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Leonida Correia

University of Trás-os-Montes and Alto Douro (UTAD),
Centre for Transdisciplinary Development Studies (CETRAD),
Department of Economy, Sociology and Management (DESG),
Portugal
✉ lcorreia@utad.pt

Patrícia Martins

University of Trás-os-Montes and Alto Douro (UTAD),
Centre for Transdisciplinary Development Studies (CETRAD),
Department of Economy, Sociology and Management (DESG),
Portugal
✉ smartins@utad.pt

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The Global Financial Crisis: From US Subprime Mortgages to European Sovereign Debt

by **George K. Zestos**

Routledge, Taylor & Francis Group, 2016.

The recent financial crisis began with the United States (US) subprime mortgage crisis in 2007 and pushed the US and several European economies into the broadest, longest and deepest recession since the Great Depression (GD) of the 1930s. This book, *The Global Financial Crisis: From US Subprime Mortgages to European Sovereign Debt*, results from the intense research of George Zestos, Professor of Economics and Jean Monnet Chair of European Integration at Christopher Newport University in Virginia and a recognized specialist in international economics, particularly in European integration. The author set himself the considerable challenge of writing a book about this crisis, offering a comprehensive overview of its causes, policy responses, effects and future implications. He has succeeded well in providing an analytical, critical, consistent and rigorous work with abundant data to support its arguments and an actual and substantial selection of bibliographical references.

In this book, edited by Routledge and organized in nine chapters (beyond the preface), George Zestos underlines the uniqueness of this crisis, reporting an analysis for a long time period ranging from the GD to the euro crisis. The author demonstrates that this crisis, like no other, generated financial panic and macroeconomic problems in developed economies. In fact, the Great Recession, as it is commonly called, affected the US and the European Union (EU) members in ways that almost nobody expected, but what are the differences between the two crises, the American and the European crisis? This text offers a previously unexplored comparative overview of both crises, constituting its main contribution relative to other published studies concerning the recent global crisis.

The first two chapters focus on the historical background and the mutation of the subprime mortgage crisis in the US, whereas the next two chapters develop a similar analysis for the EU, discussing how the financial crisis spread to Europe and why the European crisis has lasted for so long. The three following chapters are committed to the examination of the policies, regulations and governance reforms implemented in the US and Europe to answer and solve the crisis. This core brings us the information that provides density to the analysis undertaken by the author. Critical questions about the EU's inefficacy in solving the crisis are explored, including the role of Germany in this process as well as the special case of Greece. Before the last chapter of concluding comments, the financial struggles in the EU and the euro area (EA) are surveyed.

To examine the emergence and causes of the US subprime mortgage crisis, the obvious starting point is the evolution of the US monetary and banking system to identify the determinants of the boom in the housing market and of the consequent housing bubble. It is also important to identify the involvement of the American Government in the housing industry. The book highlights these topics in the first two chapters, which address several issues relating to US banking, the home finance system and the regulatory regime that was established after the GD. They include a thorough description of the efforts of the US Government to stabilize the economy and the legislative acts implemented to regulate both economic and financial activities. Additionally, the contribution to the crisis of several US federal housing agencies is critically analysed. This thorough assessment supports the conclusion that the subprime mortgage crisis was the result of both public and private failures.

The excessively expansive monetary and fiscal policies were a strong factor in the creation of the housing bubble. The "nobel efforts" (p. 27) of the US Government to increase home ownership, *via* the democratization of credit, contributed negatively to the formation of the subprime mortgage crisis by encouraging increased lending by banks and other financial institutions to lower-income classes and minority groups. These subprime mortgages were securitized by several investment banks (such as the financial giants Freddie Mac and Fannie Mae). However, the banks "had no skin in the game" (p. 28). They expanded the credit without a correct evaluation of the risks involved, namely the ability of the mortgage applicants to pay. In addition, some of the professionals adopted unethical practices, exhibiting perverse and predatory behaviour in their lending activities. Financial innovations, such as the creation of numerous novel structured financial products, which spread quickly, also played a crucial role in the development of the crisis. Some of these financial derivatives were so extremely complex and opaque that the markets could not price them correctly. Due to the lack of transparency of such assets, both buyers and suppliers lacked a well-informed notion of their intrinsic value. As a result, these highly risky products "soon became known as toxic securities or assets" (p. 29).

