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EUROZONE CRISIS: BEGGAR THYSELF AND THY NEIGHBOUR

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Executive Summary

Background

The public debt crisis of Greece and other peripheral eurozone countries has the potential to harm the European Monetary Union. But the eurozone project has already inflicted damage onto Greece and other peripheral countries. There are two related reasons for the crisis: first, the skewed nature of monetary union and, second, the economic upheaval of 2007-9.

Monetary union has removed or limited the freedom to set monetary and fiscal policy, thus forcing the pressures of economic adjustment onto the labour market. Guided by EU policy, eurozone countries have entered a 'race to the bottom' encouraging flexibility, wage restraint, and part-time work. Labour has lost out to capital across the eurozone. The race has been won by Germany squeezing its workers hard in the aftermath of reunification. The eurozone has become an area of entrenched current account surpluses for Germany, financed by current account deficits for peripheral countries. Monetary union is a 'beggar-thy-neighbour' policy for Germany, on condition that it beggars its own workers first.

The crisis of 2007-9 compounded the predicament of peripheral countries because of the monetary and financial structures of the eurozone. The crisis resulted in extreme shortage of liquidity for European banks. The ECB intervened, lending freely and making it possible for banks to start dealing with their weak position. But ECB reaction was very different in 2009 when states faced growing borrowing needs due to the crisis. The eurozone left each state to fend for itself in the financial markets. The ECB watched as interest rates rose, financial institutions speculated against state debt, and state bankruptcy raised its head.

Confronted with a public debt crisis, peripheral countries have been forced by the eurozone to impose harsh austerity. Yet, until early 2010, they have received no bridging loans to ease the pressure. This is grossly damaging, and offers no assurances of future growth. In effect, peripheral countries have been forced to accept IMF conditionality, but without an IMF loan.

Better policy alternatives are available, but they involve radical social and economic change. One option would be to reform the eurozone by relaxing fiscal constraints, introducing an enlarged European budget, guaranteeing a minimum wage, and providing unemployment insurance. A more radical alternative would be to exit from the eurozone, nationalising banks and other key areas of the economy as well as introducing industrial policy. Under all circumstances, peripheral countries face hard choices involving social conflict.

The mechanisms of crisis

Gains for German capital, losses for German workers and periphery

- i. Monetary union has imposed fiscal rigidity, removed monetary independence, and forced economic adjustment through the labour market. Workers have lost share of output relative to capital in Germany and peripheral countries.
- ii. The German economy has performed poorly, with low growth, weak productivity gains, and high unemployment. But Germany has been able to keep down inflation as well as the nominal remuneration of labour. Peripheral countries have performed generally better, but labour costs and inflation have risen faster.
- iii. Germany has gained competitiveness within the eurozone for the sole reason that it has been able to squeeze its workers harder. Inevitably it has generated persistent current account surpluses against the periphery. The surpluses were turned into foreign direct investment and bank lending to the eurozone.

Finance creates a crisis and then takes advantage of it

- iv. European banks faced a pressing need for liquidity after 2007. Banks also had to deal with the excesses of the preceding bubble. The ECB provided extraordinary volumes of liquidity, allowing banks to repair balance sheets by reducing lending, but thus intensified the recession. By 2009 bank lending was in retreat in the eurozone, and banks were not acquiring long-term securities.
- v. But during 2007-8 banks of core eurozone countries (Germany, France, Netherlands, Belgium) had continued to lend to peripheral countries (Italy, Spain, Ireland, Greece, Portugal). Gross cross-border claims from core to periphery reached 1.5 trillion euro in 2008, representing almost three times the capital of core banks.
- vi. Peripheral and core states arrived in financial markets in 2009 seeking extra funds of nearly one trillion euro because of the crisis. Public revenue had collapsed as the recession deepened, while public expenditure had risen to rescue finance and perhaps to maintain demand.
- vii. Thus, states appeared in financial markets at the 'worst moment'. With banks reluctant to lend, yields rose for all public debt. Financial capital was able to engage in speculative attacks on public debt of peripheral states, while the ECB watched. In short, European finance was rescued, only to turn and bite its rescuer.

Alternatives

There are three strategic alternatives available to peripheral countries.

1. The first is austerity accompanied with further liberalisation. This is the preferred choice of the eurozone and of the ruling elites across the periphery. It is also the worst option. It will achieve stabilisation through recession, imposing huge costs on working people. It offers little prospect of sustained growth in the future since productivity is expected to rise spontaneously following liberalisation. And it does not address the structural bias at the heart of the eurozone.
2. The second is radical reform of the eurozone. It would involve greater fiscal freedom by member states; a substantially enlarged European budget; fiscal transfers from rich to poor; protection for employment; support for wages; and cross-European investment in sustainable industries. The strict regulations applying to ECB purchases of state debt would also be relaxed. This might be called the 'good euro' option. Political problems aside, this strategy is likely to threaten the international role of the euro by leading to a fall in its value. It could thus threaten monetary union itself.
3. The third is radical exit from the eurozone. There would be devaluation followed by cessation of payments and restructuring of debt. Banks would have to be nationalised and public control extended over utilities, transport, energy and telecommunications. Industrial policy would be introduced, including strategies to improve productivity. Infrastructure and environmentally sensitive investment could support equitable growth. This option requires a decisive shift in the balance of political power in favour of labour. To avoid veering toward national autarky peripheral countries would need to maintain access to international trade, technology and investment.

1. Several dimensions of a public debt crisis: The report condensed

1.1. A crisis with deep roots

The sovereign debt crisis that broke out in Greece at the end of 2009 is fundamentally due to the precarious integration of peripheral countries in the eurozone. Its immediate causes, however, lie with the crisis of 2007-9. Speculative mortgage lending by US financial institutions, and trading of resultant derivative securities by international banks created a vast bubble in 2001-7, leading to crisis and recession. State provision of liquidity and capital in 2008-9 rescued the banks, while state expenditure prevented a worsening of the recession. The result in the eurozone was a sovereign debt crisis, exacerbated by the structural weaknesses of monetary union.

The crisis of public debt, thus, represents Stage Two of an upheaval that started in 2007 and can be called a crisis of financialisation.¹ Mature economies have become 'financialised' during the last three decades resulting in growing weight of finance relative to production. Large corporations have come to rely less on banks, while becoming more engaged in financial markets. Households have become heavily involved in the financial system in terms of assets (pension and insurance) and liabilities (mortgage and unsecured debt). Banks have been transformed, seeking profits through fees, commissions and own trading, while rebalancing their activities toward households rather than corporations. Financial profit has emerged as a large part of total profit.²

But financialisation has unfolded in different ways across mature countries, including in the European Union. Germany has avoided the explosion of household debt that recently took place in other mature countries and peripheral eurozone countries. The performance of the German economy has been mediocre for many years, while great pressure has been applied on German workers' pay and conditions. The main source of growth for Germany has been its current account surplus within the eurozone, resulting from pressure on pay and conditions rather than superior productivity growth. This surplus has been recycled through foreign direct investment and German bank lending to peripheral countries and beyond.

¹ Financialisation has been extensively discussed by political economists. A useful, but not complete, survey can be found in van Treeck, T. 2009. The political economy debate on 'financialization' - a macroeconomic perspective, *Review of International Political Economy*, 16: 5, 907-944. The theoretical views underpinning this report can be found in C. Lapavistas, 2009. Financialised Capitalism: Crisis and Financial Expropriation, *Historical Materialism*, 17:2, 114-148 and Dos Santos P. 2009. On the Content of Banking in Contemporary Capitalism, *Historical Materialism*, 17:2, 180-213.

² See, for example: Krippner, G. 2005. The Financialization of the American Economy. *Socio-Economic Review*, 3, 173-208; and Dumenil, G. & Levy, D. 2004. The Real and Financial Components of Profitability. *Review of Radical Political Economics*, 36, 82-110.

1. Several dimensions of a public debt crisis: The report condensed

The implications for the eurozone have been severe. Financialisation in the periphery has proceeded within the framework of the monetary union and under the dominant shadow of Germany. Peripheral economies have acquired entrenched current account deficits. Growth has come from expansion of consumption financed by expanding household debt, or from investment bubbles characterised by real estate speculation. There has been a general rise of indebtedness, whether of households or corporations. Meanwhile, pressure has been applied to workers' pay and conditions across the periphery, but not as persistently as in Germany. The integration of peripheral countries in the eurozone has thus been precarious, leaving them vulnerable to the crisis of 2007-9 and eventually leading to the sovereign debt crisis.

1.2 Institutional bias and malfunction in the eurozone

The institutional mechanisms surrounding the euro have been an integral part of the crisis. To be more specific, European monetary union is supported by a host of treaties and multilateral agreements, including the Maastricht Treaty, the Growth and Stability Pact and the Lisbon Strategy. It is also supported by the European Central Bank, in charge of monetary policy across the eurozone. The combination of these institutions has produced a mix of monetary, fiscal, and labour market policies with powerful social implications.

A single monetary policy has been applied across the eurozone. The ECB has targeted inflation and focused exclusively on the domestic value of money. To attain this target the ECB has taken cognisance of conditions primarily in core countries rather than assigning equal weight to all. In practice this has meant low interest rates across the eurozone. Further, the ECB has operated deficiently since it has not been allowed to acquire and manage state debt. And nor has it actively opposed financial speculation against member states. Yet, the ECB has emerged as protector of financial interests and guarantor of financialisation in the eurozone.

Fiscal policy has been placed under the tight constraints of the Stability Pact, though considerable residual sovereignty has remained with member states. Fiscal discipline has been vital to the acceptability of the euro as international reserve, thus allowing the euro to act as world money. Since it lacks a unitary state and polity, the eurozone has not had an integrated tax system or fiscal transfers between areas. In practice, fiscal rules have been applied with some laxity in core countries and elsewhere. Peripheral countries have attempted to disguise budget deficits in a variety of ways. Nonetheless, fiscal stringency has prevailed during this period.

Given these constraints, national competitiveness within the eurozone has depended on the conditions of work and the performance of labour markets, and in this regard EU policy has been unambiguous. The European Employment Strategy has encouraged greater flexibility of employment as well as more part-time and temporary work. There has

1. Several dimensions of a public debt crisis: The report condensed

been considerable pressure on pay and conditions, a race to the bottom across the eurozone. The actual application of this policy across the eurozone has varied considerably, depending on welfare systems, trade union organisation, and social and political history.

It is apparent that the institutions of the eurozone are more than plain technical arrangements to support the euro as domestic common currency as well as world money. Rather, they have had profound social and political implications. They have protected the interests of financial capital by lowering inflation, fostering liberalisation, and ensuring rescue operations in times of crisis. They have also worsened the position of labour compared to capital. Not least, they have facilitated the domination of the eurozone by Germany at the expense of peripheral countries.

1.3 Peripheral countries in the shadow of Germany

Peripheral countries joined the euro at generally high rates of exchange presumably to control inflation, thus signing away some of their competitiveness at the outset. Since monetary policy has been set by the ECB and fiscal policy has been constrained by the Stability Pact, peripheral countries were encouraged to improve competitiveness primarily by applying pressure on their workers. But they have faced two major problems in this regard. First, real wages and welfare states are generally worse in the periphery than the core of the eurozone. The scope for gains in competitiveness through pressure on workers is correspondingly less. Second, Germany has been unrelenting in squeezing its own workers throughout this period. During the last two decades, the most powerful economy of the eurozone has produced the lowest increases in nominal labour costs, while its workers have systematically lost share of output. European monetary union has been an ordeal for German workers.

German competitiveness has thus risen further within the eurozone. The result has been a structural current account surplus for Germany, mirrored by current account deficits for peripheral countries. This surplus has been the only source of dynamism for the German economy throughout the 2000s. In terms of output, employment, productivity, investment, consumption, and so on, German performance has been mediocre. Thus, at the core of the eurozone lies an economy that delivers growth through current account surpluses deriving in large part from the arrangements of the euro. German surpluses, meanwhile, have been translated into capital exports - primarily bank lending and foreign direct investment - the main recipient of which has been the eurozone, including the periphery.

This is not to imply that workers in peripheral countries have avoided pressures on pay and conditions. Indeed, the share of labour in output has declined across the periphery. It is true that the remuneration of labour has increased in nominal and real terms in the periphery, but productivity has risen by more - and generally faster than in Germany.

1. Several dimensions of a public debt crisis: The report condensed

But conditions within the eurozone have not encouraged rapid and sustained productivity growth in peripheral countries, partly due to middling levels of technology, with the exception of Ireland. Peripheral countries have thus lost competitiveness as the nominal compensation of German workers has remained practically stagnant throughout the period.

Confronted with a sluggish but competitive Germany, peripheral countries have opted for growth strategies that reflected their own history, politics and social structure. Greece and Portugal sustained high levels of consumption, while Ireland and Spain had investment booms that involved real estate speculation. Across the periphery, household debt rose as interest rates fell. The financial system expanded its weight and presence across the economy. But in 2009-10 it became apparent that these strategies were incapable of producing long-term results.

The integration of peripheral countries in the eurozone has been precarious as well as rebounding in favour of Germany. The sovereign debt crisis has its roots in this underlying reality rather than in public profligacy in peripheral countries. When the crisis of 2007-9 hit the eurozone, the structural weaknesses of monetary union emerged violently, taking the form of a public debt crisis for Greece, and potentially for other peripheral countries.

1.4 The impact of the crisis of 2007-9 and the role of finance

The immediate causes of the crisis of 2007-9 lay in the US mortgage bubble which became global due to securitisation of subprime assets. European banks began to face liquidity problems after August 2007, and German banks in particular found that they were heavily exposed to problematic, subprime-related securities. During the first phase of the crisis, core eurozone banks continued to lend heavily to peripheral borrowers in the mistaken belief that they were a safe outlet. Net exposure rose substantially in 2008.

But reality had changed dramatically for banks as liquidity became increasingly scarce in 2008, particularly after the 'rescue' of Bear Stearns in early 2008 and the collapse of Lehman Brothers six months later. To rescue banks, the ECB engaged in extensive liquidity provision, accepting many and debatable types of paper as collateral for secure debt. ECB actions allowed banks to begin to adjust their balance sheet, engaging in deleveraging. By late 2008 banks were already reducing their lending, including to the periphery. Banks also stopped buying long-term securities preferring to hold short-term instruments - backed by the ECB - with a view to improving liquidity. The result was credit shortage and accelerated recession across the eurozone, including the periphery.

These were the conditions under which states – both core and periphery of the eurozone but also the UK and other states – began to seek additional loanable funds in financial markets. A major cause of rising state borrowing was the decline of public revenue as recession

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lowered the tax intake. State expenditure also rose in several countries after 2007 as the rescuing of banks proved expensive, and to a lesser extent as states attempted to support aggregate demand. Accelerated public borrowing in 2009 was induced by the crisis, and hence by the earlier speculations of the financial system. In this respect, the Greek state was typical of several others, including the USA and the UK.

In the conditions of financial markets in 2009, with the banks reluctant to lend, the rising supply of state paper put upward pressure on yields. Thus, speculators found an environment conducive to their activities. In the past, similar pressures in financial markets would have led to speculative attacks on currencies and collapsing exchange rates for the heavy borrowers. But this was obviously impossible within the eurozone, and hence speculative pressures appeared as falling prices of sovereign debt.

Speculators focused on Greek public debt on account of the country's large and entrenched current account deficit as well as because of the small size of the market in Greek public bonds. Credibility was also lost by the Greek government because of systematic fiddling of national statistics to reduce the size of budget deficits. But the broader significance of the Greek crisis was not due to the inherent importance of the country. Rather, Greece represented potentially the start of speculative attacks on other peripherals - and even on countries beyond the eurozone, such as the UK - that faced expanding public debt.

The Greek crisis, therefore, is symptomatic of a wider malaise. It is notable that the institutions of the eurozone, above all the central bank, have performed badly in this context. For the ECB private banks were obviously 'too big to fail' in 2007-9, meriting extraordinary provision of liquidity. But there was no similar sensitivity toward peripheral countries that found themselves in dire straits. It made little difference that the problems of public debt were largely caused by the crisis as well as by the very actions of the ECB in providing banks with liquidity.

To be sure the ECB has been hamstrung by its statutes which prevent it from directly acquiring public debt. But this is yet more evidence of the ill-conceived and biased nature of European monetary union. A well-functioning central bank would not have simply sat and watched while speculators played destabilising games in financial markets. At the very least, it would have deployed some of its ingenuity, as the ECB generously did when private banks needed liquidity in 2007-9. And nor would it have decided what types of paper to accept as collateral on the basis of ratings provided by the discredited private organisations that were instrumental to the bubble of 2001-7.

1.5 Policy options for peripheral countries

The crisis is so severe that there are neither soft options, nor easy compromises for peripheral countries. The choices are stark, similar to

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those of developing countries confronted with repeated crises during the last three decades.

The first alternative is to adopt austerity by cutting wages, reducing public spending and raising taxes, in the hope of reducing public borrowing requirements. Austerity would probably have to be accompanied by bridging loans, or guarantees by core countries to bring down commercial borrowing rates. It is likely that there would also be 'structural reform', including further labour market flexibility, tougher pension conditions, privatisation of remaining public enterprises, privatisation of education, and so on. The aim of such liberalisation would presumably be to raise the productivity of labour, thus improving competitiveness.

This is the preferred alternative of ruling elites across peripheral and core countries, since it shifts the burden of adjustment onto working people. But there are several imponderables. The first is the opposition of workers to austerity, leading to political unrest. Further, the eurozone lacks established mechanisms both to provide bridging loans and to enforce austerity on peripheral members. There is also strong political opposition within core countries to rescuing others within the eurozone. On the other hand, the option of forcing a peripheral country to seek recourse to the IMF would be damaging for the eurozone as a whole.

Yet, despite apparent legal constraints, it is not beyond the EU to find ways of advancing bridging loans, at the same time enforcing austerity through political pressure. The real problem with this option is not the institutional machinery of the eurozone. It is, rather, that the policy is likely to lead to aggravated recession in peripheral countries making it even more difficult to meet public borrowing targets. Poverty, inequality and social division will increase substantially. Even worse, it is unlikely that there will be long-term increases in productivity through a strategy of liberalisation. Productivity increases require investment and new technologies, neither of which will be provided spontaneously by liberalised markets.

Peripheral countries would probably find themselves lodged in an unequal competitive struggle against Germany, whose workers would continue to be severely squeezed. Attempting to remain within the eurozone by adopting austerity and liberalisation would lead to sustained falls in real wages in the vain hope of reversing current account deficits against Germany. The eurozone as a whole, meanwhile, would continue to be faced with a weaker world economy due to the crisis of 2007-9. It is a grim prospect for working people in the periphery, and far from a bed of roses for German workers.

The second alternative is to reform the eurozone. There is almost universal agreement that unitary monetary policy and fragmented fiscal policy have been a dysfunctional mix. There is also widespread criticism of the ECB for the way it has provided abundant liquidity to banks, while keeping aloof of borrowing states, even to the extent of ignoring speculative attacks. A range of reforms that would not challenge the fundamentals of the Maastricht Treaty, the Stability Pact, and the

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Lisbon agenda might well be possible. The aim would be to produce smoother interaction of monetary and fiscal forces, while maintaining the underlying conservatism of the eurozone.

