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THE EUROZONE BETWEEN AUSTERITY AND DEFAULT

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Executive Summary

The causes of peripheral country indebtedness: EMU membership and private sector deficits

1. The turmoil in the Eurozone is due to the global crisis of financialisation that broke out in 2007. But it is also due to the biased nature of the European Monetary Union (EMU). Systematic pressure on labour has intensified the disparities of competitiveness among Eurozone members, splitting the Eurozone into core and periphery.

2. The periphery includes Spain, Portugal and Greece. It also includes Ireland, which is subject to the same pressures as the other three but has several peculiar economic features that call for separate analysis. The periphery has been unable to compete against the core, while being constrained by uniform monetary policy and rigid fiscal discipline. Thus it has registered current account deficits, mirroring the current account surpluses of the core, above all, Germany.

3. Current account deficits in general must be financed by capital flows from abroad. The latter can be either debt-creating, e.g., bank loans or portfolio flows, or non-debt-creating, e.g., foreign direct investment. Furthermore, current account deficits correspond to financial deficits by the public and the private sector.

4. In the periphery, the Stability and Growth Pact has prevented the public sector from registering systematic financial deficits. Consequently, current account deficits have corresponded largely to private sector financial deficits. Furthermore, current account deficits were financed overwhelmingly by bank lending from the core.

5. In short, peripheral country indebtedness is largely due to the behaviour of the private sector in the course of EMU. Unable to compete against the core, peripheral private sectors have generated large financial deficits. Consumption was boosted in all three countries, while a real estate bubble emerged in Spain. Capital flows from abroad – typically lending by core banks – provided finance. Furthermore, the domestic financial system found the opportunity to expand, thus increasing domestic financialisation and indebtedness. The result has been the accumulation of vast debts, partly external (and owed to the core), partly domestic (reflecting internal financialisation).

Measuring the crushing burden of peripheral debt

6. Total debt (private and public) of Spain, Portugal and Greece stands at, respectively, 5315, 783 and 703 bn euro, or 506%, 479% and 296% of

GDP. Total debt has increased between two and three times in the course of EMU.

7. The ratio of private to public debt in Spain, Portugal and Greece is, respectively, 87:13, 85:15, and 58:42. The bulk of fresh debt created in the course of EMU has been private, while public debt has fallen proportionately. But the recession of 2008-9 has boosted public debt, turning it into the pivot of the Eurozone crisis. The Greek state is more heavily indebted than the other two for historical and social reasons.

8. The ratio of external to domestic debt in Spain, Portugal and Greece is, respectively, 33:67, 49:51, 51:49. The proportion of external debt has risen significantly in the course of EMU. Both the Greek and the Portuguese public debt are largely external as European financial markets have systematically overestimated the creditworthiness of peripheral states.

Weak banks

9. Peripheral debt represents a major threat to European banks. In recent years core banks – mostly German and French – have become heavily exposed to peripheral debt because of its high returns. In addition, all European banks face substantial funding problems because of financing large dollar assets with euro liabilities.

10. The intervention packages of May 2010 have been ostensibly directed at peripheral states, but were in practice aimed at banks. The ECB has provided liquidity to banks; it has also begun to acquire peripheral public debt with the aim of relieving the pressures on banks. State intervention has temporarily pacified markets but not decisively resolved the crisis. European banks continue to hold large volumes of peripheral debt while also facing funding problems.

The blight of austerity

11. Rescuing the banks has come at the cost of austerity, with negative implications for European economies and societies. Austerity will compress public expenditure and weaken private consumption, i.e. the elements of aggregate demand that have shown some vitality during the recession of 2008-9. Given the collapse of investment and the retreat of credit, austerity has increased the risk of recession.

12. It is not plausible that exports would sustain growth across the Eurozone, given the weak condition of global demand. Moreover, austerity is likely to press wages down across the Eurozone, thus exacerbating the competitive advantage of the core, above all, Germany. The opposition between current account surpluses in Germany and current account deficits in the periphery is likely to become sharper.

13. Austerity will worsen income distribution across the Eurozone, particularly in the periphery. Since it is accompanied by further liberalisation, austerity will also shift the balance of power against labour and in favour of capital.

The prospect of default

14. The burden of debt and the negative aspects of austerity have raised the prospect of peripheral countries defaulting on public debt. But default could be either creditor- or debtor-led. Creditor-led default is unlikely to lead to significant reductions of debt; it would also generate profits for the managing banks.

15. Debtor-led default could significantly reduce peripheral debt. Preconditions include unilateral cessation of payments and full auditing of public debt with participation of workers' organisations and civil society. Renegotiation of debt would follow with foreign lenders but also with domestic holders, particularly banks. There is a risk of becoming cut off from capital markets for a period. However, the experience of Argentina and Russia shows that debtor-led default could have positive results, if it was swift and decisive.

16. Debtor-led default raises the prospect of exit from the Eurozone. Exit would improve competitiveness through devaluation of the currency as well as removing the bind on monetary and fiscal policy. But it would also threaten the banking system and disrupt monetary circulation. These risks could be confronted through broad-ranging measures that would alter the balance of social forces in favour of labour.

17. More specifically, exit from the Eurozone would require - at least - public ownership and control over banks and other areas of the economy, extensive capital controls, reforming the tax system to include the rich and capital, introducing industrial policy, and thoroughly restructuring the state. In short, exit would provide the opportunity for a wholesale reversal of neoliberal economic policy. For this reason, exit requires radical political and social alliances.

18. Default, debt renegotiation and exit from the Eurozone have very serious implications. These must be weighed against the equally serious implications of recession and long-term stagnation of several Eurozone countries. It is essential to have a frank public debate over the costs, benefits and social implications of bold action to break the cycle of debt as opposed to enduring long-term stagnation.

1. Introduction

The crisis that has afflicted the Eurozone has two main causes.[1] First, it is due to the great turmoil that began in the US financial markets in 2007 and soon became a global recession. It is thus a further phase of the great crisis that began in the late 2000s, one of those rare events that mark the historical evolution of capitalism. This systemic upheaval has been called a crisis of financialisation, reflecting the rise of finance during the last several decades and the concomitant transformation of mature capitalist economies.[2]

Second, the crisis is due to the culmination of the structural biases within the Eurozone. A sharp internal division has emerged between core and periphery, typified by, on the one hand, Germany and, on the other, Spain, Portugal, and Greece.[3] This division has been reflected in progressive loss of competitiveness by the periphery relative to the core. The competitiveness of the core has benefited from extraordinary pressure on workers' wages which, in Germany, has meant practically stagnant real wages for well over a decade. Loss of competitiveness has entailed systematic current account deficits for the periphery, mirrored by equally systematic surpluses for Germany. The eruption of generalised instability in late 2009 reflects these profound imbalances within the Eurozone.

Nonetheless, the Eurozone crisis is, in the first instance, a crisis of debt, particularly of Greek public debt. Since late 2009, financial markets have been roiled by pressures arising from the extraordinary accumulation of debt by the peripheral countries of the Eurozone. It is shown in chapter 2 that peripheral debt has resulted in good measure from the unbalanced economic relations between Eurozone core and periphery. Peripheral countries have been mired in debt – private and public, domestic and external – as their competitiveness has declined relative to the core. Debt has also accumulated as financialisation has proceeded apace in peripheral countries, a process that has been reflected in the growth of the financial sector and in the expansion of

[1] This point was established in full detail in the RMF report 'Eurozone Crisis: Beggar Thyself and Thy Neighbour', March 2010, http://researchonmoneyandfinance.org/media/reports/eurocrisis/fullreport.pdf.

[2] See C. Lapavitsas, 2009. Financialised Capitalism: Crisis and Financial Expropriation, *Historical Materialism*, 17:2, 114-148.

[3] The internal periphery of the Eurozone also includes Ireland, which has been as much a part of this crisis as the other three countries. However, the path of development of the Irish economy during the last two decades exhibits several peculiar characteristics, probably associated with the strong presence of multinational corporations, and it is best examined separately. Needless to say, there is an even sharper division between the core of the Eurozone and several countries in Eastern Europe, which might be called the external periphery. Since 2008 the latter has also entered a crisis with similar characteristics to that of the internal periphery. But, once again, it is best to leave the external periphery aside in order to keep the analysis within manageable bounds.

corporate and household indebtedness. Public debt, finally, began to accumulate rapidly once the recession of 2008-9 had emerged fully.

Irrespective of its origin, debt has its own logic, through which it has determined the unfolding of the crisis. Chapter 3 shows that the accumulation of peripheral debt has threatened the liquidity and solvency of European banks. The threat to banks has arisen for two related reasons: first, because the banks of the core have become heavily exposed to the periphery and, second, because banks have faced sustained funding problems. The debt crisis has, consequently, threatened to become a renewed banking crisis. This is the underlying reason why Eurozone authorities put together an extraordinary intervention package in May 2010, aimed at stabilising financial markets. However, banks have remained weak and their problems have not gone away, whatever the results of the stress tests of July 2010.

The counterpart to rescuing banks by Eurozone governments has been the imposition of austerity across the periphery, but also across much of the core. This turn of policy has major social costs and could prove highly damaging to European economies. Chapter 4 shows that austerity compresses the only element of aggregate demand that has demonstrated any dynamism during the last two years, namely public expenditure. Austerity is also likely to weaken consumption, thus further hitting aggregate demand. The possibility of severe recession across the Eurozone in the near future cannot be discounted. Even worse, since austerity has spread beyond the periphery, it could lead to downward wage pressure in the countries of the core. Consequently, the competitive disadvantage of the periphery, which lies at the heart of the Eurozone crisis, is unlikely to be eliminated in the foreseeable future. This is a recipe for further economic instability and dislocation, particularly for peripheral countries. Finally, austerity is also likely to change the long-term balance of power between capital and labour in favour of the former. The Eurozone will probably become even more hostile to the interests of working people in the coming years.

If austerity is such a lamentable course of action, what alternatives are there? The crisis is so profound that alternatives are likely to be radical, both economically and socially. The volume of debt of peripheral countries raises the prospect of default. It is argued in chapter 5 that default has to be debtor- (rather than creditor-) led, if it is to be effective. Creditor-led default is unlikely to lead to substantial reduction of debt and it would also mean fresh profits for banks. In contrast, debtor-led default could significantly reduce the crushing burden of debt on the periphery. But debtor-led default requires full transparency as well as participation by organisations of workers and civil society in renegotiating debt. Debtor-led default, moreover, poses the issue of exiting the Eurozone in order to revive economic activity in the periphery.

It is arguable that default, debt renegotiation and exit from the Eurozone constitute a preferable path for countries facing intractable public debt problems. But the risks are many, including to the viability of

the financial system, and thus requiring decisive government action. Furthermore, such a radical policy option would have complex social implications. Appendix A offers some historical perspective by considering the experience of Argentina and Russia, both of which defaulted and devalued their currencies in recent years.

Chapter 5 thus concludes by considering the political economy of default in the Eurozone and the possible implications of exit for a single peripheral country. The issue has obvious topicality for Greece, which has been at the forefront of the crisis, but also for other peripheral countries as well as for the core. Default poses complex questions with regard to the debtor's international position and the balance of internal social forces. Apart from foreign holders of public debt, there are also domestic holders of public debt, domestic issuers of private debt which is owed to foreigners, and domestic owners of foreign assets abroad. Default presents different opportunities and threats to all these parties, requiring decisive action, if the interests of working people are to be protected. Furthermore, exit would deliver the shock of changing the monetary standard, bringing devaluation in its wake. It would thus pose major risks for the economy as a whole, above all, for the domestic banking system. But exit could also ameliorate the competitive weakness that has bedevilled peripheral countries within the Eurozone.

In sum, peripheral countries face a harsh choice and their predicament reflects the historic failure of the Eurozone. The crisis could be managed in an undemocratic way that defends the interests of financial capital, particularly of core Eurozone countries. Alternatively, the crisis could become an opportunity for radical change that would alter the balance of social forces in favour of labour in the periphery as well as the core. If appropriate political and social alliances were formed, the vice that is currently crushing Europe between debt and austerity could be removed.

2. A profusion of debt: If you cannot compete, keep borrowing

Obtaining an accurate picture of the debt of peripheral countries is the first difficulty in analysing the crisis of the Eurozone. Information on debt is hard to come by, not least because governments are not forthcoming regarding their own debt. This chapter develops a systematic picture of peripheral debt by using the information available as of December 2009. It is shown that peripheral countries are heavily indebted, while the debt is domestic and external as well as private and public. But the mix varies considerably among Spain, Portugal and Greece, with significant implications for the path of the crisis in each country.

The chapter also discusses the causes of peripheral indebtedness, showing that they are related to the structure of the Eurozone and, more broadly, to the global trend of financialisation. To be more precise, indebtedness is due to the loss of competitiveness by peripheral countries as well as to the rapid growth of the financial sector in recent years. Participation in the European Monetary System has been of decisive importance in this regard, both because it contributed to the loss of competitiveness and because it facilitated the growth of the financial sector. Enormous accumulation of debt by peripheral countries has been the counterpart to adopting the common currency.

However, the actual pattern of indebtedness reflects the particular economic, social, institutional and political conditions in each country. Thus, the chapter considers in some detail the evolution of debt in Spain, Portugal and Greece. It is shown that by far the strongest growth has been in private, not public, debt. Furthermore, the heaviest holders of peripheral debt are countries of the core. But the balance between private and public debt varies considerably, as does the mix between external and domestic debt. Therefore, the threat posed by debt is significantly different for each of the three countries.

2.1 The magnitude of peripheral debt

Table 1 provides a picture of aggregate Spanish, Portuguese and Greek debt as of 31 December 2009.[4]

Several aspects of peripheral indebtedness stand out and call for explanation. First, in absolute terms, Spanish debt is roughly three and a half times the sum of Portuguese and Greek debt, the last two being fairly similar to each other. Thus, any suggestion of Spanish insolvency would pose a threat of an entirely different order to global financial markets compared to Greece and Portugal. As a proportion of GDP, however, aggregate Spanish indebtedness is very similar to Portuguese,

[4] For a summary of the sources, the methods and the assumptions involved in the calculation of table 1, see Appendix B.

Table 1 Aggregate debt (end 2009)

	Spain		Portugal		Greece	
	EUR Bn	%	EUR Bn	%	EUR Bn	%
Total Debt						
EUR Bn	**5,315**		**783**		**703**	
% GDP	**506 %**		**479 %**		**296 %**	
by issuer						
General government	676	13 %	121	15 %	293	42 %
Financial corporations	1,669	31 %	238	30 %	120	17 %
Non-fin corporations	2,053	39 %	246	31 %	165	23 %
Households	918	17 %	178	23 %	123	17 %
		100 %		100 %		100 %
by instrument						
Short-term	**1,586**	**30 %**	**271**	**35 %**	**189**	**27 %**
Non-resident deposits	549				106	
Bonds	156		44		11	
Loans	258		49		72	
Trade credit	623		32			
Long-term	**3,730**	**70 %**	**512**	**65 %**	**514**	**73 %**
Bonds	1,472		173		301	
Loans	2,258		339		212	
		100 %		**100 %**		**100 %**
External Debt		% of total debt		% of total debt		% of total debt
EUR Bn	**1779**	**33 %**	**381**	**49 %**	**385**	**51 %**
% GDP	**169 %**		**233 %**		**162 %**	
by issuer		% of ext debt		% of ext debt		% of ext debt
General government	299	17 %	98	26 %	206	53 %
Financial corporations	823	47 %	210	55 %	112	29 %
Other sectors	645	37 %	73	19 %	68	18 %
		100 %		100 %		100 %
by instrument						
Short-term	**686**	**39 %**	**182**	**48 %**	**127**	**33 %**
Non-resident Deposits	549		146		106	
Bonds	75		25		7	
Loans	17		1		13	
Trade Credit	45		10		1	
Long-term	**1,093**	**61 %**	**198**	**52 %**	**258**	**67 %**
Bonds	739		141		206	
Loans	354		58		53	
		100 %		**100 %**		**100 %**
Sources:	Bank of Spain, Statistical bulletin- National Financial Accounts and Balance Payments - International Investor Position		Bank of Portugal, Statistical bulletin- National Financial Accounts and Balance Payments - International Investor Position		Bank of Greece, QEDS, IMF, Eurostat	

and both are significantly higher than Greek indebtedness. On this basis, the financialisation of the Greek economy as a whole appears to be less advanced than the other two, as will also be shown below.

Second, the composition of aggregate debt is quite different among the three countries. The proportion of domestic to external debt stands at 67% to 33% for Spain, compared to 51% to 49% for Portugal and 49% to 51% for Greece. It seems that Portugal and Greece are equally indebted externally and domestically, while Spain carries a lower proportion of external debt. On this basis, the domestic financialisation of the Spanish economy appears to have been more pronounced than that of the other two. However, the salient fact is that all three countries are heavily indebted abroad relative to GDP, Spain at 169%, while Portugal and Greece at, respectively, 233% and 162%.

Third, the composition of aggregate debt is even more strikingly different when the proportion of private to public debt is considered. For Spain and Portugal the proportion is quite similar, standing at, respectively, 87% to 13% and 85% to 15%. But for Greece the proportion stands at 58% to 42%. The Greek state is more indebted than the other two by several orders of magnitude. The difference is even more pronounced with regard to the composition of external debt. The balance of private to public external debt stood at 83% to 17% for Spain, 74% to 26% for Portugal, but 47% to 53% for Greece. However, when it comes to the balance between the domestic and external components of public debt alone, the proportions are 56% to 44% for Spain, 19% to 81% for Portugal, and 30% to 70% for Greece. Both the Greek and the Portuguese state are heavily indebted abroad, the latter proportionately more than the former.

Finally, fourth, the composition of debt in terms of instruments is quite similar among the three countries, standing roughly at 1/3 short-term to 2/3 long-term debt. But there are significant differences in the composition of external debt, largely reflecting the different weight of public debt in external debt. Thus, Greek external debt is preponderantly long-term, since its dominant element is public bonds. The external debt of the other two countries tends to be shorter-term, reflecting the heavier presence of the private sector.

One final aspect of aggregate peripheral debt that merits mention is the composition of holders by nationality. The data in figures 1, 2 and 3 refer only to securities, but this is still a large part of external debt, as can be seen in Table 1. The vast bulk of peripheral securities are held by the countries of the Eurozone core, primarily France and Germany. There are variations and specific features, for instance, French predominance in Portugal and Greece, but the fundamental point is clear: the periphery is indebted mostly to the core of the Eurozone.

To sum up, all three countries carry large volumes of debt, significant parts of which are owed abroad. Domestic Spanish finance appears to have grown more robustly, but the country remains heavily indebted abroad. Both Spain and Portugal seem to have advanced further than Greece down the path of financialisation. However, Greece

Figure 1 External holders of Spanish debt securities (end 2008)
Source: CPIS

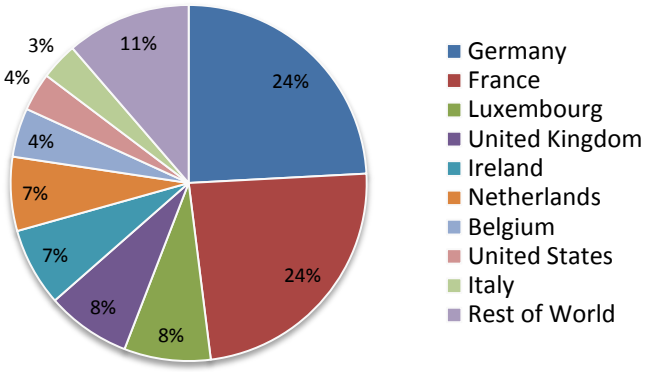


Figure 2 External holders of Portuguese debt securities (end 2008)
Source: CPIS

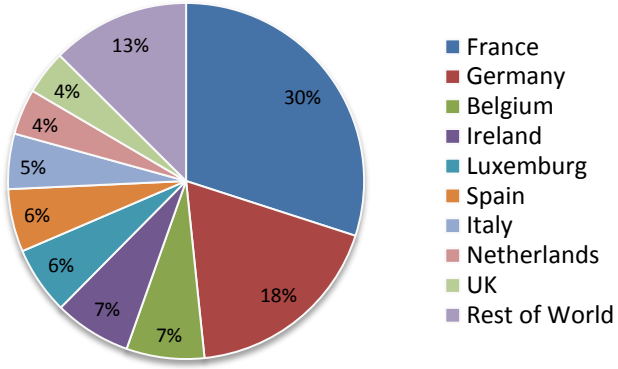
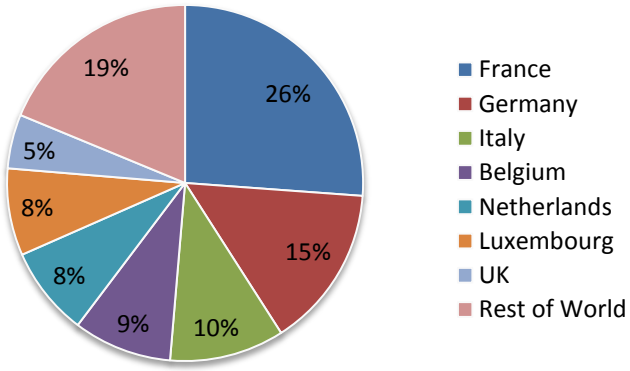


Figure 3 External holders of Greek debt securities (end 2008)
Source CPIS



carries a far heavier burden of public debt, both domestically and externally. In short, there are common patterns of heavy indebtedness across the three countries, which are borne differently in accordance with the social, historical, political and institutional characteristics of each country. One further thing the three countries have in common is that their external debt is owed to the countries of the core, primarily France and Germany. The rest of this chapter considers the common causes and differential patterns of indebtedness of peripheral countries. The starting point is external debt, which has been by far the most pressing element of the crisis.

