you have to do is to say that your policy will create confidence and thereby economic growth (Krugman, 2010a, b; Stiglitz, 2010; cf. Romer, 2010, Soros, 2010a).

An important part of the argument in this paper will finally be played by a theory of the way that financial crises can be triggered by a loss of confidence. It draws on an idea in a classic study in the finance literature that is often mentioned when financial panics are discussed, namely *Lombard Street* (1873) by Walter Bagehot. It is in this very work, for example, that one finds the famous piece of advice for how central banks are supposed to operate in moments of crises, namely to infuse huge amounts of credit into the system ("spend freely").

What is often not mentioned is that *Lombard Street* also contains a very interesting theory of what may trigger a financial crisis. According to Bagehot, a whole economic system can be brought down by *hidden costs*. Nothing unnerves investors and depositors so much, he argues, as the sudden discovery that a bank has huge hidden losses. The key passage in *Lombard Street* reads as follows:

We should cease...to be surprised at the sudden panics [in the banking system]. During the period of reaction and adversity, just even at the last instant of prosperity, the whole structure is delicate. "The peculiar essence of our banking system is an unprecedented trust between man

and man; and when that trust is much weakened by hidden causes, a small accident may greatly hurt it, and a great accident for a moment may almost destroy it". (Bagehot, 1922:151-52; emphasis added)

The dynamics of a run-on-the-bank has been nicely formulated by Robert K. Merton in his essay "The Self-fulfilling Prophecy" (Merton, 1968). A bank becomes insolvent when it is seen as insolvent by the depositors, who, in acting on the belief that it is insolvent, will end up making it so - even if the bank was perfectly sound to start out with (Merton, 1968). Bagehot, in a complementary fashion, has explained what triggers a whole financial panic: there is a sudden loss of confidence which comes about when hidden losses are suddenly discovered; and this unnerves investors.

While both Merton and Bagehot realized how central confidence is in economic life, neither of them defines what constitutes confidence. Neither can one say that the issue of confidence has attracted much interest among economists or that there is consensus in whatever little literature there is on the topic (Swedberg, 2010b). I will therefore suggest my own theory of confidence; and as my point of departure I will use a statement by Mancur Olson.

Confidence, Mancur Olson once said in an interview, is all pervasive in society as well as in the economy. When I for example walk on a pavement, he continued, I put down my feet in the belief that what I take to be solid concrete, is indeed solid concrete, and not, say, a piece of paper painted to look like concrete (Olson, 1990:178).

Olson's seemingly trivial example brings to mind a comment that can be found in *Philosophical Investigations*. Wittgenstein makes more or less the same point as Olson, but also adds that confidence is closely linked to action. He says,

"When I sat down on this chair, of course I believed it would bear me. I had no thought of its possibly collapsing ... The feeling of confidence. How is this manifested in behavior?" (Wittgenstein, 1978: 577, 579)

What unites these two ways of looking at confidence is that confidence is seen as consisting of what can be called a double structure. There is, on the one hand, the actual issue that the actor is concerned with (that the sidewalk is strong enough to walk on or that the chair is strong enough to sit on). There also exists, on the other hand, something that indicates that this is indeed the case to the person who is doing the walking or about to sit down. This indicator can be conceptualized as a *sign* that stands in for something else - what I will call a *proxy sign*. From this perspective, confidence can be conceptualized as something that you need to have in order to act, in situations where you lack accurate information and must rely on signs instead.

The proxy sign can either correctly indicate the actual situation or not (see Fig. 1). In the former case, the sign can either indicate that the situation is positive, and the situation *is* positive (+/+). Or the sign can indicate that the situation is negative, and so it is (-/-). The sign tells us that the sidewalk or the chair is sturdy,

and so it is. Or that it is not sturdy, and it is not. In both cases the actor can have full confidence in the situation and adjust his or behavior accordingly.

Fig.1. Proxy Signs and the Nature of Confidence

		The Economic Situation is	
		Positive	Negative
Proxy Sign Indicating the Economic Situation is	Positive	+ + + -	
	Negative	- + - -	

Comment:

Confidence can be defined as an actor’s readiness to base the decision to act on *proxy signs*, in situations where the actor lacks access to better information. A proxy sign be either aligned with the state of affairs or not. In the former case, a positive proxy sign correctly indicates a positive state of affairs; and a negative sign correctly indicates a negative state of affairs. Confidence is maintained in both of these cases, since the actor has correct information (++/--). When, in contrast, the proxy sign and the situation are misaligned, and the proxy sign consequently misrepresent the situation, confidence will suffer.

If the proxy sign is negative, and the state of affairs positive; and this is applied to the situation of a bank, one may get a run on the bank along the lines that Robert K. Merton has outlined in his essay on self-fulfilling prophecy (Merton, 1968). When the proxy sign is positive, and the state of affairs negative in the banking community, one in contrast gets a case that is closer to the dangerous situation that is described by Walter Bagehot in *Lombard Street* (1873).

But when the proxy sign and the situation are *not* aligned, there will be trouble (-/+; +/-). Merton describes what happens when the sign is negative and the situation is positive (-/+); there is a rumor that a bank is not solvent, while in reality it is solvent. And Bagehot describes the very opposite case: the sign is positive and the situation negative (+/-). A bank appears to be solvent but has in reality hidden losses. In the case of Merton we may want to speak of a loss of confidence due to incorrect information; and in the case of Bagehot, of *false confidence*. Typically the two go together in a crisis: a situation à la Bagehot may trigger the crisis, while healthy banks are drawn into the turmoil along the lines of Merton.

