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"The Role of Confidence in the European Debt Crisis"

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The Role of Confidence in the European Debt Crisis (2009-2010)

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ABSTRACT

In this paper I analyze the role that confidence has played in the events that rocked the European economies in 2009-2010. The European debt crisis was 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 package of 750 bn euro in order to restore confidence. What happened during 2009-2010 is analyzed from the perspective of a sociological theory of confidence that is based on Walter Bagehot's idea that financial crises are typically unleashed by the discovery of hidden losses; and Robert K. Merton's idea that a loss of confidence in economic actors may result in their bankruptcy even if they are solvent. It is also argued that confidence plummeted when investors realized that EU was not going to assume responsibility for member countries but that each country was on its own. In this situation investor confidence was redirected from the collective level to that of each individual country.

In this paper I analyze the role that confidence has played during the first phase of the European debt crisis, which began in October 2009 and ended in May 2010. In October 2009 the Greek government made the announcement that its deficit was several times larger than what it had earlier predicted; and in May 2010 EU had to hastily put together a package of 750 bn euro in order to avoid a systemic crisis. Much of what has taken place after May 2010 has followed a similar pattern: deterioration of confidence in the bonds of individual member countries, followed by attempts by EU to restore confidence and avoid a systemic crisis.

The paper begins with a discussion of confidence, which constitutes its heoretical focus. This is followed by a presentation and analysis of the way that Greece and EU reacted during the first year of the European debt crisis. I conclude by discussing what the future holds for EU and also argue that in order to understand the financial crisisi one needs not only to take economic factors into account but also sociological ones.

The Role of Confidence in Finance

When one looks at existing analyses of the role of confidence in economic life, it soon becomes clear that there does not exist one generally accepted theory of what constitutes confidence, be it in economics or some other social science (Swedberg forthcoming). To this should be added that economists for a long time ignored the issue of confidence. Recently, however, there has been a reawakening among economists on this score.

What many analysts agree on today is that confidence plays a central role in the economy, both on a micro level and a macro level. Many actions will not take place unless actors show confidence in each other; and the withdrawal of confidence can hurt not only the actors in a transaction but also spread to other actors.

It has also been realized that some economic actors are active in areas of the economy that are what may be called confidence intensive. One of these is deposit banking; and the reason for this is that deposits are quickly withdrawn when confidence is lost. The same mechanism is at work in certain modern financial institutions, such as investment banks of the U.S. type. These borrow funds on a short-term basis and invest them on a long-term basis, which makes them highly vulnerable to situations in which confidence is lost.

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 traditionally seen as confidence intensive institutions, they do rely on confidence in their economic activities. A state that depends on loans is by definition also dependent on the confidence that it inspires among its creditors. While loans to states cannot be quickly withdrawn, in the way that deposits can be withdrawn from a bank, they are bought and sold as well as evaluated on a daily basis on the international capital market.

Looking at the role of states, it is also clear that the way that confidence is managed by politicians becomes an important topic. When the head of some country makes a public statement about the situation, say, of the banks in his/her country, is he or she describing their economic situation or managing confidence? Depending on the answer, investors may wish to buy or sell.

The blatant way in which the notion of confidence has recently been used to justify budget cuts, has also made some economists refer in a disparaging manner to the belief in a mythical “confidence fairy”. All you have to do, in order to justify otherwise unacceptable budget cuts, is to say that your policy will restore confidence and thereby economic growth (Krugman 2010a, b; Stiglitz 2010; cf. Romer 2010).

An important part of the argument in this paper is played by the notion that a financial crises can be triggered by a loss of confidence. This idea draws on 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 work, for example, that one finds the famous piece of advice for how central banks should act in moments of crises, namely to infuse huge amounts of credit into the system (“spend freely”).