There is very little in such reforms that would be attractive to working people, or that would indeed deal with the structural imbalances within the eurozone. Hence there have been calls for more radical reforms, including abolition of the Stability Pact and altering the statutes of the ECB to allow it regularly to lend to member states. The aim of such reform would be to retain monetary union, while creating a 'good euro' that would be beneficial to working people. The 'good euro' strategy would involve significantly expanding the European budget to deliver fiscal transfers from rich to poor countries. There would be an active European investment strategy to support new areas of economic activity. There would also be a minimum wage policy, reducing differentials in competitiveness, and lowering inequality across the eurozone.

The 'good euro' strategy, appealing as it sounds, would face two major problems. The first is that the eurozone lacks a unitary state, and there is no prospect of acquiring one in the near future, certainly not with the required progressive disposition. The current machinery of the eurozone is entirely unsuited to this task. The strategy would face a continuous conflict between, on the one hand, its ambitious pan-European aims and, on the other, the absence of state mechanisms that could begin to turn these aims into reality.

More complexly, the 'good euro' strategy would clash with the putative role of the euro as world money. If fiscal discipline was relaxed among member states, there would be a risk that the value of the euro would collapse in international markets. Were that to happen, at the very least, the international operations of European banks would become extremely difficult. The international role of the euro, which has been vital to the project from the beginning, would come under heavy pressure. Thus, it is not clear that the 'good euro' strategy is compatible with monetary union. In this light, a 'good euro' might end up as 'no euro'. Those who advocate this strategy ought to be aware of its likely implications, i.e., leading to the end of monetary union. Institutional, political and social demands have to be tailored accordingly.

The third alternative is to exit from the eurozone. Even here, however, there are choices. There is 'conservative exit', which is increasingly discussed in the Anglo-Saxon press, and would aim at devaluation. Some of the pressure of adjustment would be passed onto the international sphere, and exports would revive. But there would also be losses for those servicing debt abroad, including banks. Workers would face wage declines as the price of tradeable goods would rise. Devaluation would probably be accompanied by austerity and liberalisation, compounding the pressure on workers.

Long-term improvements in productivity would, however, occur only if market forces began spontaneously to develop new capacity in the tradeable goods sector. This is extremely difficult for peripheral

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eurozone countries, with middling technology and middling real wages. It is notable that the ruling elites of peripheral countries are aware of these difficulties, as well as of their own lack of capacity to deal with them. They have implicitly admitted that they possess neither the means nor the will to pursue an independent path. Consequently, conservative exit might lead to stagnation with repeated devaluations and decline in incomes.

There is, finally, 'progressive exit' from the eurozone, which would require a shift of economic and social power toward labour in peripheral countries. There would be devaluation accompanied by cessation of payments and restructuring of debt. To prevent collapse of the financial system there would have to be widespread nationalisation of banking, creating a system of public banks. Controls would also have to be imposed on the capital account to prevent outflows of capital. To protect output and employment, finally, it would then be necessary to expand public ownership over key areas of the economy, including public utilities, transport and energy.

On this basis, it would be possible to develop industrial policy that could combine public resources with public credit. There are broad areas of the national economy in peripheral countries that call for public investment, including infrastructure. Opportunities exist to develop new fields of activity in the 'green' economy. Investment growth would provide a basis on which to improve productivity, ever the Achilles heel of peripheral economies. Financialisation could then begin to be reversed by lessening the relative weight of finance.

A radical policy shift of this type would require transforming the state by establishing mechanisms of transparency and accountability. The tax and transfer payments of the state would then take a different shape. The tax base would be broadened by limiting tax evasion by the rich as well as by capital. Public provision for health and education would be gradually improved, as would redistribution policies to alleviate high inequality in peripheral countries.

A policy of progressive exit for peripheral countries would come with evident costs and risks. The broad political alliances necessary to support such a shift do not exist at present. This absence, incidentally, is not necessarily due to lack of popular support for radical change. More important is that no credible political force in Europe has had the boldness to oppose austerity hitherto. Beyond political difficulties, a major problem for progressive exit would be to avoid turning into national autarky. Peripheral countries are often small and need to maintain access to international trade and investment, particularly within Europe. They also need technology transfer.

International alliances and support would be necessary in order to sustain flows of trade, skills and investment. These would be far from easy to secure if the rest of the EU remained under the spell of monetary union. But note that progressive exit by the periphery would also offer fresh prospects to core eurozone countries, particularly to labour which has suffered throughout this period. If the eurozone unravelled generally,

1. Several dimensions of a public debt crisis: The report condensed

economic relations between core and periphery could be put on a more cooperative basis.

1.6 The structure of the report

The report focuses on the peripheral countries of the eurozone, above all, Greece, Portugal, Spain and Ireland. When appropriate, Italian data and performance have also been considered, though Italy is by no means a peripheral country to the EU. The core of the eurozone is taken to comprise Germany, France, Belgium and the Netherlands.³ Comparisons are usually made with Germany, the leading country of the core and the EU as a whole. The introduction of the euro in 1999 – and 2001 for Greece – provides a natural point of reference for all comparisons. Each country has its own distinctive institutional, social and historical trajectory, and therefore some pretty brutal generalisations are deployed below. But there are also evident commonalities which derive in large part from worldwide patterns of economic development in recent years, as well as from the nature of the EU and the eurozone.

Thus, section 2 of the report discusses macroeconomic performance of peripheral countries compared to Germany. Section 3 moves to labour markets, the remuneration of labour and the patterns of productivity growth. Section 4 then turns to international transactions particularly within the eurozone. On this basis, section 5 considers the evolution of public finance and the expansion of public indebtedness after 2007. Section 6 places the growth of public debt in the context of the operations and performance of the financial sector following the crisis of 2007-9. Section 7 concludes by considering the alternatives available to peripheral countries.

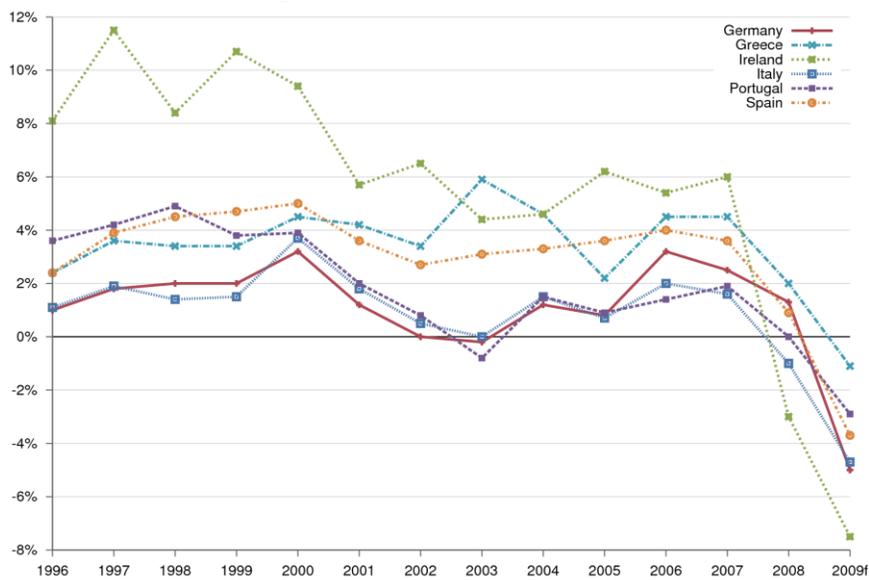
³ Needless to say the EU also has a Central and Eastern European periphery, including the Czech Republic, Poland, the Baltic countries, Hungary, and so on. This is an important part of the EU economy, particularly as production is increasingly relocated from the core, above all, Germany. But these countries are not members of the eurozone, and hence they have been left out of the analysis. Still, the crisis of 2007-9 hit the central and eastern periphery first, forcing several countries to adopt IMF programmes that enforced severe austerity. The trigger was rising indebtedness associated with free capital flows. In this respect, there are similarities with the public debt crises in the periphery of the eurozone.

2. Macroeconomic performance: Stagnation in Germany, bubbles in the periphery

2.1 Growth, unemployment and inflation

Growth rates among the countries in the sample were generally lower in the 2000s than in the 1990s (fig. 1). This fits the pattern of steadily declining growth rates across developed countries since the late 1970s. But there is also significant variation. Thus, Ireland registered very high rates of growth in the 1990s, driven by investment by US multinational corporations that were given tax breaks. Profit repatriation has been substantial, creating a large disparity between Irish GDP and GNP. Much of Irish growth has been due to transfer pricing within multinationals, thus also inflating productivity growth. Greek growth also accelerated in the early 2000s, bolstered by expenditure for the Olympic Games. Spanish growth, finally, has been reasonably high throughout the period.

Fig. 1 GDP Growth Rates



Source: Eurostat

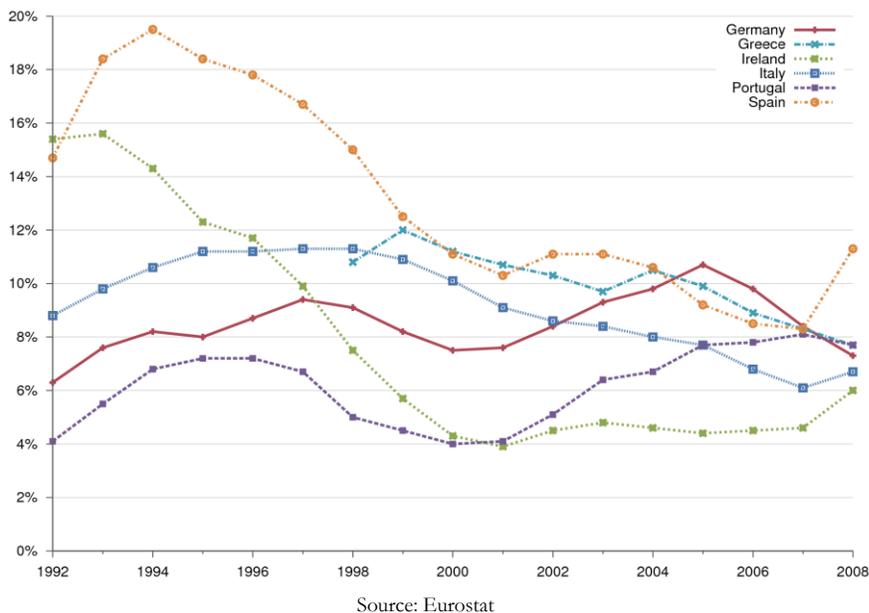
However German growth rates have remained anaemic throughout, with the exception of a minor burst in the second half of the 2000s. Exports have played a significant role in causing this uptick of growth, a development of the first importance for the evolution of the eurozone. Portuguese and Italian growth has barely diverged from German rates since the introduction of the euro.

Unemployment rates are consistent with growth rates (fig. 2), showing convergence toward lower levels in the 2000s compared to the

2. Macroeconomic performance: Stagnation in Germany; bubbles in the periphery

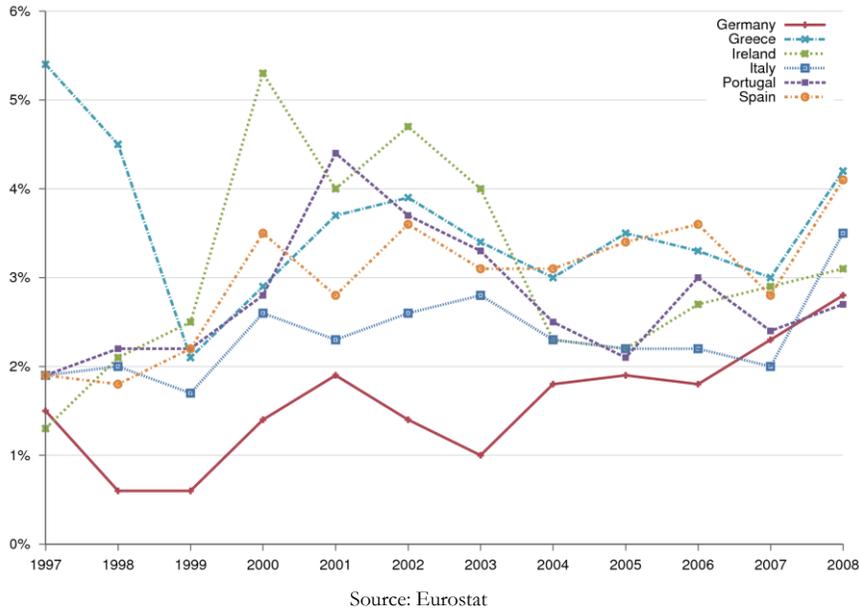
1990s. This is mostly because Spanish and Irish unemployment rates declined rapidly at the end of the 1990s. Spanish unemployment, however, remained on the high end of the spectrum throughout, and has risen faster than the rest once the crisis of 2007-9 materialised. Unemployment seems to expand rapidly in Spain at the first sign of economic difficulty. The Greek labour market is probably not very different, bearing in mind that official statistics tend to underestimate unemployment. Greek unemployment rose rapidly in 2009, once the crisis hit hard. Equally striking, however, have been the high rates of German unemployment throughout this period, if anything exhibiting an upward trend. The same holds for Portugal, which has followed Germany in this respect too.

Fig.2 Unemployment Rates



Inflation rates, on the other hand, present a more complex pattern (fig. 3). Rates converged to a fairly narrow range of 2-4% in 2001, at the time of the introduction of the euro. However, in the following three years rates diverged, only to converge again in 2004, this time to a narrower range of 2-3%. Inflation targeting by the ECB and the application of a common monetary policy took some time to produce the desired effect. The picture is at most a qualified success for the ECB as inflation rates accelerated again in 2007-8. The most important element of figure 3, however, is that German inflation rates have remained consistently below the rest throughout the period, rarely exceeding 2%.

Fig. 3 Inflation Rates
(Harmonised Index of Consumer Prices)



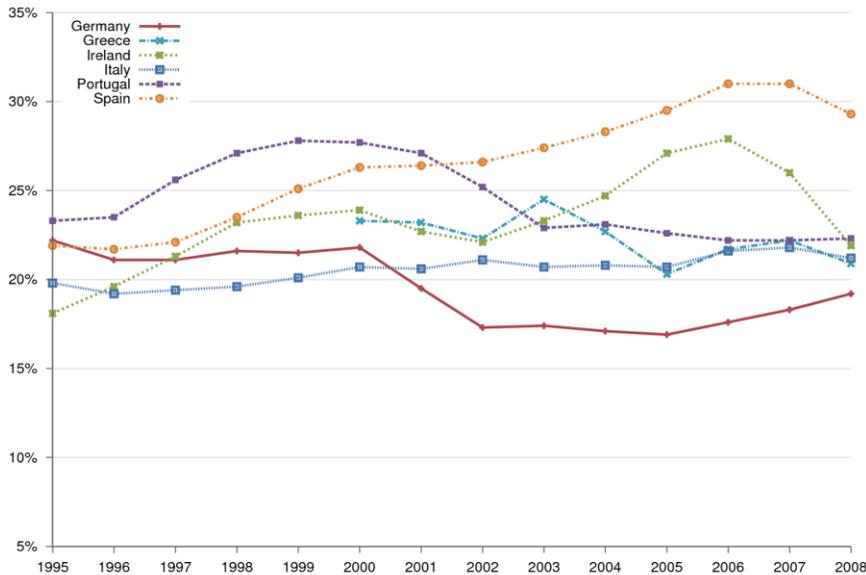
In short, the German economy has produced a characteristic and consistent macroeconomic performance throughout the period, marked by mediocre growth, high unemployment and low inflation. German performance has set the tone for the eurozone and placed its stamp on the operation of the euro. The sovereign debt crisis has its roots as much in the performance of Germany, as it does in the actions of peripheral countries.

2.2. Investment and Consumption

A closer look at the components of aggregate demand gives further insight into macroeconomic performance. Before looking at investment and consumption, however, note that the economies in the sample are generally service-based. The secondary sector contributes slightly less than 30% of GDP in Germany, Italy, Spain and Portugal. It amounts to roughly 45% of GDP in Ireland, but that is largely due to the presence of multinationals. Greece is also an exception, the secondary sector standing at about 20% of GDP. Agriculture makes a minor contribution to output throughout.

Investment performance has been poor, with the exception of Spain and Ireland (fig. 4), which even underwent investment booms in the late 2000s. But Irish investment in the 1990s was in large part due to US multinational activities. Generally, investment has been weak:

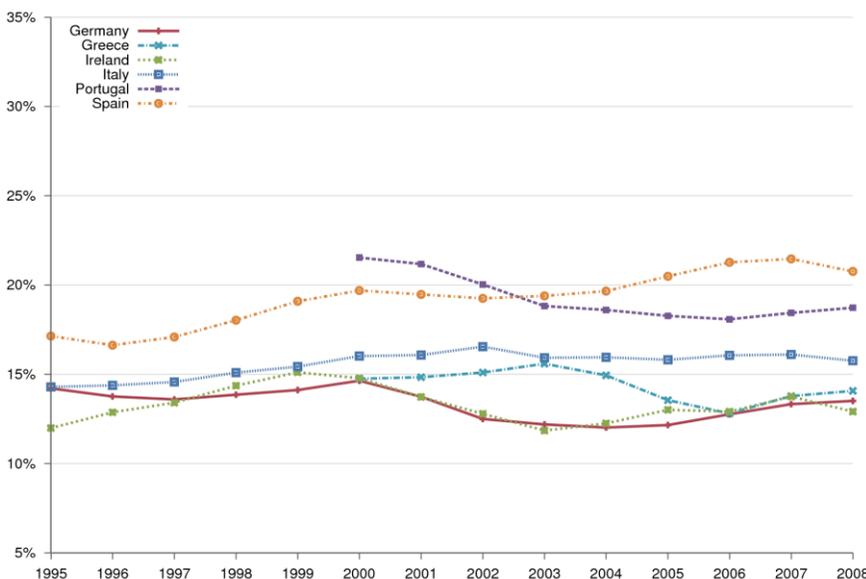
Fig. 4 Gross Fixed Capital Formation
% of GDP



Source: Eurostat

A better picture of underlying trends is given by investment net of housing (fig. 5). It is clear that the investment boom in Ireland in the 2000s was primarily due to a real estate bubble. The Spanish investment boom was also heavily based on real estate. Investment in the productive sector has been generally weak in the sample

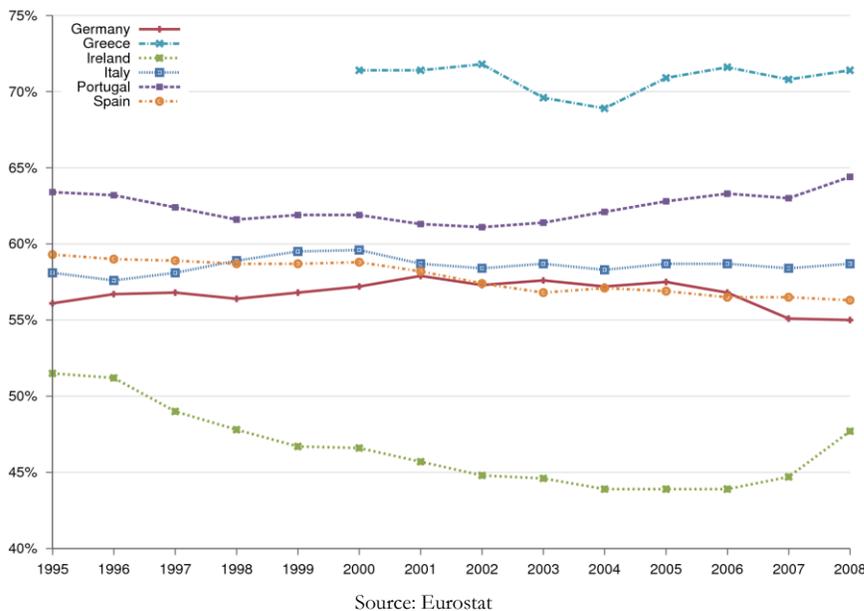
Fig. 5 Gross Fixed Capital Formation Net of Housing
% of GDP



Source: Eurostat

Consumption, on the other hand, has remained pretty flat relative to GDP, with the exception of Portugal where it rose significantly after the introduction of the euro (fig. 6). The striking aspect of consumption, however, is the exceptionally high level of Greece, rapidly approached by Portugal in the second half of the 2000s. High household consumption has been the mode of integration for both countries in the eurozone. This is a significant difference with Spain and Italy, and has important implications for indebtedness, as is shown below. The other exception is Ireland, where private consumption has been a very low proportion of GDP.