3. THE TRIGGER OF THE SOVEREIGN DEBT CRISIS IN EUROPE: THE HIDDEN LOSSES OF GREECE

It is often said that Greece set off the European sovereign debt crisis in the fall of 2009. Still, one is justified in asking how this could be done:

“Looking at Europe from afar, it must be difficult to understand the Eurozone crisis. How could a small nation’s refinancing difficulties - Greece constitutes only 2% of the Eurozone GDP - trigger a systemic crisis for the euro that brought global financial markets to the brink?” (Baldwin and Gros, 2010:1).

In discussing what set off the European sovereign debt crisis (rather than what caused it), this article will suggest that it had to do with hidden losses. More precisely, the trigger was the disclosure in late October 2009 that the projected budget deficit of Greece for 2009 (calculated as a percentage of GDP) was going to be several times larger than what the government had earlier reported. This disclosure made investors suddenly realize with a shock that Greece was in deep trouble.

Before looking at what happened in the Greek case in more detail, it should be noted that information about the economic situation of a corporation or a country (a proxy sign in our terminology) is often linked to very strong economic interests. If the proxy signs are wrong, the consequences can be enormous; and this affects the way that the knowledge of this type is disseminated and made known. When there are losses in a firm or a country, there exist very strong interests to let these remain unknown, so that the firm or the country can continue to get credit at a low rate or, in very serious cases, just continue to exist. Still, there is often talk and gossip.

What all of this adds up to is a very complex situation, which is difficult for a researcher to document. Secrets are difficult to study and so are rumors. There exist, for example, no studies yet of the role that hidden losses have played in the case of Greece; and the account that follows makes no claim to be complete.

The following is approximately what happened. On October 21, 2009 the newly elected Greek government announced to the EU Commission that its projected budget deficit (in relation to GDP) for 2009 was three times larger than what its predecessor had claimed a few months back. The projected budget deficit was suddenly adjusted from 3.7 % to 12.5 %, according to the figures of the PASOK government. This also meant that it was four times higher than what was allowed according to the Maastricht Treaty.

The press, including *Financial Times*, had disclosed this information one day before the report of the European Commission was published, something that illustrates the fact that secret information is often whispered and known by some actors before it gets officially announced (Barber 2009). It was also later reported that a secret memo had circulated in EU circles already in July, according to which the Greek deficit was likely to be more than 10% (Barber, 2010d; cf. de Gruyter, 2009).

In the report of the European Commission that was made public on October 21, it was said that while EU countries practically never had made major revisions in their statistics, the Greek government had done so on several occasions (Alloway, 2010). Eurostat, the statistical agency of EU, had been struggling with the issue of inaccurate Greek data for years; it had made more than ten visits to the Greek Statistical Agency (ELSTAT); and on five occasions it had made public reservations about the data. The new incidence, the report concluded, testified to “the lack of quality of Greek statistics”.

In December 2009 the figure of 12.5 % was revised to 12.7 %. The Greek Prime Minister promised to reform the Greek Statistical Agency. He also stated that “we have suffered a complete loss of credibility” and that this was the reason why Greece was in such trouble. “Many of our problems have less to do with the absolute figures as with the fact that

nobody believes us because our statistics are not correct” (Spiegelonlineinternational, 2009a).

In early January 2010 it was time for another revision, this time from 12.7% to 13.6%. Within a few days this was followed by another report on the problem of Greek statistics by the European Commission. This time the report spoke of “deliberate misreporting” of data by the Greek government, and added that Eurostat had “major doubts” about the current figures (European Commission, 2010). The main reason for the poor state of Greek statistics, it was noted, had to do with “institutional weaknesses”. The Greek government responded by stating that the misleading statistics had come from the government which PASOK had replaced after its electoral victory in October 2009 (Barber, 2010b).

No revisions were made during the month of February, but there were rumors in the international press that the Greek government had used credit default swaps and similar financial instruments to hide some of its deficit; and that it had been helped by Goldman Sachs in this. The American investment bank was at the time seen as the incarnation of the evil speculator. As things turned out, Goldman Sachs and some other financial firms had indeed helped the Greek government to hide expenses - but this was several years ago, it was reported in the press (e.g. Story et al., 2010). And with this, the issue of using secret financial deals to hide the extent of the Greek deficit disappeared from public view.

In April 2010 another revision of the figures for 2009 was made. This time Eurostat suggested that the correct figure was probably higher than 14 %. The history of the hidden losses of Greece can consequently, so far, be summarized as follows. What had started out as a projected deficit of 3.7 % had first been revised to 12.5 % (October 2009), then to 12.7 % (December 2009), to 13.6 % (January 2010) and finally to more than 14 % (April 2010).