2.2. The economic roots of external debt

Accounting relations, summed up in Box 1, indicate that the external debt of a country corresponds to its current account deficit as well as to the financial deficit of the private and the public sector. With this in mind, this subsection and the next are concerned with establishing the analytical relations between the external debt, the current account deficit and the financial deficit of core and peripheral countries.

A striking feature of the Eurozone has been the emergence of structural current account deficits in the periphery, mirrored by equally structural surpluses in the core, above all, Germany. The cause has been the rise in German competitiveness due to unrelenting pressure on German wages (Germany already starting from a higher level of competitiveness, needless to say).[5] Pressure on wages has been a general feature of Eurozone countries, following the Maastricht Treaty, which has forced 'flexibility' onto the labour market thus complementing the imposition of single monetary policy and rigid fiscal policy across the Eurozone. The race to the bottom has been won by Germany, which has squeezed wages far more successfully than peripheral countries during the last decade. The result has been loss of competitiveness in the periphery, producing current account deficits that have been mirrored by current account surpluses in Germany. Figure 4 shows the divergent paths of the German, Spanish, Portuguese and Greek current accounts.

Peripheral current accounts worsened steadily since the mid-1990s on the approach to European Monetary Union, and the deficits became entrenched once the euro was adopted. Germany, meanwhile, has registered regular surpluses since the introduction of the euro. The deficits of the periphery reached extraordinary levels in the second half of the 2000s, nearing 15% in Greece in 2007 and 2008.

Current account deficits must be matched by flows of external finance, as is shown in Box 1. For peripheral countries, such finance has not come from flows of foreign direct investment (FDI), which have remained weak throughout this period. Consequently, current account deficits have been financed through bank loans (BL) and portfolio flows

[5] As was shown in the RMF report 'Eurozone Crisis: Beggar Thyself and Thy Neighbour', March 2010, chapter 3, pp. 21-6.

BOX 1 CURRENT ACCOUNT AND EXTERNAL DEBT ACCOUNTING

External debt can be related to the domestic components of the economy by using the framework of national income statistics. The framework deploys identities rather than behavioural relations, and hence should be treated with considerable caution. However, it can still shed light on the relations of external debt.

The financial balances of a country are given by:

(X – M) = (S – I) – (G – T), or External Deficit = Private Deficit + Public Deficit (1)

Where, S, I, G, T, X, M are, respectively, saving, investment, government expenditure, taxes, exports and imports.

Now, the Balance of Payments must balance, hence,

(X – M) = F

Where F represents total financial flows from/to abroad. In the case of the Eurozone, total financial flows do not include foreign exchange reserves, which is one of the few advantages offered by the common currency. Consequently,

F = FDI + BL + PF

Where FDI, BL, PF are, respectively, foreign direct investment, bank lending, and portfolio flows. Thus,

(X – M) = FDI + BL + PF *(2)*

In short, a deficit on current account (for simplicity taken as the difference between exports and imports) must be matched by financial inflows from abroad. These can be either debt-creating, as for bank lending and portfolio flows (if they are directed to bonds), or non-debt-creating, as for foreign direct investment and portfolio flows (if they are directed to shares). Typically portfolio flows are debt-creating, and this is how they will be interpreted in the rest of this report.

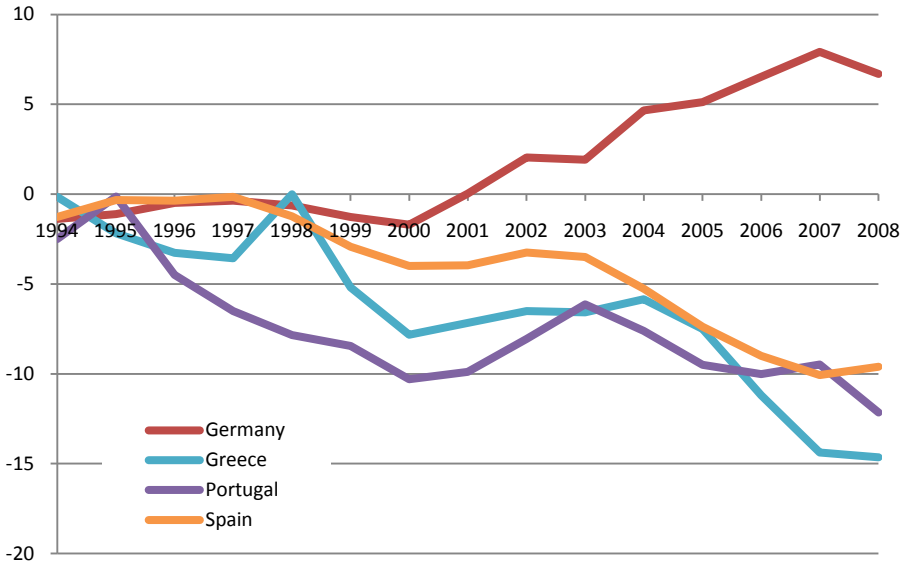
Combining (1) and (2):

(X – M) = FDI + BL + PF = (S – I) – (G – T) *(3)*

That is, current account deficits correspond to debt-creating and non-debt-creating financial inflows from abroad, which further correspond to the deficit of the private sector plus the deficit of the public sector. Used with caution, these identities can help analyse the relationship between the components of domestic demand, the current account, and the accumulation of external debt.

(PF) from abroad (bonds). Figures 5, 6 and 7 show the composition of capital inflows into peripheral countries by splitting them into FDI (which do not create debt) and non-FDI (which do). Debt-creating flows are heavily preponderant. This feature of capital flows lies at the root of the external indebtedness of the periphery, depicted in Table 1. Unsurprisingly, the funds have originated with banks and other lenders at the core.

Figure 4 Current account balance
(% of GDP)

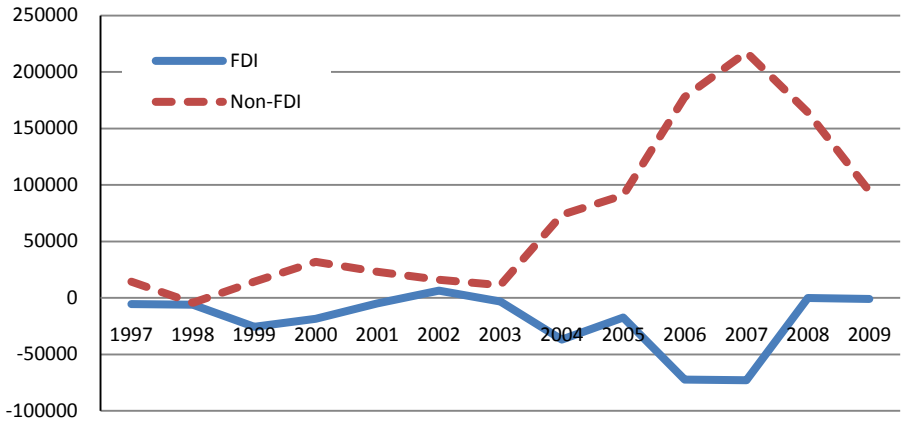


Source: IMF BoP

Current account deficits further correspond to financial deficits of the private and the public sector, as was also shown in Box 1. As far as the public sector is concerned, the conclusion is unambiguous: the rising current account deficits of peripheral countries were not matched by rising public sector primary deficits. Figure 8 establishes the point clearly.

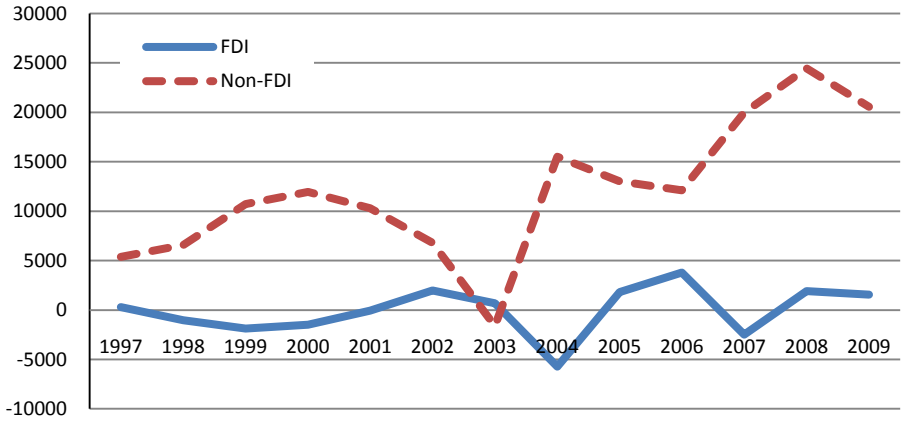
Portugal maintained a broadly balanced budget, with modest deficits for short periods of time, and roughly the same holds true for Greece. As for Spain, the country ran steady primary balance surpluses throughout the period. Fiscal deficits rose across the three countries in 2008-9, but that was clearly the result of falling tax revenues due to the recession as well as states attempting to maintain demand. There was a bulge in public deficits in 2008-9 that has certainly accounted for the sharpening of peripheral indebtedness, but not for the accumulated volume of debt. To put it differently, the Stability and Growth Pact, which is an integral part of European Monetary Union, might have been occasionally breached but, on the whole, forced peripheral countries to comply with fiscal conservatism. The Spanish state has proven more conservative even than the German state, though it has not received much of a reward for its virtue.

Figure 5 Composition of Capital Flows: Spain ($ mn)



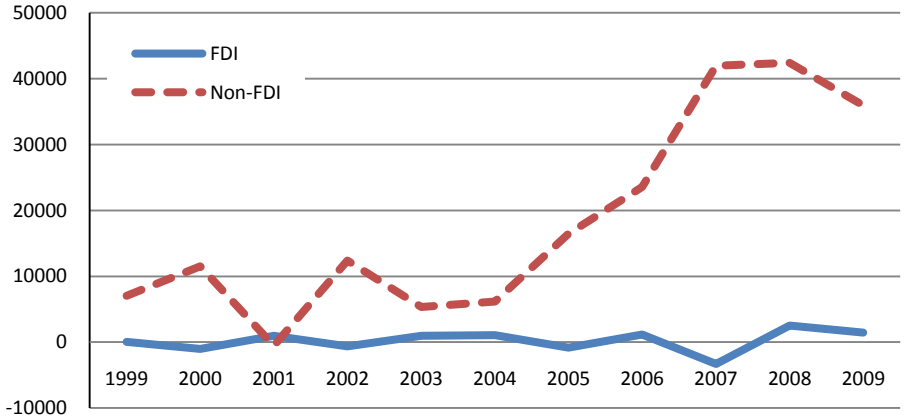
Source: IMF IFS

Figure 6 Composition of Capital Flows: Portugal ($ mn)



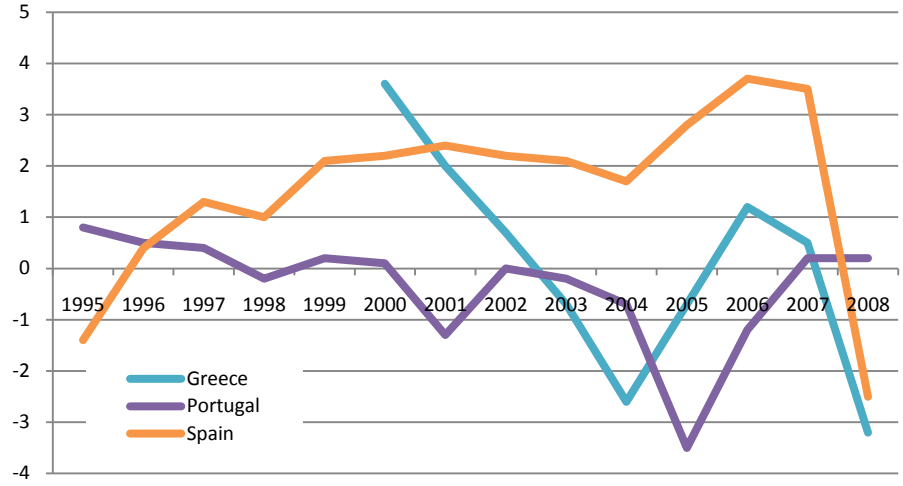
Source: IMF IFS

Figure 7 Composition of Capital Flows: Greece ($ mn)



Source: IMF IFS

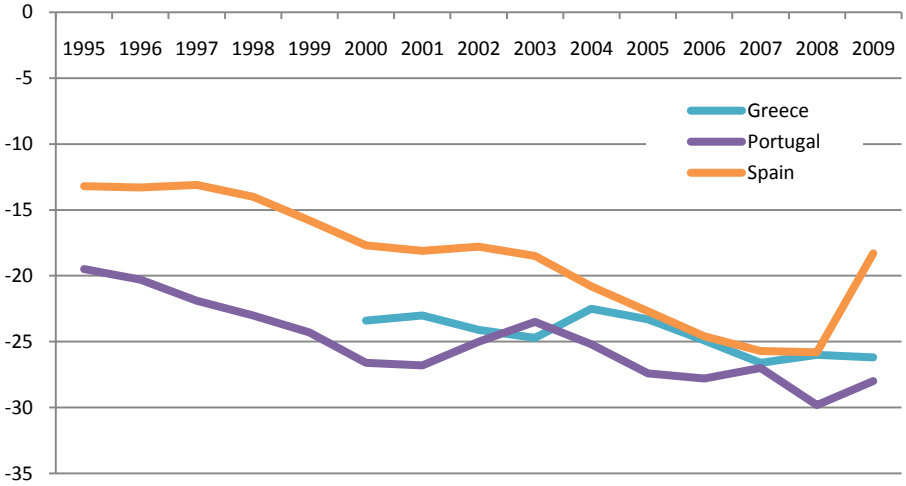
Figure 8 Government primary balance
(% of GDP)



Source: Eurostat

Inevitably, then, current account deficits in the periphery have been matched by financial deficits of the private sector. The deficits of the private sector in Spain have corresponded partly to rising investment spending, much of it related to real estate. In Greece and Portugal, however, there was no upsurge of investment in the 2000s, with a brief exception prior to the Olympics in Greece. The financial deficits of the Greek and Portuguese private sectors corresponded largely to the collapse of saving, particularly after the adoption of the euro. At about the same time, Spanish saving also began to decline, thus exacerbating the financial deficit of the private sector. Figure 9 sums up trends across the three peripheral countries:

Figure 9 Private sector saving less investment
(% of GDP)



Source: Eurostat

The key macroeconomic factors contributing to the accumulation of external debt by the periphery seem clear. Peripheral countries lost competitiveness relative to the core, and thus faced current account deficits which were financed from abroad. The current account deficits had little to do with the public sector of peripheral countries, which did not generate systematic financial deficits, even though it has often been described as profligate and inefficient. Rather, the current account deficits were associated with private sector financial deficits. Unable to compete with the core countries of the monetary union, the private sector of peripheral countries reacted in ways that produced systematic financial deficits. Thus, in Spain, there was an investment bubble pivoting on real estate, while in Greece and Portugal, private saving collapsed as consumption remained at high levels. The financial deficits of the private sector matched the accumulation of external debt, which financed the current account deficit.

In other words, external indebtedness reflects the biased integration of the periphery into the Eurozone. Generalised pressure on wages has allowed the core to gain competitiveness, thus leading to rising indebtedness of the periphery to the core. Far from promoting convergence among member states, European Monetary Union has been a source of unrelenting pressure on workers that has resulted in systematic disparities between core and periphery.

2.3 The composition of peripheral debt: Domestic financialisation and external flows

The present section explores further the causes of debt accumulation by the periphery, examining the composition and the trajectory of debt during the last decade and more. A significant part of the debt has been external for reasons explained above. Note that as the pressures to accumulate external debt were rising in the 2000s, so did the opportunities to obtain international credit, particularly for the state. Membership of EMU appeared to confer to peripheral countries the creditworthiness of Germany at a stroke. On the grounds that the strong would provide support for the weak, international financial markets implicitly assumed that members of EMU simply would not go bankrupt. This assumption was enough to raise the credit ratings of the periphery to levels that were hardly justified by track record and economic performance. Self-evidently, financial markets and Eurozone banks failed to assess risks appropriately. The error of their assumptions became apparent as the crisis of 2007 unfolded, and hit with a vengeance in late 2009.

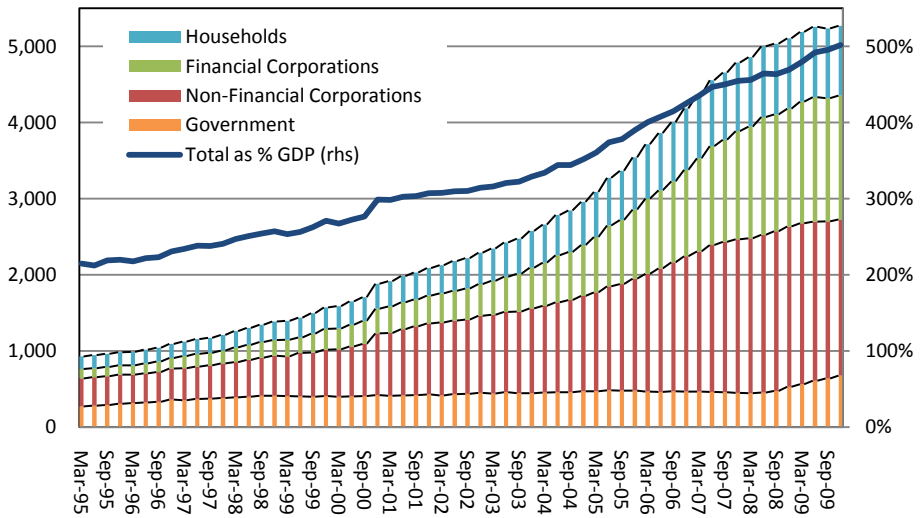
But the domestic debt of peripheral countries has also risen spectacularly during the same period. There are similarities in this respect among all three countries, particularly with regard to household debt which has increased steadily. Speaking broadly, the accumulation of domestic debt bespeaks of advancing financialisation of peripheral

economies, that is, of a structural transformation that has raised the weight of finance within the economy.

Financialisation has affected the corporate sector, the financial institutions, and households in mature and developing countries in recent years. In peripheral countries of the Eurozone, financialisation has been directly related to the common currency for the following reasons. First, the euro has offered substantial advantages to banks, particularly as it has exhibited a persistent appreciation bias relative to dollar. [6] Eurozone banks have been able to expand their international activities, while also funding their domestic activities cheaply. Second, the loss of competitiveness has forced peripheral countries to focus on boosting domestic demand, above all, through investment in real estate and consumption. Support for demand has been provided by credit generated by the growing banks, thus leading to the accumulation of domestic debt by the periphery. Third, and most significant, the Eurozone has offered the opportunity to the private sector to borrow at cheap rates, both domestically and externally. The application of a common monetary policy across the zone brought interest rates down to German levels. Indeed, since inflation has tended to be higher in the periphery compared to the core, real interest rates in the periphery have tended to be even lower. Banks were able to meet the rising domestic demand for credit on cheap terms.

Consider now the trajectory of aggregate debt in the three peripheral countries in recent years, starting with Spain in figure 10:

Figure 10 Spanish debt by sector of issuer
(Euro bn)

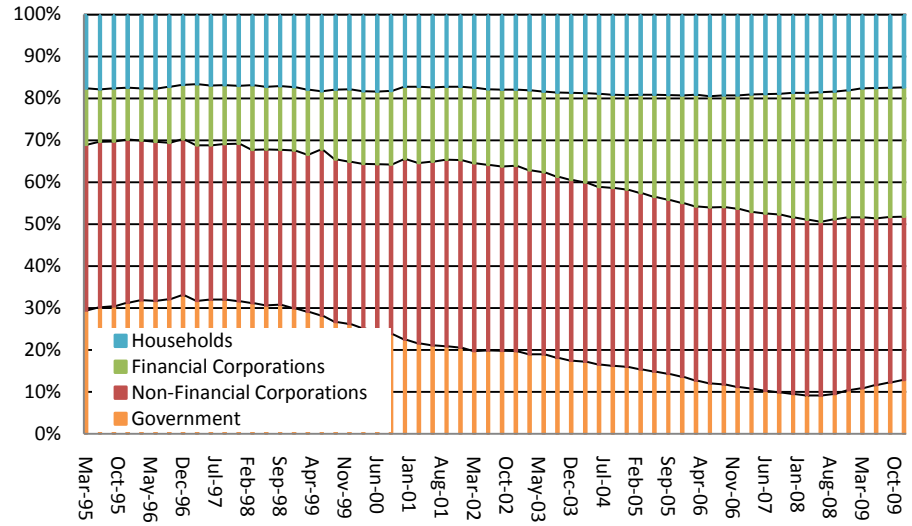


Source: Bank of Spain, authors' calculation

[6] As was shown in the RMF report 'Eurozone Crisis: Beggar Thyself and Thy Neighbour', March 2010, chapter 6, pp. 36-48.

