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BREAKING UP?

A ROUTE OUT OF THE EUROZONE CRISIS

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Executive summary

1. The Eurozone crisis is part of the global turmoil that began in 2007 as a US real estate crisis, became a global banking crisis, turned into a global recession, and thus gave rise to a sovereign debt crisis. At the end of 2011 there is a risk of returning to a banking crisis in Europe and elsewhere. At the heart of bank weakness lies private and public debt accumulated during the period of intense financialisation in the 2000s.

2. The euro is a form of international reserve currency created by a group of European states to secure advantages for European banks and large enterprises in the context of financialisation. The euro has attempted to compete against the dollar but without a correspondingly powerful state to back it up. Its fundamental weakness is that it relies on an alliance of disparate states representing economies of diverging competitiveness.

3. The euro has acted as mediator in Europe of the global crisis that began in 2007. The European Monetary Union (EMU) has created a split between core and periphery, and relations between the two are hierarchical and discriminatory. The periphery has lost competitiveness in the 2000s, therefore developing current account deficits with the core and accumulating large debts to the financial institutions of the core. The result has been that Germany has emerged as the economic master of the Eurozone.

4. Eurozone policy to confront the crisis has been profoundly neoliberal: cutting public expenditure, raising indirect taxes, reducing wages, further liberalising markets and privatising public property. Corresponding institutional changes within the EMU – above all for the European Central Bank (ECB) and the European Financial Stabilisation Facility (EFSF) – have entrenched the dominance of the core, particularly of Germany. More broadly, policies are threatening to shift the balance of economic, social and political power in favour of capital and against labour across Europe.

5. Austerity is contradictory because it leads to recession thus worsening the burden of debt and further imperilling banks and the monetary union itself. This contradiction is compounded by the nature of the EMU as an alliance of disparate states with diverging competitiveness. As a result, the EMU currently faces a sharp dilemma: either to create state mechanisms that could enforce policies raising the competitiveness of the periphery, or to undergo a rupture.

6. The credit of the ECB has been arbitrarily deployed to protect the interests of large banks, bondholders and enterprises, even by-passing the ECB's own statutes. Social power has been undemocratically appropriated by an elitist institution subsequently to be placed at the service of large capital in Europe. But the capacity of the ECB to relieve the pressures of crisis is limited because it is has been asked to play a fiscal role for which it was not designed. Moreover, the EMU is hampered by the absence of a state to back up its liabilities and solvency.

7. The EFSF is similarly hampered by the absence of a state authority that could reliably support an expansion of its lending powers. More than that, the ability of the EFSF to recapitalise banks is limited by the national character of banks in Europe. Banks remain closely attached to their nation states. An alliance of disparate states cannot easily raise funds jointly to rescue the national banks of one of its members. It is hardly credible that Germany could, for instance, rescue French or Spanish banks without a commensurate return.

8. The association of nation states with their domestic banks has become more pronounced in the course of the crisis. Banks have been acquiring the public debt of their own states; they have also been depositing spare liquidity with their own National Central Banks (NCBs); they have, finally, relied increasingly on Emergency Liquidity Assistance (ELA) provided by their own NCB. The result is that banks and nation states now face a heightened danger of joint default. The emerging choice for peripheral states is particularly stark: either fully nationalise banks, or lose control over them.

9. The persistence of the split between core and periphery, the absence of effective institutional change for the EMU, the pressures of austerity and the threat to banks are creating harsh conditions for peripheral countries. Future prospects are bleak, including low growth, high unemployment and worsening burden of debt. The ability of peripheral countries to remain within the EMU is in doubt, and the most likely candidate for exit is Greece.

10. Greece is manifestly unable either to service its public debt, or to comply with the conditionality of the rescue plans, making default inevitable. However, default led by the creditors and occurring within the confines of the EMU (so-called orderly default) would not be in the best interests of the country. It would probably lead to loss of control over domestic banks; it would not lift austerity; it would keep the country within the competitive vice of the euro. The social costs would be great. The country would also lose some of its sovereignty as fiscal policy would come under the explicit control of the core. The prospect of eventual exit from the EMU would remain.

11. Default ought to be debtor-led, sovereign and democratic, leading to deep cancellation of debt. Debtor-led default would probably precipitate exit from the EMU. Quitting the euro would offer additional options for dealing with public debt since the state could re-denominate its entire debt in the new currency. Exit would further allow the state more scope to rescue banks through nationalisation and provision of domestic liquidity once command over monetary policy would have been restored. Nonetheless, exit would also create fresh problems for banks as some assets and liabilities would remain denominated in euro. The outcome would probably be the shrinking of Greek banks over time. Exit, finally, would disrupt monetary circulation and cause problems of foreign exchange as the new currency would depreciate. Still, the disruption of circulation is unlikely to be decisive, w hile depreciation would present the opportunity of rapidly retrieving competitiveness. On balance, if Greece is to default, it should also exit the EMU.

12. Debtor-led default and exit are fraught with risk, and have costs attached to them. But the alternative is economic and social decline within the EMU that could still end up in chaotic and even costlier exit. In contrast, if default and exit were planned and executed by a decisive government, they could put the country on the path to recovery. For that it would be necessary to adopt a broad economic and social programme including capital controls, redistribution, industrial policy, and thorough restructuring of the state. The aim would be to change the balance of power in favour of labour, simultaneously putting the country on the path of sustainable growth and high employment. Not least, national independence would also be protected.

13. More broadly, the Eurozone crisis brings to a close a period of confident economic and political integration in Europe. The ideology of Europeanism which promised solidarity and unity to European people, is in retreat as the core has demonised the periphery in the course of the crisis. The depth and severity of the crisis are eliciting intense social reaction against large banks and enterprises in the EU. The impasse reached by the EMU raises the possibility of more active economic and social intervention by the nation states of Europe in the foreseeable future.

14. The required restructuring of Europe as the EU and the EMU face decline could not be undertaken by neoliberal agents aiming to defend the interests of big business. The restructuring should be democratic in content, relying on the forces of organised labour and civil society; it should draw on the theoretical tradition of political economy and heterodox economics; it should also tread a careful path between declining Europeanism and nascent nationalism. Above all, it should keep firmly in mind the old socialist dictum that European unity is possible only on the basis of workers' interests.

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Glossary

BIS: Bank of International Settlement
BoG: Bank of Greece
CAC: Collective Action Clauses
CB: Central Bank
CDO: Collateralised Debt Obligation
EBA: European Bank Authority
ECB: European Central Bank
EFSF: European Financial Stability Facility
ELA: Emergency Liquidity Assistance
ELG: Eligible Liabilities Guarantee
EMU: European Monetary Union
ESCB: European System of Central Banks
ESM: European Stability Mechanism
GDP: Gross Domestic Product
IMF: International Monetary Fund
MFI: Monetary Financial Institution
MRO: Main Refinancing Operation
NCB: National Central Banks
NPV: Net Present Value
OMO: Open Market Operation
SME: Small and Medium Enterprises
SMP: Securities Market Program
SPV: Special Purpose Vehicle
TAF: Term Auction Facility
TARGET: Trans-European Automated Real-time Gross Settlement Express Transfer System
VAT: Value Added Tax

Chapter 1
Hitting the buffers

1.1 A global upheaval

The fundamental features of the global upheaval that commenced in August 2007 are well understood[1]. A vast real estate bubble occurred in the USA in 2001-6, spurred by low interest rates due to Federal Reserve policy in 2001-3. The bubble was subsequently sustained by capital inflows from developing countries forced by the operations of the world market to hold huge dollar reserves. Availability of cheap funds together with relentless financial engineering allowed US financial institutions to generate mortgage debt among subprime borrowers on the assumption that it would subsequently be securitised and sold in the open markets.

In 2004 US interest rates began to rise, signalling the end of the period of very cheap credit. Rising rates eventually led to large debt delinquencies among the indebted poor, thus bursting the bubble and resulting in enormous volumes of bad securitised debt in the possession of financial institutions across the world. The ensuing banking crisis in 2008-9 brought credit contraction and caused a collapse of aggregate demand, partly through investment and partly through exports. Among EMU countries, Germany was hit especially hard, as its exports collapsed and its banks found themselves exposed to bad securitised debt.

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1 The brief account given here derives from Lapavitsas C. (2009), 'Financialised Capitalism: Crisis and Financial Expropriation', Historical Materialism, 17.2, pp.114-148. Further arguments can be found in several discussion papers by Research on Money and Finance, www.researchonmoneyandfinance.org. Broadly speaking, the global crisis reflects the financialisation of contemporary capitalism, a complex and multifaceted phenomenon that has concerned political economists for well over a decade, see, for instance, Epstein G., (ed.) (2005), Financialization and the World Economy. Cheltenham: Edward Elgar. The view of financialisation that underpins analysis in this report stresses three features of contemporary, mature economies: first, the ability of large corporations to finance investment out of retained profits as well as to participate in financial markets on their own account; second, the turn of banks toward making profits out of trading in financial markets and lending to individuals; third, the increasing involvement of workers and households in financial markets to borrow and to place savings.

Falling aggregate demand induced a sharp global recession that led to state intervention with the aim of, first, rescuing banks and, second, ameliorating the effects of the crisis. Given that tax revenue declined as economies went into recession, the result was ballooning budget deficits in the USA, the UK and elsewhere. The negative impact on public finances was particularly severe in the periphery of the Eurozone, eventually leading to loss of control in Greece, Ireland and Portugal, while Spain struggled to avoid the same fate. The persistence of the crisis in 2010-11 eventually raised the spectre of contagion for countries of the core, primarily Italy which has stagnated throughout its period of Eurozone membership and which effectively occupies an intermediate place between periphery and core. Once the sovereign debt crisis had acquired major dimensions in the Eurozone, it became clear that European and other banks were at risk, threatening to re-ignite the banking crisis across the world.

1.2 The euro: A novel form of international reserve currency

The tendencies of global crisis were mediated in Europe by the institutional mechanisms of the Eurozone. The euro is not simply a common currency devised to facilitate trade and financial flows among member countries. More important than that, it is an international reserve currency, or in more precise political economy terms, a form of world money[2]. This is ultimately the reason why it has impacted with such ferocity on peripheral economies, and why the EU has pursued relentless austerity to protect the euro.

The world market lacks a corresponding world state to give it homogeneity of accounting and trading practices, law, norms, and even weights and measures. It also lacks an integrated credit system that could provide credit and liquidity facilities under the supervision of a world central bank. Consequently, its functioning relies heavily on an international currency that is expected to act as trusted means of reserve (hoarding) and means of payment for international operations, on the assumption that it already functions as a reliable unit of account. In addition the international reserve currency must also act as reliable means of payment and

2 The significance of the euro as world money is more fully analysed in Lapavitsas C. (2012), 'The Eurozone crisis through the prism of world money', forthcoming in Epstein G., Kregel J., and Wolfson M. (2012). A discussion of the role of the euro as world money can also be found in Lapavitsas C. (2011), 'Default and Exit from the Eurozone: A Radical Left Strategy', forthcoming in Socialist Register. Throughout this report the term 'international reserve currency' will be used to avoid unnecessary problems for those unfamiliar with the terminology of political economy.

reserve among states in the world market. Command over the reserve currency is a means of establishing a hierarchy among states and ultimately a weapon of imperial power.

Historically the reserve currency has taken the form of a commodity - gold or silver - but for most of the twentieth century gold has been reduced to a hoard-of-last-resort. The functioning of reserve currency money is currently undertaken by national currencies, above all, the US dollar. This development has transformed the reserve currency into a partly managed economic entity that affords extraordinary power to the issuing state[3]. For this reason, the dollar has been subject to continuous competition from other forms of money. This is the perspective from which the European Monetary Union is analysed in this report, establishing its contradictory and discriminatory character.

The euro is the main competitor to the dollar as reserve currency, aiming to meet the paying and reserve requirements of large European enterprises and facilitating the global operations of European states. Yet, the euro is a very unusual form of international reserve currency. Unlike the dollar it is not a pre-existing national money that has been catapulted into its world role because of the intrinsic power of its economy and state. And nor has it arisen organically out of the commercial and financial operations of large capitals in Europe and elsewhere. Instead, it has been created ex nihilo by an alliance of European states. The peculiar construction of the euro is a source of considerable strength but also weakness for it as international reserve currency.

The institutional framework of the Eurozone has been determined by the large European banks and enterprises that primarily deploy the euro. Thus, the ECB took it upon itself to keep inflation below 2%, while creating a homogeneous market for bank liquidity across Europe. Fiscal discipline was shaped by the Growth and Stability Pact, but responsibility for compliance was left to each sovereign state. Finally, the Eurozone has directed the pressures of economic adjustment to the labour market: competitiveness in the internal market would depend on productivity growth and labour costs in each country, while labour

3 The USA has drawn many and varied benefits, including several degrees of freedom in undertaking domestic monetary policy. Perhaps the most egregious benefit, however, has been a form of rent extracted from developing countries forced to keep extraordinary dollar reserves, see Painceira J.P. (2009). 'Developing Countries in the Era of Financialisation: From Deficit Accumulation to Reserve Accumulation', RMF Discussion Papers, no. 4, February, www.researchonmoneyandfinance.org

mobility would be in practice relatively limited. As a result, a 'race to the bottom' for wages and conditions has emerged in the Eurozone benefiting large industrial capital[4].

In addition, the institutional mechanisms of the EMU have reflected hierarchical relations among member states. Extending the membership of the Eurozone to include smaller and weaker states was a rational step to create a substantial internal market that would allow the new currency to function as global means of reserve and payment. Core countries - particularly Germany - then exercised partial control over lesser states[5]. The euro has provided German financial and industrial capital with competitive advantages in the European and the world market. For industrial capital it meant lower transaction costs within the common market and improved capital allocation, facilitating the outsourcing of parts of productive capacity. The euro also eliminated one of the major instruments European countries have traditionally deployed in the face of German exporting prowess: currency depreciation.

But the most attractive aspect of the euro for German capital has been its role as reserve currency, potentially creating a much stronger substitute for the old Deutschmark. Advancing financialisation in Germany and other core countries turned the euro into a decisive instrument for obtaining finance in international financial markets, for lending across the world, and for engaging in financial transactions to earn trading profits. A strong euro accepted globally as a reserve currency has been sought by both banks and industrial capital in Germany. It turned Germany into an important international financial center, while allowing its industrial capital to gain further access to capital markets as well as relocating across Europe[6].

A final requirement for a managed reserve currency is an ideological shroud. In the case of domestic money this is nationalism which treats money as part of the 'national identity'. Since nationalism could not be used within the EMU, the euro has

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4 The institutional structure of the EMU and the interests it serves were discussed in detail in two previous RMF reports, see Research on Money and Finance, 2010a. Eurozone Crisis: Begar Thyself and Thy Neighbour, C. Lapavitsas, A. Kaltenbrunner, D. Lindo, J. Michell, J.P. Painceira, E. Pires, J. Powell, A. Stenfors, N. Teles, Occasional Report 1, March, www.researchonmoneyandfinance.org, and Research on Money and Finance, 2010b. The Eurozone between Austerity and Default, C. Lapavitsas, A. Kaltenbrunner, G. Lambrinidis, D. Lindo, J. Meadway, J. Michell, J.P. Painceira, E. Pires, J. Powell, A. Stenfors, N. Teles, Occasional Report 2, September, www.researchonmoneyandfinance.org.

5 It matters not at all whether Germany or France played the main role in setting up the Eurozone in the 1990s. The point is that Germany has emerged as the dominant country of the core of the Eurozone, fully conscious of its place.

6 See Macartney I., (2009), Variegated neo-liberalism: Transnationally oriented fractions of capital in EU financial market integration, Review of International Studies, 35: 451-480.

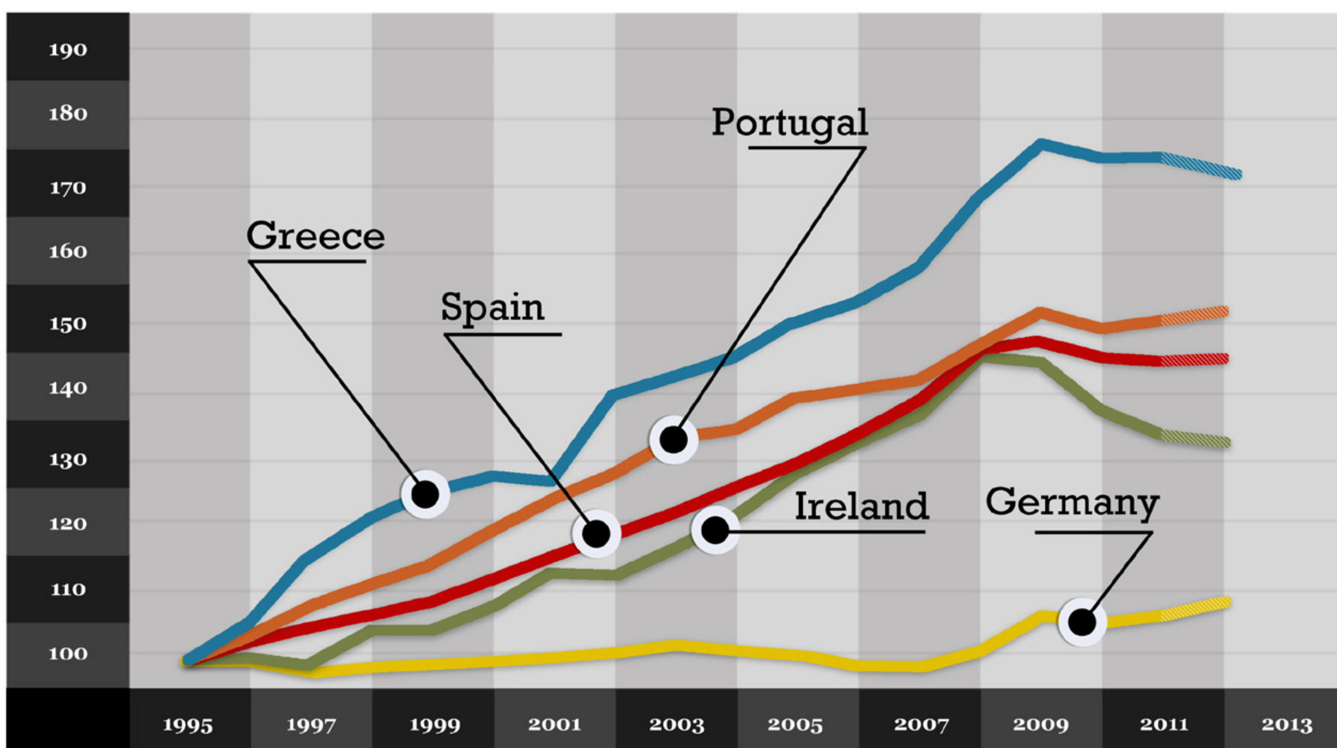
had to rely on the presumed solidarity and unity among European peoples. The euro is the very essence of the neoliberal Europeanism that presently dominates the EU. Its actual deployment has in turn strengthened Europeanist ideology, particularly among the smaller states of the union.

But the core has never been prepared to accept fiscal costs on behalf of its lesser partners. For Germany, in particular, the Eurozone was not to be allowed to become a field of systematic 'fiscal transfers'. The Europeanist ideology of the monetary union has always had a hard edge reflecting the underlying character of the common currency. This feature has been of vital importance in the unfolding of the crisis.

1.3 The euro mediates the global crisis in Europe

The euro has mediated the world crisis in Europe and determined its characteristic form. Fundamental to it has been the sharp internal division of the Eurozone between core and periphery, the latter including Spain, Portugal, Ireland and Greece. The 'race to the bottom' fostered by the monetary union was won by Germany in the 2000s by keeping wages down since the early 1990s, while weakening trade union organisation. Figure 1 shows the path of nominal unit labour costs - a standard measure of competitiveness – in Germany and peripheral countries since the mid-1990s:

Fig. 1 - Evolution of nominal unit labour costs



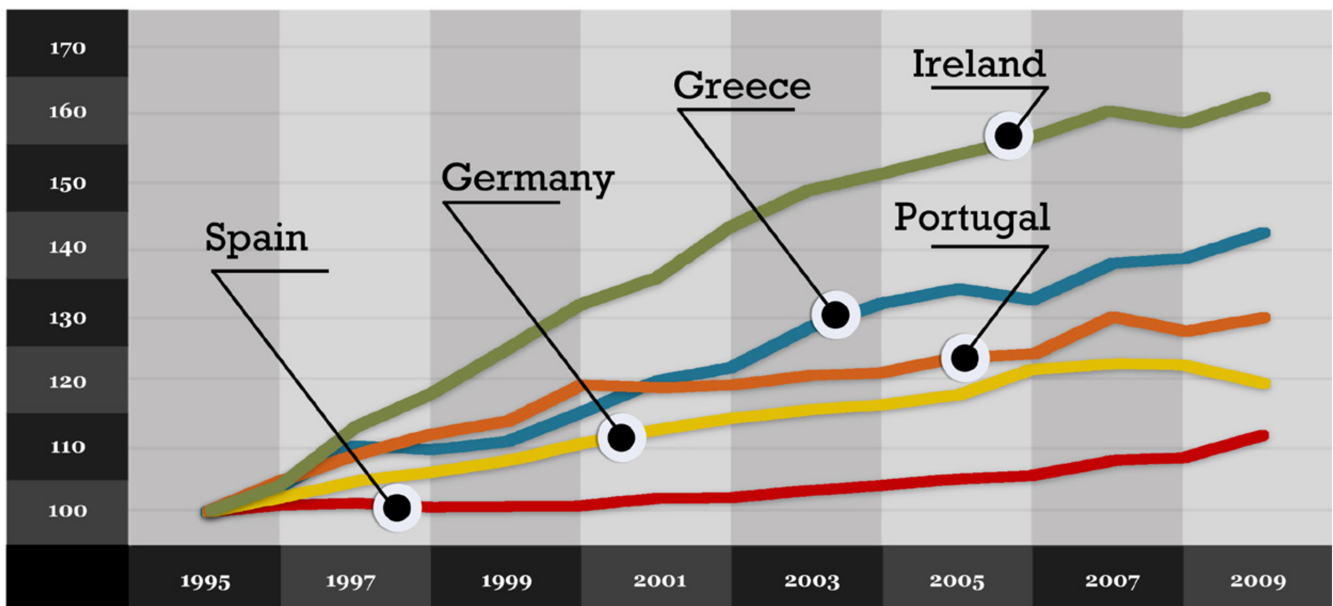
Source: AMECO (2011 and 2012 are forecasts)

Germany has had significant competitive advantages from the beginning but the divergence of nominal unit labour costs - reflecting higher rates of inflation in the periphery countries - has exacerbated its lead. The roots of the division of the Eurozone into core and periphery lie in the systematic gains of competitiveness by Germany[7]. It is worth stressing that German gains have resulted entirely from keeping the nominal cost of labour low, i.e., from applying severe wage restraint on German workers. The structures of the EMU might have been beneficial for German capital, but they were not so for German workers.

It seems that since 2009 unit labour costs have begun to converge. German costs are rising gently as the country recovered rapidly from the recession of 2008-9, mostly on the back of strong export performance. Greek and Irish costs, on the other hand, are collapsing as severe austerity plans were imposed following the eruption of the Eurozone crisis, while Spanish and Portuguese costs are probably declining more gently. The preferred adjustment policy of the EU is apparent: drastically reduce unit labour costs in the periphery through austerity. This policy has severe social costs and class implications, and will take several years significantly to reduce the gap of competitiveness, in view of persistent German wage restraint.