By the summer of 2010 it appeared that the revisions of the Greek debt were over for good. In early September, however, the Director-General of Eurostat announced in an interview that Greece had still not produced the full record of the ways in which it had been helped by Goldman Sachs and other financial institutions to hide its debt (Katz and Martinuzzi 2010). Already in 2008, it was now disclosed, some member states of the Eurozone had been asked to disclose swaps and similar deals they had used for this purpose. All countries complied, except for Greece. This request was repeated in early 2010, the Director-General of Eurostat continued, when there were rumors that Goldman Sachs had helped Greece to hide its debt - but Greece has yet to hand in all the records. That this could lead to another revision is clear from the fact that the 2001 deal that Goldman Sachs owed up to, reduced Greece’s debt in relation to GDP with 1.6 %. The day after the interview, it can be added, the finance minister of Greece stated: “The statistics now reflect the guarantees which have been called, they reflect swaps that were not reflected and there is a clear and complete break with past practices” (Petrakis, 2010).

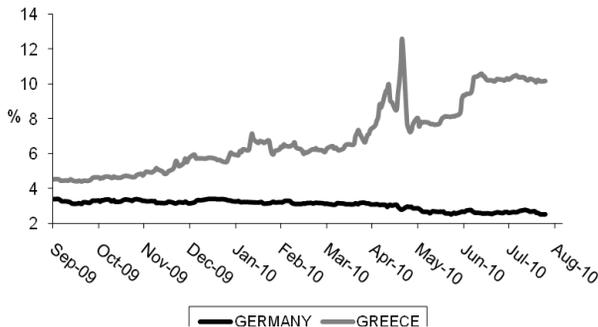
In mid-November Eurostat, after lengthy investigations in Greece, declared that a final figure for the 2009 deficit had finally been decided on. The figure presented was 15.4% (Petrakis, 2010a, Eurostat Newsrelease, 2010b).

What were the effects of the disclosure of the hidden losses of Greece? One way to find this out is to look at the cost for Greece to borrow money, which is typically done by studying the spread between the cost for German 10-year bonds and Greek 10-year bonds. In doing so it is clear that many factors probably caused the rise besides the revision of the Greek statistics. Many investors, for example, probably looked to the three major rating

agencies for guidance. There is also the fact that the sudden discovery of hidden losses may cause more losses to take place, through the process of self-fulfilling prophecy.

If one inspects the price for 10-year bond yields in the case of Greece, it seems to have taken the investors a while to register the disclosures on October 21 (see Fig. 2). One reason for this may have been confusion; another that Greek and German bond yields had been close for many years. When a norm or habit is broken, the reaction may take a while. In any case, by the second half of November the price was clearly rising on the yield Greece had to pay. The financial press also began to pay more attention to Greece (Juko 2010). In December 2009 its bonds were also downgraded by Fitch as well as by Standard and Poor (from AA- to BBB+).

Fig. 2. 10-Year Bond Yield for Greece and Germany, September 2009 to August 2010



Comment: The Greek statistics scandal took place in late October 2009, and on May 2 a loan on 110 bn euro was arranged for Greece.

Source: Bloomberg Terminals

Down grades and warnings by the rating agencies continued during the spring. These were also extended to the country's banks, which by now had no access to the international market but had to rely on ECB for funds. This was a first sign that not only states but also banks were involved in the new phase of the crisis.

From late April to early May the yield rose dramatically on Greek bonds. The downgrade of Greek bonds to junk status on April 27 by Standard and Poor added to the difficulty. The situation was so bad that the decision by EU on May 2 to lend Greece 110 bn euro on a coordinated bilateral basis failed to stop the rise. It was not till a decision was made to establish a 750 bn euro facility on May 10 that the situation stabilized. Since then, however, the yield has started to climb again; and it has remained high far into the fall of 2010 (when this paper was written).

Since the October 2009 disclosure the Greek government has tried to restore confidence in its bonds in several ways, but it has been a difficult task for a number of reasons. One is that Greece has been handing out false information for a very long time in EU, including when it applied for membership in the Eurozone in 2001 (e.g. BBC News, 2004). Jacques Delors has, for example, recently stated that "we have long been aware that the Greeks had concealed the real figures" (Delors, 2010). According to a former commissioner, pretty

much every statistics that the Greeks supplied was faulty, and this was commonly known. "It was a case of: 'We all pretend to believe them and they all pretend to be doing enough for us to believe them'" (Barber, 2010d).

Adding to the problems for Greece is the fact that investors tend to regard countries that have often defaulted differently from those who have not. From 1800 to 2008 Greece spent more than half the years in default; it also went through five defaults or reschedulings (Reinhart and Rogoff, 2010:98).

One way in which the Greek government has tried to restore confidence is by reforming its statistical agency, ELSTAT (e.g. Katz and Martinuzzi, 2010). This project was announced in the fall of 2009 and carried out in the spring. Instead of falling under the finance department and reporting directly to it, ELSTAT was from now on to be independent and report to the Greek parliament. By June ELSTAT's board had several new members, including a former statistician from IMF and a board member of Eurostat.

The main effort of the Greek government to restore confidence has however been to make cuts in the government budget. In general, however, little is known how investors react to this type of action. It is also difficult to evaluate a country's economy, since it not only a question of how the state acts but also the population. Greece, for example, has had a number of strikes since its troubles began in October 2009.

Since these problems began the Greek government has made cuts and changes in its budget several times, most radically in connection with the 110 bn euro loan on May 2. These changes include a rise in the age at which people retire and an attempt to open up a number of closed jobs and professions, from lorry drivers to medical doctors. None of this, however, has been able to stop the downward spiral of the Greek economy, which is projected to shrink 1.5% during 2010. Unemployment is also high and on the rise.

