

The euro crisis: Taking the PIGS to market



INTRODUCTION

On the 30th November 2011 Olli Rehn – vice president of the European Commission – declared that there were only ‘ten days to save the euro!’ This declaration, from such an eminent source, gave a dramatic rhetorical twist to the often fraught and frantic negotiations leading up to the summit of European leaders and financial ministers that had been tasked with finding a solution to the euro crisis. After the repeated failure of Europe’s politicians and policy makers to get a grip, it was now official – they were now all drinking in ‘the last chance saloon’.

With the world looking on with apprehension, by 11th December the assembled politicians and policy makers had come to a nail biting last minute agreement on how to contain the crisis. Central to this agreement had been the Greek government’s humiliating acceptance of a closely monitored draconian austerity package, in return for help from both the IMF and the rest of the eurozone in financing its rapidly growing debts. Yet no sooner than the deal was signed it seemed that the entire agreement might unravel. The Greek prime minister George Papandreou, in one last gesture of defiance, proposed to put the austerity measures to a referendum of the Greek people. Already, earlier in the autumn, Silvio Berlusconi – the rather boorish prime minister of Italy – had been sacrificed to appease the agitated

bond markets. It did not take much time for the European ruling class to bundle Papandreou off stage. With scant regard for democratic niceties, in little more than a week Papandreou had been replaced as Greek prime minister by the safe pair of hands of Dr Lucas Papademos, former vice president of the European Central Bank (ECB), at the head of a ‘government of national unity’ firmly under the direction of Berlin and Brussels.

By the end of 2011 it seemed that the ‘euro had at last been saved’ – at least for the time being. The gods of the bond markets had been suitably appeased, and the crisis had begun to abate. But six months later, like the sequel to a bad Hollywood horror film, the euro crisis has erupted once more. Once again there are frantic negotiations and summits to ‘save the euro’, and once again we are having the increasingly clichéd dire warnings of the consequences of not finding such a solution.

So what is the significance of the euro crisis? Is it merely a matter of making a drama out of a crisis? Or is it more than this? Certainly the euro crisis has had a very real impact on the majority of the population of Europe. It has provided the opportunity for the European ruling class to launch a continent-wide class offensive against the entrenched positions of the European working class. Nowhere is this more evident than in Greece. The imposition of draconian austerity



measures has amounted to the effective carpet bombing of the Greek economy. Hundreds of thousands of businesses have gone bankrupt, and public services have been slashed. As a result unemployment has more than doubled in the last two years – with youth unemployment standing at more than 50%. This together with cuts to the minimum wage and pensions, has meant that the standard of living of the average Greek has fallen by more than a third since the beginning of the crisis. As the rich take their money abroad, the numbers below the official poverty line have soared – with an estimated 250,000 people in Athens alone now dependent on food parcels and soup kitchens.

So how are we to understand the euro crisis? Has it been simply due to the profligacy of certain governments such as those of Portugal, Ireland, Greece and Spain – the so-called PIGS – of the southern and western periphery of Europe?¹ Or is it the inevitable result of attempting to impose a single currency on the heterogeneous economies of Europe? Is it the result of European politicians and policy makers being trapped by outdated economic dogma that has forgotten Keynes and the lessons of the 1930s? Or is the euro crisis a symptom of the terminal decline of capitalism in which the bourgeoisie are no longer able to prevent the self-destruction of their own economic system?

As we shall see, all these positions have an element of truth. However, we shall argue that the euro crisis cannot be fully understood unless it is placed in the context of the shifting tectonic plates of global capitalism, that is seeing the emergence of China and the ‘global south’ and the beginnings of the decline of an American-centred global accumulation of capital.

In the first section we shall give a brief account of the unfolding of the euro crisis since the end of 2009. In the second section we shall consider the competing arguments over the causes of the euro crisis, and in the third section

¹ Some commentators have included Italy amongst the PIGS giving rise to the acronym PIIGS.

we shall consider how the European ruling class has sought to deal with the crisis. In the final section we shall place the euro crisis in the broader context of the shifting tectonic plates of global capitalism. We shall see how the response of the European ruling class to the euro crisis has been shaped by the prospects opened up for the re-orientation of European capital accumulation by the rise of China.

ALWAYS TOO LITTLE, TOO LATE?

Looking on in dismay

By the time the drama of the euro crisis had reached its crescendo in the autumn of 2011, leading policy makers outside Europe – from Timothy Geithner, the US treasury secretary, to even Christine Lagarde, the former French finance minister and the newly appointed head of the IMF – could barely disguise their exasperation at the failure of both European politicians and the institutions of the European Union to act decisively enough to contain the crisis. The financial difficulties of Greece – whose economy amounts to little more than 2% of that of the entire eurozone – had been allowed to spiral out of control, to the point where it was now threatening to engulf the entire eurozone. At each stage in the crisis the European politicians could be accused of being ‘behind the curve’ – unable to convince the financial markets that they were prepared to take the obvious action on a sufficiently bold scale necessary to contain the crisis. And each failure to act with sufficient boldness had only served to further exacerbate the situation.

After having stared into the abyss only three years before, the ineptitude of the European politicians and institutions in the handling of the euro crisis, it seemed, had brought the world once again close to the brink of another global financial meltdown like that which had threatened to follow the collapse of Lehman Brothers. Only this time the financially weakened governments of the world might not be in a position to avert such a financial meltdown, and thereby save world capitalism from the economic collapse that would inevitably follow, as they had done before. Even if they eventually did ‘manage to get their act together’ and took the action necessary to contain the crisis, the failure on the part of the European ruling class to at least contain the euro crisis at an earlier stage could already be seen to have contributed to the serious delay in the long hoped for global economic recovery.

So how had the rather marginal financial problems facing Greece been allowed to spiral out of control? What could have been done to contain the crisis? And, if the policy actions necessary to contain the crisis were so evident, why did the European policy makers fail to take such actions?

To answer such questions we must first look a little closer at how the euro crisis has unfolded.

In the eye of the storm

By the end of 2009 it had become clear that the worst of the storm that had followed the collapse of Lehman Brothers a year before had passed. The leaders of the world could now congratulate themselves that their often frantic efforts over the previous months to save the world from both financial and economic collapse had been successful. The banking system had been stabilised and the financial markets that had seized up were now more or less functioning again. At the same time, under the leadership of the US, the loosely co-ordinated adoption of Keynesian reflationary policies by the world's major governments had succeeded in averting a 1930s-scale global economic depression.

What was more, much of the costs of the crisis had been borne by the working class across the world in the form of mass redundancies, short-time working and a sharp decline in living standards. Indeed almost everywhere employers had seized the opportunity presented by the crisis to push through changes to workers' pay and conditions to their advantage. As a result profits were already bouncing back, and business was rapidly returning to normal. Although there had been a few doomsters from both the left and the right who predicted the world economy would either plunge back into recession or else stagnate for years to come, the mainstream view was that, while it may be sluggish at first, particularly in the US and Europe, economic recovery could be expected to take off more or less everywhere by 2011.

However, although world leaders could heave a sigh of relief that the worst was over, it was quite clear that the global economy was still very far from being out of the woods. Firstly, the global financial system was still fragile. No one could be certain what debts banks and other financial institutions held would turn out to be 'toxic'. As such there still remained a very real possibility that a major bank would suddenly be obliged to reveal huge losses and find itself on the verge of bankruptcy, thereby triggering another 'panic' in the financial markets.

Secondly, there was the looming problem of sovereign debt. The global response of governments to the crisis had been to borrow and spend in order to make up for collapsing private sector demand. The impact of the crisis therefore had been to a large extent absorbed by a sharp increase in government debt. Now this may have served to prevent a major global economic depression, but it had also made government finances potentially unstable. How much longer,



it could be asked, would governments be able to finance ever growing levels of debt?

For the time being at least the situation seemed sustainable. Banks in particular were keen to buy up government bonds issued to finance increasing government debt because they needed to hold them as reserve assets, both to meet the more stringent 'capital requirements' being imposed by the monetary authorities in the wake of the banking crisis, and to reassure their business partners that they had sufficient reserves to cover any unexpected losses. More generally, with the flight to safety following the financial panic of the previous months, safe and reliable government bonds provided an ideal safe haven for institutional investors to park their funds until the general economic and financial situation became more certain. Most governments could therefore expect to find sufficient buyers for the government bonds that they would have to sell to raise the money needed to cover their deficits. As both the UK and the US had already shown, for those governments that did find it difficult to finance their debts there was always the last resort of 'quantitative easing' in which their central banks created the money to buy up the bonds necessary to finance their debts.

Nevertheless, as the IMF and other august bodies of the international bourgeoisie warned, this situation would not last forever. Once the economic recovery picked up steam it would become increasingly difficult for governments to sell ever greater amounts of debt. Government bonds would have to compete with other forms of investment such as corporate bonds or shares that, while less safe, promised much higher returns, particularly in a booming economy. Governments would therefore either have to offer higher returns on their bonds, forcing up interest rates which may then serve to kill off private investment; or else adopt unorthodox monetary policies such as quantitative easing. But quantitative easing could only work in the current rather exceptional post-crisis circumstances where banks were slashing back on their lending in order to bolster their reserves. In doing so the

banks were in effect destroying money in vast amounts that quantitative easing was serving to replace. Once the economy and the banking system returned to normal, the policy of the central bank printing money so as to buy up government bonds would sooner or later inevitably lead to hyper-inflation.

Therefore the IMF had urged governments to draw up medium term 'exit strategies' from the exceptional fiscal and monetary policies they had adopted to absorb the impact of the crisis. First and foremost government deficits would have to be cut back in order to stabilise the burden of sovereign debt - as measured by debt to GDP ratios. Further, it was generally agreed that the bulk of the burden of reducing government deficits should fall on public spending, rather than on tax increases.

Indeed, many amongst the bourgeoisie policy makers saw the prospect of public spending cuts as an excellent opportunity to accelerate neoliberal reforms of the state that in many countries, particularly in Europe, had previously stalled or been reduced to a snail's pace. After all, the crisis had exposed the weakness of the working class across the industrialised world. Having forced through changes in the private sector with remarkably little opposition, it now seemed the time to take on the entrenched public sector unions, cut public sector wages and pensions, and push through programmes for the privatisation and the commercialisation of the provision of state services - all under the guise of the 'necessity' of cutting government deficits.

Yet as the wise heads of the IMF warned, the eagerness on the part of many in the bourgeoisie to strike while the iron was hot had to be tempered by the need to ensure that slashing public spending did not kill off the global economic recovery. Indeed, there were very real fears that if too many governments sought to cut their deficits too fast and too early this could precipitate a 'double dip recession', if not plunge the world economy into an outright depression.²

Nevertheless, despite such worries, by the end of 2009 there had emerged a certain cautious

optimism amongst most bourgeois policy makers and commentators that was broadly shared by the markets for government bonds. The crisis had resulted in a deterioration in the financial position of nearly all governments. But, with sufficient care, there was no reason why the problem of sovereign debt could not be dealt with over the medium and long term. Indeed, to the extent that the 'need' to cut debt concentrated the minds of politicians to force through neoliberal reforms, the problem of government indebtedness could be seen as an excellent and timely opportunity.

So how was it that the financial problems of the PIGS managed to stir up the bond markets into a speculative 'frenzy'? After all, compared with other financial markets that trade in company shares or foreign exchange - let alone those that deal in the multitude of complex derivatives - the bond market is normally considered as rather placid and boring.

Greek confessions and the bond markets

The revelation at the beginning of 2010 that the Greek government, with the connivance of the US investment bank Goldman Sachs, had been hiding some of its debts, and that the Greek finance ministry had been systematically misleading the European statistical authorities regarding the likely size of the government's current budget deficit for 2009, certainly had an impact on the bond markets. It is true that the amount of hidden debt was in fact relatively small compared with the Greek government's total debt, and that most bondholders who had been paying any serious attention to the economic situation in Greece following the crisis would have taken the Greek finance ministry's previous predictions concerning the deficit with a pinch of salt. However, it did raise the issue of whether these revelations were merely the tip of the iceberg, and how much other governments on the periphery of the eurozone were concealing about their financial position. If nothing else the Greeks' confessions served to focus the attention of the bond markets on the financial predicament of the PIGS.

Many banks across Europe had accumulated over the previous decade a substantial amount of the bonds issued by the governments of the PIGS. As far as the European banking regulators were concerned, the government bonds issued by the PIGS were as good as German bonds and as such were counted equally as a form in which banks could hold their legally required reserves. But, because there was always a grain of suspicion that the PIGS were more likely to default than the German government, the PIGS bonds had offered a small but significantly higher rate of return. Particularly in the period in the run up to the credit crunch, when there had been a desperate search for yields, the PIGS bonds had provided a

² From 2009 the IMF began publishing *Fiscal Monitor* on a regular basis in which they put forward their advice on dealing with the problems of mounting sovereign debt. The IMF has urged those governments that have found themselves with high deficits and high debt burdens to implement exit strategies sooner rather than later. Indeed, as we shall see the IMF has played its usual role in insisting on stringent austerity measures when it was called to aid the bailout of Greece. Yet the IMF has also been concerned that austerity measures have been implemented too early and gone too far in the less indebted economies of Europe. See in particular IMF, 'Fiscal exit: from strategy to implementation', *Fiscal Monitor*, November 2010 for the IMF's views on striking the balance between reducing government debt at the same time as maintaining the economic recovery.

welcome form for European banks to place their reserves. Following the Greek government's revelations it would have certainly made these banks a little nervous. After all as members of the eurozone the PIGS had neither the option to devalue nor to adopt unorthodox monetary policies, such as 'quantitative easing', to contain a sovereign debt crisis that was open to other countries with control over their own currency.

Nevertheless, even for the worst case of Greece, there were still plausible, if rather optimistic scenarios that could be put forward that could show that in the medium to long term the PIGS could stabilise and eventually reduce



their burden of debt. With the global economic recovery the PIGS could be expected to return to their long term average rate of economic growth. Once their economies were growing it could be expected that their tax revenues would grow. So long as the growth in public spending was kept below the growth in tax revenues the government's budget deficit would fall. Thus, given sufficient time, the PIGS could eliminate their government deficits and thus begin to reduce their debts. However, if the PIGS were to stabilise their financial position in a time scale acceptable to the markets then it would not be sufficient merely to rely on economic growth. The rise in tax revenues due to economic growth would have to be supplemented by rises in tax rates and substantial cuts in public expenditure. However, this would be true, if to a lesser extent, for most European governments, including both Germany and France.

The more cynical amongst the bondholders could doubt whether the PIGS, particularly the Greeks, would have the bottle, not only to force through, but to sustain the levels of austerity that would be necessary to turn around their financial position. Indeed, given their record, it could be suspected that at the first whiff of petrol bombs, the Greek government for one would start to

wobble. The more pessimistic amongst bondholders could argue that even if the PIGS did push through and sustain the required degree of austerity, this would only serve to reduce economic growth thus derailing the whole programme of deficit reduction.

There was therefore considerable uncertainty as to whether the PIGS, and particularly Greece, would be able to pay their debts over the medium to long term. However, there was a tacit assumption that if any of PIGS found themselves in serious financial trouble then the other European governments and the ECB would ride to the rescue. However much the rules that governed European monetary union might rule out bailouts, and restricted the actions of the ECB to save member states, a means would eventually be found to go round them - as had happened so often in the past when the rules had become politically inconvenient. After all the project of European monetary union was far too important to be wrecked by the financial problems of a minor and peripheral country like Greece or Portugal that was most likely to find themselves in such a predicament. Thus, despite the Greek revelations and the continuing uncertainty surrounding the financial prospects of the PIGS, the predominant view of the PIGS major bondholders remained as it had been before: to hold firm and wait and see what happened. After all, the situation might look very different in two or three years' time.

Although in terms of its burden of government debt or the size of its budget deficit the Greek financial position was not all that different from the other PIGS, what did become rapidly apparent after the Greek's announcement that it had been cooking the books, was that much of its debt was short term. As a result, the Greek government faced large and increasing tranches of debt falling due over the next few quarters. Although major bondholders may be prepared to hold on to existing bonds or even renew them, it was certainly questionable whether they could be persuaded to take on even more of the Greek government's debt in the current period of uncertainty.