Aggregate Spanish debt has risen dramatically as a proportion of GDP since the late 1990s. The bulk of growth has been in private debt, driven mostly by rising debt of the financial sector. The breakdown of Spanish debt by sector (figure 11), reveals the relative rise of Spanish bank indebtedness and the relative decline of Spanish public debt during the period. Spanish banks have been avid participants in financialisation, taking advantage of the opportunities opened up by euro membership.

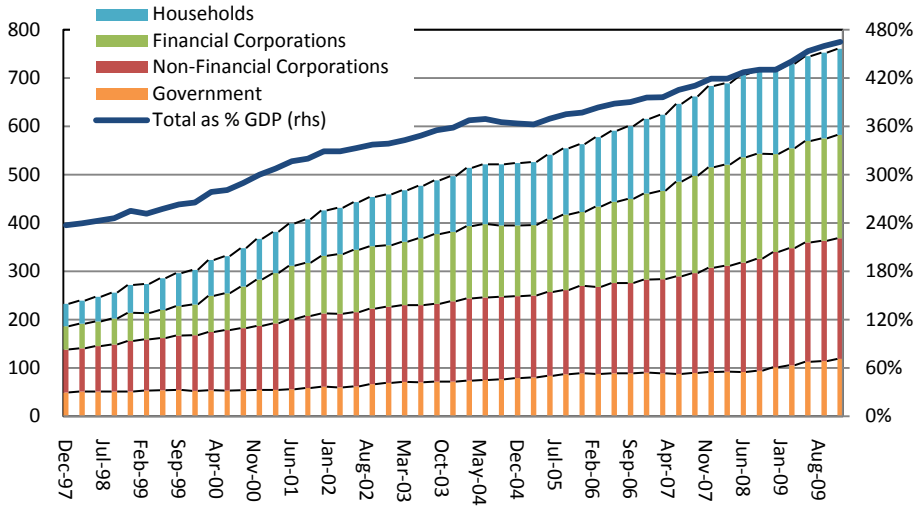
Figure 11 Spanish debt by sector of issuer
(% of total)



Source: Bank of Spain, authors' calculation

Aggregate Portuguese debt has also risen substantially as a proportion of GDP during this period, as is shown in figure 12:

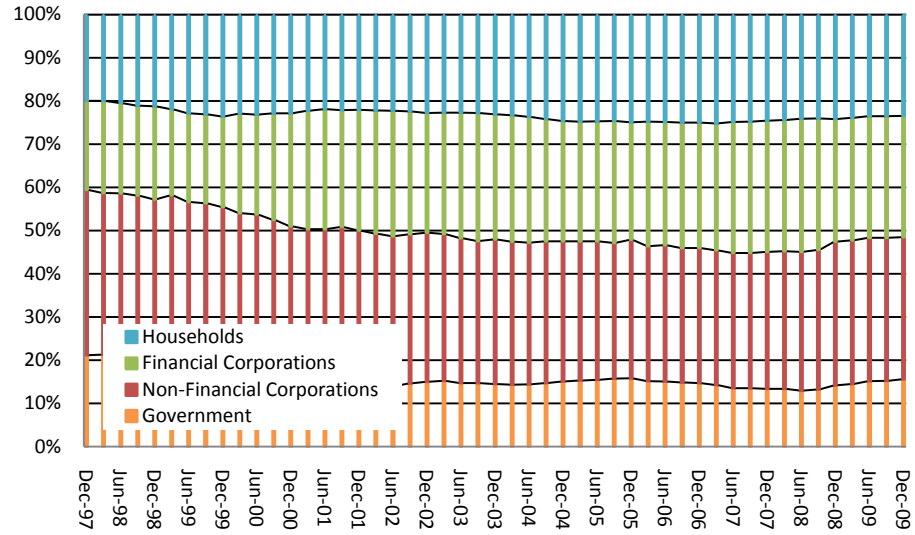
Figure 12 Portuguese debt by sector of issuer
(Euro bn)



Source: Bank of Portugal, authors' calculation

Once again, public debt has declined as a proportion of the total, though not nearly as much as in Spain. Corporate indebtedness has declined proportionately, but this has been more than made up by the relative rise in indebtedness by the financial sector. Domestic financialisation has developed steadily in Portugal during this period:

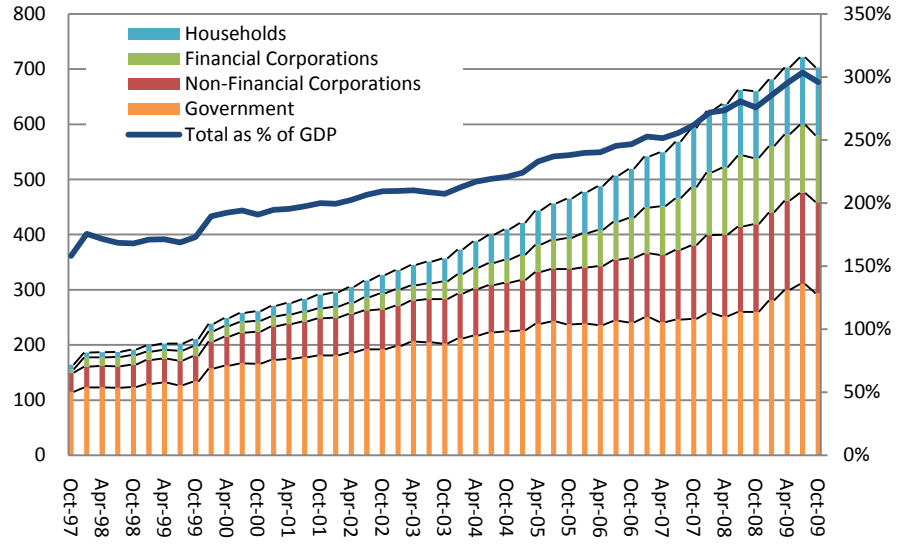
Figure 13 Portuguese debt by sector of issuer
(% of total)



Source: Bank of Portugal, authors' calculation

Greek aggregate debt has approximately doubled as a proportion of GDP during this period, driven again by private indebtedness, as is shown in figure 14:

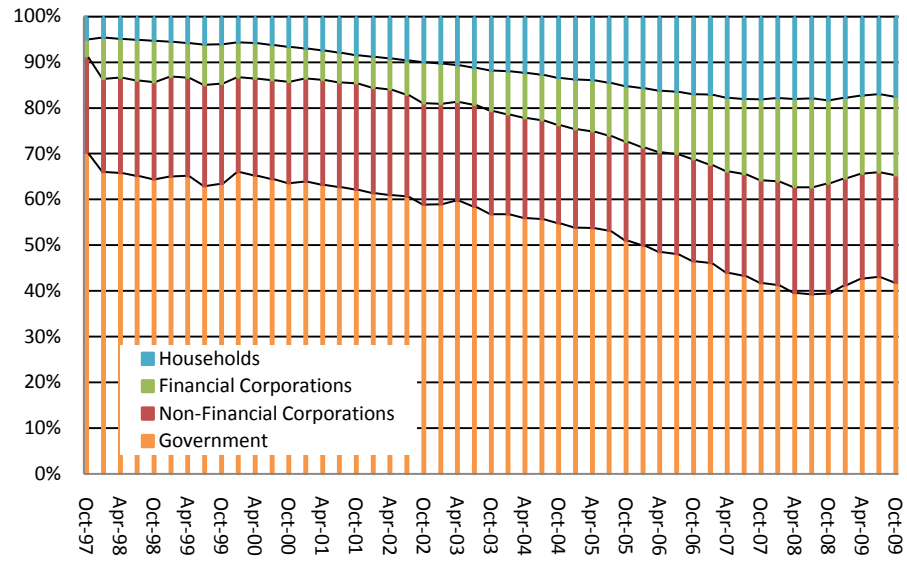
Figure 14 Greek debt by sector of issuer
(Euro bn)



Source: Bank of Greece, QEDS, IMF, authors' calculation

Greek public debt has declined significantly as proportion of the total debt, though it has remained considerably higher than in Spain and Portugal, as is shown in figure 15. The sectors whose debt has risen significantly in proportionate terms are banks and households. For Greece, joining the EMU has brought rapid financialisation, more opportunities for Greek banks, and growing household indebtedness to support consumption:

Figure 15 Greek debt by sector of issuer
(% of total)

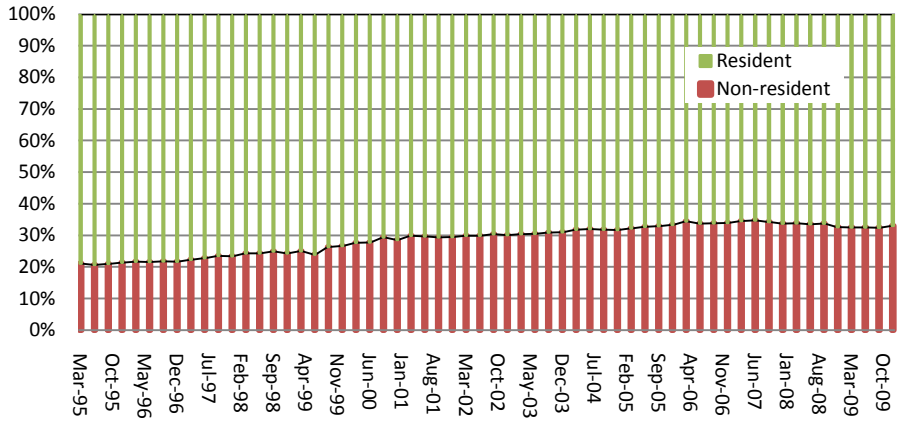


Source: Bank of Greece, QEDS, IMF, authors' calculation

It is striking, however, that Greek public debt has been a far more significant part of aggregate debt than in Spain and Portugal. This has been a feature of the Greek economy since the 1980s, the initial growth of public debt being an outcome of the redistribution policies followed by the social-democratic government of PASOK led by Andreas Papandreou. Be that as it may, the point is that the tremendous growth of aggregate Greek debt during the last decade has not been driven by public debt. On the contrary, it has been the result of advancing domestic financialisation that has brought rising banking and household debt in its wake.

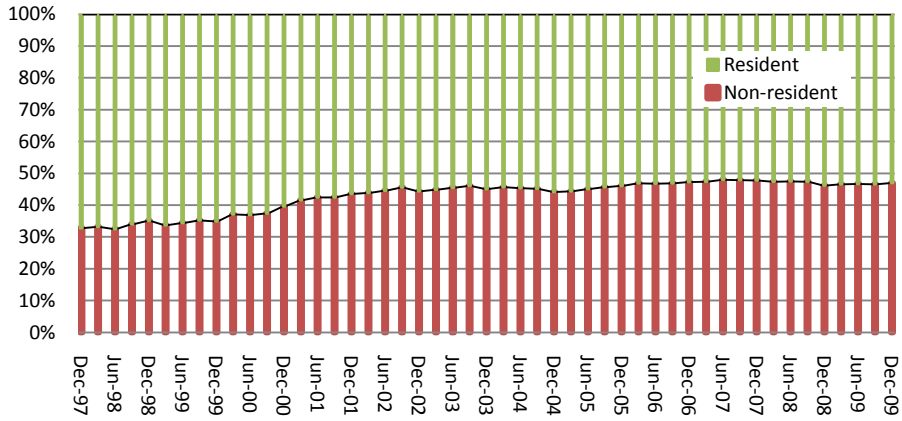
To recap, peripheral economies have been driven by debt for more than a decade, and certainly since they adopted the euro. Much of this debt has been due to domestic financialisation that has resulted in growing volumes of debt by enterprises, banks and households. Equally important has been the growth of external debt once peripheral countries joined the euro and found themselves within the biased framework of the monetary union. Figures 16, 17 and 18 bring out clearly the change that EMU membership has made to the composition of aggregate debt:

Figure 16 Spanish debt by holder: Resident / non-resident
(% of total)



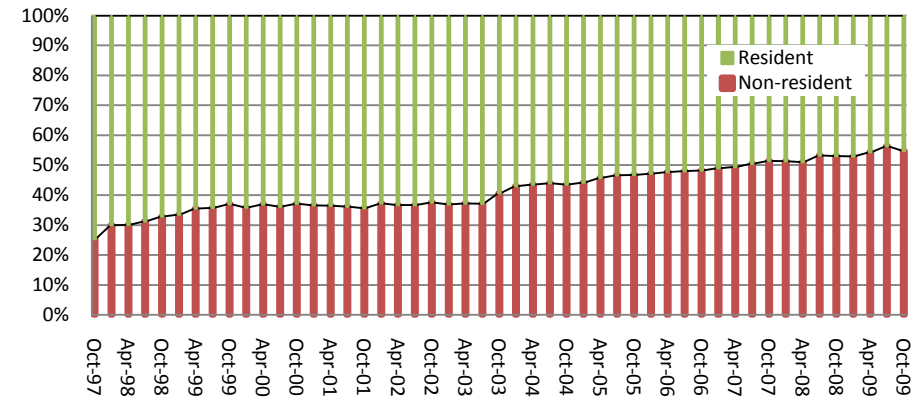
Source: Bank of Spain, authors' calculation

Figure 17 Portuguese debt by holder: Resident / non-resident
(% of total)



Source: Bank of Portugal, authors' calculation

Figure 18 Greek debt by holder: Resident / non-resident
(% of total)



Source: Bank of Greece, QEDS, IMF, authors' calculation

The figures show an upward shift in the proportion of external debt in all three countries after adoption of the euro. This is evidence supporting the analysis of external debt in the earlier sections. Confronted with current account deficits, peripheral countries began to rely more heavily on external borrowing, while also expanding domestic debt. Low interest rates and falsely-rising credibility allowed them to obtain necessary funds without undue difficulties for several years. But in late 2009 the structural biases of the Eurozone finally met the inefficiency of financial markets and the results were catastrophic for peripheral countries.

3. Rescuing the banks once again

3.1 Banks in the eye of the storm

The accumulation of debt by the countries of the periphery eventually led to a major sovereign debt crisis in late 2009, starting with Greek public debt. Escalating public deficits and manipulation of statistical data in Greece led to downgrades by ratings agencies, rising spreads and eventually loss of access to financial markets by the Greek state. The sovereign debt of Spain and Portugal also came under heavy pressure during the same period. But the real threat posed by the sovereign debt crisis has been to the banks of the core. In early 2010 there emerged the danger of a full-blown crisis for the banks of the core which held significant volumes of peripheral debt. It thus became clear that the sovereign debt crisis was a continuation of the great upheaval that began in 2007.

The subprime crisis that burst out in the USA in August 2007 turned into a gigantic banking crisis and then a global recession. Unprecedented state intervention in 2008-9 rescued the banks in the USA and Europe, ameliorated the worst of the recession, and shifted much of the cost of the crisis onto the public. But the recession placed state finances under strain across mature capitalist countries, and nowhere more than in the periphery of the Eurozone. As deficits escalated, the burden of accumulated debt became increasingly severe, above all, in Greece. The resulting sovereign debt crisis once again put the banks under enormous strain, particularly in Europe. The crisis had come full circle – starting with banks in 2007 and threatening to return to banks in 2010.

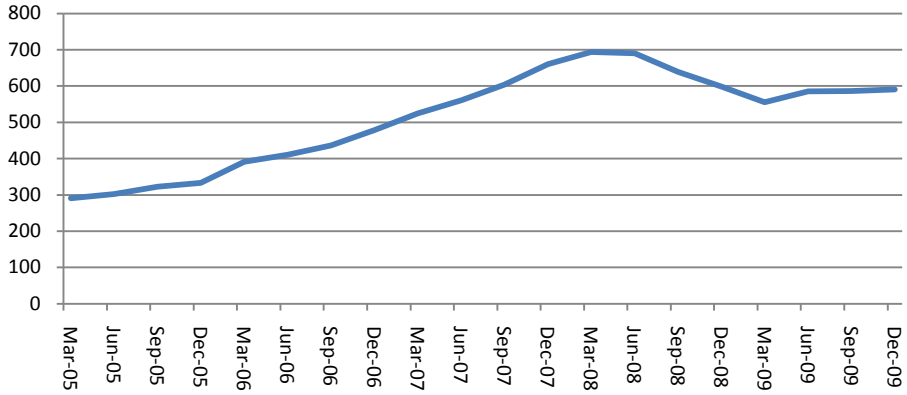
The vulnerable position of European banks was directly related to the accumulation of debt - both public and private - by peripheral countries. The chief providers of credit to the periphery were the banks of the core, which had taken advantage of the single currency and the associated removal of capital controls. Core banks exploited the new markets, generating revenues by lending to corporations and governments as well as to households for housing and consumption. The exposure of core banks to the periphery consequently rose throughout this period, as is shown in figures 19, 20, and 21.

It is notable that lending by core banks to the periphery kept rising even after the crisis of 2007 had begun in earnest. Indeed, the stock of outstanding bank debt peaked in the summer of 2008, a year after the start of the crisis. Furthermore, lending remained at high levels throughout the rest of 2008 and 2009, despite the collapse of Lehman Brothers and the ensuing global turmoil. The reason for the perseverance of lending to the periphery by core banks even under conditions of crisis has to do with the policies of the European Central Bank (ECB).

As the crisis unfolded in 2007, interest rate spreads began to widen for peripheral countries. This development allowed banks in core

Figure 19 Eurocore bank exposure to Spain

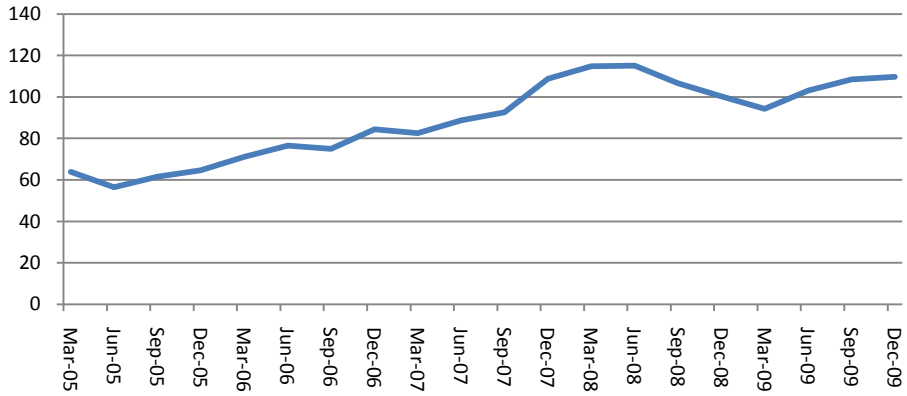
($ bn)



Source: BIS consolidated statistics, ultimate risk basis

Figure 20 Eurocore bank exposure to Portugal

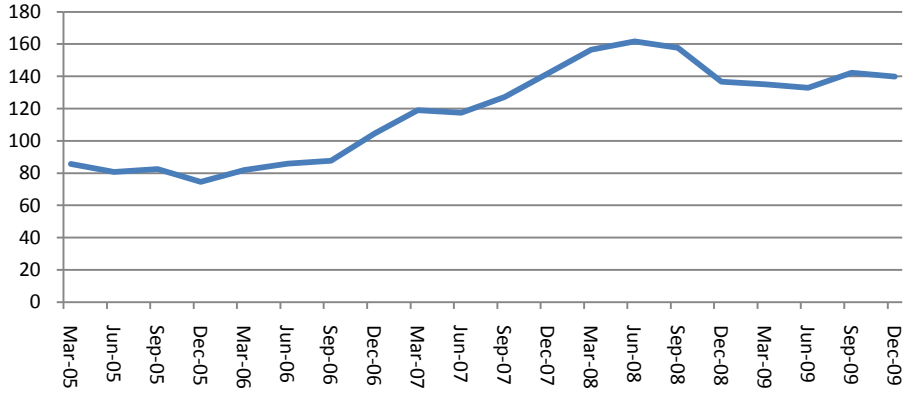
($ bn)



Source: BIS consolidated statistics, ultimate risk basis

Figure 21 Eurocore bank exposure to Greece

($ bn)



Source: BIS consolidated statistics, ultimate risk basis

countries to make attractive profits for a period. Profit making by banks was facilitated by the reaction of the ECB to events in financial markets. To be more specific, European banks started to face a pressing need of liquidity as soon as the global crisis broke out in 2007. Moreover, several European banks – above all in Germany – had made poor loans during the housing bubble in the USA and elsewhere. Consequently, in 2007-9, there was a significant danger of a banking crisis, which led the ECB to intervene by providing large volumes of liquidity to banks (denominated in euros). At the same time, the Federal Reserve provided bilateral foreign exchange swap lines thus also expanding the supply of liquidity to banks (denominated in dollars). Eurozone banks used the liquidity provided by the ECB and the Federal Reserve in order to increase their lending to peripheral countries, thus taking advantage of the rising returns.