4. HOW EU MANAGED THE GREEK CRISIS

Not only did Greece itself try to restore confidence in the country after the debacle in October 2009. So did EU, and the reason for this was that Greece is one of its members as well as a member of the Eurozone. Especially the latter fact is significant, since it meant that Greece had the same currency as the other euro zone countries, and that a threat to its economy could affect that of the other Eurozone countries. Since it joined the Eurozone in 2001, Greece has had the advantage of using a strong currency despite its high level of debt; on the other hand, it has been unable to devalue, as it used to do when its debts mounted.

The choices that were open to the Eurozone countries in dealing with Greece were as follows: a bailout or allowing Greece to go bankrupt. The latter would mean a loss of prestige for EU and also a loss for everyone who owned Greek bonds, especially banks. Today we also know that this option was firmly ruled out already in the fall of 2009 (Walker, Forelle and Blackstone, 2010b). A bailout of a member state was, however, expressly forbidden in the constitution of EU, be it by EU or ECB. According to Article 125 in the Lisbon Treaty, no bailout of a member state is allowed.

But it is also true that another article in the treaty allows extraordinary measures to be taken under extraordinary circumstances (Article 122). This can possibly be interpreted to mean that EU can bail out one of its members in especially urgent situations. This is in any

case what happened on May 2, 2010, when EU and IMF arranged for a loan on 110 bn euro to Greece.

The choice between the options of bail-out and bankruptcy, however, is not what made it so hard for EU to help Greece during the period October 2009-May 2010. Something else was involved, namely the conflict between two opposed tendencies in ***EU. One of these wanted EU as a whole to assist Greece and the other that all aid should be bilateral

***The leader of those wanting EU to act on its own, was France, led by Sarkozy. And the leader of the opposing tendency, arguing that the individual states should be the key actors, was Germany, led by Merkel. The differences between these two approaches are very deep seated and linked to two very different visions of what EU should be: a new and independent entity or just the existing member states, working together.

The difficulties that this opposition entailed for EU helps to explain why the aid to Greece was postponed for half a year until May 2. For one thing, it made things very hard for the German leadership. The more that Germany insisted on a bilateral solution, the more its own contribution to the loan was accentuated - and the more it also became obvious to the German citizens that they were supposed to pay for “other people” rather than for “their own”.

Merkel had an important election in North Rhine-Westphalia on May 9; and early on, commentators began to say that this made her want to postpone any concrete decision to give aid to Greece. The hostility towards Greeks that emerged in the German mass media during the spring of 2010 also shows how difficult the political situation was for Merkel.

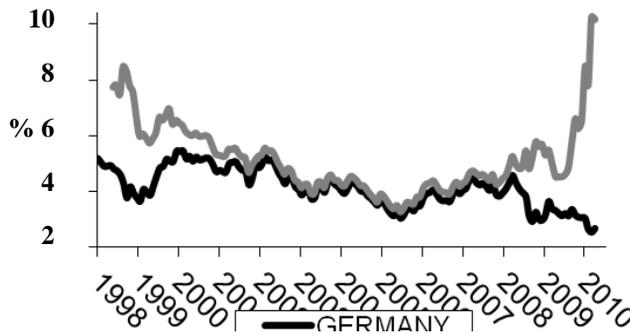
While it is clear that the delay in helping Greece till May 2 was very costly for Europe, it should also be realized that it was probably less Merkel herself than the combination of no-sayers to aid (such as Merkel) and yes-sayers (such as Sarkozy) that made the situation deteriorate in the spring of 2010. I have earlier argued that for confidence to be stable, you need an alignment of proxy sign with the economic reality (+/+ or -/-). In this case, however, there was a non-alignment of a special kind (+/-). Some political actors first said “yes, aid has been decided and will come”; and this was then followed by other actors who said “no” and stopped EU from providing the aid.

Before looking at the way that the reactions of EU unfolded after the Greek statistics scandal in October 2009, it must be emphasized that we currently know very little of what actually made the various EU actors act as they did. The situation is even harder to read since many actors said one thing, just to calm the markets - and then acted in a different way. Archival research, interviews and autobiographical accounts of what happened at the various meetings of EU leaders and their finance ministers will eventually make it possible to piece together the story. In the meantime, one has to rely on fragments - while also noting that this is about as much information as the markets actors typically have.

It seems that it took a while after October 2009 before EU understood the danger that Greece represented. The ECB, for example, cut off some of its facilities for banks, which it had installed during the first round of the financial crisis, in the late fall of 2009. One reason for this was no doubt that ECB did not realize how vulnerable Greece was. Like other members of EU, Greece had for a long time been able to draw on the strength that came from being associated with EU. In its capacity as a member of the Eurozone Greece had also for years been able to sell its bonds at practically the same low rates of interest as Germany (see Fig. 3).

Eventually, however, EU began to act; and in December 2009 EU countries expressed their verbal support for Greece. By this time rumors also began to circulate that a loan would eventually be made. At this early stage it was made clear by the leading EU countries that the IMF would not be involved. The French associated the IMF with U.S. supremacy and the Germans viewed its potential participation in a loan as a loss of prestige. “We don’t need the IMF”, to cite Axel Weber, the powerful President of the Bundesbank (Spiegelonlineinternational, 2009b).