The only way of ensuring that it could raise the money to renew the debt falling due, as well as to finance the still increasing budget deficit, was to sell its bonds at an extra discount so as to provide higher returns for those who purchased them. But this would mean that it would have to issue an even greater quantity of bonds, thereby increasing the amount of its debt. Indeed, Greece could quickly find itself on a slippery slope to bankruptcy. The more it had to discount its bonds, the more it would find itself in debt, and hence the greater would be the fears that it was reaching the point where it would be unable to

redeem this debt when it fell due. The more bondholders feared that they might not get their money back, the less willing they would be to lend unless they were offered a higher rate of return - and even then they would only be prepared to buy bonds with ever shorter maturities.

Indeed, it was no doubt the fear that it would not be able to raise enough money to meet the next tranche of debt due to be redeemed in March without offering prohibitively high rates of returns to investors, that had prompted the Greek government to come clean in the hope that the other members of the eurozone would come to their rescue out of a sense of European bourgeois solidarity. Thus the validity of the tacit assumption that the ECB and the governments of the eurozone would organise a rescue in the event of one of the PIGS finding itself in financial trouble was now no longer some remote hypothetical issue. It was an assumption that was facing a real and imminent test.

As fears that perhaps the long held assumption that there might not be a rescue grew, many of the smaller Greek bondholders began to sell off their Greek bonds. As a result the price of existing Greek bonds began to fall. This was further exacerbated by speculators who saw a fall in Greek bonds as something of a one way bet - with the bigger the fall the greater the profits they could make. However, the major European banks that had been accumulating Greek bonds, along with other major financial institutions, who together were the principal bondholders, were to a large extent locked into holding Greek debt. Because they had bought Greek bonds with a view to holding them until they reached maturity, the stock of outstanding Greek bonds that these banks and financial institutions held was relatively large compared to the amount that was traded day to day on the bond markets. As a consequence, any attempt to reduce their exposure to Greek debt by selling off their stock of Greek bonds could have an appreciable impact on the market. Indeed, if they attempted to start dumping their Greek government bonds on the market in its current precarious state they risked precipitating a sudden collapse in the price of these bonds. If they were then slow off the mark in getting rid of the rest of their stock of Greek bonds they may well find themselves holding worthless bits of paper, since a collapse in the price of bonds would make it impossible for the Greek government to raise enough money to redeem their bonds when they fell due by issuing new bonds. The fear of default would then have become a self-fulfilling prophecy.

The major European holders of Greek bonds were therefore easily persuaded by their governments and monetary authorities to hold on to their existing stock of Greek bonds - or even to

increase them in order to both meet the increasing funding needs of the PIGS, and to buy up bonds being off loaded by non-European banks, small traders and speculators - particularly if they could be assured that other major bondholders across Europe were being persuaded to do likewise. If all the major European bondholders held firm, then the price of their bonds could be protected from the attacks of the speculators until the authorities could organise a rescue.



Rescuing the Greeks?

There were a number of ways a rescue of Greece could have been mounted, but they would have all essentially involved a whip-round amongst the other member states of the eurozone. The governments of the eurozone could be expected to raise money mainly from the global financial markets by issuing and selling their own bonds. The money raised could then be lent to the Greek government in the form of a medium or long term loan. The Greeks would then be able to redeem bonds falling due, finance its current deficit without having to issue more bonds, and perhaps buy up outstanding bonds in order to shore up their price. In return the Greek government would have been obliged to agree to an austerity plan aimed at reducing its deficit so that it could eventually pay the loan back.

Sufficiently well-funded, such a rescue operation could be expected to fulfil three functions, which together, would serve to resolve Greece's sovereign debt crisis. Firstly, it would serve to restructure the Greek government's debt. The predominantly short term debt owed by the Greek government to bondholders would be replaced by a medium to long term debt owed to the governments of the eurozone. The threat of an impending Greek default would thereby be removed. Secondly, the rescue operation could be expected to reduce the burden of Greek debt,

thereby making it more likely to be able to repay the loan from eurozone governments. This was most likely to have taken the form of a low rate of interest being charged on the loan, and perhaps the deferral of interest payments until the Greek economy had recovered, or at least was expected to have recovered. Indeed, even if the eurozone governments charged Greece the interest which they would have to pay by the issue of their own bonds then, given the likely size of the loan compared with Greece's GDP, this alone would have gone a long way towards making the Greek government's debts far more manageable. Thirdly, by allowing the Greek government to buy up its old bonds, and redeem its bonds that were falling due, such a rescue operation would allow the major European bondholders to reduce their exposure to Greek debt without precipitating a collapse in the Greek government bond market.

Any form of rescue along such lines would not have involved the ECB in printing money to finance government debt, or any other unorthodox monetary policy that was against either the spirit or the letter of the rules governing its procedures. Any such rescue would mainly involve inter-government operations, which at most would require the ECB to act as an intermediary. However, it has been argued that any such rescue operation would be in breach of the treaties governing the operation of European monetary union. In order to deter 'reckless' governments from running up debts and then expecting other members of the eurozone to come to their rescue, Article 125 of the *Consolidated treaty on the functioning of the European Union*, which provides the legal basis governing European monetary union, explicitly prohibits either the European Union as a whole or individual governments from bailing out a member of the European Union.³ Yet as has been pointed out in response, this prohibition of a bailout is qualified in the treaty by the provision that in exceptional circumstances, when a member state finds itself in a perilous financial position due to factors beyond its control, the European authorities are permitted to provide financial assistance.⁴ From the wording of Article

³ Article 125 section 1 states that: "*The Union shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of any Member State, without prejudice to mutual financial guarantees for the joint execution of a specific project. A Member State shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of another Member State, without prejudice to mutual financial guarantees for the joint execution of a specific project.*"

⁴ Article 122 section 2 states that: "*Where a Member State is in difficulties or is seriously threatened with severe difficulties caused by natural disasters or exceptional*

122 it is clear that such an exemption from the 'no bailout clause' was intended to cover natural disasters such as earthquakes, or other 'acts of god' such as a large scale nuclear accident. But was not the global economic crisis beyond the control of any particular government? Could this not be stretched to cover the case of Greece?

Whatever the legal niceties surrounding the rescue of Greece, it has been argued that prompt action would have been a case of 'a stitch in time saves nine'. The amount the eurozone governments would have had to raise to fund a fully funded bailout of Greece would have been relatively small. Even if they had to borrow enough funds to buy up all of the Greek government's debt, this would have meant each of the governments of the eurozone increasing their own debt to GDP ratio by around 2 or 3 percentage points. With Germany for example already bearing a debt burden of nearly 75% this would have been of little consequence.

Furthermore, it could be argued that if such a fully-fledged rescue had been mounted promptly then merely the announcement that ample funds were available to bailout Greece would have gone a long way towards 'calming' the bond markets by reassuring the major bondholders that none of the PIGS would be allowed to default. Indeed, most of the money pledged by governments may never have been needed.

Where's the cavalry!?

But if the Greek government, and indeed the major European Greek bondholders, thought that the rest of the eurozone would soon saddle up and ride to the rescue they were to be disappointed. At first the declarations by Angela Merkel that the 'rules were the rules' and that there could be no Greek bailout - particularly if it cost the German taxpayer money - could be discounted as both political posturing for the benefit of the German electorate, and as an initial bargaining position to ensure that the Greek government took its responsibilities in any bailout seriously. Yet March came and went with Merkel remaining intransigent on the issue of a Greek bailout. The Greek government had been consequently left struggling to raise enough money to redeem those of its bonds that had fallen due, as well as to covering its growing budget deficit. Having to pay through the nose to refinance its debt, and with a receding prospect of a rescue coming any time soon, it was becoming increasingly evident that Greece would not be able

occurrences beyond its control, the Council, acting by a qualified majority on a proposal from the Commission, may grant, under certain conditions, Community financial assistance to the Member State concerned. The President of the Council shall inform the European Parliament of the decision taken."

to refinance the next tranche of bonds that would need to be redeemed in June.

The German government seemed determined to allow Greece to default on its debts. But there were serious problems with simply allowing Greece to default, even if it was merely a marginal member of the eurozone. Firstly, the realisation that it was a very real possibility that Greece would have no option but to default on its debts had raised concerns about the financial position of Ireland, Portugal, Spain and even Italy. If Greece was allowed to go bust, who would be next? Since January the price of the other PIGS bonds had begun to soften, as bondholders began to reduce their exposure to risky government debt and speculators took advantage to make a quick profit by betting on falling bond prices. The PIGS were already beginning to slide down the slippery slope where the fear of default becomes self-fulfilling.

Secondly, as we have seen, banks and other major financial companies had stockpiled the bonds issued by the governments of the PIGS. Although it might be able to absorb the losses resulting from the Greek government reneging on its debt, the European banking system, still fragile after the financial crisis of 2008, could easily collapse as a result of the losses incurred if one or more of the other PIGS followed Greece into default.

Thirdly, as we have mentioned, governments and monetary authorities across Europe had been urging banks and other major bondholders of the PIGS to hold on to their bonds, and stand firm against speculative attacks that sought to drive down bond prices. Could they now simply leave these banks and bondholders in the lurch and still retain their creditability in the future?

French banks were particularly exposed to the risk of default on the part of the PIGS. It was therefore the French government that led the opposition to the German refusal to countenance any form of bailout of Greece within the counsels of Europe. With June fast approaching and under mounting pressure from Sarkozy – the French President – Angela Merkel finally relented. At the beginning of May 2010, after frantic diplomatic activity between Paris and Berlin, it was agreed that there would be an *ad hoc* bailout to prevent the impending Greek default. It was decided that the governments of the European Union, with the exception of Slovakia who initially refused to join in, would put up 80 billion euros into an emergency bailout fund. This fund would then be topped up by a further 30 billion euros provided by the IMF.

In addition, during the discussions leading up to the Greek bailout, the German government had accepted that in the longer term there was a need for a permanent body able to provide financial

assistance to governments in the eurozone that found themselves in financial difficulties in the future. It was therefore decided to set up what was to be known as the European Stability Mechanism (ESM) that would in effect be an embryonic European Monetary Fund, which would be funded by all the eurozone governments. By acting in accordance with predetermined guidelines the ESM would be empowered to act swiftly to offer loans - and impose conditions on these loans - without the need for protracted multilateral negotiations between either the 17 eurozone or even all 27 European Union governments.

However, it was accepted that the establishment of the ESM required substantial amendments to the existing treaties governing European monetary union. These amendments would certainly require a lengthy process of ratification by national parliaments and even referendums in some member states. Furthermore, the Germans in particular insisted that the rules governing the ESM would have to be subject to lengthy negotiations to ensure it was only used by governments as a last resort, not merely a means to avoid 'fiscal discipline'. As a consequence of all these considerations it was agreed to aim to set up the ESM sometime in 2013.

But neither the agreement reached for the emergency bailout of Greece, nor the agreement to set up the ESM in three years' time, was sufficient to allay the growing fears of a default by another of the PIGS. After all, it had taken protracted negotiations in the teeth of opposition, not only from Germany but also from several other north and east European members of the European Union, to secure a bailout of Greece. Such a procedure, it was feared, might prove far too slow when the next of the PIGS came under a concerted speculative attack in the bond markets, and this could easily occur before 2013. As a result, after a fraught meeting between Merkel and Sarkozy over the weekend of May 9th-10th 2010 it had been finally agreed to set up a temporary bailout mechanism, which was to be known as the European Financial Stability Facility (EFSF). The EFSF was to be a stop gap measure until the ESM could be brought into operation.

The EFSF was certainly a clever wheeze to get round both article 103's prohibition of bailouts and the restrictions placed on the ECB's ability to purchase government bonds. The EFSF was to be set up as a 'special purpose vehicle' that would be a distinct legal entity, and, as such, would be nominally independent of both the European Union and the member states of the eurozone. The EFSF would be able to borrow money from the financial markets in its own name, and the

member states of the eurozone would then collectively and 'irrevocably' guarantee the repayment of these loans up to a total of 440 billion euros. The money borrowed could then be lent to eurozone members in financial distress directly, or else be used to buy up the bonds they issued to raise money on the financial markets. It would therefore not be the European Union, the member states of Eurozone or the ECB bailing out the Greek government, but the EFSF. Much to the satisfaction of Angela Merkel, the no bailout rules, which had been stretched to breaking point with the Greek bailout, could at least be preserved.

The provision of a maximum of 440 billion euros, together with a further 250 billion euros that the IMF agreed to stump up in the event of a bailout of one of the PIGS being necessary, proved to be sufficient for the time being to restore 'the confidence of the markets'. The major holders of PIGS bonds were now reassured that some form of bailout could be promptly put in place if another of the PIGS reached the point that they could not redeem their bonds. With the major PIGS bondholders standing firm there was little hope for speculators to make a killing by a concerted attempt to drive down the price of bonds.

For a few months it appeared that Europe's sovereign debt crisis had been contained. Once the European economic recovery took off in 2011 it could be hoped that the problems of sovereign debt would gradually evaporate as economic growth would allow governments to 'grow out of their debts'.

Driving the PIGS to the slaughter house?

Yet the emergency bailout of Greece agreed in May 2010 fell far short of a fully-fledged rescue package that would have put Greece back on a sound financial footing. The 110 billion euros made available was little more than a third of Greece's entire government debt, and came with stringent and rather humiliating conditions. Firstly, the bailout would be provided as a loan with a punitive rate of interest. Secondly, the Greek government had to agree to the immediate implementation of a programme of draconian austerity measures. Thirdly, the loan would be issued in tranches that were only sufficient to allow the Greek government to meet its immediate refinancing needs every quarter. What is more each tranche would only be paid out if the

inspectors sent in by the 'troika' of the European Commission, the ECB and the IMF were satisfied that the Greek government was sticking to the agreed austerity programme. It was certainly intended to keep the 'miscreant' Greek government under a tight rein.

Up until their acceptance of the bailout in May 2010, the Greek government had been reluctant to start cutting public spending and increasing taxes at a time when the Greek economy was still barely out of recession for fear that it would kill off the prospect of an economic recovery. Now, in accepting the emergency bailout under the tutelage of the 'troika', there was little option but to embark on such a course of action. Indeed, the austerity programme drove Greece back into recession. But falling economic output meant falling tax revenues, which only served to offset much of the reduction in the deficit that was being achieved through cuts to government spending and rises in tax rates. Thus the draconian austerity programme, combined with the punitive interest rates charged on the bailout loan, not only destroyed any hope of a rapid economic recovery, but in doing so drove Greece further in to debt.

Far from rescuing the Greeks, and resolving the sovereign debt crisis more generally, the emergency bailout had therefore only served to defer what was rapidly becoming an almost inevitable Greek default. For the more cynical of observers, it seemed that the Germans were intent on making an example of Greece by driving it towards economic ruin.

Whether or not intended, the example of Greece served to galvanise the bourgeoisie across Europe to firm up plans for their own exit strategies from the 'exceptional fiscal and monetary policies' they had been obliged to adopt to cope with the impact of the financial crisis of 2008. For politicians the fear of finding themselves in the rather humiliating predicament of their Greek colleagues clearly more than outweighed any apprehension they may have had at the possibility of concerted working class resistance to austerity measures. Indeed, for many amongst the bourgeoisie, who had seen the weak response of their working classes to the repercussions of the financial crisis, the sovereign debt crisis provided an excellent opportunity to press ahead with long 'overdue' neoliberal reforms to the state and the public sector.



Merkel drives the PIGS into the arms of the market

This was certainly the case in the UK. The drama of the Greek bailout had coincided with the results of an inconclusive general election. The supposed risk that the markets 'might turn on the UK' and lead to 'credit ratings downgrade' so that Britain might then find itself in the same position as Greece, was used as means to forge a coalition government between the Conservatives and the Liberal Democrats based on the overriding imperative to 'save the nation's economy' by eliminating the government's 'structural budget deficit' in just five years. An imperative that not only has meant an austerity programme on a scale unprecedented in the postwar era, which is to be borne overwhelmingly by the working class, but which has also led to the acceleration of neoliberal reforms. In its first parliamentary session the Conservative-led coalition government has forced through legislation that opens the way for the wholesale privatisation of education and the NHS as the Tories seek to complete Thatcher's unfinished '(counter)-revolution'.⁵

⁵ There had been little immediate danger in May 2010 that the bond markets would take fright at the UK government's mounting debt. The average maturity of government debt was more than 14 years, far longer than any other advanced capitalist nation. Even if the government did find it difficult to sell its bonds then the Bank of England was more than willing to act as buyer of last resort. Now of course there was the danger that once the economy began recover the policy of the Bank of England buying up government bonds by merely creating money - i.e. quantitative easing - would lead to a sharp rise in inflation. Fears for the inflationary consequences of quantitative easing might then lead to capital flight from the UK, thereby precipitating a collapse in the exchange rate of the pound. But this was far from being imminent. The immediate problem was deflation not inflation and in the midst of the developing euro crisis the City of London was seen as a safe haven and was attracting financial inflows. What was needed to 'reassure' the financial markets at the time was a clear commitment to some form of medium term debt reduction plan. A seven or even ten year plan that depended far more on economic growth

But in the case of the UK the implementation of austerity measures could be phased in over a five year period, allowing time for an economic recovery to become established and thereby mitigate their impact. For the PIGS the possibility of going the way of Greece was far more real and imminent. The 'need' for austerity was therefore deemed far more urgent. Thus the governments of Ireland, Portugal and Spain began to speed up their own severe deficit reduction plans. But, like Greece, by cutting too fast and too early the other PIGS also found themselves on the verge of a downward spiral, in which the more they imposed austerity the more their economies shrunk, and thus the more they had to impose further austerity measures to meet their original deficit reduction targets.