Much of the fresh business for banks was provided by public debt. In 2008-9, states across the developed world had arrived in financial markets seeking extraordinary volumes of fresh funds, perhaps close to a trillion euro.[7] The need for public borrowing had been created by declining tax revenue due to the recession as well as by the attempt to rescue the financial system and to avoid a depression. The result was to drive up yields for most public debt. With cheap and abundant funding from the ECB, European banks were able to take advantage of this opportunity. The euro became the new funding currency in a peculiar "carry trade", whereby banks obtained funds at low rates from the central bank to lend at much higher rates to states. During that time, banks showed no real concern about exposure to sovereign debt in peripheral countries. The assumption was that default within the Eurozone was impossible.

Unfortunately, good things do not last forever, even with the ECB doing its best. The escalating Greek budget deficit in late 2009 and the downgrading of Greek public debt brought an end to easy profit-making for core banks. They were forced to re-examine their balance sheets, particularly the value of their loans to peripheral countries as well as the sources of their funding. It then became clear that core Eurozone banks faced an incipient crisis that directly threatened their survival.

Detailed information on the exposure of core banks to the periphery is not available. However, the Bank for International Settlements (BIS) estimates that Eurozone banks, as of December 2009**,** had exposure of $727bn to Spain, $244bn to Portugal, $206bn to Greece, and $402bn to Ireland.[8] The sum total of exposure to the four countries came to $1579bn, of which $254bn, or approximately 16%, was government debt. The bulk (both private and public) was held by French and German banks. With regard to public debt, the BIS

[7] As was shown in the RMF report 'Eurozone Crisis: Beggar Thyself and Thy Neighbour', March 2010, chapter 6, pp. 45.
[8] BIS (2010: 18-9) International banking and financial market developments, *BIS Quarterly Review*, June.

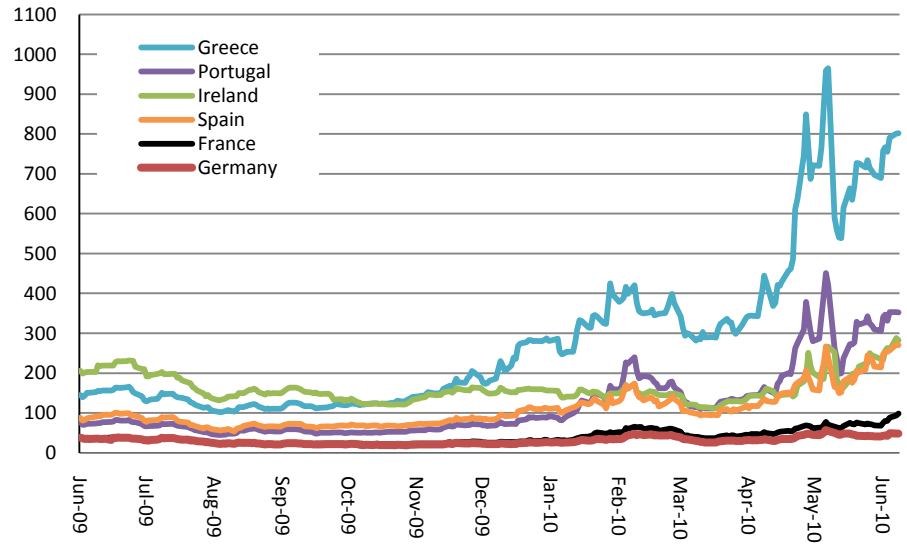
estimated that French and German banks held, respectively, $48bn and $33bn of Spanish debt, $31bn and $23bn of Greek debt, and $21bn and $10bn of Portuguese debt. These figures are consistent with the calculations of debt in chapter 2. Total exposure of core banks to the public sector was, of course, dwarfed by exposure to the private sector, particularly in Spain.

Predictably enough, when the threat to the solvency of core banks became clear in the spring of 2010, European governments and the ECB intervened once again. Two support packages were put in place in May 2010, a relatively modest one for Greece and a far larger one for the Eurozone in general. The ostensible purpose of the packages was to deal with the sovereign debt crisis by allowing peripheral countries to continue financing their public debt. In reality the aim was to protect the banks of the core from the banking crisis that had just reared its head.

3.2 Funding pressures on European banks

Financial markets in the Eurozone signalled the rekindling of banking crisis in late 2009. As the Greek sovereign debt crisis gathered momentum, threatening contagion across the periphery, Credit Default Swaps (CDS) on government bonds began to rise rapidly, reaching levels unprecedented since the introduction of the common currency (Fig. 22). As sovereign default suddenly became plausible, banks became wary of each other's exposure to the debt of peripheral states, thus raising bank CDS.

Figure 22 Sovereign CDS spreads: 5 years
(basis points)

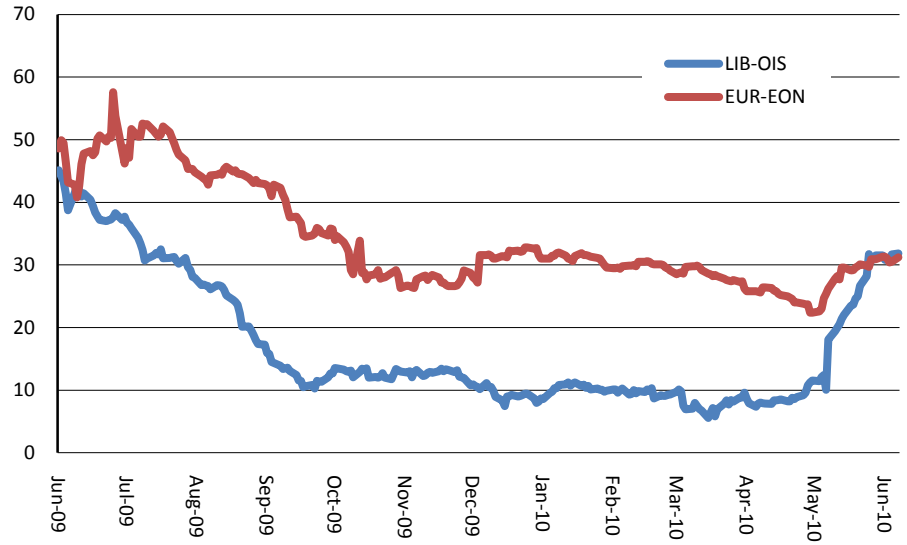


Source: Bloomberg

Banks were also concerned that the fall in the price of sovereign bonds would affect the value of the parts of their balance sheet that were

marked-to-market. Consequently, lending among banks became tighter in the money markets. Figure 23 shows the rising costs for banks in the interbank markets in terms of LIBOR-OIS and EURIBOR-EONIA spreads.[9] In the spring of 2010 both spreads widened, indicating that borrowing both dollars and euros in the interbank market had become more expensive. Borrowing dollars, in particular, was much more expensive than borrowing euros. A banking crisis was in the offing.

Figure 23 Credit spreads: 3 month US LIB-OIS & EUR-EON
(basis points)



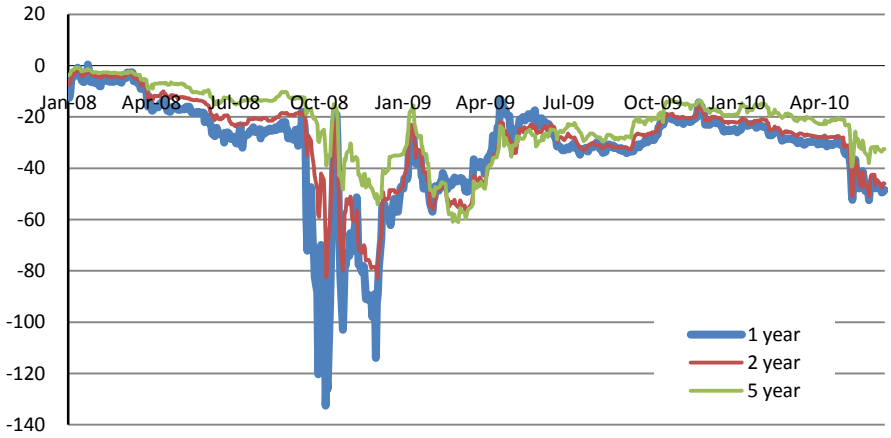
Source: Datastream

Borrowing costs rose sharply because European banks were exposed to peripheral debt but also because they faced complex funding problems. A specific funding gap arose due to banks taking positions in dollar-denominated assets funded through borrowing in euros. The borrowed euros were then swapped for dollars by using short-term foreign exchange swaps. The funding gap declined significantly since September 2008, but still amounted to, perhaps, $500 billion in mid-2010. European banks were able to fund the gap cheaply by borrowing euros from the ECB, which were then swapped for dollars through short-term foreign exchange swaps. But as the euro weakened in 2009-10, the banks were forced to borrow more euros in order to match the dollar gap. By the same token, the banks were forced to rely increasingly on the foreign exchange swap market. The resulting higher dollar funding costs, or "US dollar premium", are shown in figure 24 in the

[9] LIBOR (or EURIBOR in the Eurozone) is a rate of interest closely linked to the interbank money market for maturities between 1 month and 1 year. OIS (or EONIA in the Eurozone) relates to the rate of interest for overnight cash. Under normal conditions the spreads would be negligible, but in a crisis they begin to widen, acting as a gauge for the shortage of liquidity in money markets.

form of increasingly negative cross-currency basis swaps that prevailed since late 2009.[10]

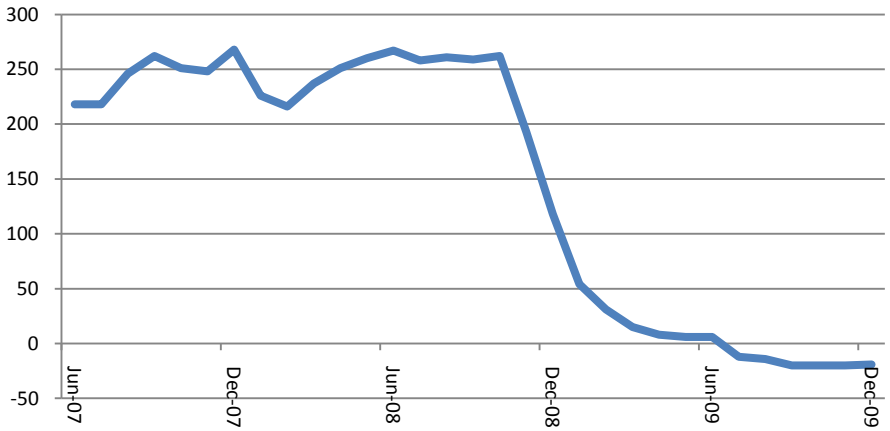
Figure 24 Cross-country basis swap: Euro/US$
(basis points)



Source: Bloomberg

Funding pressures also rose as bank deposits became more expensive after the collapse of Lehman's, as is shown in figure 25 below. Specifically, the spread between 3 month EURIBOR and the rate that banks paid for new deposits actually became negative in the second half of 2009. Furthermore, banks faced difficulties in issuing bonds because conditions in the financial markets remained tense, particularly in view of substantial volumes of banking debt due to be rolled over by 2012.

Figure 25 Bank funding: 3 mo Euribor - avg rate for new deposits
(basis points)



Source: IMF FSR, April 2010, Fig. 1.18

[10]The dollar premium is the cost of borrowing at floating rates in dollars compared to other currencies. This is reflected in cross-currency basis swaps which are, in effect, a string of 3 months FX forwards for a longer duration expressed in basis point differentials.

Increasing funding problems and rising credit risk from peripheral sovereign debt inevitably led to a sharp rise to CDS spreads for European banks compared to other sectors, as is shown in figure 26. European banks were in deepening trouble:

Figure 26 Eurozone 5 Year CDS spreads by sector (basis points)

Source: Datastream

The budding crisis among European banks could hardly leave the US banking system unaffected. Figure 27 shows that US banks were heavily exposed to the European banking system, their exposure roughly doubling during the last five years. If a full-blown banking crisis materialised in Europe, there would be ripple effects across the US banking system, and indeed across global finance. The threat of a global banking crisis had become real during the early part of 2010.

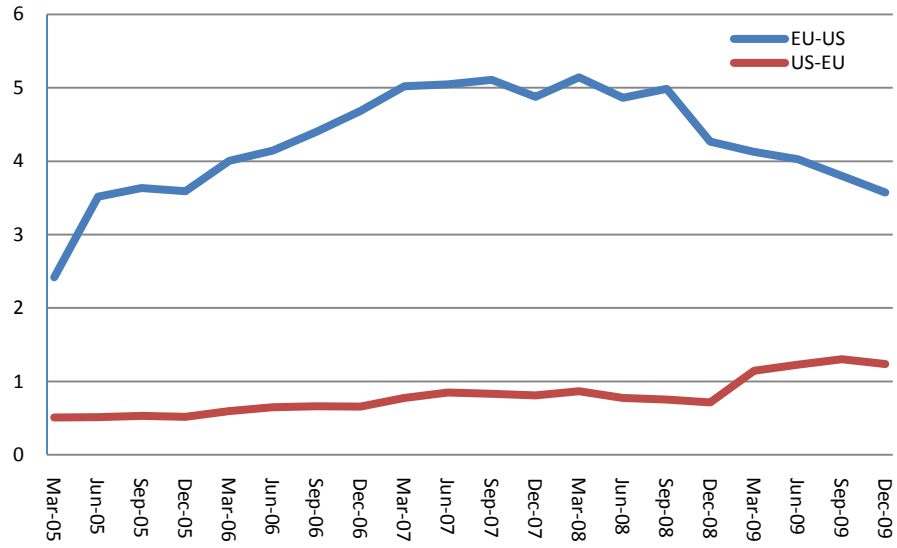
3.3 The European support package and its aims

On 2 May 2010, after much procrastination and internal wrangling, the European Union announced a support package for Greece of 110bn euro, jointly put together with the International Monetary Fund. The Greek intervention acted as pilot for a far larger package, announced on 9-10 May, of roughly 750bn euro. The second package was aimed at European financial markets in general, and was put together by the EU, the IMF, the ECB and other major central banks. The underlying approach of the two packages was the same.

Although the rhetoric of European leaders was about saving the European Monetary Union by rescuing peripheral countries, the real problem was the parlous state of the banks of the core. The intervention was less concerned with the unfolding disaster in Athens and more worried about European (mainly German and French) banks facing a wave of losses and further funding difficulties. A weaker euro would also

become less acceptable as international reserve currency, thus harming the potential for expansion of European financial capital. Not to mention that it would further worsen the funding problems that European banks faced on their balance sheets.

Figure 27 EU-US and US-EU banking exposure
($ trillion)



Source: BIS IBS - Consolidated foreign claims of reporting banks - ultimate risk basis

The EU contributed to the package by establishing the European Stabilisation Mechanism. This resulted in a new lending facility of 60bn euro available to all EU member states. The facility was financed through the issuing of European Commission debt and could be advanced without the approval of national parliaments. Clearly, the sum was small, reflecting the limited resources directly at the disposal of the EU. Potentially much more significant was the establishment of the European Financial Stabilisation Facility (EFSF). This would be up to 440bn euro, and available only to Eurozone members. The mode of operation of the EFSF had not been made clear well into the summer of 2010, but it appeared that it would be, in effect, a Structured Investment Vehicle (SIV) funded through the issuing of bonds guaranteed by Eurozone members on a pro rata basis. The guarantees had to be approved by national parliaments, and would come into force only after approval by countries representing at least 90% of the shares of the EFSF. Thus, the EU demonstrated a strong preference for market-based solutions to its financial problems, even to the extent of creating a vehicle similar to those that had caused the gigantic crisis of 2007-9. The EFSF further rested on dominance by the core countries. In short, the package has shown a profound lack of solidarity among the members of the Eurozone.

The IMF also announced that it would cooperate with the EU by making available the equivalent of 250bn euro of its own financial

assistance to supplement the European Stabilisation Mechanism. The price of its assistance would, of course, be economic and fiscal adjustment programmes. In short, austerity would be imposed on member states in trouble, as happened immediately in Greece. The nature and possible implications of the shift toward austerity are examined in chapter 4. Be that as it may, the intervention of the IMF in Eurozone affairs bespeaks of reliance on US power to support the common currency. The euro has lost credibility in its attempt to become world money.

More relevant for our purposes in this section, and vitally important for the stabilisation of financial markets, were the remaining parts of the package. Above all, the ECB announced that it would start purchasing public securities of Eurozone countries in the secondary markets. This was a remarkable step, contravening the ECB's founding principles. Thus, the ECB suspended the application of the minimum credit rating threshold in collateral eligibility requirements, starting with marketable debt instruments issued or guaranteed by the Greek government. Moreover, it began to conduct interventions in secondary markets that were sterilised by altering time deposits. To tackle the funding problems of banks, the ECB adopted a procedure of fixed rate tender with full allotment in its regular 3-month longer-term refinancing operations; it also increased liquidity provision through long-term repo operations. Finally, the ECB resumed dollar liquidity-providing operations.

It is apparent that these extraordinary actions by the ECB were aimed at gaining time for banks. By purchasing European public debt in the secondary markets (even if sterilised), the ECB acted as market maker of last resort, despite not being allowed to buy public bonds directly in the primary markets. A clear signal was given to banks that they could continue to dispose of poor quality peripheral public debt. However, the ECB was allowed to buy such bonds only from the banks themselves. The chief aim of the exercise was to help banks strengthen their balance sheets, rather than to support struggling peripheral states.

Finally, the rescue package involved the Federal Reserve, which reinstated temporary dollar swap lines with the ECB and a range of other major central banks, authorised until January 2011. The US has emerged as ultimate guarantor of the euro, particularly as no limits were placed on the swap lines. In doing so, the US authorities were trying to protect US banks, while avoiding the re-emergence of a global banking crisis. As was shown above, the exposure of US banks to Eurozone banks has risen steadily during the last few years. Generalised crisis in the European banking sector could have important consequences for US banks, thus forcing the Federal Reserve to take action in support of European banks. Once again, the euro was shown to pose an ineffectual challenge to the dollar as world money.

3.4 Will the package work?

The rescue package did not immediately reassure financial markets. It was thus followed by some desperate reactions on the part of European governments, none more so than the intervention by BaFin, the German financial regulator. In March 2010 BaFin had argued against the notion that the root of the crisis lay in speculative transactions in the market for Greek CDS. But under pressure from the German government, BaFin reversed its position and banned short-selling of key German financial stocks, European bonds and CDS. The action appeared hostile to financial markets and coincided with a broader discussion on adopting tougher European regulation of hedge funds. In practice, the clumsy intervention by BaFin aimed at protecting German banks, which had been at the receiving end of some CDS speculation.

Nonetheless, even by July 2010, the package had not fully restored confidence in the health of the European banking sector. During the same month the results of stress tests on 91 European banks were announced, indicating that only 7 did not have adequate capital (at least 6% Tier 1 capital).[11] The tests had been undertaken over a period of months and were designed to restore confidence in the banking sector. Remarkably, the tests assumed that there was no possibility of default on sovereign debt, even by Greece. Confidence appeared to improve, but financial markets remained sceptical. They had good reason for scepticism, in view of the haphazard nature of the rescue package and the deep-seated nature of the problem.

The bulk of the funding (440bn euro) comprises guarantees backing the issuance of debt by EFSF, subject to approval by national parliaments. There remains some lack of clarity, therefore, on how the package will be financed, and by which governments. In addition, intervention in the secondary market by the ECB can affect securities prices in the short-term, but judgement of long-term prices is left to markets. Moreover, the more that the ECB intervenes in the public debt market, the greater the volume of potentially 'toxic' sovereign bonds that it is likely to acquire. Who will carry the ultimate risk of these bonds? Finally, few European banks appear to have taken advantage of the currency swap lines immediately after the introduction of the package.[12] This is, perhaps, due to the lines being very expensive as they were set at 100 basis points over the overnight indexed swap rate. The maturity of the lines (between 7 and 84 days) is also quite short for the current needs of banks.

[11] See Committee of European Banking Supervisors (2010) Aggregate outcome of the 2010 EU wide stress test exercise coordinated by CEBS in cooperation with the ECB. http://stress-test.c-ebs.org/documents/Summaryreport.pdf

[12] As is evidenced by the balance sheets of the ECB between the middle of May and June, see http://www.ecb.int/press/pr/wfs/2010/html/index.en.html

In short, there were several reasons for concern arising from the technical features of the rescue package. But the deeper causes of concern had to do with its impact on the European economies, both core and periphery. The package had come at the price of austerity, the implications of which were unclear. To rescue banks, Europe had found itself in the grip of contractionary government policies, which run the risk of exacerbating recession. The next chapter considers in detail the costs and risks posed by austerity across Europe.

4. Society pays the price: Austerity and further liberalisation

The counterpart to the rescue package has been the imposition of austerity on the periphery, and increasingly on the core. Confronted with a shaken monetary union, renewed banking crisis, and continuing recession, several governments of the Eurozone have opted for contraction of public expenditure. In effect, the costs of rescuing the euro and the banks have been shifted onto society at large. At the same time, and partly at the behest of the IMF, liberalisation measures have been imposed on peripheral countries, above all, in the labour market. The ostensible aim has been to strengthen growth potential.