Note, finally, that the gains in German competitiveness have nothing to do with advances in productivity, which has been considerably worse in Germany than Greece and Ireland. The weakness of German productivity growth, moreover, has not been ameliorated in the course of the crisis, as Figure 2 shows:

Fig. 2 - Evolution of productivity growth

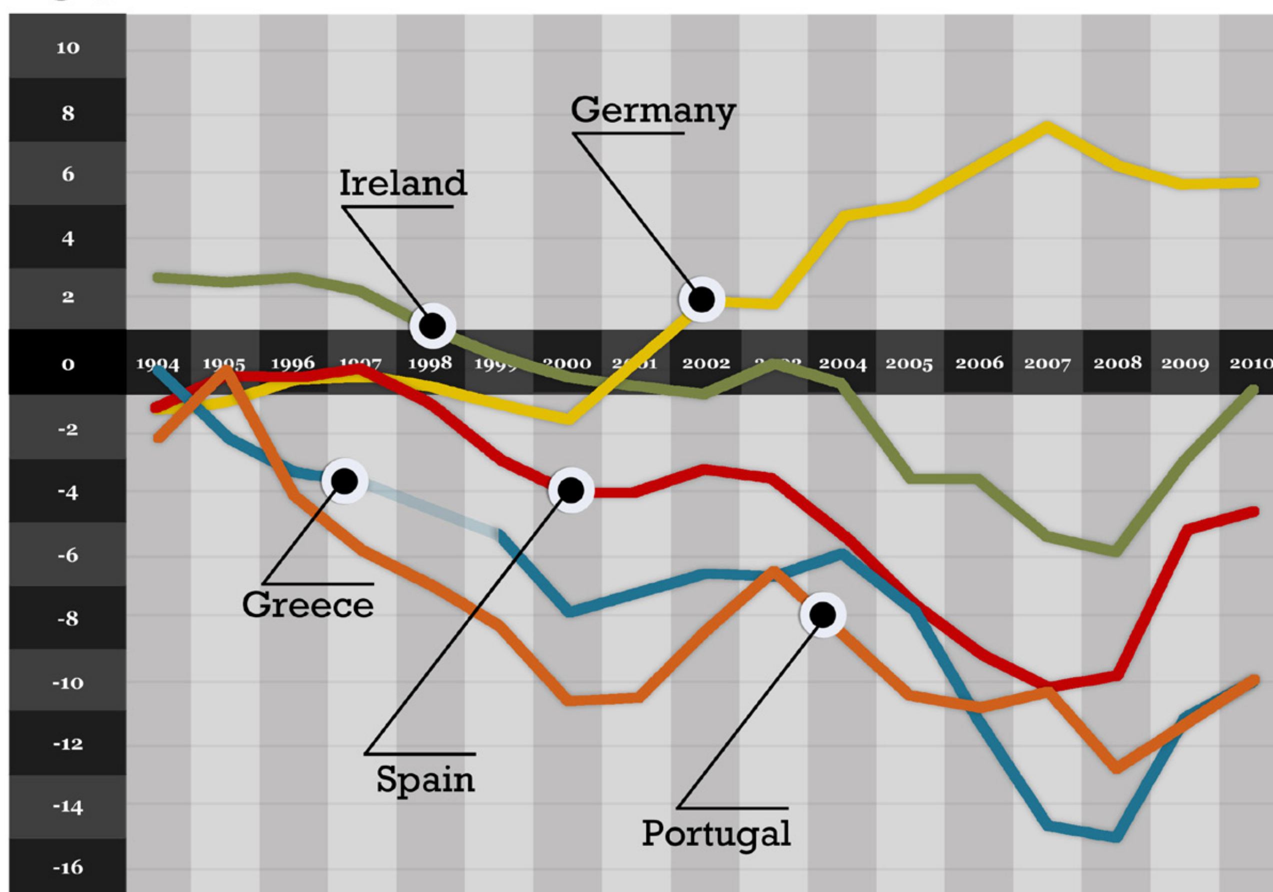


Source: OECD

7 As was already mentioned, the Eurozone also has an external periphery in Eastern Europe which has presented similar tendencies to the internal periphery but does not concern us here.

Loss of competitiveness led to persistent current account deficits for the periphery, mirrored by equally persistent surpluses for the core, above all, Germany, as is shown in Figure 3. There is variation among peripheral countries in this respect. Greece, for instance, has recorded enormous current account deficits driven by equally large trade deficits, while Ireland has had much smaller current account deficits and its trade balance has typically been in surplus. Nonetheless, the bulk of German surpluses have not derived only – or even mostly – from the periphery, but from across the Eurozone. Note, finally, that the divergence has narrowed in the course of the crisis, and as austerity has narrowed the competitiveness gap. But it will be a long time before the scissors actually closed on the basis of austerity.

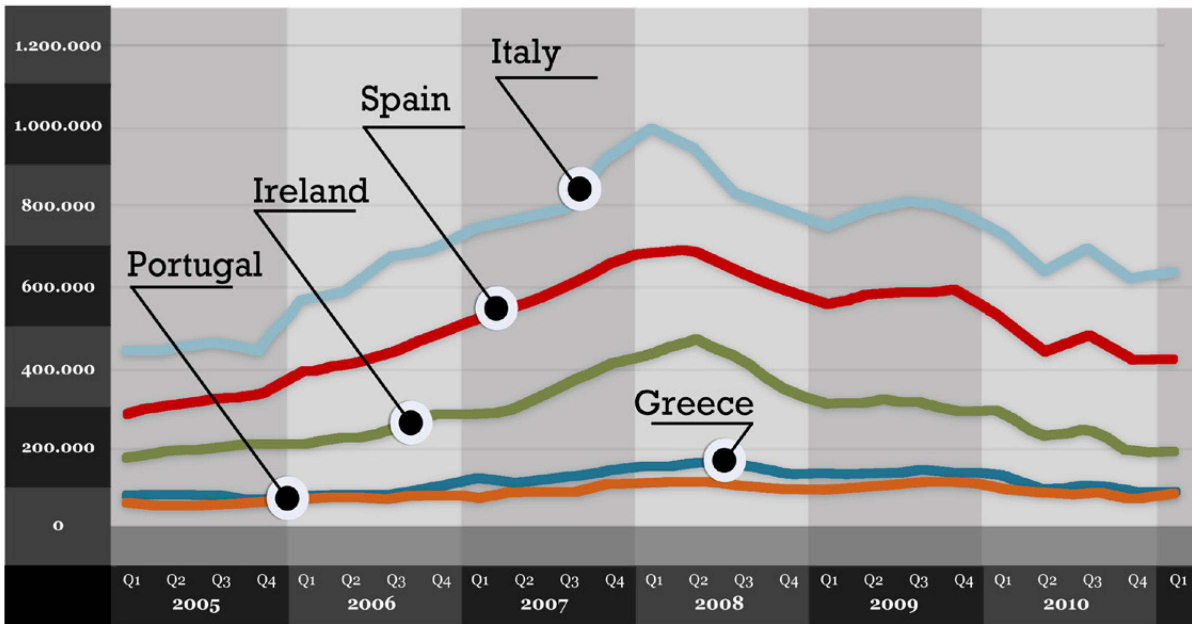
Fig. 3 - Current account balances as % of GDP



Source: BoPS Yearbook (BPM5)

Rising current account deficits in the periphery were financed by foreign lending, both private and public, which was easy for much of the 2000s as the ECB kept interest rates low. Figure 4 shows the exposure of core banks – mostly French and German - to the periphery, which peaked in early 2008. But note that there was also a second, lower, peak in 2009. Following the collapse of Lehman Brothers in late 2008, core banks increased their lending to peripheral countries, including Greece. Much of this lending was to sovereigns on the assumption that they would not default: there was plain market failure.

Fig. 4 - Core bank exposure to Eurozone periphery



Source: BIS Consolidated Banking Statistics

Fig. 5 - Total bank assets (% of GDP)

Source: National Central Banks

At the same time, peripheral banks had access to cheap funds available in the interbank euro market. They were, therefore, able rapidly to expand their assets particularly after 2005, as is shown in Figure 5. Note that Irish banks operated on a hugely greater scale than the rest, partly reflecting the development path adopted by Ireland privileging foreign capital inflows.

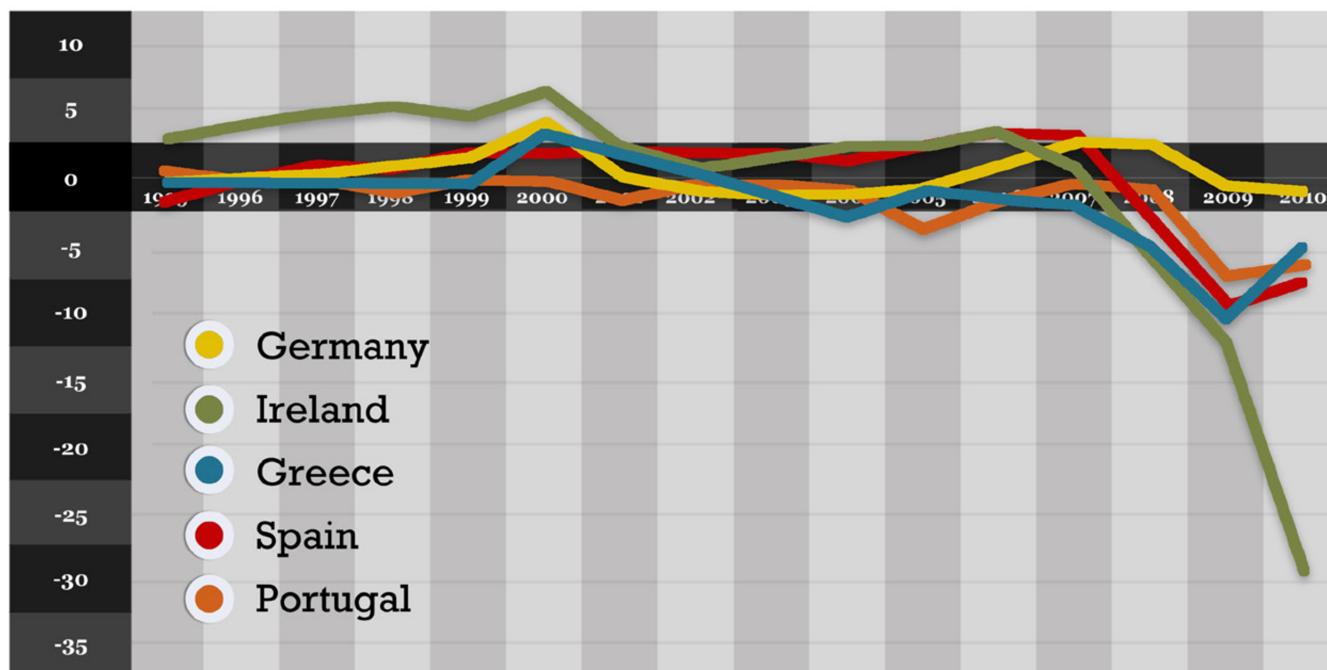
For a brief period cheap credit made peripheral membership of the Eurozone seem successful as rates of GDP growth were generally higher than the core, although not for Portugal. When the crisis of 2007 broke out, however, it became apparent that peripheral success lacked foundations, shown by the divergence in competitiveness. The periphery found itself enormously indebted, domestically and abroad, privately and publicly, though the particular mix of debt varied in each country according to its social and political features[8].

By 2009 Greece carried a large public debt, although private debt had increased much faster during the preceding period. Even more strikingly, the composition of Greek public debt had changed and two thirds were owed to foreign lenders by the end of the 2000s. Ireland and Spain, on the other hand, carried lower public debt, but much greater private debts generated by banks that financed real estate bubbles in the 2000s. Portugal also had relatively modest public debts - though, similarly to Greece, these were owed heavily to foreign lenders - while facing increased debts of households and banks.

The process through which the debt crisis broke out in the periphery is not in doubt. The collapse of Lehman Brothers in 2008 led to recession in both the core and the periphery of the Eurozone as exports and investment fell. Eurozone states faced falling tax revenues, while attempting to support aggregate demand and to rescue banks. Rising budget deficits followed, the direct result of the crisis and not of state profligacy, even in Greece, as Figure 6 shows:

[8] The macroeconomic processes of peripheral indebtedness and the profile of peripheral debt have been discussed in detail in Research on Money and Finance, 2010b. The Eurozone between Austerity and Default, C. Lapavitsas, A. Kaltenbrunner, G. Lambrinidis, D. Lindo, J. Meadway, J. Michell, J.P. Painceira, E. Pires, J. Powell, A. Stenfors, N. Teles, Occasional Report 2, September, www.researchonmoneyandfinance.org.

Fig. 6 - Government primary balances



Source: Eurostat

Escalating budget deficits and unfolding recession led to rapid growth of sovereign debt in the periphery. Bond markets began to have doubts about the creditworthiness of the debt of peripheral sovereigns. It gradually became clear that the core would not accept responsibility for the public debt of the periphery. Consequently, Greece, Ireland and Portugal were successively shut out of bond markets in 2010-11. The attitude of the core has been entirely consistent with the nature of the euro as a sui generis reserve currency. Core countries, above all Germany, have never accepted fiscal responsibility for the periphery since they have lacked effective means of monitoring and sanctioning fiscal performance.

The real problem for the core, however, was the likely impact of peripheral default on core banks. Indebted peripheral states threatened the banks of both core and periphery which had grown enormously by taking advantage of the common currency. The countries of the core were forced to respond to protect their own banks as well as the euro. As contagion began to spread beyond the periphery in 2011, threatening Spain and Italy, the danger to banks and to the monetary union as a whole loomed large. The response of core countries reflected the contradictory and discriminatory nature of the monetary union, and also indicated that the euro was no longer sustainable in its existing form, if at all. The political economy of the threatened rupture is examined in the following chapter.

Chapter 2
Monetary disunion: Institutional malfunctioning and power relations

Several economists have argued that the EMU is inherently unstable and could lead to crisis. A cursory list would include Flassbeck, who has claimed consistently that the monetary union would prove untenable in view of the entrenched differences in competitiveness that favour Germany[9]. It would also include Arestis and Sawyer who have examined the institutional defects of the Eurozone.[10] Others, such as Feldstein and Friedman, have noted the contradiction between the homogeneity of monetary policy and the fragmentation of fiscal policy across the Eurozone[11].

When the crisis burst out, several economists claimed that its resolution would require radical change of the monetary union. Thus, Goodhart and Tsomocos have proposed the creation of a dual-currency system for peripheral countries; [12]Aliber has argued that devaluation and exiting the Eurozone would prove inevitable for Greece; [13] and Rogoff has insisted that peripheral countries, above all, Greece and Portugal, would probably default and exit the Eurozone[14].

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9 For a succinct summary see Flassbeck H. and Spiecker F. (2009), 'Cracks in Euroland and no way out', 44: 1, pp. 2-3, http://www.springerlink.com/content/6l73h06043663p4q/fulltext.pdf.

10 See, for instance, Arestis P., Brown A., and Sawyer M., (eds), (2001), 'The Euro: Evolution and Prospects', Cheltenham, UK and Northampton, USA: Edward Elgar.

11 See Feldstein M. (1997). 'The political economy of the European Economic and Monetary Union: Political sources of an economic liability', National Bureau of Economic Research Working Paper Series, no. 6150. See also 'An interview with Milton Friedman. Interviewed by John B. Taylor, May 2000' in Samuelson P. and Barnett W., (eds), (2007), Inside the Economist's Mind: Conversations with Eminent Economists, Blackwell: Oxford.

12 See Goodhart CAE and Tsomocos D. (2010), 'The Californian solution for Club Med', Financial Times, January 25, http://www.ft.com/intl/cms/s/0/2074e990-0952-11df-ba88-00144feabdc0.html#axzz1TVMjulHv.

13 See R. Aliber (2010), 'The Devaluation of the Greek Euro', International Political Economy, Marvin Zonis + Associates, February 17, Inc., http://pmteam.ru/upload/image/TheDevaluationoftheGreekEuro2-17-10.pdf?PHPSESSID=d74ff6bcfe6f77e8c9a9faed12b28658.

14 See, for instance, Pressley J. (2010), 'Harvard's Rogoff Says EU's Bazooka Won't Prevent Defaults' Bloomberg, May 19, http://www.bloomberg.com/news/2010-05-18/harvard-s-rogoff-says-eu-s-bazooka-won-t-prevent-defaults.html

As the crisis deepened in 2010-11 it has become conventional wisdom that the Eurozone suffers from major institutional weaknesses. Above all, the union is thought to possess a unitary monetary policy backed by a single central bank and a homogeneous money market, but not to have made equivalent provision for fiscal policy. During the 2000s it relied on the Growth and Stability Pact which stipulated limits for budget deficits and the aggregate national debt (3% and 60% of GDP, respectively) an approach that worked badly since responsibility was left to individual sovereign states.

The point is, however, that institutional malfunctioning of the Eurozone is not merely the result of poor design, and nor of bad economic theory. It is, rather, the outcome of political and social relations that have underpinned the creation of a new international reserve currency. At the root of the turmoil in the Eurozone lie class and imperial interests, not the 'technical' errors of monetary union. Both the crisis and the subsequent response of the EU have been shaped by these interests, leading to contradictory and problematic outcomes, as is shown in subsequent sections.

2.1 The ECB and the limits of liquidity provision

The main agent of EU intervention has been the ECB for two reasons. First, the true threat posed by the crisis is to the financial system of Europe, which is the natural province of a central bank. Second, in the absence of a state to support the EMU, the ECB has been forced to substitute itself in part for a fiscal authority. The result has been to complicate, instead of resolving, the crisis. To establish this claim consider the following points about central banking.

A central bank is the dominant bank of the interbank (or money) market overseeing the supply of liquidity among private banks. It can play this role because its own liabilities are typically the most acceptable form of credit money. The specific ways of liquidity provision depend on the institutional composition of the financial system. For much of the post-war period, central banks provided liquidity directly, for instance, through the discount window. Financialisation brought rapid growth of financial markets and increased trading of financial assets, encouraging central banks to provide liquidity through market transactions, including the outright purchase of securities, or more often the use of repos.

Nonetheless, the principle has remained that central banks can act as last line of defence on liquidity because their liabilities are the most acceptable form of credit money. The ultimate guarantor of this function, however, is the state whose power – fiat – turns the liabilities of the central bank into legal tender for commercial and other obligations. The state is also the ultimate guarantor of the solvency of the central bank which remains, after all, a bank. By lending freely at times of crisis the central bank acquires substantial credit risk, and hence relies on the state to replenish its capital out of tax and other revenues, should there be major losses. In short, the unencumbered delivery of central banking functions ultimately depends on the fiscal authority.

In this light, the ECB is a peculiar central bank, as befits the principal institution supporting a novel and peculiar form of reserve currency. It is by far the dominant bank in the EMU interbank market determining benchmark interest rates and normalising the supply of liquidity. It formulates and conducts monetary policy through the medium of the NCBs, as is described in Box 1. Yet, it cannot rely on the backing of a state, and has to draw its legitimacy from social trust mobilised across the Eurozone as well as from shifting relations among member states. This is a major weakness for the ECB.

It is important to note in this respect that ECB capital has been provided by member states in carefully calibrated proportions, each carrying individual responsibility for its share, as is shown in Box 2. These proportions – as well as locating the ECB in Frankfurt – reflect the inherently hierarchical nature of the EMU, with Germany at the top. It is no accident that they have been used as the benchmark for the bail-out loans to member states in 2010-11.

It is equally important to note that the ECB was set up as an 'independent' central bank, in part following the theoretical fashions of the 1990s. From its inception it has been an exclusionary agglomeration of public servants, bureaucrats and technocrats operating under the explicit mandate of controlling inflation. Under no circumstances was the 'independent' ECB to finance the borrowing of member states since that could potentially breach the fundamental principle of EMU construction, i.e., that weaker should not impose fiscal obligations on stronger states. On the wake of Lehman Brothers' collapse in 2008, the ECB has provided liquidity to banks on a large scale, at very low rates, through a variety of methods summed

up in Box 3. Much of this funding has been through longer-term financing operations typically on the basis of accepting illiquid private securities and problematic sovereign bonds as collateral.

In the course of the crisis, however, the ECB has come under increasing pressure to play an implicit fiscal role by acquiring sovereign paper from banks in the secondary markets. Indeed, in 2011, it faced demands to play an even stronger fiscal role by directly acquiring sovereign paper from weaker countries, possibly running in the trillions of euro. In effect, it has been asked to homogenise public borrowing in the EMU and substitute itself for the missing state. And yet, the ECB would itself require the presence of a state, if it was to act as a fiscal agent for the entire EMU. This absurdity reflects the contradictory and unsustainable nature of the monetary union.

Much of the trouble for the ECB arises because sovereign debt and banking difficulties are inextricably intertwined within the EMU, as was discussed in chapter 1, and have become even more so in the course of the crisis. European banks indeed face liquidity shortages, but their deeper problem is weak solvency as a result of exposure to sovereign debt, particularly in the periphery. Dealing with solvency requires either shutting down the insolvent agent, or making injections of fresh capital. Liquidity provision is of no use and it can even make the problem worse by sending good money after bad.

The proper agent to deal with insolvent banks would be an arm of the Ministry of Finance able to shut down insolvent banks as well as providing fresh capital by mobilising the state's capacity to tax. A central bank is not equipped for this task, either by nature or by design. In the absence of a Ministry of Finance, the ECB has been forced to take problematic sovereign and private paper from banks, allowing the latter to shift credit risk onto the balance sheet of the central bank. The oft-heard demand that the ECB should play an even more active fiscal role in resolving the crisis means that the ECB would be providing gigantic loans to states, which would be partly used to bolster the solvency of the European banking system.
For a central bank that lacks a state to lean on, the complexities could become serious, particularly for the acceptability of its own liabilities as is discussed in chapter 3. In sum, the ECB is under pressure to play a role that it cannot deliver well and which creates risks both for the central bank and for the common currency.

BOX 1

CENTRAL BANKING IN THE EMU

The ECB was established on 1 June 1998 as the central bank in charge of the single European Currency. The ECB manages the European System of Central Banks (ESCB), which comprises the ECB and the National Central Banks (NCBs) of all members of the EU, including those that have not adopted the euro. The Eurosystem refers to the ECB and the NCBs of the 17 countries that have adopted the euro.

On 1 January 1998, the third and final stage of Monetary Union (EMU) was launched, with the irrevocable fixing of the conversion rates of the 11 member states that initially chose to adopt the euro, the surrendering of monetary policy control to the ESCB, and the introduction of the single currency.

The objectives of the ESCB are defined as follows: ‘The primary objective of the ESCB shall be to maintain price stability. Without prejudice to the objective of price stability, the ESCB shall support the general economic policies in the Community with a view to contributing to the achievement of the objectives of the Community as laid down in Article 2’ (Article 105.1 of the Treaty Establishing the European Community). Article 2 of the Treaty specifies that the objectives of the economic policy of the European Community include a high level of employment and sustainable, non- inflationary growth.

The independence of the ESCB is legally encoded in the Treaty establishing the European Community and in the Statutes of the ESCB and the ECB. This serves to preclude the possibility of the national government of any member state from exerting influence on either the ECB or the NCBs of member states.

The ESCB formulates and implements monetary policy, with the primary objective of maintaining price stability. Although monetary policy is decided by the ECB, policy implementation is undertaken by the NCBs on the behalf of the ECB.

Monetary policy implementation is carried out using three main instruments: standing facilities, open market operations and reserve requirements. The technical details of monetary policy implementation are briefly discussed below with reference to a consolidated Eurosystem balance sheet, adapted following Bindseil, U. (2004) Monetary Policy Implementation, Theory, Past, Present, Oxford: Oxford University Press.

Under normal circumstances, the ECB does not hold securities outright for the purposes of monetary policy implementation. Instead, repurchase agreement operations (repos) are used as the primary tool for liquidity management of the Eurozone banking system. These operations are shown on the balance sheet as 'OMO short term' and 'OMO long term'. However since the start of the Securities Market Programme (SMP) in 2010, aimed at easing conditions in government bond markets, the ECB has been making outright purchases of government securities in the secondary markets. These are recorded under the category 'Domestic Securities incl. Government debt and SMP', which has expanded significantly in recent months, with purchases made through the SMP reaching around EUR 160bn by the end of September 2011. The ECB aims to 'sterilise' liquidity released through these operations by using offsetting operations. The item 'fixed term deposits' on the liabilities side of the balance sheet represents one of the mechanisms by which the ECB attempts to withdraw liquidity, auctioning fixed-term deposits at above-market-rates of interest.

The ECB provides both a borrowing and a lending facility with unlimited access. Under normal market conditions, recourse to both is very limited and tends to be symmetrical, reflecting the fact that the ECB is able to control money market interest rates such that they stay close to the target level by using open market operations as the primary policy instrument. However, as can be seen from the balance sheet shown in the figure below, while recourse to the marginal lending facility was negligible at around EUR 0.5bn, recourse to the deposit facility was significant at EUR 150bn. This reflects increasing tension in the money markets as banks have become more wary of lending, and have instead chosen to keep liquidity safe at a low rate of interest (currently 0.75%) at the ECB.

Note that NCBs remain crucial to the Eurozone. In the course of the crisis NCBs have become even more important, signalling a reassertion of national interest

across the Eurozone, as is shown in chapter 4. NCBs retain the ability to act separately from each other, while the financial system of each country gains access to the ESCB through its own NCB. Transactions between NCBs, or between NCBs and the ECB, give rise to (gross and net) NCB claims on each other within the Eurozone.