The resurgence of the sovereign debt crisis

By the autumn of 2010 it had become evident that the sovereign debt crisis had not simply gone away with the Greek bailout. As the Greek debts continued to increase, despite the implementation of the austerity measures overseen by the 'troika', it became clear that the Greek government would have to sooner or later request additional funds from the EFSF. But perhaps far more troubling for the bond markets was the prospect that Spain might have to follow Ireland in bailing out its crippled banking system. Already Ireland was having to borrow vast amounts of money from the bond markets in order to pay for the bailout and the nationalisation of its leading banks. If Spain, the fourth biggest economy in the eurozone, and

rather than spending cuts and tax rises to reduce the government's burden of debt would have probably been sufficient. The decision to set a target of eliminating the structural budget deficit in five years and to place the burden of doing so on those on lower and middle income was clearly a political decision.

with a government debt larger than all the other three PIGS put together, found itself in a similar situation and had to request a bailout, there might not be much money left in EFSF to meet the request for financial assistance for anyone else.

The government debt of Portugal, Ireland, Spain and Greece already totalled more than 1.3 trillion euros, and was still rising. What the *Economist* in May had described as a 'stonking' bailout fund provided by the EFSF and IMF did not seem so 'stonking' after all.⁶ Indeed, with stiff opposition, particularly by Merkel, to any suggestion that the EFSF should be increased, bondholders began to fear that there would not be enough money in the kitty if all the PIGS required a bailout at the same time. Indeed, it now began to seem quite possible that if one of the PIGS went under then this could lead to the others going under as well.

In November Ireland came under speculative attack and was forced to request support from the EFSF to the tune of 85 billion euros. In April 2011 Portugal was obliged to followed suit with a request for 78 billion euros. Only Spain managed to avoid having to tap the bailout funds, but the question was how much longer it could hold out. Then, in May, amidst rising tensions concerning Greece's compliance with the austerity programme, serious concerns began to circulate in the German press, much to the alarm of both the German government and the wider ruling circles of the European Union, that the Greek government was seriously considering the possibility of unilaterally reneging on its debts in order to escape from the dictates of the 'troika'.⁷

Although these rumours were quickly denied they served to concentrate the minds of those within the 'troika'. If Greece was driven into declaring a sudden unilateral default – potentially making all outstanding Greek government bonds worthless – it could cause panic on the financial markets. Holders of bonds of the other PIGS might dump their holdings in the rush for the exit fearing other governments might follow suit. At the same time, fears that European banks might suffer significant losses would put pressure on the European banking system. In order to deter the PIGS from even considering a unilateral default the European authorities had long made it known that any such action would be punished by expulsion from the eurozone. Rumours that the Greek government was reaching breaking point and was now even contemplating calling this bluff only served to raise the stakes. A

unilateral default by Greece threatened to set in motion a process that might mean the breakup of the eurozone.

It now became a matter of urgency to arrange a second Greek bailout to steady the uncertainty in the financial markets, and this would mean that Greek government would be obliged to request more money either from the EFSF or the IMF. However, the IMF was not prepared to cough up more funds unless the EFSF provided the bulk of the extra finance. Yet if the EFSF was to provide sufficient funds to finance its share of the new Greek bailout it would have to borrow more money. But, if it was to convince the bond markets of its capacity to shore up the other PIGS if they were to require further financial assistance, then it would have to be agreed to raise the EFSF's borrowing limit. This would mean that the eurozone governments would then have to pledge even more money to guarantee this increase in the EFSF's greater borrowing limits.

But the Germans refused to countenance such an expansion of the EFSF. Instead, Merkel insisted that any shortfall would have to be made up by the banks agreeing to accept a write off of part of the debt. Hence there would have to be a controlled and negotiated default. In return the Greek government would have to accept a further round of austerity measures, a fire sale of its public assets, the proceeds of which would be used to pay off its debts, and far closer supervision from the 'troika' inspectors.

The original bailout of Greece had always been more of a bailout of the banks and the other major Greek bondholders than it had been a bailout of the Greek government. The 110 billion euro bailout fund had certainly been drawn on to help pay the wages of Greek public sector workers and other day to day expenses necessary to keep the Greek government functioning. But the lion's share of the money that was borrowed from this bailout was used to redeem the government bonds that were falling due, thus ensuring the banks and other major bondholders across Europe were able to get their money back. As a result, the exposure to Greek debt on the part of the banks and other financial companies across Europe had been substantially reduced over the course of the previous four quarters. They were therefore in a position where they could far more easily absorb the losses imposed by a substantial write-down of the value of the Greek bonds they still held than they could have done a year earlier.

However, as we have seen the situation regarding the other PIGS had become far more precarious. The danger that other PIGS might be driven into a situation where they might have to negotiate a write down of their debts, or even unilaterally default, was now all the more greater than it had been in the spring of 2010 –

⁶ See 'Bailing out the bailout', *Economist*, 9th May 2011 and 'Fixing Europe's single currency', *Economist*, 25th September 2011.

⁷ See 'Hardline of IMF forced Germany to guarantee Greek bailout', *Guardian*, 19th May 2011.

particularly as the German government remained steadfastly opposed to any expansion of the EFSF that would be sufficient to convince the markets that this would not be allowed to happen. If one or more of the other PIGS defaulted a large slice of the reserves of banks across Europe, which were held in the form of government bonds issued by the defaulting countries, could be substantially devalued or even rendered worthless. Hence, there now loomed a far greater threat that the sovereign debt crisis might trigger a crisis in the entire European banking system.

Furthermore, a crisis in the European banking system could then rebound back on the sovereign debt crisis. If banks that were too 'large to fail' had to be bailed out, then governments across the eurozone would find themselves having to borrow vast amounts of money. Even governments that had up until now been considered financially sound could then rapidly find themselves in the similar position as the PIGS. The possibility that the sovereign debt crisis could spiral out of control was now all the more greater than it had been a year early.

The worries on the part of the major bondholders over such possibilities were further compounded by the long drawn out negotiations over Greece's second bailout. The general outlines of the bailout had been agreed in June. However, negotiations over the new austerity programme and its implementation dragged on until November, while the negotiations between the Greek government and its main creditors were not fully completed until February 2012. Such uncertainty over whether the Greek bailout would unravel or not only served to hasten the spread of the crisis.

In August, Italy found itself under speculative attack in the bond markets. Italy had from the very beginning of the debt crisis been considered the next in line after Spain. This was largely because it had a very high government debt to GDP ratio. However, unlike the PIGS, the Italian government's budget deficit had been relatively small. With the implementation of the austerity measures that had been motivated by the first Greek bailout, by the summer of 2011 this deficit had been more or less eliminated. Thus it had seemed Italy had been able to distance itself from the fate of the PIGS. But now with Italy - the third largest economy in the eurozone - beginning to slide down the slippery slope of falling bond prices, it was clear that the crisis was beginning to spread well beyond the PIGS.

By the autumn, rising fear that the sovereign debt crisis might trigger a collapse in the

European banking system had begun to raise concerns over Belgium, the Netherlands and even France. Even Germany now accepted the need to increase the 'fire power' of the EFSF. All agreed that, if the markets were to be calmed, there was a need for a 'big bazooka' that would convince major bondholders that their bonds were guaranteed against the possibility of default, and make it clear to speculators that if they sought to make a killing by driving down the price of any government's bonds there would be effectively unlimited funds to buy up any bonds they had to sell.

Yet as more eurozone countries found themselves on the 'danger list' the more colossal the 'big bazooka' would have to be, and the fewer the number of financially sound countries there would be to provide it with ammunition. The more delay there was in constructing a 'big bazooka' the worse the situation would become. The eurozone seemed to be rapidly approaching the point of break up.

Yet Merkel still remained reluctant to pledge more money to the EFSF for fear that Germany would also find itself in financial trouble. If Germany had to issue large amounts of bonds to raise the money to meet commitments to bailout the likes of Italy or Spain it could well find that its own bond prices would begin to fall. Germany would then itself be on the slippery slope to bankruptcy.

To go around this problem of Merkel's reluctance to sanction a substantial increase in the money pledged to guarantee the EFSF, attempts were made to solicit more funds from the IMF. But the US and other member states were not prepared to make further contributions to the IMF to allow it to bailout Europe if Germany was not prepared to pledge more money for the EFSF. Attempts to go cap in hand to China were likewise rebuffed.

In the end a further clever wheeze was devised to allow the EFSF to increase the amount it could borrow over and above the amount Merkel was prepared to pledge to guarantee its borrowing. Instead of guaranteeing the entire amount that was borrowed through the EFSF, it was proposed that the member states of the eurozone would only guarantee a proportion of the loans that it made to distressed governments. This 'leveraging up' of the funds available to the EFSF would then allow it to borrow several times the amount that the eurozone governments were prepared to pledge.



The PIGS' lifestyle upsets Merkel

But although this limited the amount of 'taxpayers' money that might be put at risk, this wheeze meant that the EFSF would have to ensure that it could maintain the confidence of the financial markets that the proportion of the loans it made to financially distressed governments over and above that guaranteed collectively by the eurozone governments, would be repaid in full. Otherwise it would not be able to borrow the additional funds. Thus the very mechanism to shore up confidence in the financial markets was therefore itself to be made, at least in part, dependent on the confidence of the financial markets.

For the bourgeoisie outside the closed policy making circles of Berlin and Brussels this proposal for a super-charged EFSF was far from convincing. It was yet another policy response that was too little and too late. The painfully slow decision making process of the EU coupled with what could only be described as the perilous obstinacy of Angela Merkel had, it seemed, allowed the crisis to spiral out of control.

The obvious solution for the governments of the eurozone was to make it clear to the financial markets that they were prepared to borrow as much money as was necessary to resolve the sovereign debt crisis. If this led to falling bond prices then the ECB would have to follow the example of other central banks across the world – particularly the US Federal Reserve Board and the Bank of England – and create vast amounts of money *ex nihilo* in order to buy up government bonds. As we shall see in more detail later, this would serve to kill two birds with one stone: it would serve to allow eurozone governments in financial distress to finance their debts, and it would serve to shore up the fragile European banking system.

Much to the exasperation of the world bourgeoisie outside Berlin and Brussels, Merkel – backed by both the Bundesbank and the ECB – resolutely refused to adopt such unorthodox and

imprudent monetary policies. They could argue that such policies were merely a quick fix that would only store up problems with inflation later on. What is more, they did nothing to solve the underlying problems of the eurozone that had given rise to the sovereign debt crisis.

So what were these underlying problems?

WHAT WAS THE UNDERLYING CAUSE OF THE EURO CRISIS?

Angela Merkel's morality tale – the story of the four little PIGS

It may well appear at first sight that the dramatic events that have unfolded during the 'euro crisis' have been first and foremost the result of 'fiscal irresponsibility' on the part of the governments on the periphery of Europe. Put simply, the governments of Portugal, Ireland, Greece and Spain, together with Italy, have been guilty of spending far in excess of the revenues they have been willing or able to raise by taxation. As a result they have incurred large budget deficits, which they have had to finance by borrowing from the international money and capital markets. They have thereby been accumulating debts that they can only repay when they fall due by further borrowing – not only to pay back the amount they originally borrowed, but also to pay off the interest due on these debts. They have therefore placed themselves in the purgatory of the imprudent, facing mounting debts and an increasing reluctance on the part of their creditors to lend them any further money for fear that they will be unable to pay it back. In doing so they have not only imperilled themselves but also the euro if not the entire European Union, as well as the prospect of a rapid world economic recovery.

This view that it is the governments of the PIGS that are primarily to blame for the euro crisis – although those financial investors reckless

enough to lend to them cannot be allowed to entirely escape responsibility – is one that has been widely propagated by mainstream commentators. It is a view that has also been forcefully propounded by Angela Merkel and the German government in order to justify taking a hard line towards first the PIGS and then Italy in the recurrent negotiations to resolve the crisis over the past two years.

Now of course, the more liberal hearted might well object that the PIGS present financial predicament has not been due so much to their ‘fiscal irresponsibility’, but is the result of the severe economic recession that followed the near meltdown of the global financial system in 2008. It was the recession that was the primary cause of the sharp and unexpected fall in tax revenues. After all the PIGS had played their part in worldwide efforts, agreed at the G20 meetings following the collapse of Lehman brothers, to prevent a catastrophic collapse in global demand by not slashing government spending in response to the sharp falls in tax revenues that had been caused by the economic downturn. They had merely done their bit by allowing their budget deficits to take the strain in cushioning the impact of the bankers’ crisis - without which the world economy would most likely have plunged in to depression on a scale greater than that of the 1930s.

In response to this Merkel would no doubt reply that governments across Europe had all faced sharp falls in their tax revenues as a result of the global economic downturn, but most European governments have not found themselves in the predicament faced by the PIGS. This is because they had made sure that they were in a far stronger financial position before the crisis of 2008. They had been prudent enough to prepare for the unexpected. As such, for Merkel, the crisis only served to expose both the profligate and perfidious nature of the politicians of the southern and western periphery of Europe. Unlike their more virtuous and prudent counterparts elsewhere in Europe, who remained true to their commitments to ensuring the financial stability of the eurozone, the politicians of the PIGS had failed to take the tough decisions when the times were good before the onset of the crisis.

In Germany, all the mainstream parties had both backed and subsequently implemented the so-called Agenda 2010, which was originally set out by Gerhard Schröder in 2003, in the teeth of at times vociferous opposition of the trade unions and other ‘entrenched interests’. In accordance with this wide-ranging programme of economic and social reforms substantial cuts were made to welfare programmes and legislation to make German labour markets more ‘flexible’. In addition, in 2006 plans were put forward to raise

the old age pension age in order to address the looming problem of an aging population and burdens this would place on the public purse. In contrast, it is claimed, despite all their effusive promises and commitments made at innumerable European summits, the politicians of the PIGS took the easy option. They failed to face down the entrenched special interests opposing ‘necessary reforms’. They continued to tolerate a large black economy, which meant that not only those who paid good money to tax consultants and lawyers to make themselves ‘tax efficient’, but any tom, dick or harry amongst the general population could avoid paying tax. They failed to take action to root out corruption in government. And perhaps worst of all, they courted popularity by increasing government spending on welfare and public services. In other words politicians of the PIGS consistently failed to show sufficient backbone in disciplining the working class.

As a result, the PIGS failed to get their house in order when times were good, and were therefore ill prepared when the wolves eventually turned up at the door. With a huff and a puff their defences of sticks and straw soon blew down.

With this morality tale Merkel has been able to claim the moral high ground and rally not only much of the European ruling classes but also much of the German electorate around her position of having ‘to be cruel to be kind’ to the PIGS in their current plight. If the PIGS are to be bailed out by the ‘German taxpayer’, she has insisted, then their politicians must be made to face up to the consequence of their previous actions and learn the hard way to mend their feckless ways.