The response of the Eurozone has been consistent with entrenched neoliberalism within the EU. The overriding concern of policy has been to rescue the financial system. The practices and the institutional framework of the Eurozone were accordingly altered. Thus, contrary to all previous assertions, a bail-out of member states was organised, first for Greece but also potentially extending to others. Along similar lines, the statutes of the ECB were ignored, allowing it buy public debt from banks. There has even been talk of establishing a European Monetary Fund. Yet, at the same time, fiscal conservatism has re-emerged triumphant. It has even been proposed that the Stability and Growth Pact be hardened by introducing severe penalties for countries that contravene its strictures. In short, the Eurozone has certainly shown a capacity to change. But it has all been change in the same conservative and neoliberal direction, favouring capital over labour.

The mix of austerity and liberalisation within the Eurozone is harsh on working people but also dangerous for economy and society. In the midst of a severe recession, policy-makers appear to believe that European economies need a good dose of cleansing medicine plus more flexibility to ensure growth. This is a return to the hoariest economic ideas of pre-Keynesian vintage. It is shown in this chapter that the policy shift within the Eurozone poses major economic risks, and could have disastrous implications across the continent.

4.1 The spread of austerity and its likely impact

The global recession of 2008-9 appeared in Europe mainly in the form of collapsing aggregate demand. Figures 28, 29, 30, 31, 32, and 33 trace the evolution of the components of aggregate demand in three major Eurozone economies (Germany, France, Italy) as well as in three peripheral economies at the epicentre of the public debt crisis (Spain, Portugal, Greece).[13]

[13] It is never an easy task accurately to place Italy within the Eurozone. In this context it is located within the core for obvious reasons of population size and relative economic weight. Details on the construction of these figures are given in Appendix C.

Figure 28 GDP growth by aggregate demand category-Germany (%)

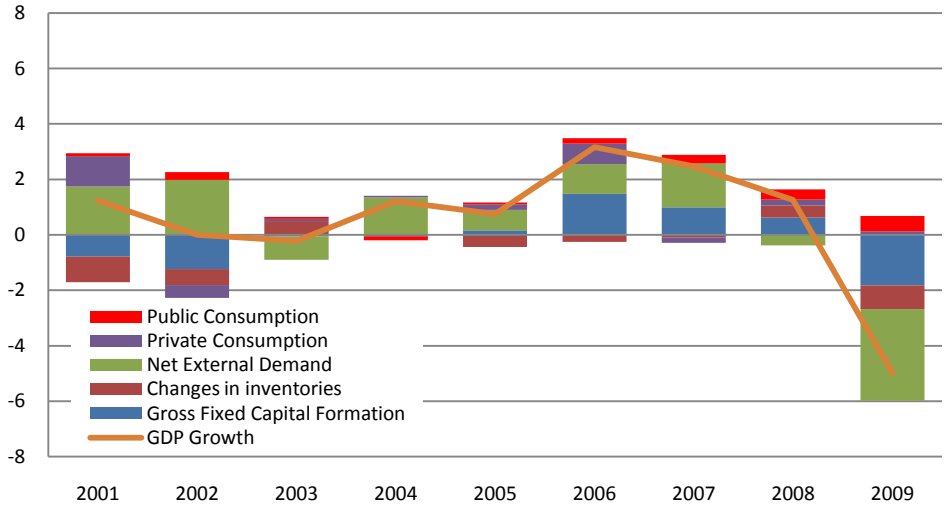


Figure 29 GDP growth by aggregate demand category – France (%)

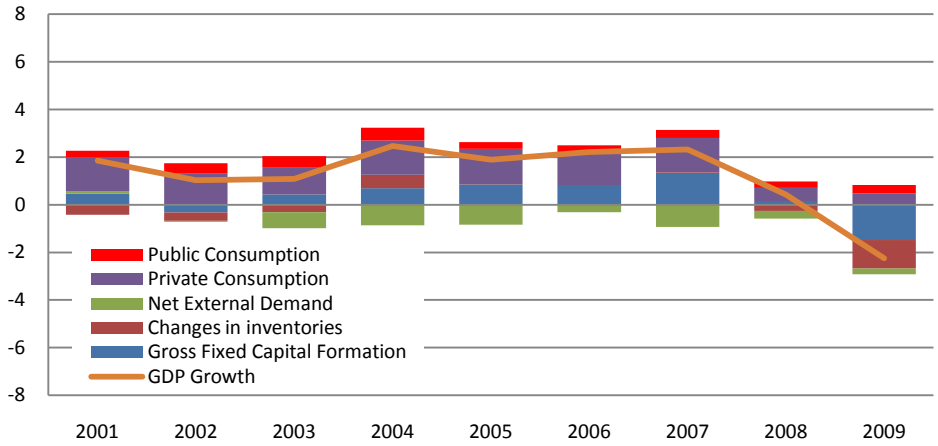


Figure 30 GDP growth by aggregate demand category – Italy (%)

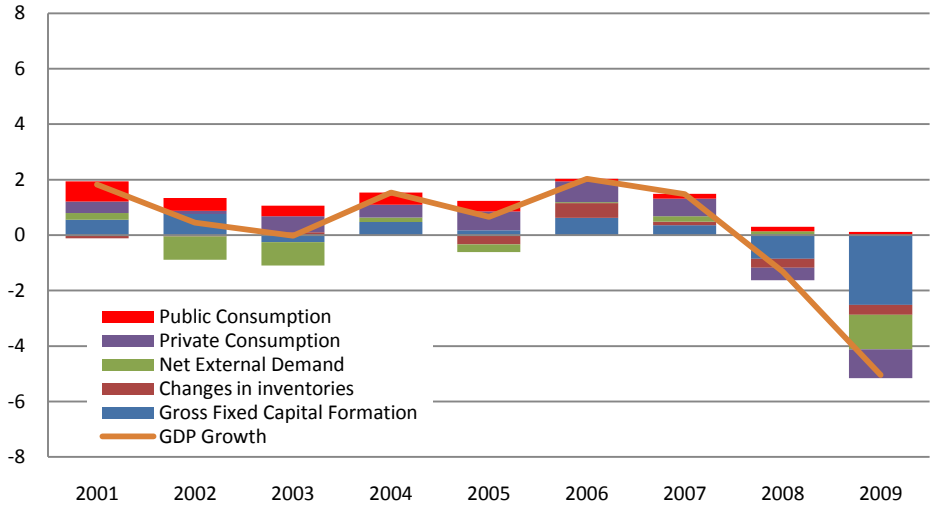


Figure 31 GDP growth by aggregate demand category – Spain (%)

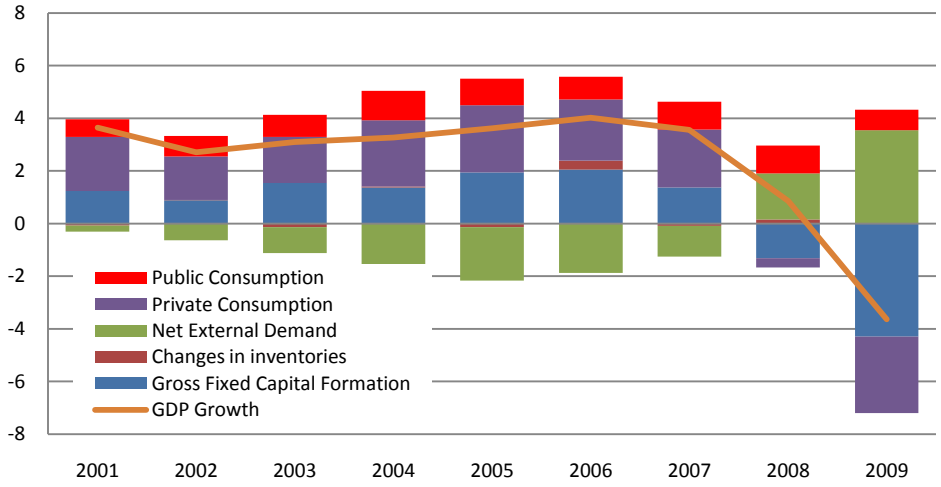


Figure 32 GDP growth by aggregate demand category – Portugal (%)

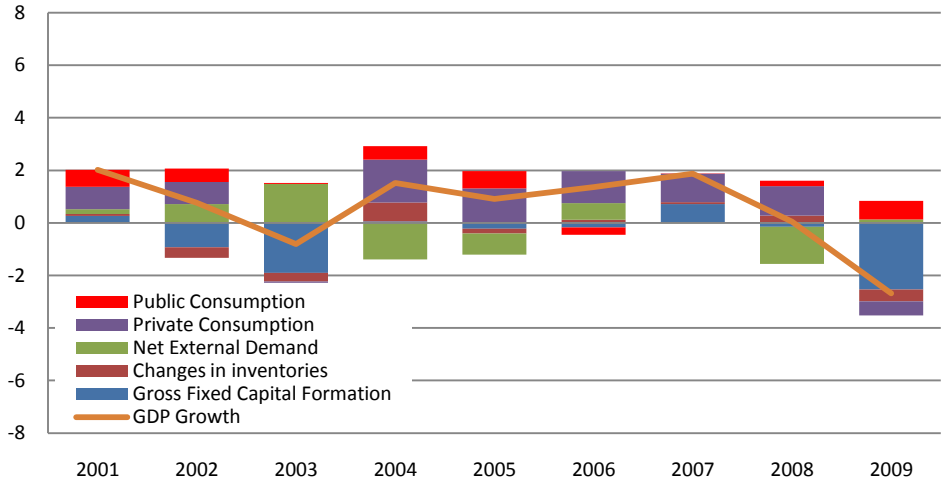
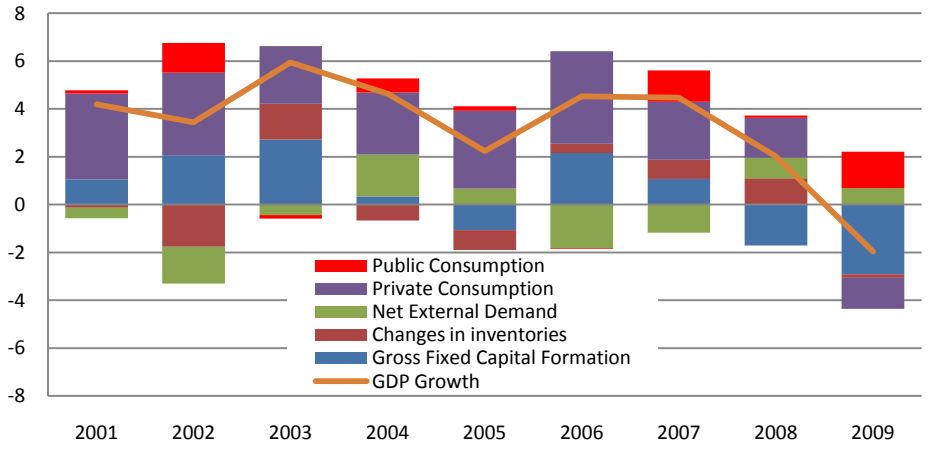


Figure 33 GDP growth by aggregate demand category – Greece (%)



Source: Ameco

Differences in the pattern and composition of growth during the last decade are immediately apparent. Thus, Germany, Italy, France and Portugal showed poor growth throughout the 2000s, while Greece and Spain performed much better, fuelled by credit, as was shown in chapter 2. The main source of growth for Germany was net external demand, reflecting its rising competitiveness within the Eurozone. Private consumption played an important role in France, Portugal, and Spain, but above all in Greece. Private investment was significant in Spain, partly reflecting the real estate bubble, but it was generally weak across the sample. Italy is a picture of stagnation in all respects.

More relevant for our purposes is that growth rates turned downward in 2008 as the crisis began to bite, and became strongly negative in 2009 as recession materialised. The main cause of negative economic growth in 2009 was the general collapse of private investment, as is typical of capitalist crises, but also the collapse of exports in Germany. In an environment of radical uncertainty and tightening credit, corporations postponed or cancelled investment projects. Private consumption remained broadly stable, partly due to remaining labour protection in Europe. Complete collapse of aggregate demand was prevented through public expenditure, which reflected the role and weight of the state in the economy.[14]

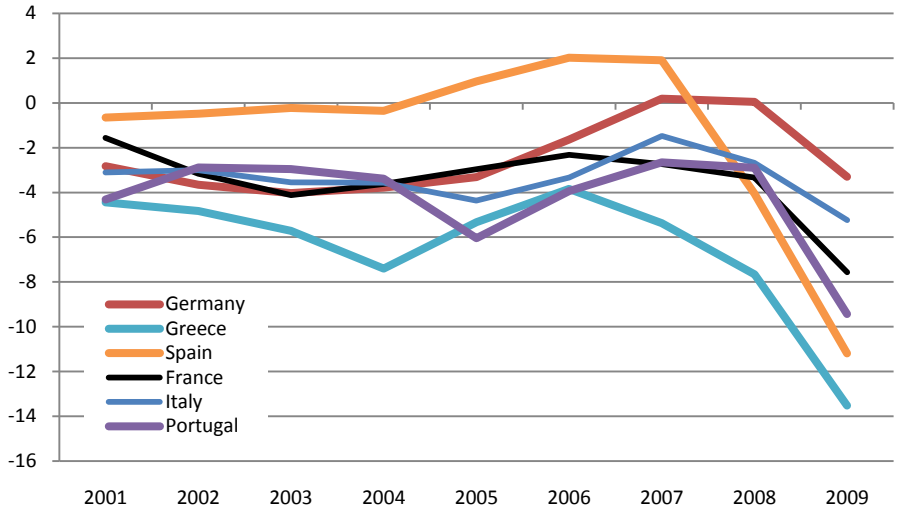
The impact of the recession on public finances was inevitable and predictable. As tax revenues fell, the attempt by the state to prevent depression led to record-breaking public deficits in most Eurozone countries, easily exceeding the limit of 3% of GDP imposed by the Stability Pact. Even France, Italy and Germany exceeded the limit (deficits for 2010 projected at, respectively, 8%, 5.3%, and 5%). In Spain, Portugal and Greece, where the problems of integration into the Eurozone became sharply apparent, public deficits reached very high levels, as is shown in figure 34.

This is the context in which austerity has spread across the Eurozone. Pressed by financial markets, which were in turmoil at the prospect of peripheral default, even the biggest economies of the Eurozone adopted austerity programmes with the aim of complying with the 3% limit for the deficit within three years. Germany announced a plan to cut public spending by 80bn euro, lowering civil servant wages, reducing the number of civil servants, reforming social security, cutting military expenditure and reducing public subsidies. France followed the same path, while remaining critical of Germany. The French government declared its intention to inscribe the limit to budget deficits in the constitution (following Germany in this respect). Public savings of up to 100bn euro were to be made until 2013 through freezing central government spending, removing tax breaks, and considering a pay freeze for public sector workers. Even Italy, where the economy has shown no dynamism at all for more than a decade, announced an austerity

[14] Positive net external demand in Spain, Portugal and Greece reflects collapsing imports as recession took hold, not rising exports.

programme of 24bn euro aimed at bringing its relatively small fiscal deficit down to 3% by 2012.

Figure 34 Fiscal balance
(% of GDP)



Source: Ameco

The implications are likely to be severe since the policy puts pressure on the component of aggregate demand that showed resilience in 2009, namely public expenditure. Further pressure is also put on already troubled private consumption. The prospect of the private sector taking up the mantle of sustaining demand is not at all persuasive. Investment has been weak throughout the 2000s, while collapsing in 2009. There remains considerable uncertainty within the productive sector, while access to credit has hardly improved for private enterprises, given the parlous state of the financial sector. Meanwhile, with the global economy performing indifferently, and given the high regional integration of European economies, it is unlikely that exports will prove the engine of growth for Europe as a whole. The policy of austerity runs the risk of resulting in major recession.

To recap, the Eurozone, spurred by turmoil in the financial sector, has opted for a violent adjustment of economic activity. There has been a resurgence of neoliberal conservatism, even though recovery from the turmoil of 2007-9 has barely taken shape. Faced with falling aggregate demand, Eurozone governments have opted for cutting public expenditure and applying pressure on wages. The resulting economic purge would presumably result in overall efficiency gains, leading to robust economic growth through healthy private activity. A pre-Keynesian approach to economic policy appears to have taken hold, as if the Great Depression of the 1930s had never taken place. The risks for European economy and society are grave.

4.2 The periphery takes the brunt of austerity policy

Peripheral governments in Greece, Spain, and Portugal have led the way in adopting austerity policy with the aim of bringing public deficits within the 3% limit of the Stability and Growth Pact by 2013. Greece imposed austerity already in early 2010 off its own accord, but adopted far harsher measures once its support package had been agreed with the EU and the IMF in early May 2010. With the second and far broader package agreed across the Eurozone, austerity measures spread to the rest of the periphery, and indeed to the core.

The measures adopted by peripheral countries have varied widely in scale, reflecting differences in fiscal and economic outlook. They have been at their harshest in Greece, as codified in the Memorandum signed by the Greek government, the EU and the IMF.[15] The Memorandum has been passed by the Greek parliament and thus has the force of law. It is notable that, in addition to specific measures described below, the Memorandum also contains explicit clauses requiring the government to do whatever else might be necessary to attain fiscal balance. Open field has been effectively declared on Greek economy and society in order to reduce the fiscal deficit. Greece has been obliged to undertake violent cuts in public spending and raise taxes. At the same time it has been forced to introduce new legislation in labour markets and engage in ambitious privatisation.

Spain has withdrawn the extraordinary measures that it had put in place after 2007 in order to ameliorate the impact of the financial crisis and the recession. Further austerity measures were announced in May aiming to reduce public sector expenditure by cutting wages, pensions, and transfers to local authorities. Nonetheless, Spanish measures are milder than those introduced in Greece. In contrast, Portugal appears to have positioned itself in between the other two countries. Public spending cuts have been announced affecting wages and pensions but also social spending. Tax rates have been generally raised, while new taxes have been introduced. As for Greece, a programme of further privatisation of public enterprises has been put in place.

The austerity measures in all three countries are heavily directed against labour, as is shown in Box 2. The aim of wage cuts and freezes, reductions in social spending, contraction of employment, and harsher pension terms is not simply to reduce public expenditure but also to lower the cost of labour in the public sector. If labour costs are lowered in the public sector, the effect is likely to spread across the rest of the economy. The aim of lowering labour costs in general has been quite explicit in Greece, but is also present in other peripheral and even core countries. The austerity drive will place workers in a weaker position in

[15] See: http://www.mnec.gr/export/sites/mnec/en/press_office/DeltiaTypou/Documents/2010_05_04_GreecexLOI.pdf

the labour market, thus allowing capital to benefit. The pressure on labour is also apparent from the regressive character of the tax increases incorporated in the austerity programmes, which rely on raising VAT and income tax, rather than corporate tax. Finally, the privatisation programmes in Greece and Portugal will probably lead to a retreat of public provision, while worsening the conditions of labour in the newly privatised enterprises.

In short, the shift toward austerity is partly intended to cut fiscal deficits, and partly to compress labour costs. Working people will bear the burden of adjustment, while capital will benefit. Furthermore, austerity will set in motion a formidably regressive redistribution of income. The impact will be at its sharpest in Portugal and Greece, the poorest and most unequal countries of the Eurozone.

4.3 Mission impossible?

It is now clear that austerity policy will compress demand, while cutting wages and paving the way for the introduction of a radical liberalisation programme. The role of the state in the economy will be redefined, also promoting a more regressive distribution of income that would appease the ruling social layers in Eurozone countries. But austerity policy represents a huge gamble for Eurozone governments, particularly those in the periphery. For, the policy rests on the hope that exports and private expenditure will pick up, thus avoiding recession. Things could turn out very different. Allowing bond markets to dictate a neoliberal shift of policy across the Eurozone carries major risks for the economy as a whole. Given the weak state of private consumption and investment in 2010, contraction of public expenditure is fraught with danger. It is worth pursuing the argument further by deploying Parenteau's recent discussion in terms of Sector Financial Balances.[16] Its point of departure is the identity that was also used in Box 1:

Domestic Private Sector Financial Balance + Fiscal Balance + Foreign Financial Balance = 0

Parenteau's use of the framework allows for penetrating conclusions. Namely, if the foreign financial balance does not change radically, then changes in the fiscal balance must be matched by an equal and opposite adjustment of the private sector's financial balance. Given that current accounts are unlikely to shift dramatically in Europe in the foreseeable future, it follows that the effort to reduce public deficits must be matched by increased private spending. Hence, the private sector must totally reverse its recent behaviour, summed up in 4.1 above. But how likely is it that private investment and consumption would rise

[16] See Parenteau , Robert (2010). "On Fiscal Correctness and Animal Sacrifices (Leading PIIGS to Slaughter)". http://www.nakedcapitalism.com/2010/03/parenteau-on-fiscal-correctness-and-animal-sacrifices-leading-the-piigs-to-slaughter-part-1.html

BOX 2 AUSTERITY MEASURES, OR SHIFTING THE BURDEN ON TO LABOUR

i)Wages, social spending, and conditions of labour

In Greece there will be a reduction of public sector wages by, perhaps, 20%-30%. There will be a cut of nominal wages that could be as high as 20%, while the so-called 13th and 14th salaries will be replaced by an annual lump sum the size of which varies with the wage. Wages and salaries are to be frozen for the next three years. Employment in the public sector is to be reduced on the basis of one-for-five, that is, one worker hired for every five workers who retire. Unemployment benefits have been cut, while a poverty support scheme that had been put in place in December 2009 has been suspended. It is more than likely that the pressure on the income of labour will also spread to the private sector.