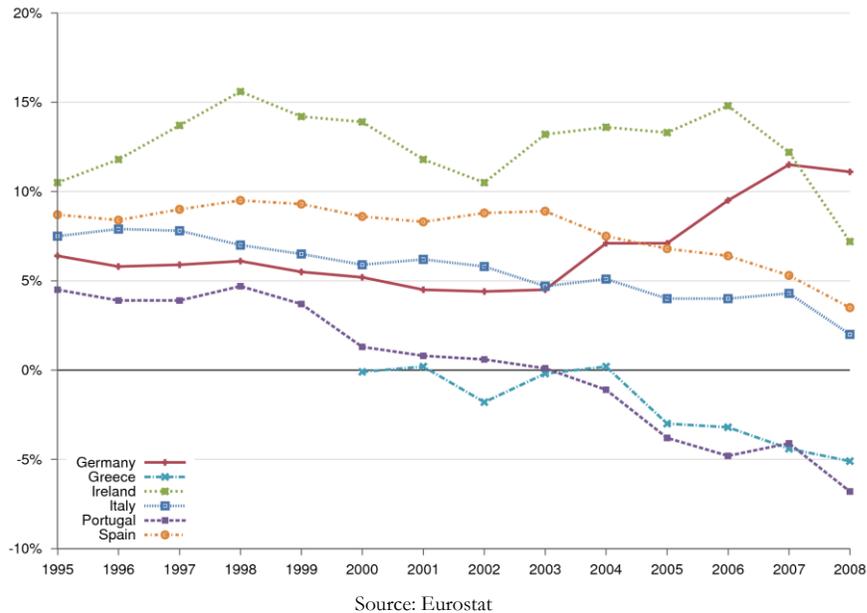
Fig. 6 Household Consumption
% of GDP



The patterns of consumption are broadly reflected in saving (fig. 7). For both Greece and Portugal saving as a percentage of GDP became negative in the second half of the 2000s. Thus, high and rising consumption has been supported by rising household debt. However, savings have also declined in Spain, Italy, and even in Ireland in the 2000s. Households across the periphery have found it difficult to sustain consumption on current income. The exception is Germany, where saving rose in the second half of the 2000s, in line with weak consumption. German growth, such it has been in the 2000s, has come neither from investment nor from consumption, but from exports. The contractionary pressures at the core of the German economy have been fundamental to the evolution of the euro, directly contributing to the sovereign debt crisis.

Fig. 7 Savings

% of GDP

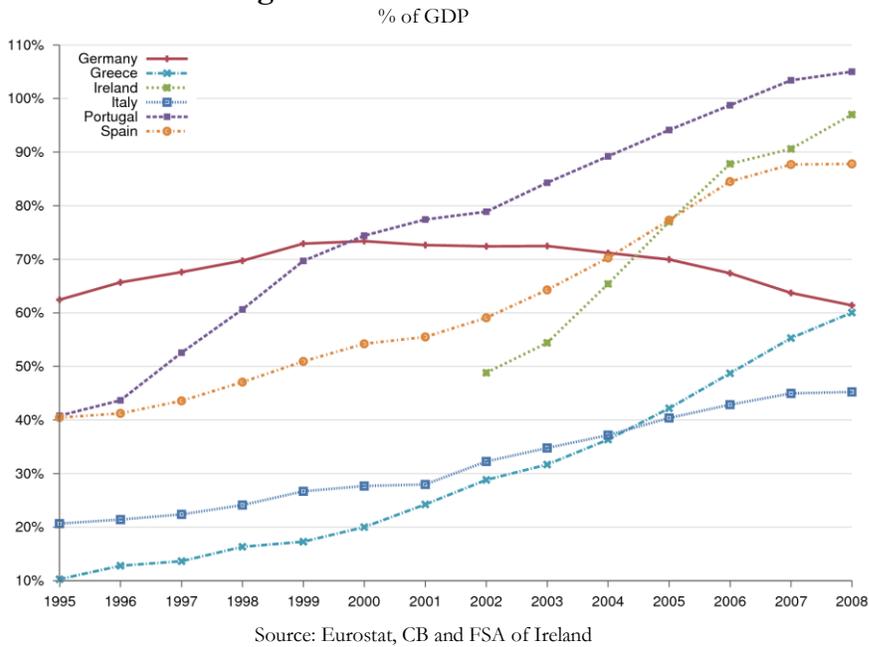


2.3 Debt

Household debt has risen consistently across peripheral countries in the sample. Financialisation of individual worker incomes has proceeded apace among peripheral countries of the eurozone throughout the last two decades. Growth of debt has been driven by consumption but also by rising prices of real estate. Low interest rates in the 2000s, as the ECB applied the same monetary policy across the eurozone, allowed workers to increase their indebtedness. In particular, Portugal, Spain and Ireland have approached ratios of household debt to GDP of around 100% (fig. 8). These are very high levels of debt that would be difficult to support if unemployment and interest rates rose in the near future.

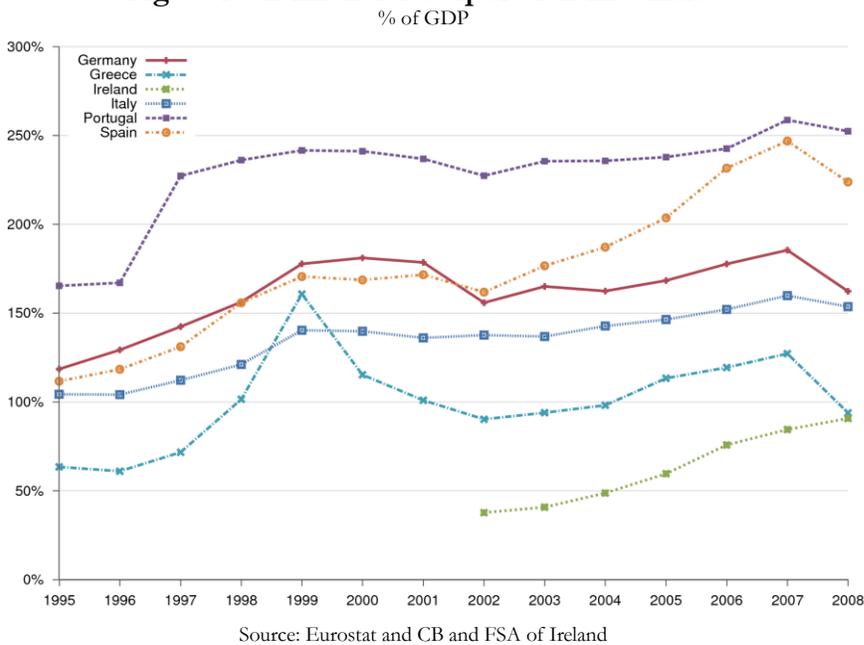
The vital exception is, again, Germany, where household indebtedness has declined, in line with weak consumption and the absence of a housing bubble. While households in peripheral countries have been accumulating debt as part of the integration of these countries in the eurozone, German households have been reducing the relative burden of their debt. This contrast is an integral part of the differential response of eurozone countries to the shock of the crisis of 2007-9, contributing to the sovereign debt crisis.

Fig. 8 Household Liabilities



Corporate debt, meanwhile, has not shown a tendency to rise significantly across the sample in the years following the introduction of the euro, with the exception of Spain and Ireland, the only countries in which investment also rose strongly during the period (fig. 9).

Fig. 9 Non-financial Corporation Liabilities



2. Macroeconomic performance: Stagnation in Germany; bubbles in the periphery

Recapping, macroeconomic performance of peripheral countries relative to Germany has demonstrated considerable variation but also common patterns. At the core of the eurozone, Germany has been marked by low growth, flat investment, stagnant consumption, rising savings, and falling household debt. This is not a dynamic capitalist economy on any score. The only source of dynamism has been exports, for reasons that will become clear below.

Confronted with the weak performance of the dominant partner of the eurozone, peripheral countries have adopted a variety of approaches. Thus, Spain and Ireland have had investment booms that were based heavily on real estate speculation and bubbles. Greece and Portugal, meanwhile, have relied on high consumption, driven by household debt. Indeed, household debt has risen substantially across the peripherals. Italy, finally, has been lodged in what could only be described as stagnation throughout this period.

Integration of peripheral countries into the eurozone, in other words, has been precarious. This is apparent in their export performance, which is the mirror image of German performance, as is shown below. It is also apparent in the patterns of household financialisation, which have moved in the opposite direction to Germany. These structural contrasts lie at the root of the current crisis. The evidence also shows that it is fallacious to interpret the crisis as the result of inefficient peripheral economies being unable to deal with the efficient German economy. It is the size of the German economy and its export performance – which has very specific causes attached to the euro – that have allowed it to dominate the eurozone. Efficiency has had little to do with it. Consider now the labour market in order fully to establish this point.

3. Labour remuneration and productivity: A general squeeze, but more effective in Germany

3.1 A race to the bottom

The EU has systematically promoted labour market reform aimed at reinforcing the process of monetary integration. Starting with the Maastricht treaty (1992), social provisions began to be included in European treaties apparently to reinforce economic coordination. Labour market policies have been considered national initiatives, but the Luxemburg European Council (1997) launched the first European Employment Strategy, followed by the Lisbon Strategy in 2000. The Lisbon Strategy stated the need for more flexibility in labour markets. The apparent aims were to achieve full-employment, create a knowledge intensive labour market, and raise employment rates.

During the 2000s, the Lisbon agenda was repeatedly reinforced, including by "Guidelines for Growth and Jobs", "National Reform Programmes" and "Recommendations" from the European Council. Particularly after the de Kok report (2004), policy toward labour markets has stressed the need for flexibility, contract standardisation, promotion of temporary and part-time work, and creation of (tax) incentives to encourage labour force participation.⁴ It is also true that improving the quality of employment was emphasised by the Council meetings of Nice (2000) and Barcelona (2002). In practice, however, the pressure of reform has led to a race to the bottom for workers' pay and conditions. Several European legislative initiatives have met with strong resistance in recent years, for instance, reform of the internal market in services (Bolkenstein directive), or the new Working Time directive that would potentially increase the working week to sixty-five hours. Partly as a response, the European Commission has recently promoted a general agenda of reform focused on the Danish model of "flexicurity" – weak legal protection of labour relations compensated by strong state support for the unemployed.

Given that a single monetary policy has applied across the eurozone, and given also the tough constraints on fiscal policy (through the Stability Pact), labour market policy has been one of the few levers available to different countries to improve external competitiveness. Therefore, the effects of labour market policies have varied profoundly among different eurozone countries. Core countries are characterised by high real wages and strong social policies, while peripheral countries typically have low real wages and weak welfare states. Political and trade union organisation also differ substantially among eurozone countries. All eurozone countries have joined the race of imposing labour market flexibility and compressing labour costs, but from very different starting points.

⁴ http://ec.europa.eu/growthandjobs/pdf/kok_report_en.pdf

3. Labour remuneration and productivity

Of fundamental importance in this connection has been labour market policy in Germany. Put in a nutshell, Germany has been more successful than peripheral countries at squeezing workers' pay and conditions. The German economy might have performed poorly, but Germany has led the way in imposing flexibility and restraining real wages. Characteristic of the trend have been labour market reforms of 2003 introduced by the Social Democratic Party and known as Agenda 2010. New labour contracts have reduced social contributions and unemployment benefits. Since the early 1990s, furthermore, it has been possible for German capital to take full advantage of cheaper labour in Eastern Europe. The combined effect of these factors has been to put downward pressure on German wages, thus improving the competitiveness of the German economy.⁵

Peripheral countries with weak welfare states, lower real wages, and well-organised labour movements, such as Greece, Portugal, Italy and Spain, have been unable to squeeze workers equally hard. Ireland, on the other hand, has been at the forefront of imposing more liberal conditions on its workers. Unfortunately for the Irish elite, this did not spare the country from the severe impact of the crisis of 2007-9.

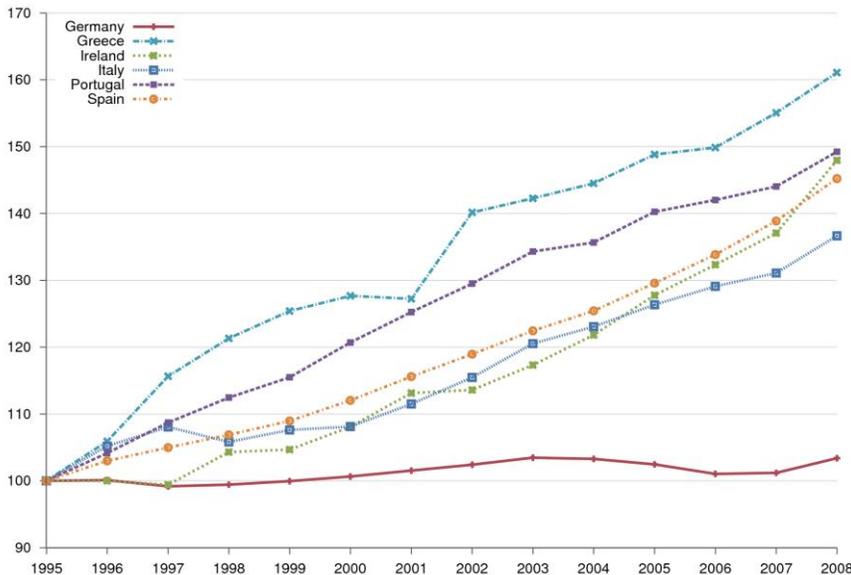
3.2. The determinants of German competitive success

The difference in outlook between Germany and the peripheral countries can be demonstrated by considering the behaviour of nominal labour unit costs, that is, nominal labour remuneration divided by real output. Nominal unit costs can be disaggregated into nominal cost per hour of labour divided by labour productivity. This is a standard measure used to compare competitiveness internationally.⁶ The trajectory of nominal unit costs, therefore, gives insight into the variation of nominal cost of labour relative to labour productivity. This trajectory is shown in figure 10 across the sample during this period, with 1995 as base year. Note that data on productivity is notoriously unreliable, thus the evidence should be used with considerable caution.

⁵ Germany has a long history of competitive real devaluation of the Deutschmark, to which labour unions were often complicit. Nonetheless, union power has been significantly reduced under the social-democratic government of Schroeder. Equally, German unification has had a major impact on German labour relations, weakening collective bargaining and creating large union-free zones in the east that are slowly spreading to parts of the west.

⁶ Take W to be the nominal remuneration of labour, which is more than wages and includes other labour costs for employers. Take Y to be nominal output and P the price level. The nominal unit cost of labour would then be $W/(Y/P)$, a standard measure of international competitiveness. This could obviously be disaggregated into $(W/L)/(Y/PL)$. It would then show nominal remuneration per hour of labour divided by labour productivity, which is the variable traced in figure 10, allowing for comparisons in underlying trends. Note that real remuneration of labour is simply W/P , the variable captured in figure 11. If rendered per unit of real output, i.e., as $(W/P)/(Y/P)$, it would show the share of labour in real output, traced in figure 13.

Fig. 10 Nominal Unit Labour Costs
 (1995 = 100) Source: AMECO

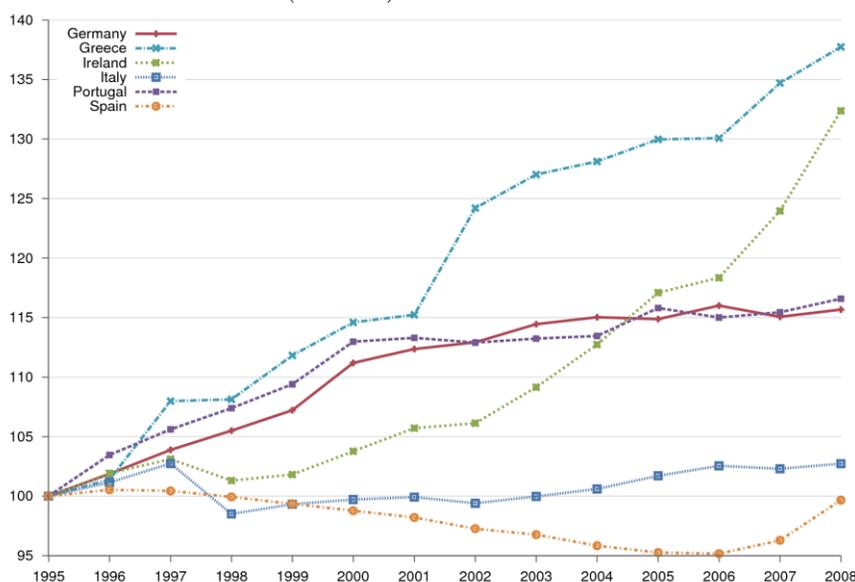


The most striking aspect of this data is the flatness of nominal unit labour costs in Germany. It appears that the opening of Eastern Europe to German capital together with sustained pressure on pay and conditions has forced nominal labour costs to move at an almost identical pace to productivity. However, in peripheral countries things have been different. Unit labour costs have increased significantly as nominal labour costs have risen faster than productivity, with Greece in the lead. In short, peripheral countries have been losing competitiveness relative to Germany in the internal eurozone market.

The more rapid rise in nominal labour costs was accompanied by generally higher inflation in the periphery compared to Germany, as was previously shown in relation to figure 3. Nevertheless, nominal labour costs rose generally faster than inflation, thus leading to increasing real compensation of labour in the periphery, as is shown in figure 11 (definition in footnote 6). Extra care is required here as real compensation is not the same thing as real wages, and moreover it hides a broad range of payments to managers and others in the form of wages and bonuses. Furthermore, the aggregate conceals considerable inequality in real wages among different groups of workers. Still, figure 11 shows that the real compensation of labour has risen faster in peripheral countries compared to Germany, with the exception of Spain.