	2007 (The eve of banking crisis)	2008	2009 (The eve of sovereign debt crisis)	2010
Eurozone as a whole:				
Government <i>deficit(-)/surplus</i> (+) and debt both as % GDP	-0.7 66.3	-2.1 70.1	-6.4 79.8	-6.2 85.4
<u>Germany</u>				
Government <i>deficit(-)/surplus</i> (+) and debt both as % GDP	+0.2 65.2	-0.1 66.7	-3.2 74.4	-4.3 83.2
<u>France</u>				
Government <i>deficit(-)/surplus</i> (+) and debt both as % GDP	-2.7 64.2	-3.3 68.2	-7.5 79.0	-7.1 82.3
<u>Italy</u>				
Government <i>deficit(-)/surplus</i> (+) and debt both as % GDP	-1.6 103.1	-2.7 105.8	-5.4 115.8	-4.6 118.4
<u>Spain</u>				
Government <i>deficit(-)/surplus</i> (+) and debt both as % GDP	1.9 36.2	-4.5 40.1	-11.2 53.8	-9.3 61.0
<u>Portugal</u>				
Government <i>deficit(-)/surplus</i> (+) and debt both as % GDP	-3.1 68.3	-3.6 71.6	-10.1 83.0	-9.8 93.3
<u>Greece</u>				
Government <i>deficit(-)/surplus</i> (+) and debt both as % GDP	-6.5 107.4	-9.8 113	-15.8 129.3	-10.6 144.9
<u>Ireland</u>				
Government <i>deficit(-)/surplus</i> (+) and debt both as % GDP	+0.1 24.9	-7.3 44.3	-14.2 65.2	-31.3 94.9
<u>United Kingdom</u>				
Government <i>deficit(-)/surplus</i> (+) and debt both as % GDP	-2.7 41.1	-5.0 54.8	-11.5 69.0	-10.3 79.9

Table 1 – The financial position of the PIGS compared with the UK and other eurozone member states. Source: Eurostat, ‘euroindicators’, no.153, October 2011.

Although Merkel’s morality tale has proved particularly persuasive, on closer examination it does not quite fit the facts. As has been pointed out by more perceptive observers, with the notable exception of Greece, the financial position of all the European governments beset by

sovereign debt crises over the last couple of years, by the most commonly used measures of financial stability, had been comparable with – and in some cases even better – than either of the supposedly more virtuous governments of Germany or France. As can be seen from table 1, in 2007,

on the eve of the financial crisis, both Spain and Ireland had significant government budget surpluses. Indeed Ireland had been running budget surpluses for several years. In addition, the burden of sovereign debt of both Spain and Ireland, as measured by the ratio of accumulated government debt to GDP, was not only well below the eurozone average, but also far less than that of both Germany and France. In fact whereas both Germany and France were in breach of the 'European stability and growth pact', which stipulated that eurozone countries should keep government deficits below 3% of their GDP and government accumulated debt below 60% of GDP, both Spain and Ireland were fully compliant. Portugal's deficit was only marginally above the 3% stipulated in the 'European stability and growth pact', and the burden of its government debt was not much more than that of Germany and France. It is true that Italy had an exceptionally high sovereign debt but, with its government budget deficits small, this debt had been more or less stable.

Thus the notion that these governments were somehow spending way above their means would seem to be little more than a fairy story. But if 'fiscal irresponsibility' was not the cause of the euro crisis, what was? And why did it take the immediate form of a 'sovereign debt crisis'?

Structural trade imbalances and the crisis of the eurozone – the alternative story

The main alternative explanation to that of Merkel's fairy story, which has been put forward particularly - but by no means exclusively - by more Keynesian inclined commentators, has been that the euro crisis had been caused by the structural trade imbalances that have arisen as a result of European monetary union. As such, the euro crisis is indeed a crisis of the euro.⁸

The starting point of all the various adherents to this alternative explanation is the observation that there are longstanding patterns of uneven economic development amongst the heterogeneous national economies that have come to make up the eurozone. In particular there has been a sharp differentiation between the more economically advanced economies of northern

Europe – which has come to constitute the core of the eurozone – such as Germany, France and Netherlands, and the less developed economies of the periphery, that includes all of the PIGS along with Italy.

Although the various proponents of this explanation may differ over the precise cause of this uneven economic development, they all concur that it has resulted in a longstanding divergence in the economic competitiveness between the core and the periphery of Europe. With the exception of those industries such as tourism and certain lines of agriculture where natural factors such as climate and soil give them an absolute competitive advantage over their northern neighbours, the capitalists of the periphery have found themselves at a competitive disadvantage. As a consequence, as their economies grow – and demand for more sophisticated manufactured goods and services increases – the nations on the periphery find that the amount they import from Germany and other northern economies tends to rise faster than the amount they are able to export to them. As a result there arises a tendency towards an imbalance of trade between the core and the periphery – with the core tending towards a trade surplus and the periphery tending towards a corresponding trade deficit. What is more, by the sweeping away of many of the barriers to international trade within Europe that had once served to protect the industries of the periphery, the introduction of the single market has only served to exacerbate this tendency towards trade imbalances between the core and the periphery of Europe.

In the past the governments of the peripheral economies had two options in addressing the problem of trade deficits. The first option was to constrain the demand for imports from the more advanced north by kerbing the growth of their economy through restrictive fiscal and monetary policies. But this option was far from popular since it meant high and rising levels of unemployment and downward pressure on wages and public spending. It also tended to restrict both private and public investment, which in turn only served to reinforce the relative underdevelopment of their economy.

The second, and ultimately the most favoured option, was for the government to devalue its currency. By allowing the rate at which its currency exchanged with the currencies of northern Europe to fall they were able to increase their economy's competitiveness. Thus, for example, if the Greeks had devalued their drachma relative to the German deutsche mark then the price of German imports would rise in terms of drachma – this would allow Greek firms competing with German imports to either raise

⁸ In the British press Martin Wolf of the *Financial Times* and Larry Elliot of the *Guardian* have been the foremost proponents of the view that the cause of the euro crisis is the underlying trade imbalances between the core and periphery of Europe and have also been highly critical of the austerity policies pursued by Angela Merkel. For a more detailed exposition of this position see Jörg Bibow, 'The euro debt crisis and Germany's euro trilemma', *Working Paper no. 721* of the Levy Economics Institute of Bard College. However, it is a view that is also echoed by many on the British eurosceptic right who can now claim that their persistent opposition to greater European unification has been at last vindicated.

their prices and profit margins, or else use the lower prices to expand their market share. Either way Greek firms would be able to increase their rate of profit. At the same time, the cost of production of Greek exports to Germany would become cheaper in terms of deutsche marks. Again Greek capitalists seeking to export to Germany could raise their prices or else gain greater market share relative to their German competitors via lower prices.

Of course the problem of this simple expedient of devaluation was that it was often short-lived. A fall in the exchange rate would lead to the price of imported commodities rising, thereby ultimately increasing the general level of prices and hence the cost of living. If the working class were able to claw back this rise in prices through increased wages then the competitive advantage gained by the country's capitalists over their northern competitors by means of the devaluation would soon be eroded as their wage costs rose. Indeed, frequent resort to the expedient of devaluation had led to chronic high price inflation - all too evident in the ridiculous accumulation of zeros on many of the banknotes issued in countries on the periphery of Europe - the most notorious of course being Italy.

However, with European monetary union, devaluation was no longer an option. With the introduction of the euro in 1999 the exchange rates in effect became irrevocably fixed. The option to transmute the tendency towards trade imbalances into a tendency for higher levels of inflation was then ruled out. But although joining the eurozone closed the door to devaluation as a means of addressing the structural tendency towards trade deficits, it at the same time opened another door for addressing this problem. Previously the global financiers had been reluctant to lend money to economies on the periphery of Europe precisely because of the propensity of these countries to frequent currency devaluations and high levels of inflation. If they lent money to such countries they could never be certain how much their money would be worth when they were repaid. Now they could lend, and be repaid, in euros: a currency governed by the ECB, which was both modelled on and imbued with the culture of the German Bundesbank that was long known for its resolute commitment to maintaining a solid and stable currency.

As a consequence, the trade deficit could be financed by borrowing on the global money and capital markets. The euros that flowed out to pay for the trade deficit arising from the structural imbalance of trade, could be more or less offset by the inflow of euros in the form of loans from foreign investors. Although the governments of the European periphery often took advantage of the willingness of foreign investors to lend money,

it was far more the private sector of these countries that took the new opportunities to borrow from abroad. Indeed what characterises the PIGS in the run up to the financial crisis was the exceptionally high accumulation of foreign private debt.



From private foreign debt to the sovereign debt crisis

Now at this point it may be asked how it came about that the accumulation of private debt arising from the PIGS chronic trade deficits happened to manifest itself as a 'sovereign debt crisis'? How did a problem of private debt become transmuted into a problem of public debt? To answer this it is necessary to look at how the financial crisis, which began with the credit crunch in the summer of 2007 and culminated with the near meltdown of the global financial system following the collapse of Lehman Brothers a year later, impacted on the banking systems of the PIGS.

It had been the PIGS banks that had been pivotal in the accumulation of private debt. The PIGS banks had taken advantage of the cheap and plentiful supply of short term loans available on the global money markets to borrow vast amounts of money. This money was then lent out in the form of longer term loans at significantly higher rates of interest to domestic businesses and individual households. By tapping the global money markets in this way the PIGS banks - like banks elsewhere - had been able to extend the amount they lent far beyond the limits warranted by the money deposited with them by their own domestic customers. However, by borrowing short and lending long in this manner, the banks were obliged to repeatedly 'roll over' their short term debt before the longer term debts owed to them fell due. As result they had become increasingly dependent on the continued supply of cheap money on the global money markets.

With the onset of the financial crisis the PIGS banks – just as banks elsewhere in Europe – found it far more difficult to borrow from the global money markets without paying significantly higher interest rates. Their profit margins, which arose from the interest they now had to pay to renew their loans from the global money markets, and what they had charged when lending to their customers, was squeezed or even became a loss. With mounting losses the banks found it difficult to borrow any money at all, and faced the prospect of bankruptcy if they could not meet the demands for repayment as and when their debts fell due. The banks' immediate response to this lack of 'ready cash' was to slash their lending to businesses and individual households. But this retrenchment in advancing loans and credit to the 'real economy' only served to cause a sharp slowdown in economic growth. As a consequence, demand for goods and services fell, companies went bankrupt and unemployment soared. Hence increasing numbers of the banks' customers found themselves having to default on their loans, thereby further intensifying the losses and liquidity crisis of the banking system.

Yet, although the banking systems of countries across both Europe and the world faced similar problems as a result of the financial crisis, it may be argued that the impact on the banking systems of the PIGS had been particularly severe because of their chronic trade deficits. Not only did PIGS banks face the severe shortage of money available to borrow on the global markets, they also faced the continued drain of the money deposited with them as importers withdrew money from their bank accounts to meet the demands for prompt payment from their foreign suppliers. What is more, to the extent that the fall in world trade led to a rapid fall in the PIGS exports, the banks found that the money being deposited with them by exporters from sales abroad was also falling. Thus it may be argued that the trade deficit greatly exacerbated the impact of the financial crisis for the PIGS banks by intensifying the shortage of money available to them.

The particularly severe impact of the financial crisis on the PIGS banking system can be seen to have undermined the financial position of their governments in two distinct ways.

First, facing a more severe liquidity crisis, the PIGS banks were forced to slash lending to their real economies much faster and further than elsewhere in Europe. This meant that the real economies of the PIGS tended to suffer a far sharper and more severe economic recession. As their economies contracted profits and wages fell, and unemployment rose. As a result tax revenues plummeted and the costs of unemployment benefits and other welfare measures rose –

leading to a far sharper rise in government budget deficit in the PIGS than in the core European countries.

The impact of the recession following the financial crisis was certainly significantly greater than that of the rest of the eurozone. The sharp rise in government deficits in response to the greater impact of the financial crisis therefore goes a long way towards explaining why the financial position of the PIGS deteriorated so markedly and made them vulnerable to speculative attacks from the bond markets.

Second, and more directly, under the rules of the European System of Central Banks, the national central bank – and ultimately the government – of each country was responsible for regulating and guaranteeing their own banking system. As such, despite the integration of the European banking system, each country was responsible for bailing out any bank that was deemed 'too big to fail'. With their banking system in a more precarious state due to the impact of the financial crisis, the governments of the PIGS were faced with the far more likely prospect of having to borrow money in order to bail out their banks.

This was clearly exemplified in the case of Ireland. The Irish banks had developed a particularly ferocious appetite for borrowing on the global money and capital markets before the onset of the financial crisis - with a large and increasing proportion of this borrowing having been funnelled by the banks into fuelling Ireland's great property boom. As a result the Irish banking system had grown out of all proportion to the size of Ireland's economy. In 1998 banking lending in Ireland had been a modest 60% of GDP. By 2008 this had grown to 200% of GDP, far higher than anywhere else in Europe. Much of this increased lending being funded by banks borrowing on global financial markets rather than from money deposited with the banks by their domestic customers.⁹

With the onset of the financial crisis the property boom collapsed, leaving the Irish banks facing huge losses. Both the Irish government and Ireland's central bank struggled to shore up the banking system by providing loans, and by forestalling a run on the banks by promising that the government would indemnify the bank's depositors against any losses. But this only served to defer the inevitable. In September 2010 the government was finally obliged to mount a comprehensive rescue of the Irish banking system. The Anglo-Irish bank along with a number of smaller banks was bailed out to the

⁹ See Morgan Kelly, 'The Irish credit bubble', *UCD Centre for Economic Research Working Paper Series*, University College Dublin.

tune of 45 billion euros, which the government had to borrow. This bailout amounted to more than 30% of Ireland's annual GDP – far greater than the bailout of the UK banks, which cost the British government the 'mere' equivalent of 6% of Britain's annual GDP. As a result, a large slice of the private debt held by the banks was effectively nationalised. As can be seen from table 1, Ireland went from being one of Merkel's pet PIGS before the crisis – having both a budget surplus and one of the eurozone's lowest sovereign debt burdens – to the back of the class – with one of the highest debt to GDP ratios together with a substantial budget deficit.

But, as we have mentioned earlier, it is not merely the fact of governments having to nationalise private debt that has been a problem, but also merely the possibility of having to do so. This clearly has been the case with Spain.

Spain was particularly badly hit by the economic recession that resulted from the financial crisis. From a surplus in 2007 the Spanish government found itself running a budget deficit of more than 11% by 2009. The borrowing required to cover this deficit had caused Spain's public debt to rise, but this was from exceptionally low levels compared with other eurozone economies. As can again be seen from table 1, the government's debt to GDP ratio still remained significantly below the 60% stipulated by the 'European stability and growth pact', and certainly well below that of both Germany and France.

However, like Ireland, Spain had experienced a prolonged property boom before the onset of the crisis. The bursting of the property bubble had

left the Spanish banks nursing considerable losses. However, the Spanish property boom had been far less reliant on foreign borrowing than had been the case in Ireland. As a consequence, the banking sector had not grown to such grotesque proportions relative to Spain's much larger GDP. This, together with Spain's more decentralised and regulated banking system, meant that the Spanish government was able to avoid having to bail out the banking system on anything like the scale seen in Ireland – or indeed the UK for that matter – up until the spring of 2012.

Nevertheless, as the financial markets have been well aware, the Spanish banks have been in considerable trouble ever since the collapse of the property bubble in 2008. In order to shore up confidence in the banking system, the Spanish government was obliged to announce in May 2009 that it had plans for a bailout costing up to 99 billion euros (almost 10% of its GDP) if it proved to be necessary. It can be argued that it has been the continued possibility that the Spanish government might have to borrow such large sums to bailout its banks, on top of the amount that it is having to borrow simply to finance its budget deficit, that has spooked the markets and has made Spain one of the PIGS, despite its relatively low level of government debt.

However, chronic trade deficits, and the consequent growth of foreign debt to pay for them, were not a sufficient precondition for a government to find itself as one of the PIGS. After all the UK has run a trade deficit for decades and has accumulated high levels of foreign debt. The UK economy also saw a sharp economic



contraction after the onset of the financial crisis and its banks had to receive a huge bailout from Her Majesty's government. But Britain did not experience a sovereign debt crisis.

What was the reason for this? Firstly, the UK was not part of the eurozone and was therefore able to allow its currency to devalue. Indeed the pound was to fall by 25% against the euro in the immediate aftermath of the financial crisis.

Secondly, the Bank of England has had a far greater freedom of action when compared to both the ECB and to each of the national central banks within the eurozone. The Bank of England, like the Federal Reserve Board in the USA, has been free to adopt unorthodox monetary measures to mitigate the impact of the financial crisis. Most importantly, as we have previously mentioned, the Bank of England has been able to adopt the policy of 'quantitative easing' by means of which it has created vast quantities of money *ex nihilo* in order to buy up government bonds. By buying up government bonds, which the government issues in order to borrow money from the global capital markets, the Bank of England has allowed the British government to finance its rapidly growing debt – without causing a collapse in the price of its bonds and thereby triggering a sovereign debt crisis. At the same time, it has also served to shore up the British banking system, since British banks hold a large part of their reserves in the form of government bonds. A sharp fall in government bond prices, due to an over issue of bonds to finance government debt, would have left the banks dangerously exposed to unexpected losses or cash shortages.