In Portugal public sector wages have been frozen for 2010, and they are expected to remain frozen for the next two years. Public sector employment will be cut on the basis of one-for-two. Social spending has been capped through limiting transfer payments, and unemployment benefits have been reduced. The freezing of public sector wages is expected to act as a benchmark for private sector wages. In Spain the first austerity package has introduced a wage freeze for the public sector, while halting new employment in the public sector. The second austerity package introduced of cut of 5% in public sector wages. Social spending has also been cut, for instance, by withdrawing the subsidy for newborn babies that had been put in place in 2007.

Equally important are plans to abolish collective bargaining in Greece, replacing it with individual contracts. The existing practice of internships for very low paid or even unpaid workers has been given the force of law. The provision of temporary labour via specialist agents has also been established by law, and it has been made possible to supply temporary workers to the public sector. The so-called 'closed professions', i.e., mostly self-employed businesses or professionals operating under restrictive internal regulations, are due to be liberalised. Similarly, in Spain, labour market reforms have been approved aiming for greater flexibility in paid work hours, reducing negotiation time in labour disputes, and aiming to create an unemployment fund out of workers' own contributions.

ii) Tax

In Greece there have been increases across a range of indirect taxes, including the rise of VAT from 19% to 23% and the imposition of Special Consumption Taxes on fuel, tobacco and alcohol. Income tax has also been raised for the middling band of incomes. Corporate taxes, on the other hand, have been reduced. Attempts have also been made to reduce tax evasion and to expand the tax base. In Portugal VAT has been increased by 1% across all categories of goods and services. Income tax has also been also raised, as has corporate tax. In Spain, similarly, VAT has been increased by 2% across all categories of goods and services, while income tax has also been raised.

iii) Privatisation

A broad-ranging privatisation programme has been proposed for Greece, including ports, airports, railways, finance, the water supply and energy as well as public land. A similarly ambitious privatisation programme has been introduced in Portugal, including energy, defence and naval construction, transport, finance, the postal service and mining.

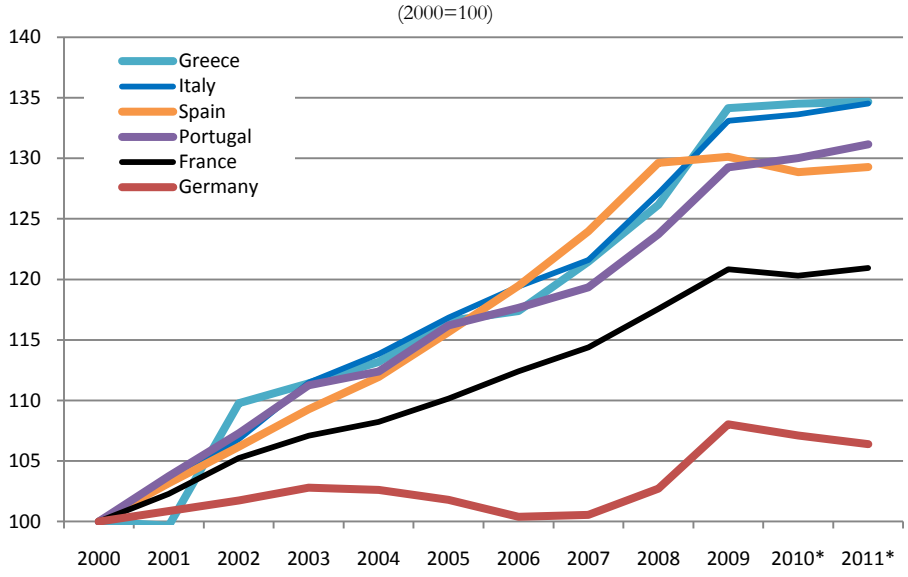
iv) Pension systems

Greek pensions will be lowered substantially and then frozen, though, again, it is difficult to estimate the losses, particularly as further decisions are to be taken in the early autumn. The retirement age will be raised significantly, ranging from three to seventeen years, and the worst affected workers will be women. It will be necessary to complete forty years in employment before claiming a pension. In Portugal the convergence period for public and private sector pensions has been shortened. Spanish pensions will be practically frozen.

significantly, given wage cuts and freezes, rising unemployment, and considerable uncertainty? And that is without even mentioning the weak state of European banks, which has resulted in expensive and tight credit for enterprises. It is more likely that austerity will lead to contraction of GDP, rising unemployment and wage deflation. In this light, the official growth forecasts for peripheral countries, summarised in Box 3, appear to be excessively optimistic.

Even worse, the austerity strategy suffers from a deep flaw that bodes ill for its future. The core-periphery opposition within the Eurozone and the resulting debt problems of peripheral countries ultimately derive from the loss of competitiveness by the periphery, as was shown in chapter 2. The core has enjoyed sustained competitive gains due to wage repression, particularly in Germany. The adoption of austerity across the Eurozone, including by the core and especially Germany, is likely to entrench the divergence in competitiveness for the foreseeable future. Austerity represents an attempt by peripheral countries to improve competitiveness through repressing wages, but similar, if milder, policies have also been applied by the core. The handicap of the periphery is unlikely to go away.

Figure 35 Nominal unit labour costs



Source: Ameco

Support for this argument is given by the forecast of nominal unit labour costs for 2010 and 2011 by the European Commission, shown in figure 35. Even if peripheral economies succeeded in freezing nominal costs, which would imply a fall in real income for workers, the projection is for Germany to decrease its own nominal labour costs. On this basis, Germany is set once again to win the race to the bottom that EMU has brought in its trail. The result will be further current account deficits for the periphery and surpluses for Germany. Far from solving

the underlying problem, austerity is likely to make it even more intractable, despite imposing huge costs on working people.

The prospects for peripheral countries of the Eurozone are grim. Given the spread of austerity policies, the public and private debts that have been accumulated during the last decade are unlikely to be significantly reduced. It is even possible that peripheral countries might enter a deflationary spiral in which the contraction of GDP as well as of prices and wages would lead to a rise of debt relative to income. This would in turn exacerbate the difficulties of both public and private sector in servicing debt. The Eurozone is threatening to engulf peripheral countries in long-term recession that would lead to an even sharper contrast between core and periphery.

BOX 3 GROWTH FORECASTS

Forecasts of GDP growth for peripheral countries have been repeatedly revised during the past several months. The material included here draws on the best available official sources.

GREECE

The IMF expects contraction in 2010-11 as public expenditure declines.[17] But recovery is expected to take place in 2012 led by steady growth in exports from 2010 onwards. Private investment is also expected to recover in 2012. Public debt as proportion of GDP, meanwhile, will continue to worsen, peaking at 149% in 2012 and 2013. Thereafter, the burden of debt is expected to decline slowly. Unemployment meanwhile is expected to stay at high levels throughout.

IMF forecasts

	2009	2010	2011	2012	2013	2014	2015
GDP Growth	-2.0	-4.0	-2.6	1.1	2.1	2.1	2.7
Private Consumption	-1.8	-4.0	-3.7	0.8	2.8	2.5	2.5
Public Consumption	9.6	-10.6	-5.1	-3.6	-6.6	-3.2	-0.1
Investment	-13.9	-11.4	-11.8	0.8	4.8	3.5	2.3
Exports	-18.1	4.5	5.4	5.9	6.0	5.9	6.0
Imports	-14.1	-9.7	-6.1	1.6	3.8	4.6	3.7
Unemployment rate	9.4	11.8	14.6	14.8	14.3	14.1	13.4
Public Debt/GDP	115	133	145	149	149	146	140

Along similar - if more optimistic - lines the European Commission's Spring Report in May 2010 expects contraction of 3% for 2010, and contraction of 0.5% for 2011.[18] The worst of the recession is expected to be over by 2011 as exports pick up and private investment recovers.

European Commission Spring Report

	2009	2010	2011
GDP Growth	-2.0	-3.0	-0.5
Private Consumption	-1.8	-3.5	-2.4
Public Consumption	9.6	-7.0	-3.1
Investment	-13.1	-5.5	-0.8
Exports	-18.1	2.6	4.1
Imports	-14.1	-10.5	-3.4
Unemployment rate	9.5	11.8	13.2

[17] See http://www.imf.org/external/np/sec/pr/2010/pr10187.htm
[18] See http://ec.europa.eu/economy_finance/publications/european_economy/2010/pdf/ee-2010-2_en.pdf

The Memorandum on the other hand, expects a decline of GDP by 4% in 2010 and 2.5% in 2011.[19] Growth is expected to become positive in 2012 and following years.

This is despite contractionary measures (cuts in expenditure and increases in taxes) that would be cumulatively equivalent to 11% of GDP up to 2013. The fiscal deficit alone is expected to decline from 13.6% of GDP in 2009 to 8.1% of GDP in 2010, with the eventual aim of bringing it considerably below 3% by 2014.

PORTUGAL

Portuguese government forecasts for the period of 2010-13 have remained the same even after the further austerity measures of May 2010, and despite surprisingly strong growth in the first quarter (annualised rate of 1.7%).[20] The official forecasts assume recovery of external trade and a mild recovery of private consumption and investment. These will presumably countermand public spending cuts, leading to positive, even if sluggish, growth rates. Unemployment rate is expected to stabilise around 10%, while public debt relative to GDP is expected to grow to a peak of 90.7% in 2012, falling to 89.8% in 2013.

Portuguese Government Forecasts

	2009	2010	2011	2012	2013
GDP Growth	-2.7	0.7	0.9	1.3	1.7
Private Consumption	-0.8	1.0	0.8	0.9	1.0
Public Consumption	3.5	-0.9	-1.3	-1.4	0.2
Investment	-11.1	-0.8	1.0	1.6	1.8
Exports	-11.4	3.5	4.1	4.5	4.6
Imports	-9.2	1.7	1.9	1.9	2.0
Unemployment rate	9.5	9.8	9.8	9.5	9.3
Public Debt/GDP	77.2	86	89.4	90.7	89.8

These estimates are consistent with, if more optimistic than, those by the European Commission:

European Commission Spring Report

	2009	2010	2011
GDP Growth	-2.7	0.5	0.7
Private Consumption	-0.8	1.0	0
Public Consumption	3.5	-0.3	-0.2
Investment	-11.1	-4.2	-0.6
Exports	-11.4	3.8	4.4
Imports	-9.2	1.1	1.5
Unemployment rate	9.5	9.	9.9
Public Debt/GDP	76.8	85.6	91.1

[19] See http://www.mnec.gr/export/sites/mnec/en/press_office/DeltiaTypou/Documents/2010_05_04_GreecexLOI.pdf

[20] See http://www.portugal.gov.pt/pt/GC18/Documentos/MFAP/PEC2010_2013.pdf

SPAIN

Spanish official macroeconomic forecasts for the period 2010-13 were presented in March, when the Stability Programme measures were presented to the European Commission, but were revised for 2010 and 2011 at the end of May, following the announcement of new austerity measures. There is thus quite a discrepancy between 2011 and 2012, the latter showing a rather optimistic 3% growth. Given the cuts in public expenditure, the Spanish government expects a strong recovery of investment, private consumption and exports.

Official Spanish Forecasts

	2009	2010*	2011*	2012	2013
GDP Growth	-3.6	-0.3	1.3	2.9	3.1
Private Consumption	-4.9	0.3	1.8	3.3	3.3
Public Consumption	3.8	0.8	-1.6	-1.1	-1.4
Investment	-15.3	-7.2	-1.3	4.2	5.9
Exports	-11.5	7.3	6.4	6.9	7.4
Imports	-17.9	2.3	3.0	5.8	6.8
Unemployment rate*	18.0	19.4	18.9	17	15.5
Public Debt	55.2	65.9	71.9	74.3	74.1

*Revised figures after the new austerity measures were taken in May.

The European Commission is, again, less optimistic, though within broadly the same spirit:

European Commission Spring Report

	2009	2010	2011
GDP Growth	-3.6	-0.4	0.8
Private Consumption	-4.9	0.2	1.2
Public Consumption	3.8	1.0	-1.2
Investment	-15.3	-8.3	-1.8
Exports	-11.5	4.4	4.7
Imports	-17.9	-1.1	1.8
Unemployment rate	18.0	19.7	19.8
Public Debt	53.6	64.9	72.5

5. The spectre of default in Europe

5.1 Default, debt renegotiation and exit

When the Eurozone crisis burst out in early 2010, an RMF report identified three strategic options for peripheral countries, namely, first, austerity imposed by the core and transferring the costs of adjustment onto society at large, second, broad structural reform of the Eurozone in favour of labour and, third, exit from the Eurozone accompanied by default thus shifting the social balance in favour of labour.[21] Not surprisingly, the preferred policy of Eurozone governments – at the behest of the IMF – has been austerity. There has also been some reform, all of which has been in a neoliberal direction, as was discussed in chapters 3 and 4. This course of action is consistent with the nature of the Eurozone and the entrenched neoliberal ideology at its core. And nor is it surprising that the second option has found little favour, either in official discussions or in policy-making. The nature of the crisis has required immediate measures leaving little room for long-term reforming initiatives, quite apart from the inherent difficulty of reforming the Eurozone in favour of labour. Indeed, the Eurozone has become even more conservative during this period.

Nevertheless, as the policy of austerity has spread, the idea of default on public debt has also made significant headway. Austerity is a highly fraught path for the economies of both periphery and core, as was shown in chapter 4, which might even worsen the problem of indebtedness. In the global financial markets it is widely expected that Greece, at least, will face default in the future. Voices have been heard within the mainstream claiming that austerity might be a dead-end, particularly for Greece, and thus favouring controlled restructuring of public debt.[22] At the radical end of the political spectrum in Greece and elsewhere there have also been calls for default. It is probable that even governments have considered the possibility, though in hermetically sealed rooms.

The concluding chapter of this report tackles default and debt renegotiation in view of the preceding analysis. Since default inevitably raises the issue of Eurozone membership, the possibility of exit by peripheral countries is also considered. The focus of discussion lies on the political economy of these options, all of which involve complex social changes and different sets of winners and losers, both domestically and internationally. It is not easy to ascertain what is in the interests of

[21] See RMF report, 'Eurozone Crisis: Beggar Thyself and Thy Neighbour', March 2010, chapter 7, pp. 49-59.
[22] See Roubini, N. Greece's best option is an orderly default, Financial Times, 28 June 2010. Available at: http://www.ft.com/cms/s/0/a3874e80-82e8-11df-8b15-00144feabdc0.html; or Beattie, A. Why Greece should default, lecture delivered at the LSE, 14 July 2010. Podcast available at: http://richmedia.lse.ac.uk/publicLecturesAndEvents/20100714_1830_whyGreeceShouldDefault.mp3

working people in the periphery, not to mention the core. The approach adopted here is that, if the path of default, renegotiation and exit was entered, it should lead to a change in the social balance in favour of labour. By the same token, it should break the grip of conservatism and neoliberalism on the Eurozone.

Discussion below is conducted under the rubrics of creditor-led and debtor-led default. Distinguishing between the two is useful in order to ascertain the social interests involved in default, renegotiation and exit. Creditor-led default is likely to be a conservative policy path that would still impose the costs of adjustment onto working people, while leaving unchanged the underlying nature of the Eurozone. Debtor-led default, in contrast, could bring significant benefits to peripheral countries, while creating room to shift the social balance in favour of labour. Debtor-led default would immediately pose the question of exit from the Eurozone, thus inviting analysis of the implications for economy and society.

Default, renegotiation and exit are discussed below mostly as they would apply to a single peripheral country. It is natural to make this assumption, given that the pressures of crisis have been overwhelmingly heavier in Greece compared to other peripheral countries. Greece has been at the sharp end of the Eurozone crisis, and is likely to remain in that position for the foreseeable future. But even for analytical purposes alone, it would still have been necessary to make the assumption that default, renegotiation and exit occurred in a single country. Only then could the balance of social forces, the levers of economic policy and the international economic context be taken as given with any degree of precision.

Needless to say, if these decisive events occurred in one peripheral country, there would be major repercussions on the rest of the Eurozone. For one thing, what holds individually for Greece, also holds individually for Spain and Portugal (and probably for Ireland, though it has not been considered in this report). There are significant differences among the three, as was established in the body of this report, but their predicament as peripheral countries of the Eurozone is similar. If one was to adopt default, renegotiation, and exit, the demonstration effect on the others would be great. Each would naturally approach the issue from the perspective of its own social, political and institutional outlook, but the underlying economic compulsion would be similar. The tale might be told primarily for Greece, but Spain and Portugal will also recognise themselves.

It should finally be mentioned that default, renegotiation and exit could, at the limit, lead to fracturing, or even collapse, of the Eurozone as a whole. It is impossible to analyse with any credibility the repercussions of such a cataclysmic event, other than to state that the costs for both periphery and core would be great. Yet, even this outcome would ultimately be the result of the nature of the Eurozone – exploitative, unequal, and badly put together. The fault would not lie with peripheral countries but with the monetary union as a whole, which

has placed the periphery in an impossible situation. Working people in peripheral countries have no obligation to accept austerity for the indefinite future in order to rescue the Eurozone. Moreover, if the Eurozone collapsed under the weight of its own sins, the opportunity would arise to put relations among the people of Europe on a different basis. Solidarity and equality among European people are certainly possible, but they require grass roots initiatives. The Eurozone in its present form is a barrier to this development.

5.2 Creditor-led default: Reinforcing the straightjacket of the Eurozone

Austerity is a highly risky strategy when dealing with public debt because it restricts economic activity, as was shown in chapter 4. Even official projections expect the ratio of public debt to GDP to continue rising in all peripheral countries until 2012-3, reaching 149% in Greece. The dynamic of debt could become unsustainable, if there was a deeper than expected domestic recession, if social and political unrest occurred on a large scale, or if the European and the world economies took a turn for the worse. The pressures would be greatest in Greece because of the extent of austerity measures and the volume of public debt; but the danger would be present for all peripheral countries.

If it became clear that austerity had begun to fail in Greece - and elsewhere - the prospect of creditor-led debt restructuring would raise its head. Creditor-led default would not necessarily involve a unilateral suspension of interest payments, and formal default might not be declared. Nonetheless, a controlled form of default could occur in practice, involving the exchange of old for new debt, perhaps along the lines of Argentina in the period immediately before its final default, discussed in Appendix A. This process would obviously take place under the aegis of banks and within the framework of the Eurozone. It would mean, at best, a mild 'haircut' for lenders accompanied by a lengthening of maturities and possibly lower interest rates. The banks that organised such a restructuring could expect to earn substantial fees.

Creditor-led default would be in the interests of lenders, particularly banks. It should be stressed that this includes domestic lenders, for instance, domestic banks that hold significant volumes of public debt. Lenders would benefit because the institutional mechanisms of the Eurozone would be brought to bear on borrowing states with the aim of minimising lender losses. Banks would also benefit since they would continue to have access to ECB liquidity, in effect using the mechanisms of the ECB to facilitate the default. Above all, lender banks would benefit by accepting the already-known fact that some of the public debt on their books was bad, subsequently shifting it off the balance sheet on favourable terms. In that context, domestic banks would also attempt to swap old for new public debt on terms that transferred onto the state as much of the cost as possible.

Is it conceivable that creditor-controlled default could occur together with radical reform of the Eurozone? Some political circles in Greece are still hoping for an associational approach to the problem of debt, the countries of the core offering genuine support to the countries of the periphery. Could there be action that decisively lightened the burden of debt on the borrowers within the framework of the Eurozone, while also allowing for fiscal transfers from rich to poor, a larger European budget, wage protection, and so on?

The enormous difficulties of reforming the Eurozone in a pro-labour direction have been made clear in the course of the current crisis. Default and debt renegotiation have pressing urgency, requiring counter-measures of equal urgency. The Eurozone has introduced a rescue package at the cost of austerity, first in Greece but then across much of the rest of the union. Faced with turmoil, it has opted for more pressure on working people, greater fiscal rigidity and punitive terms imposed on indebted countries. At the same time, it has taken strong steps to rescue banks. These actions are consistent with the nature of the euro as world money serving primarily the interests of financial capital in Europe. The actions are also consistent with entrenched neoliberalism at the heart of the Eurozone. This is not a system that would admit of pro-labour reform within the timescale of a debt crisis, if at all.

In sum, creditor-controlled restructuring of debt within the framework of the Eurozone is a conservative approach that would be consistent with the current policy of austerity. For this reason, it is unlikely to prove a long-term solution for the crisis, and nor to bring significant benefits to working people in peripheral countries. The burden of debt would remain substantial and austerity policies would probably continue. The long-term outlook for Greece and other peripheral countries would remain poor.

5.3 Debtor-led default and the feasibility of exit from the Eurozone

Debtor-led default is potentially a more radical option, though its outcomes would vary depending on how it took place. If, for instance, austerity failed and creditor-led restructuring did not produce decisive results, the option of debtor-led default would emerge even for the current crop of peripheral governments. But the prospect would then arise in the midst of social and economic chaos caused by failed austerity. Thus, the deeper danger of the current policies of the EU and the IMF is that they might lead to a repetition of the experience of Argentina, discussed in Appendix A. From this perspective, if peripheral countries were to adopt debtor-led default, they ought to do so on their own accord, decisively, in good time, and while setting in train profound social changes.