Fig. 11 Real Compensation of Labour

(1995 = 100) Source: AMECO



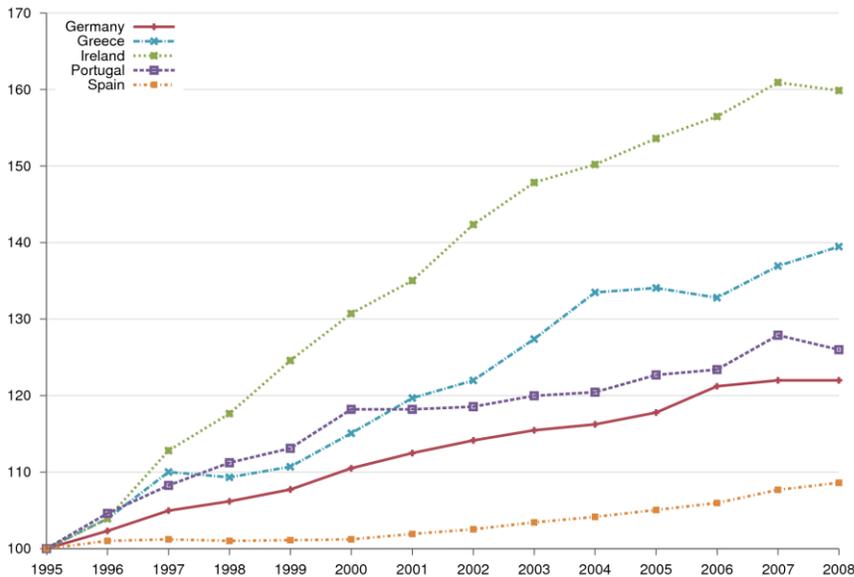
3.3. Real compensation and the share of labour in output

It is no wonder, therefore, that conservative commentators in the press have remarked that the sovereign debt crisis ultimately derives from peripheral country workers receiving higher increases in compensation than German workers, leading to a loss of competitiveness.⁷ This is true, but also misleading. For, the real problem has not been excessive compensation for peripheral workers but negligible increases for German workers, particularly after the introduction of the euro. Even in Greece, in which nominal and real compensation have increased the most, the rise in real compensation has been of the order of 20% during the period of 2000-8, and that from a low base compared to Germany.

The modesty of labour remuneration in the periphery becomes clear when put in the context of productivity growth:

⁷ See, for example: Roubini, N. and E. Parisi-Capone, "An IMF rescue for Greece?", *Forbes.com*, 18 Feb 2010. <http://www.forbes.com/2010/02/17/greek-financial-crisis-imf-ecb-opinions-columnists-nouriel-roubini-elisa-parisi-capone.html>. Also: Roubini, N. "Teaching PIIGS to fly", *Project Syndicate*, 15 Feb 2010. <http://www.project-syndicate.org/commentary/roubini22/English>

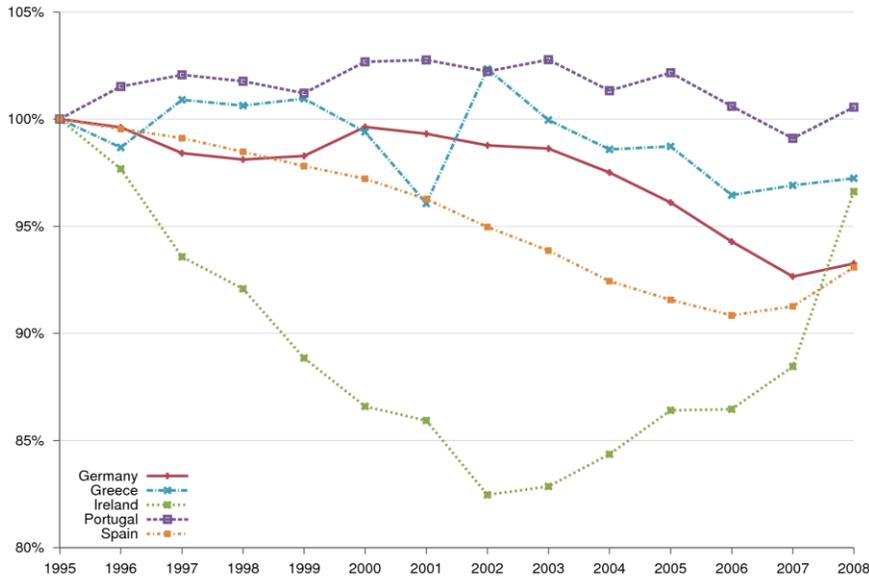
Fig. 12 Labour Productivity
 (1995 = 100) Source: OECD



There has been weaker productivity growth in Germany compared to the rest during this period, with the exception of Spain which has been extremely weak. This is more evidence of the lack of dynamism of the German economy: Irish, Greek and Portuguese productivity rose faster, even if from a lower base (Irish productivity is probably exaggerated for reasons to do with multinational transfer pricing). Peripheral countries have generally improved productivity, and certainly done better than Germany, which has been a laggard. But the Lisbon Strategy has not succeeded in putting peripheral countries on a strongly rising path of productivity. There has been no true catching up with the more advanced economies of the eurozone, with the partial exception of Ireland. Productivity increases have been respectable compared to Germany, but that is because Germany has performed badly.

Nonetheless, productivity growth has still been faster than the rise in real remuneration of labour. Consequently, labour has lost share in output more or less across the sample, as is shown in figure 13 (definition in footnote 6). The only sustained increase after the introduction of the euro was in Ireland, where workers barely made good the losses sustained in the 1990s. Workers have generally lost relative to capital across the sample, German workers faring poorly compared to the others.

Fig. 13 Labour share in GDP
 (1995 = 100) Source: AMECO



To sum up, labour market policies at national and EU level have applied sustained pressure on workers across the eurozone. This pressure has played an important role in determining competitiveness, given the rigidity of monetary and fiscal policies. The result has been loss of output share by workers across the eurozone. In peripheral countries real compensation has increased in some countries, though productivity has increased even faster. Nonetheless, productivity did not rise fast enough to ensure catching up with the more advanced economies of the core.

In Germany, on the other hand, productivity, real compensation, and nominal unit labour costs have increased very slowly. It cannot be overstressed that gains in German competitiveness have nothing to do with investment, technology, and efficiency. The competitive advantage of German exporters has derived from the high exchange rates at which peripheral countries entered the eurozone and, more significantly, from the harsh squeeze on German workers. Hence Germany has been able to dominate trade and capital flows within the eurozone. This has contributed directly to the current crisis.

4. International transactions: Trade and capital flows in the shadow of Germany

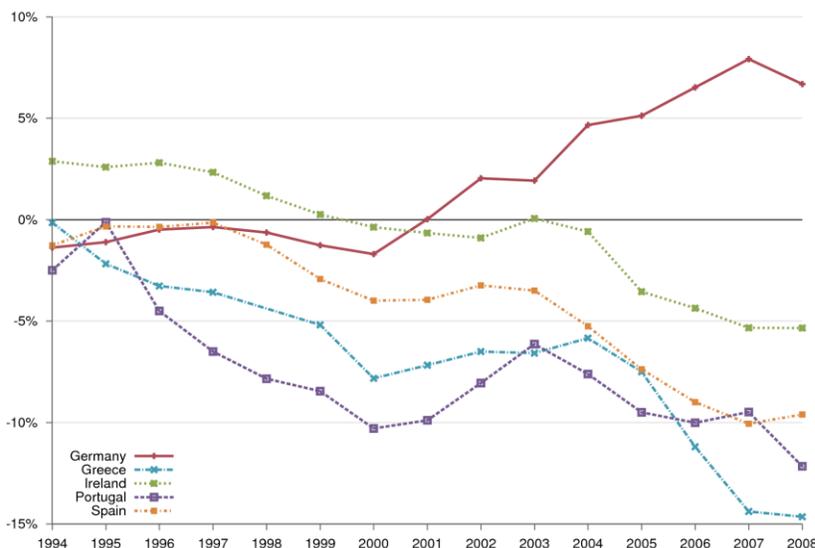
4.1 Current account: surplus for Germany, deficits for periphery

The international transactions of eurozone countries have been shaped in large measure by the policies adopted to support the euro. The euro has been devised as a common measure of value and means of payment within the eurozone. The intention was that it should also become means of payment and reserve outside the eurozone, thus competing directly with the US dollar in the world market. Monetary and fiscal policies of eurozone countries have had to be consistent with this aim, thus imposing a common monetary policy and tight constraints on fiscal policy for each state. The institutional and policy framework of the eurozone have not arisen merely due to ideological dominance of neo-liberal thinking within the EU. They have also been dictated by the need to sustain the euro in its role within and outside the eurozone.

The pattern of international transactions that has emerged for eurozone countries is consistent with the putative role of the euro. In the first instance, peripheral countries were obliged to join the euro at generally high exchange rates. Core countries, above all Germany, insisted upon this policy with the ostensible purpose of ensuring low inflation. High inflation in individual countries would have undermined the ability of the euro to compete internationally against the dollar. The implication was to reduce at a stroke the competitiveness of peripheral countries in the internal market. To this poor start was added sustained loss of competitiveness, discussed in the previous section. The result, shown in figure 14, was inevitable: emergence of entrenched current account deficits for peripheral countries, matched by an equally entrenched current account surplus for Germany.

Fig. 14 Current account balance

% GDP Source: IMF BOP



4. International transactions: Trade and capital flows in the shadow of Germany

Care is obviously necessary in interpreting this picture. Greece, Portugal and Spain have run substantial balance of trade deficits, but they have also had significant surpluses on services. Ireland has followed the opposite path, again reflecting its own mode of integration into the eurozone based on high investment, much of it directed to housing, and intensified labour flexibility. For all, inability to restrain nominal labour unit costs at German levels and, more fundamentally, inability to set productivity growth on a strongly rising path, resulted in current account deficits mirrored by surpluses for Germany. Note that two thirds of German trade is with the eurozone. Note also that the eurozone trade with the rest of the world is roughly in balance.

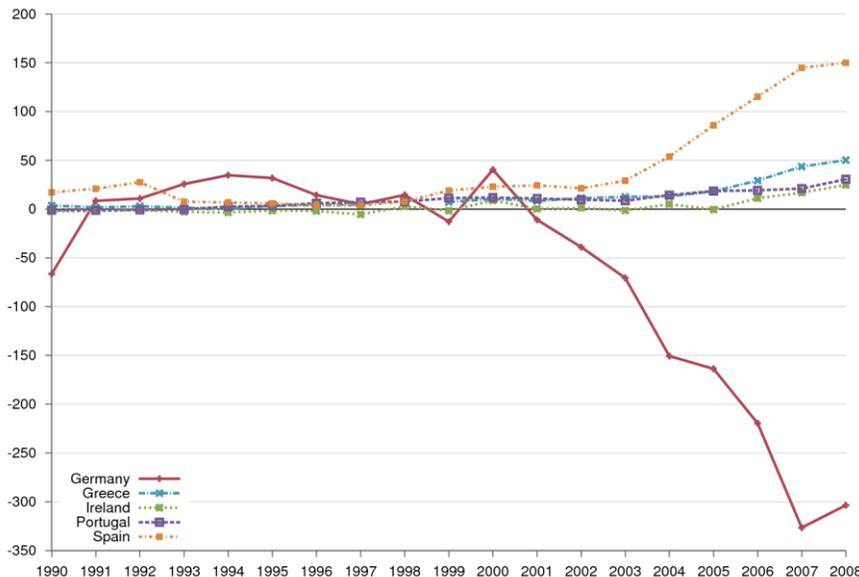
The euro and its attendant policy framework have become mechanisms ensuring German current account surpluses that derive mostly from the eurozone. Peripheral countries joined a monetary system that purported to create a world money, thus signing away some of their competitiveness, while adopting policies that exacerbated the competitiveness gap. The beneficiary of this process has been Germany, because it has a larger economy with higher levels of productivity, and because it has been able to squeeze its own workers harder than others. Structural current account surpluses have been the only source of growth for the German economy during the last two decades. The euro is a ‘beggar-thy-neighbour’ policy for Germany, on condition that it beggars its own workers first.

4.2 Financial account: German FDI and bank lending to the periphery

Inevitably, the picture appears in reverse on the capital and financial account (fig. 15). Germany has exported capital on a large scale, while peripheral countries have been importing capital.

Fig. 15 Capital and financial account

Net, \$bn. Source: IMF BOP

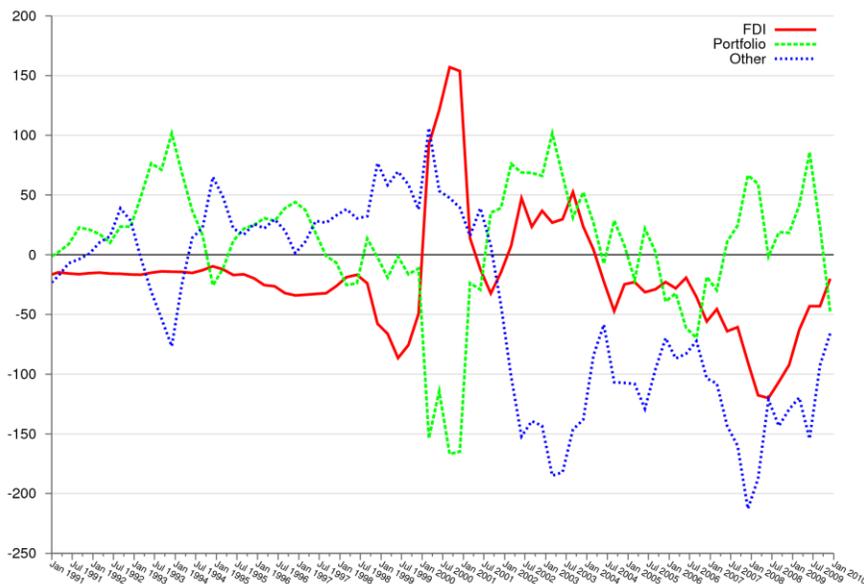


4. International transactions: Trade and capital flows in the shadow of Germany

The financial account comprises fundamentally foreign direct investment (FDI), portfolio flows, and ‘other’ flows that are heavily driven by banks. The direction of aggregate flows between Germany and the periphery of the eurozone can be simply gauged from the composition of the German financial account (fig. 16):

Fig. 16 Composition of German financial account

Euro, bn. Source: Bundesbank



The driving forces behind sustained capital exports by Germany since the introduction of the euro have been ‘other’ and FDI flows. Portfolio flows have been weaker, even turning inward for much of the 2000s. Put summarily, Germany has been recycling its current account surpluses as FDI and bank lending abroad. Bank lending peaked in 2007-8 and, as is shown below, this has been a vital element of the current sovereign debt crisis.

The geographical direction of the recycling of surpluses is clear once again from the composition of German capital exports. The eurozone has been the main recipient of German FDI (fig. 17), while also competing with the non-euro part of the EU for German bank lending in the 2000s (fig. 18). Once the crisis of 2007-9 broke out, German banks restricted their lending to non-euro EU countries but continued to lend significantly to eurozone countries.

To recap, international transactions of eurozone countries have been driven by the requirements and implications of monetary union. Peripheral countries have lost competitiveness relative to Germany because of initially high exchange rates as well as because of the ability of German employers to squeeze workers harder. The result has been a structural current account surplus for Germany, mirrored by structural current account deficits for peripheral countries. Consequently, German FDI and bank lending to the eurozone have increased significantly.

4. International transactions: Trade and capital flows in the shadow of Germany

‘Other’ flows to peripheral countries rose rapidly in 2007-8 as the crisis unfolded, but then declined equally rapidly. That was the time when peripheral states were forced to appear in credit markets seeking funds.

Fig 17 German outward FDI by region

Euro, bn. Source: Bundesbank

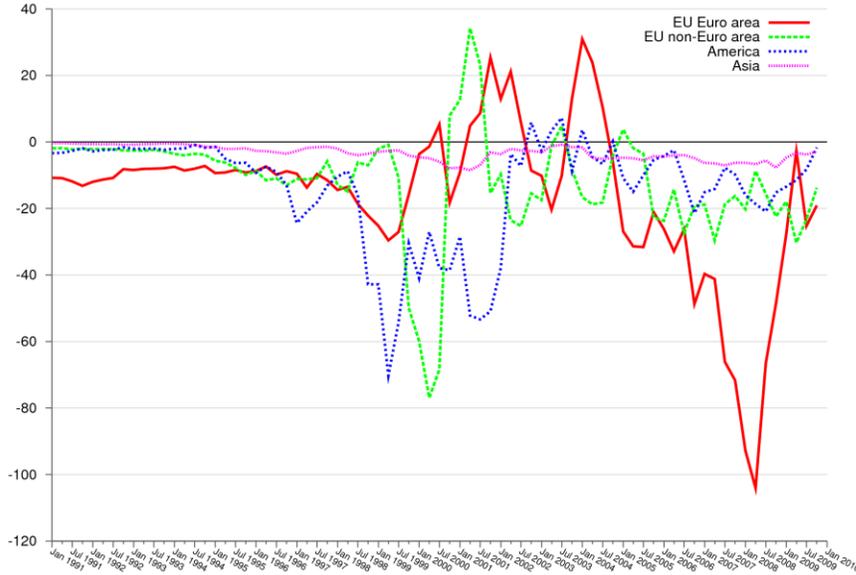
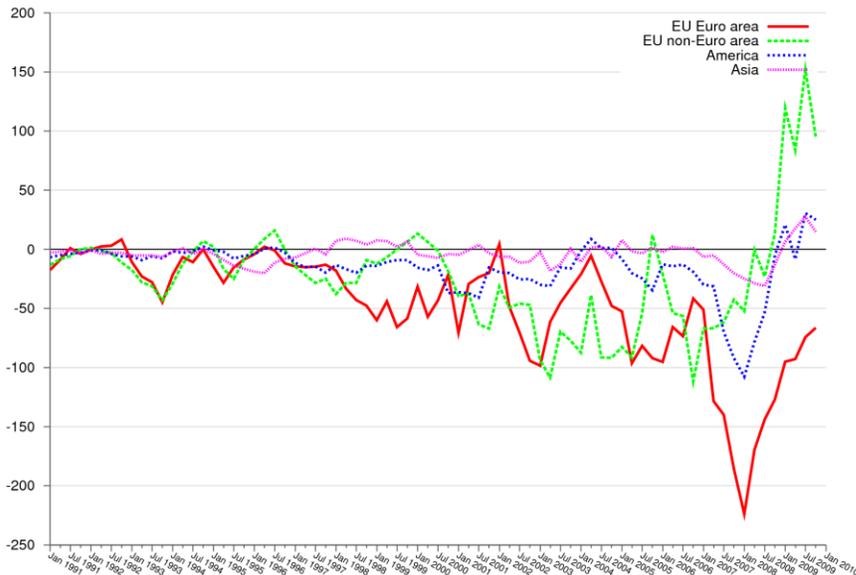


Fig 18 German ‘other’ outward flows by region

Euro, bn. Source: Bundesbank



5. Rising public sector borrowing: Dealing with failed banks and worsening recession

5.1. The straightjacket on fiscal policy

The public sector of peripheral countries, and above all Greece, has been at the epicentre of the current turmoil. The reasons for this, however, are only partially related to the intrinsic weaknesses of the public sector in peripheral countries. The current crisis is due to the nature of monetary union, the mode of integration of peripheral countries in the eurozone, and the impact of the crisis of 2007-9. Public sector debt has become a focus for the tensions that have emanated from these sources for reasons discussed below.