However, under the rules governing the European System of Central Banks, although each national central bank retains responsibility for maintaining the stability of the banking system within their own jurisdictions, most of their powers over the determination of monetary policy have been surrendered to the ECB. The ECB has been highly reluctant to follow the Bank of England and the US Federal Reserve Board in adopting the policy of 'quantitative easing' for fear of generating inflation. Furthermore, in order to avoid accusations that it operates monetary policy in favour of certain countries, its regulations limit its ability to buy government bonds of particular countries, even if such purchases are carried out with money borrowed rather than simply created out of nothing. The European monetary system has therefore not been able to act to anything like the degree of either the Bank of England or the US Federal Reserve Board in addressing the sovereign debt crisis in the PIGS. Indeed, by raising interest rates in April 2011 in order to head off inflationary pressures in Germany, it has exacerbated the problems of the PIGS.

Sovereign debt crisis as a crisis of the euro

Thus, in short, it is argued that the accumulation of total debt – particularly debt borrowed from the global financial markets – in the peripheral economies has served to cover up the underlying structural trade imbalance within the eurozone. But with the financial crisis of 2007/8 international financiers became reluctant to continue lending to maintain the growing debts of the peripheral economies necessary to sustain the underlying trade imbalance. The underlying trade imbalances, combined with the architecture of the European System of Central Banks, has resulted in a fundamental fault line in the eurozone, between the core and periphery – that has become manifest in the sovereign debt crisis.

It is perhaps no surprise, therefore, that the sovereign debt crisis has become widely seen as a crisis of the euro and indeed the entire 'European project'. The basic problem of the euro, in this view, is that it is something of a half-way house. Even in moderately sized nation states such as France, Italy or the UK there are distinct regional differences in terms of economic development and prosperity. In the UK, for example the division lies broadly between the prosperous south-east, based largely around the profits reaped from the City of London, and the old industrial areas of the north and west. These differences give rise to money flowing towards the most prosperous areas. For the continental wide eurozone, which encompasses countries with greatly varying histories of economic development, such differences are all the greater.

In a nation state with its own currency these differences in economic development can be mitigated by the state. The provision of uniform welfare policies mean that money is transferred back to the more deprived regions. The state can generate income and employment in less developed regions through the relocation of government offices. The state can also actively counter the tendency for wealth and production to concentrate in the already prosperous regions through investment in infrastructure such as roads and railways that promote new centres of capital accumulation and economic growth. However, a nation state will dispose of 40%-50% of the nation's GDP. It has considerable economic weight. The European Union budget in contrast accounts for little more than 2% of the European Union's GDP. What is more, as it is made up of 27 sovereign nations – all jealous of their own interests – the political agreement necessary to establish even a minimum system of economic transfers is fraught with difficulties. Therefore both the European Union and the eurozone, as presently constituted, are unable to provide the means to carry out the large scale transfers of money and wealth necessary to contain the

structural imbalances caused by uneven economic development within the eurozone.

It can therefore be concluded that now the fundamental fault lines within the eurozone have been exposed by the financial crisis, there are two stark options. Either the single currency breaks up or there has to be an acceleration in the process of political, fiscal and monetary union.

Merkelian response

The argument that the underlying causes of the euro crisis are *structural*, rather than due to merely the moral failings of southern European politicians, is one that has been taken up forcefully by those exasperated at Merkel's apparently perilous obstinacy in defending the *status quo* concerning the eurozone, and stubbornly insisting that the 'rules are the rules', regardless of the dangers this might involve for the world economy. Yet the more sophisticated supporters of Merkel's political stance may well concur with much of the argument that the underlying cause of the euro crisis was the structural trade imbalances arising from the divergence of relative economic competitiveness between the core and periphery of Europe. They may well also agree that such structural imbalances have been covered up by both large scale public and private borrowing from the global financial markets. But, for them, what is necessary is to sustain the political and economic restructuring of the European periphery, which had always been central to the introduction of the euro.

As we have seen, before European monetary union, governments had been able to address the problem of a lack of economic competitiveness relative to their northern neighbours by the simple expedient of devaluation. This, it could be argued, had allowed them a degree of flexibility that had been necessary during the postwar era to maintain social and political cohesiveness. In the face of a militant and politically organised working class it was often wise to avoid an open confrontation that would occur if economic competitiveness was to be increased through wage cuts and labour market reforms designed to increase labour flexibility. Devaluation could therefore be seen as a means of both defusing and deferring class confrontation.

The shift in class forces in the 1980s opened up the possibilities for the bourgeoisie in the periphery of Europe, like their brethren in the core of Europe, to take a more confrontational stance. However, the long established political and institutional practices made such a shift in stance difficult since any concerted attempt to claw back the gains the working class had made during the postwar era were prone to be undermined by the long established expectation

of devaluation as an easy way out. Individual capitalists and politicians had come to anticipate that devaluation and inflation would always come to their rescue. Individual capitalists could always break ranks to come to some compromise with their workers secure in the knowledge that other capitalists would soon break ranks and follow them. Sooner or later, the government, faced with the prospects of widespread bankruptcies and the consequent political instability due to rising unemployment, would be obliged to countenance a substantial devaluation, which would then allow them to raise prices and thereby restore any profits that they may have lost by caving in to their workers' demands in the first place. Likewise, individual politicians could always break ranks in order to win short term popular support by opposing neoliberal reforms to labour legislation and welfare systems 'necessary to improve economic efficiency and competitiveness', sure in the knowledge that there was the easy option of devaluation.

European monetary union was seen by the European bourgeoisie, not least by the bourgeoisie within the peripheral countries themselves, as a means to stiffen resolve in confronting the 'entrenched interests' opposed to the 'necessity' of economic and social restructuring. This was all the more important for peripheral countries that had for too long lagged behind in terms of competitiveness compared with the core European economies. The hard line monetary policies of the ECB, inherited from the Bundesbank, would ensure that the euro would be a 'hard' currency. There would be no option to devalue and inflationary policies would not be tolerated. As such there was no place to hide. Ultimately politicians and capitalists, particularly in the periphery, had to grasp the opportunities opened up by the single market, and the new neoliberal world order more generally, or die.

For such Merkelians, the fact that many within the ruling classes of the periphery, whether politicians or capitalists, took advantage of the cheap loans to indulge in speculative over borrowing, which then allowed them to postpone the necessary social and economic restructuring that would allow them to become 'more like Germany', only serves to demonstrate the need to sustain the rigour of European monetary union, now at this its most testing time. This is the view that not only emanates from Berlin, Brussels or Paris but is broadly shared by the bourgeoisie of the European periphery.

To this extent the issue that separates such supporters of Merkel and many of her critics boils down to bourgeois strategy. Is it better in the current circumstances to use the euro crisis to force through neoliberal reforms and economic restructuring through a full scale confrontation

with the working class? Or is this strategy too risky, both in terms of maintaining social cohesion necessary for continued capital accumulation, and in terms of the danger of triggering an economic depression, which could cause untold economic damage, the consequences of which even the bourgeoisie could not be sure to escape?

Of course, calculus of risk and gain depend upon what you stand to gain and what you stand to lose. This as we shall see is important in understanding how the ruling classes within Europe dealt with the euro crisis and why their policies have been criticised by those outside Europe. But before considering this we shall make a brief digression.

Trade imbalances: the underlying cause or merely a consequence? – the question of investment flows and the structure of capital accumulation

As we have seen, it can be argued that the underlying cause of the sovereign debt crisis was the structural trade imbalances between the core and the periphery of the eurozone that had been covered up over the last decade by the plentiful supply of loans available on the global money and capital markets. This would certainly seem to explain why it was not profligate government spending that has been the common characteristic of the PIGS in the run up to the crisis but rather the accumulation of foreign debt. However, as we have also seen, this structural trade imbalance is seen in turn as the result of a divergence in the competitiveness between the core and the periphery of the eurozone. But what is it that has caused this divergence in competitiveness. Is it, as the Merkelians imply, simply the institutional balance of class forces that mean German workers work longer and harder and are thus more productive?

Merkel herself has made much play of the fact that the German retirement age has been raised to 66, while in Greece the retirement age is a mere 60. This is taken to epitomise the fact that the Germans work longer and harder. But although they are more productive, and hence the German economy is far more competitive, German workers take longer holidays, work less hours a week and have much higher wages and pensions. What is important for competitiveness is the productivity of labour and this is not merely dependent on how hard or how long workers work, but on the means of production they have available to work with. German workers have a far higher productivity of labour because are equipped with state of the art machinery. Indeed however much harder or longer the Greeks work, however much the Greek government reduces the burden of taxes on business by cutting corruption and

'wasteful' public spending, the Greek economy is in no position to compete directly with German industry without large scale investment in productive capital.

In the long term, it is the investment of productive capital that determines the relative competitiveness between economies, and this in turn depends on the overall structure of capital accumulation that divides the world into core and peripheral economies. We shall return to this point in more detail later, but now we shall consider why the European ruling classes have steadfastly opposed what has been seen as the obvious solution to the euro crisis.

THE SOLUTION TO THE EURO CRISIS... OR THE EURO CRISIS AS THE SOLUTION?

So, as we have seen, for bourgeois policy makers and many commentators outside of the eurozone it has seemed that, what can only be described as the perilous obstinacy of Angela Merkel, coupled with the rather ponderous European decision making process, had, by the autumn of 2011, allowed the euro crisis to spiral out of control. As a result, the entire world economy had once again been put in danger of yet another global financial crisis, and with this the danger of a 1930s-style depression, in little more than three years.



But Angela Merkel's insistence that the cause of the crisis was both the 'fiscal irresponsibility' and duplicity of the governments of the PIGS, and that they had to be made to learn their lesson through a harsh dose of austerity, has been seen as not merely reckless, but counter-productive. As we have pointed out, the draconian conditions imposed on the Greek bailouts have only served to drive Greece further into debt and made default ultimately inevitable. Of course, Merkel may retort that it was necessary to make an example of Greece as a warning to the other PIGS to put their

house in order. But, by insisting on making an example of Greece, Merkel has ended up driving not only the rest of the PIGS into cutting 'too far too fast and too early', but also much of the rest of Europe. The resulting wave of austerity measures across Europe is now threatening to kill off the fragile European economic recovery. With 70% of Germany's exports going to the rest of the eurozone, slow economic growth, or even economic contraction, in the rest of Europe can only rebound on Germany's own export-led economic recovery. Indeed, Merkel's misguided policies of stringent austerity could be seen as a case of Germany cutting off its nose to spite its face.

Yet it has been not only the failure of Merkel, and indeed much of the rest of Europe's ruling circles, to act promptly and decisively to contain the euro crisis that has so exasperated the bourgeois policy makers and commentators beyond the eurozone, but also their conservatism that has prevented the radical institutional, economic and political reforms necessary to prevent such a crisis reoccurring in the future. As the euro crisis has made clear, either the eurozone must move towards greater monetary, fiscal and political integration, or the eurozone will break up. Yet despite all her repeated avowals of the German government's commitment to the euro – and the European project more generally – Merkel has seemed reluctant to countenance the radical reforms necessary for further European integration.



So, what was to be done?

By the autumn of 2011 there had emerged a broad agreement from mainstream opinion outside Europe's ruling circles as to what should be done to resolve the euro crisis, prevent the breakup of the eurozone and thereby pull the world back from the brink of yet another global financial crisis.

First, and most urgently, the immediate sovereign debt crisis must be contained. The governments and monetary authorities of the eurozone should make it clear that they will take whatever action is necessary to prevent an uncontrolled default of any member state. If necessary this might mean that they would have to bite the bullet and accept full scale 'quantitative easing' in order to finance government debt across the eurozone.

Second, the ESM will have to be put in place without further delay. Governments of the eurozone, particularly Germany, will have to be prepared to provide it with ample funds so that it could prevent a future euro crisis.

Third, there is a need to promote economic growth. The austerity measures imposed on heavily indebted states will have to be eased. At the same time Germany will have to adopt more expansionary fiscal and monetary policies to offset the austerity measures necessary to reduce the deficits in the PIGS, even if this meant the Germans had to tolerate significantly higher rates of inflation and a greater burden of debt.

For the longer term there will have to be progress towards far greater financial, fiscal and political integration.

First, in terms of finance, this will mean co-responsibility for financial regulation. Instead of each national central bank having the primary responsibility of regulating its own banking and financial system and, as a consequence, being responsible for guaranteeing to bailout any bank deemed 'too big to fail', the European System of Central Banks will have to be collectively responsible for banking and financial regulation for the entire eurozone and, as a result, will have to take collective responsibility for any guarantees or bank bailouts. Hence, if a strategically important bank failed, then the costs of its bailout would be shared by all the governments in the eurozone. The banks will therefore be guaranteed by the resources of the entire eurozone rather than that of a single country. Financial co-responsibility will make banking regulation far more effective by making it harder for banks to play one regulator off against another. It will thereby make it possible to reduce the risk of a banking crisis in the first place. Furthermore, even if a banking crisis did arise it would be far less likely to spill over into a sovereign debt crisis as it has done in Ireland and Spain since the burden of government debt required for any bailout would be shared by all eurozone states.

Second, to prevent the build-up of unsustainable levels of government debt there will have to be more strict and enforceable rules over how much national governments can tax and spend. The 'growth and stability pact', which has been repeatedly breached by even Germany and

France, will have to be greatly strengthened. But, as many of the more Keynesian inclined commentators have pointed out, simply bolstering the 'growth and stability pact' to ensure greater fiscal discipline would not be sufficient to heal the fault lines within the eurozone. If the divergence between the economies of the eurozone were to be contained there will have to be mechanisms to allow substantial 'fiscal transfers' between member states: that is the 'taxpayers' of more prosperous economies would have to pay for public investment projects, and perhaps even welfare programmes, in the less prosperous economies.

As a consequence of both financial co-responsibility and greater fiscal integration it will be necessary to have greater political integration in order that decisions over financial and fiscal matters could be made swiftly and with legitimacy. There would therefore have to be a huge stride towards a United States of Europe amongst the states making up the eurozone – even if this meant leaving members of the European Union that are outside the eurozone behind.

However, although such measures might appear obvious from the outside, the politicians and policy makers within the power centres of Europe, led by Angela Merkel, have appeared reluctant to take the prescribed action despite the dire circumstances that were facing them and the world. Indeed, they have remained largely committed to their reckless and counter-productive policies.¹⁰

Of course, it could be argued that the process of European integration necessary to resolve the problems of the euro in the long term, with all the loss of political sovereignty of national governments this would involve and the economic disparities it would have to overcome, was simply unfeasible. The euro crisis had simply made manifest that the project of European monetary union had been misconceived all along. As such, it would perhaps be better for European leaders to recognise this and allow the breakup of the eurozone.

This has led some of the more cynical commentators, from both the left and the right, to suspect that Germany's true intention is to use the euro crisis as a means to force a breakup of

the eurozone – either by Germany breaking away to form a new strong deutsche mark zone in northern and eastern Europe, or else by expelling the PIGS from the euro by forcing them into default. This is certainly a position held by a significant section of the German bourgeoisie, but it has yet to become a mainstream position in Germany and, at least ostensibly, it is not a position that is held by Merkel's government. Indeed, Merkel would seem to share with the European ruling class more generally the long held commitment to European integration of which monetary union is an essential part.

So, it would seem, certainly from the perspective of Washington, New York and the rest of world, that the problem at the centre of the euro crisis is to be found, not with the fiscal irrectitude of the PIGS, but in the pig-headedness of the Germans that have been stubbornly sticking to long discredited economic theories of financial prudence. So what is the response to the charges made against both the Germans and the European ruling circles that their handling of the euro crisis has been both 'reckless' and 'counter-productive'?

The view from Brussels and Berlin

Although those within the European ruling circles would certainly not deny the seriousness of the euro crisis, they could certainly claim that fears voiced in the autumn of 2011 that the world was on the brink of another global financial crisis were a little exaggerated. Far from acting too little too late and losing control of the situation, the view from Brussels and Berlin was that they had been acting all along in a calm and calculated manner that has been necessary to keep control of the crisis.