What is less often 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* (1873) 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 [1873]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" (1938). A bank becomes insolvent when it is seen as insolvent by the depositors, who, in acting on the belief that it insolvent, will end up making it so - even if the bank was perfectly sound to start out with (Merton [1938] 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 to 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 exists a consensus in whatever little literature there is on the topic (Swedberg forthcoming). This is especially the case when confidence is seen as a fundamentally sociological phenomenon, as opposed to a psychological phenomenon. While Bagehot looks at confidence in terms of what happens "between man and man", as he puts it, proponents of confidence as a psychological phenomenon, view it as essentially rooted in the nature of human beings. This is, for example, the case with Keynes as well as with most economists (Keynes 1936: Ch. 12; e.g. Akerlof and Shiller 2009).[1]

For these reasons I will suggest my own theory of confidence in this paper; and as my point of departure I will use a statement by Mancur Olson. Confidence or trust, Mancur Olson once said in an interview, is all pervasive in society as well as in the economy.[2] 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 is echoed in a comment by Wittgenstein in *Philosophical Investigations*. Wittgenstein says more or less the same as Olson, but adds the important point that confidence is closely linked to action. Trust is not so much a feeling as a way of looking at things that is closely linked to an action. His comment reads as follows:

> 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 Olson's and Wittgenstein's views of confidence is that confidence is seen as having *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 and that the chair is strong enough to sit on). But there also exists something that indicates that this is indeed the case to the person who is doing the walking or about to sit down. This indicator, I suggest, can be conceptualized as a *sign* that stands in for something else - what may be called a *proxy sign*. From this perspective, confidence can be defined in the following way: *confidence is something you need to have in order to act, in situations where you lack accurate information and instead must rely on signs*.

The idea of proxy signs can be developed further. A proxy sign can either correctly indicate the actual situation or not. 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 in the former case 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 (see Fig. 1).

/Fig. 1 about here/[1]

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

[1] For Fig. 1, see the end of the paper.

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 described by Merton.

<u>The Trigger of the Sovereign Debt Crisis in Europe: The Hidden Losses of Greece</u>

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 can be the case:

> 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).

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.

In December 2009 the figure of 12.5 % was revised to 12.7 %. The Greek Prime Minister now 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%. 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 doing this (e.g. Story et al 2010

In April 2010 another revision was made. This time Eurostat suggested that the correct figure for the deficit was probably higher than 14 %. The history of the hidden losses of Greece can consequently be summarized as follows. What had started out as a projected deficit of 3.7 % was first 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).

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. While doing so, it should also be noted that many factors besides the revision of the Greek statistics may have caused the rise. Some 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 mechanism of the 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 disclosure of 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 about here/[2]

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 the European Central Bank (ECB) for funds. This

[2] For Fig. 2, see the end of this paper.

was a clear sign that not only states but also banks were deeply 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.

After the October 2009 disclosure the Greek government tried to restore confidence in its finances in several ways, but it was a difficult task for a number of reasons. One is that Greece had 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, for example, has 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 provided to EU 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 was 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 after the October 2009 events has however taken the form of budget cuts, and most radically in connection with the 110 bn euro loan on May 2. It has also raised the age at which people retire and tried to open up a number of closed jobs and professions, from lorry drivers to medical doctors. None of this, however, has restored confidence.

How EU Managed the Greek Crisis

Not only did Greece itself try to restore confidence after the debacle in October 2009. So also did EU since Greece is one of its member 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.

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 might also set off a systemic crisis. Today we know that this option was firmly ruled out already during 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 this 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 must 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 different visions of what EU should be: a new and independent political entity of its own or simply an organization whose member states work 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 very 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 commentators early began to say that this made her want to postpone any concrete decision to give aid to Greece. The hostility to 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 nay-sayers to aid (such as Merkel) and yes-sayers (such as Sarkozy) that made the situation deteriorate so quickly in the spring of 2010. I have earlier argued that for confidence to be stable, you need an alignment of the proxy sign with the economic reality (+/+ or -/-). In this case, however, there was a non-alignment of a very 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 the way they did. The situation is even harder to read since many actors said one thing, just to calm the markets – and then acted in another 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 full story. In the meantime, one has to rely on fragments – which is also what the market actors did.

It appears 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 had been opened up 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. These funds, however, had not been put to productive use (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", said Axel Weber, the powerful President of the Bundesbank (Spiegelonlineinternational 2009b).

/ Fig. 3 about here/[3]

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, announced on CNBC that "there is an agreement"; and a few days later the EU finance ministers said they would 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

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[3] For Fig. 3, see the end of this paper.

European Monetary Fund. 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” (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 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 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. The 110 bn euro loan was essentially a stop gap measure.

Heading towards a Systemic 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 understood 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 an important meeting on October 12, 2008, it was for example 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. This is pretty common in banking, but would in this case have disastrous consequences. 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 that the eurozone might fall apart. 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). The bond investors, however, were not convinced; 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 for several eurozone countries. 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 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 bonds were faced with the situation that they might have to acknowledge these losses – and 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 dangerously encouraged banks in EU countries to buy bonds with a slightly higher yield, in order to earn a small but (seemingly) safe profit (Buiter and Sibert 2005; Soros 2010; Boone and Johnson 2011). This way the bad debt was spread around.