It is apparent that the sovereign debt crisis has not been chiefly caused by state incompetence, inefficiency and the like. Eurozone states have been operating within the framework of the Growth and Stability Pact, the main components of which emerged already in the early 1990s with the Maastricht Treaty. The underlying logic has been that, if the euro was going to become a world reserve currency and means of payment, there had to be coherence of fiscal policy to match the single monetary policy. Rising public deficits and accumulating state debt would have reduced the international value of the euro. The Stability Pact is important to making the euro a competitor to the dollar.

In this respect, the EU has faced an inherent contradiction because it is an alliance of sovereign states. Sovereignty means little without power and ability to tax, always reflecting the social composition of particular countries. Therefore, a compromise was reached, in large measure imposed by the core countries. The Stability Pact has imposed the arbitrary limit of 60% national debt relative to GDP and an almost as arbitrary limit of 3% for budget deficits that would hopefully prevent the level of public debt from rising. Fiscal policy was placed in a straightjacket that has tormented eurozone states for nearly two decades.

The Stability Pact represents a loss of sovereignty for eurozone states. However, not all states within the eurozone were created equal. The loss of sovereignty has been more severe for peripheral states, as has been repeatedly demonstrated when France or Italy have exceeded the limits on deficits and debt. It is no surprise that peripheral states have resorted to the weapons of the weak, that is, subterfuge and guile. Some of the techniques used to hide public debt have been ruinous to public accounts in the long run. The Greeks have led the way with persistent manipulation of national statistics throughout the 2000s as well as barely legal deals with Goldman Sachs that presented public borrowing as a derivative transaction. Public-private transactions have also been widely deployed in the periphery to postpone expenditure into the future, typically at a loss to the public.

But fiscal policy has continued to be the province of each individual state, and has remained fragmented compared to unified monetary policy. Furthermore, the Stability Pact has made no provision

for fiscal transfers across the eurozone, as would have happened within a unitary state. There are no centralised fiscal means of relieving the pressures of differential competitiveness and variable integration into the eurozone. The European budget is currently very small, at just over 1% of the aggregate GDP of all EU states, which is a small fraction of the German, French, and UK budgets. Moreover, it is not allowed to go into deficit.

This structural weakness of the eurozone has been much discussed in recent years, including in the course of the current crisis.⁸ What is less discussed, however, is that it also has implications for the ECB. A key function of a central bank is to manage the debt of its state, handling the state's access to financial markets and ensuring the smooth absorption of fresh issues. A central bank is also able to acquire state debt directly, facilitating the financing of fiscal deficits for longer or shorter periods of time. But the ECB has no obligation to manage the debt of member states, and is expressly forbidden to buy state debt. On both scores, the ECB does not behave as a normal central bank. The inherent weakness of the ECB is part of the dysfunctional co-ordination of monetary and fiscal policy within the eurozone, which has been made evident in the course of the sovereign debt crisis.

5.2 Rising public deficits and debt due to the crisis

Turning to the actual path of public finances, it is important to note that public finance reflects the historical, institutional, and social development of each country. There can be no generalisation in this regard as welfare systems are variable, tax regimes reflect past compromises, the ability to collect tax depends on the efficiency of the state machine, and so on. Nonetheless, the Stability Pact has imposed certain common trends upon eurozone states.

Public expenditure declined steadily in the 1990s, with the exception of Greece, where it remained fairly flat (fig. 19). In the 2000s expenditure stayed more or less flat across the sample, except for Germany, where it continued to fall steadily, and Portugal, where it rose gently. Once again, Germany has had considerable success in imposing fiscal austerity on itself, but also across the sample. Public expenditure turned upward after 2007 as the crisis hit and states attempted to rescue financial systems while also supporting aggregate demand. Once again, Germany is the exception as expenditure did not pick up.

⁸ See Thomas Palley in FT, 10th Feb 2010

<http://blogs.ft.com/economistsforum/2010/02/euroland-is-being-crucified-upon-its-cross-of-gold/#more-8751>. On the structural weaknesses of the eurozone see Arestis, P. and M. Sawyer. 2006. Macroeconomic Policy and the European Constitution, in *Alternative Perspectives on Economic Policies in the European Union*, P. Arestis and M. Sawyer (eds.), Palgrave Macmillan, pp. 1-33. On the specific response of the EU to the crisis, see EuroMemorandum Group. 2009. *Europe in Crisis: A Critique of the EU'S Failure to Respond*, available at <http://criticalpoliticaleconomy.blogspot.com/2009/11/euromemorandum-20092010.html>

5. Rising public sector borrowing: Dealing with failed banks and worsening recession

Fig. 19 Government expenditure

% GDP Source: Eurostat

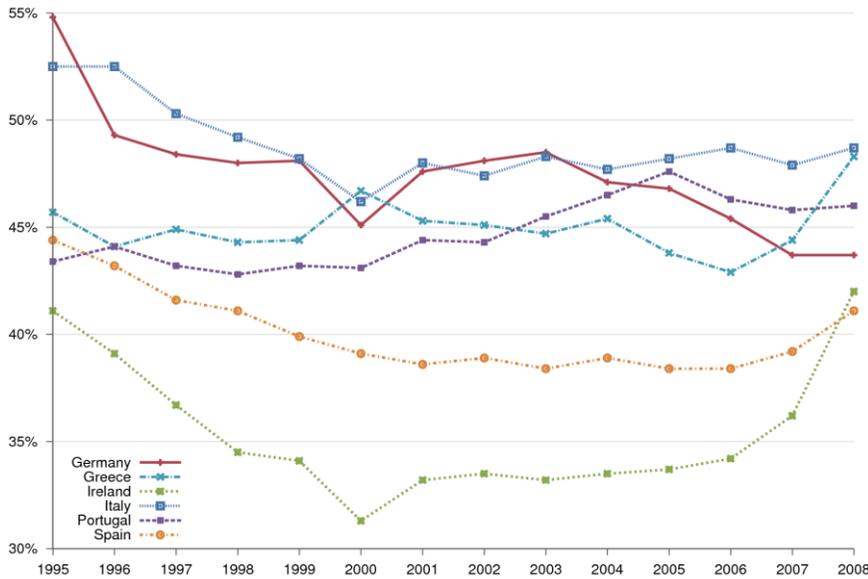
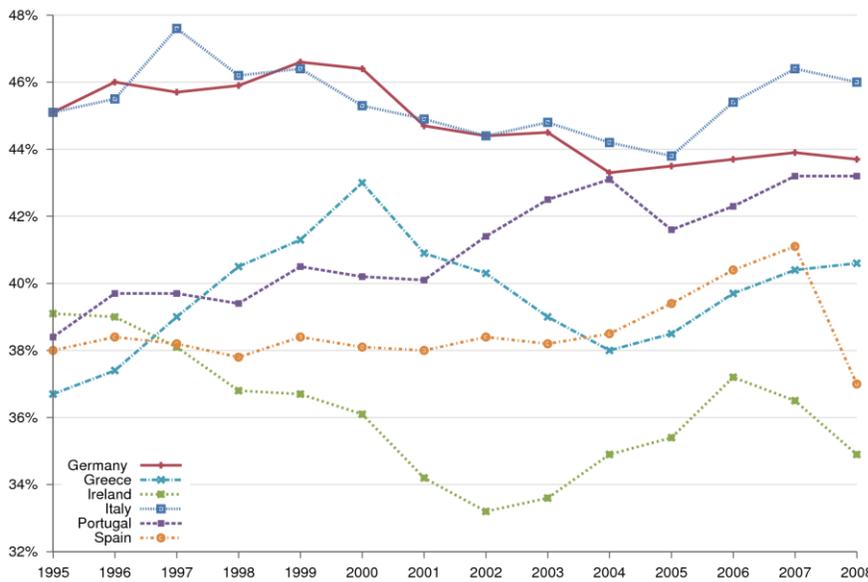


Fig. 20 Government revenue

% GDP Source: Eurostat



Public revenue showed equal complexity, reflecting the particular conditions of each country (fig. 20). Greek public revenue slumped in the middle of the 2000s as taxation was lowered on the rich, while the tax-collecting mechanism was disrupted. It rose toward the end of the decade, but not enough to make good the decline. Irish public revenue was the weakest, though an attempt was made to shore things up in the second half of the 2000s. Spain and Portugal maintained reasonable revenue collection throughout. Public revenue declined across the

5. Rising public sector borrowing: Dealing with failed banks and worsening recession

sample once the crisis of 2007-9 began to bite. Recessions and falling aggregate demand were at the heart of the fall.

Falling revenue and rising expenditure caused by the crisis inevitably led to strong increases in public deficits. Consequently, in 2009, several peripheral and other eurozone states arrived in the financial markets seeking to borrow large volumes of funds. The pressure appears to have been particularly strong for Greece, Spain and Ireland, less so for Portugal:

Fig. 21 Government primary balance

% GDP Source: Eurostat

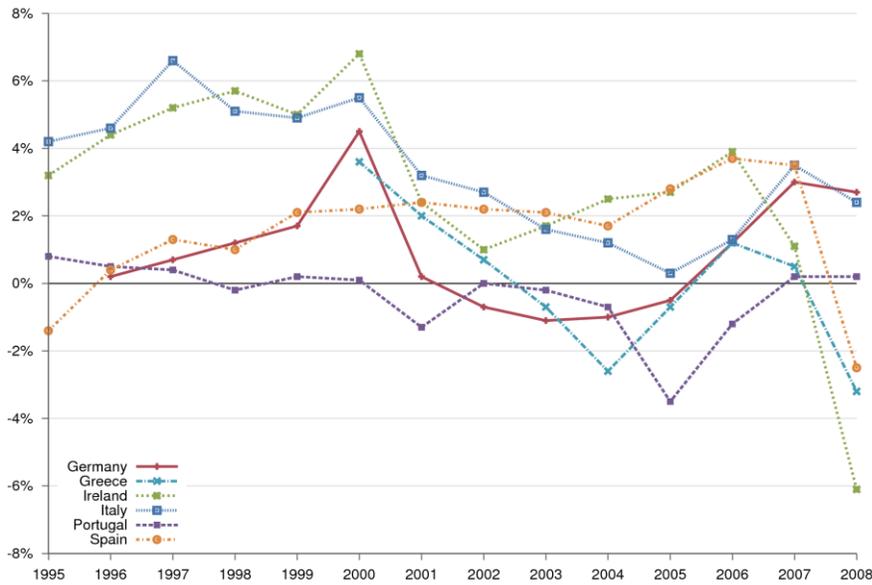
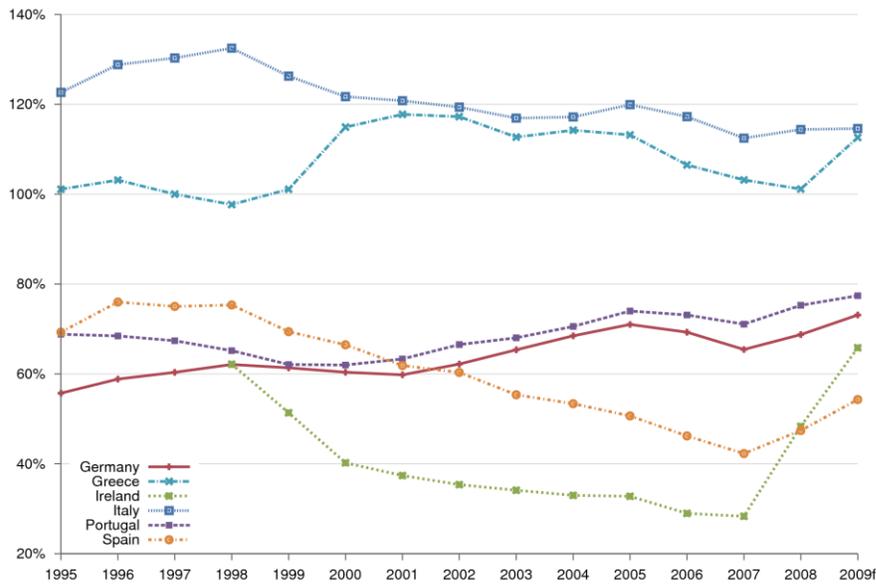


Fig. 22 General Government Gross Debt

% of GDP Source: Eurostat



Inevitably, national debt also began to rise relative to GDP after 2007 (See Fig. 22).

Note that there are significant differences in the volumes of eurozone public debt, again reflecting each country's respective economic and social trajectory. But Greek debt, about which so much has been written recently, is not the highest in the group, and nor has it been rising in the 2000s. On the contrary, Greek national debt declined gently as a proportion of GDP in the second half of the 2000s. Only in Germany and Portugal did national debt rise throughout this period, though gently and from a fairly low base. The sudden rise of public debt across the eurozone in the last couple of years has been purely the result of the crisis of 2007-9.

Public sector performance in the eurozone can be easily summed up. The Stability Pact has imposed a straightjacket on member states, but its effect has been conditioned by residual sovereignty in each state. The fragmentation of fiscal policy has contrasted sharply with the unification of monetary policy. Nevertheless, eurozone states have generally restrained public expenditure, while maintaining a variable outlook on revenue collection. The decisive moment arrived with the crisis of 2007-9, which pushed peripheral states toward deficits. At that point the underlying weaknesses of integration in the eurozone emerged for each peripheral state, including current account deficits and rising capital imports from the core.

There are no structural reasons why these tensions should have concentrated so heavily on Greece. No doubt the country has a relatively large public debt and therefore faces a heavy need for refinancing, particularly as the budget swung violently into deficit in 2009. But Italian public debt is also high. It is also true that the Greeks have been persistently manipulating data and they face a large current account deficit. But these pressures could have been handled reasonably smoothly if it was not for speculation in the financial markets. Even speculation could have been confronted decisively, if the eurozone authorities had shown any inclination. To analyse the interplay of these factors it is now necessary to consider the financial sector, the part of the economy that is most heavily responsible for the crisis of 2007-9.

6. The financial sector: How to create a global crisis and then benefit from it

6.1 An institutional framework that favours financial but also productive capital

The European Central Bank (ECB) and the national central banks constitute the European System of Central Banks (ESCB), which has price stability as its primary objective. The ECB has normative power over the national central banks since decision making on monetary (and financial) policy emanates from the ECB and then reaches national central banks. It can also make recommendations to national authorities relating to prudential supervision of credit institutions and the stability of the financial system.

The ECB is an unusual central bank. It has the exclusive right to authorise the issuing of banknotes in the EU, though notes are printed by individual central banks. It is also responsible for holding and managing official foreign reserves of member states. However, the ECB (and national central banks) is prohibited from offering overdrafts or other credit facilities to member states, including the purchase of public debt instruments. The ECB is considered independent in the sense that no public institution or individual member state is authorised to influence its operations and decisions. But its substantial independence comes from the absence of a unitary European state with which it would have been obliged to interact.

The peculiar character of the ECB is also apparent in its own statutes. Subscription to ECB capital and the transfer of foreign reserve assets to the ECB, for instance, are proportionate to each member state's population and GDP. Furthermore, when the number of member states exceeds fifteen, participation in the decision-making process of the ECB is supposed to take place on the basis of GDP as well as on the aggregate balance sheet of the monetary financial institutions of each member state, again reflecting a hierarchy of state power.⁹

The ECB has supported financialisation in Europe mostly by protecting the interests of financial capital. European financial markets have been unified as financial liberalisation has spread and become deeper. Restrictions on financial operations have been abolished among the member states. Monetary union and establishing the euro as world money have benefited European financial capital in competition with US and other global banks. The euro has also been marked by an appreciation bias, rising from around 0.95 to the dollar at its launch to reach a peak of 1.58 in July 2008. The euro has retreated since then, particularly following the sovereign debt crisis, and currently stands at around 1.35 to the dollar. Without necessarily being deliberate, the

⁹ According to the Consolidated Version of the Treaty on European Union and the Treaty on the Functioning of the European Union, in the Official Journal of the European Union, C115.

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appreciation bias has served the interests of financial capital since it has helped to induce global wealth holders to change the currency composition of their portfolios in favour of the euro.

The appreciation bias of the euro also appears not to have hurt the interests of the European productive sector, because it has forced productive capital to lower costs in order to be able to compete globally. This has meant steady pressure on workers' pay and conditions. German structural adjustment in the 2000s, in particular, has been based on squeezing workers, as was shown in section 3. Productive capital has also benefited from reductions in uncertainty surrounding exchange rates as well as from differences in financial environment. Finally, a strong and rising euro has also supported European capital in mergers and acquisitions (M&A) in other parts of the world. In short, the euro as world money has been in the international interests of both financial and productive capital in Europe.

For European banks in particular, the euro has provided liquidity facilities regulated by the ECB that have been able to support banking expansion across the world. The European banking system (mainly German and Dutch banks) steadily increased its net long US-dollar positions until the middle of 2007 (roughly \$400 bn), with the ECB effectively acting as one of the main funding counterparties.¹⁰ Note also that, in contrast to other central banks of mature countries, the ECB has always accepted private securities as collateral in its operations. Normal procedure for central banks is to accept only government securities. The Federal Reserve, for instance, started to accept private securities in 2008 only as an extraordinary response to the crisis.

There is no doubt that the institutional arrangements of the euro have been beneficial to European finance. However, after the outbreak of the global crisis and as global banks faced trouble, the significance of the absence of coordination between the monetary and the fiscal spheres became apparent. In contrast to the USA and the UK, monetary union has revealed an underlying weakness, namely the absence of a unitary state in Europe.

Given the absence of political union, the Stability Pact has acted as anchor for the euro in the world market. Contrary to the USA, which has been able to relax fiscal policy, the euro has required fiscal tightening as the crisis unfolded. The implication has been to push states toward policies that further squeeze workers in peripheral countries, while defending the interests of the European financial system. Thus, monetary union has meant an asymmetric adjustment between banks and states in the financial sphere after the crisis: banks have been protected, while the onus of adjustment has fallen on weaker peripheral states.

¹⁰ Bank of International Settlement. 2009. *The US dollar shortage in global banking and the international policy response*, Working Paper 291.