This is certainly the view of the European monetary authorities. The ECB has been at pains to refute the allegations that its stubborn commitment to conventional monetary policies has meant that it has repeatedly acted too little and too late to bring the euro crisis under control.¹¹ As is pointed out, the ECB was far from being slow in reacting to the financial crisis of 2008. Along with other major central banks, such as the US Federal Reserve Board and the Bank of England, the ECB had acted quickly to cut interest rates to exceptionally low levels and adopted highly unorthodox measures to prevent a meltdown of the European banking system. It had greatly extended its 'lender of last resort' facilities by both enlarging the number of banks and other financial institutions that it was prepared to provide 'overnight' emergency loans, and greatly extended the forms of collateral that these

¹⁰ Although the focus of political debate has been on the sovereign debt crisis and the pressing imperative to cut government deficits, there has been a widespread recognition by economists and other policy advisers in Europe that if the euro is to survive there is a need for further progress towards financial and political union. The issue, as we shall see, is how this should be done. For a discussion of the euro crisis from an influential Brussels think-tank see Jean Pisani-Ferry, 'The euro crisis and the new impossible trinity', *Bruegel Policy Contribution*, Issue 2012/11.

¹¹ See, for example, 'The ECB's response to the financial crisis', *ECB Monthly Bulletin*, October 2010.

institutions were required to put up to secure these emergency loans. Indeed, it had been prepared to go as far as lending money against 'toxic assets' whose value was far from certain in order to prevent banks going bust due a lack of ready cash. Subsequently, with its exceptional 'short term refinancing operations' (STRO) and 'medium term refinancing operations' (MTRO), the ECB has also provided longer term loans to banks of three months and up to a year respectively.

Although it had been planned to phase them out during 2009, the ECB had sustained these unorthodox measures with the onset of the sovereign debt crisis in order to shore up the European banking system. In addition the ECB can also claim that it was prepared to accept the relaxation of its self-imposed restrictions on buying government bonds in order to play its part in the Greek bailouts of both 2010 and 2011.

Furthermore, in December 2011, in what was tantamount to its own version of 'quantitative easing', the ECB announced it was launching a 'long-term refinancing operation' (LTRO) in which it was prepared to create money to lend to banks for up to three years at below market rates of interest. This money was then used by banks to buy up government bonds. The LTRO, like 'quantitative easing' acted to both bolster the reserves of the European banks but also helped governments, particularly those of the PIGS, to shore up the price of their bonds and thereby help them refinance their debts.

But the LTRO had distinct advantages for the ECB over 'quantitative easing'. Firstly, the ECB did not have to take what could turn out to be the politically sensitive decisions concerning how much it should spend on buying up the bonds of each of the governments within the eurozone. The decision of what bonds to buy would be left to banks. Secondly, and perhaps far more importantly, pumping money into the European banking system via the LTRO served to untangle the European banking system from the sovereign debt crisis and thereby reduced the impact any default by a sovereign state might have on the financial system.

With the rate of interest to be paid on money borrowed from the ECB through the LTRO at 1% while the rate of return offered by the PIGS government bonds was standing at 5% or more, there was certainly the tempting possibility of making a fat profit over the course of three years if banks bought up the sovereign debt of the PIGS, at the same time as making it easier for them to meet their regulatory reserve requirements. However, for most banks such prospects of making a fat profit had to be weighed against the distinct possibility of a default that might render these bonds worthless. However, for banks based in the PIGS this was far less of a

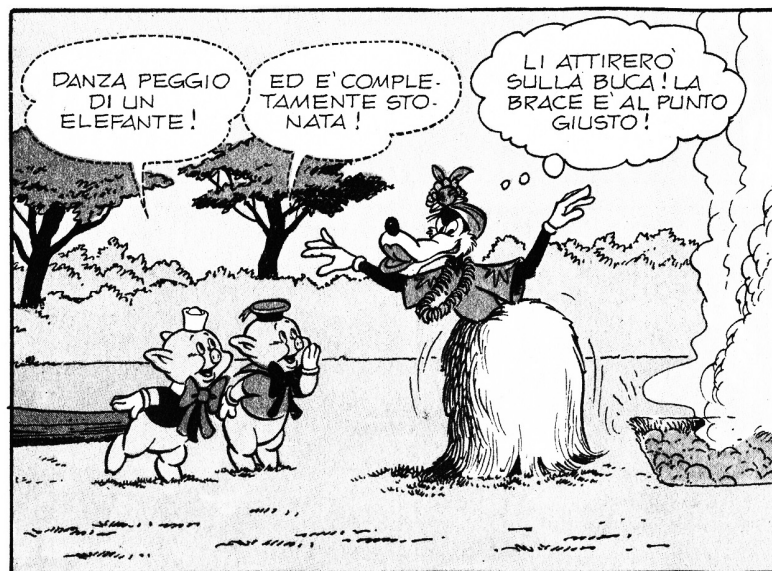
concern. After all if their government defaulted they would go belly up anyway. Hence banks in the PIGS were particularly keen to utilise the LTRO to borrow money in order to buy up their own government's bonds. As a result, the LTRO has served to concentrate the bonds of the PIGS governments into the hands of their own banks. Therefore, if one of the PIGS defaults on its debts the resulting losses will be concentrated far more in its own banking system. The risk of a sovereign debt crisis precipitating a crisis of the entire European banking system could be substantially reduced.

However, this was not all. Although it has been unwilling to admit it openly, some German economists have pointed out that the ECB has also facilitated a huge 'back door bailout' of the banking systems of the PIGS on the part of the Bundesbank through the rather arcane TARGET¹² euro payment system.¹³ The Target system was set up with the introduction of the euro as a means to carry out payments between banks across the eurozone. As such it was designed to ensure the smooth flow of euros between the different national banking systems. However, it was recognised that the day to day ebbs and flows of euros across borders could cause problems. The banking systems of some member states might find that they had a net inflow of euros, others may find that they had a net outflow. Hence temporary gluts and shortages of euros could arise. This could cause the interest rates at which banks in a particular banking system lend to each other to become highly volatile, which could be highly destabilising.

In order to overcome this provision was made for banks in banking systems that were experiencing a shortage of euros to borrow euros 'overnight' from their own national central bank. This central bank would then borrow euros from the ECB. The ECB would then borrow euros from the central banks that had a surplus of euros. These central banks would then borrow money

¹² TARGET stands for Trans-European Automated Real-time Gross settlement Express Transfer system.

¹³ The German economist Hans-Werner Sinn was the first to suggest that the Target payment system was being used as a back door bailout for the banks of the PIGS. See Hans-Werner Sinn and Timo Wollmershauser, 'Target loans, current account balances and capital flows: the ECB's rescue facility', CESifo Working Paper No. 3500, June 2011. This was extended and updated in the National Bureau of Economic Research Working Paper No. 17626, November 2011. Also see Hans-Werner Sinn, 'Rescuing Europe', CESifo Forum, Special Issue, August 2010. Although Sinn is an ardent defender of Angela Merkel's policies regarding the euro crisis – arguing against Merkel's critics that Germany, though its back door bailout, has been actively attempting to defuse the crisis – Martin Wolf has also taken up the issue of Target loans. For Wolf Target loans are an indicator of the fundamental problem of trade imbalances arising from the divergence between the core and periphery of Europe.



from their own banks. In this way euros would be transferred from those banking systems temporarily experiencing a surplus to those with a deficit.

This provision of the Target system had only been intended to cover very short term fluctuations in the flows of euro payments across the eurozone. Indeed, up until 2008, over the course of the year the lending and borrowing by the central banks through the Target system had more or less cancelled out. However, with the financial crisis this had changed. As we have seen, the banking systems of the PIGS had faced a severe drain of euros as they found it increasingly difficult to cover the money being sent abroad by their depositors to pay for imports by borrowing from the global financial markets. In response they used the facilities provided by the Target system to borrow from their central banks. But this shortage of euros was not temporary. The PIGS banks have had to repeatedly roll over these Target debts as well as borrowing more to meet the growing shortage of euros. Because Germany was the main banking system with a surplus of euros, the ECB ended up borrowing from the Bundesbank. With no provision in the TARGET system having been made to prevent the accumulation of TARGET debts, the ECB simply chose to turn a blind eye. As a result, by August 2011 the Bundesbank had, in effect, ended up lending more than 390 billion euros to shore up the banking systems of the PIGS. By the spring of 2012, following the crisis in the autumn, this 'back door' loan has soared even higher, reaching a figure of 644 billion euros.¹⁴

¹⁴ See Han-Werner Sinn and Timo Wollmershauser, 'Target loans', National Bureau of Economic Research Working Paper No. 17626, November 2011, and T. Garton Ash, 'The Greek people now face a stark choice: in or out?', *Guardian*, 17th May 2012.

As we have pointed out, the bailout of Greece had been more of a bailout of the banks than it had been a bailout of the Greek government. This, combined with the ECB's adoption of unorthodox monetary policies and the 'secret bailout' of the PIGS banking system by the Bundesbank through the TARGET payment system, has amounted to a substantial and concerted intervention on the part of both the European monetary and political authorities to shore up the European banking system during the unfolding of the euro crisis. In doing they have acted to insulate the European banking and financial system from any fallout from a sovereign debt default.¹⁵

Playing with fire or the re-forging a new Europe?

Yet, although the European political and monetary authorities can claim they have acted boldly and decisively to reduce the risks that a default on sovereign debt might bring down the European banking system, and with it the entire structure of global finance, it is still true that they have held back in their attempts to resolve the sovereign debt crisis by rescuing endangered governments.¹⁶ By doing so the European authorities have allowed the euro crisis to balloon to the point that, by the autumn of 2011, if there

¹⁵ As we have seen, public debt was only the tip of the iceberg in the euro crisis. It was more a problem of the over-accumulation of private debt that had been channelled through the banks that had placed the PIGS in their predicament. It can therefore be argued that the sovereign debt crisis was not merely the result of the banking and financial crisis of 2008 but a continuation of that crisis. Indeed, by their actions to shore up the European banking system, the European authorities had left the sovereign debt crisis of the PIGS as the main manifestation of the continuation of the banking crisis.

¹⁶ Indeed, their attitude towards saving the banks has been in stark contrast to their attitude to rescuing governments facing serious debt problems. This is perhaps best exemplified by the 1% interest rate banks will have to pay for drawing on the ECB's recent LTRO and the 4% interest rate Greece is obliged to pay for drawing on the EFSF.

had been another default on sovereign debt then all the efforts to buttress the European banking system may well have been to no avail. Merkel, and indeed the policy making circles of both Berlin and Brussels, can be certainly accused of playing with fire.

The response from Brussels and Berlin would no doubt be – if they were prepared to be explicit – that they had played an astute game of brinkmanship. Far from having allowed the sovereign debt crisis to spiral out of control, they have used the crisis as an opportunity to force through what they see as the long overdue economic and political reforms ‘necessary’ for the future of European capitalism. Indeed, they could argue, it was only by bringing the crisis to the point where it threatened to engulf the entire eurozone, if not the European Union as whole, that it was possible to overcome the inertia and resistance across Europe to the reforms that were necessary if the underlying causes of the sovereign debt crisis were to be addressed.

As such their critics have put things the wrong way round. Rather than first of all resolving the sovereign debt crisis and then putting in place the longer term reforms necessary to address the underlying problems of the eurozone, it has been necessary to maintain the pressure of the euro crisis to ensure these reforms could be put in place.

On the economic level, it can be argued that it was necessary to increase the competitiveness not only of the PIGS but Europe as a whole. By making an example of Greece, and allowing the crisis to escalate to the point where it might engulf Europe as a whole, it has been possible to force through austerity measures across the continent. This has not only provided governments with the opportunity to reduce the burden of public spending to levels closer to that of the USA, it has also opened the way for pushing through neoliberal reforms such as the repeal of ‘restrictive employment laws’ and the privatisation and commercialisation of the public sector.

On the political level, the euro crisis has served to concentrate the minds of diplomats and politicians towards accepting the steps necessary for greater political unification – with all the loss of national sovereignty that this implies. The introduction of the euro in 1999 together with the ascension to the European Union of much of the former Eastern Bloc countries had marked a rapid acceleration towards European integration. However, the enlargement of the European Union had rendered what had already been a rather cumbersome political decision making process far more unwieldy. Attempts to streamline the decision making process through the introduction of a new constitution of the European Union in

2005 and the subsequent Lisbon Treaty have faced concerted popular opposition, which has resulted in embarrassing referendum defeats in France, Ireland and the Netherlands. As a consequence, much to the consternation of the eurocrats in Brussels, politicians across the European Union have been reluctant to press ahead with the process of political unification. With the euro crisis, the politicians of Europe have had to put such qualms aside. The crisis has forced the issue: either the eurozone, and with it perhaps the European Union itself, would explode, or there had to be further progress towards unification.

Thus, it was only after the governments of the European Union had accepted the need for economic and political reforms that action could be taken to at least contain the sovereign debt crisis. First of all, after the drama of the long drawn out negotiations, Greece was obliged to sign up to the draconian and rather humiliating conditions of its second bailout. Secondly, all the member states of the eurozone had to sign up to a new ‘fiscal compact’. Unlike the ‘European growth and stability pact’, which was merely a commitment on the part of member states to do their best to meet the prescribed fiscal rules, the fiscal compact will not only impose more stringent rules, but will be legally binding. As such the member states will be obliged to surrender a substantial part of their national sovereignty to Brussels, and marks a decisive step towards greater political union.

It was only once these measures had been accepted that Germany accepted that a modestly enhanced ESM should be established a year earlier than previously agreed, and the ECB announced its decision to launch its LTRO scheme in order to calm the sovereign debt crisis and shore up the European banking system.

Now of course it could be argued that the ‘fiscal compact’ agreed at the height of crisis in the autumn of 2011 might satisfy Angela Merkel’s





vision of a European fiscal union that would ensure fiscal rectitude of member states, but it would do little to address the underlying problems of the eurozone. It would do nothing to allow for fiscal transfers between member states that could offset trade imbalances nor would it promote economic convergence by promoting economic development in the peripheral countries. Indeed, the fiscal compact could make things worse. The fiscal compact more or less outlaws discretionary fiscal policy. In the event of another financial crisis the member states of the eurozone would be forbidden by law to absorb the deflationary impact by acting as a spender and borrower of last resort and allowing their debts to increase in order to play their part in preventing a 1930s-scale economic depression. Even if there is no Lehman's-style banking crisis, the fiscal compact effectively locks in austerity, and hence slower economic growth, across Europe for years to come. Furthermore, neither the earlier introduction of the ESM nor the ECB's LTRO have been sufficient to resolve the immediate debt crisis. These agreements may have served to contain the crisis for a while, but, as has been confirmed with the re-emergence of the crisis four months later, they only did so by once again 'kicking the can down the road'.

But from the perspective of Brussels and Berlin this is precisely the point. The agreements last autumn are only one preliminary step. After all, as the history of the European Union has repeatedly shown, it is one thing for European politicians to make grand commitments, it is quite another for them to carry such commitments out. No sooner than the ink has dried on an agreement than all the weaselling and backsliding can be expected to begin. Thus, it can be argued, the pressure must kept up in order that member states of the eurozone honour their commitments, and it is only once the fiscal compact is secure that further steps towards fiscal and monetary union can be made. There can therefore be no

attempt to resolve the crisis once and for all until the political and economic restructuring of Europe has been secured.

Sure enough, as expected by both Merkel and her critics, by March there were already growing concerns that the agreement of the previous autumn might begin to unravel.

Firstly, there were the Greek elections. Support for the two main bourgeois parties – PASOK and New Democracy – which had accepted the dictates of the troika, was collapsing. At the same time the 'radical left' Syriza party – which only months before had been on the margins of Greek politics – was being catapulted centre stage, with an unequivocal commitment to call the 'Germans' bluff' and demand that the terms of the Greek bailout should be radically renegotiated.

Secondly, there was the French presidential election. Although he had certain differences with Merkel and the European Commission over the handling of the euro crisis – particularly when it came to the interests of the French banks – Sarkozy had been broadly in favour of taking a 'hard line'. However, with the cold winds of austerity and economic stagnation reaching even the European heartlands, not only was there emerging substantial popular opposition to the Brussels-Berlin consensus, but also rising concerns amongst wider sections of the bourgeoisie across Europe that Merkel was going too far. As French President, François Hollande would be in a strong position to rally broad support across Europe for his demand for the 'fiscal compact' to be substantially renegotiated to allow 'for more growth'.

Thirdly, there were growing concerns over the financial viability of the Spanish banking system. As we have seen, the Spanish government has so far avoided the need for a full scale bailout of its banks. The Spanish banking system had proved to have had sufficient reserves to absorb most of the losses due to the wave of mortgage defaults that had followed the bursting of the great property bubble with the financial crisis of 2008. They had also been in a sufficiently strong financial position to postpone foreclosure on troubled debts by rolling over the loans and mortgages of many individuals and businesses who were at least able to more or less pay the interest on their debts. In doing so the Spanish banks could hope that with the coming of the expected economic recovery, either these individuals and businesses would soon find themselves in a stronger financial position that would allow them to repay their loans and mortgages, together with any missed payments, or else property prices would have risen sufficiently that the sale of repossessed property following any foreclosure would more or less recover any losses due to the default on the foreclosed loans.