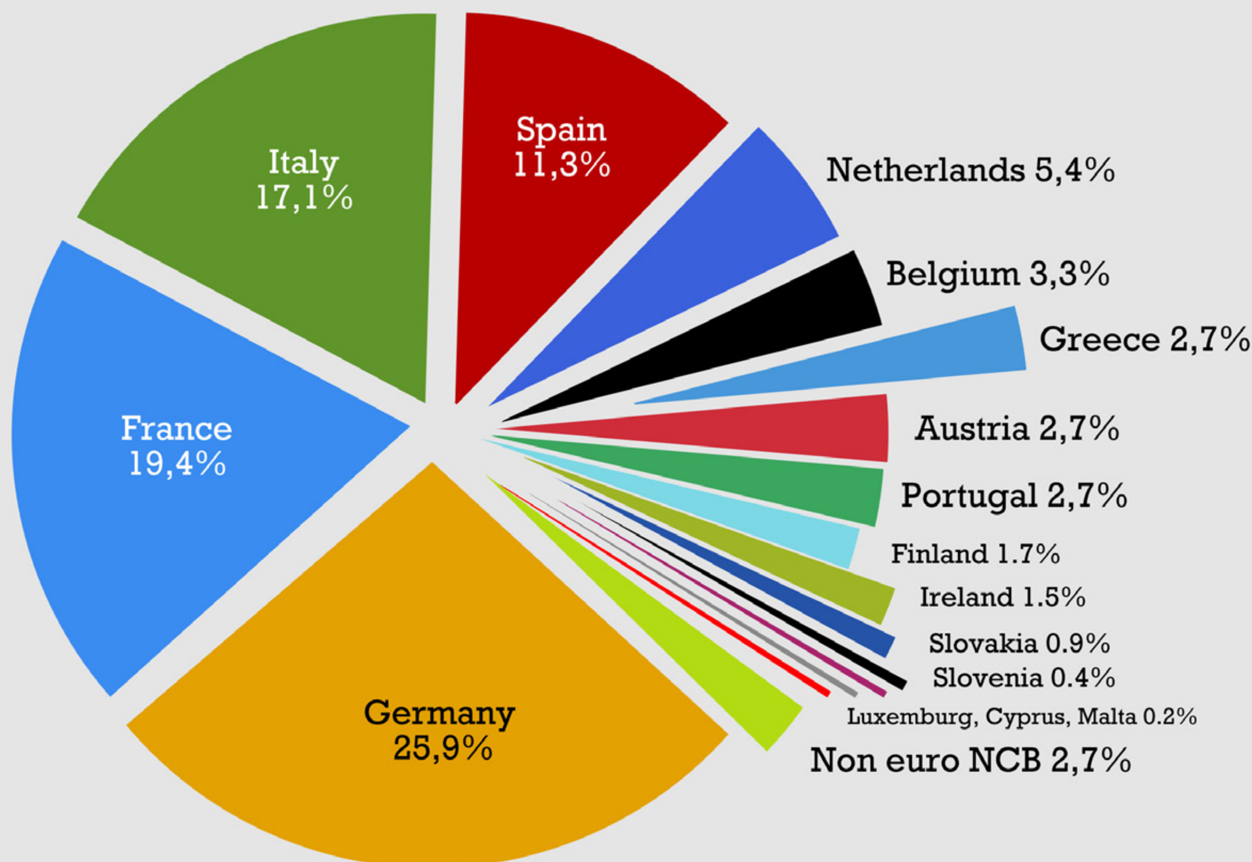
The Eurosystem can thus be considered as a kind of European interbank market for NCBs in which central banks with surplus reserves lend to others that are short of reserves. At the same time, NCBs are also linked to domestic money markets, allowing domestic banks to have access to a continental pool of liquidity through the Eurosystem.

Consolidated financial statement of the Eurosystem as at 23 September 2011 (units: bn EUR)

ASSETS		LIABILITIES	
Gold and Net Foreign Assets	541.1	Banknotes in circulation	852.5
Domestic Securities incl. Government	586.1	Capital, reserves, incl. Revaluation accounts	398.1
Other domestic assets	70.8	Other autonomous factors	125.3
OMO Short term	201.1	Deposits of credit institutions	154.0
OMO Longer term	369.6	Reserves of credit instutions	223.5
Borrowing Facility	0.5	Fixed-term deposits	152.5
Other Assets	344.1	Other liabilities	207.4
TOTAL	2113.3	TOTAL	2113.3

BOX 2

National Central Bank (NCB) contributions to ECB capital



Source: ECB, available at http://www.ecb.int/ecb/orga/capital/html/index.en.html

The data refers to the amounts paid-up by NCBs on 01/01/2011, which reflect:

• NCB shares in ECB capital - calculated using the respective country's share in the total population and gross domestic product of the EU, with equal weights. They are adjusted every five years and whenever a new country joins the EU.

• The EU non-euro area NCB contributions – reflecting the operational costs incurred by the ECB due to their participation in the European System of Central Banks (ESCB) and equivalent to 3.75% of their subscribed capital. The non-euro area NCBs are not entitled to receive any share of the profits of the ECB, nor are they liable to fund losses of the ECB.

• The recent increase in ECB subscribed capital of €5 billion, from €5.76 billion to €10.76 billion, with effect from 29 December 2010. In order to smooth the transfer of capital to the ECB, additional capital contributions by NCBs have been subscribed in three equal annual instalments, starting on 29 December 2010.

BOX 3

MAIN ECB OPERATIONS FROM AUGUST 2007 TO LATE 2011

August 2007: (1) temporary supply of additional liquidity; (2) supplementary longer-term refinancing operations - more than €600 billion of refinancing to the banking sector.
December 2007: To meet the dollar funding problems of banks the ECB provided US$ liquidity, against collateral eligible for Eurosystem credit operation, in connection with the Federal Reserve System's US$ Term Auction Facility (TAF); The US dollars were provided by the Federal Reserve System to the ECB by means of a temporary swap line and the Eurosystem passed them on to its counterparties in repo operations.
September 2008: (1) special-term refinancing operations; (2) fixed rate full allotment procedure; (3) narrowing of formed by the rates on the two standing facilities around the MRO rate.
October 2008: (1) expansion of the eligible securities as collateral; to enhance the provision of longer-term refinancing, with effect from 30 October 2008 and until the end of the first quarter of 2009, and (2) to provide US dollar liquidity through foreign exchange swaps.
May 2009: (1) enhanced credit support; refinancing operations with a maturity of 12 months; (2) purchase euro denominated covered bonds.
May 2010: The Governing Council of the ECB decided on several measures to address severe tensions in financial markets. In particular, it decided to conduct interventions in the public and private debt securities markets (Securities Markets Programme) and to adopt a fixed rate tender procedure with full allotment in the regular three-month longer-term refinancing operations in May and June 2010.
August 2011: Provision of liquidity to banks by means of full allotment at fixed rates extended until at least to early 2012; Eurosystem will conduct a liquidity-providing supplementary longer-term refinancing operation with maturity of approximately six months as a fixed rate tender procedure with full allotment; active implementation of the SMP
September 2011: ECB announces additional US dollar liquidity-providing operations.

To sum up, ECB interventions have amounted to:

A. Non-standard monetary measures:
Securities Markets Programme (SMP), i.e. provision of unlimited liquidity at various maturities (up to 1 year) with fixed interest rates in exchange for eligible securities the criteria for which have become more flexible in the course of the financial crisis

B. Main liquidity provision measures:
On the ECB´s asset side:

- Main refinancing operations
- Longer-term refinancing operations
- SMP
- Covered bond purchase programme
- US dollar repo and swap operations

On the ECB's liability side:

- Banknotes
- Liquidity absorbing fine-tuning operations
- Overnight deposit facilities as main counterparty of the refinancing operations and more recently the SMP

C. Features of SMP Operations
Collateral accepted after a haircut
Only in secondary markets, not directly from governments
Fully sterilised by means of specific liquidity absorbing operations, mainly through term-deposit facilities

2.2 EFSF and ESM fumbling

The knotty problem of bank solvency ultimately reflects the contradictory and hierarchical relations at the heart of the Eurozone. The monetary union possesses both a homogeneous monetary sphere and a homogeneous interbank market, but there is no such thing as a 'European' bank. Banks are international when it comes to liquidity, but national when it comes to solvency. If credit losses put solvency at risk, the last recourse of a bank in Europe would be to its nation state.

This contradiction has a vicious aspect in the context of Eurozone crisis since the major threat to bank solvency has arisen precisely because of the debt of nation states. How could a nation state be the rescuer of its banks when it also is the pre-eminent threat to them? Given the close interconnection among European banks, the insolvency of some banks could thus pose a major threat to the stability of the system as a whole. By implication, the monetary union would be at risk of collapse. In principle the problem could be solved through private takeover of weak banks, or capital injections by another state, or states. The former option remains valid and might well materialise in the long term thus leading to wholesale restructuring of European banking. The latter option, however, has proven exceedingly difficult because the Eurozone lacks an over-arching state. The sovereign states of the core have neither the disposition, nor the legitimacy, to rescue troubled banks in the periphery, or indeed in other countries of the core. If they were to provide the required capital injections, there would have to be a hardnosed quid pro quo. The EMU has consistently skirted around this difficulty, mostly because of its inherent complexity. Its preferred response has been to advance bailout loans to peripheral states, thus enabling them to support their banks and to continue financing their expenditure. This had the further advantage of concealing the banking problem under a putative fiscal crisis caused by profligate and dissolute peripheral countries. The mechanism chosen for the purpose was the European Financial Stability Facility (EFSF) an essentially temporary mechanism that would be replaced by the permanent mechanism of the European Stability Mechanism (ESM) in 2013, or even earlier. Both are briefly discussed in Box 4.

These mechanisms are the product of social and political relations constitutive of the EMU. The EFSF is essentially a Special Purpose Vehicle (or Collateralised Debt Obligation) issuing its own bonds to lend to states in distress. It own borrow-

ing, however, has stuck rigidly to the fundamental EMU principle of individual responsibility for the debt of each guarantor state.

The support that peripheral countries have received from the EFSF (and the support Greece initially received through its special programme of May 2010) has comprised loans guaranteed on an intergovernmental basis, pro rata to each state's contribution to the capital of the ECB. Even toward the end of 2011, and as the crisis became acute, the core of the union showed no disposition to setting up a system of jointly honouring the debts of the periphery. Rescue loans have remained temporary, crisis-driven measures forced upon core countries. Hierarchical relations, enshrined in capital provision to the ECB, have been strictly maintained with the result that Germany has had the final word on all rescues.

Furthermore, rescue loans were initially designed to be punitively expensive presumably to teach a moral lesson to delinquent sovereign borrowers. The contrast with the exceptionally cheap liquidity that the ECB provided to equally troubled banks could not be sharper. Perhaps private banks were not in need of additional moral fortitude. Last, but far from least, support for the periphery came on condition of tough austerity policies, designed and supervised by the IMF, which also contributed to the bailouts.

The inadequacy of this response has become vividly apparent in late 2011 as austerity led to a worsening of the crisis thus making sovereign default more likely. The risks to banks have increased correspondingly. If the EFSF is to confront the problem, it would have to command greater resources but, more significantly, it would also have to rescue the banks of failing sovereigns. For this, it would need either to operate on the basis of joint and several liability for its debts, or it would draw directly on the guarantees of the leading states of the EMU to rescue the banks of other states. In both cases it would come into direct conflict with the fundamental fiscal principle of the EMU. Try as it might, the EMU cannot get away from the underlying absence of a unitary or federal state to buttress it.

The implications for both the ECB and the EFSF are considered in more detail chapter 3 after briefly examining the results of the bailouts and austerity in the periphery.

BOX 4

THE EFSF AND THE ESM

The EFSF resembles the Special Purpose Vehicles (SPVs) that allowed banks to remove risky assets from their balance sheets during the sub-prime bubble, and which played a central role in the early stages of the crisis. It is an independent company, headquartered in Luxembourg, with the remit of issuing bonds in capital markets to raise funds to assist Eurozone countries facing serious fiscal difficulties. It was established in May 2010 with an initial lending capacity of around EUR 250bn, but has subsequently been expanded to raise the lending capacity to EUR440bn.

The bonds issued by the EFSF are guaranteed by Eurozone member states according to their share in the capital contributions to the ECB. The initial design of the EFSF made provision for EUR440bn of guarantees, which allowed for a total lending capacity of around 250bn at an over-guarantee rate of 120%. The facility was subsequently expanded to allow for up to 440bn of lending against guarantees of 780bn, an over-guarantee rate of 165%. Of that 780bn in guarantees, around 450bn is AAA-rated, with the rest AA and below. The largest guarantee contributions have come from Germany and France, at 210bn and 160bn respectively. The structure of the vehicle in its current form implies that lenders would be fully covered on the principal as long as defaults by sovereign guarantors do not exceed 165% of the total amount borrowed.

At present the Facility can use the funds raised to provide assistance to distressed sovereigns in one of three ways:

- Sovereigns that are not currently in IMF packages could borrow directly from the EFSF on the basis of strict conditionality on the debtor government. Conditionality would inevitably entail austerity packages that aim to reduce fiscal deficits through deflationary policies.

- Countries could also borrow from the EFSF for the purposes of domestic bank recapitalisation. This borrowing is not provided directly to the banks that require the funds, but is done via the government of the country in which the bank to be recapitalised is resident.

- The EFSF can intervene directly in the secondary bond markets, buying up the debt of distressed countries with the aim of stabilising yields. In exceptional circumstances the EFSF would be allowed to make purchases directly in the primary bond markets.

The EFSF was conceived initially as a temporary ‘holding measure’ to calm markets and allow for short-term emergency lending. At the same time, a permanent entity, the European Stabilisation Mechanism (ESM), is due to come into existence in June 2013 in a phased takeover from the EFSF.

The proposed ESM would act as a permanent lending facility, with powers similar to that of the EFSF, and is to be capitalised with EUR700bn, allowing for a total lending capacity of EUR500bn. Of the EUR700bn capitalisation, EUR80bn would take the form of paid-in capital, with the remainder taking the form of guarantees, as in the EFSF. This capital is to be paid in instalments of EUR16bn on an annual basis starting from 2013.

Chapter 3
Failing austerity:
Class interests and institutional fixes

3.1Virtuous austerity: Hurting without working

The rescue packages for the periphery have been driven by neoliberal ideology convinced of the virtues of 'fiscal responsibility' as both cure and preventative of crises. Austerity has been imposed, coupled with liberalisation and privatisation: public spending has been cut, taxes increased, wages reduced, markets further deregulated, and public enterprises have been lined up for privatisation. A summary of the most recent measures is given in Box 5 below.

BOX 5

THE HOLY TRINITY: AUSTERITY, LIBERALISATION, PRIVATISATION

Since the end of 2010 cuts in public expenditure, increased taxes, privatisations and further labour market deregulation have been adopted across Europe. But the degree and incidence have varied considerably among countries of the periphery, or those close to it.

Spain and Italy, confronted with increasing difficulties in accessing international bond markets, have adopted austerity programs voluntarily, though almost certainly under pressure from the EU. Spain, in particular, has endured an adjustment programme that was initiated in 2010 bringing spending cuts, tax increases and labour market liberalisation. It has recently accepted the introduction of formal public deficit limits in its constitution. Italy has approved an austerity package of EUR45.5bn that would entail spending cuts and increased taxes, affecting in particular local council services.

Portugal, Ireland and Greece have signed memoranda with the “troika” institutions (IMF, ECB and EU). Provision was made for spending cuts and higher taxes, but the memoranda are far more than fiscal road maps to lower public deficits and debt. They promise profound change to the historic organisation of these societies, including liberalising reforms in health, education, social security, the judicial system and so on. In a little more detail:

Greece
After more than a year of unrelenting austerity, and under pressure from the troika, Greece announced in September/October 2011 a new round of measures, despite the severity of recession in 2010-11. Key points are the dismissal of 30000 public sector workers and further cuts of 20% on pensions above 1200 euro (or 40% for retired people under 55 years old). The Greek government has also proposed an extremely ambitious - and widely perceived as unattainable - privatisation programme that would ostensibly raise EUR50bn.

Portugal
The new right-wing Portuguese government has announced its intention to go beyond the troika memorandum signed by the previous government. Following a cut of 5% of public sector workers wages and pensions in 2011, further cuts of 14% are planned for 2012-13. New taxes have been announced: income tax equivalent to 3.5% of annual income, VAT on essential goods and utilities (gas and electricity have risen to 18%) property taxes, and so on. Further cuts in unemployment and other social benefits and labour market liberalisation are scheduled for the coming months. The privatisation programme has been accelerated forecasting revenues of EUR5bn.

Ireland
In Ireland, the troika has forced reform of income tax by widening the tax base, lowering tax bands and reducing various tax benefits. New taxes are to be imposed on property and capital gains. The pension system is to be reformed raising the average age of retirement, while new entrants would suffer a 10% cut on expected pension. An average cut of pensions of 4% was expected for 2011. Social protection and the number of public sector workers are to be reduced in coming years.

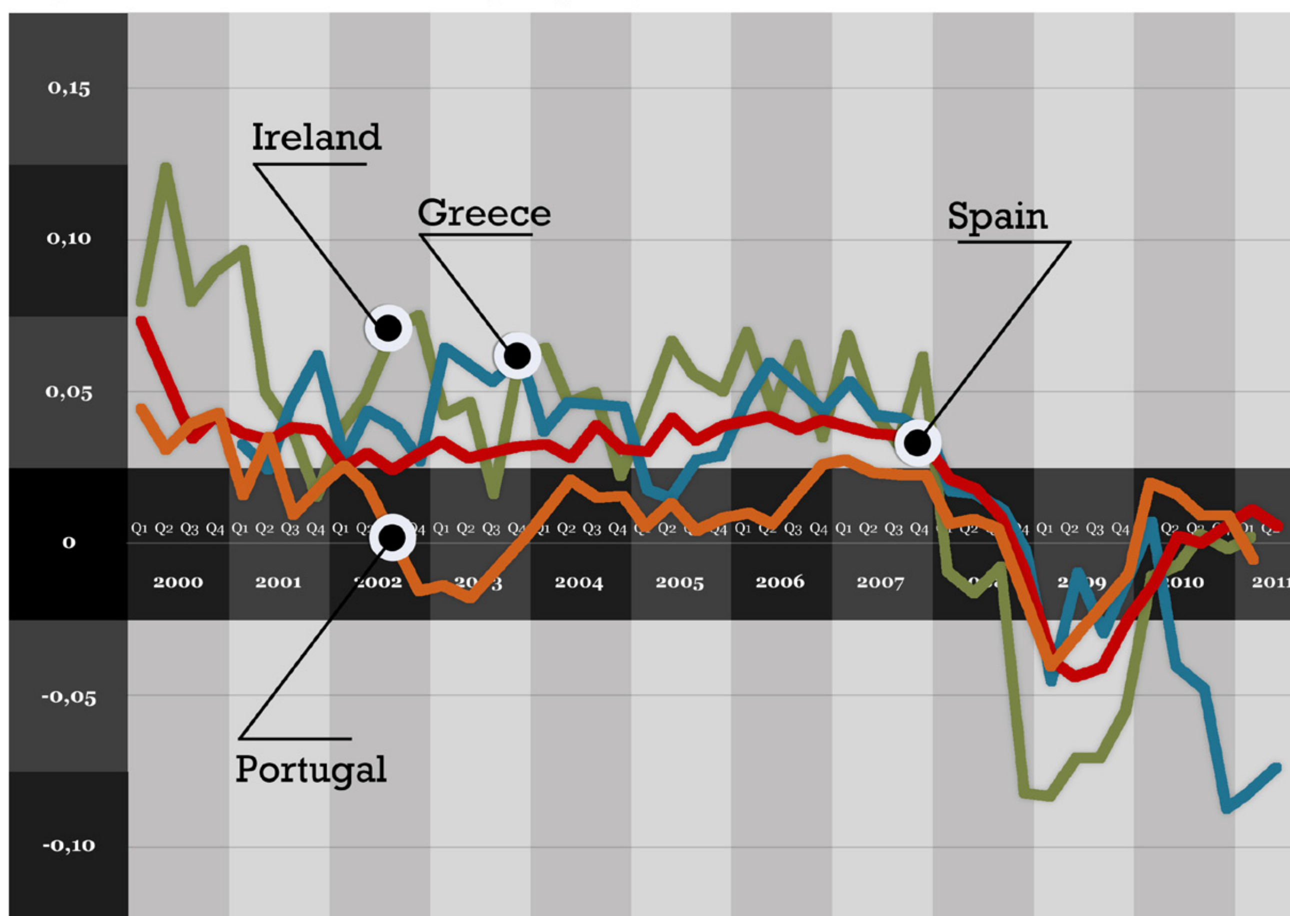
These policies aim at protecting the interests of banks and bondholders by preventing default as well as protecting the interests of industrial capital by changing the balance of power against labour. Pressure has been so severe that the conditions of life of the middle class have also been disrupted in terms of income and employment, including the operations of small business.

Predictably, austerity has failed to resolve the crisis and indeed made things worse, since the crisis is not due to fiscal profligacy, as was discussed in chapter 1. Its roots lie in the loss of competitiveness by the periphery coupled with an enormous

financial expansion in the 2000s. Austerity and additional pressure on labour in the periphery are unlikely to be effective in the short run, if at all. The competitiveness gap and the current account imbalances between core and periphery are likely to persist. At the same time, public expenditure cuts and tax increases together with credit shortages due to problems of banks have exacerbated recession in the periphery. Conditions in Greece in particular have become very severe.

Figure 7 indicates that recovery from the recession of 2008-9 in the periphery is at considerable risk following the application of austerity. Greek GDP has collapsed as the country entered one of the most severe contractions in its recent history. It is likely that the other peripheral countries will also re-enter recession in the coming period.

Fig. 7 - Growth rates in the periphery

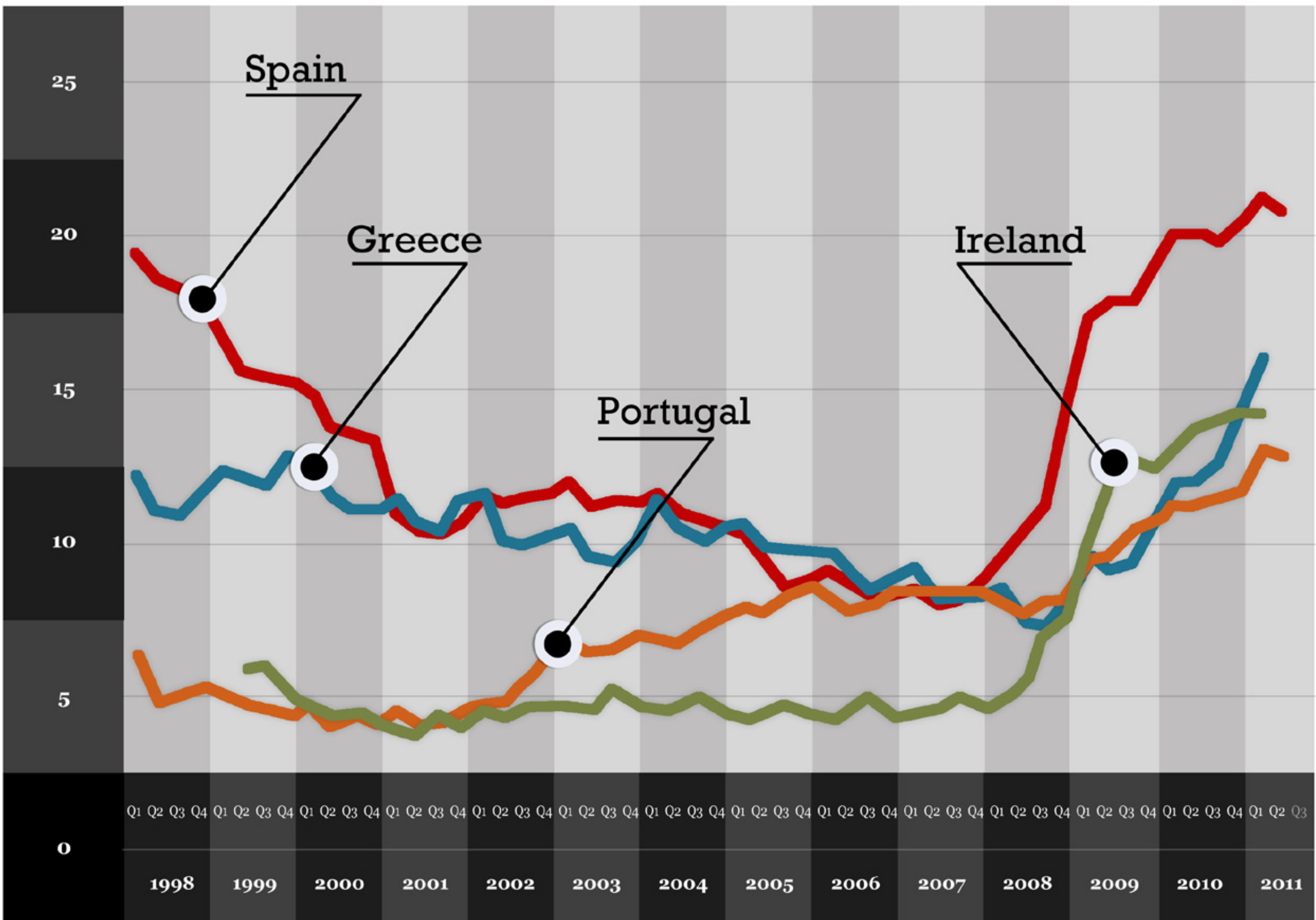


Source: Eurostat

The counterpart to recession has been a rise in unemployment, a true reflection of the social cost of austerity. Emigration, especially among the young, also appears

to be increasing in the periphery. Figure 8 shows the rapid growth in unemployment, particularly in Spain and Greece where conditions have begun to resemble the Great Depression of the 1930s.