6.2 Banking in the eurozone: The core becomes exposed to the periphery

Financialisation has developed in both core and peripheral countries of the eurozone, as is clear from the rising volume of financial institution assets relative to GDP:

Table 1: Credit institutions, Total Assets/GDP

Source: ECB (2010): Structural indicators for the European Union banking sector, and ECB (2005):

European Union banking structures												
1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	
107%	123%	142%	156%	155%	142%	124%	124%	142%	147%	167%	190%	Greece
262%	304%	240%	404%	461%	364%	413%	487%	583%	674%	715%	760%	Ireland
156%	143%	147%	152%	152%	161%	159%	164%	176%	189%	217%	231%	Italy
237%	286%	281%	274%	287%	263%	252%	240%	242%	255%	270%	290%	Portugal
170%	173%	178%	185%	193%	184%	192%	204%	237%	256%	281%	309%	Spain
227%	239%	247%	258%	272%	251%	263%	273%	295%	307%	329%	379%	Austria
306%	298%	304%	282%	303%	297%	302%	316%	349%	354%	392%	370%	Belgium
244%	239%	251%	247%	257%	247%	251%	266%	294%	317%	353%	371%	France
256%	275%	287%	299%	304%	297%	295%	298%	304%	307%	312%	316%	Germany
231%	255%	263%	286%	298%	292%	309%	342%	333%	351%	392%	376%	Netherlands

It is not apparent that there are systematic differences between core and peripheral countries with respect to financialisation. There is, however, considerable variety among them. Furthermore, there has been no dramatic increase in foreign banking ownership, unlike trends in several developing economies during the same period. Assets of foreign banks (both subsidiaries and branches) in the eurozone stand around 20-25% of total assets of credit institutions, the only exception being Ireland, with around 50%.¹¹

The international investment position of European banks, however, presents several noteworthy features. Figure 23 shows that the aggregate cross-border claims of banks have been rising globally since the mid-1980s, and quite rapidly in the 2000s.¹² But the aggregate of cross-border claims of European banks rose much faster in the 2000s. The data is presented in US dollars, and the appreciating euro to US

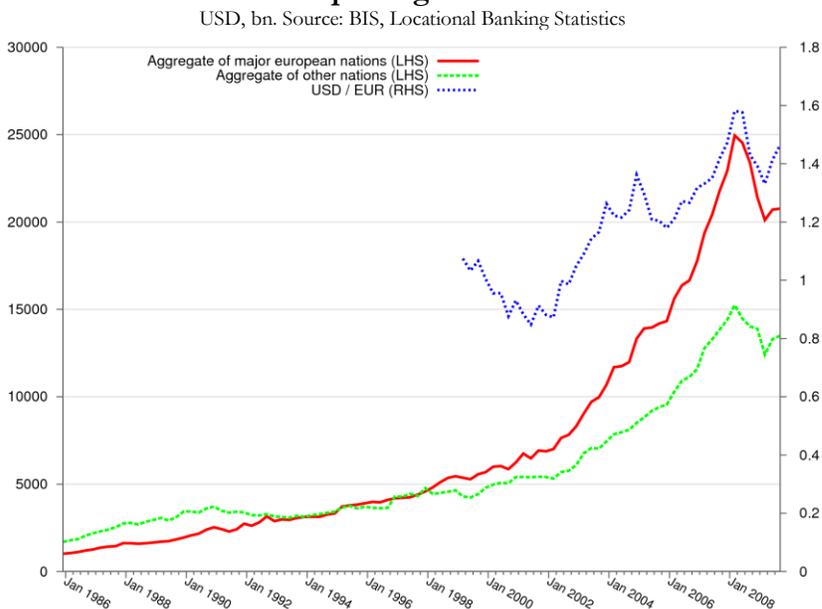
¹¹ See tables 8,15,18,21 and 24 in ECB: Structural analysis of the EU banking sector, 16/11/2002; tables 2,11 and 13 in ECB: EU banking structures, 07/10/2005; tables 2,11 and 13 in ECB: Structural indicators for the EU banking sector, 15/01/2010.

¹² Source is the BIS Locational Banking Statistics, Table 8 (<http://www.bis.org/statistics/bankstats.htm>). "Aggregate of Major European Nations" is calculated as the sum of the International Position of reporting banks from Austria, Belgium, Cyprus, Denmark, Finland, France, Germany, Greece, Guernsey, Ireland, Isle of Man, Italy, Jersey, Luxembourg, Netherlands, Norway, Spain, Sweden, United Kingdom, Europe. "Aggregate of other nations" is calculated as the reported item 'All Countries' minus the "Aggregate of Major European Nations".

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dollar exchange rate is shown on the right hand scale. To a certain extent, the appreciating euro would have inflated balance sheets denominated in euros compared to those denominated in dollars. Nevertheless the growth in the international claims of European banks appears also to reflect greater integration within the European Union, drawing on the beneficial effect of the single currency and single market for finance.

Fig.23 International positions by nationality of ownership of reporting banks



Turning to cross-border lending within the eurozone, it is useful to consider those in terms of core (Germany, France, Belgium and the Netherlands) and periphery (Greece, Ireland, Italy, Portugal, Spain). Lending has increased in both directions. As is shown in figure 24, gross exposure by banks grew from March 2005 until early 2008, after which it declined across the board as banks reined in their lending. It is important to highlight, however, that even though there has been growth across the sample, flows from core to periphery have become more important in size than flows from core to core.

Furthermore, as figure 25 shows, net banking flows from core to the periphery have been positive and increasing in the second half of the 2000s (starting March 2005, notwithstanding a statistical adjustment in March 2007)¹³ peaking in September 2008. As gross flows in figure 24 indicate, this change has been driven mainly by lending from core to periphery, which rose throughout this period. It is also notable that

¹³ 'Italian banks' foreign claims rose by \$649 billion in March 2007, nearly twice the increase in the previous quarter, due to a change in reporting that led to a reclassification of a number of subsidiaries, particularly those located in Germany.' *BIS Quarterly Review*, Sep. 2007, p.21.

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claims by the periphery to core began to fall earlier than those from core to periphery.

Fig.24 Gross cross-border bank claims

Euro, bn Source: BIS Consolidated Bank Statistics

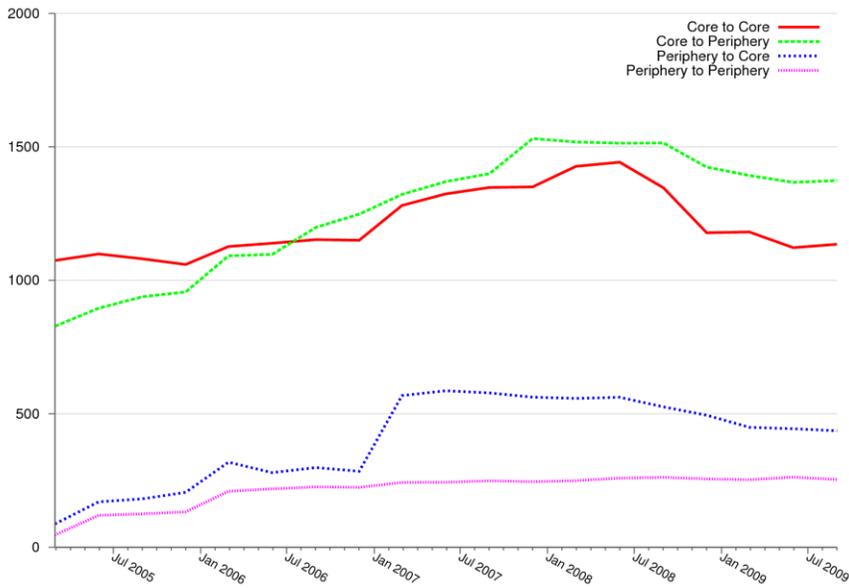
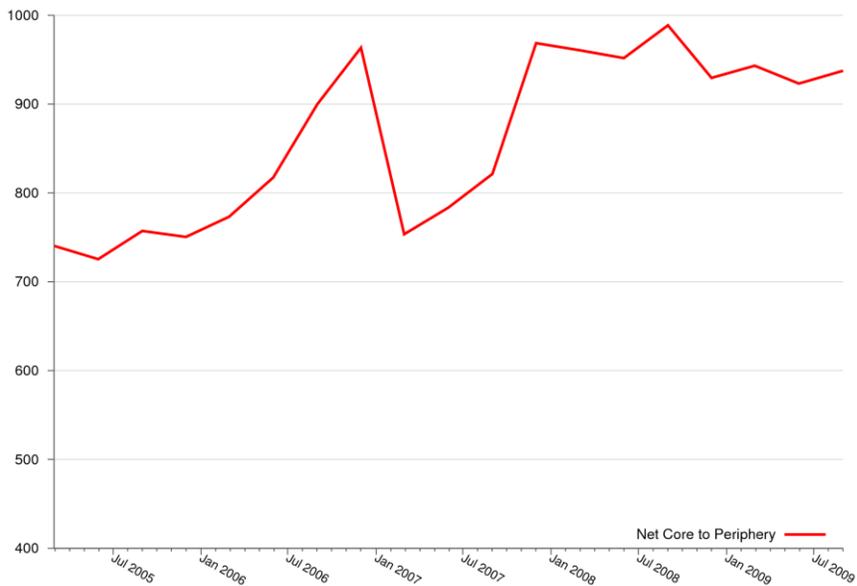


Fig.25 Net cross-border claims, core to periphery

Euro, bn Source: BIS Consolidated Bank Statistics



The evidence presented here shows that exposure of core banks to peripheral countries increased considerably after the first signs of the international financial crisis in 2007. There are several probable reasons for this phenomenon. Core banks had no concerns about the creditworthiness of peripheral states until 2009, indeed lending to governments seemed a reasonable course of action. ECB policy,

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furthermore, was to support all banks, thus increasing the creditworthiness of peripheral banks. Above all, money markets became very volatile after August 2007 and there were significant differences between individual inter-bank rates (LIBOR). Core banks found themselves holding surplus euros in 2007-8 and, given overall credit concerns, they perceived peripheral banks as safer than banks in other countries (especially the US and the UK). While the Anglo-Saxon financial systems were already affected by the crisis, European countries appeared to be safer locations. This lack of concern with the European periphery can also be inferred from the Credit Default Swap (CDS) spreads shown in Figure 32, which were low and stable until mid September 2008 (when Lehman Brothers failed). Rising spreads in Greece and Portugal and a buoyant housing market in Spain appeared to offer high and reasonably secure returns to core banks.

Figure 26 below shows the gross exposure of the core countries compared to their Capital and Reserves. Additionally it shows the equity of the banking system at the end of 2008, which is the only date for which this type of data is available from the ECB or Eurosystem Central Banks. The graph shows that exposure of core banks to the periphery grew faster than their capital and reserves until early 2008. At that time banks began to reign in lending while continuing to strengthen their capital base. The main contributors to core lending to the periphery are France and Germany, whose trajectories are shown in figure 27.

Fig. 26 Core bank gross claims on periphery vs. capital & reserves

Euro, bn Source: BIS Consolidated Banking Statistics; ECB Eurosystem Statistical Data Warehouse

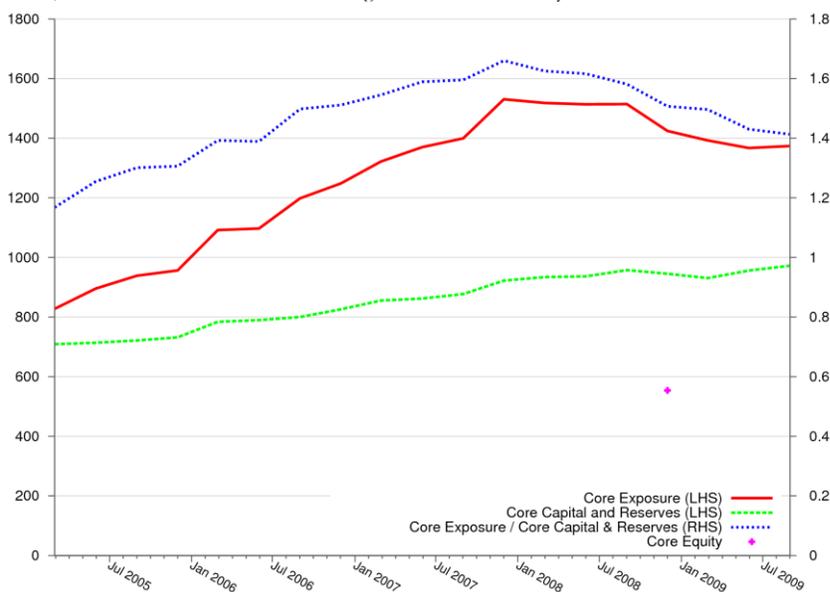
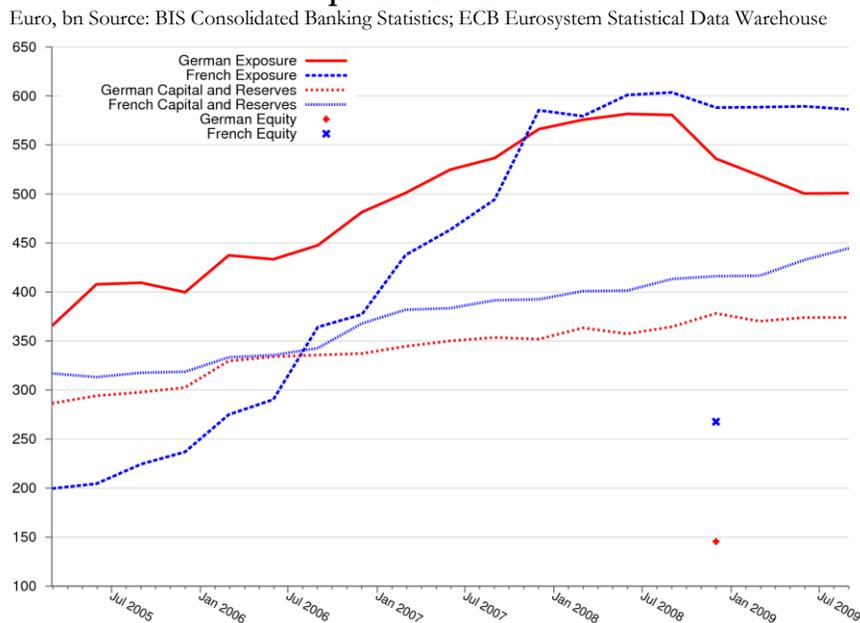


Fig 27 French and German bank gross claims on periphery vs. capital & reserves



The single point in figure 26 marks the equity of core banks in December 2008, allowing for visual assessment of exposure. At the end of 2008 the gross exposure of core banks to the periphery stood at around 1.4 trillion euros. Meanwhile, total equity of the core banking system was 0.6 trillion euro, making the exposure to peripheral countries approximately 2.6 times equity. The two single points in figure 27 indicate the equity of French and German banks, respectively, in March 2009. On this basis, the exposure of German banks appears perhaps somewhat heavier than that of French banks.

Be that as it may, there is no doubt that core banks are heavily exposed to peripheral countries. Yet, the assets are loans and therefore it is probable that they are not entered on the balance sheet on a mark-to-market basis, reflecting current market prices. Consequently, provision against losses will presumably take place only when the possibility of default by borrowers is very high, and the loans begin to look impaired. Judging by current Credit Default Swap (CDS) spreads (fig. 32), which capture risk premia, the risk to core banks does not look forbidding at the moment.

However, things could change very rapidly, if peripheral countries took a turn for the worse. A 10% drop in the value of banking assets would be serious for the core banking systems, but it may not necessarily be terminal. If, on the other hand, 50% of loans to the periphery defaulted with a 50% recovery ratio, resulting in a loss of 25% of total exposure; or equally, if an exit from the euro resulted in a 25% devaluation of domestic currencies, the outcome would be disastrous for the banking system of the core nations, given current levels of equity. German and French banks would be particularly vulnerable.

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This is the hard reality behind the negotiations currently taking place between core and periphery regarding a rescue plan for the weakest, in the first instance, Greece. If the periphery was not rescued and generalised default occurred, the banking system of the core would find itself in a tight corner. Needless to say, banks have been rescued once in 2007-9, and it is likely that they would be rescued again.

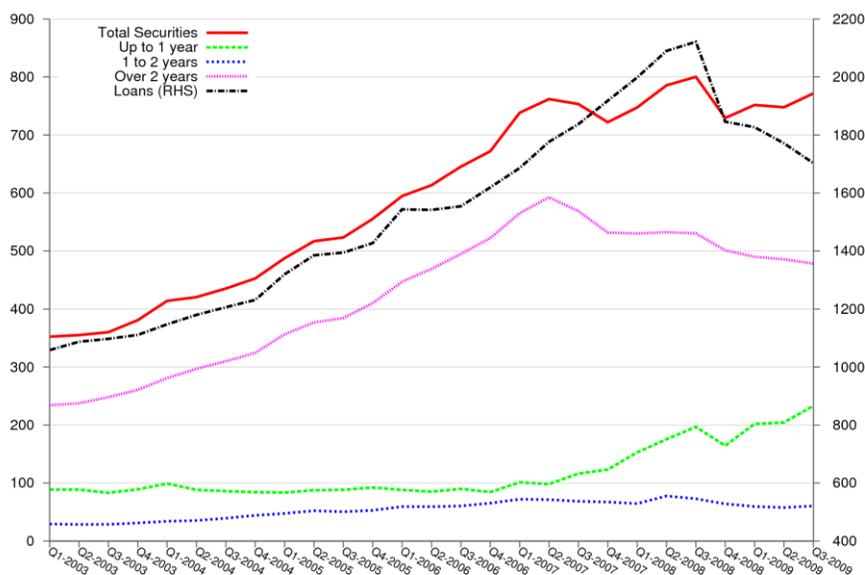
6.3 ECB operations allow banks to restrict their lending

When the financial crisis hit in 2007, many European banks found that their assets were worth less than estimated. In the preceding period European banks had attempted to keep in step with large US banks by borrowing to acquire speculative mortgage-backed and other asset-backed securities, thus raising their returns. When the interbank market froze in 2007-8, European banks struggled to find liquidity, thus coming under heavy pressure.

The most visible effect of this development in the money markets was the drastic widening of the LIBOR-OIS spreads. The LIBOR is a rate of interest closely linked to the interbank money market for maturities between 1 month and 1 year; the OIS (or EONIA in the Eurozone) relates to the rate of interest for overnight cash. The result of the freeze was a sharp increase in money market rates, while overnight rates remained largely unchanged. The situation worsened after Lehman Brothers collapsed in September 2008. To confront the problem, the ECB decided to increase its long-term refinancing operations. The expectation was that this would re-establish confidence in the money markets, as well as inducing banks to lend more freely beyond the interbank market.