Fig. 3: 10-Year Bond Yield for Germany and Greece, January 1998-August 2010



Comment: Greece joined the Euro in 2001; the financial crisis began in August 2007; and the Greek statistics scandal broke in late October 2009.

Source: Bloomberg Terminals

Despite the talk of a loan in December, no concrete measures were taken. During January and early February 2010 the rumors that EU was going to offer Greece a loan intensified. On February 11, Van Rompuy, President of the European Council, said on CNBC that “there is an agreement”; and a few days later the EU finance ministers announced their intention to assist Greece. According to leaks and rumors in the international press, the loan was to be in the range of 20-25 bn euro and be managed in a strictly bilateral fashion. The credit was going to come both from states (in the form of loans via state controlled banks) and from private banks in the respective countries. Especially Germany insisted on the bilateral nature of the loan.

But just as insistent as these rumors were in early to mid-February, equally insistent were the denials by Merkel and the European Commission some time later. Greece can manage very well itself, was one line; another that Greece had not asked for help.

During the month of March Greece’s need for aid was getting close to desperate; and the rate of interest it had to pay was shooting up rapidly. During the first part of the month Germany countered with the idea of creating a European equivalent to IMF, a European Monetary Fund. The European Commission endorsed the idea, while some market actors wondered if the whole thing was not really meant as a signal to Greece that it would not get a loan for a long time. The delay that the creation of a new EU institution meant, did not however seem to deter Merkel, who said that “a quick act of solidarity is definitely not

the right answer. Rather, the right answer is to seize the problem at the roots” (EurActiv.com, 2010).

During the second half of March, key EU members changed their view of IMF and now decided that they wanted it to participate in a loan to Greece. The IMF itself was eager to get into the action. On March 25 a loan to Greece was announced; and it amounted to 45 bn euro at a few percentage points lower than the market price.

The loan could only be used as a last resource, however. This meant that the loan was not distributed, and that the project of providing Greece with some resources therefore continued to be on the agenda in April. During this month the economic situation of Greece continued to deteriorate and was soon close to catastrophic. Greece was at this point described as “a sinking ship” by its prime minister (Kitsantonis and Saltmarsh, 2010).

By the time that the negotiations for the 45 bn euro loan had become concrete and everything was set to go, however, the situation had changed dramatically. More than twice the amount was now needed to take care of Greece’s needs; and the figure had risen to 110 bn euro. The loan was hastily put together and agreed upon on May 2, 2010, with the IMF contributing 30 bn euro.

The May 2 agreement made it possible for Greece to roll over its debts for the next few years without having to use the international financial market. It did this at a very steep prize - by adding 110 bn euro at 5 % to its debts. Greece, as already mentioned, also had to make a number of radical reforms and cuts in its budget. The key issue for Greece - how to increase the productivity of the economy, so it could pay off its debts - was not addressed in the loan. The 110 bn euro loan was a stop gap measure and nothing else.

5. THE PEAK OF THE EUROPEAN DEBT CRISIS (LATE APRIL - EARLY MAY 2010)

While the disclosure of the hidden losses of Greece may have triggered some of the development that led up to the May 2 loan, it is clear that the major cause of the decline of the Greek economy had to do with its own economic state and how it had been affected by the financial crisis. Two of the main sources of income of the country, tourism and transportation, had been especially hard hit by the turmoil in the European economy from the fall of 2008 and onwards.

During 2009 it was gradually realized that the financial crisis had also had a very severe impact on the EU countries in general, including the Eurozone countries. Already in the fall of 2008 emergency measures had to be taken to save many individual banks as well as whole national banking systems. At a meeting on October 12, 2008, it was also decided that each country in EU should guarantee its own banking system.

Many of the losses in the financial sector that now came about were allowed to remain hidden, in the hope that things would improve. The general economic development in each country was also, to repeat, deeply affected by the financial crisis. The average rise in deficit in relation to GDP for the year 2008-2009 was 4.3% for EU countries and 4.5 % for Eurozone countries (Eurostat Newsrelease, 2010a).

In January 2010 the spread for Greek 10-year bonds was going up and the same also started to happen with Spanish bonds. For the first time since the introduction of the euro

in 1999, voices began to be heard, arguing that the Eurozone might fall apart and the euro go down with it. Nouriel Roubini, for example, told Bloomberg News in an interview around this time that a very dangerous development had been set in motion by the Greek debacle; and that in a few years it could lead to “a break-up of the monetary union” (Keene, 2010). He described the fiscal difficulties that the Eurozone countries found themselves in as “a new phenomenon”. He noted that the bond investors so far “have been asleep at the wheel”, but that they were about to wake up.

Trichet countered by labeling the idea of EU braking up as “absurd”; he also stated that the difficulties of Spain and Ireland did not constitute a threat to the Eurozone (Keene, 2010). Soros, who was following the financial crisis very closely, took an intermediary stance and noted that while the economic crisis in Greece had made it clear that the Eurozone had its weak points, there also existed a “strong force” that held it together (Keene, 2010).

The bond investors, however, continued to worry; and as the aid to Greece from EU was postponed over and over again, the costs to borrow money on the international market continued to rise. As with Greece, the downgrades of the bonds of Spain, Portugal and Italy by the three major rating agencies accompanied and probably worsened this development. In brief, the problems of Greece had set off a contagion process that was now threatening to engulf EU as a whole.