But the austerity measures implemented by the Spanish government to appease Merkel and the bond markets had all but killed off hopes of an early economic recovery. Indeed, the Spanish economy was beginning to contract. With growing unemployment and rising numbers of businesses going bankrupt bad debt began to rise again. In April it became clear that Bankia – Spain’s fourth largest bank – was in serious trouble and would need to be nationalised and bailed out by the Spanish government. The bond markets now started to become seriously worried about the possibility that the Spanish government would have to join the rest of the PIGS and ask for a bail out. First, if Bankia had to be bailed out it was highly likely that other major Spanish banks would soon follow. Like the Irish government before it, the Spanish government would then have to borrow vast sums of money from the global financial markets – thereby greatly increasing its debt to GDP ratio. Second, with a large part of Spanish government bonds held by Spanish banks as reserve assets, a crisis in the Spanish banking system might force the Spanish banks to sell off their bond holdings to raise cash. This sell off could then lead to a collapse in the price of Spanish government bonds.¹⁷

By May the euro crisis was once again coming to a head. The Greek parliamentary elections in May ended up in a rather inconclusive result requiring fresh elections in June. Although the pro-austerity establishment parties have been able to form a coalition government – led by the ‘centre right’ New Democracy party – the Syriza Party has ended up as the main opposition party. The new Greek government will have little option but to take a tougher position in future negotiations with the troika over the terms of its bailout. Also in May, Hollande won the French presidential elections, and his position was then further strengthened by the victory of the Socialist Party in the French parliamentary elections in June. With France demanding a greater emphasis on economic growth it would seem clear that the fiscal compact if not completely renegotiated will have to be significantly modified.

However, perhaps more significant were the developments in Spain. By May Spain was beginning to slide down the slippery slope towards the point where it would have to ask for a bailout if it was not to default on its debts. In June, after now familiar frantic attempts to avoid the inevitable, Spain had to go cap in hand to Brussels and negotiations began on the terms of the Spanish bailout. Yet unlike Greece, Ireland and Portugal that had gone before it, Spain was far too big to fail. If Spain goes down then Europe

¹⁷ As we mentioned earlier, the concentration of PIGS government bonds in the PIGS banks had been significantly increased by the ECB’s LTRO over the winter of 2012.



will undoubtedly be dragged down with it. This has given the Spanish government a far stronger bargaining position. As a result the initial negotiations over the bailout have been rather favourable to Spain. But this favourable treatment of Spain has prompted the other PIGS to demand, in the name of fairness, that the terms of their own bailout should be eased.

Yet, although it might seem to many that six months after the agreements made in the autumn of 2011 to resolve the euro crisis are already unravelling, for Brussels and Berlin the re-emergence of the euro crisis offers an opportunity to press on with the radical restructuring of the governance of Europe. Indeed, with the re-emergence of the euro crisis in the spring of 2012 the ‘method in Merkel’s madness’ has become far more apparent.

In March the European Commission let it be known that they had found up to 85 billion euros down the back of the sofa which could be used to finance infrastructure projects across Europe. Although this is not a huge amount – less than 0.5 % of the eurozone’s total annual GDP – it was suggested that this money could be further leveraged up by the issue of ‘euro-project’ bonds. These bonds would be issued by the European Commission, and backed by all the governments in the eurozone. The funds raised by issuing these ‘euro-project bonds’ would then allow this trans-European investment programme to be carried out on a far greater scale.

It was also hinted that many of the restrictions imposed on European-wide spending – particularly the requirement that member governments had to match any funds provided by the European Commission euro for euro – could be relaxed. This would allow this large scale public investment programme to be directed towards the less developed regions of Europe – including those in the PIGS.

In the face of mounting opposition to imposition of relentless austerity measures, these



proposals for a large scale public investment programme can be seen to be something of a sweetener that would at least offer some light at the end of the tunnel. If the PIGS knuckled down and implemented the austerity measures necessary for 'fiscal consolidation' then they could hope in two or three years' time to be able to obtain a large slice of this investment programme. Furthermore, for France and other member states worried that the austerity measures were threatening to condemn Europe to a decade or more of stagnation, the European Commission's proposals offered some hope that concerted action would eventually be taken to stimulate the European wide economy.

But perhaps far more significantly in the longer term, the European Commission's proposals mark a decisive shift towards the centralisation of fiscal policy that on closer consideration complements the fiscal compact. While the fiscal compact may serve to restrict the powers of member states of the eurozone to adopt Keynesian-style policies of borrowing to spend in order to regulate capital accumulation, the European Commission's proposals paves the way for such Keynesian style policies to be conducted on a European wide scale. At least in terms of fiscal policy, the national governments of the eurozone will thereby become little more than local authorities while the European Commission will become more like a federal government exercising powers to regulate the economy of Europe as a whole.

Yet the European Commission's response to the re-emergence of the euro crisis has not only been to put forwarded proposals that would make tentative steps towards greater fiscal unification. In response to fears that the Spanish government

would have to borrow vast sums to bailout its banks the European Commission proposed that the newly operational ESM could bailout Spain's distressed banks directly. This would mean that Spain would not have to carry the burden of the costs of its bailout on its books. Instead the burden of the bailout would be shared by all the member states of the eurozone. Although this might appear as a clever accounting ruse to keep down Spain's debt to GDP ratio, it would also mark a significant step towards 'financial co-responsibility' in which the monetary authorities of the eurozone would collectively taking over the responsibility of guaranteeing the banking system of the eurozone as a whole. Yet, as Merkel has been keen to point out, if the responsibility of guaranteeing Europe's banking system is to be transferred from national monetary authorities to those of the eurozone as a whole, then regulatory powers will also have to be transferred. There will therefore have to be a move to far greater unification of banking regulation and the ECB will have to be given far greater powers.

Now of course it can be pointed out that Merkel strenuously opposed these proposals of the European Commission when they were originally put forward. However, as has become apparent in the protracted negotiations that have now begun, Merkel's opposition has been one of timing and sequencing than that of principal. Indeed, Merkel and the European Commission can be seen playing something of a double act; the European Commission playing the soft cop, pushing forward the rewards, radical reform and European integration, while Merkel plays the hard cop, insisting on the hard decisions that must be made to ensure such reform and integration works in the long term. As such Merkel's

obduracy can be seen as the fulcrum around which the radical restructuring of Europe is being leveraged into being.

Yet while it may be admitted that there is 'method in Merkel's madness' she can still be accused of 'playing with fire'. There is still a very real danger that the euro crisis will run out of control and bring about a serious financial and economic crisis not only in Europe but across the world. Even if the crisis continues to be contained, the imposition of austerity measures across Europe is already holding back the global economic recovery. Of course, if Merkel is accused of 'playing with fire' she can claim that it is only by 'playing with fire' that she can re-forging Europe. But is this 'reforging' of Europe at this time worth the enormous gamble with the global economy? After all, Merkel could have taken what she would see as the easy option by taking the obvious measures advocated by her critics to resolve, or at least contain the crisis.

Merkel's original reaction to the sovereign debt crisis was in keeping with that of a rather cautious conservative politician who was keen to take the opportunity to demonstrate that she was the champion of the German taxpayer. However, as the crisis developed Merkel was quick to see the logic of her position of taking a hard line against the PIGS required either the breakup of the eurozone or its radical reform. Merkel chose the latter.¹⁸ In this she found ready allies in the main European institutions such as the European Commission and the ECB whose interests were naturally for a more unified Europe. Yet in order to sustain this position, despite all the risks, Merkel and her allies in Brussels have had to rally the support of the bourgeoisie not only of Germany but across Europe.

To understand why the European bourgeoisie has supported Merkel's gamble in using the crisis to reforge Europe, we must put the euro crisis in the broader perspective of the 'tectonic' shifts that are occurring in the global accumulation of capital.

GERMANY AND THE RISE OF CHINA

Germany and the tale of the two speed recovery

As we have previously mentioned, the economic recovery from the 'great recession' that followed the financial crisis of 2008 has proved to be very slow for most of the old established advanced capitalist economies. In North America, Japan and for much of Europe, economic activity has barely, if at all, recovered to the levels that they had been on the eve of the crisis in 2006. In

contrast, the 'newly emerging market economies' of Asia, parts of Africa and South America – and in particular the so-called BRICS (Brazil, Russia, India, China and South Africa) – have bounced back from the recession.¹⁹

The driving force of this recovery of the 'global south' has been China. In response to the impact of the financial crisis, which saw a sharp slowdown in the growth of demand for its exports from the US and Europe, the Chinese government launched a major investment programme that amounted to nearly 15% of its GDP. This substantial increase in investment increased China's demand for fuel, food and raw materials from abroad. The main beneficiaries of this increased demand from China's surge in investment have been the 'newly emerging economies' of the south.

As a result, while the economies of the old capitalist nations of the global north have more or less stagnated over the past four years, the newly emerging economies of the global south have grown substantially. China's GDP is now nearly 50% larger than it was in 2008, and during this time China has overtaken Japan to become the second biggest economy in the world. The financial crisis, and the consequent 'great recession' in the north, can therefore be seen as marking a significant 'tectonic' shift in the global economy away from the old capitalist heartlands of the 'north' to China and the newly emerging economies of the 'south'.

However, Germany, and its economic hinterland in north and east Europe, has been something of an exception to the tale of a slow and disappointing economic recovery in the old capitalist heartlands. At least since the 1950s, German capital accumulation has been driven by the production and export of high precision engineering manufacturers. This has perhaps been most evidently symbolised by German car makers, such as Mercedes-Benz and BMW. But far more important has been Germany's position as world leader in the production of machinery, machine tools and other technologically advanced means of production.

In the past Germany's export-led growth had been ultimately dependent, either directly or indirectly, on capital accumulation in the USA. Economic growth in the US would lead to increased investment in American manufacturing industry, which would directly increase American industry's demand for the import of German high precision machine tools. But, at the same time, such economic growth in the US would increase the rate of growth, and with it investment, in Europe and the rest of the world. This increased investment would then in turn lead to an

¹⁸ See Quentin Peel, 'A very federal formula', *Financial Times*, 10th February 2012 for an account of Merkel's acceptance of the need for further European integration.

¹⁹ See IMF, *World Economic Outlook*, May 2012.

increased demand for Germany's manufacturing industries.

However, over the last decade there has begun a significant shift in the driving force behind Germany's export-led growth. At first, the rapid rise of China as the world's manufacturing powerhouse had been based on the assembly of parts that had been manufactured elsewhere in Asia. However, since the turn of the millennium Chinese industry has rapidly 'moved up the value chain', with more technologically sophisticated production processes being located in China itself. This has meant that Chinese industry has needed to import more sophisticated means of production, and has found ready and reliable suppliers in Germany.

Thus, although 70% of German exports are still destined for the rest of the eurozone, the fastest growing market for German exports is China. With the surge in productive investment in China and slow economic growth in the US and the rest of the old capitalist heartlands, following the financial crisis, this re-orientation of German capital accumulation towards Chinese markets has been greatly accelerated. For the German bourgeoisie, and indeed for much of European ruling class circles, China is increasingly being seen as the 'future'.²⁰

This re-orientation of German capital towards China has an important bearing on the unfolding of the euro crisis. To understand this we must briefly consider the historical relation of Germany to European monetary union since the fall of the Berlin Wall.

Germany and the euro

Although the proposal for a single European currency had been mooted as far back as the 1960s, it had been the fall of the Berlin Wall that was to provide the catalyst for its realisation. The fall of the Berlin Wall, and the consequent breakup of the old Eastern Bloc, had opened up the prospect of a new unified Germany capable of exploiting the potential of the skilled and educated populations of both East Germany and eastern Europe. It had been widely feared amongst the nations of western Europe, but particularly by France, that this new unified Germany would no longer be the first amongst equals, as it had been since the second world war, within the Europe Union; and no longer would the European project be driven by a partnership

²⁰ Having already quadrupled over the past decade, German exports to China are now rising at a rate of over 40% a year. China is rapidly overtaking the US as the main non-European importer of German exports, and by 2020 is expected to account for 15% of all of Germany's exports. See Jeff Black, 'Germany's future rising in east as exports to China eclipse US', *Bloomberg*, 6th April 2011. www.bloomberg.com/news/2011-04-06/germany-s-future-rising-in-east-as-exports-to-china



between Germany and France. Instead a unified Germany would rapidly emerge as the continent's dominant economic and political super-power.

There was therefore a concerted attempt on the part of Germany's west European partners to anchor Germany in to the longstanding commitment to the project of European political and economic unification. Central to this was the introduction of a single European currency. It was after all far better for the rest of Europe to have a single currency over which they could exercise some control rather than having to become part of a *de facto* deutsche mark zone, and consequently having their economic and monetary policies increasingly dictated by the Bundesbank.

However, the fears of the emergence of an über-Germany, if not misplaced, were certainly premature. The problems of absorbing East Germany were to be greatly exacerbated by the decision to greatly overvalue the East German ost mark when the East German currency was replaced by the deutsche mark. This decision was certainly politically astute in the short term in that it made unification popular in East Germany, but it was to have serious long term economic consequences. Under the East German command economy chronic shortages in the availability of consumer goods had meant that many East Germans had accumulated large amounts of ost marks that they had not been able to spend. With unification with West Germany they found they could convert these ost marks into deutsche marks mark for mark, and buy what they wanted from the well-stocked West German shops.²¹ The

²¹ Each person was allowed to convert up to 4,000 ost marks into deutsche marks at the rate of 1:1. Any amounts above 4,000 were then converted at the rate of 2:1. The ost mark had been an unconvertible currency and therefore there was no market determined exchange rate other than that of the black market on which to base monetary conversion. Before the fall of the Berlin Wall the black market rate had been in the region of 4 ost marks to the deutsche mark. This fell to 20:1 following the fall of the Berlin Wall due the economic dislocation and political uncertainty in East Germany. However, the black market

result was a consumer boom across Germany that threatened to have serious inflationary consequences as German industry could not keep up with the increased demand.

To contain inflation the Bundesbank tightened monetary policy and the German government was forced to cut public spending and raise taxes. This led to a sharp slowdown in economic growth in the former West Germany. At the same time, the over-valuation of the ost mark meant that much of East German industry was rendered hopelessly uncompetitive compared with that of West Germany. As a result swathes of East German industry went bankrupt and unemployment soared. The boom was thereby soon followed by a sharp economic slowdown across Germany.

What is more, the East German unemployed were now entitled to the generous West German welfare benefits. The consequent increase in the welfare bill, together with the costs of restructuring and modernising East Germany, had to be paid for by substantial increases in taxation. With a still strong entrenched German working class, a large part of this increased level of taxation was ultimately borne by the capitalists of West Germany. Lower profits led to a lower rate of investment and hence slower capital accumulation and economic growth. As a result, the cost of absorbing East Germany was to weigh down Germany's economic growth for more than a decade. By the time the euro was introduced in 1999 the German 'economic and social model' had seemed to have long passed its sell by date, and fears of an über-Germany had been more or less forgotten.

But it was not merely the problems of integrating East Germany into a united Germany that prevented the realisation of Germany's rise to the status of Europe's economic super-power, it was also the problem of realising the great potential investment opportunities that had been opened up by the breakup of the Eastern Bloc. On Germany's very door step, eastern Europe offered the prospect of a cheap but skilled and trained workforce, along with a developed economic infrastructure. For the neoliberal ideologues, who came to control economic policy after the fall of

the Stalinist regimes, what had been holding the eastern European economies back from exploiting their great potential had simply been excessive state interference. All that was needed to create a prosperous economy was to sweep away all the state regulations at once and allow the 'entrepreneurial spirit of the east European peoples' free rein to develop. Yet the 'short-sharp shock therapy' prescribed by the neoliberal ideologues, and imposed on the populations of eastern Europe, only led to rapid inflation, soaring unemployment and economic devastation through much of the 1990s. The dislocated and devastated economies of the former Eastern Bloc offered few investment opportunities for either western or German capital.