Fig. 28 Securities and Loans held by banks, cross-border positions

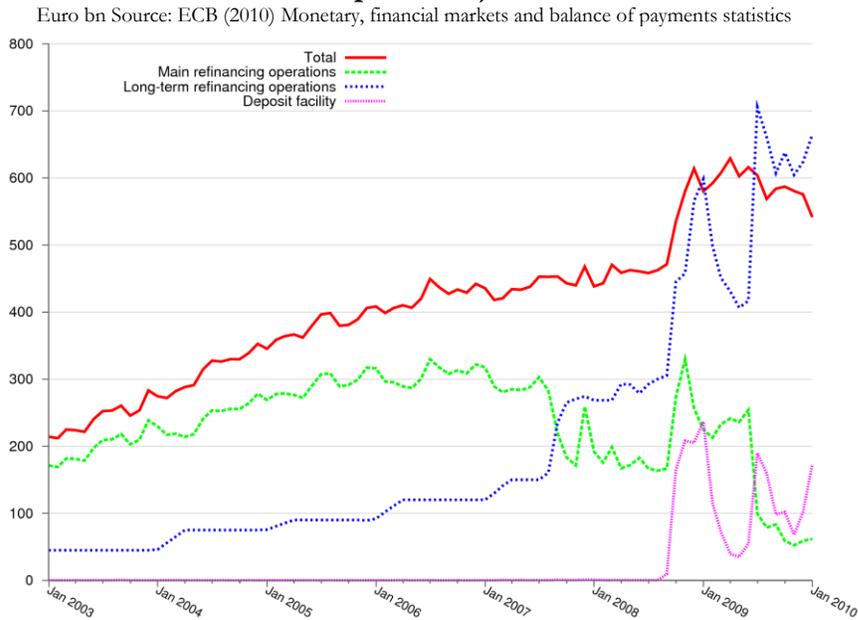
Euro bn Source: ECB (2010) Monetary, financial markets and balance of payments statistics



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Figure 28 shows that increased demand for liquidity by European banks resulted in a rising share of short-term assets on their balance sheets (represented here by securities up to 1 year).¹⁴ At the same time, banks engaged in rapid restructuring of their balance sheets by reducing longer-term securities (securities of over 2 years) as well as loans. This is a characteristic feature of the general ‘deleveraging’ in which banks have engaged across the world following the crisis. In the eurozone this process has rested on increased liquidity provision (in euros) by the ECB, in exchange for long-term assets held by banks. Technically, short-term securities held by banks were increased as the ECB rapidly expanded its long-term refinancing operations (mostly securities with one year maturity, which is long for a central bank), as is shown in figure 29:

Fig. 29 Net central bank lending in the Eurosystem (main operations)



Intensified liquidity provision also took place by the national central banks of Spain, Portugal, Greece and Italy. Liquid short-term securities were supplied to the domestic banks in the wake of open market operations during the crisis. Figure 29 further shows a significant increase in bank deposits held at the central bank during this time. Banks have preferred to hold some of their reserves at the central bank instead of boosting their lending or acquiring securities. This development has, in turn, reinforced the process of banking deleverage, thus restricting the supply of credit to the economy, and worsening the recession.

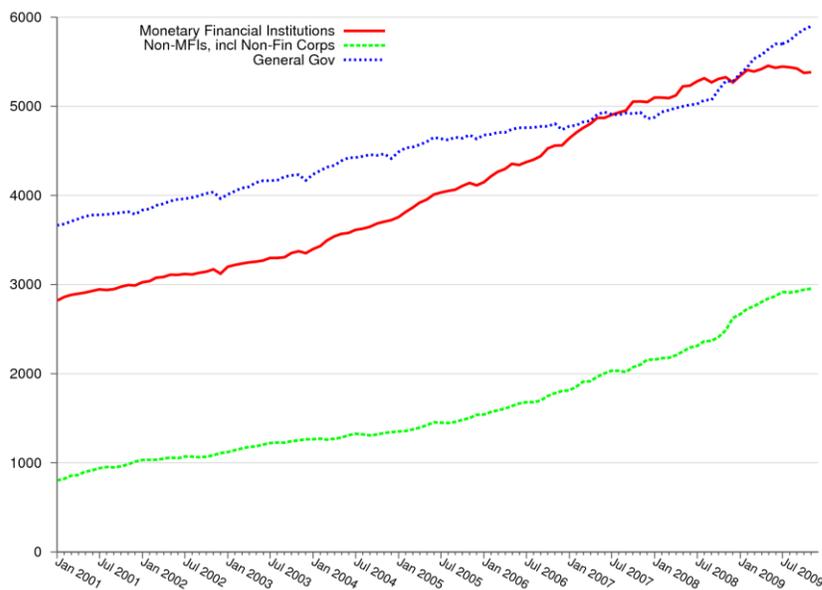
¹⁴ Cross border positions are assumed to be a good proxy for the overall balance sheet of banks.

6.4 Sovereign debt rises

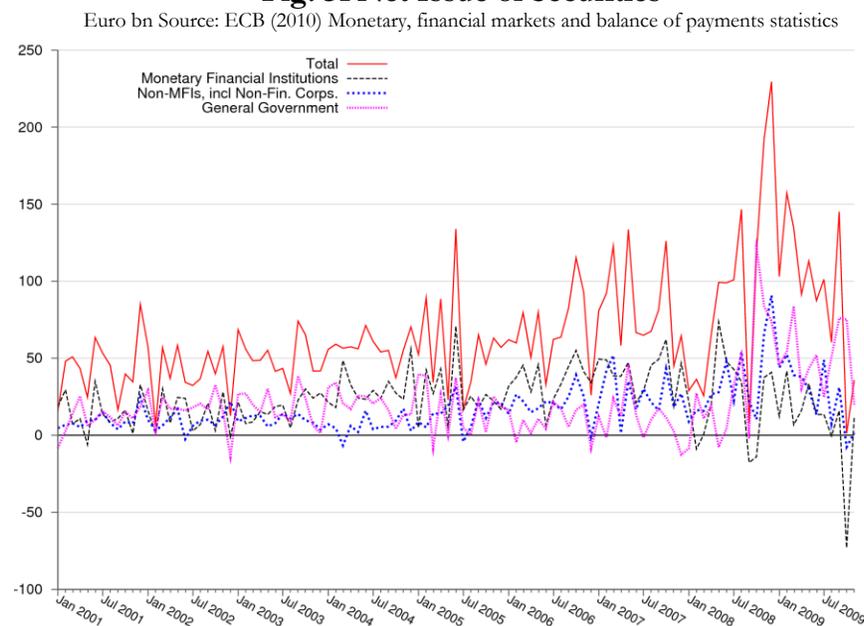
Sovereign debt rose rapidly once the crisis had set in, as was discussed in section 5. The drop in output led to falling revenue, while expenditure rose chiefly to rescue the financial system. Figure 30 shows that sovereign debt rose slightly between September 2007 and September 2008; the outstanding amount climbing from 4.9 trillion to 5.1 trillion euros. But after September 2008, when the banking crisis turned into a global crisis that damaged all sectors in the economy, sovereign debt rose by almost 900bn euros. The rise in public debt represents close to 60% of the entire increase in outstanding debt among all issuers in Europe, as is also shown in figure 30.

Fig. 30 Total outstanding debt European markets

Euro bn Source: ECB (2010) Monetary, financial markets and balance of payments statistics



The immediate cause of the sovereign debt crisis is now clear: states have had to issue enormous amounts of debt at the ‘worst time’, thus facing increases in yield (as reflected in CDS spreads). Banks reduced their lending in 2009 and switched to holding short-term securities. They also avoided issuing bonds in 2009, fully aware of the rising pressure in financial markets, and opting to issue equities as figure 31 shows. The stock market revived in 2009 due to government support for the financial system, thus banks could obtain funds cheaply. Non-banks were able to issue fresh debt at yields similar to the previous period because they have more flexible term structure and timing of issuance. The brunt of the crisis has been shifted onto the public sector.

Fig. 31 Net Issue of Securities

This outcome was facilitated by the ECB's response to the liquidity crunch which, as was shown above, was to flood the financial markets with liquidity in order to avert bank collapses. Co-ordinated action by the ECB allowed banks to start repairing their balance sheets. But ECB action helped to shift the problem onto the state, since the increase of ECB short-term securities made it more difficult for sovereigns to issue bonds, particularly as these have longer maturity. Furthermore, the ECB has extended the list of assets it accepts as collateral in liquidity operations by including further types of private securities. Currently government securities account for less than half of the nominal value of the securities on the list. Access to ECB liquidity facilities has thus been broadened for banks, negatively affecting demand for government securities. States have been left struggling to raise funds, pushing up refinancing costs. In the absence of unified fiscal policy in the eurozone, each state has competed against the others, leading to higher yields for peripheral bonds.

The structural weaknesses of monetary union are apparent in this regard. All countries have the same access to the money markets; but they do not have the same access to credit, which is obtained at a different price by each country. The money market is unified in Europe as each domestic banking system has access to the ECB through national central banks, and faces the same interest rates and conditions. Bank nationality does not matter. However, in the government bond market each country faces particular conditions to refinance or issue debt. Supply and demand conditions - not to mention a country's credit rating - determine how much and at what price a country can borrow. The ECB does not act as government agent in managing public debt, highlighting the unique fiscal and monetary arrangement within the

eurozone. In effect, the ECB does not act as a genuine central bank since it supports banks within the eurozone, but lacks power to extend support to member states.

6.5 A hothouse for speculation

The reaction of financial markets to the unfolding conditions was to foster speculation. Two related trends have prevailed in outburst of speculation: the weakening of the euro, and the widening of both government bond and CDS spreads of peripherals versus the core.

As national currencies no longer exist, it has not been possible for speculators to bet on a weakening of currencies due to public finances getting out of kilter. But selling the euro has been a win-win bet for speculators, and peripheral countries have been at the eye of the storm. From a speculator's perspective there are three main scenarios. First, one or several peripheral countries exit the eurozone, thus leaving the common currency in a much weaker position. Second, a bail-out of peripheral countries is agreed, even if it implies bending the rules of monetary union. This would in itself mean a loss of faith in the euro as a common currency. The third option, which might even lead to a strengthening of the euro, is for peripheral countries to adjust their economies. But this would mean tremendous fiscal tightening and austerity imposed across peripheral countries.

The money markets have not provided a promising field for speculative activity. As was shown above, ECB policy has been to keep interest rates low and to continue with huge long-term refinancing operations. Thus, both the repo rate and the LIBOR-OIS spread have been at low levels since late 2009. Speculative attacks have focused on government bonds and CDS of peripheral countries versus the core. Greece has been hit harder, partly because of the lack of credibility as its accounts have been fiddled repeatedly, partly because of its large current account deficit, and partly because the relatively small size of its bond market makes it an easier target for speculation.

It is important to note that a considerable part of government bonds are held on an accrual basis. Consequently, despite its relatively small size, the CDS market has close similarities to the government bond market that is actively traded and marked-to-market. In addition, trading of sovereign CDS does not require a repo market or on-balance sheet reporting. As a result, CDSs have become another instrument for betting on a worsening of the crisis, or on outright default.

As is apparent from the preceding sections of the report, the crisis has not been caused by the CDS market on public debt. However, the CDS market has recently emerged as a benchmark for measuring, trading and speculating against the risk of a country defaulting. Sovereign borrowers are not only judged by rating agencies, but also receive a market judgement on the risk of default through CDS. Conceptually, the CDS benchmark resembles an independent index. Governments, central banks, rating agencies, and so on, have been forced to follow CDS

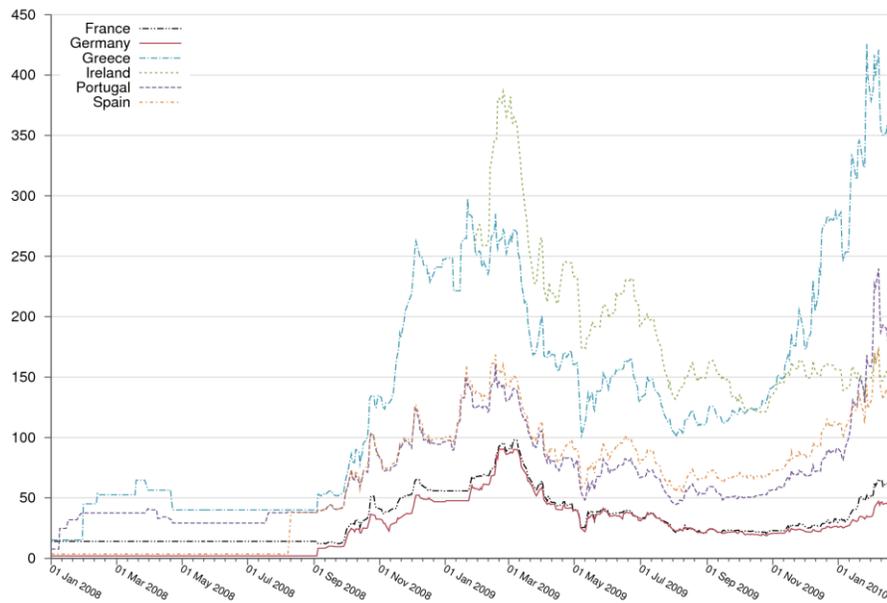
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spreads closely, making decisions accordingly. The CDS market might still be relatively small, but its impact is undoubtedly large.

The CDS spreads shown in figure 32 reveal how the perception of the euro has changed in light of the crisis. Bank and corporate CDS spreads were hit hard during the initial phase of the crisis. But the second phase, which began in 2009, has been marked mainly by widening sovereign CDS spreads. This puts in better perspective the older arguments in favour of joining the euro, namely that it would not only reduce exchange rate volatility but also limit government funding costs. The assumption was that bond yields within the Eurozone would converge, as indeed they did for a period. But the crisis has shown that this argument is seriously flawed. The structural weaknesses of monetary union and the impact of the crisis have raised the debt servicing costs of peripheral countries. Speculators have acted as the trigger, and were able to profit from the difficulties of others as the ECB watched. The financial system was rescued by state intervention, only to turn and bite its rescuer.

Fig 32 CDS spreads, 5 yrs

Source: Bloomberg



7. Political economy of alternative strategies

European monetary union has been problematic for peripheral countries, above all, Greece, Portugal, Spain, and Ireland. It has been no less problematic for working people in the core countries, with Germany in the lead. But Germany has also benefited at the expense of peripheral countries, mostly through entrenched current account surpluses that have been translated into capital flows to the rest of the eurozone.

The sovereign debt crisis is the outcome of, first, precarious integration of peripheral countries in the eurozone and, second, the crisis of 2007-9. The public sector in peripheral countries has confronted an increased need of borrowing because it rescued finance while attempting to forestall deep recession. The weaknesses of integration subsequently provided a field for speculative attacks by financial capital. The ECB has had neither the means nor the inclination to confront speculators.

The question now is: what strategies are available for peripheral countries? This is a huge topic that would merit separate study. However, on the basis of the preceding analysis, it is possible to sketch the broad outlines of alternatives. These could be split into three: first, imposing austerity on peripheral countries; second, seeking to alter the institutional structure of the eurozone; and third, exiting from the eurozone.

7.1 Austerity, or imposing the costs on workers in peripheral countries

The imposition of austerity is the currently prevalent policy in Greece and elsewhere. It is, after all, in line with the standard response to financial crises during the last three decades, typically overseen by the IMF. The normal terms of intervention by the IMF include the advance of a bridging loan to stabilise financial and foreign exchange markets, accompanied by ‘conditionality’. The content of conditionality has changed over the years, and there is evidence that the IMF is even beginning to countenance some relaxation of its rules.¹⁵ But broadly speaking it still amounts to austerity coupled with liberalisation of the economy.

The problem with inviting the IMF to deal with Greece - and potentially others - is that the eurozone issues what purports to be the second ranking form of world money. The damage to the standing of the euro would be palpable. The first option for core countries, therefore, has been to foster austerity on the periphery, attempting to manage the process from within. However, the eurozone lacks well-established mechanisms through which to replicate the approach of the IMF. Providing bridging loans, for one thing, is expressly forbidden by the

¹⁵ Blanchard, O., Della Ariccia G. and Mauro P. “Rethinking Macroeconomic Policy”, IMF Staff Position Note, 12 Feb 2010. <http://www.imf.org/external/pubs/ft/spn/2010/spn1003.pdf>

treaties establishing the euro. The result has been persistent political pressure on peripheral countries to adopt austerity policies, but without advancing the requisite finance. The costs of adjustment have been shifted disproportionately onto peripheral countries, inevitably leading to clashes of national interest.

In this context, the governments of peripheral countries have begun to introduce austerity policies in the hope of bringing down borrowing costs in the open markets. The strategy was first adopted by Ireland, but then also by Portugal and Spain, and now with increasing alacrity by Greece. In effect, peripheral countries have been forced to adopt IMF conditionality, without the IMF loan.

The Greek government, newly elected in October 2009, has introduced ever tougher austerity measures, including general reductions in public spending, direct cuts of public sector wages, and worsening of pension rights. The impact of these measures will inevitably spread to the private sector as employers take the opportunity to impose worse conditions on labour. The government has also imposed higher indirect taxes, while taking steps to reduce tax evasion.

This approach has already been tried in Ireland, bringing down borrowing costs to a degree, as is shown by CDS spreads in figure 32, but will face more tribulations in Greece. The country's borrowing requirements are higher, and there has been a profound loss of credibility for the Greek state in financial markets. Furthermore, speculative fever is far more advanced in early 2010 compared to 2009, making it unlikely that speculators would desist for long. With good reason too, since the declared aim of the Greek government to reduce its budget deficit by 4% in the course of 2010 is implausible. Even worse, austerity measures would probably intensify the recession, bringing government revenues under further pressure and making the targets even harder.

Greece has found itself in a very difficult position in early 2010: imposing cuts and raising taxes in order to pay high interest rates to buyers of its public debt. The country has been able to borrow commercially in January and March 2010, but the rate of interest was high on both occasions, well in excess of 6%. This represents a transfer of income on a grand scale from the many to the few. Greece has a substantial volume of debt to refinance in the rest of 2010. If commercial borrowing costs did not decline, it is apparent that the policy could not last for long, given the huge social costs involved. What the government would be cutting with one hand, it would be passing onto lenders with other. External help would then be necessary, which can come either from the eurozone, or from the IMF.

The political economy of a eurozone loan, however, is far from simple. In the first instance, the constitution of the eurozone forbids formal advance of such loans. Yet, the EU has been highly inventive under pressure in the past. It might be possible, for instance, to make bilateral loans to Greece, possibly in the form of guarantees of Greek debt. The real difficulty, though, is not formal arrangements but political

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relations within the eurozone. Germany, which will probably bear the main burden, has gone through sustained austerity for almost two decades. It has also expressly and repeatedly opposed the notion of bailing out states within the eurozone. There would be significant political costs for any German government in making money available to other states. Furthermore, lending to Greece might open the gates to other peripheral countries.

On the other hand, there are significant risks to avoiding a euroloan and thus forcing Greece to go directly to the IMF. Technically the country would remain within the euro, particularly as there are no legal mechanisms to force it out. But its membership would in effect become second tier, and the long-term implications for its ability to borrow at standard sovereign rates within the eurozone would be entirely unclear. More significantly, going to the IMF would create a precedent for other peripheral countries, and might invite further speculative attacks. The risks posed for the euro as world money would be multiplied, particularly given the high exposure of core banks to peripheral countries.

The Greek ruling establishment is fully aware of these complexities. Though its preferred choice has been to tie its mast to a 'European' solution, it has also raised the threat of unilaterally going to the IMF. On the whole, the dominant opinion has been that the country needs to do whatever it takes in order to remain within the euro. Nevertheless, austerity imposed from the top is likely to be met with stiff resistance from trade unions, popular organisations, and political parties. Greece will be wracked by political strife in the coming period. The government will probably draw some support from widespread popular fear of national bankruptcy as well as from (misplaced) national pride in remaining a member of the 'rich club' of the euro.