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. But another important factor may also have been at play in the loss of confidence that now took place, and it was more of a sociological character than of an economic character. This was the change in perception of the investors of EU and the eurozone from being a single unit to a collection of individual states.

European unity is often discussed in terms of how its citizens view EU, but a group's identity and unity is also decided by the way that it is seen by actors on the outside. In evaluating eurozone bonds, the investors initially 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. This is also true for Greece, which joined EU in 1981 and the eurozone in 2001 (see Fig. 4).

/Fig. 4 about here/[4]

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 so-to-speak emergent social unit was now questioned, and

[4] For Fig. 4, see the end of this paper.

attention switched to its parts. The orientation of the investors moved from the overall unit to its parts.

The result was that a new evaluation slowly began to take place: of each country by itself. “New” costs appeared when the look was turned from the level of EU to that of individual countries, such as Italy, Spain, Portugal and Greece. What had been able to inspire confidence in the investors as long as it was seen as being part of something larger, was unable to do so when it was evaluated exclusively on its own merits. In terms of our proxy signs, +/+ now turned into +/- in the mind of the investors.

/Fig. 5 about here/[5]

We here also sense 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 this 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, 2008 or a month after the collapse of Lehman Brothers. 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

[5] For Fig. 5, see the end of this paper.

> 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 now return 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 on September 15, 2008, systemic risks had emerged several times in the United States. It did so as well 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 about to be unleashed. 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 package 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 still not 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 markets all over the world were diving, set off by the Eurozone crisis. One participant recalls Trichet as 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. Acording to an EU ambassador "Sarkozy was white with shock. I've never seen him so pale" (Barber 2010c). Some of Sarkozy's anger was 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 his ideas about how to proceed 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 instructed 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 act decisively.

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.

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 was not going to solve the difficult economic situation that faced 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 and Portugal also began to rise again (see Fig.5).

/Fig. 5 about here/[6]

Concluding Remarks

[6] For Fig. 5, see the end of the paper.

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 financial system? It should first of all be emphasized that 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 forth and back in the world today is truly astronomical; and the number of financial crises has accelerated in a very ominous way 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 (fall of 2008 - spring of 2009) as well as by its second round (spring of 2009 – spring of 2010) and third round (summer of 2010-; e.g. Beckert and Streeck 2010). The current projections for growth in Europe are not positive; and its banks have huge amounts of hidden losses. According to what history teaches us, it may also take something like a decade before Europe will again experience vigorous growth (e.g. Reinhart and Reinhart 2010).

Not only what happened during 2009-2010, but also the events that have taken place afterwards, indicate in a very clear manner that there does not exist any 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 eurozone country was on its own, investors could evaluate it exclusively on its own merits. It could also very importantly devalue its currency. 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 converged. In this case it would not matter so much if an individual country was in poor economic shape or not, 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 have devastating results.

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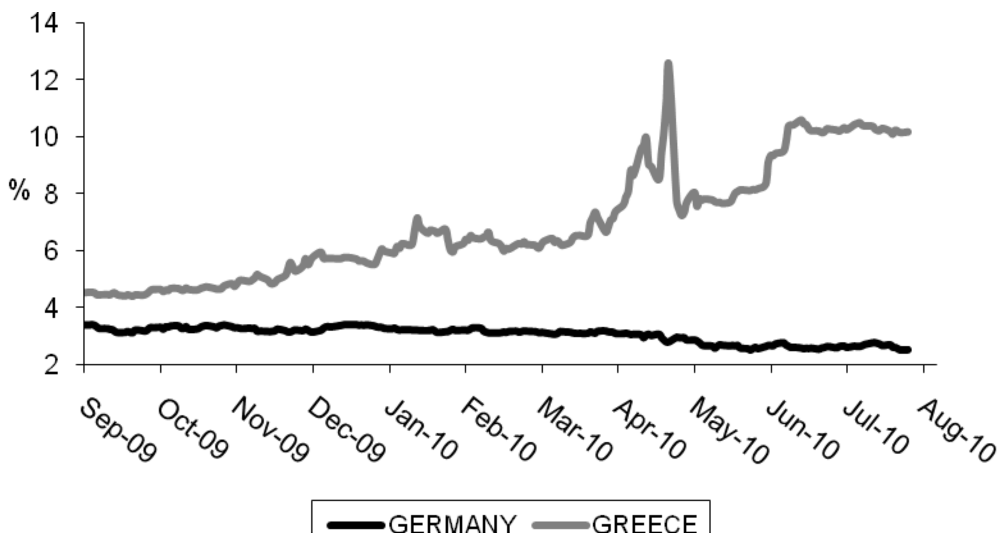
Fig.1. Proxy Signs and the Nature of Confidence