Debtor-led default would mean, in the first instance, unilateral suspension of payments. The latter would usher in a period of intensified domestic social struggle as well as major tensions in international relations. Thus, the country would have to decide which among its

foreign obligations to honour, and in what order. Even more complexly, domestic banks, institutional investors, and other holders of public debt would seek to protect their own interests.

From the perspective of working people, but also of society as a whole, it is imperative that there should be a public audit of debt following suspension of payments. Transparency is a vital demand in view of the cloak of secrecy that envelops government borrowing. Auditing the debt would allow society to know what is owed to whom as well as the terms on which debt contracts were struck. It would also show whether parts of the debt were 'odious' or illegal, allowing the debtor to refuse to honour such debts outright. The future direction of default and its ability to produce benefits for working people would depend on whether transparency prevailed regarding the stock of debt. This would be prime terrain of internal social struggle once default materialised.

Negotiations to settle the debt would follow at the initiative of the debtor, with a view to being concluded as rapidly as possible. The objective of the enterprise could only be to achieve a deep 'haircut' for lenders, thus lifting the crushing weight of debt on borrowing countries. It is impossible to ascertain the extent of the 'haircut' in advance and prior to auditing the debt but, for Greece, it is unlikely to be less than for Russia or Argentina, some details of which are given in Appendix A. Two thirds of Greek public debt is held abroad, while the rest is held domestically. The largest holders, both domestically and abroad, are banks. Note further that the great bulk of public bonds appear to have been issued under Greek law, thus possibly allowing the country to avoid extended legal wrangles in US and UK courts, as would have happened for other middle income countries.[23] Given that core banks are substantially exposed to Greece (and even more heavily to the periphery) as was shown in chapter 2, there are some advantages to Greece in renegotiating its public debt. A government that reflected popular will and acted decisively might be able to secure deep 'haircuts' in a fairly short order of time.

But debtor-led default would also carry significant risks. The most immediate risk would be that of becoming cut off from capital markets for a period. More complexly, default might lead to trade credit becoming scarce as international and domestic banks would be affected, thus hurting the debtor's exports. Even more seriously, default would run the risk of precipitating a banking crisis, since substantial volumes of public debt are held by both domestic and foreign banks.

International experience shows that the period of being cut off from capital markets does not last long, and there are always alternative sources of funding. Typically, countries regain credibility within a short space of time, and capital markets exhibit a very short memory. The threat to trade credit, on the other hand, would probably be of greater

[23] See Buchheit L. and Gulati G. Mitu, 2010, How to Restructure Greek Debt, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1603304there

consequence, and the government would have to intervene to guarantee trade debts. But the gravest danger would be posed by the threat of banking crisis, which could greatly magnify the shock of default. To avert a banking crisis, there would have to be extensive and decisive government intervention. In Greece this would certainly mean extending public ownership and control over banks, thus protecting the banks from collapse and preventing depositor runs. Under public ownership, the banks could act as levers for root and branch transformation of the economy in favour of labour.

Could such a drastic course of action occur within the confines of the Eurozone? Note first that it is entirely unclear whether it would be formally feasible. No precedents of sovereign default exist within the Eurozone, and its legal framework makes no allowance for such an event.[24] There is no firm way of ascertaining the formal response of the Eurozone to a unilateral suspension of debt payments by one or more of its members. And nor is it clear what default would mean in terms of participating in the decision-making mechanisms of the Eurozone, including the setting of interest rates. It is inevitable that the defaulter would become a pariah, but the formal outlook remains unclear.

Formal feasibility aside, would it be desirable for debtor-led default to occur within the confines of the Eurozone? The answer is in the negative. First, it would be more difficult for the defaulting country to confront a domestic banking crisis without full command over monetary policy. More broadly, if banks were placed under public ownership following default but continued to remain within the Eurosystem, it would be practically impossible to deploy them in order to reshape the economy. Second, continued membership of the Eurozone would offer little benefit to the defaulter in terms of accessing capital markets, or lowering the costs of borrowing. Third, the option of devaluation would be impossible, thus removing a vital component of recovery. The accumulation of peripheral country debt is inextricably tied to the common currency and as long as the defaulter remained within the Eurozone the problem would reappear.

Consequently, debtor-led default raises the prospect of exit from the Eurozone. Exit would offer immediate control over domestic fiscal and monetary policy. It would also remove the constraints of a monetary system that has resulted in embedded current account deficits for the periphery. It is reasonable to expect that devaluation would allow for recovery of competitiveness. It is also plausible that there would be a rebalancing of resources in favour of domestic industry. The outcome would be protection of employment as well as lifting the pressures of

[24] See Athanassiou P. 2009. 'Withdrawal and Expulsion from the EU and EMU: Some Reflections', Legal Working Paper Series, No. 10, December, European Central Bank, Eurosystem. Athanassiou thinks that exit from the Eurozone would be 'inconceivable' without also exiting the EU. Suffice it to note that what is inconceivable to lawyers at one point in time could become eminently conceivable at another.

austerity on wages. As can be seen for Argentina and Russia in Appendix A, default and devaluation resulted in rapid recovery. To be sure, peripheral European economies are different from these resource-rich, primary commodities exporters. But there is no reason to expect that other areas of activity, such as tourism and parts of the secondary sector, would not respond positively to devaluation.

But exit would also entail costs, given the violent change of monetary system. The return to a national currency for Greece, or another peripheral country, would be more difficult than the 'pesification' of the Argentine economy, given the unprecedented degree of monetary integration within the Eurozone. However, replacing the euro is not a complex policy, and its basic parameters are not hard to ascertain. The decision would have to be announced suddenly in order to minimise capital flight; there would be an extended bank holiday; banks would be instructed to convert deposits and other domestic liabilities and assets into the new currency at a nationally chosen rate. When banks reopened, there would be parallel domestic circulation of the euro and the new currency, resulting in twin prices for a range of goods and services. There would also be monetary unrest as contracts and fixed obligations adjusted to the new unit of account. To prevent collapse of confidence, which could have catastrophic effects for economic activity, there must not be dithering once the policy has been adopted. Eventually prices and monetary circulation would adjust to the new currency, while the euro would be excluded from the domestic economy.

The international value of the new currency would inevitably fall, creating complex movements in the balance of domestic social forces. Banks and enterprises servicing debt abroad would face major difficulties; their immediate response would be to try to shift some of their own debt onto the state. On the other hand, those holding assets abroad would seek to speculate against the new currency. For the domestic capitalist class, the return to a national currency would represent an opportunity to transfer costs onto society, while attempting to obtain a transfer of wealth as the new currency devalued.

From the perspective of working people, but also of society as a whole, the answer would be a broad programme of public ownership and control over the economy, starting with the financial system. Public ownership over banks would guarantee their continuing existence, preventing a run on deposits. Capital and foreign exchange controls would also be imposed to prevent export of capital and to minimise speculative transactions. A set of conditions would thus be created allowing for the adoption of industrial policy which would alter the balance of the domestic economy by strengthening the productive sector. The sources of growth in the medium term would be found in the decisive restructuring of the economy, rather than the expansion of exports through devaluation.

The new currency would also create inflationary pressures as import prices would surge, particularly energy prices; real wages would fall as a result. Confronting these pressures would be far from easy, but

certainly feasible. It is, first of all, impossible to tell what would be the pass-through from import prices to domestic prices. Furthermore, renewed command over monetary policy would allow for counter-inflationary measures, particularly during the months of the initial shock of devaluation. Support for real wages could then be provided through a policy of income redistribution effected through taxing higher incomes and wealth. After all, peripheral countries are the most unequal in the Eurozone and in urgent need of redistribution. Note further that a bout of inflation would reduce the vast burden of domestic debt.

Default and exit, finally, would create problems of public finance, particularly as access to the international funds would come to an end. International experience shows that the primary balance typically returns to surpluses soon after an event of this nature has occurred. In the short term, public finance problems would be ameliorated as recovery began after default. The government could also borrow from the nationalised banking system as well as monetising the deficit to a certain extent. But for a country such as Greece, the medium term answer must be to restructure the tax system by expanding the tax base to include the rich and capital itself. This would be an integral part of restructuring the Greek state as a whole, making it more democratic and accountable. There could be no permanent resolution to public finance problems in Greece, or other peripheral countries, unless there was a change in the nature of the state, reflecting an underlying shift in the balance of class forces. More broadly, there could be no rebalancing of the economy in favour of working people without a profound restructuring of the state.

In sum, there are no easy alternatives for working people in peripheral Eurozone countries. The dilemma faced by these countries is harsh. They could acquiesce to austerity, remaining within the Eurozone and putting up with recession, or stagnation, for the indefinite future. Alternatively, they could opt for debtor-led default accompanied by exit from the Eurozone. The latter option could signal a radical transformation of economy and society, shifting the balance of power against capital. The distributional struggle over who would carry the costs of the crisis would continue, but more favourable conditions would have been created within which to fight for a progressive solution in the interests of the many. Debtor-led default could prove the start of an anti-capitalist turn across the periphery of the Eurozone that would lift the neoliberal stranglehold over the EU, thus jolting Europe in an associational, socialist direction. It remains to be seen whether European workers in the periphery but also the core have enough organisational and ideological strength to bring about such profound change.

Appendix A
The crisis last time: Argentina and Russia

The crisis in the periphery of the Eurozone is only the latest in a long line of sovereign debt crises during the last three decades, mostly in the developing world. The European Union, despite asserting its promotion of convergence of per capita income and living standards, has effectively created a sharp two-tier structure of core and periphery, without even counting the broader periphery in Eastern Europe. The debt problems of the Eurozone periphery have an inherent similarity with those of the global periphery. It is instructive in this respect briefly to consider the sovereign debt crises of Argentina and Russia in recent years.

On 24 December 2001, Argentina announced the suspension of payments on almost its entire public debt of $144bn. The fixed exchange rate, binding the Argentine peso to the US dollar, was abandoned a few months later. GDP collapsed by 11 per cent the following year. Yet the Argentine economy bounced back, sustaining growth of 8%-9% annually from 2003 to 2007, while GDP per capita returned to its pre-crisis peak in 2008. International debt markets were reopened to Argentina in 2006, with the sale of $500m worth of five-year bonds.

Two years earlier Russia had also defaulted on its external debts, forcing an immediate devaluation of the rouble. Within months the economy had returned to growth, expanding rapidly for almost a decade. Indeed, Russia weathered the crisis far better than Argentina. The experience of the two countries is compared below, drawing out the implications for the Eurozone sovereign debt crises.

The Washington Consensus brings collapse to Buenos Aires

In 1991 Argentina adopted the "Convertibility Plan" that included trade and capital liberalisation, privatisation of state-owned assets, tight monetary policy and, above all, the pegging of the peso to the US dollar on a one-to-one basis, overseen by a currency board.[25] The country thus spent the 1990s following the prescriptions of the Washington Consensus, with the IMF's benign approval and extended financial support.[26] The initial rewards appeared to be substantial as hyperinflation ended and growth averaged 6% over 1991-1998.[27] Net capital inflows totalled $100bn over 1992-1999.[28] Apparent success turned Argentina into the Fund's favourite emerging economy, paraded

[25] Cibils, A. and Lo Volo, R. (2007), "At debt's door: what can we learn from Argentina's recent debt crisis and restructuring?", *Seattle Journal for Social Justice* 5:2, p.757
[26] Cavallo, D.F. and Cottani, J.A. (May 1997), "Argentina's convertibility plan and the IMF", *American Economic Review* 87:2, pp.18-19
[27] International Monetary Fund Independent Evaluation Office (2004), The IMF and Argentina, 1991-2001, Washington, DC: International Monetary Fund, p.10
[28] International Monetary Fund Independent Evaluation Office (2004), The IMF and Argentina, 1991-2001, Washington, DC: International Monetary Fund, p.11

as an example for others to follow.[29] Continued IMF support helped ease borrowing conditions for Argentina, with creditors believing that the Fund would not allow such an exemplary country to fail. [30]

With hindsight, it is evident that macroeconomic stabilisation was more the product of good fortune than good policy. Low US interest rates had held back dollar appreciation, whilst a recovering US economy in the 1990s buoyed up Latin America. Once the dollar began to rise steadily in value from the mid-1990s onwards, the fixed dollar-peso link became a noose for the Argentine economy. Following the Russian crisis of 1998, Brazil undertook a devaluation of 70% in January 1999, worsening Argentina's terms of trade further.[31] The peso became heavily overvalued, up to 55% according to the estimates of the World Bank. [32] Deflation and output contraction set in.

The incipient recession turned into a full-blown economic slump in subsequent years, and by the latter half of 2002 Argentina's GDP had declined by nearly 20 percent. The number of Argentines living below the poverty line hit 57.5% of the population in October 2002, while the proportion living in extreme poverty – even lacking the ability to purchase food – exceeded 27.5%. Inequality rose sharply and unemployment reached 25%.

As the slump gathered pace, the federal government's debt rose steadily relative to GDP: from 34.5% in 1997 to 37.6% in 1998, to 43% in 1999, to 45% in 2001, and to 53.7% in 2002. By the middle of 2001, capital markets were effectively closed to Argentina. Throughout this period, the IMF actively supported Argentine policy-making, particularly the peso-dollar peg. Indeed, the Fund moved from assessing policies under the peg, to actively endorsing the peg itself.[33] As late as October 1998, mere weeks before the debacle opened, the Fund's Managing Director described Argentina as "exemplary".[34] After capital markets had effectively closed to Argentina in mid-2001, the IMF became the only source of external loan support for the country, increasing further its leverage. Nonetheless, there was a remarkable degree of unanimity between IMF advisors to Argentina, and senior Argentine officials and

[29] See, for example, remarks by Michael Camdessuss, IMF Managing Director, press conference, 24 April 1997; Camdessuss, M. (1996), "Argentina and the challenge of globalisation", speech, Academy of Economic Science, Buenos Aires, 27 May 1996; and International Monetary Fund (1998), Country Report: Argentina, IMF Staff Country Report 98/38

[30] Although the size of this moral hazard effect may not have been especially large in Argentina's case. See IMF Policy Development and Review Department (March 2007), "Fund financial support and moral hazard: analytics and empirics", Washington: International Monetary Fund

[31] Sturzenegger, F. and Zettelmeyer, J. (2007), *Debt Defaults and Lessons from a Decade of Crises*, Cambridge MA: MIT Press, p.168

[32] Perry, G. and Servén, L. (2003), "The anatomy of a multiple crisis: why was Argentina special and what we can learn from it", working paper WPS 3081, World Bank

[33] International Monetary Fund Independent Evaluation Office (2004), The IMF and Argentina, 1991-2001, Washington, DC: International Monetary Fund, p.37

[34] Quoted in International Monetary Fund Independent Evaluation Office (2004), The IMF and Argentina, 1991-2001, Washington, DC: International Monetary Fund, p.12

ministers. The IMF imposed its prescriptions in cahoots with the ruling elite of Argentina. [35] The result was a series of chaotic policy turns that eventually led to default.

An initial round of tax increases and spending cuts reduced the government's primary deficit from 19.4% to 18.9% of GDP from 1999 to 2000. But this fiscal tightening proved insufficient particularly as the central government seemed to lack fiscal control over regional authorities. Promises to control the latter allowed for the release of further financial assistance from the IMF and the World Bank, totalling close to $20bn.[36] But the fiscal targets imposed by the IMF for the first quarter of 2001 were missed, prompting the resignation of the finance minister. A new minister attempted to impose direct cuts of approximately $2bn, but was forced to resign within a fortnight of his appointment.[37]

A further turn of policy followed, attempting to peg the peso to the average of the euro and the dollar, thus boosting the productive sector. The policy failed, opening the way for the *megacanje de deuda* ("mega debt swap") in June 2001. This was co-ordinated by a syndicate of major North American and European banks, offering longer maturities for existing debt holders through a "competitive" process. The end result was that the overall foreign debt of Argentina was actually increased and, of course, the banks that arranged the deal earned an "enormous commission".[38] The economy continued to decline rapidly and another debt swap was attempted in September 2001 with the approval of the IMF. The gains for Argentina were again modest. As spending continued to overshoot agreed IMF limits, dissent began to emerge within the Fund on whether support should continue. An expected disbursement was left unpaid, provoking a run on the Argentine banking system. The government was forced to ban deposit withdrawals, leading to massive popular unrest. On Christmas Eve of 2001 the country eventually defaulted.

In January the Convertibility Law was repealed and a new fixed dollar-peso rate was adopted. The resulting capital flight soon forced the government to announce the "pesification" of dollar-denominated financial assets and liabilities held in Argentina. Consequently, demand for dollars rose, further increasing the pressure on the peg, while the banks were rendered insolvent.[39] In March 2002 the country was forced to abandon the fixed exchange rate regime entirely, and the peso fell to around 75% of its previous dollar rate. As a result, consumer prices rose by 40%. The ensuing dislocation of fundamental monetary functions

[35] Cibils, A. and Lo Volo, R. (2007), "At debt's door: what can we learn from Argentina's recent debt crisis and restructuring?", *Seattle Journal for Social Justice* 5:2, p.755
[36] Ibid., p.170
[37] Ibid., p.171
[38] Teubal, M. (2004), "The rise and collapse of neoliberalism in Argentina: the role of economic groups", *Journal of Developing Societies* 20:3-4, p.185
[39] Miller, M., Fronti, J.G., Lei, Z. (2004), "Default, devaluation, and depression: Argentina after 2001", working paper

contributed to an extremely sharp slump. But the substantial devaluation of the peso, alongside the government regaining control of the situation, meant that the worst of the crisis was over by April 2002. Growth for the last three quarters of 2002 was positive, and continued to accelerate over subsequent years.

In September 2003, with the crisis clearly over, the government sought a formal restructuring of its debt. Bondholders were initially offered a 75% reduction in capital, lower interest rates and longer debt maturities. Creditors reacted angrily, forming a pressure group that worked with the IMF to demand better conditions. The IMF refused to recognise an improved offer from the Argentine government of 45% capital reduction in January 2004. The government then took the unprecedented step for a developing country of proceeding with the restructuring without IMF support. By February 2005, 76% of Argentina's creditors had reluctantly agreed to the new credit terms.[40]

Some lessons from Argentina

The official view of default stresses its substantial costs, particularly the slide in economic output, accelerating unemployment and possible impoverishment. This is in line with much conventional economic literature, which suggests that costs act as a means to discourage governments from reneging on debts. [41] But there is also a counter view within mainstream theory, which effectively treats default as a policy option with both costs and benefits. [42]

The experience of Argentina is consistent with the view that default can be a positive step for an economy crushed by debt. The worst collapse of the Argentine economy occurred in the first three months of 2002 as the government attempted to maintain a new currency peg without credibility. During the same period, it attempted to force "pesification" into a currency that lacked credibility, thus encouraging capital outflows. The economy began to recover strongly only after the illusion of a "strong" domestic currency was abandoned.

It is important to note that the Argentine debt crisis was not a product of lax fiscal discipline. The primary deficit remained "remarkably flat" relative to GDP over 1993-2001.[43] Fiscal problems began to emerge as a recession materialised in 1997-8, driving tax revenues down steeply. Indeed, many of Argentina's fiscal troubles can be traced to the privatisation of its pay-as-you-go social security system under the

[40] Cibils, A. and Lo Volo, R. (2007), "At debt's door: what can we learn from Argentina's recent debt crisis and restructuring?", *Seattle Journal for Social Justice* 5:2, pp.775
[41] Eaton, J. and Gersovitz, M. (1981), "Debt with potential repudiation: theoretical and empirical analysis", *Review of Economic Studies* 43, 289-309
[42] See Reinhart, C. and Rogoff, K. (2004), "The modern history of exchange rate arrangements: a re-interpretation", *Quarterly Journal of Economics* 119: 1; Tovar, C.E. (May 2010), "Currency collapses and output dynamics: a long-run perspective", *BIS Quarterly Bulletin*.
[43] Hausman, R. and Velasco, A. (2002), "Hard money's soft underbelly: understanding the Argentine crisis", Brookings Trade Forum

Convertibility Plan.[44] Government revenues declined but, astoundingly, the government retained all its existing social security liabilities. By 2001, the gap between lost social security revenues, and continued payments to pensioners with cumulative debt interest – amounted to virtually the entire primary deficit.[45]

Argentina was certainly affected by the decline in the terms of trade after the Asian crisis of 1997; by the US slowdown in 2001; and by capital flight and rising spreads across developing countries following the 1998 Russian crisis. But their impact was no more than for other Latin American countries.[46] The depth and severity of the Argentine crisis was due to the monetary framework of the country, in particular the fixed dollar peg run by a currency board. Fixing the exchange rate contributed to a current account deficit that was only closed through recession. The result was growing public and private sector debt in the late 1990s and early 2000s.[47]

Sticking to "respectable" "orthodox" economic policy, supervised by the IMF, also proved disastrous for Argentina. At every turn it prevented decisive policy action that could have removed the monetary bind at the heart of the problem, thus encouraging policy confusion. Finally, "orthodox" policy created room for the illicit export of capital by large sections of the Argentine ruling and middle class. Domestic capital held abroad could speculate on the prospect of "pesification", continually destabilising the economy. When "pesification" eventually arrived, it created opportunities for wealth transfers in favour of the ruling class. Default and "pesification" released the economy from the straightjacket of the Convertibility Plan, but the Argentine rich were still able to benefit.