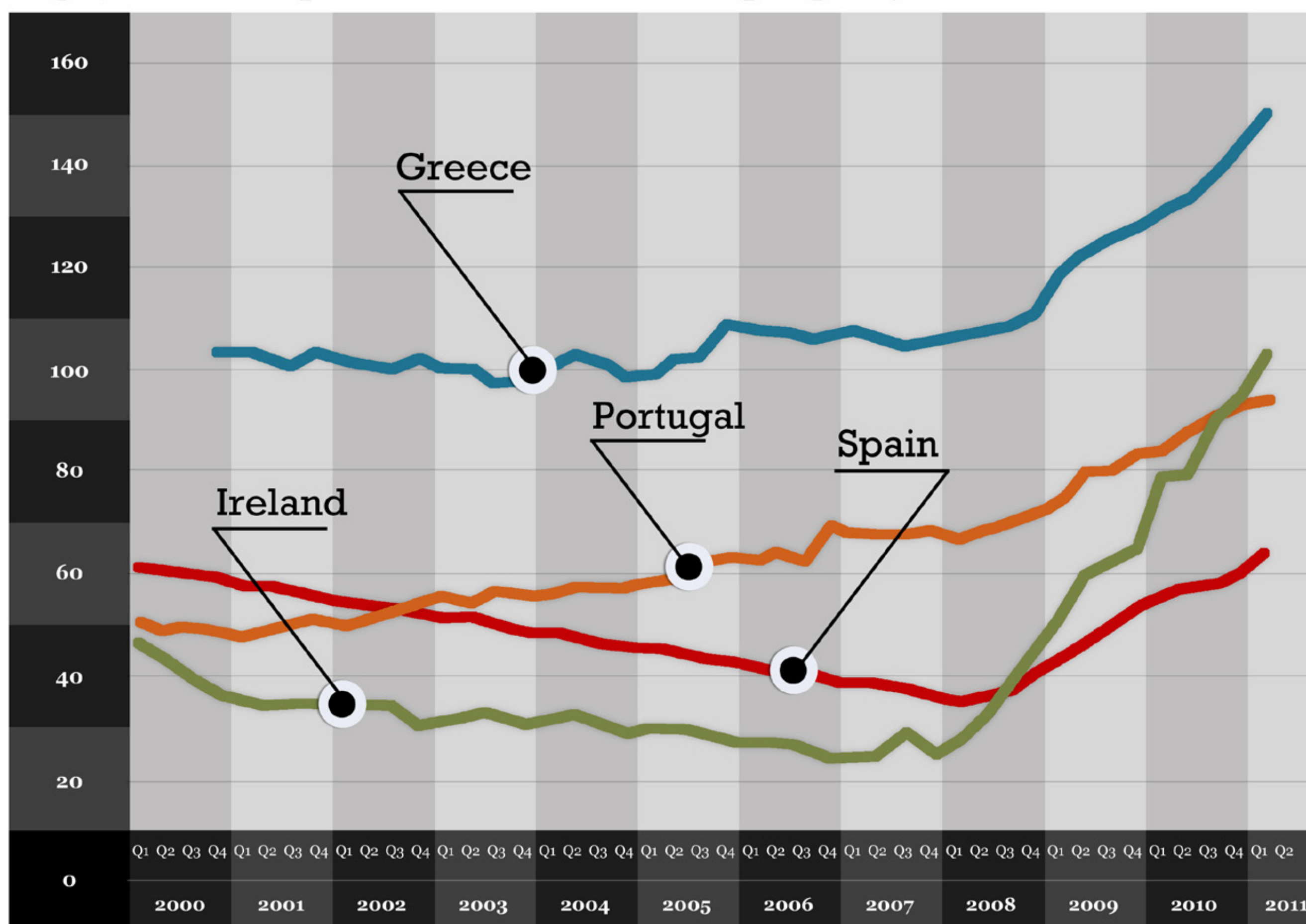
Fig. 8 - Unemployment rates in the periphery



Source: Eurostat

The failure of austerity, however, is apparent in the ratio of public debt to GDP. Far from declining, or even coming under control, the ratio has been rising across the periphery, especially in Greece and Ireland, as is shown in Figure 9. This is hardly surprising, considering the contraction of GDP in Greece, but also the gigantic shift of private debt onto the public books in Ireland.

Fig. 9 - Ratio of public debt to GDP in the periphery



Source: Eurostat

The failure of austerity has been in large part due to the inability of the periphery to devalue, thus regaining competitiveness decisively. The contraction of aggregate demand has been barely offset by the narrowing of the current account deficits. In effect, peripheral countries have found themselves trapped within the Eurozone, facing austerity and high unemployment for the foreseeable future. The rising burden of sovereign debt, meanwhile, has exacerbated the prospect of insolvency and default for peripheral states.

The EU response to the crisis is an example of policies that aim to protect the interests of large financial and industrial capital, only to undermine them. As recession in the periphery deepens and insolvency becomes worse, the banks of both core and periphery would face greater risks. The creditworthiness of Italy and other large countries in the Eurozone would also be affected since they carry sizeable volumes of debt and their economies have performed weakly for years. It appears that financial capital and neoliberal ideology in the Eurozone are burying themselves in a hole of their own making.

3.2 Desperately searching alternatives

In response to perceived failure, various alternative proposals have been mooted, most prominently the suggestion of issuing Eurobonds. [15] Despite variations, the basic notion is the same: a single authority, such as the EFSF or the ECB, would take it upon itself to borrow on behalf of the union, subsequently allowing individual states to meet shortfalls in funding. Debts issued in this way would be guaranteed jointly and severally, thus breaking with the underlying principle of individual sovereign responsibility.

The idea of Eurobonds has been held in abeyance by the determined opposition of the governments of Germany and other core countries. German political opposition has owed to petty electoral calculation and to the dominance of conservative neoliberal ideas within the political establishment. But it also bespeaks of powerful interests that are keenly aware of the risks of making tactical fiscal innovations such as Eurobonds.

For one thing, Eurobonds would entail higher borrowing rates for core countries, above all, for Germany. The higher creditworthiness of the core would act as a subsidy for the periphery. For another, the issuing of Eurobonds would be a great stride in the direction of creating an aggregate fiscal authority in the EU. If there is no backing from a federal budget, Eurobond liability would ultimately rest on the public purse of core economies. However, creating a substantial federal budget for an over-arching fiscal authority is a very thorny problem for the EU, as was discussed in previous chapters. A tactical move that anticipated the creation of unitary fiscal authority, such as issuing Eurobonds, would generate major political problems in both core and periphery.

Finally, Eurobond proposals frequently fail to address the structural problems of competitiveness between core and periphery. If the monetary union is to become viable, core countries must willingly reduce their current account surpluses. Not only would transfers have to be made to peripheral countries, but

15 See, most notably, Delpla J. and von Weizsäcker (2010), The Blue Bond Proposal, Bruegel Policy Brief 2010/13, May; Delpla J. and von Weizsäcker (2011), Eurobonds: The Blue Bond Concept and its Implications, Bruegel Policy Contribution 2011/02, March; Juncker J.C. and Tremonti G. (2010), 'E-bonds would end the crisis', Financial Times, December 5, http://www.ft.com/intl/cms/s/0/540d41c2-009f-11e0-aa29-00144feab49a.html#axzz1TVMjulHv; Amato G. and Verhofstadt G. (2011), 'A plan to save the euro and curb speculators', Financial Times, July 3, http://www.ft.com/intl/cms/s/0/1c6c3d0c-a59c-11e0-83b2-00144feabdc0.html#axzz1TVMjulHv.

national labour markets, social policy and tax systems would need to be harmonised among all participants. Resolving the crisis is not just a matter of devising ingenious methods of borrowing and effecting fiscal transfers, but one of radical political and social change across Europe.

Note that left-minded Eurobond supporters have generally been in favour of using the borrowing powers of the union to engage in large-scale investment programmes. The intention would be to raise productivity and competitiveness across the periphery, for instance through the European Investment Bank. Under such an outcome, neoliberalism could at last be overcome and the EMU would acquire a more Keynesian character. Yet, given the social and political interests characteristic of the Eurozone, this is a remote prospect.

The search for alternatives, even when it has been fruitless, as per Eurobonds, has helped to clarify the range of alternative options available to policy makers at present. These range from full European fiscal federalism at one extreme, to allowing the ECB to purchase large volumes of the debt of member states, thus also cleansing the balance sheets of insolvent banks, at the other. [16] All options would involve some sort of redistributive transfer mechanism between the core and the periphery of Europe, from straightforward taxation and expenditure by a European federal state, to using the seigniorage 'revenues' of the ECB to transfer value from euro holders to the creditors of insolvent institutions, or to states and peripheral tax-payers. In this light, three broad strategic directions for policy stand out.

The first strategy would be full fiscal federalism that could also give full vent to Eurobonds. A European federal state, with an autonomous budget financed by levying its own taxes, would issue federal bonds in order to calm debt markets and undertake bank recapitalisations. In theory, it could also allow for European investment policies that might serve to lessen the chronic problems of competitiveness between core and periphery. It is clear from the preceding discussion of the Eurozone, however, that this possibility is unlikely to materialise in the near future.

16 See Buiter, W. (2011), 'The future of the euro area: fiscal union or blundering towards a "you own it you break it Europe"', Citi Global Economics View, September 9, for a more detailed analysis of these proposals: https://www.citigroupgeo.com/pdf/SGL88698.pdf

The second strategy would be to rely more heavily on the ECB. The central bank has considerable latent powers of credit and could act as lender of last resort to states in difficulties. ECB credit could be mobilised directly, for instance, by intervening heavily in both the secondary and the primary markets for sovereign bonds. [17] To this purpose the ECB could also fund itself by issuing a variant of Eurobonds. The costs of bad sovereign debt would thus be transferred to the ECB, avoiding the normal processes of democratic scrutiny applying to fiscal transfers. Unfortunately, there are major problems with assigning this convenient role to the ECB, even without taking into account that its statutes would have to be changed, and that in Germany there is strong public awareness of how it manages its balance sheet.

The fundamental difficulty, already discussed in chapter 2, is that the strategy would delegate a major fiscal role to the ECB, when the latter is no more than a central bank. Even worse, the state on which the ECB would have to rely if it was to assume this role does not exist. The result would be highly precarious: the ECB would expand its balance sheet enormously in the absence of a unitary fiscal authority to guarantee such an expansion.

If, for instance, the ECB proceeded to lend another EUR2tr, its balance sheet would roughly double from the current level of EUR2.1tr, shown in Box 1. Its ability to absorb credit shocks would remain substantial (currently standing at about EUR465bn of revaluation accounts plus capital and reserves, as is shown in the table of Box 1) though extensive recapitalisation would probably be necessary At the same time, the quality of its assets would decline precipitously since it would be acquiring credit risk while its monetary liabilities would balloon. In the absence of a state to act as ultimate back up for the ECB in confronting these problems, the international acceptability of the euro would be immediately in doubt.

The third strategy would be to make heavier fiscal transfers from the core in exchange for loss of sovereignty by peripheral countries. Fiscally sound countries would endure continued and open-ended bail-out guarantees to the periphery with the aim of helping the latter to overcome solvency and competitiveness; the price would be surrender of control over fiscal policy. This would essentially represent a development of the current status quo, with discretionary bailout loans replaced by uncapped fiscal transfers.

The instrument could be the EFSF, deployed to buy sovereign debt and recapitalise banks on a large scale. To this purpose, its lending capacity of EUR440bn would have to be increased by a factor of at least five and possibly more. The problem with this tidy suggestion, however, is that it would require core countries to commit substantial further public funds. Given the social and political relations of the Eurozone, this would not be very likely.

With the reluctance of core countries to commit further public funds in mind, various proposals have been made to leverage the lending power of the EFSF. Thus, one far-fetched suggestion has been to turn the EFSF into a CDO by tranching its bonds into an 'equity' and a 'junior' layer thus expanding its lending capacity up to two, or more trillion. [18] Since the EFSF is already a CDO (its EUR440bn lending capacity rests on state guarantees of up to EUR780bn) the suggestion would turn it into a CDO squared. The risks would be enormous and, unlike the subprime crisis, there would be no state to pick up the pieces should a collapse ensue. [19]

Another and more plausible suggestion has been to turn the EFSF into a bank that would then raise its capacity to lend up to EUR2tr by borrowing from the ECB.[20] The new bank would be able to rescue other private banks and buy sovereign paper. In effect this scheme amounts to mobilising ECB credit indirectly and thus by-passing the limitations posed by ECB statutes.

Proposals to deploy the EFSF as fiscal transfer mechanism, whether by committing further public funds or by leveraging it, would run up against two underlying structural weaknesses already mentioned above. First, if the expanded lending capacity of the EFSF relied on the ECB, the question would reappear: who would back up the expanded ECB? Second, if the EFSF undertook a Europe-wide programme of recapitalising banks, the implication would be that, in effect, the German state would be guaranteeing the rescue of, say, French banks. There is no evidence that the alliance of social and political interests required for such action currently exists in Europe.

18 See Brunnermeier M., Garicano L., Lane P., van Nieuwerburgh, Pagano M., Reis R., Santos T., Vayanos D. (2011) . European Safe Bonds (ESBies), The Euro-nomics Group, 26 September, http://euro-nomics.com/wp-content/uploads/2011/09/ESBiesWEBsept262011.pdf

19 See Munchau W., Eurozone fix a con trick for the desperate, Financial Times, http://www.ft.com/cms/s/0/9a6d727e-eb57-11e0-9a41-00144feab49a.html#axzz1Zv487PSL)

20 See Gros D. and Mayer T. (2010), How to deal with sovereign default in Europe: Toward a Euro(pean) Monetary Fund, CEPS Policy Brief No 2, CEPS, Brussels, February/updated May; Gros D. and Mayer T. (2011), August 2011: What to do when the euro crisis reaches the core, Economic Policy. CEPS Commentaries, 18 August.

And yet, despite the problems inherent to all policy options, there is overwhelming pressure on core states, especially Germany, to take further steps to confront the deepening crisis by both rescuing banks and relieving lesser sovereigns. The most plausible course for core powers would be to continue muddling through by mixing bits of several options. Needless to say, austerity in the periphery and elsewhere would continue as well as privatisation, and deregulation. There could be further bailout loans to states in trouble. If the debt burden of the periphery became unsustainable, as would be likely, the core would even tolerate default, provided that it would be managed by the leading powers and creditors of the union. Finally, there would be heavier reliance on the ECB and EFSF along lines discussed above, though the precise form is unclear.

Thus, in an important step, the ECB launched on 6 October 2011 two new long-term refinancing operations with maturity, respectively, of 12 and 13 months, to take place in November and December 2011. They will be conducted as fixed rate tender procedures with full allotment on top of regular ECB liquidity operations. In addition, the ECB announced a new covered bond purchase programme with the intended amount of EUR40bn. Purchases will begin in November 2011 and are expected to be completed by the end of October 2012.

In Box 3 it can be seen that the original long-term refinancing operations and the covered bond purchases by the ECB began in May 2009 and lasted for about a year. The operations bought time for EMU authorities; when they expired in the middle of 2010, the authorities launched the Securities Market Programme (SMP) and the EFSF. Both of the latter were radical measures to support peripheral states and thus the banks of Europe. It is likely that the recent announcement of fresh liquidity provision by the ECB similarly intends to buy time thus preparing the ground for more radical measures to support banks, perhaps through heavier purchases of bonds by the ECB.

Even more important was the EU summit in Brussels on 26 October which took a number of strategic decisions but without immediately providing requisite detail.[21] Thus, European banks would be asked to meet a higher - 9% - capital adequacy threshold after revaluing sovereign bond holdings at market prices. The resulting capital shortfall was estimated at more than EUR100bn, and is supposed

21 See Euro Summit Statement, http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/125644.pdf

to be met from reserves, equity issue, or state support. For states that were in a weak fiscal position, the funds would presumably come from the EFSF, as has already happened for states in receipt of rescue programmes in 2010-11.

The summit also openly contemplated peripheral default with significant haircuts for banks. The contours of default had already been sketched in the deal that had been offered to Greece in July 2011 (see Box 6 below). Private lenders to Greece (banks and other bondholders) would have had to take modest losses (presumably 21% of the exposure on average, though in practice the losses would have probably turned out to be much lower) in exchange for new bonds with better creditworthiness. The deal unravelled quickly as financial agents calculated that, if default was officially possible for Greece and private lenders were forced to take a modest haircut, then default would also be possible for other countries, including Spain and Italy. Given the fraught state of the financial system, the possibility of such losses caused flight from the sovereign debt of these countries.

The summit of October 26th followed the broad outline of the earlier agreement but proposed, under intense German pressure, to apply an even deeper haircut to private holders of Greek sovereign paper - 50% of face value. Greece would effectively default, but pressure was put on private banks to accept the haircut 'voluntarily' in order to avoid formal default that would trigger CDS payments. Up to EUR30bn of the losses would be covered by other member states of EMU. Greece would also receive additional programme financing of up to EUR100bn until 2014. The expectation was that Greek debt would be reduced to 120% of GDP by 2020.

It remains to be seen whether banks would agree to such a prospect, in view especially of the difficulty in persuading them to accept the much lower haircut of July 21st, If they do not, it is not clear how they could be coerced into it by states that are not counterparties to the rescheduled obligations. Be that as it may, the implications of a 50% haircut for banks are examined in more detail in chapter 6.
There would naturally be a price to pay for Greece for the debt reduction. In the first instance, the country would have to accept the permanent monitoring of its fiscal affairs by the EU. The details are unclear but there is little doubt that national sovereignty would be severely compromised. Furthermore, there would probably be an extensive programme of privatising public assets. If the press is to be believed, the German government has considered plans of widespread privatisation in Greece along the lines of the Treuhand Model in East Germany. Privatisations

would be executed by German officials in the hope of netting EUR125bn that could be used to pay off remaining lenders to Greece.[22]

To prevent the new agreement from unravelling similarly to that of 21 July, EU leaders attempted to make stronger provision for the EFSF enabling it to purchase sovereign debt as well as to support banks. But the structural weaknesses of the EFSF could hardly be wished away. The summit did not commit fresh resources to the EFSF but aimed to boost its lending capacity through leverage. Two methods were suggested, though detail was scarce. First, the EFSF would provide credit enhancement to new sovereign paper issues; in effect it would be act as a monoline insurer for public debt in the Eurozone. Second, the EFSF together other private and public investors, could set up SPVs aiming to use the borrowed funds for bank recapitalisation or to buy sovereign paper in the secondary markets.

It is hard to believe that these policies would decisively resolve the crisis. The increased lending capacity of the EFSF is largely a mirage since much of the existing EUR440bn is already committed to bail out programmes for Greece, Ireland and Portugal. What is left appears to be around EUR250bn and even that, as was discussed above, is already levered on a far smaller amount of actual cash. It is a sign of fundamental weakness that the core powers of Europe are resorting to the discredited methods of financial engineering of the 2000s to create the impression of possessing lending power necessary to tackle the crisis. The most that can be expected from twice-levered EFSF funds is perhaps a short period of calm for the sovereign borrowing of Spain and Italy. If heavy demand for assistance re-emerged, the leveraging would be unable to cope.

More fundamentally, the entrenched policies of austerity are likely to worsen the crisis. For Greece to reach a sustainable level of debt there would have to be strong growth. Even the level of 120% of GDP, which is far from low, would require sustained growth. If growth did not materialise, there would probably be severe social unrest. As recession bites in Spain and Italy in 2012, furthermore, the ability of these countries to access bond markets will be continually tested. In such circumstances, the prospect of a break up of the EMU would emerge inexorably. To consider the content and the implications of a possible rupture, it is first necessary to have a closer look at European banks in chapter 4.

22 See Roland Berger Strategy Consultants, http://www.rolandberger.com/media/press/releases/Recovery_plan_for_the_Greek_economy.html

BOX 6

EUROZONE SUMMIT, 21st July 2011

The agreement included the following:

• All Eurozone countries, except those already under a stabilization programme, would bring their deficits to below 3% by 2013. Eurozone leaders welcomed an austerity package by Italy and reforms by Spain to embed deficit limits in the constitution.

• Creation of a Task Force by the Commission which would officially work with the Greek authorities to secure "competitiveness and growth, job creation and training".

• New stabilisation programme for Greece including contributions by the IMF and the private sector, which would amount to EUR109bn and would be advanced as EFSF loans. The plan was designed by private banks, namely the Institute of International Finance.

• Article 9 stated that "where appropriate, a collateral agreement will be put in place so as to cover the risk to euro area member states from their guarantees to the EFSF". Finland has indeed demanded collateral, and the Greek government has accepted its demand. The result has been to threaten the implementation of the agreement as others have also demanded collateral.

• The EFSF would be allowed to intervene in the secondary markets under "exceptional financial markets circumstances" with the aim of preventing contagion to other member states.

The agreement of 21st July was in fact an extension and partial revision of decisions with respect to Greece taken by Eurozone leaders on March 11 2011, and by the European Council on March 24-25 2011. These included:

• Rescheduling of Greek public debt in the form of lowering interest rates by 100 basis points and increasing the maturity of all programme loans to 7.5 years.

•New austerity measures, including a privatisation programme of EUR50bn, setting up a numerical benchmark of 5% debt reduction each year, commitments to reform the labour market, pension schemes, health care and benefit schemes, and so on.

Chapter 4
Centrifugal finance: Re-strengthened links between banks and nation states

The proudest achievement of the EMU has been the creation of a homogeneous money market for European banks, presided over by the ECB. Nevertheless, the banking space of Europe has never been homogenised, banks retaining a national outlook. One of the more striking aspects of the Eurozone crisis has been that it has re-strengthened the importance of national compared to supranational relations in the field of banking. Interdependence between sovereign states and their domestic banking systems has increased, revealing centrifugal tendencies within the EMU.

The ECB has acted as bank of banks within the EMU, also putting in place mechanisms for trading, holding and funding sovereign debt, thus creating elements of a supranational financial system. Yet, sovereign debt is a claim on future taxes and debt markets are a device to allow individual holders of bonds access to money before the claim falls due. When the credibility of the claim is in doubt, the liquidity of the market evaporates. That moment arrived in the Eurozone in 2010. It then transpired that there were constraints to ECB intervention because of the absence of a supporting state. Consequently, the underlying relation between, on the one hand, the sovereign state as collector of taxes and, on the other, domestic banks as lenders to the state and hence claimants to future taxes, came forcibly to the fore.