We currently know very little about the way that the contagion accelerated and spread during the spring of 2010 in Europe. It is clear, however, that as the Greek bonds were devalued, all banks and other financial institutions that owned some of these were faced with the situation that they might have to acknowledge these losses - as so were those who had invested in the latter. It is also clear that ECB’s policy of accepting the bonds of all member states as equally valid collateral had encouraged banks in different EU countries to buy bonds that with a slightly higher yield, in order to earn a small but (seemingly) safe profit (Soros, 2010b). This way the bad debt was spread around.

Fig. 4: 10-Year Bond Yield for Germany and GIPS Countries, January 1993-August 2010



Comment: The Euro was created in 1999 and the Greek statistics scandal took place in late October 2009.

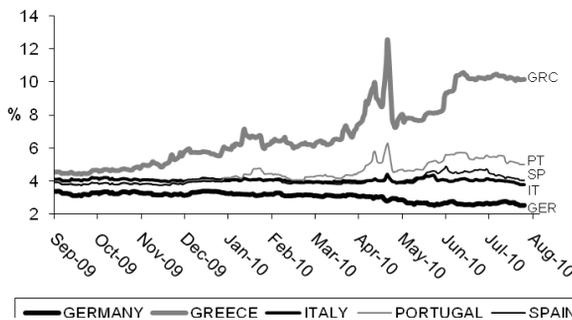
Source: Bloomberg Terminals

It is obvious that the economic difficulties that the Eurozone countries experienced after the first round of the financial crisis (2008-2009), played an important part in the contagion that took place in the spring of 2010. ***Money represents a form of interest; and like water it will tend to flow where it can.

Another important factor may also have been at play and it was of an even more sociological character. This was the perception of the investors of EU and the Eurozone as one single unit. European unity is often discussed in terms of how its citizens view EU, but a group's unity is also decided by the way that it is seen by actors on the outside. In evaluating Eurozone bonds, the investors oriented their actions to EU or the Eurozone, rather than to its individual members (to use Weberian language). This is indicated by the fact that from the very creation of the euro in 1999, there was a strong convergence in the spread for 10-year bonds of such countries as Spain, Portugal, Italy and Germany (see Fig. 4). This is also true for Greece, which joined EU in 1981 and the Eurozone in 2001 (see Fig. 3).

What the spread for 10-year bonds also shows is that once the crisis began, the convergence ended and each country now started to be seen – and evaluated - as its own separate entity by the investors (see Fig. 5). From a sociological perspective, it would seem that as the higher and emergent social unit was broken up, attention was switched to its parts; and the orientation of the investors went from the overall unit to its parts. Also this time a new evaluation took place: of each country by itself. “New” costs suddenly appeared, when the eyes were turned from EU to individual countries, such as Italy, Spain, Portugal and so on.

Fig. 5. 10-Year Bond Yield for Germany and GIPS Countries, September 2009-August 2010



Comment: The Greek statistics scandal took place in late October 2009 and the 750 bn euro facility was arranged for on May 10, 2010.

Source: Bloomberg Terminals

We here see another side of the problematic that was mentioned earlier: the federal view of Europe versus the bilateral or intergovernmental view. To decide whether to act in unison or separately is a problem that has plagued EU from the very beginning of the

financial crisis. Shortly after the collapse of Lehman Brothers in September 2008, attempts were made, primarily by France, to coordinate the European response to the crisis (e.g. Kulish and Bowley, 2008). Germany, however, firmly opposed it and demonstratively acted on its own to insure its banks on October 5 (Gow and Chrisafis, 2008).

The official decision to let each country fend for itself was announced at a meeting of the European leaders on October 12. George Soros describes the situation in the financial world at the time of the meeting in the following way:

Conditions in the financial system continued to deteriorate. The commercial paper market grounded to a halt, LIBOR rose, swap spreads widened, CDSs blew out, and investment banks and other financial institutions without direct access to the Federal reserve could not get access to overnight or short-term credit. The Fed had to extend one lifeline after another. It was in this atmosphere that the International Monetary Fund (IMF) held its annual meeting in Washington, starting on October 11, 2008. The European leaders left early and met in Paris on Sunday October 12. At that meeting they decided to guarantee, in effect, that no major European financial institution would be allowed to fail. They could not agree, however, to do this on an inclusive Europe-wide basis, so each country set up its own arrangements...After a heated debate in which Germany resisted a Europewide solution, it was decided that each country should guarantee its own financial system. (Soros, 2009:162, 212)

With this in mind, let us move back to the spring of 2010. The contagion that begun in January 2010 made a qualitative leap in April; and towards the end of this month and the first few days of May, many feared that the very financial system of Europe and perhaps of the whole world would come apart. After the collapse of Lehman Brothers in September 2008, systemic risks emerged several times in the United States. It also did so during period between the end of April and early May 2010; and this time it took place in Europe.

One can cite many examples of important actors who thought that a systemic crisis was present. According to IMF, there were “tensions [during these days] threatening a financial meltdown”. And according to OECD’s General Secretary, the crisis had begun “threatening the stability of the financial system” (IMF 2010:7; Davis and Ross-Thomas 2010). EU’s President would later say that “we were on the edge of a breakdown. At a certain moment it could have become a world crisis” (Barber, 2010a). Trichet said that “it looked somewhat like the situation in mid-September 2008 after the Lehman Brothers’ bankruptcy”. He also added that “contagion... can occur quickly. Sometimes it is a question of half days” (Trichet, 2010).