Russia's transition from a planned economy: Collapse and recovery

Russia spent the 1990s in transition to free-market capitalism under IMF tutelage. During the 1980s, the USSR had developed substantial foreign debt exposure, which Russia, as the main successor state, took over in its entirety. Notoriously, the transition process led to economic collapse.[48] Money disappeared from much of economic life; half of industrial sales were completed through barter by early 1998. Tax collection by the central government was extraordinarily erratic, while a tiny fraction of

[44] Holzmann, R. (2000), "The World Bank Approach to Pension Reform", World Bank presentation

[45] Baker, D. and Weisbrot, M. (2002), "The role of social security privatisation in Argentina's economic crisis", working paper, Center for Economic and Policy Research

[46] Perry, G. and Servén, L. (2003), "The anatomy of a multiple crisis: why was Argentina special and what we can learn from it", working paper WPS 3081, World Bank

[47] Cibils, A. and Lo Volo, R. (2007), "At debt's door: what can we learn from Argentina's recent debt crisis and restructuring?", *Seattle Journal for Social Justice* 5:2, pp.765-766

[48] Milanovic, B. (1998), Income, Inequality, and Poverty During the Transformation from Planned to Market Economy, Washington DC: World Bank, pp.186–90

taxes was collected in cash.[49] Russia concluded agreements with the IMF in 1995 and 1996 which, together with the adoption of a high and fixed exchange rate, appeared to be bringing inflation under control.[50] Access to international credit markets moved towards normalisation after 1996.[51]

Success was entirely fictitious. After the onset of the Asian crisis, the rouble came under speculative attack. The prices of oil and nonferrous metals, together accounting for around two-thirds of Russian exports, began to fall.[52] Political unrest followed as the economy faltered. Tax collection was extraordinarily weak and public debt began to rise relative to GDP: from 43.4% in 1996, to 53.6% in 1997, to 68.1% in 1998, to 90.2% in 1999. The fear of default and devaluation pushed up central bank lending rates to banks, and the Russian government found it very difficult to continue with its short-term borrowing operations. In an effort to support it, a $22.6bn multilateral assistance package was announced in July, with $4.8bn to be disbursed immediately.[53] The intention was to support the currency peg, while swapping expensive short-term for long-term bonds. The package failed within days and capital flight swelled to perhaps $4bn between May and August.

On 17 August 1998 the Yeltsin government announced that it was devaluing the rouble, imposing a moratorium on all rouble-denominated public debt payments, and suspending payments on all foreign currency liabilities by Russian financial institutions. Renewed political unrest provoked further pressure on the rouble and all attempts to control the exchange rate were abandoned in September. The rouble plunged to less than a third of its value relative to the dollar.[54] The attempt to defend the peg from October 1997 to September 1998 had cost roughly $30bn, about one-sixth of Russia's GDP at the time.[55]

Default produced a major banking crisis as the aggregate capital of Russia's banks was approximately equal to the volume of frozen Russian loan payments. A run on Russian financial institutions had been brewing since August 1998, with queues of worried depositors beginning to form outside bank doors. In response, the central bank injected massive volumes of liquidity into the system, lowering reserve

[49] Gaddy, C.G. and Ickes, B.W. (1998), "Russia's virtual economy", *Foreign Affairs* 77:5, p.56
[50] Chiodo, A.J. and Owyang, M.T. (2002), "A case study of a currency crisis: the Russian default of 1998", *St Louis Federal Reserve Review*, p.9
[51] Sturzenegger, F. and Zettelmeyer, J. (2007), *Debt Defaults and Lessons from a Decade of Crises*, Cambridge MA: MIT Press, p.95
[52] Chiodo, A.J. and Owyang, M.T. (2002), "A case study of a currency crisis: the Russian default of 1998", *St Louis Federal Reserve Review*, p.10
[53] Kharas, H., Pinto, B. and Ulatov, S. (2001), "An analysis of Russia's 1998 meltdown: fundamentals and market signals", Brookings Papers on Economic Activity, p.10. The IMF contribution was reduced from $5.6 to $4.8bn after the Duma failed to agree to all of the conditionalities the Fund wished to impose.
[54] Kharas, H., Pinto, B. and Ulatov, S. (2001), "An analysis of Russia's 1998 meltdown: fundamentals and market signals", Brookings Papers on Economic Activity, p.1
[55] Kharas, H., Pinto, B. and Ulatov, S. (2001), "An analysis of Russia's 1998 meltdown: fundamentals and market signals", Brookings Papers on Economic Activity, p.3

requirements, extending loans to major institutions, and swapping frozen bonds for cash. The measures successfully halted the run, at the cost of reinforcing the devaluation of the rouble and subsequent inflation.

Devaluation had the effect of pushing the cost of servicing dollar-denominated debt sky-high. In January 1999 credit rating agencies declared Russia to be in complete default. The Russian government quickly opened negotiations with holders of debt aiming at restructuring. By May 1999 agreement was secured with approximately 95% of resident, and 89% of non-resident debt-holders. Bondholders received haircuts estimated at around 53%.[56]

Swift action on the banking crisis, speedy renegotiation of debts and the devaluation of the rouble paved the way for a sharp rebound in the Russian economy. Growth resumed apace, reaching 6.3% in 1999 and 10% in 2000, never falling below 4% annually until the recession of 2008. Barter, arrears and non-payments were steadily eradicated.[57] The fiscal balance shifted into surplus for the first time in 2000, and Russia had repaid its debts to the IMF fully by 2005. Foreign exchange reserves topped $200bn in 2006, the fourth largest amongst emerging market economies.[58]

Much of this success was determined by sharp rises in primary commodity prices, especially oil, from around 1999 onwards. But the recovery also helped domestic producers, as consumption shifted from expensive foreign goods into locally-produced commodities. Household consumption also recovered strongly on the back of sharp rises in real disposable incomes. [59] There is little doubt that such growth would have been impossible, even with rising oil prices, had Russia still attempted to maintain the overvalued rate of the rouble. Default and devaluation, though undoubtedly carrying immediate economic costs, proved a more viable option for the Russian economy.

Default is not such a disaster, after all

Fundamental to the crisis in both Argentina and Russia was the attempt to maintain an overvalued exchange rate, ostensibly for the purpose of stabilising prices. The result was to cripple private sector output, create current account deficits, and generate private and public debt. The problems of public finance in both countries thus resulted from the broader framework of neoliberal policy imposed by the IMF as well as from external shocks. Eventual default and devaluation, while carrying significant economic costs, created the conditions for rapid economic

[56] Sturzenegger, F. and Zettelmeyer, J. (2007), *Debt Defaults and Lessons from a Decade of Crises*, Cambridge MA: MIT Press, pp.105-106
[57] Ahrend, R. (2008), "Can Russia sustain strong growth as a resource-based economy?", CESifo Forum 2/2008, Paris: Organisation for Economic Co-operation and Development, p.3
[58] Sturzenegger, F. and Zettelmeyer, J. (2007), *Debt Defaults and Lessons from a Decade of Crises*, Cambridge MA: MIT Press, p.113
[59] Ahrend, R. (2008), "Can Russia sustain strong growth as a resource-based economy?", CESifo Forum 2/2008, Paris: Organisation for Economic Co-operation and Development

recovery. Both countries underwent debt renegotiation relatively smoothly, without official IMF support. Access to international capital markets was regained not long after default. It should be noted, however, that Argentina continued to rely on bilateral Venezuelan loans. Even so, default did not leave the two countries without access to credit.

Russia and Argentina handled default and devaluation quite differently. Confronted with an implausible exchange rate peg and a worsening debt position, Russia's government acted decisively to default and devalue in short order. The entire process took approximately five months, while renegotiation of the great bulk of debt finished a little more than a year later. Argentine governments, in contrast, clung to the unworkable currency board for years, while generally adopting the view that 'orthodox' methods would resolve the worsening economic crisis. Furthermore, once a banking crisis had emerged following default, Russia resolved the problem rapidly through restrictions on capital movements and by effectively nationalising bank deposits. Procrastination and policy confusion in Argentina contributed to bank runs that led to riots and deaths.

Default and devaluation certainly carry costs. But they might well be the better option for a country facing an intractable debt crisis that has been created in large measure by international monetary and financial relations. The costs can be reduced and a path can be cleared for future economic growth, if governments are prepared to act decisively, breaking the international consensus if needed.

At the same time, default and devaluation, particularly when they involve a change of monetary standard, as in Argentina, also entail wealth transfers and a rebalancing of class forces. They could re-strengthen the rule of the domestic capitalist class, but they could also create opportunities to shift the balance of power in favour of labour. They could open the way for public ownership and control over banks, regulation of capital flows, public control over other areas of the economy, industrial policy, and redistribution of income and wealth. The eventual outcome of default and devaluation, in other words, depends on social struggle. This is the challenge that is currently confronting working people in the periphery of the Eurozone.

Appendix B
Construction of aggregate debt profiles

Data about the debt liabilities of a country tend to be dispersed over a number of sources and classified according to varying sets of criteria. The lack of data that is consolidated at the national level according to the same accounting standard presents difficulties in the analysis of data, and in particular makes international comparisons, such as that in the present report, problematic. In order to clarify the data methods used to reach the conclusions in this report, this Appendix provides an outline of the data sources, calculations and assumptions used in constructing the figures on the debt of periphery countries contained in Chapter 2.

There are two primary ways in which the debt of a country may be disaggregated: by issuer, most importantly public vs. private-issued debt, and by holder, where domestic vs. foreign holding is the most significant division. With regard to the former, data about public debt is broadly disclosed, usually through the national public debt agencies which take responsibility for the production of these statistics. These agencies provide data about outstanding volumes of debt disaggregated in a number of ways, for example by instrument, maturity, currency, type and geographical location of the debt holder at the initial placement[60]. With regard to foreign holdings of debt, data about countries' external debt is disclosed through supranational institutions and is usually based on the International Investor Position statistics of the Balance of Payments, provided by home central banks[61].

Consolidated statistics on the total volume of debt liabilities of individual countries are not published by either national authorities or international organisations. In order to calculate the level of indebtedness of periphery countries, the "National Financial Accounts", published by the central banks of each country, were used as primary sources. These data sets provide a detailed breakdown of the stocks of financial assets and liabilities of each institutional sector of an economy. The data are classified by issuing sector[62] and by type of instrument.

The total indebtedness of each country was calculated by summing over the total the debt securities, loans and non-resident deposits of each of the institutional sectors. The following assumptions were made:

1. Domestically held deposits were excluded from the definition of debt, while foreign deposits were included.

[60] Data about Spanish public debt can be found at http://www.tesoro.es; about Portuguese debt at http://www.igcp.pt; and about Greek debt at http://www.mof-glk.gr.
[61] For Spain http://www.bde.es/homee.htm; Portugal http://www.bportugal.pt/en-US/Pages/inicio.aspx; and Greece http://www.bankofgreece.gr/Pages/en/default.aspx.
[62] General government; financial corporations; non-financial corporations; households

2. The foreign liabilities of the monetary authorities were excluded from total indebtedness. These liabilities are the result of ECB liquidity provision operations. These repo operations take place via the home country central bank, resulting in the expansion of both sides of the balance sheet and giving rise to the appearance of increasing indebtedness at the national level. However, as these operations are essentially domestic liquidity provision by the central bank, they do not constitute an expansion of external debt.

3. In the case of Portugal, the quarterly financial accounts do not provide data about trade credit debt. Yet, those are provided for the period 2004-2009 in the annual tables. The annual figures were then used to calculate values for trade credit for the respective years. However, for the period before 2004 estimates were calculated by extrapolating the average of period 2004-2009 and applying it to period 1997-2003. It was also assumed that trade credit is evenly split between households and non-financial corporations, reflecting the trend observed for the period 2004-2009 and ignoring marginal amounts for general government.

With respect to the categorisation of debt by holder, in the case of Spain and Portugal, the data provided by the national Financial Accounts for externally-held debt are not broken down by issuing sector. This information was obtained from an alternative source, the International Investor Position of the Balance of Payments, which gives information, broken down by domestic sector and by type of foreign capital flow: direct investment, portfolio investment (equity and debt securities) and 'other investment' (primarily bank lending). The total volume of external debt was thus obtained by summing the liabilities of domestic sectors to direct investors and affiliated enterprises, portfolio investment debt and "other investment" liabilities. In the case of Greece, more detailed information about external debt was given in the Financial Accounts, however this did not match the equivalent figures in the International Investor Position – see the subsequent section for more detail.

As the two sources adopt different classification criteria, some assumptions needed to be made in order to make the balance of payments' data compatible with the financial accounts:

1. Once again, monetary authorities liabilities were not considered; and

2. Liabilities to direct investors, classified as 'other capital' in direct investment rubric were classified as 'other sectors' debt', which includes non-financial corporations and households.

A final remark is in order regarding the data on the holders of debt securities, and in particular the split between domestic and foreign holdings. As debt securities are easily exchanged in capital markets it is particularly difficult to know where they are held if we do not use data about holders at clearing houses. This classification frequently refers to the data provided by the issuer based on the original placement in the market. Therefore any data about the location of debt holders needs to be treated with some caution.

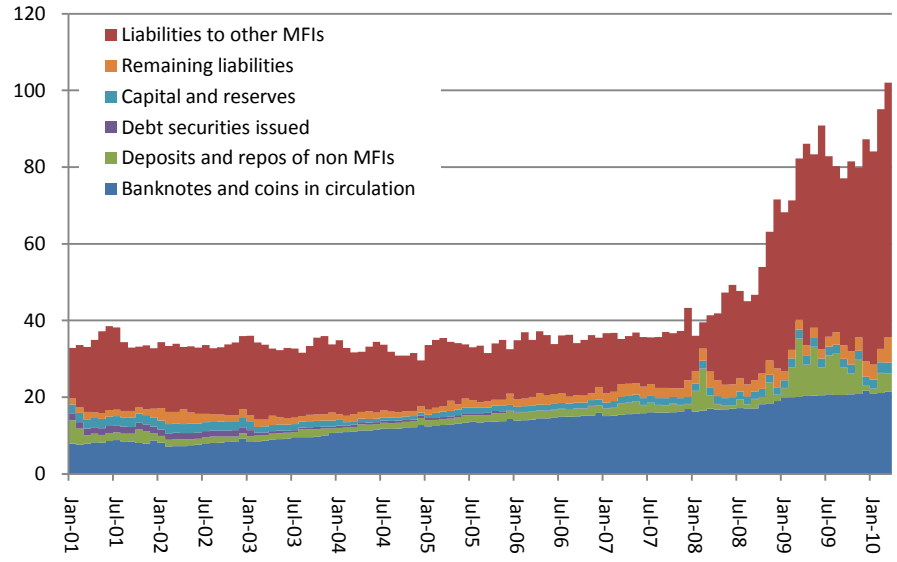
Greece

This section provides more detail on the methods used to calculate the debt profile of Greece. This is provided for two main reasons: firstly, the volume of the ECB liquidity provision operations were largest in Greece and this is illustrated by showing the changes in the balance sheet of the bank of Greece. Secondly, there were discrepancies between different data sources, particularly with respect to external debt. This is discussed in more detail below.

As in the other cases, the primary source for the data on Greek indebtedness was the set of "Financial Accounts", published by the Bank of Greece[63] This data set provides a detailed breakdown of the stocks of financial assets and liabilities of each sector of the Greek economy.

Figure B1 Bank of Greece liabilities

(Euro bn)



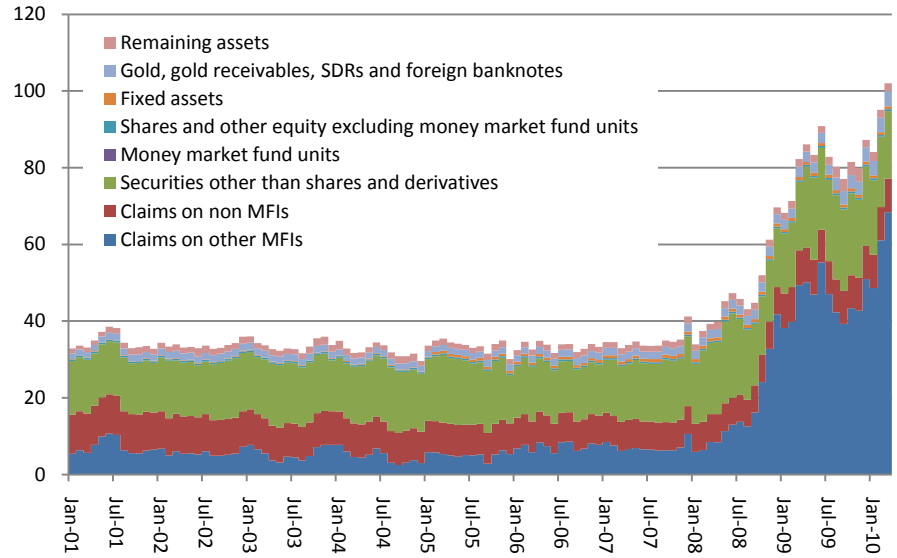
Source: Bank of Greece

It was noted that both the assets and liabilities of the Bank of Greece have ballooned in recent years. This was cross-checked against

[63] http://www.bankofgreece.gr/Pages/en/Statistics/accounts.aspx

the balance sheet of the Bank of Greece.[64] What was found was that liabilities to "other Euro-area MFIs" accounted for this increase, while on the asset side, corresponding claims were held against domestic MFIs. This is illustrated in Figures B1 and B2.

Figure B2 Bank of Greece assets
(Euro, bn)



Source: Bank of Greece

It can be seen that "Liabilities to other MFIs" (which is dominated by "other Euro Area MFIs") and "Claims on other MFIs" (dominated by domestic MFIs) jump sharply following the onset of the financial crisis. This expansion of the balance sheet is accounted for by operations by the ECB for the purposes of liquidity provision: repo operations take place via the home country central bank, resulting in the expansion of both sides of the balance sheet, giving the appearance of increasing indebtedness at the country level. However, as these operations are essentially domestic liquidity provision by the central bank, they do not in fact constitute an expansion of debt. For this reason the external liabilities of the Bank of Greece were excluded from the total debt figures.

A further issue arose in that a significant discrepancy in the external debt figures occurs between the Financial Accounts, and the equivalent figures in the "Gross External Debt Position"[65] that is published by the Bank of Greece as part of the "Special Data Dissemination Service" – an IMF initiative aimed at providing

[64] http://www.bankofgreece.gr/BogDocumentEn/Balance_sheet_BoG.xls
[65] http://www.bankofgreece.gr/BogDocumentEn/Gross_External_Debt_Position-Data.xls

standardised external debt statistics. The SDDS figures[66] for the private sector are significantly lower than those in the Financial Accounts with the most significant difference occurring in the "Financial Corporations" sector. It was found that by subtracting the volume of central bank liquidity-providing operations from the reported external liabilities of the Financial Corporations, a figure almost exactly matching that reported in the SDDS figures was obtained. The assumption was therefore made that the Financial Account figures include the liabilities arising from these liquidity operations in the accounts of the financial corporations. The data used to generate the figures in Chapter 2 thus had these liabilities removed from them.

Finally, the discrepancy between the SDDS and Financial Account statements of the external liabilities of the Household and Non-Financial Corporation sectors remains unresolved. In both cases, the higher of the two values were used to generate the figures, i.e. those reported in the Financial Accounts. By way of an illustration, the level of private sector debt, excluding financial corporations, as reported in the SDDS figures for the final quarter of 2009 was almost EUR 25bn. When calculated using the Financial Account figures, the volume of externally held private sector debt was more than double this amount at around EUR 67.5bn. Although the difference is large, it is still relatively small when put in the context of total private sector debt (both domestically and externally held) reported in the Financial Account, which is almost EUR 290bn.

[66] The SDDS figures match those on the IMF sponsored "Quarterly External Debt Statistics" website:
http://web.worldbank.org/WBSITE/EXTERNAL/DATASTATISTICS/EXTDECQEDS/0,,menuPK:1805431~pagePK:64168427~piPK:64168435~theSitePK:1805415,00.html

Appendix C
Decomposition of aggregate demand

The decomposed aggregate demand graphics for GDP Growth were built using the European Commission's AMECO database, deploying absolute values for each category at constant prices. Rates of growth for each category were then calculated as:

$r = (X_t - X_{t-1})/X_t$

The contribution of each category to growth was measured by weighing each rate of growth with its relative weight in GDP:

$r*(X_t/GDP)$

In order to simplify the graph, a single category for net external demand was created of (Exports-Imports).

GDP growth figures were calculated from final GDP provided by AMECO. Small discrepancies between the two methods for calculating GDP (adding each demand category contribution and using the absolute values for GDP at constant prices) were identified in certain years for particular countries. However, such differences were insignificant and few.

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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