		The Economic Situation is Positive	The Economic Situation is 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 1[938]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] 1922).

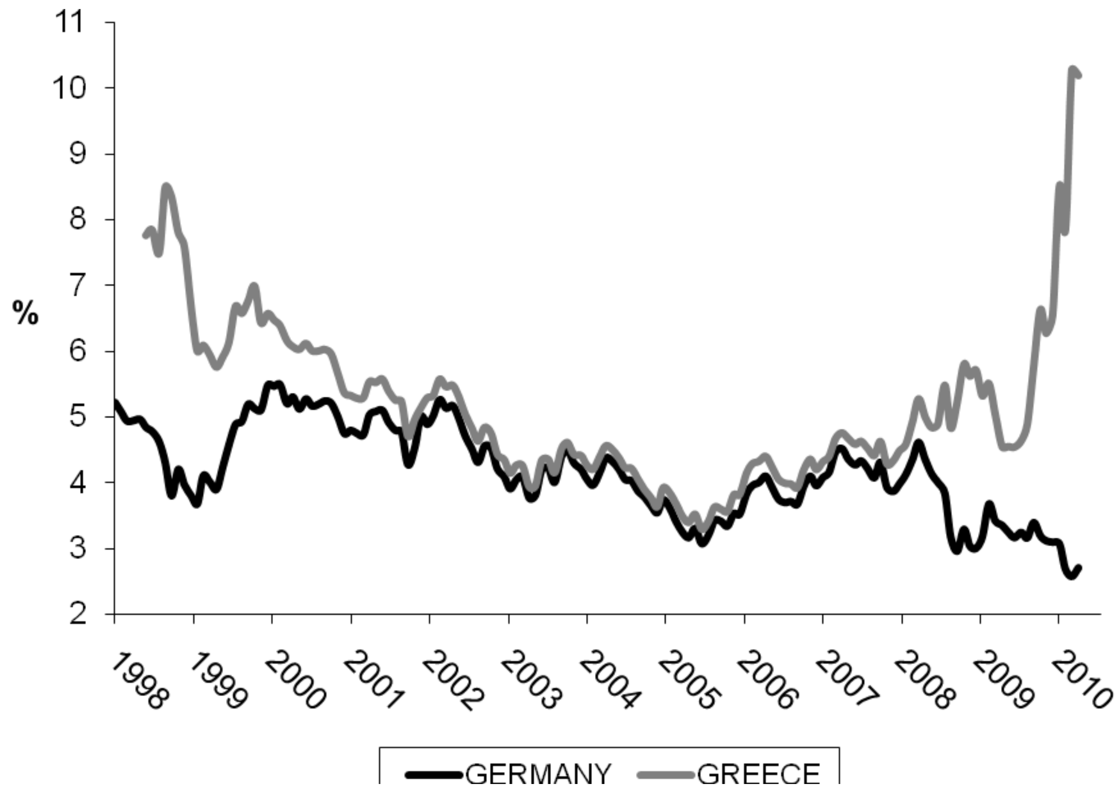
Fig. 2. 10-Year Bond Yield for Greece and Germany, September 2009 to August 2010