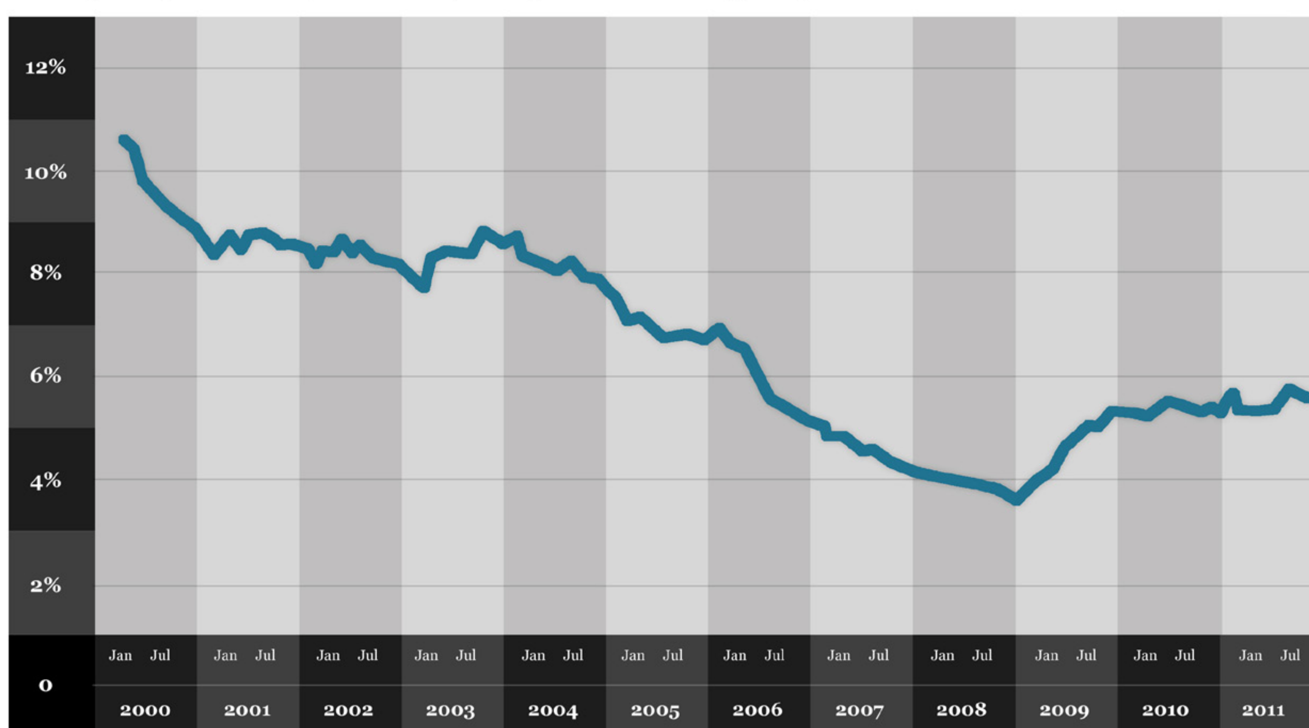
As the Eurozone crisis unfolded, each member country has become increasingly concerned about its own predicament, and thus more tightly bound up with its own banking system. Extraordinary measures, sidelining the mechanisms of the Eurosystem, have been used to support national banks. At the same time, relentless pressure by Eurozone authorities has gradually given shape to a harsh dilemma for some peripheral countries: either complete the tight embrace with domestic banks by nationalising them, or forcibly sell them. This choice will be important to deciding whether peripheral countries remain within the EMU.

4.1 The re-strengthening of national financial relations

Huge holdings of sovereign debt by banks coupled with abundant and cheap liquidity from the ECB have had the paradoxical result of loosening the links between member states and the supranational financial mechanisms of the Eurozone. Bank holdings of sovereign bonds have began to switch toward domestic issues as banks have become imperilled by the sovereign debt of the Eurozone periphery. Notably, peripheral banks also switched to domestic issues.

Figure 10 shows that holdings of government bonds as a proportion of total Monetary Financial Institution assets fell during the 2000s, but began to rise in the periphery after October 2008.

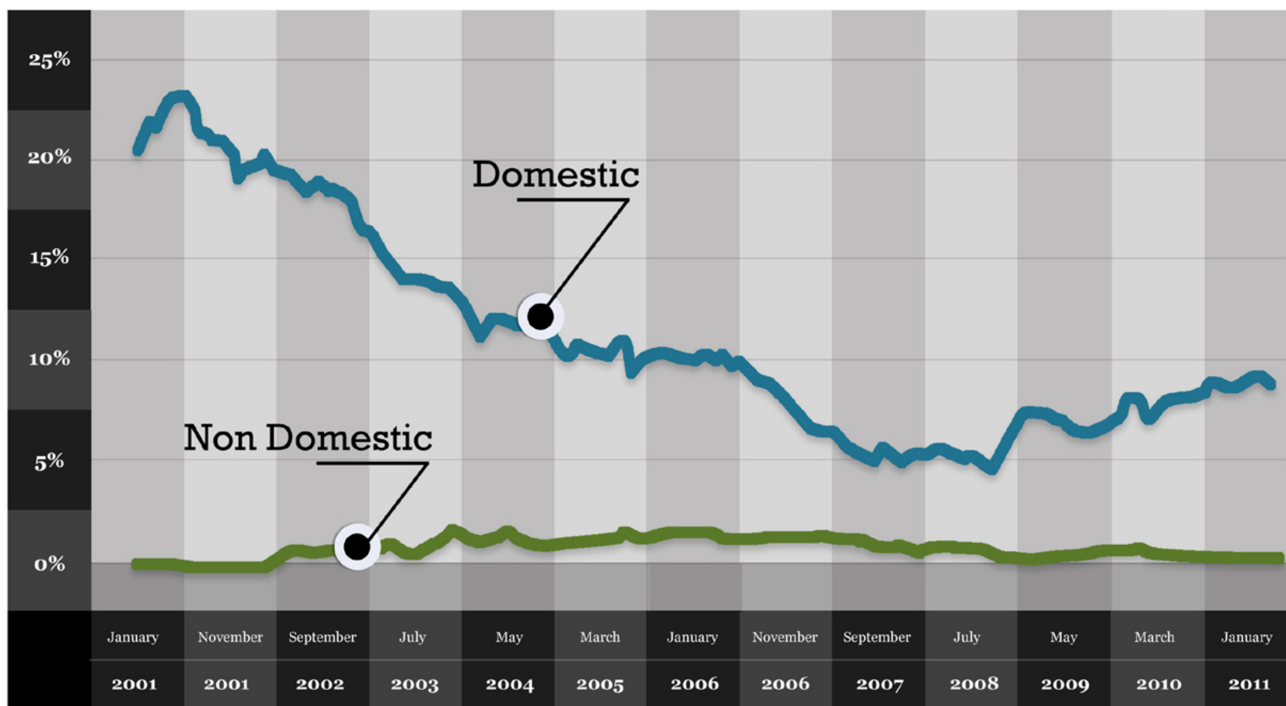
Fig. 10 - Government Securities as % of total MFI assets for Spain, Greece, Ireland, Italy and Portugalry



Source: Bundesbank

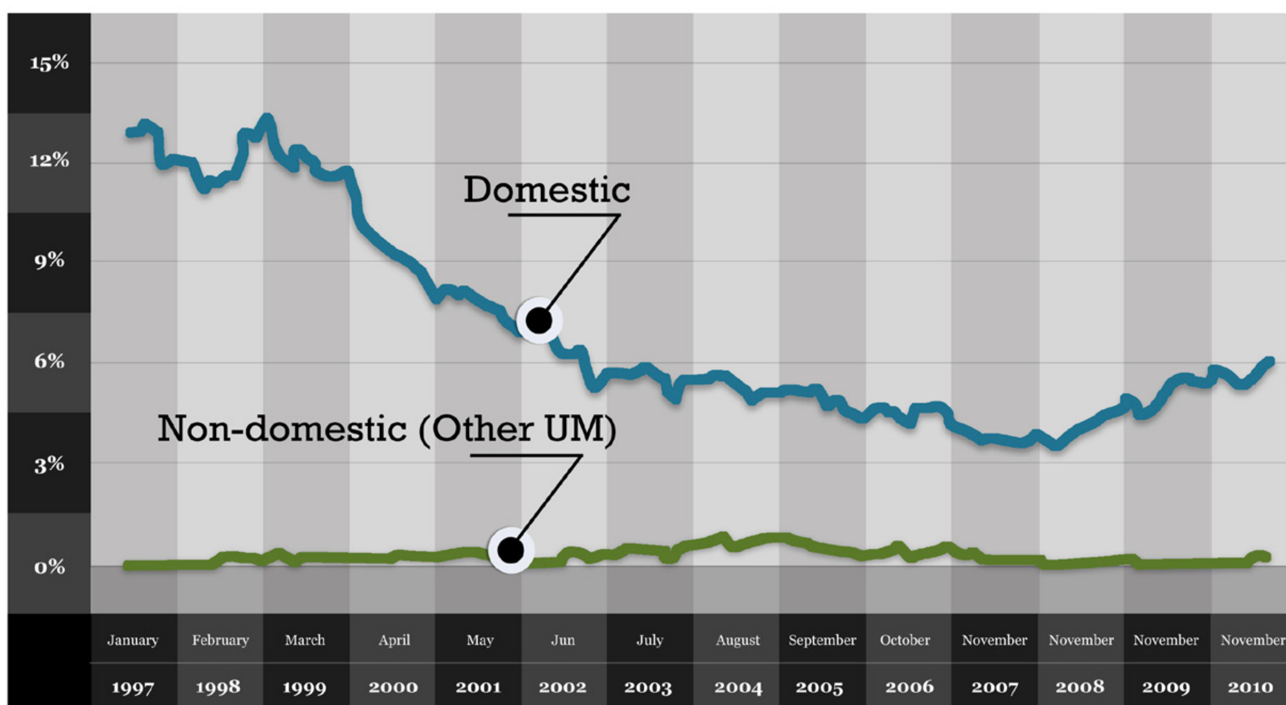
In Greece and Italy, holdings of non-domestic government bonds started to fall from 2006, as is shown in Figures 11 and 12, respectively. Holdings of domestic government bonds, meanwhile, have been on the rise since late 2008

Fig. 11 - Government securities as % of total MFI assets for Greece - domestic / non-domestic breakdown



Source: Bank of Greece

Fig. 12 - Government securities as a % of total MFI assets for Italy - domestic / non-domestic breakdown



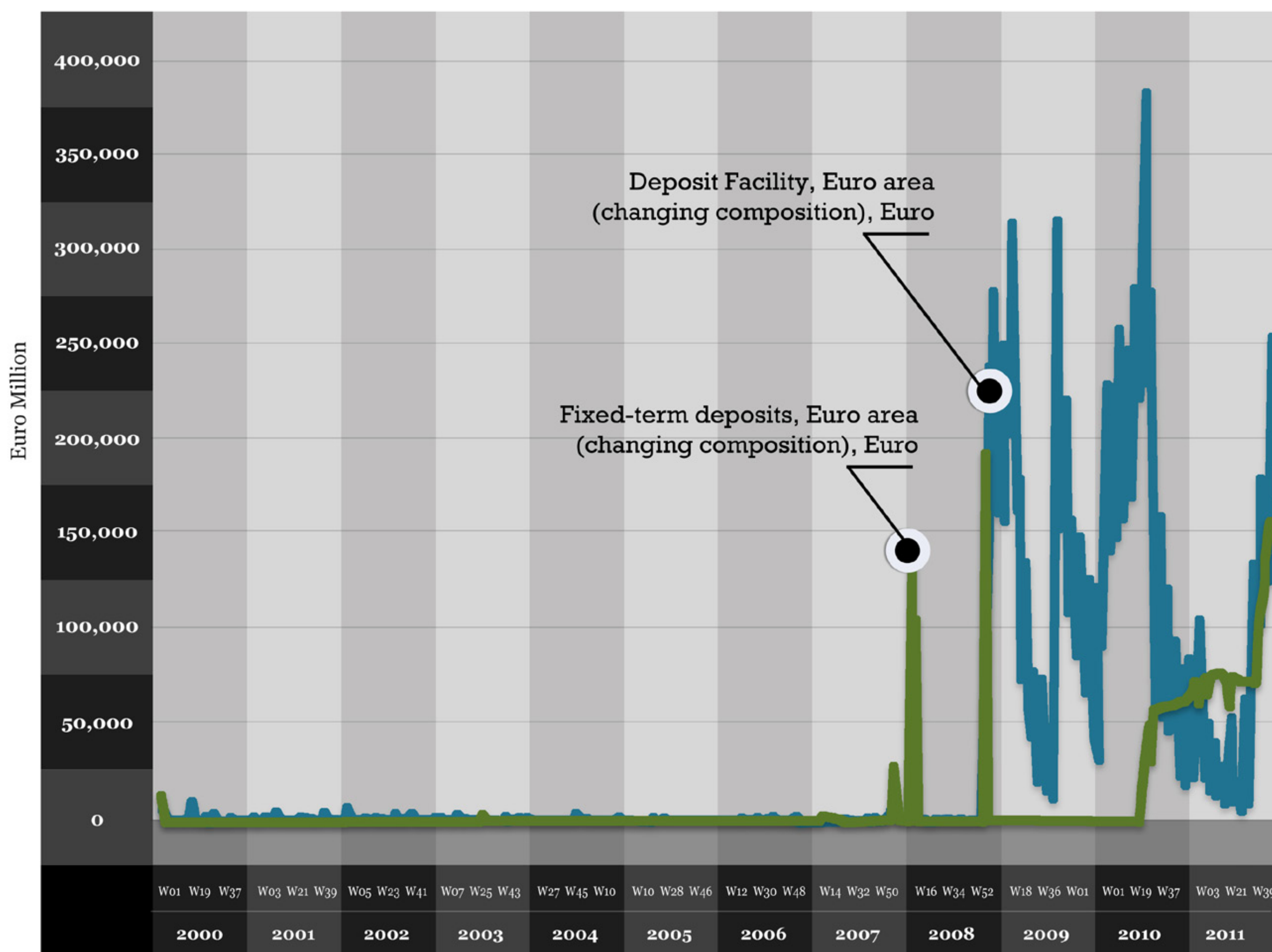
Source: Bank of Greece

Three reasons stand out for this development. First, government bonds (particularly those of own jurisdiction) have traditionally been regarded by banks as low-risk, and even riskless. A bank's risk profile is typically skewed in favour of the debt of its own sovereign, since the latter is perceived as the collector of taxes and the ultimate guarantor of means of payment within the bank's original territory. The Eurozone crisis has exacerbated this preference even though banks have discovered that the debt of sovereigns is generally far from being risk-free. Second domestic banking systems may be subject to a variety of subtle - or not so subtle - pressures from the government to acquire bonds thus funding public expenditure. Third, member states of the Eurozone have been forced to rely more heavily on their domestic banking systems as a reaction to Eurozone policies after the outbreak of the crisis.

From the middle of 2010 the switch from the supranational to the national has become ever more pronounced. Sovereigns and their domestic banking systems have pulled closer together with the result that in late 2011 several Eurozone states and their banking systems are so intertwined that they face joint default.

Fundamental to this trend has been the decision of the ECB to start buying sovereign bonds in the secondary markets in 2010 through the SMP. It thus offered the opportunity to private banks – particularly those of the core – to divest from the sovereign bonds of the weakest Eurozone states. At the same time, banks in both core and periphery reduced funding to other banks, enterprises, and foreign sovereigns. They began to accumulate liquidity newly available from the ECB with their own NCBs. Figure 13 shows this trend as an accumulation of fixed-term deposits by banks within the Eurosystem in the course of the crisis.

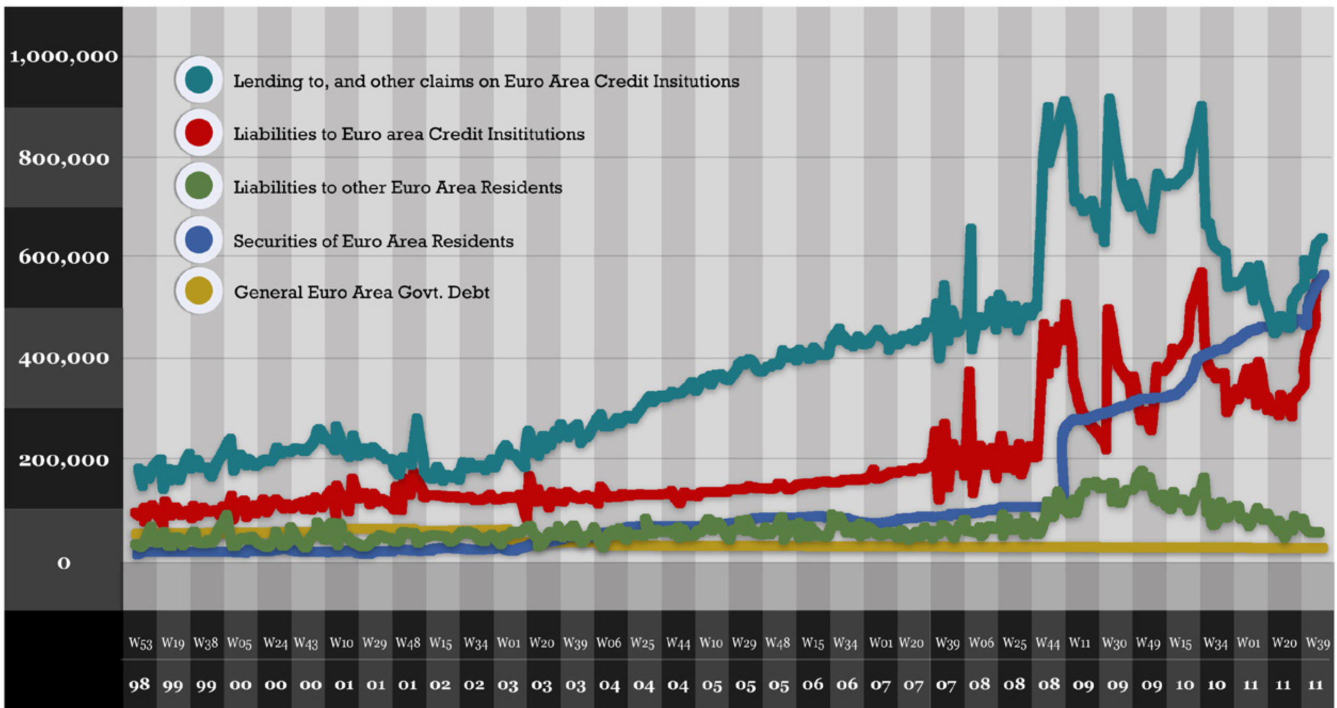
Fig. 13 - Deposits in the Eurosystem balance sheet



Source: ECB

At the same time, persistent shortage of liquidity in the money markets has forced banks to continue borrowing from official lenders, which means the Eurosystem, as is shown in Figure 14. However, national financial systems can only access the Eurosystem via their own NCBs, as was discussed in chapter 2. The result has been to increase intra-ESCB obligations among NCBs which appear as the so-called Target2 accounts, briefly described in Box 7 below.

Fig. 14 - Bank borrowing from the Eurosystem:
Selected Items from the Eurosystem balance sheet



Source: ECB

To sum up, as the Eurozone crisis deepened, core banks reduced their exposure to peripheral sovereigns and to other banks in response to declining creditworthiness. Spare funds from ECB liquidity provision were posted at the NCBs of the core. Meanwhile banks and sovereigns of the periphery resorted increasingly to borrowing from the ESCB, which could only be accessed via their NCBs. The result was an accumulation of liabilities among NCBs within the Eurosystem.

BOX 7

TARGET

Normally, a country's current account deficit is financed with inflows of foreign private capital. In a currency union, however, central banking credit may play this role, if private capital flows are insufficient. This is what has happened in the Eurozone when the interbank market first broke down in mid-2007.

The ECB operates the system of so-called Target claims and liabilities in the National Central Banks' balance sheets. Target is the acronym of Trans-European Automated Real-time Gross Settlement Express Transfer System. It appears as a mere technicality, nothing more than a settlement system for inter-bank transactions within the Eurozone. However, the system is not merely a mechanism of book-keeping entries but can also act as a means of financing/funding across the member countries of the Eurozone, thus supporting domestic financial systems.

In practice, Target balances are interest-bearing public loans used to finance current-account deficits. The balances resemble short-term Eurobonds since they function as short-term finance for deficit countries. By the end of 2010, the aggregate stock of central-bank money in the euro area was around EUR1.1tr, and EUR380bn was already absorbed by ECB credit to Greece, Ireland, Portugal and Spain together. This figure is close to the current-account deficit needs of these countries. Furthermore, between the end of 2008 and the end of 2010 central bank facilities increased from EUR120 billion to EUR380 billion. At the same time, the accumulated current account deficit of the four countries amounted to around EUR235 billion.

The amount of the ECB's "replacement lending" is shown by the so-called Target2 account, which measures the deficit or surplus of a country's financial transactions with other countries. As the account includes international payments for both trade in goods and financial claims, a deficit in a country's Target account indicates foreign borrowing via the ECB´s system, whereas a surplus denotes foreign lending via the ECB. It is clear from the figure below that the Bundesbank has been financing [23] the NCBs of the periphery. The Bundesbank has been able to do that in part because German banks have chosen to store liquidity with the Bundesbank rather than lending it out to enterprises and others.

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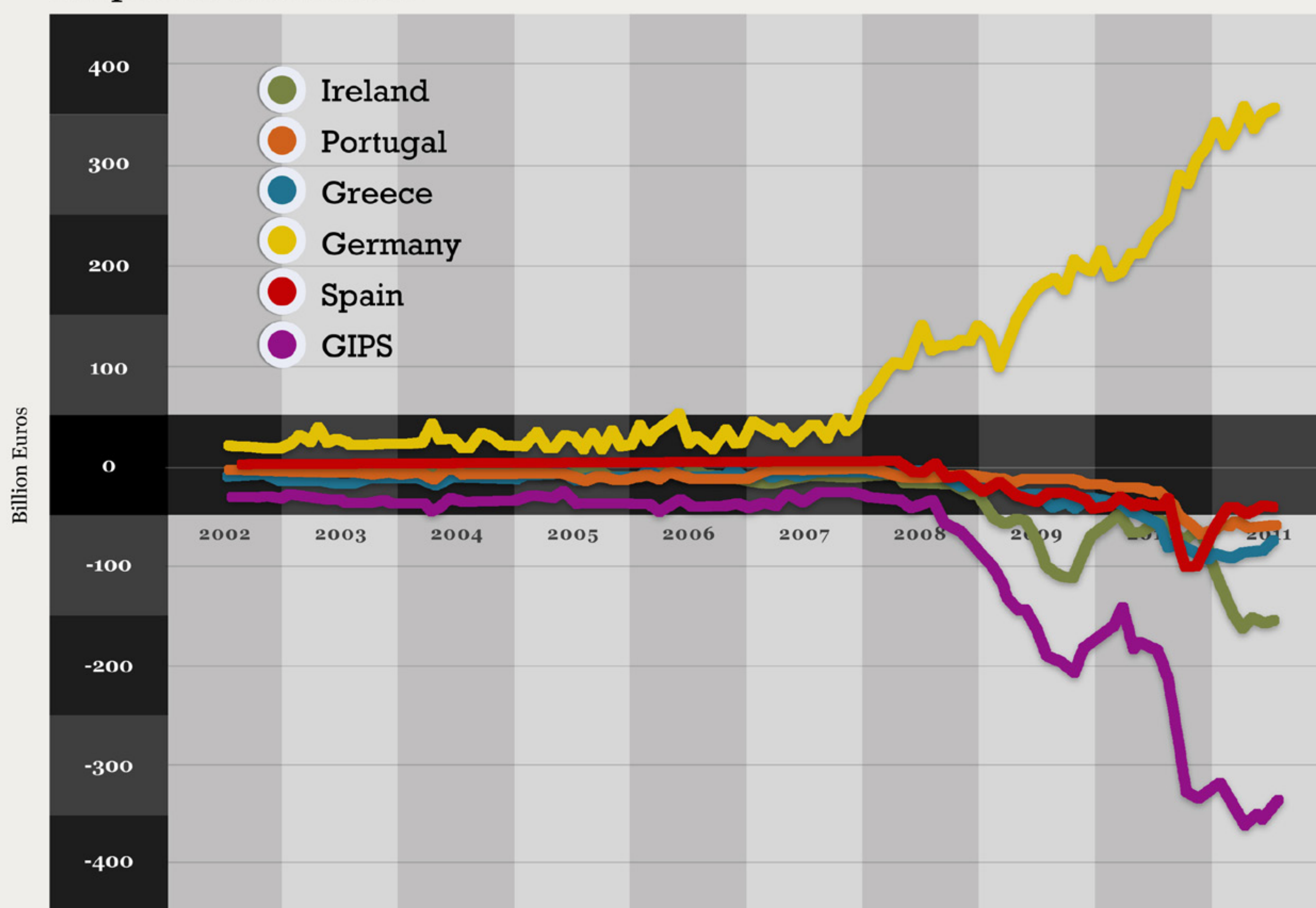
23 See Whittaker, J. (2011), Intra-eurosystem debts, Monetary Research, Lancaster University Management School, 30 March, http://www.lancs.ac.uk/staff/whittaj1/eurosystem.pdf