The actors who were involved in arranging the 110 bn euro loan to Greece on May 2 understood very quickly that they had failed to stop the crisis. From this point onwards, till the early hours of May 10 when EU announced the creation of a 750 bn euro facility to fight the crisis, a truly dramatic set of events took place. During the days from a few days into May to May 10, EU was the eye of the storm, as the French minister of finance put it (Kassenaar and Deen, 2010).

While many details of what happened during these days are not yet known, the broad outlines of what took place are clear enough (e.g. Walker, Forelle and Blackstone, 2010a).

On May 6 the flash crash took place in New York and the Greek bonds went down even further. On Friday May 7 the Eurozone leaders met in Brussels and understood that they had to act forcefully. On Sunday and Monday morning, May 9-10, the actual deal was hammered out by EU's finance ministers.

On May 7, Sarkozy arrived extra early to the meeting in Brussels and spent the extra time to round up support for making a forceful intervention in the crisis in the name of EU, as opposed to a bilateral deal. By the time that Merkel arrived much had already been decided, to her great dismay. "When she was told [what had happened]", according to one source, "she looked like a boxer who had been punched in the chest" (Baker, 2010).

Things, however, would get worse and not only for Merkel. Trichet was present during the meeting and handed out material that showed how the markets were diving all over the world, set off by the Eurozone crisis. One participant recalls Trichet saying, "this isn't only a problem for one country [Greece]. It's several countries. It's Europe. It's global. It's a situation that is deteriorating with extreme rapidity and intensity" (Barber, 2010c).

The audience was stunned by Trichet's message. According to an EU ambassador "Sarkozy was white with shock. I've never seen him so pale" (Barber, 2010c). Some of Sarkozy's anger was immediately directed at ECB and its policy of not buying member states' bonds. One participant recalls how "Sarkozy was screaming [to Trichet]: 'Come on, come on, stop hesitating'" (Barber 2010c). Trichet however did not budge, since he wanted the EU leaders to commit to a major intervention before revealing his decision to let ECB buy member states' bonds.

With Trichet impossible to move, Sarkozy again started to push for his view that it was EU that must act, not the individual states (Walker and Gauthier-Villars, 2010). "This is the moment of truth", he said, "we must act". Having arrived late Merkel was at a clear disadvantage, but she nonetheless tried to block a decision till she knew all the details about what Sarkozy had in mind. When she realized that these were quite hazy and that the deal itself was much too federally minded for her taste, she went against Sarkozy's proposal.

The deadlock between Merkel and Sarkozy that now developed was broken by EU President Van Rompuy, who proposed the creation of a "stabilization fund", with the details worked out by the finance ministers over the weekend (Walker, Forelle and Blackstone, 2010a). This was accepted by the participants who directed the European Commission to design a "stabilization mechanism" to be later worked out by the finance ministers (Barber 2010c).

When the meeting was over Sarkozy felt like a winner and held a triumphant press conference, while Merkel quickly disappeared looking "utterly humiliated" (Charlemagne 2010). Sarkozy told the assembled world press that "today we face an attack on the whole of Europe, not just Greece. We had to respond with community mechanisms, not just bilateral loans as it was the case of Greece" (Willis and Pop, 2010). He announced that the whole deal would be in place on Monday morning and that he had imposed his will "95%" (Walker and Gauthier-Villars, 2010).

The sense that the market was endangering the whole project of EU as well as the euro was very strong among the finance ministers who assembled in Brussels on Sunday May 9. The Swedish finance minister told the press in a much quoted statement that "we now see... wolfpack behavior [in the financial markets], and if we will not stop these packs,

even if it is self-inflicted weakness, they will tear the weaker countries apart” (Hume, 2010).

Once the meeting begun, however, strong differences in opinion soon emerged between those who were for and those who were against a federal solution. Germany and Spain refused to accept the Commission’s proposal, which was defended by France and the Nordic countries. The discussion got so heated that at one point one of the participants bit off a tooth. After a few hours discussion the French finance minister also privately told her delegation that the Eurozone was on the verge of breaking up (Walker, Forelle and Blackstone, 2010b).

After a break to cool things down, suggested by the French finance minister, an agreement was finally reached. The German line had won on all major points. The deal was sealed in the early morning hours of May 10, just a few minutes before the markets in Asia opened. By this time the results from the important North Rhine-Westphalia election were also in, which made it easier for Germany to back the deal.

Trichet, who had refused to move before a deal had been made, now made an announcement that ECB was ready to buy bonds of member countries (e.g. Walker, Forelle and Blackstone, 2010a; Barber, 2010c). His announcement that ECB was ready to go for its “nuclear option” was met with relief by the finance ministers since it was believed that without an active intervention in the markets by ECB the markets might continue to go down (Barber, 2010c).

The amount involved in the May 10 deal - 750 bn euro - was a testimony to the attempt of the EU leaders to stop the crisis through a big blow-out (“shock and awe”). The strategy succeeded. The prices for European bonds immediately shot up and so did the prices on the world’s stock markets. The VIX or the fear index took a sharp dive downwards.

But it was also clear that those who had wanted to see the deal as a manifestation of European unity had failed, and that the bilateral strategy of Merkel and her supporters in EU had won. The European Commission was not, as it had wanted, in charge of the new European Financial Stability Facility (EFSF), and no Eurobonds were to be issued to finance it.