However, by the end of the 1990s the obstacles to integrating the former Eastern Bloc in to a German-centred capital accumulation had begun to turn into an advantage. The surplus population of the former East Germany, together with rising unemployment in the former West Germany due to slow economic growth, had begun to hold back the growth of real wages across the German economy.²² At the same time, the migration of workers from east to west Germany looking for work had created a pool of mobile and flexible labour that now began to undermine the entrenched position of the German working class. German industry was thereby able to become more competitive and more profitable.

At the same time, investment opportunities began to open up at last in the some of the east European economies as they recovered from the short-sharp shock policies of the early 1990s. Although such policies had dismally failed to release the 'entrepreneurial spirit of the east European peoples' so as to provide a rapid transition to the economic prosperity enjoyed by the peoples of western Europe, the economic devastation that they had wrought had eventually begun to clear the way for the investment of western capital. Prolonged mass unemployment and falling living standards had served to discipline the east European working class that had previously been accustomed to job security and a significant degree of negative control over the production process.

Western capital, and German capital in particular, could now begin to flow into the former Eastern Bloc in order to take advantage of cheap, and now compliant, labour. This could take the form of simply outsourcing production to newly

rate is perhaps not an accurate guide to what would have been the 'economic' rate of conversion of ost marks into deutsche marks. The Bundesbank had drawn up proposals for German monetary unification that would have eventually seen ost marks converted into deutsche marks at a rate of 2:1 before being over ruled by Chancellor Kohl. Certainly the rate 1:1 substantially over-valued the ost mark. See Jonathan R. Zatlín, 'Rethinking German reunification: German monetary union and European integration', for an account of the politics surrounding the conversion of ost marks into deutsche marks. www.bakerinstitute.org/files/.../BI-pub-ZatlínRethinking%20Reunification-102709.pdf

²² Although German wages remain amongst the highest in Europe their rate of growth has been amongst the lowest in the eurozone since the introduction of the euro. See Jörg Bibow, 'The euro debt crisis and Germany's euro trilemma', Working Paper no. 721 of the Levy Economics Institute of Bard College.

emerged east European firms, but mostly it took the form of direct productive investment whereby German and other western capitals relocated the less skilled labour process to the east. By the time the first wave of east European countries had achieved ascension status within the European Union in 2004, the flow of foreign direct investment into the former Eastern Bloc had turned into a flood. However, capital investment was highly uneven, leading to a stark polarisation in capital accumulation in eastern Europe. Those countries that won the competitive battle to attract western investment – such as Poland, Czech Republic, Slovenia and Hungary – saw rapid economic growth; those that did not stagnated and were pushed to the margins of the ‘new Europe’.

As we have mentioned, the success of Germany’s model of export-led growth had been dependent on rapid capital accumulation in the US. However, the relative decline of US manufacturing industry since the 1970s has meant a far slower growth in the demand for high precision machine tools and other advanced engineering products than that produced by the German ‘economic miracle’ of the 1950s and 1960s. Since the late 1970s, German industry has also faced growing competition from Japan and South Korea in these lines of production. Thus ever since the end of the 1970s German export-led growth has been restricted by diminishing market share in a slow growing market.

However the integration of eastern Europe by the turn of the millennium had served to lower wages and production costs, making German industry more competitive relative to Japan and South Korea. This allowed German industry to reverse the decline in its share of the world market in precision engineered manufactures. But this increased competitiveness was insufficient to overcome the slow growth of US manufacturing and hence the slow growth of the world market as a whole. So, at first, the shift in capital accumulation eastwards certainly bolstered the profits of German business, but it only did so by ‘exporting’ jobs and growth to the east. Economic growth in Germany itself remained slow, unemployment remained high, and the ever present threat of the relocation of production to east Europe served to further depress wages.

However, since around the middle of the last decade the remorseless rise of China as the manufacturing powerhouse of the world has begun to change all this. Germany’s new found competitiveness has placed it in an excellent position to exploit the rapidly expanding export opportunities opened up by China’s rapidly growing manufacturing industries. Indeed, China

is expected to overtake the US as Germany’s main export market outside Europe as early as 2015. As a result, Germany has seen in recent years an end to its decade long stagnation. Economic growth has accelerated and the rate of unemployment has fallen to levels not seen since before unification.

Although the economy sharply contracted in 2009 it has since resumed its upward trend even as much of the rest of Europe, in the face of austerity measures, struggles to avoid slipping back into recession. Indeed, a limited general economic slowdown across Europe, due to the austerity measures inspired by the euro crisis, may well be welcomed in Berlin in the short term as a way of cooling off a German economy that has been at risk of growing too fast and overheating.

Yet it is not a foregone conclusion that Germany will be able to consolidate its hold over the expanding Chinese market. In the longer term the German export machine must be kept competitive in order to fight off competition from Japan and South Korea. But more importantly it must find room to expand if it is to meet the growing demand from China. Already wages have risen substantially in many of the east European economies, and shortages of engineers and other skilled labour have begun to emerge in Germany itself. In the longer term Germany needs to restructure the rest of Europe – to do this it needs to integrate the rest of Europe into a re-orientated German-centred European capital accumulation.

The euro crisis has offered an excellent opportunity to bring about this restructuring of Europe. Hence, just as the economic devastation following the fall of Berlin Wall had eventually offered the opportunity to re-structure the eastern periphery, then the sovereign debt crisis can be seen to offer a similar opportunity to do the same for the southern and western periphery of Europe.



From PIGS to frankfurters

It has long been observed that there is a strong tendency towards the concentration and centralisation of capital. Capital will tend to gravitate towards where capital has already been invested. Thus capital accumulation not only produces growing inequality of wealth between classes it also creates a polarisation of wealth between geographical areas and indeed nations. This has been clearly demonstrated on a world scale.

During much of the twentieth century capital accumulation was concentrated in a few core economies in Europe and North America. The rest of the world, comprising as much as 80% of the world's population was confined to the margins of capital accumulation, and as a consequence remained economically underdeveloped. Surplus value produced in the core was largely reinvested in the core. Productive capital was invested in the world's periphery only in those lines of industry that could not be produced in the core countries, due to natural factors – such as climate, soil or the location of raw materials. As a result, the major capitalist economies that had emerged by the last quarter of the nineteenth century as the core of world capital accumulation were very much the same a hundred years later. The only country of any note to join the club of advanced capitalist nations being Japan. On a smaller scale, a similar polarisation between a core of capital accumulation and a periphery developed within Europe.

However, over the last couple of decades this polarisation of core and periphery has begun to be undermined. Following the crisis of the 1970s and 1980s capital has sought to outflank the entrenched working classes in the core nations by investing in the periphery. As a consequence, capital, in the form of both foreign direct investments by transnational corporations and by financial investments funnelled through the developing global capital and money markets, has flowed into an increasing number of economies of what was once known as the third world. This flow of capital has given rise to the rapid economic development that was first seen in east and south east Asia, and that has then to spread to China, India and parts of South America.

A similar phenomenon has occurred in Europe. As we have already seen, following the break up the Eastern Bloc following the fall of the Berlin Wall, and the consequent traumatic transition from state capitalism in the 1990s, there has been a flood of capital from Germany and the core of Europe into the periphery of eastern European countries, giving rise to the rapid development of 'emergent market economies', such as Poland, Czech Republic,

Hungary and Slovenia.²³ But this phenomenon has also occurred, to a varying extent, in the southern and western periphery of Europe – including the PIGS – following the beginning of the process of European monetary unification in the early 1990s. Spain and Ireland, and to a lesser extent Portugal and Greece, have also seen a transformation of their economies over the last decade or so in large part due to foreign investment, which has been greatly facilitated by European monetary union. Indeed the PIGS had been, up until the middle of the last decade, far more economically vibrant and dynamic than Germany since the early 1990s.

Ireland perhaps best exemplifies this rapid economic development driven by foreign investment in the southern and western periphery of Europe. Although more recently investment inflows became increasingly speculative - helping to fuel Ireland's huge property bubble – the Irish economy has been transformed over the past two decades with the aid of foreign inflows of capital. In the early 1990s Ireland still remained a predominately agricultural backwater producing little more than beef, cream and whiskey. However since then foreign investment has fuelled rapid economic development, with Ireland becoming a centre for cutting edge industries based around biotechnology, pharmaceuticals, information and communications technologies. Indeed, before the onset of the crisis Ireland had been dubbed the 'Celtic Tiger' for the resemblance of its rapid economic growth and development to that of the tiger economies of the far east.

However, there has been an important difference between the foreign investment flows that have taken place on the southern and western periphery of Europe compared with those that have taken place in the eastern periphery of Europe. As we have already pointed out, the flow of capital east was largely driven by direct productive investment by transnational corporations based in Germany and other core European nations. In contrast foreign investment in the southern and western periphery has taken the form of financial flows channelled through the European banking system and the global finance markets. This crucial difference has had two important consequences.

Firstly, by being far more dependent on the global financial markets to fund capital accumulation the PIGS of the southern and western periphery were far more vulnerable to the repercussions of the global financial crisis. With

²³ For a detailed case study of German investment into central and eastern Europe see Peter Nunnenkamp, 'The German automobile industry and central Europe's integration into the international division of labour: foreign production, intra-industry trade and labour market repercussions', Kiel Institute for World Economics.

the global financial crisis in 2008 there was a sudden reversal of short term money-capital flows. Instead of money-capital flowing from the core to the periphery it sharply turned to flow from the periphery to the core. As we have previously seen, banks in the PIGS that had financed long term investments by borrowing short term had found themselves with serious financing problems. In contrast by taking the form of direct productive investment, the capital flows into the eastern periphery were far more solid. With investment sunk into plant and machinery and other fixed forms of capital it could not so easily take flight.

Secondly, to the extent that they largely took the form of direct productive investment by German based transnational corporations, capital flows into the eastern periphery were intricately linked to the development of a German-centred capital accumulation. Thus, for example, a decision by a German transnational to invest in setting up factories in Poland to supply parts for its German factories would necessarily be an integral part of its long term investment strategy to optimise the geographical distribution of its production facilities. In contrast, to the extent that this investment largely took the form of banks borrowing from the global financial markets, capital accumulation in the southern and western periphery of Europe had been far less integrated into the German-centred accumulation of capital. In deciding to finance an investment project banks and financiers are not particularly concerned with the concrete nature of the project, or its long term strategic significance, but are concerned with how quick it will bring a return. Thus it will be of little concern to a banker or a financier if their money is used to build a factory in Spain to supply parts to German factories, or to build factories supplying parts to US factories or even to provide mortgages for Spanish home buyers, so long as they can hope to make a quick and handsome return.

The sovereign debt crisis opened up the possibility for the southern and western periphery to be integrated into a renewed German-centred European wide accumulation of capital re-orientated towards the rise of China and the emerging economies of the 'global south'. Just as the eastern periphery of Europe was integrated following the economic devastation caused by the neoliberal 'short sharp shock therapies' administered following the breakup of the Eastern Bloc, so it might be expected that the southern and western periphery will be integrated into the German industrial complex following the economic devastation following the sovereign debt

crisis.²⁴ Already high levels of youth unemployment are leading to engineering graduates and other young skilled workers to start migrating to Germany from Spain and the other PIGS.²⁵ In the longer term, with swathes of industry destroyed, and prolonged unemployment and falling living standards serving to discipline their working classes, the ground will be cleared for German and other core European based transnational corporations to start investing in the PIGS.²⁶ As regions and nations of the south and west of Europe compete for the favour of German investment some will win, and will become part of the new Europe, others will lose and be relegated to the margins.

The prospect of such a radical restructure of Europe to take advantage of the rise of China and the 'new realities' of global capitalism, is certainly a tempting one for the German bourgeoisie. But it is also a strategy supported by many within the European bourgeoisie as a whole. After all what is the alternative? The slow decline of Europe? Most of the European bourgeoisie and their governments see carving out a niche within the new German-centred European model as the best bet. Thus the European Commission, the ECB and the other European institutions, whose role is to represent the general interests of European capital, have largely backed Merkel and the German government's approach during the euro crisis.

²⁴ In some ways there are important parallels with the tiger economies of south east Asia. Indeed, Ireland's characterisation as a 'Celtic Tiger' before the crisis may have been more apt than is often realised. Foreign investment had flooded into the PIGS, just as it did with the south east Asian tigers in the early 1990s. As in Ireland this investment had originally taken the form of direct foreign investment – mainly by Japanese transnational corporations – that financed rapid real capital accumulation leading to rapid economic growth. Investment then increasingly took the form of borrowing from the global financial markets and became increasingly speculative. Trade deficits grew as imports grew faster than exports, and the tigers economies defended fixed exchange rates with the US dollar, until the east Asian crisis struck in 1998. The crisis caused widespread economic devastation amongst the tigers, but they were subsequently re-integrated into the Chinese-centred Asian accumulation of capital. See 'Welcome to the Chinese century?', *Aufheben* #14 and 'The return of the crisis', *Aufheben* #19.

²⁵ See 'Germany lures talent from south', *New York Times* supplement, *Observer*, 6th May 2012.

²⁶ Between 1989 and 1994 it has been estimated that the economy of Czech Republic contracted by 21%, that of Hungary by 18.2%, Poland by 17% Slovak Republic 25% and Slovenia by 16.2, while economic output in Russia slumped by nearly 50%. See Stanley Fischer, Ratna Sahay and Carlos A. Végh, 'Stabilization and growth in transition economies: The early experience', *The Journal of Economic Perspectives*, spring 1996. In comparison the Greek economy has contracted by nearly 20% since 2008 and is currently shrinking at a rate of 7% a year.

Nevertheless it has been a risky strategy. Not only has the hard-line taken during the euro crisis threatened to cause a global financial meltdown – with unknown consequences – but it is a bet based on the continued remorseless rise of both China and the emerging economies of the global south that is by no means a certainty. Even if China and the global south continues to grow there no certainty that German industry will be able to hold on to its market share of these markets - particularly as China ‘moves up the value chain’ and begins to produce precision engineered manufactures for itself.

CONCLUSION

The exasperation expressed by the rest of the world’s ruling classes, and in particular by the US Obama administration, at the Europeans’ handling of the euro crisis has perhaps been imbued with a certain sense of betrayal. At the G20 meetings in the wake of the financial crisis of 2008 the leaders of the world, led by the US, had agreed to put the interests of saving global capitalism before their own special interests. This agreement had not been put in the form of a binding international treaty – which would have of course taken far too long to bring into being - but had taken the form of a common commitment based on a sense of international bourgeois solidarity. However, with the euro crisis the Europeans, led by Angela Merkel, can be seen to have betrayed this solidarity of the world’s bourgeoisie, and in doing so they have put the global economy once more at risk, for their own particular interests. Free riding on the reflationary policies of the US and China, the Europeans can be seen to be seeking to steal a march on their competitors by prematurely forcing through deficit reduction policies, in order both to reduce their national debt burdens, and to force the pace of neoliberal reforms to make European industry more competitive.

But for the Europeans the euro crisis has been an opportunity too good to miss. The opportunity presented by the euro crisis is not merely one of making European labour markets more flexible, like that of the USA. It is an opportunity to radically restructure Europe to take advantage of the rise of China and the emerging economies of the global south. It is the prospects offered by the construction of a German-centred European accumulation of capital orientated towards China that explains why the European bourgeoisie has backed Merkel’s high risk strategy of dealing with the euro crisis.

Yet all the same this strategy is a gamble with no guarantee of success. The risk of derailing the world economic recovery, or even plunging world capitalism into another global financial crisis, still

remains. On the other hand there is always the possibility that the political and economic restructuring of Europe will stall.

Although most of the European bourgeoisie may be in favour of using the crisis to grasp the opportunities opened up by the rise of China there is plenty of room for disagreement of who should bear the brunt of such restructuring. The European negotiations surrounding the on-going euro crisis are set to remain a multi-handed poker game based on bluff and brinkmanship. At present the fear is that Merkel will overplay her hand. Certainly Merkel has invested heavily in her reputation as the Iron Chancellor and it will be politically difficult for her to make concessions when the time is right. On the other hand it has been relatively easy for Merkel and other north European leaders to demand austerity measures of the PIGS while their own economies are booming. But as the world economy stalls, and even Germany and northern Europe begin to relapse into economic stagnation, the consequences of cutting too early and too fast on the economy of Europe as a whole are becoming more apparent. Merkel may soon find herself in a position where she can easily soften her line. But if she bottles it too early then the opportunity for the radical restructuring of Europe may be lost.

In the longer term the euro crisis can be seen to be a part of the long predicted beginnings of the decline of US hegemony. The global economy is now no longer solely dependent on the US as the locomotive of global accumulation and as such there is more room to defy the Americans. But as a consequence we are entering a far more uncertain world.