The deeper weakness of the current strategy, however, is neither the imposition of austerity on working people, nor the difficulty of securing bridging loans. It is, rather, that its prospects of dealing with the underlying causes of the crisis are minimal. As was shown above, the underlying structural problem of the eurozone is that German competitiveness has surged ahead during the last decade. Greece and other peripheral countries have not succeeded in raising productivity sufficiently to overcome the pressure that Germany has applied onto its workers.

A policy of austerity would do very little to tackle the underlying problem of competitiveness. It might succeed in lowering nominal and real wages for a period, but it is apparent that this cannot be a long-term competitiveness strategy for countries that already have substantially lower wages than Germany. Given the flatness of German nominal remuneration, it would simply mean falling wages for years ahead. The answer, then, must be policies to raise productivity, and in this regard the ideas that typically accompany such IMF-related packages are disastrous.

The standard prescription, still touted after persistent failure, is liberalisation. In the context of the eurozone, it would amount to the full

unfolding, and even intensification, of the underlying ideas of the European Employment Strategy. Key elements might be: further weakening of labour protection, particularly through reducing trade union power; abolishing collective bargaining on wages; facilitating the entry of women into the labour force, especially in part-time and temporary jobs; removal of barriers into certain closed professions; reducing the tax burden on capital by introducing heavier indirect taxes; introducing privatisation into the education system; and significantly raising the pension age, while facilitating a funded system that promotes the activities of financial institutions.

There is no reason to think that such measures, or similar, would lead to sustained growth of productivity, allowing for genuine convergence toward the countries of the core. Productivity growth requires investment, new technologies, and opening fresh fields of activity. In the case of Greece it also means moving the country away from a pattern of growth that has rested on consumption with rising household debt. These changes will not come from liberalising markets, and nor is there any evidence that Greek capitalists have the capacity to perform such a miracle. In the medium term liberalisation measures are likely to lead to stagnation, with systematic transfers of income from labour to capital. Meanwhile, Greek society - the second most unequal within the eurozone - is likely to become even more polarised and callous toward social deprivation. The policy of remaining within the eurozone at all costs is likely to have grim results.

7.2 Reform of the eurozone: Aiming for a 'good euro'

The second alternative involves making structural changes to the institutional arrangements of the eurozone. A distinction should be drawn here between, on the one hand, reforms that would not alter the fundamental character of the eurozone and, on the other, reforms that would go against economic and social relations at the heart of the monetary union.

The former have been extensively discussed in the academic literature as well as in the popular press.¹⁶ There is, after all, manifest failure of the institutions of the eurozone, extensively discussed in the earlier parts of the report. Above all, there is a disjuncture between unitary monetary policy and fragmented fiscal policy. The rules under which the ECB operates are unnecessarily restrictive, including exclusive focus on inflation targeting and forbidding the acquisition of public debt. Furthermore, there is no provision for centralised fiscal transfers that could alleviate some of the tensions created by the single monetary

¹⁶ For a critical perspective, see: Arestis, P. and M. Sawyer (eds.). 2006. *Alternative Perspectives on Economic Policies in the European Union*, Palgrave/Macmillan. For reform that aims to maintain the eurozone status quo see Gros, D. and Mayer T. 2010. "Towards a Euro(pear) Monetary Fund", Centre for European Policy Studies, 8 Feb, <http://www.ceps.eu/book/towards-european-monetary-fund>. Gros and Mayer's arguments were run as guest article in *The Economist* of 18 February 2010.

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policy. There is also lack of an established mechanism of fiscal intervention in crises, as became apparent during 2007-9, when each nation state was left to fend for itself in its domestic economy. The absence of such a mechanism became even clearer in 2010 as Greece neared bankruptcy.

There is nothing in principle to stop the gradual introduction of some of these reforms in the future. It is possible, for instance, for the eurozone to develop a properly functioning Public Debt Office that could coordinate the issuing and handling of public debt in cooperation with the ECB. It is also possible for the rules applying to the ECB to be relaxed, for instance, allowing the ECB to acquire state debt directly and thus more closely resembling a normal central bank. Perhaps the ECB might be supplemented by a European Monetary Fund that would lend to eurozone states facing crises on the basis of established proportional rights. It is even conceivable that a centralised system of fiscal transfers might be established within the eurozone.

It is, however, extremely unlikely that fiscal policy could become unified as that would amount to wholesale restructuring of sovereignty across the eurozone. There is a hierarchy of states within the eurozone and close calculation of national interest. Legitimacy for each state derives from its own history, but also from the structures of power and popular assent, including democratic elections. There is no prospect of a single European state, and hence no prospect of unified fiscal policy. The reforms that could take place would occur within an existing hierarchy of power, dominated by the core countries and Germany.

Consequently, such reforms would amount, at most, to palliative adjustments of fiscal policy and improved articulation of fiscal with monetary policy. For the same reason, they are unlikely to challenge directly the principles encapsulated in the Maastricht Treaty, the Stability Pact and the Lisbon Strategy, that is, fiscal and monetary conservatism which shifts the pressure of competitive adjustment onto workers.

Even so, there is a risk that mild reforms would lead to lower acceptability of the euro internationally, hence a drop in its value relative to the dollar. But if the underlying principles of monetary union were not challenged, this development might be acceptable to the core of the eurozone. It is conceivable that a slightly weaker euro backed by reformed, yet still tough, mechanisms of fiscal and monetary control would be attractive to Berlin and others. If such a configuration could be achieved, Germany would still maintain its current account surplus within the eurozone, the external terms of trade would improve, and the role of the euro as world reserve currency might not be compromised.

For peripheral countries and workers across the eurozone, such a prospect holds little attraction. German workers would continue to be squeezed, and peripheral countries would continue to generate deficits. Germany would not shift from its path of stagnation, while the economies of peripheral countries would remain precariously integrated into the eurozone. The difference would be occasional fiscal hand-outs to relieve tensions, and perhaps improved management of crises.

It is not surprising, therefore, that, there has been a search for more radical reforms particularly by sections of the European Left in peripheral but also core countries. An important aim has been to push for further fiscal transformation seeking the abolition of the Stability Pact. What would then follow is not entirely clear, but the presumption is that there would be greater fiscal independence for each state, including the ability to determine budgets and national debt, but still coordinated by new European institutional arrangements.

Coordination would be reinforced by the European budget, which would be enlarged from its currently tiny size to perhaps 5-6% of the GDP of the EU. Coordination would also presumably benefit from sustained intervention by the European Investment Bank. Scope might thus be provided to promote ecologically sound, socially inclusive and redistributive public investment programmes. These would be capable of counter-balancing existing asymmetries in European development.

The European Employment Strategy would also be abandoned in preference to coordinated policies that protected labour conditions and income. A European Minimum Wage Policy (corresponding to at least 60% of the median wage of each country) could be instigated. This would be combined with legislation to enforce progressive working time regulation across Europe. There could also be European wage coordination mechanisms that would take into account productivity gains, inflation, and unemployment. Stabilisation of labour shares in output (from the bottom up) might narrow the differentials in competitiveness that underlie the current crisis. Finally, there could be Europe-wide unemployment insurance, perhaps financed by progressive income taxes. These measures are expected to promote integration of the European economy that would be beneficial to workers.

A notable feature of such proposals is that they do not confront directly the coordination of looser fiscal policy with a single monetary policy and the implications for the practices of the ECB. The general presumption is that the monetary union would be preserved, but the statutes of the ECB would be changed, ending its undemocratic political independence, and allowing for easier provision of credit to states and financial systems. This approach might thus be termed the 'good euro'. Monetary union would be supplemented by institutional reforms that would make the currency operate in favour of working people, particularly in small economies where the scope for an autonomous economic policy might be narrow. This strategy also appears to provide a political platform to unite working people in core and peripheral countries. However, the 'good euro' also faces intrinsic problems in achieving its aims.

Set aside for a moment the political difficulties of coordinating popular pressure across several eurozone countries in order to abolish the Stability Pact in the face of bitter opposition by the existing order. An underlying economic problem is that the reforms would abandon fiscal discipline while still attempting to maintain the euro as domestic and world money. This would be implausible for a currency that

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attempted to compete with the dollar. The result would probably be a fall in the value of the euro, making it impossible for large eurozone banks to operate internationally. There would also be speculative attacks on the debt of the countries with the largest deficits within the eurozone.

A common currency area, especially one that purported to issue world money, could not tolerate large and variable fiscal deficits among its constituent parts. It is not apparent that the eurozone could continue to issue a form of world money, while allowing for substantial fiscal independence among its member states. An enlarged European budget would be no answer for this problem, much as it might contribute to redistributive policies. The real answer would be to have a European budget run by a unitary state with a sufficiently integrated presence across the eurozone to support a common currency. But for that to happen, the present institutional and political arrangements of the eurozone would have to be overturned.

There is no parallel between the USA and the eurozone in this respect. It is true that the USA has a federal structure that allows individual states to manage their own fiscal affairs with several degrees of freedom. But the US federal state is a unitary entity that provides the ultimate guarantee for all public debt. California might be running huge deficits, but the federal state is perceived to be the implicit guarantor of its debt. No state could play that role within the eurozone, and there is no prospect of one emerging. Furthermore, the US is a well-understood exception in international transactions. The dollar is already world money, and can therefore tolerate falls in its value without necessarily losing acceptability – always within limits. The euro is attempting to establish a similar role for itself, and has no comparable track record.

In other words, the strategy of radical reforms aiming at a ‘good euro’ does not face simply political problems, namely the enormous difficulties of constructing an alliance that could alter the structure of the eurozone. More fundamentally, it faces the problem of compatibility of means with ends. Radical reform in the fiscal sphere would probably lead to failure of the monetary union altogether as the international role of the euro would come under pressure.

Those who call for such reforms should be aware of what they are advocating and tailor their proposals accordingly. The nub of the issue is neither the abolition of the Stability Pact, nor the introduction of an expanded European Budget with a redistributive mandate. It is, rather, the compatibility of fiscal independence, and possibly rising public debt, with the international role of the euro. On these grounds, it is possible that radical reform would lead to collapse of monetary union. If such a step is not to result in chaos, it would require coherent social and economic transformation of national economies, including the monetary system. To put it differently, a ‘good euro’ might well lead to ‘no euro’ thus requiring profound transformation of European economy and society.

7.3 Exit from the eurozone: Radical social and economic change

The final alternative of exit from the eurozone is the great unmentionable in peripheral countries, or referred to as the ultimate horror by governments and the press. There is no doubt that it would have severe consequences. But note that influential economists in the Anglo-Saxon world have already raised the issue in the press. Thus, Goodhart has effectively proposed the reintroduction of the drachma for domestic purposes, which would in practice result in devaluation.¹⁷ Feldstein has recommended a short ‘holiday’ of Greece from the eurozone, returning at a lower exchange rate.¹⁸ The underlying logic of these proposals is clear: the problem originates in loss of competitiveness, which can be partly tackled through devaluation.

The suggestions made by Goodhart and Feldstein could be called ‘conservative exit’. In effect, conservative exit would operate as complement to the usual IMF package by also allowing for devaluation, which is currently impossible. Austerity would still be imposed, but some of the pressure of adjustment would be taken by the fall in the exchange rate. Competitiveness would be partly revived, strengthening export demand. Liberalisation measures would presumably follow in order to improve long-term competitiveness.

Devaluation would have costs for workers since real wages would fall to the degree to which tradeables entered the wage basket. But there would also be costs for sections of the capitalist class, particularly those servicing debt abroad, including corporations and banks. Cessation of payments and restructuring of international debt might become necessary. It is no wonder, therefore, that ruling elites in peripheral countries are reluctant to consider this option.

The prospect is particularly forbidding for ‘little’ Greece and Portugal as their ruling elites are aware of their own impotence to confront the problem in its full complexity. Conservative exit would not by itself deal with the longer-term challenge of raising productivity growth and altering deficient economic structures. It would merely change the terms of trade, encouraging production of tradeables and potentially shifting the economy away from non-tradeables. It would then be up to domestic capitalists to grasp this opportunity to restructure production, expand investment, and develop new fields of activity. The free market would have to generate a burst of productive dynamism, if the underlying problem is to be resolved.

There is no evidence that capitalists in peripheral countries could perform such a miracle. The task is particularly complicated because peripheral countries typically have productive structures of intermediate technology, while real wages are above those of competitors in Asia and elsewhere. There is a risk, therefore, that conservative exit coupled with liberalisation would lead to protracted stagnation accompanied by bouts

¹⁷ Goodhart, C. “The Californian Solution for the Club Med”, *Financial Times*, 25 Jan 2010.

¹⁸ Feldstein, M. “Let Greece take a Eurozone ‘holiday’”, *Financial Times*, 16 Feb 2010.

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of inflation, successive devaluations, and slow erosion of labour income. Hence the ruling elites in the periphery generally prefer the option of remaining within the eurozone and shifting the costs onto working people.

This leaves the option of ‘progressive exit’ from the eurozone, that is, exit conditional on radical restructuring of economy and society. As has already been noted, exit would involve a substantial economic shock. There would be devaluation, which would release some of the pressure of adjustment by improving the balance of trade, but would also make it impossible to service external debt. Cessation of payments and restructuring of debt would be necessary. Access to international capital markets would become extremely difficult. Banks would come under heavy pressure, facing bankruptcy. The point is, however, that these problems do not have to be confronted in the standard conservative way.

Economic survival could be ensured, and a sustainable path of growth could be achieved, provided there was drastic economic and social transformation. For that it would be necessary to mobilise broader social forces capable of taking economic measures that would shift the balance of power in favour of labour. This is not the place to discuss in detail the policy that might bring about such change. But some strategic steps are clear, including the following.

To protect the banking system it would be necessary to engage in nationalisation, creating a system of public banks. Private banking in mature countries has failed systemically in 2007-9. Bank failure has threatened the provision of liquidity across the economy. Furthermore, large private banks – or Large Complex Financial Institutions – have proven ‘too big to fail’ in the EU and the USA. This has created major problems of moral hazard, effectively subsidising the cost of capital of large banks. Large banks currently offer expensive credit to households, while reducing loans to small and medium enterprises. They also engage in complex and often speculative transactions in open markets, of negligible economic and social value.

Placing large banks under public banks would guarantee deposits. Further, it would advance credit on reasonable terms to small and medium enterprises, thus protecting employment. Public banks would also contribute to attaining sustained growth, as well as beginning to reverse the financialisation of contemporary economies. Co-operative and not-for-profit institutions have been long-standing elements of advanced financial systems. Public ownership and control over large banks is a step that could draw on extensive public knowledge and experience.

Capital controls would also be necessary, in the first instance to prevent the outflow of liquid funds and protect the banking system. More broadly, regulation of external capital flows would be required to marshal national resources. Managing capital flows is also necessary to avoid importing instability from abroad, as even the IMF appears to

recognise of late.¹⁹ The policy of freeing the capital account in recent decades has offered no growth advantages, while regularly generating crises.

The combination of public banking and controls over the capital account would immediately pose the question of public ownership over other areas of the economy. The underlying weaknesses of productivity and competitiveness already threaten the viability of entire areas of economic activity in peripheral countries. Public ownership would be necessary to prevent collapse. The specific sectors taken under public ownership, and even the form of public ownership itself, would depend on the characteristics of each country. But public utilities, transport, energy, and telecommunications would be prime candidates, at the very least in order to support the rest of economic activity.

With significant areas of economic activity under public ownership and control, the rest of the economy could be shifted onto a different growth path. To that purpose it would be necessary to introduce industrial policy. Public institutions and mechanisms of promoting development, which have been steadily abolished in the years since the Maastricht Treaty, would be rebuilt on a new basis. In conjunction with a public banking system, they would make it possible to implement a national programme of public and private investment. There is growth potential across peripheral countries for clean energy production, more energy-efficient homes and transport, as well as improved water quality and rubbish disposal. There is also scope for public investment in housing, urban planning, roads, railways, bridges, and airports. There is, finally, scope for the much more difficult task of improving technology as well as research and development.

Progressive exit for peripheral countries would be predicated on genuine structural reform of economy and society. Such change has nothing to do with the tired shibboleths of liberalisation. If productivity is to be set on an upward path, peripheral economies have to be weaned away from consumption, low savings, individual borrowing, low investment, and speculative bubbles. Structural change requires public mechanisms that could mobilise available resources for investment. It also requires transforming education by committing additional resources and expanding its reach to the poorest. Improving education would, in time, produce gains in labour skills, thus also benefiting productivity.

It is apparent that structural change of this order cannot be undertaken using the present inefficient and corrupt mechanisms of state. Broad political and social alliances are necessary to rebuild the structures of state on the basis of grass-roots control, transparency and accountability. On these grounds, the tax base would be broadened by taxing income, wealth and capital, while reducing indirect taxes. Steps would be taken to improve social provision of health and to reorganise the system of public pensions. Transfer payments would also be used

¹⁹ Ostry, J. et al. "Capital Inflows: The Role of Controls", *IMF Staff Position Note*, 19 Feb 2010. <http://www.imf.org/external/pubs/ft/spn/2010/spn1004.pdf>

directly to tackle inequality in peripheral countries, which is already the worst in the eurozone.

The political and social alliances that could deliver such change do not exist in eurozone countries at present, other than in potential form. It would be far from easy to make them real, particularly as shifting the balance of power in favour of labour is predicated upon democratic organisation of economy and society. But there is no reason to believe that, if a credible political force proposed it within peripheral countries, it would be impossible for progressive exit to win broad support.

Political difficulties aside, however, the strategy would also have to confront the deeper problem of attaining national development in a globalised economy. Progressive exit cannot be national autarky. It would be necessary for peripheral countries to maintain access to international trade, particularly within the EU. It would also be necessary to seek technology transfer and capital from abroad. There are no guarantees that such flows would be forthcoming, particularly as the established order in Europe would be hostile to radical change. But progressive exit also offers the prospect of different development for workers in the core countries, who have come under heavy pressure during the last two decades. Labour in core countries would be a natural ally of peripheral countries attempting a radical transformation of economy. And if the eurozone came apart in the periphery, it could also unravel at the core, allowing for genuinely cooperative relations among European countries.

To recap, peripheral countries are currently confronted with stark choices because of the crisis of 2007-9 and the structural weaknesses of the eurozone. The current crisis could be resolved in a way that served the interests of the social layers which created the disaster in the first place. This solution would involve austerity in an attempt to remain within the eurozone. It would be inequitable, imposing huge costs on working people, who are not to blame for the upheaval. It would also lead to a hardening of society, while probably failing to deliver growth and higher real incomes in the future.

Alternatively, there could be a solution that changed the current balance of social forces in Europe involving institutional and social transformation. In this regard there is debate between those who would attempt to change the institutional arrangements of the eurozone, and those who would advocate exit from the eurozone coupled with transformation of economy and society. There would be costs to any form of radical strategy, to be sure, but they would be borne equitably. Unlike the option of austerity, furthermore, radical change would have the potential to put the economy on a sustainable path of development that produced benefits for all. The choice belongs to society and, as always, depends on struggle.

Research on Money and Finance (RMF) is a network of political economists that have a track record in researching money and finance. Focusing on the rise of financialisation and the resulting intensification of crises, RMF has generated analytical work on the development of the monetary and the financial system in recent years.

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