The US subprime mortgage crisis spread to Europe during the fall of 2008, just after the collapse of Lehman Brothers. The most affected countries included those that were over-indebted, and "for this reason, the crisis became known as the European sovereign debt crisis" (p. 47). A root of the crisis was the violation of the fiscal rules of the Stability and Growth Pact (SGP) followed by several countries for a long time and thus the lack of fiscal discipline prior to the crisis. George Zestos complains that the SGP fiscal requirements were relaxed by pressure from large countries, such as Germany, France and Italy, when it was in their own interest to avoid the supranational rules. The author also supports the thesis that the depth of the euro crisis could have been avoided if, at the beginning of the crisis, the EU country leaders had demonstrated to the financial markets and to the credit rating agencies (CRAs) that they were committed to defending the common European currency and the European Monetary Union (EMU).

In some EA countries, the long-term interest rates on government bonds increased so much that it became prohibitively expensive to borrow in the financial markets. As a result, Greece, Ireland, Portugal, Spain and Cyprus, the main victims of the crisis, received a bailout from the European Central Bank (ECB), European Commission (EC) and International Monetary Fund (IMF) (the Troika). In return for the rescue packages, these five countries had to comply with austerity programmes imposed by the EU and IMF. In chapters three and four, George Zestos discusses the bailout coordinated efforts exhaustively and provides proof with several historical facts and figures showing their devastating economic consequences. The original goals of these austerity programmes were fiscal stability and economic growth. However, "bailout recipient countries experienced prolonged recessions, record rates of unemployment, political instability, and a humanitarian crisis of unprecedented dimensions" (p. 65).

Nevertheless, the question remains of "why the European sovereign debt crisis has lasted so long?" (p. 69). The long answer to this fundamental question begins in the fourth chapter, which critically analyses the programmes adopted by the EU to fight the debt crisis, and continues until the end of the book. To answer this question, it is necessary to retrocede to the creation of the EMU. In George Zestos's words, "One main reason that the recession in the EA countries has not subsided is because the EMU was introduced as an incomplete structure in January 1999" (p. 71). At the time of the economic foundation of the euro, the EU's optimistic view was that the greater monetary integration would create a more homogeneous structure of economic development across the EA members, resulting in greater homogeneity. However, the euro crisis showed that the EMU does not constitute an optimum currency area and that it was poorly designed.

When countries became members of the EMU and adopted the euro, they gave up their monetary and exchange rate policies. Thus, they lacked the necessary tools to fight the asymmetric shocks that affect only some members of the EMU. George Zestos also stresses that "the EU countries have also surrendered their fiscal policies" (p. 92) when they signed the Fiscal Compact Treaty. The EU countries are required to comply with stricter fiscal rules to protect the taxpayers of Germany and its northern allies from the burden of guaranteeing additional bailouts to other financially distressed EA countries. Besides, during the recession caused by the crisis, the "one-size-fits-all" monetary policy of the ECB proved to be ineffective. An expansionary monetary policy would have been appropriate for the peripheral EA countries to boost economic activity. However, for the northern EA countries, which experienced economic growth for most of the years of the crisis, a contractionary monetary policy would have been more suitable to suppress inflation.

The EU actuation to cope with the Great Recession differed strongly from the US economic policies, which are explained in detail in chapter five. The US fiscal authorities employed three fiscal stimulus plans, and the Federal Reserve Bank drove the federal funds rate down to zero-bound, launched several short-term lending programmes and adopted a new approach known as quantitative easing. The proof that these economic policies were effective is the duration of the US subprime mortgage crisis "that lasted 18 months" (p. 15).

Following a different approach, the EU decided that internal devaluation, through austerity and neoliberal supply-side policies, was the best answer to escape from the crisis. In fact, some southern EA countries became internationally competitive, increased their exports and reversed their current account deficits into surpluses. However, the real wages of urban workers were often reduced below subsistence levels, which led to "social unrest, crime, homelessness, and poverty" (p. 75). Additionally, the euro currency remained overvalued in the period 2008-2014, and thus the gains in competitiveness could be the result of a more expansionary monetary policy by the ECB if that had been the goal of the monetary authority.

In George Zestos's opinion, "a series of mistakes, gaffes, and half-baked proposed programs by European country leaders and the IMF" (p. 71) contributed to aggravating the EU member states' divisions, namely the climate of distrust among northern and southern EA members, and thus created an identity crisis. The author shares the opinion of those who argue that further European integration and less self-centred nationalistic policies are necessary. More integration and solidarity will lead to stability and growth in all the EMU member countries. These are the objectives set in the founding treaties of the EU by their founding fathers, in which "idealism and vision are more necessary now than ever to help complete the grand European project" (p. 90).