Surpluses and deficits



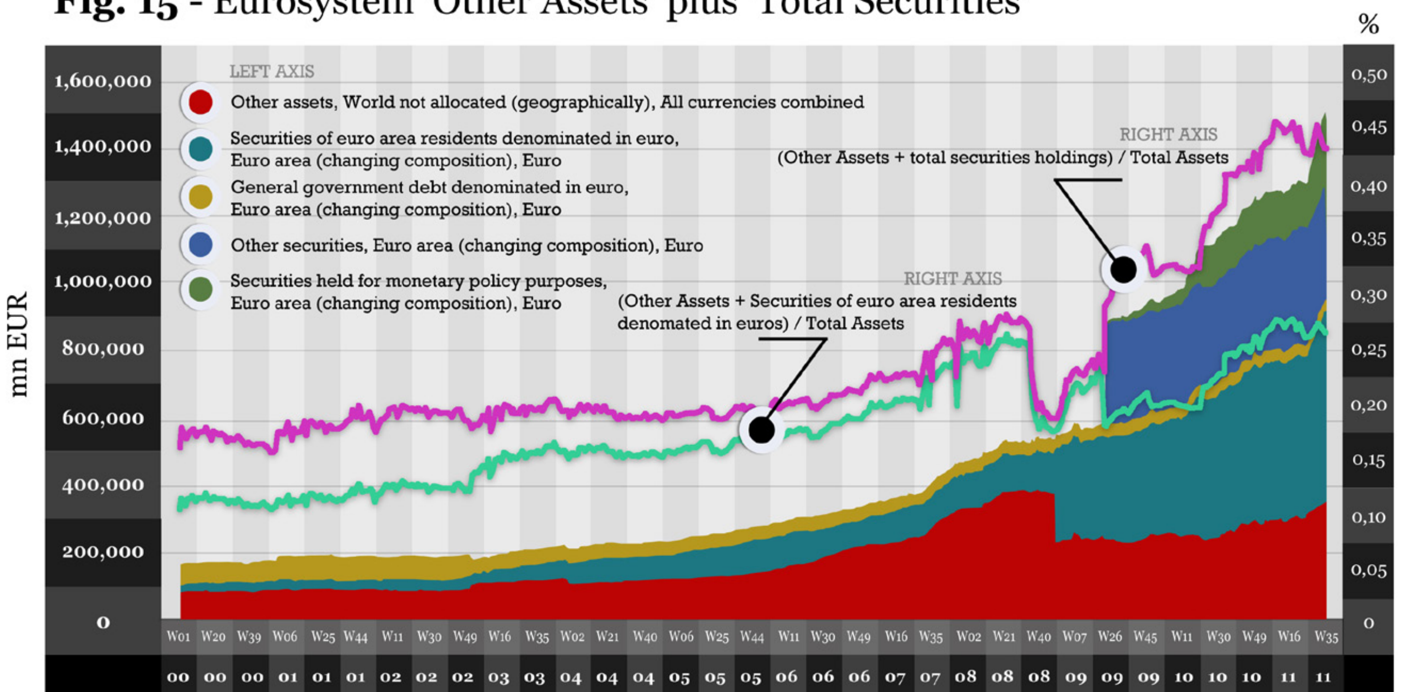
Notes: GermanyQ Other Assets of the Bundesbank. SpainQ Banco de EspanaQ LiabilitiesQ Other euro area countries: MFIsQ of which: euro. GreeceQ Bank of GreeceQ LiabilitiesQ Liabilities to Other MFIsQ Other Euro Area Countries
PortugalQ Central Bank Balance Sheet LiabilitiesQ Non-ResidentsL Deposits & Related Instruments.
IrelandQ Central Bank LiabilitiesQ Other Liabilities. GIPS is the sum of Greece, Portugal, Ireland and Spain
Source: Haver, Bundesbank, Central Bank of Ireland, Bank of Greece, Banco de Espana, Banco de Portugal, Citi Investment Research andAnalysis

As the crisis continued to worsen for peripheral sovereigns and their banking systems, peripheral bank liquidity requirements began to exceed the volumes provided by the ECB. Consequently, states and NCBs of the periphery (and not only) began to take unilateral action to provide liquidity to their stricken banking systems. The clearest evidence for this trend is Emergency Liquidity Assistance (ELA) afforded by NCBs to their banking systems.

ELA is provided temporarily to commercial banks by NCBs to support domestic financial institutions over and above the assistance provided by the ECB. It is supplied under the rules of the EMU but independently of the ECB and, as a result, possible gains or losses are not shared with other members of Eurozone. The ECB does not have legal authorisation to approve the activation of ELA but it does have the right to stop it, if two thirds of the Governing Council vote against it. It appears that ELA has been activated at least in Ireland, Germany, Belgium, Portugal, Spain and Greece, though little is known about either the amounts, or the terms, including interest rates, maturity and collateral requirements. The ways in which NCBs have financed the provision of ELA also remain opaque.

It is clear, nonetheless, that ELA represents the shifting of credit risk from private banks to their nation state within the Eurozone. It is also clear that it reveals a re-strengthening of national at the expense of supranational financial mechanisms. Figure 15 below depicts these decentralised actions as part of the Eurosystem balance sheet under “Other Assets” plus “securities”. They have increased substantially accounting for 45% of the total assets of the ESCB, and also rising as a share of the total balance sheet of Eurosystem, which is itself expanding rapidly.

Fig. 15 - Eurosystem ‘Other Assets’ plus ‘Total Securities’



Source: ECB

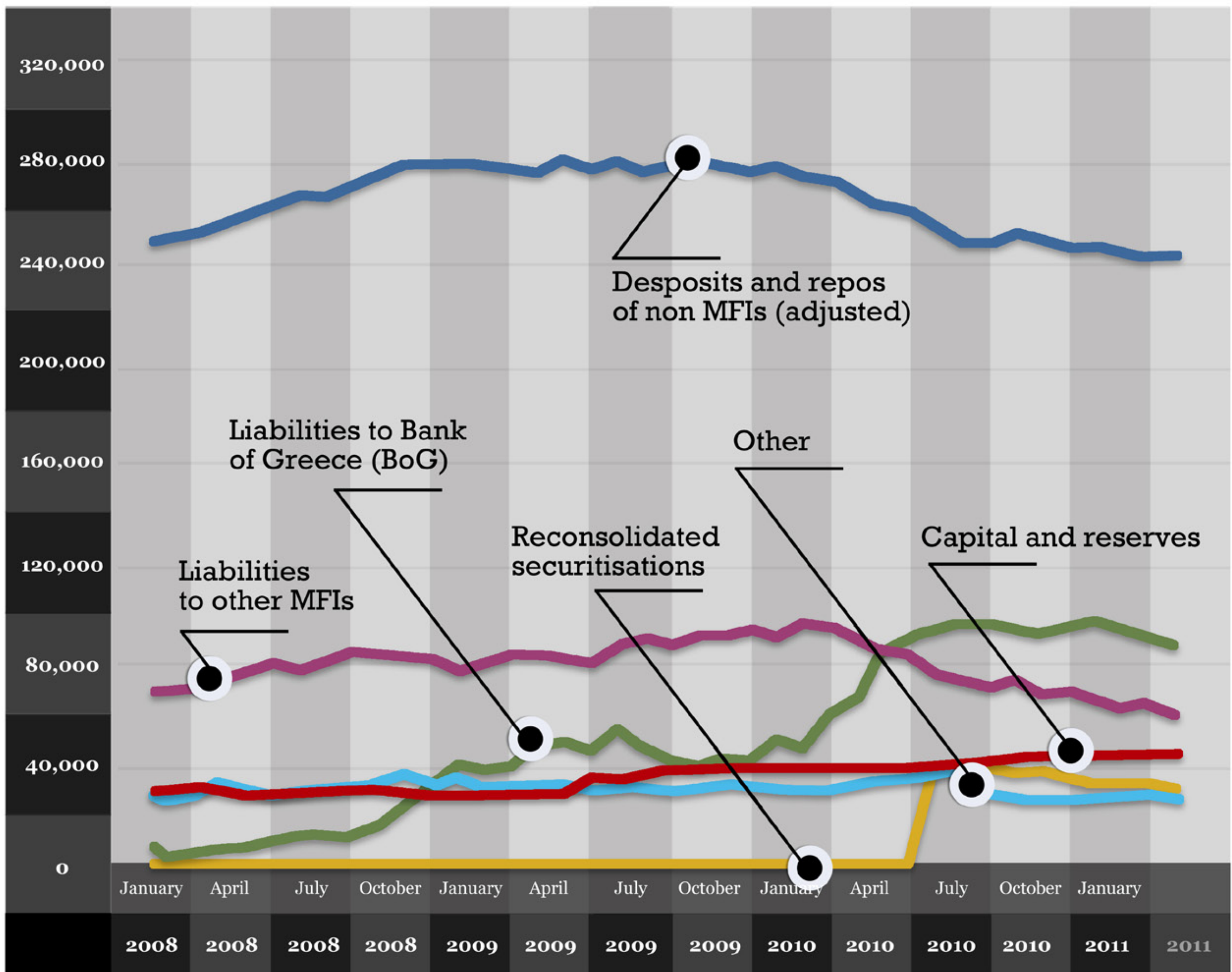
In addition governments and/or NCBs have aided their national banking systems in a variety of other ways. The Greek government, for instance, has extended guarantees to national banks when securitisations of loans that were held on balance sheet no longer qualified for ECB funding. This allowed Greek banks to unbundle these securitisations, use the guarantee of the sovereign, and thus receive ECB funding on the enhanced assets. In Ireland under the Eligible Liabilities Guarantee scheme the sovereign has guaranteed parts of the banks' liability structure. [24] In some cases Irish banks appear to have issued claims to themselves, subsequently posting those at the ECB and at the NCB to secure liquidity under ELA. [25]

These national mechanisms of support have often amounted to a subsidy for stricken banks. As funding dried up, banks were forced to increase the rates offered on deposits in the hope of sustaining the inflow of private liquidity. Banks that could not attract enough deposits had to turn to the ECB and to national ELA mechanisms for funding. Fortunately for them this often represented a saving compared to deposits - ECB rates hovered at 1.5% and Greek ELA funds cost 3.5%. The result was to boost net interest income for banks, even as they teetered on bankruptcy.

4.2 Greek banks draw closer to the Greek state

A closer look at the banks of Greece will bring out further aspects of the broader trend of re-strengthening national links within finance. Consider first the liability side of the balance sheet of Greek financial institutions, shown in figure 16 below.

Fig. 16 - Greek bank aggregate liabilities (mn EUR)



Source: Bank of Greece

The following points stand out:

1. Non-financial sector deposits and repos stopped rising around the onset of the global financial crisis and started to fall from the beginning of 2010. Note that, in the figure, "deposits and repos of non MFIs" has been adjusted by adding back "liabilities associated with assets disposed of in a securitisation but still recognised on the statistical balance sheet"

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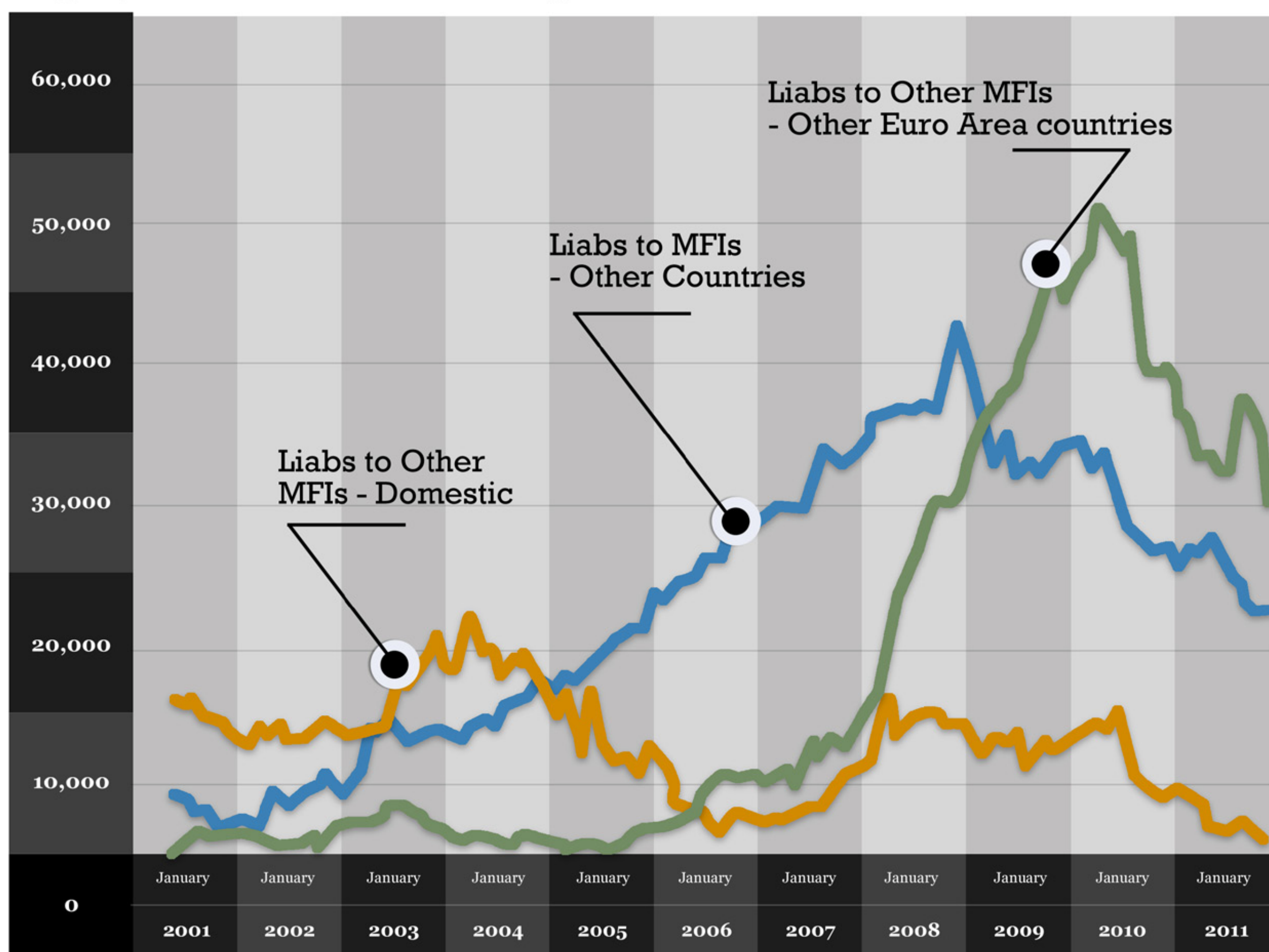
24 See http://www.finance.gov.ie/viewdoc.asp?DocID=6522
25 See http://ftalphaville.ft.com/blog/2011/02/22/495041/irelands-stylised-sovereign-bank-loop/

2. Funding from other Monetary Financial Institutions also started to fall from the beginning of 2010. Figure 17 below gives more detail and shows that MFI lending to Greek banks from outside the Eurozone fell from the onset of the financial crisis. Lending from within the Eurozone took up the slack but declined dramatically from early 2010. Domestic interbank lending was by far the smaller part of bank funding and also began to decline as Eurozone bank lending fell.

Fig. 17 - Greek bank borrowing (mn EUR)



Source: Bank of Greece

3. Funding losses from these sources were mostly compensated by increasing liabilities from the Bank of Greece. However, with the rising intensity of the Greek sovereign crisis in June 2010 funding from the Bank of Greece ceased to rise while other funding sources continued to fall. At that point the aggregate balance sheet of Greek banks started to shrink.

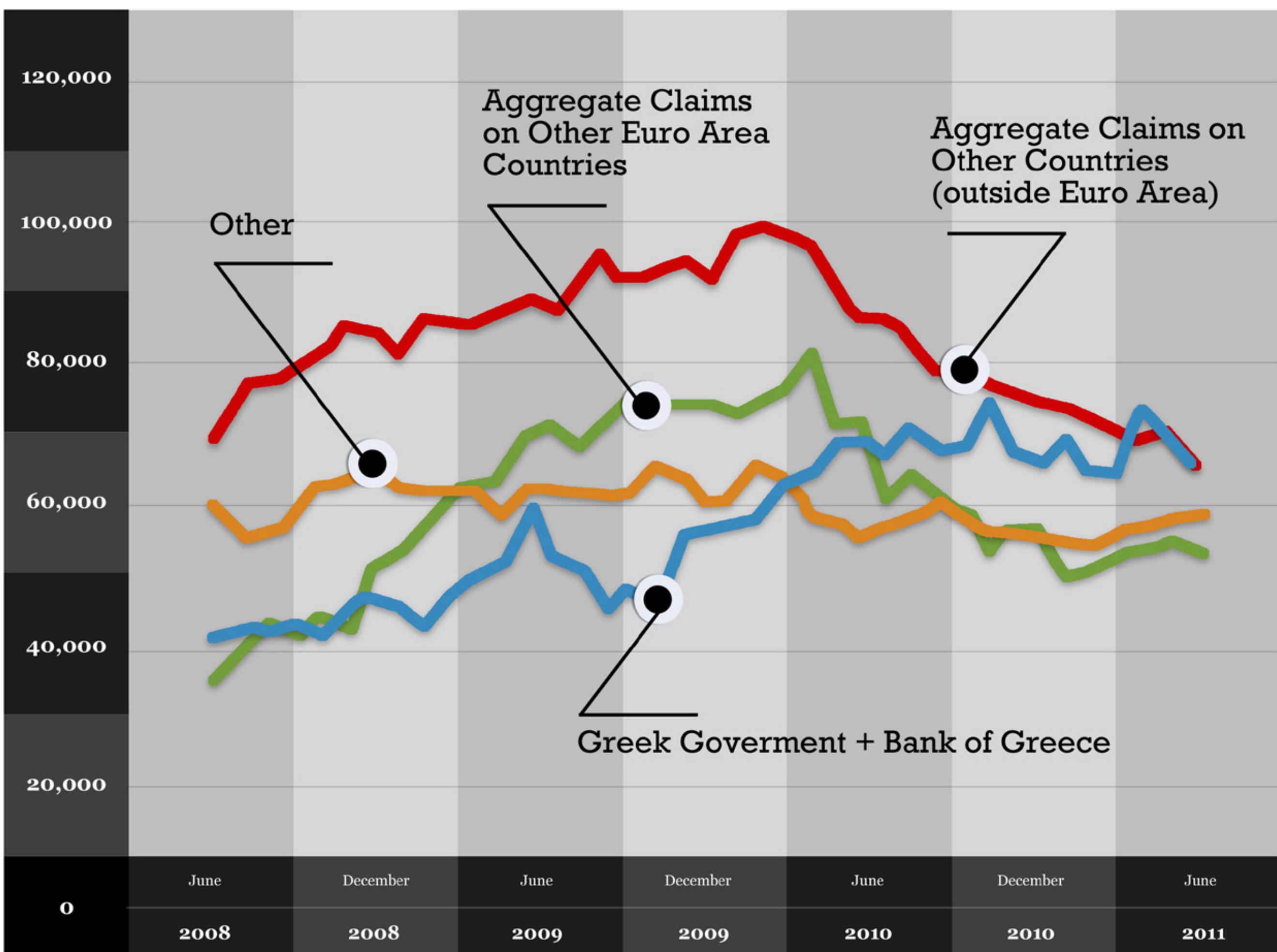
4. In June 2010 Greek banks appear to have unbundled securitisations previously used for funding at the ECB, which were subsequently brought on the balance sheet.

Consequently, banks incurred gross liabilities of roughly EUR40bn. This marked a substantial unilateral action by the sovereign guaranteeing the resulting assets to enable banks to receive continued ECB funding against them.

On the asset side, shown in figures 18 and 19, Greek banks appear to have deleveraged with regard to private and foreign borrowers, while increasing their lending to the Greek state.

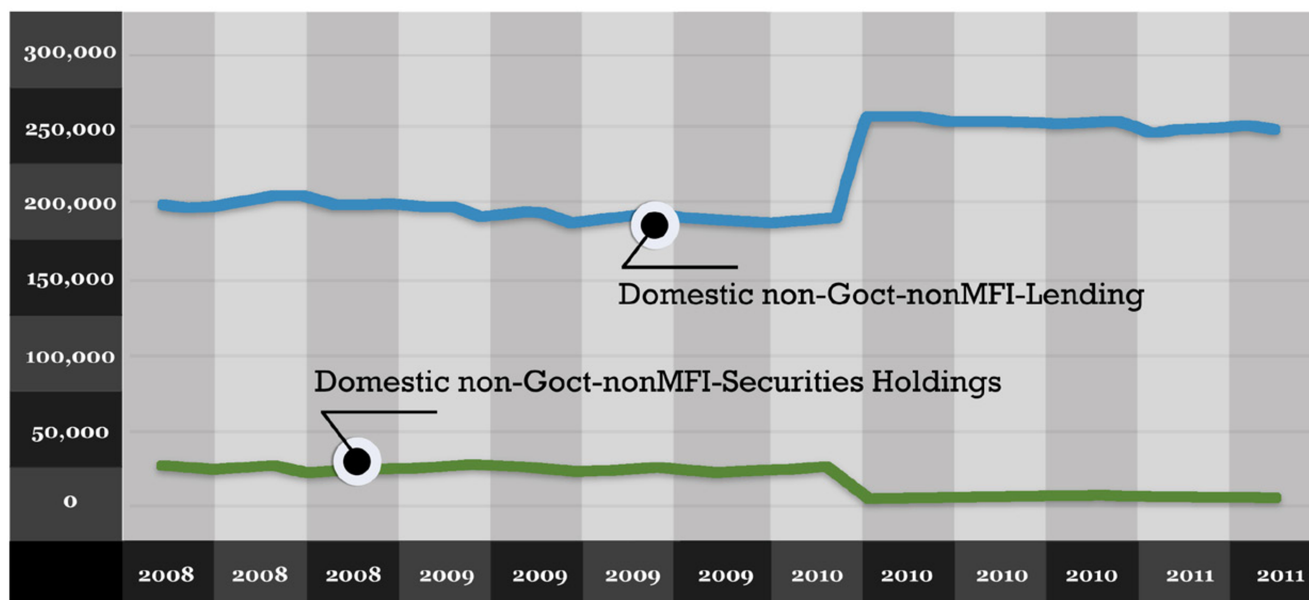
1. There has been a significant drop in lending abroad both in the Eurozone and to areas outside.
2. Government securities holdings rose significantly after the outbreak of the Eurozone crisis in late 2009.
3. Lending to the domestic economy has been flat or declining throughout this period, as is shown in figure 19, thus contributing to the worsening of the recession. Until the middle of 2010 Greek banks appear to have removed loans from their balance sheets via securitisations which were partly held on balance sheet. In mid-2010, due to ratings downgrades, these securitisations were unwound and the underlying loans were taken back on balance sheet. Figure 19 shows clearly the sudden jump in lending, some of which was already held by the banks themselves as securities, as can be seen from the accompanying fall in securities holdings. From mid-2010 domestic lending has contracted slowly as bank balance sheets overall have shrunk.

Fig. 18 - Greek bank aggregate assets (mn EUR)
(excluding domestic non-MFI non-government lending)



Source: Bank of Greece

Fig. 19 - Greek bank domestic lending (mn EUR) (non-government, non-MFI borrowers)



Source: Bank of Greece

To recap, banks and their sovereign states have come closer together in the course of the crisis. The fundamental problem has remained the insolvency of several sovereigns. Increasing reliance of banks on essentially insolvent sovereigns in the periphery has multiplied the risks for the financial system as a whole, exacerbating the prospect of a break up in the Eurozone.

In September 2011 the European Banking Authority declared that 16 banks from across the Eurozone had to boost their capital ratios by April 2012. The internal markets commissioner stated: "We want the recapitalisation for these banks to be by private means. The era of bailing out banks must end. But I cannot of course exclude the possibility that some of the above banks will require state aid." [27] These were fine sentiments but, in practice, policy makers in the periphery had already begun to face a tough dilemma: either full nationalisation, or selling banks to foreigners, for instance, to sovereign wealth funds of the emerging east or of the oil producers. [28]

Selling the banks abroad echoes the continuous calls for privatisation made by lenders to peripheral nations: repay, even if it means a firesale of future revenue streams. Nationalisation, on the other hand, would only be a first step in resolving the crisis. It would simply create a more propitious context to deal with the problem of state insolvency but also to confront the profound economic dislocations created by the Eurozone, as is shown in the next chapter for Greece.