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

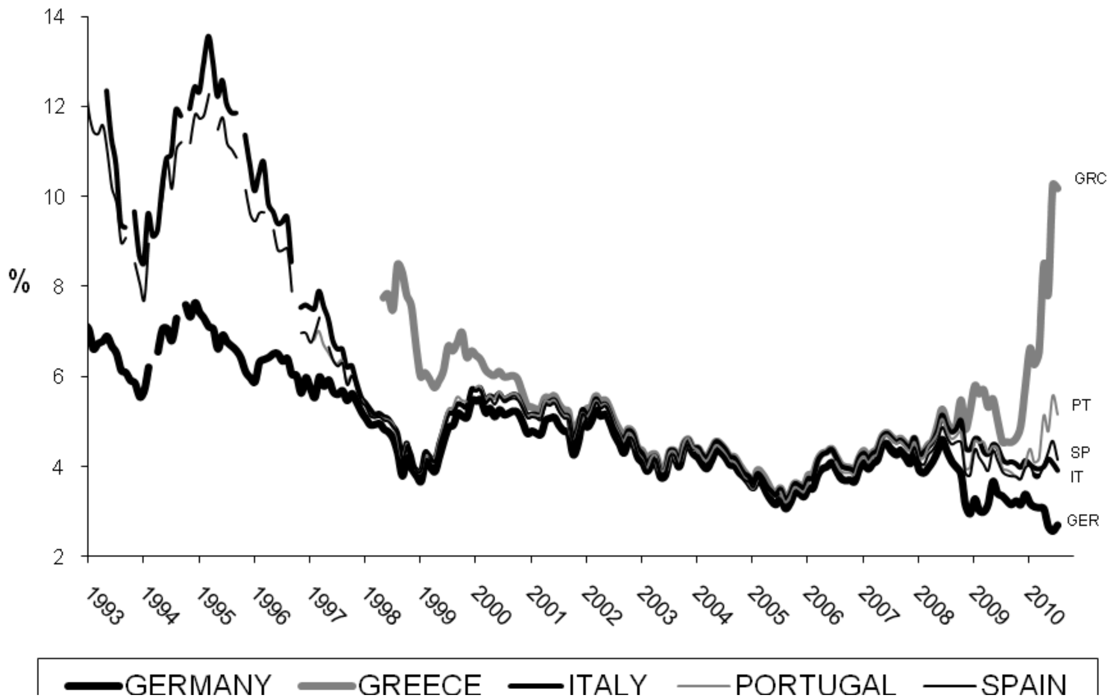
Fig. 3: 10-Year Bond Yield for Germany and Greece, January 1998-August 2010



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

Source: Bloomberg Terminals

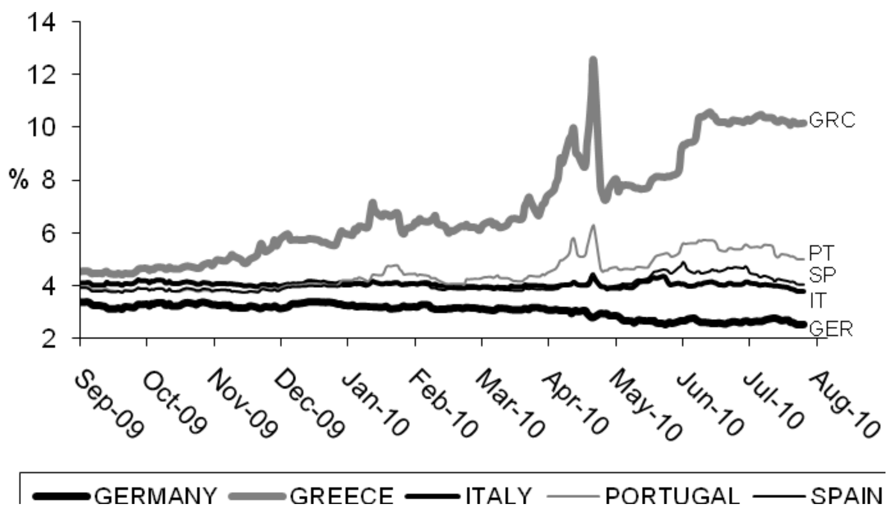
Fig. 4: 10-Year Bond Yield for Germany and GIPS Countries, January 1993-August 2010



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

Source: Bloomberg Terminals

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

[1] A business man with animal spirits is full of confidence and may, by virtue of this very confidence, set off a series of actions that will move the economy forward. Stated in this manner it should be obvious how well this approach to confidence fitted the situation in the 1930s when *General Theory* was written. Keynes' theory of animal spirits is similar to psychologists' theory of overconfidence or that people have an overly optimistic view of their own capacity (e.g. Moore, Don and Paul Healy 2008).

[2] Economists tend to use the terms confidence and trust interchangeably, while sociologists prefer the term trust and less often discuss confidence. A few attempts exist to draw a conceptual line between trust and confidence. According to e.g. Keith Hart, trust basically refers to the same phenomenon as confidence but is more intense (Hart 1988).