George Zestos argues that the EU must establish a complete monetary, banking and fiscal union. The ECB has to be granted full independence to design and exercise monetary policy freely in the EA. It must buy member countries' sovereign bonds, but mutualization of the public debt is also necessary (eurobonds). It is also important to complete the banking union because of the interdependence between the overindebted governments and their ailing banks. Finally, the establishment of a fiscal union governed by a European fiscal authority, probably within the EU Commission, is essential. Fiscal policies are now mainly conducted by the national governments, but they have been unable to coordinate their policies and protect the EMU. The fiscal union would solve the moral hazard problem once and for all. In the author's opinion, the fiscal authority must be delegated independence to apply discretionary fiscal policy in the EMU instead of rigid fiscal rules.

The crisis would not have lasted so long if the role of Germany, "the largest and strongest economy in the EU" (p. 159), had been different. In chapter six George Zestos discusses clearly and in great detail the guilt of Germany in the maintenance of the crisis's effects. Several politicians and economists have recommended the joint issuance of eurobonds by the EA countries as a solution to the euro crisis. The EC and the highly indebted southern EA countries (as well as George Zestos) view this solution favourably, but the German Government is against it because it would increase Germany's cost of borrowing. In fact, Germany, considered as "a safe haven country" (p. 147) in Europe, has been able to borrow at exceptionally low interest rates since the beginning of the sovereign debt crisis. Because of that, some critics claim that Germany achieved domestic growth partially at the expense of its EA partner countries, which starved themselves of liquidity. Besides, Germany has been the largest exporting country, and its growth is heavily dependent on exports to other EU countries.

On the contrary, Greece, which "has been at the center of the European sovereign debt crisis as it triggered the crisis" (p. 167), is the EA country that was most negatively affected and experienced the worst situation in its history at several levels (financial, economic, political, social and humanitarian). In chapter seven the author dissects sharply all these Greek problems, namely the corruption and clientelism in the public sector that mainly explain the increase in the public debt to an unsustainable level. Such a clientelistic type of relationship was developed among politicians and voters, as they both received short-term benefits, and contributed to the creation of a bad public opinion of Greek people. Additionally, the German news media was responsible for describing "Greeks as lazy" (p. 196), reinforcing this stereotyped negative view.

The dramatic situation experienced by Greece and by the other bailout recipient countries was the responsibility, at least partially, of the CRAs. These agencies were wrong in the past, both in America and in Europe. In the US they failed to warn investors and misled them into buying poor-quality securities, and in Europe they were "overreacting in downgrading countries and not giving the EU a chance to complete bailout programs designed to save the countries" (p. 239). In fact, the CRAs led to a drastic rise in interest rates (particularly in Greece, Ireland, Portugal, Spain and Italy), being one of the causes of the EA crisis. This is clearly presented and discussed in chapter eight, in which George Zestos also highlights the criticism of Ricardo Reis (Professor of Economics at Columbia University), which stresses that the EU/IMF answer to the crisis in the EMU countries was wrongly the same, regardless of the economic conditions and the causes of the crisis in each country.

Summing up, this book explores standard topics but also enters the discussion of controversial issues that are fundamental to the future of Europe. In this sense it proves to make an important contribution to the understanding of the crisis's complex dynamics, to keeping alive the discussion concerning the analysis of the crisis and to helping to deal with future problems. As mentioned by George Zestos, the euro crisis is not over yet, specifically because "millions of people were thrown into poverty and many still have not recovered yet" (p. xiv). As a result, the future of the EA and its single currency is uncertain.

In this way this book offers an excellent contribution to our understanding of the recent global crisis, giving a detailed, in-depth and comprehensive overview of its causes, policy answers, effects and implications. It also contains a critical appraisal of the “background” of the crisis and the role of the institutions, policies and politicians that is enriching and most interesting (although the reader may not agree with all the ideas presented by the author). Additionally, it challenges book readers to rethink what happened and what basic lessons could be extracted to avoid similar episodes in the future, particularly in the EU, where several problematic issues are actually affecting the process of greater European integration.

Lastly, it is worth mentioning that the chapters of this very interesting book maintain a reachable level of discussion on all the topics without the use of complex mathematical apparatus, providing references to delve deeper into them. The book is therefore accessible to anyone who is interested in financial crises, governance issues, international economics and economic policies, including students, academics, policymakers and other professionals.