27 See http://www.ft.com/cms/s/0/49d6240e-e527-11e0-bdb8-00144feabdc0.html#axzz1YNIbQpro

28 The merger of Eurobank and Alpha Bank in Greece has already been announced with an equity injection of EUR500mn from Qatar. It has also been rumoured that Greek government preference shares could be bought for roughly EUR2bn. This could be a first indication of what lies in wait for Greek banks were default to materialise in the Eurozone in the near future, though Qatar is unlikely to be a major source of funds.

Chapter 5
The social and political significance of breaking up

5.1 The context of rupture

It was shown in previous chapters that the Eurozone has been deeply problematic from its inception, in large part due to the social and political interests on which it rests. The world crisis of 2007 has exacerbated the contradictions of monetary union and the response by Eurozone authorities has worsened the problem. In late 2011 the euro faces a decisive challenge which could lead to a break up occurring within the Eurozone.

The form of the break up is impossible to predict. One or two peripheral countries could exit; there could be a group of 'hard' euro countries and a satellite group of 'soft' euro countries, with variable exchange rates between the two; there could even be complete collapse of the monetary union. At present, core countries appear reluctant to push peripheral countries out of EMU, since there are major risks for the banks of both core and periphery. Yet, the institutions of the Eurozone have exacerbated the crisis by forcing austerity on the periphery causing enormous social and economic strain without the prospect of growth.

Breaking up could occur from a range of events, including spontaneous departure by a peripheral state, or the core gradually forcing out a peripheral state. In all instances the catalyst is likely to be inability to service public debt, or what amounts to the same thing, inability to meet the conditions imposed by official lenders to continue to disburse bail-out funds. The country that is closest to this eventuality is Greece.

The rest of this chapter focuses on the likely implications of default and exit for Greece, and to a lesser extent for the rest of the Eurozone. To keep the analysis manageable, it is assumed that only Greece defaults and exits, abstracting from Portugal, or another country, following suit. For the same reason, only the first order effects on European banks, the ECB and other institutions are considered. Effects of a further order, for instance, through the interbank market, are left out of account because the degree of complexity would be simply forbidding.

The exercise below deploys quantitative data and makes specific quantitative assumptions, but keeps well away from quantitative estimates of the impact on GDP, personal income, the balance of payments, and so on. The reason is clear: given the complex and fluid nature of the problem, such quantitative estimates would be pretty worthless. Quantitative data and assumptions are important to establishing the economic content of Greek default and exit, but no more.

There is, however, a further and deeper purpose to the analysis. Exit from the Eurozone could have highly variable implications for working people and society as a whole. It could, for instance, be chaotic, undertaken at the last moment, under extreme pressure from the current untenable policies, and with minimal preparation. The costs to Greek economy and society, already weakened by austerity, would be substantial. It is far from inconceivable that chaotic exit could create phenomena similar to Argentina in 2002-3 - the economic shock combining with popular anger to cause phenomena of social disintegration. [29]

Exit could also be ‘conservative’, that is, led by private interests keen to protect the existing balance of social forces, and persevering with the austerity. The result might be an authoritarian polity atop an economy characterised by successive devaluations, poor growth outcomes, and worsening income distribution. As the prospect of Greek default and exit has gradually entered the mainstream in recent months, several studies have attempted to assess the likely implications, typically within the parameters of ‘conservative exit’ and predicting disaster. [30]

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29 For a fuller discussion, see Research on Money and Finance, 2010b. The Eurozone between Austerity and Default, C. Lapavitsas, A. Kaltenbrunner, G. Lambrinidis, D. Lindo, J. Meadway, J. Michell, J.P. Painceira, E. Pires, J. Powell, A. Stenfors, N. Teles, Occasional Report 2, September, www.researchonmoneyandfinance.org.

30 See Buiter W. and Rahbari E., (2011), The future of the euro area: fiscal union, break-up or blundering towards a ‘you break it you own it Europe, Economics, Global Economics View, 9 September. For a completely alarmist and poorly substantiated offering, see UBS, (2011), Euro break-up – the consequences, UBS Investment Research, Global Economic Perspectives, 6 September.

Yet, there could also be 'progressive exit' favouring labour against capital. This is the type of exit considered in this chapter, and it is arguably the most radical course of action available to the Greek people - and possibly to others in the Eurozone - at present. Progressive exit could open the way to social and economic change transforming Greek society in the interests of labour. However, to this purpose it would also be necessary to adopt a broad programme including, at the very least, public ownership and control over financial institutions, control over capital flows, income and wealth redistribution, sustained industrial policy to protect employment and ensure growth, and total restructuring of the state in a democratic direction. In essence it would be a transitional programme for the Greek economy - and potentially others - in the direction of labour ascendancy.

This report is not the place to discuss the particulars of such a programme. Analysis rather concentrates on 'the next day' of default and exit, ascertaining the likely impact on both the private and the public sector. But important elements of the transitional programme inevitably come into focus when considering the storm that would follow default and exit. In this light, analysis below is fully compatible with the notion that default and exit could trigger a deep and progressive transformation of the Greek economy in the longer term.

More broadly, rupture in the Eurozone could put profound social change on the agenda in Europe for the first time in decades. The preceding period of financial ascendancy has resulted in a precarious balance of economic, social and political forces in Europe and elsewhere. The relentlessly conservative response to the crisis has exacerbated discontent, tensions, and the search for alternatives. Greek default and exit could catalyse broader change, loosening the hold of financial and industrial interests on the life of the continent.

An important factor in this respect would be the ideological impact of a break up of the EMU. Money is far more than a simple means of exchange, or a means of payment and reserve. It also functions as social organiser providing signals of scarcity or surplus and facilitating the shifting of resources. In a society driven by the self-interested pursuit of profit, it provides the glue that holds together disparate areas of economic and social activity. Money is the nexus rerum of capitalist society as well as the thing that condenses impersonal social power, social distinction, and social value. It is at once the purpose, the means, and the measure of social achievement.

For this reason domestic money becomes an element of national identity, a thing that purports to capture national virtues and vices. In the world market where national capitals compete, the relative value of domestic money becomes a reflection of the worth of a nation. Possessors of 'hard' currencies are far more than mere holders of a reliable store of value. They bestride the field of global interaction looking down on the holders of 'soft' currencies. It might be fetishism, but it reflects an underlying reality: powerful nations are expected to have strong currencies.

For an international reserve currency (world money) the ideological impact is incomparably magnified. Not only is the issuing nation perceived to be dominant, but the institutional and political mechanisms supporting a reserve currency ensure the issuer's paramount position. A managed reserve currency is by construction a mechanism of global power economically, politically, ideologically, even militarily.

It is no surprise, therefore, that the euro has come to be identified with the notion of Europeanism and the idea of a united Europe. Indeed, it is entirely appropriate that a united Europe driven by big banks and big business would find its true reflection in a form of money. And yet, precisely because of the contradictory construction of the EMU, even the ideological role of the euro is contradictory.

For core countries - the main beneficiaries of the EMU - the euro is tainted by association with the weak periphery. The holy anger of EU leaders with Greece at the beginning of the crisis is partly due to having their money sullied by Greek unreliability. The suspicion constantly resurfaces that perhaps a return to a 'hard' national currency would provide greater global standing; or that the expulsion of the problematic periphery, if it could be achieved without disaster, would restore the euro to its rightful place in the global pecking order.

For peripheral countries that have suffered most from the crisis the opposite holds true. A return to a 'soft' national currency is perceived as a loss of prestige, a failure to join 'first class economies'. Among the leading social strata there is palpable fear that quitting the euro would mean a loss of identity as true Europeans. Hence the most profound paradox of the current crisis: the harder the periphery is buffeted by EMU policies, the more desperately its leadership clings on to EMU membership.

Economic reality has, of course, the ability to impose itself, irrespective of the ideology of politicians and others. The contradictory and untenable nature of the EMU cannot be overcome by imagining a united Europe. But the ideological role of the euro would be of paramount importance in shaping alternatives. It is one thing for a country to be forced into exit by ruthless reality, quite another to choose the moment of exit itself. The latter would allow for the marshalling of the required strength, and it could become the path to progressive exit.

For that, however, it would also be necessary to possess a different ideological narrative of European identity with a correspondingly different perception of national worth. There is nothing preordained about the form that ideology would take as Europeanism loses its shine alongside the euro. It could indeed lead to a revival of competing nationalisms with all the terrible echoes from European history. But it could also bring a genuine internationalism that respects national independence and aspires to a united Europe based on the interests of working people rather than banks and big business. The final outcome would be entirely dependent on the actions of the main social players.

5.2 Modalities of default

In light of the above, it is necessary to spell out key issues regarding default on public debt. Default is a catch-all term indicating several ways in which a debtor would fail to meet contractual obligations, thus imposing losses on the creditor. The legal aspects of default are not relevant to the analysis, for instance, the period of grace during which non-payment of interest would not be considered default, or agreed changes in repayment that would prevent the debtor from being officially declared in default. What matters is the economic impact irrespective of the debtor's precise legal status.

In general, default entails rescheduling debt, that is, changing (one or more of) the term, the rate of interest and the face value of debt; all these changes naturally affect the Net Present Value of debt. From the perspective of the creditor, however, the critical element is changing the face value of debt because it implies failure to receive return of the principal, which creates losses and denies the fundamental logic of the lending of money. The trickiest part of default is always the cancellation of part of the debt.

Broadly speaking, default can be divided into creditor-led and debtor-led. [31] This distinction does not admit of great theoretical precision and should be deployed heuristically. But it captures the policy dilemma better than the distinction between orderly and disorderly default that has been extensively used by the mainstream in recent months. For, 'orderly' in this context means largely in the interests of the lender. A version of creditor-led, orderly default was already attempted for Greece in July 2011 and, as was mentioned in chapter 3, it was to the benefit of the creditors rather than the country.

Given the parlous state of the Greek economy, rescheduling the term and rate of interest and even mildly reducing the face value of the debt would not decisively deal with the country's problems. Greece needs a deep reduction of the face value of its debt, i.e. cancellation on both official and private debt, which would restore the debt/GDP ratio to manageable levels assuming the country entered a sustainable growth path.

This is unlikely to occur under creditor-led default, and even if it did, the price that the creditors would extract would be correspondingly high, including possession over key national assets and direct control over the country's fiscal policy. At the limit, creditor-led default would pose issues of national independence and sovereign rule in Greece. In this light, debtor-led default is likely to be the only effective way for the country to free itself from the shackles of debt. For that, two political and social conditions would be paramount.

First, default would have to occur in a sovereign way, i.e., the borrower would have to coerce banks. This would certainly mean cessation of payments of interest and principal on public debt, in the first instance. Negotiations with the lenders would then follow seeking final settlement that would involve the cancellation of a large part of the debt. Greece is not without advantages in this connection. It appears that 90% of Greek bond debt has been issued under Greek law without Collective Action Clauses. A unilateral act of Greek parliament could alter the terms of settlement, benefiting the debtor and coercing private banks into accepting an offer. Second, default would have to take place in a democratic way by breaking the hold

31 The difference between creditor-led and debtor-led default has been discussed in some detail in Research on Money and Finance, 2010b. The Eurozone between Austerity and Default, C. Lapavitsas, A. Kaltenbrunner, G. Lambrinidis, D. Lindo, J. Meadway, J. Michell, J.P. Painceira, E. Pires, J. Powell, A. Stenfors, N. Teles, Occasional Report 2, September, www.researchonmoneyandfinance.org.

of technocrats and politicians over the management of public debt and directly involving civil society and organised labour. Public debt is complex and obscure, with many claimants and several types of indebtedness. Society has a democratic right to know the constitution of the debt and to be directly involved in its management.

From the long experience of developing countries in dealing with sovereign debt problems, it appears that the best way of ensuring democratic participation is to form an Audit Commission. The Audit Commission should be independent of the political system of both Greece and the EU. It should be international in composition, comprising specialists (lawyers, economists, fiscal auditors, and others) but also representatives of civil society and the organised labour movement. Its task would be to audit public debt with a view to ascertaining its legality, legitimacy, odiousness, and sustainability from a social standpoint. To do its work it should have access to information regarding all forms of public debt as well as being able to call witnesses and even to examine private bank accounts.

After auditing the debt, the Commission would make appropriate recommendations regarding cancellation as well as the general management of public debt. It is conceivable, for instance, that the bail-out loans advanced to Greece since 2010 would be declared illegitimate on account of the extraordinary political pressure applied on Greece, even by-passing the normal constitutional and parliamentary process. It is even conceivable that the entire burden of Greek debt in excess of 60% of GDP would be declared illegitimate since it directly contravenes the Maastricht Treaty. The latter was a deeply problematic document from the outset, but nonetheless the lenders to Greece were fully aware of its existence.

It is not surprising in this light that debtor-led default would appear disorderly to the entrenched interests in the Eurozone and more generally. Yet, what is perceived as lack of order could actually be an injection of democracy and the reassertion of national independence. By the same token, it would hold the promise of deep social transformation in favour of labour in Europe and elsewhere. Consequently, debtor-led default would be impossible within the Eurozone, probably leading to exit.

The likely implications of default and exit are considered in the next section, but two general points are important before engaging with the analysis. First, default and exit would immediately raise the prospect of a banking, a monetary, and a

foreign exchange crisis for Greece. These would be closely interconnected, but not identical. Policy ought to focus on keeping them separate, for if they coalesced the outcome would be deeply problematic. Of the three, the banking crisis would be by far the most serious as it would directly impede the capacity of the economy to sustain the core of production, and therefore employment.

Analysis in chapter 6 shows that the main danger to banks is posed by default, rather than exit. Exit would add banking problems of its own, but it could also make it easier to deal with the banking problems caused by default. Exit would certainly generate the risk of monetary and foreign exchange crises, but it would also bring advantages that could allow the country to recover. In sum, if Greece were to default, it would also make sense to exit.

Second, confronting default and exit would require the marshalling of economic, social and political resources across the country. In this respect, the adjustment programme imposed by the troika has been a disaster since it has considerably weakened the Greek economy. The cumulative loss of output for 2010-11 will probably exceed 10% of GDP; official unemployment is in the region of 17%. Time is, therefore, of the essence: the longer the country delays defaulting and exiting, the weaker will be its economy and the greater the difficulty of recovering.

Chapter 6
Default and exit: Cutting the Gordian knot

Analysis below is conducted in two distinct steps: it is assumed initially that default would take place within the EMU; it is then assumed that default would be followed by exit. The extent of debt cancellation will be taken at 50%, though the figure is purely for analytical purposes and too much should not be read into it. The proper way to ascertain the extent of cancellation as well as the terms and conditions of repayment would be to form an Audit Commission.

The analysis is based on the assumption that the composition of Greek public debt is as shown in Box 8 below. The qualitative results of the analysis with regard to privately held debt are summed up in Box 9 below. The implications of exit for the banks, monetary circulation and foreign exchange are discussed in the text.

BOX 8

HOLDINGS OF GREEK DEBT, BY CATEGORY (€m)

Category	Holder	€m
Domestic	Greek banks	55,740
	Greek central bank	7,087
	Social security and other public entities	30,000
	Non-financial corporations	3,679
	Insurance companies	3,230
	Mutual funds	41
	Households and non-profit organisations serving households	12,133
Foreign	European banks	52,258
	Non-European banks	1,938
	ECB	50,000
	National European central banks	6,013
	IMF	15,000
	EU	38,000
	Rest of the world official institutions	25,000
Unallocated		60,000
Total		360,120

Sources: Bank of Greece Financial Accounts; BIS Quarterly Review, July 2011; Barclays Capital

Three main sources were used to construct this table: the Bank of Greece's Financial Accounts and aggregated balance sheets, updated to July 2011; Bank of International Settlements Quarterly Review, published July 2011; and Barclays Capital own calculations of Greek debt holdings by individual institutions, reproduced Financial Times Alphaville blog of June 19.

Holdings by Greek banks are taken from Bank of Greece, "Aggregated balance sheet of monetary financial institutions", and tally with Barclays Capital total. Greek central bank holdings are from Bank of Greece, "Balance sheet of the Bank of Greece". Social security and other public entity holdings are taken directly from Barclays Capital reported holdings, and match other figures reported (eg JP Morgan reported "social security and other public entity holdings", FT Alphaville 9 May 2011). The figure for non-financial corporations is taken from Bank of Greece, "Financial Accounts: non-financial corporations quarterly". Insurance companies and mutual funds figures are from the aggregated balance sheet of both categories produced by the Bank of Greece under their Financial Accounts. Households and non-profit institutions serving households are likewise taken from Bank of Greece, "Financial accounts: households quarterly".

European bank holdings are given in BIS Quarterly Review, July 2011, Table 9E. This tallies with the total derived from the Barclays Capital reported holdings of individual institutions. Non-European bank holdings are from BIS Quarterly Review, July 2011, Table 9E. Holdings for the ECB are taken from JP Morgan, reported in FT Alphaville 9 May 2011, which matches Barclays Capital figures. The figure for the national central banks of Europe is from Barclays Capital, removing the Bank of Greece from the original figure. IMF, EU, and Rest of the World public institutions are from Barclays Capital. Holdings unallocated are a residual from the headline Greek debt of €360bn, and can be assumed to consist largely of private sector holdings largely outside of Greece not reported elsewhere.

BOX 9

DEFAULTING ON GREEK PUBLIC DEBT

Modalities of default	Implications for debt holders	Impact on total debt and broader repercussions
1. Creditor-led default on privately held debt:	No losses for ECB &NCBs over bonds held Significant losses for terminal bondholders including: Domestic social security&pension institutions Domestic households and non-profit organisations Other domestic investors Non-resident terminal bondholders Major losses for domestic banks Modest losses for international banks	The final reduction of debt is limited by the exclusion of ECB, NCBs, EU and IMF Recapitalisation of domestic banks takes place through state borrowing, hence increases Greek public debt Recapitalisation of international banks takes place through private equity or EFSF Greek banks are reluctantly nationalised and could end up under foreign ownership in the medium term
2. Debtor-led default with redenomination into drachma of domestically held debt only	ECB &NCBs also face losses on bonds held Official lenders (IMF and EU) could potentially face losses despite superseniority Significant losses for terminal bondholders including: Domestic social security&pension institutions Domestic households and non-profit organizations Other domestic investors Non-resident terminal bondholders Major losses for domestic banks Modest losses for international banks	The final reduction of debt is greater as the haircut also applies to bonds held by ECB and NCBs. The impact could be even greater if official loans by the EU and IMF took a haircut Greek banks swap existing bonds for long-term, low-yielding paper of the same face value Recapitalisation of European banks via private equity or EFSF Domestic terminal bonholders could be protected through swapping bonds for long-term paper and through guarantees by the state. Maintaining external debt in EUR imposes some foreign exchange risk on the sovereign. ECB, NCBs and Greek NCB face modest losses. Access to liquidity is lost for Greek banks which now need domestically-generated liquidity. Purposeful nationalisation of Greek banks, shrinkage of balance sheet, redirection to domestic economy. Banks carry significant foreign exchange risk for a period.
3. Debtor-led default with complete redenomination of debt	As for 2	The final impact on debt is as for the previous case but the haircut could also operate through the fall in the exchange rate Redenomination of the total debt into drachma imposes foreign exchange risk on non-resident bondholders, but not on the sovereign. Domestic terminal bonholders can be protected through swapping bonds for long-term paper and through guarantees by the state. Purposeful nationalisation of Greek banks, shrinkage of balance sheet, redirection to domestic economy. Banks carry foreign exchange risk for a period as some assets and liabilities cannot be redenominated. Recapitalisation of international banks via private equity or EFSF.

6.1 Greece defaults but stays in the EMU

Assume that creditor-led default amounting to a 50% write-off of Greek public debt was agreed upon while Greece remained within the EMU. Assume further that the write-off referred exclusively to privately held sovereign bonds. The main impact considered in this chapter would be on domestic and foreign banks, including the concomitant risk of a banking crisis.

Leave aside the major difficulties that the EU would face in persuading private banks voluntarily to accept - or indeed in coercing banks into accepting - a 50% fall in the face value of Greek debt. Assume also that the debt held by official lenders, including EUR56bn by the ECB and other NCBs, EUR38bn by the EU and EUR15bn by the IMF, would be left untouched. It is safe to say that the overall reduction of Greek debt is likely to be modest under the assumption that official lenders would be kept intact.

A 50% haircut of privately held debt would also imply severe losses on the EUR12bn of bonds currently held by Greek households and non-profit organisations. Significant numbers among these bondholders are likely to be small savers who opted for what appeared to be a conservative option when they purchased sovereign bonds. Even more severe would be the impact of the haircut on social security and pension institutions that would face losses of up to EUR15bn on bonds held. In the absence of fresh funding from the state and given the low level of reserves and weak balance sheets – due to chronic mismanagement – the implications could be disastrous for pensions, health insurance and other forms of welfare.

6.1.1 The banks

The immediate impact on Greek banks would be losses in the region of EUR25-30bn, wiping out the bulk of their capital. The required recapitalisation within the structures of the EMU could only be undertaken by official institutions. It would be in the interests of the EU to recapitalise Greek banks to forestall a knock-on effect on European and other banks.

The most probable method of recapitalisation would be increased borrowing by the Greek state as part of a new bailout package for the country. The new loan, however, is likely to mean even harsher conditionality, perhaps including direct supervision of public finances by EU bureaucrats. Furthermore, the outcome would

be nationalisation of Greek banks. This would not be purposeful nationalisation aiming to deploy banks to restructure the economy as a whole. Recapitalisation loans might not even be managed by the Greek state, even if they were officially incurred by it. It is possible that effective control over Greek banks would pass to the official lenders of the Eurozone, primarily Germany. That could prove the first step in transferring ownership over Greek banks to international hands once their balance sheets would have been cleansed under public control.

If this were to happen, the long-term implications for investment, growth, and employment in the Greek economy would become extremely uncertain, and in all probability would be negative. In broad terms, the Greek ruling class – the original bourgeois class of the Eastern Mediterranean – would find itself without direct ownership and control over Greek banks for the first time in its history. There would also be implications for national independence as the Greek state would be dominated by the EU in dealing with Greek banks.

A 50% write off of Greek debt would also entail losses for international (mostly German and French) banks, probably of the order of EUR25bn. This would be a significant blow, but European banks could probably replenish their capital through private equity issue or EFSF funds without undue difficulty, on the assumption that only Greece defaulted. Still, they are likely to resist strongly the imposition of losses since they are accountable to their share holders and not to states. From the perspective of banks, it would be far better if taxpayers carried the losses of a Greek default. The possibility of persistent hold-outs who will resort to litigation cannot be dismissed.

The real risk to banks, however, would arise from contagion in financial markets, including the secondary markets for European sovereign debt, once sovereign default would become a hard reality. A Greek default could potentially act as the trigger of a major crisis, even if it was creditor-led. If CDS were activated it is possible that interbank markets would freeze, leading to global banking crisis. A creditor-led default, consequently, would be a protracted and risky process. It would also have to rely on the readiness of the ECB to intervene decisively should the worst materialise. Important as these risks would be, they are only of marginal domestic concern to Greece. If the EU was truly concerned about contagion and the possibility of a global banking crisis, the troika ought to adopt a different approach to Greek debt.

6.1.2 The primary deficit

Banks aside, a 50% write-off of Greek public debt would bring to the fore the problem of the primary budget deficit of Greece. The presumption must be that, if the EU provided funding to prevent Greek banks from collapsing, it would also provide sufficient fresh loans to allow the Greek state to continue meeting its current expenditures, above all, on public sector salaries and pensions. But it must equally be presumed that the price extracted by the EU would be more severe than in previous bailouts. At the very least, it can be expected that there would be a measure of direct control over Greek public finances by EU officials. In addition there would probably be pressure to privatise public assets on an extensive scale to repay official debts. The implications for national independence would be negative.

To recap, Greek creditor-led default of, say, 50% occurring within the EMU would be a significant shock for European banks. To avoid a generalised banking crisis it would be necessary to have concerted intervention to recapitalise banks and make liquidity available, but there would still be no guarantees of success. Meanwhile, Greek banks probably end up under state control that might eventually lead to foreign ownership.

The implications for GDP growth are likely to be negative since austerity would continue and the inability to compete within the Eurozone would not be lifted. Greece would face many years of stagnation and high unemployment, while its banks and public assets would be auctioned off. At the same time, it would probably have to submit to direct external control over its public finances, thus abrogating parts of its national sovereignty.

6.2 Greece defaults and exits the EMU

Debtor-led default would almost certainly entail exit from the EMU. The Greek state would declare unilateral cessation of payments on its debt, also announcing that it would stop recognising further accrual of interest. There would be immediate problems of recapitalisation and liquidity for banks, but no ready access to the mechanisms of the EU and the EMU. It would thus be imperative for Greece to reacquire direct command over monetary policy. Exit would follow in short order, also altering the terms on which default would be handled.