The actual aid package looked very different. It consisted of three separate parts. There was first of all EFSF itself, with a capacity to make 440 bn euro in loans, drawn from resources from individual member countries. Then there was the 60 bn euro to be raised and controlled by the European Commission; and then 250 bn euro from IMF. EFSF did not become a permanent institution linked to EU, as the federalists had wanted. Instead it was to be a temporary organization, lasting only three years and housed in Luxembourg. Its loans were to be bilateral in nature, with each country (including the ones in deep economic trouble) contributing a proportional part of every loan.

The May 10 deal was hastily put together and it was well understood by the actors involved that it is not going to solve the difficult economic situation that faces EU and the Eurozone countries. A short time after the deal had been announced, the yield for the bonds of countries such as Greece-Spain-Italy-Portugal also began to rise again. As of today, they are still very high (see Fig. 5).

Since May 10 two major attempts to deal with the difficult situation in Europe and to restore confidence have been made. These are radical budget cuts and stress tests of the banks. As of today, severe budget cuts have been announced in a number of EU and Eurozone countries. A debate has also started up if these will improve the situation or

endanger it, by affecting economic growth negatively. Trichet as well as the EU countries have come out very strongly in favor of moving ahead with radical budget cuts. At a meeting of G-20 in Toronto on June 26-27, the EU succeeded in getting the advanced economies to unite around the project of budget cuts, despite strong resistance from the United States.

There exist some problems with this position; and one of these is that there exists little knowledge of what actually determines the prices on state bonds. Or, to phrase it differently, there exists little knowledge of what it is that makes investors in the international bond market behave as they do. At what point, for example, do the so-called bond vigilantes decide to lay off a special country; and what difference does it make to have EU as a whole guarantee its member countries rather than each country being on its own? It is also still not clear how you can simultaneously make deep cuts *and* increase economic growth. During the early fall of 2010 the push for budget discipline has continued.

The stress tests on European banks were conducted in the summer of 2010 and the results made public on July 23. It was at this time well-known in financial circles that the European banks were in bad shape and had plenty of hidden losses, thanks to the difficulties they had experienced after the collapse of Lehman Brothers. As a result, many of the banks were by the spring of 2009 unable to borrow in the international markets and had to rely on ECB for funds. The idea with the stress tests was that by laying bare the weaknesses of the European banks, investors would regain confidence in them.

The actual tests, however, did not probe very deeply into the financial state of the banks. All government bonds, including those from Greece, were evaluated at full value, as long as they were kept out of the trading books of the banks which they typically are.(?) Other ways of concealing the actual state of the banks were allowed as well in the tests.

On July 23 it was nevertheless announced by the authorities in charge of the stress tests that the state of European banks was fine. Only seven out of ninety-one banks had failed the tests; and these only needed 3.5 bn euro in extra capital rather than the tens of billions that many expected. Several banks that no investor wanted to touch were declared healthy. Confidence in the banks was nonetheless somewhat restored, even if it is clear that problems remain - in Germany, Ireland, Spain and so on.

6. CONCLUDING REMARKS: CONFIDENCE AND THE EUROZONE

“My main message is that the centre must be given a greater role in national fiscal policy if EMU is to become a more effective, and more resilient, monetary union. But of course I recognize that such a delegation of fiscal powers to the centre could meet political resistance in some countries, where the appetite for ceding further control to Brussels is already weak”. Dominique Strauss-Kahn, managing director of IMF, October 13, 2010 (Barber, 2010e)

What does the future of Europe look like from the perspective of this paper, which is centered around the role of confidence and the necessity to maintain confidence in the economic system? The international financial system has been very unstable since the decline of the Bretton Woods system in the early 1970s (e.g. Buchanan, 2010; Eatwell and

Taylor, 2000). The amount of money that flows back and forth in the world today is truly astronomical; and the number of financial crises has accelerated during the last few decades (e.g. Reinhart and Rogoff, 2010). There is also the fact that the European countries have been seriously weakened by the first round of the financial crisis (2008-2009) as well as by its second round (spring of 2010). The projections for growth in Europe are not positive; and its banks have huge amounts of hidden losses. To judge from experience, it will take something like a decade for Europe before there will be vigorous growth (e.g. Reinhart and Reinhart, 2010).

It would also seem that there exist no easy solution to the ongoing fight between those who want a federal Europe and those who want a more bilateral and intergovernmental one. If one or the other of these two tendencies could win out, it would be easier to reestablish confidence, something which is very difficult in any case.

If each country was on its own, investors could evaluate it exclusively on its own merits. And if the federalists won out, investors would probably once again start to view individual countries as part of a larger emerging whole, a bit like they did during 1999-2009 when the bond yields for Eurozone countries strongly converged. In this case it would not matter so much if an individual country was in poor economic shape, since it would be seen as a part of a whole. It would be protected by the community, to speak in Durkheimian terms.

But a decisive victory for one or the other of these two tendencies does not seem very likely. To this should be added the way that the Eurozone is currently constructed, with a common central bank but little else in terms of common economic governance. From the sociological perspective of this paper, this practically amounts to an institutionalization of the contradiction between parts and whole. And we know from experience today that this is particularly dangerous in difficult economic times and can even lead to systemic crises.

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