Debtor-led and exit would be a difficult option for Greece, or any other country of the periphery, for reasons explained below. But the first requirement is to establish a benchmark against which to judge their impact.

6.2.1 An appropriate comparison

Clearly, the benchmark cannot be the pre-crisis state of affairs. The appropriate comparison would be, rather, with the likely state of the country if it continued with austerity policies within the EMU, even after a measure of creditor-led default. It has been argued throughout this report that the outcome would probably be a deep contraction of GDP followed by low growth, persistent high unemployment, and low incomes. Not least, there would be loss of national independence and erosion of domestic democracy.

Support for this assessment has come from unexpected quarters. In late October 2011 there was a leak of an official document detailing a Debt Sustainability Exercise for Greece performed at the highest levels of decision making within the EU and the IMF. Recognising that the Greek economy had taken a turn for the worse since the summer of 2011, the document expected 5.5% and 3% GDP contraction in, respectively, 2011 and 2012. This would be followed by growth slightly higher than 2% until 2020, only to subside to about 1.7% in the decade to 2030. Greece would effectively stagnate for twenty years. The study did not state it openly, but it is clear that high unemployment would become permanent.

The authors were more concerned about the implications for national debt which was expected to peak at 186% of GDP in 2013, fall to only 152% of GDP by end-2010, and remain at 130% of GDP by end-2030. Greece would be profoundly insolvent even in 2030 and would require continuous official assistance running in the hundreds of billions of euro throughout this period. The study concluded that Greece would therefore need cancellation of its debt, possibly by up to 60%, with much of the cost to be borne by private banks.

Numerical accuracy aside, there can be no quibbling with the drift of these conclusions. It is logical to expect poor growth outcomes when severe austerity is imposed on an economy already hollowed out by a decade of credit-driven expansion. Even more fundamentally, poor growth would result from the inability to devalue the exchange rate, and the attempt to recover competitiveness via the brutal method of driving down unit labour costs. These constraints would not be removed if Greece was offered a measure of creditor-led default. The likely outcome would still remain long term economic and social decline with deeply problematic implications for national independence and democratic practice.

There can be little doubt that debtor-led default and exit could have better long-term results for both growth and employment. At the very least the country would be freed from the grip of austerity as well as of fixed and high exchange rates. More broadly, a path could be opened toward dynamic improvements in productivity away from the tired shibboleths of liberalisation and privatisation. If debtor-led default and exit were accompanied by an appropriate programme, they could deliver better growth outcomes with greater equality, while also strengthening the position of labour in society.

The real difficulty is not to work out the likely long-term results for Greece but to ascertain the adjustment path, especially during the initial period. Real incomes, in particular, are likely to fluctuate in unpredictable directions as relative prices would change following exit. It is likely, for instance, that food prices would decline as Greek agriculture would reoccupy the domestic market. But the prices of cars, foreign travel, clothing and other consumer goods would be likely to rise. Once growth returned to a higher path, access to several of those goods would also improve since real incomes would rise. However, adjustment in the short term would remain difficult.

Consequently, several factors militate in favour of progressive exit that would actively shape the adjustment path. A progressive government that drew strength from popular support - particularly from organised labour - would recapture control over the instruments of economic policy. It would be able to offer effective protection of employment, loss of which is the single most important cause of poverty for working people. It would also be able to support small and medium businesses - the backbone of the Greek economy – by deploying credit and tax policy. Stability of employment and a stable framework for small and medium businesses would create better living conditions for working people, irrespective of how real income might fluctuate in the short term.

A progressive government in command of policy instruments would also be able to intervene in income allocation in the short term. The weaker sections of society could be supported through selected wage and salary increases as well as through subsidies for public transport, heating oil, and other key commodities. Equally important, redistribution of income and wealth could be effected by restructuring the tax system in favour of direct taxes, including the better off strata of society that have systematically evaded tax for decades.

Several key issues of the adjustment path are examined in the rest of this chapter. It is, however, important to make one final point at the outset. If Greece defaulted and quit the EMU it would probably come into conflict with the EU since the required interventions would be at odds with the neoliberal core of the Maastricht Treaty and a raft of other treaties and agreements. The path of the adjustment would therefore depend on social and political struggle that would involve both Greece and the EU.

Default and exit occurring on a progressive basis with grassroots support would re-strengthen democracy in Greece allowing the country better to confront the challenge. If the Greek people decided that the necessary policies were incompatible with remaining in the EU, it would be up to them to exercise their choice. But it is also likely that progressive Greek default and exit would lead to rapid change in the EU, in view especially of the unsustainable nature of the monetary union. The EU would probably look very different after the turmoil of Greek default and exit.

6.2.2 The debt

Following cessation of payments, the state would engage in negotiations seeking substantial cancellation of debt. It is intuitive that, were Greece to enter this path, it would not necessarily accept a mere 50% reduction, or indeed any rate that the creditors wished to impose. After subjecting the debt to independent examination by an Audit Commission, the country could opt for significantly deeper cancellation, including debt held by official institutions. However, to keep things broadly comparable with the case above assume that the cancellation is still 50% and affects private holders of sovereign paper but also the ECB.

Even with the assumption that the write-off would be given at 50%, exit would significantly alter the problem of public debt. For one thing, domestically held public debt would be redenominated in the new currency – the new drachma. It is conceivable, though, that the state would retain the denomination of internationally held debt in euro. Since the new drachma would depreciate rapidly, the ratio of euro-denominated debt to GDP would rise. This possibility often leads to a misconception among those who oppose Greece quitting the euro. If, for the sake of argument, the new drachma was depreciated by 50%, the ratio of externally-held euro-denominated debt to drachma-denominated GDP would still remain very high even after a 50% default. The country would seem to lose much of the benefit of default.

This is plain confusion of arithmetic with economics. If default took place, the economic burden of the public debt on the Greek economy would be lessened by the equivalent of the loss taken by the creditors, i.e., by 50%. The real resources required to service the remaining euro-denominated debt would be substantially reduced, irrespective of its higher value in new drachma. The real difference for both the Greek state and its creditors would be that some foreign exchange risk would now be attached to remaining euro-denominated debt. But this predicament would be no worse for Greece than for a host of developing and other countries that currently borrow in foreign currency.

Exit, however, would give to the Greek state further options with respect to debt, since even its internationally-held obligations could also be re-denominated in new drachmas. After all, Greece borrowed in its national currency when it accumulated euro debt, and it would be paying back in its national currency if it used new drachmas for settlement. The state could at a stroke transform the entire stock of euro debt into domestic new drachma debt. The inevitable depreciation of the new drachma would shift the burden onto the lender – the haircut would occur through the fall of the exchange rate. Greece would gain the further advantage of encouraging core countries to support the new drachma, though the effectiveness of any such support would be very limited during the initial period as the new currency would be aggressively sold.

Note, finally, that the reputation costs of debtor-led default and exit would not necessarily be greater than those from imposing a severe haircut on euro-denominated debt following creditor-led default within the EMU. As far as the international bond markets are concerned, Greece would be a delinquent whether default occurred within the EMU or outside it, in euro or in drachmas. The sensible thing to do for Greece would be to default in the most beneficial way to itself.

6.2.3 The banks

For Greek banks a write-off of 50% would again bring losses of EUR25-30bn. In the absence of bailout funds by the EU there would be no option other than nationalisation without compensation for private equity holders. The difference with the previous case would be that nationalisation would be purposeful, aiming to rescue banks subsequently to deploy them to restructure the economy. Under public ownership, sovereign debt held by banks could be swapped for very long term, low interest bonds of the same face value. The new bonds could be backed

by state property, including real estate and public enterprises. The debt-servicing burden of the state would be reduced, in effect creating the equivalent of a haircut. The balance sheet of nationalised banks would have to be subsequently cleansed by slowly rebuilding capital and reorganising lending. A necessary step in this regard would be to scale back the international presence of Greek banks, probably selling subsidiaries in Turkey, the Balkans and elsewhere. Under public ownership and control, banks would then rebalance the supply of credit to the economy, including to Small and Medium Enterprises, which are the backbone of the Greek economy and the main source of employment. Nationalisation of banks would give to a progressive government the tools to apply credit policy thus reviving output and protecting employment.

Exit, however, would bring further complications for banks since they would acquire foreign exchange risk due to both assets and liabilities incurred under foreign law and thus remaining in euro. Moreover, banks would not be able to roll over euro liabilities since they would be shut out of interbank markets and they would lose access to liquidity from the ECB. The loss of euro-denominated liquidity for banks would impact on funding for bank assets, whether denominated in euro or new drachmas.

To deal with this aspect of the shock to banks, the state would have to reconstitute the central bank immediately, detaching it from the Eurosystem and enabling it to provide drachma-denominated liquidity to banks. Command would have to be re-established over monetary policy, thereby allowing banks to support drachma-denominated assets. Nonetheless, banks would still have to off-load euro-denominated assets in line with the inevitable shrinkage of their euro-denominated liabilities. This process is likely to take time, leading to bankruptcies of private enterprises and litigation. At the end of it, once again, Greek banks are likely to be smaller and more focused on the productive sector, thus acting as a lever for the restructuring of the Greek economy.

As for the EUR30bn held by pension and social security institutions, it would be important again to swap their sovereign paper for very long-term new bonds backed by real estate and other public property. The aim would be to prevent losses that would threaten the viability of the institutions. Regular payment of pensions would, meanwhile, be guaranteed out of the government budget. It should be stressed in this connection that pensions are a part of annual GDP accruing to various claimants. The best guarantee for pensions would be to restart the process

of growth, which can be expected following default and exit. Finally, small savers could also be helped through swapping their holdings of sovereign paper, always on the basis of an independent audit of the debt.

A write-off of 50% would also imply losses for the ECB and other NCBs in the Eurosystem, in the first instance on bonds held outright. These bonds were acquired mostly through the SMP, operated by the ECB on the basis of shared responsibility for losses. But they were also acquired through covered bond purchases, operated by the Greek NCB which has sole responsibility for losses. The magnitude of losses would depend on the haircut applied at the time of purchase, which is not public information.

On the assumption that Greek bonds were acquired at a haircut of 20%, and given that total holdings are in the in the region of EUR56bn, a 50% default would probably lead to losses of less than EUR20bn. This is not a significant sum for the ECB, and nor is the Greek NCB likely to suffer much from its own share of losses. However, the blow to the reputation of the ECB would be substantial.

Of greater complexity would be the impact of the write-off on the collateral held by the ECB against liquidity provided to Greek banks as part of its long-term refinancing operations. According to the ECB, the average amount of eligible collateral in 2010 stood at EUR14tr, of which 41% was general government debt and the balance comprised a variety of private debt instruments, including uncovered bank bonds, covered bank bonds, corporate bonds, asset-backed securities and other bonds. However, the actual collateral placed with the ECB was in the region of EUR2tr and comprised mostly private securities, including a rising volume of non-marketable assets (bank loans). Less than 20% was government paper, though the proportion had increased in the course of the crisis. [32]

The haircut already applied to collateral is not known. The difference in the composition between eligible and actually deposited securities, and the heavy preponderance of private securities, would indicate that the ECB has imposed a significantly lower haircut on private compared to public securities. As far as Greek collateral is concerned, there is no information on its composition, and nor on the haircut imposed on private and public paper. However, it is reasonable to assume that the total liquidity borrowed by Greek banks in October 2011 was at least

32 See ECB Annual Report 2010, pp.97-98, http://www.ecb.eu/pub/pdf/annrep/ar2010en.pdf

EUR100bn and that collateral composition was 80% private to 20% public paper. On this basis, a 50% default on public bonds would immediately lead to substantial losses forcing the ECB to issue a fresh call for more collateral. Note also that the value of private paper would decline, leading to further losses in effective collateral, if the ECB attempted to dispose of it in the open markets. Faced with fresh calls for collateral, Greek banks would default on liquidity borrowed. Total losses for the ECB are impossible to estimate given the paucity of public information, but it would not be surprising if they proved higher than losses on bonds held under the SMP and the covered bonds programmes. Again, the most significant effect would be on the reputation of the ECB.

It is also worth noting that the Greek NCB would find itself in trouble since it has acted as a channel for ECB liquidity throughout this crisis. To be more specific, if Greek banks defaulted on their liquidity obligations to the ECB, they would be effectively defaulting on the Greek CB, which would then be forced to default on the ECB. Losses on collateral would be incurred first by the Greek CB, subsequently to be passed to the ECB. As for the impact of default on ELA obligations by Greek banks, it is impossible to surmise given the lack of information. Reconstituting the central bank would be a vital task for these reasons too.

6.2.4 The primary deficit

As far as the primary deficit is concerned, finally, default and exit would offer further options to Greece in the short term. Note first that the official budget for 2011 (drafted on the assumption of higher expenditures and lower revenues than those currently prevailing) estimates that tax income (excluding net receipts from EU) suffices to cover the most pressing social and national security needs in Greece. Specifically, total expenditures on salaries and pensions, funding for social security, for the Ministry of Health, for the Ministry of Education and for the Ministry of National Defence were projected at EUR51.6bn. Total revenue from direct and indirect taxes, on the other hand, was projected at EUR52.9bn. The first step in confronting the problem of the primary deficit should thus be to re-order public expenditure on the basis of social priorities.

Beyond re-ordering expenditures, the state would be able to monetise the deficit for a short period of time since it would have re-acquired command over monetary policy. The immediate impact of monetisation would be beneficial to the economy by lifting the austerity that is currently strangling it. There would be no need to

impose the additional cuts in public expenditure, nor the increases in indirect and other taxes that are planned for 2012 and beyond. Indeed, the troika strategy of imposing extreme fiscal tightness to achieve a primary surplus in the shortest possible time to placate bond markets and allow Greece to return to international borrowing would be abandoned altogether. Greece would be able to adopt a sensible strategy of reducing fiscal deficits through growth over a period of time.

There would, of course, be a risk of inflation, if monetisation continued for a long time, especially in view of the rise in import prices following depreciation. But note that the size of the primary deficit is likely to be modest for the rest of 2011 and probably for 2012, possibly of the order of 2-3% of GDP. Even if the planned austerity was abandoned and the primary deficit turned out to be 5%-6% of GDP in 2012, that would still not be a huge gap to monetise for a short period. In the current heavily depressed conditions of the Greek economy, monetisation would allow for a boost to aggregate demand. The risk of inflation should not be exaggerated.

If, nonetheless, significant inflation did materialise for a period of time, wages and salaries could be indexed to protect the income of working people. Furthermore, significant inflation would have the beneficial effect of eating away at the value of the remaining public and private debt and thus lowering the burden on the Greek economy. All in all, given the current predicament of its economy, Greece should not be excessively concerned about inflation.

The longer-term response to the problem of the government deficit, on the other hand, would have to be structural. The answer to deficits must be provided through growth rather than austerity. Moreover, there must be wholesale restructuring of the tax system to reduce tax avoidance and to force the well-off to pay taxes regularly. The Greek tax system is one of the most unfair systems in Europe. Implicit tax rates on capital in Greece would have to rise from 15.8% in 2006 (the last year for which data is available) to at least the average for the EU, at 25.4%, or to the average for the Eurozone, at 26.9%. Restructuring the tax system would also eliminate institutionalised tax evasion of ship-owners, the Orthodox Church, and the banks.

33 Eurostat, 2010, Taxation trends in the European Union. Main results, p. 34, http://epp.eurostat.ec.europa.eu/cache/ITY_OFFPUB/KS-EU-10-001/EN/KS-EU-10-001-EN.PDF

Finally, the government would be able to finance modest deficits by rebalancing the domestic credit system through public ownership. Domestic borrowing was the standard means of financing primary deficits in Greece to the end of the 1990s. The adoption of the euro has had two profoundly negative results that eventually led to disaster. First, it encouraged the growth of domestic expenditure financed by cheap credit, which resulted in aggregate consumption of the order of 70% of GDP. Saving became correspondingly small, even negative in the second half of the 2000s, thus removing domestic sources of public finance.[34] Second, the Greek state was able to access international markets because it could borrow in euro. Consequently, it changed the composition of its debt, turning two thirds of it into foreign debt, as is shown in Box 8.

No state can avoid major problems for long if there are no domestic savings on which to draw and if it has to rely on international bond markets to finance current expenditure. The only partial exception is the US state, and that is because the USA issues the dominant reserve currency. Adopting the euro turned the Greek sovereign into a hostage of international bond markets, the IMF and the EU. A country such as Greece ought to sustain its public sector by restarting the process of growth as well as by re-strengthening domestic borrowing. It needs no more than sporadic access to international bond markets.

6.2.5 The monetary problem

The monetary problem of switching to the new drachma is conceptually trivial, although it presents several technical complexities. A bank holiday would have to be declared for a limited period of time, perhaps a week, to lessen the scope for a bank run. The conversion would have to occur as suddenly as possible, probably on a Friday evening. The state would immediately declare the new drachma to be legal tender, and would make all public obligations payable in it. Banks would be instructed to convert their balance sheets accordingly, including loans and deposits. The legal basis for converting assets and liabilities issued under Greek law is clear. However, since banks also hold assets and liabilities issued to non-residents, or under foreign law, the banking system would retain significant euro-denominated assets and liabilities, as was discussed above.

34 See, Research on Money and Finance, 2010a. Eurozone Crisis: Begar Thyself and Thy Neighbour, C. Lapavitsas, A. Kaltenbrunner, D. Lindo, J. Michell, J.P. Painceira, E. Pires, J. Powell, A. Stenfors, N. Teles, Occasional Report 1, March, p. 18, www.researchonmoneyandfinance.org

It would thus be necessary to impose capital controls with immediate effect, including on currency that could be physically taken out of the country. Withdrawals from remaining euro accounts would have to be frozen until some normality returned to transactions. By far the most decisive step to stabilising monetary circulation, however, would be nationalisation of banks that would allow the state to offer a blanket guarantee for drachma-denominated deposits.

The printing press would have to be set immediately to work to produce the new currency for circulation; resetting the ATMs would also have to start straight away. It would, of course, prove physically impossible to effect the physical change in a single week, particularly as new drachmas can hardly be printed prior to announcing the change. Thus, some euro already in possession of banks and the state could be stamped and called new drachmas, though it would be desirable to keep this to a minimum to economise on what would now effectively become foreign exchange.

Given the physical difficulties of replacing the currency, the state could also resort to issuing short-term promissory notes and bonds denominated in new drachmas to make its own payments. This would be a crude fiat money with limited acceptability outside the circuits of personal consumption. The sooner it would be eliminated, the better for the stability of monetary circulation. However, it could facilitate transition to the new drachma for several months.

Once the new drachma found itself in circulation it would take time to gain public confidence. There would be parallel circulation of the euro and the new drachma for a period, and a system of dual prices reflecting the fluctuating exchange rate between the two. Dual prices would entail transactions costs for businesses and households, also offering opportunities for speculation. However, these phenomena would be unlikely to persist as long as the state continued to make payments and purchases in new drachma.

A more costly problem would be the redenomination of existing contracts. The legal basis would be provided by the adoption of a new legal tender by the state, but there would be transactions costs as well as scope for arbitrary alterations of relative prices particularly as existing contracts would have some time to run. Furthermore, the adjustment of the banking system to the new accounting unit would also be costly. There would have to be adjustment of computer programming, clearing techniques, accounts keeping, and so on. It would take several months before banks learnt to operate smoothly with the new drachma.

None of these technical problems would be insuperable, and none would justify remaining within the EMU. [35] The price system and the domestic functioning of the new drachma would probably settle down within a few months. Note, finally, that switching to a new drachma has the advantage of creating scope for redistributive policies. The simplest conversion rate for banks liabilities and assets could be 1:1 EUR/GRD, but a range of other rates could also be used to effect wealth redistribution. Thus, deposits of, say, less than 10000 euro could be converted at 0.5:1 EUR/GRD, those between 10000 and 30000 could be converted at 0.8:1, and those above 30000 at 1:1. Redistribution could also make it easier to accept the new currency in a country as unequal as Greece.

6.2.6 The foreign exchange problem

The new drachma would immediately fall in value in the foreign exchange markets, though it is impossible to assess the extent of depreciation. It seems likely that the rate would at first overshoot but remain volatile afterwards. During the first period it would be impossible to adopt conventional exchange rate policy because the new drachma would be aggressively sold-off, but also because Greece runs a current account deficit and lacks foreign exchange reserves.

Still, it might be possible to exercise some controlling influence on the exchange rate through administrative controls on particular foreign exchange transactions, and through controls over capital flows. In the medium term, and if the current account deficit began to shrink and reserves to accumulate, it would be possible for the state to adopt a policy of stabilising the exchange rate.

Depreciation is likely to be beneficial to the Greek economy. The alarmist assertions - emanating mostly from bank research departments - that depreciation would be ineffective and that it would bring accelerated inflation, have to be treated cautiously. [36] One of the few careful studies of the issue estimates that a 50% depreciation of the new drachma would lead to inflation of 5-9% in the first year, while raising competitiveness by 37-42%. Depreciation would immediately deliver a large positive boost to the Greek economy by recapturing lost competitive-

35 It is interesting to note that as the crisis has deepened, it has become clearer that the main problems of exit lie with foreign exchange and banking. Even mainstream commentators who are against Greece exiting the EMU acknowledge that the purely monetary side of things is not particularly important. See Buiter W. and Rahbari E., (2011), The future of the euro area: fiscal union, break-up or blundering towards a 'you break it you own it Europe, Citi Economics, Global Economics View, 9 September.

36See, for instance, Buiter W. and Rahbari E., (2011), The future of the euro area: fiscal union, break-up or blundering towards a 'you break it you own it Europe, Economics, Global Economics View, 9 September.

ness without the socially destructive method of directly lowering unit labour costs. The current account would benefit in the short term.

Depreciation would, however, raise the price of imports and thus impact negatively on the income of workers and others. Note that the problem in this connection is not inflation as such, even though imported inflation would probably rise. In the depressed state of the Greek economy a modest measure of inflation is unlikely to be the main source of concern. The real problem would be that depreciation would change the relative prices of imports, thus affecting the consumption basket of workers and others. The following three points are vital in this respect.

First, contrary to the policy of directly reducing unit labour costs (or internal depreciation, as it is sometimes called) currency depreciation does not work by reducing workers income. This is a misconception that is often purposely cultivated in the mass media and elsewhere. Rather, depreciation works by changing the relative price of exports and imports, therefore influencing demand. In effect, depreciation releases abroad some of the pressure on the domestic economy by allowing it immediately to recapture lost competitiveness. This is why it is preferable to the current policy of the troika.

Second, by raising the relative price of imports, depreciation would certainly reduce the income of workers and others. However, the pass-through to import prices would not be full in the short run – the rise would be unlikely to reflect the full effect of depreciation. Furthermore, workers would be able to exercise some choice over which commodities to include in the consumption basket. The fall in real income, therefore, would not be externally determined and across the board, as it is with the present policy.

Third, workers are likely to benefit from increased production and therefore from the boost to employment that would result from depreciation. Once again, the benchmark against which to judge the impact of depreciation would be given by the current policies of stagnation and high unemployment. Workers might also draw benefits from further changes in relative prices as the economy picks up. The introduction of the euro led to substantial increases in the prices of several food staples in the early 2000s, including vegetables and dairy produce. It is reasonable to expect that the relative price of food would decline following the return to the drachma and the recovery of Greek agriculture.

In the very short run, however, the sudden rise in the relative prices of energy, food and medicine, on all of which Greece has significant import dependence, would be problematic. Note that the country is practically self-sufficient in electricity generated through domestic production of lignite which would have to be intensified for a period. Nonetheless, up to two thirds of its energy is supplied by imported oil that is used mostly for transport, and national reserves are unlikely to last for longer than three months.

The priority for the authorities in the very short run, therefore, would be, first, to secure access to foreign exchange and, second, to secure emergency access to supplies of energy, food and medicine. Bilateral deals with oil producers, such as Russia, and with other producers of vital commodities would be very important. Still, it is likely that there will have to be rationing and other administrative measures for oil and other key commodities during the first months following exit from the EMU.

The pressure would also be felt by households since they have a heavy dependence on imported oil and other commodities. It would thus be necessary to use tax and subsidy policy to lighten the burden for the poorest in terms of transport and heating. In effect, the country would find itself in a state of emergency for several months during the initial period and until the economy began to recover. This would be part of the cost of escaping long-term decline within the EMU.
Short-term problems aside, depreciation would still be insufficient to produce longer-lasting benefits for the Greek economy by itself. After a period, its beneficial impact would be eliminated as the rise in the price of imports would eventually pass through to domestic prices and to the price of exports. However, the aim of exiting the EMU is not to restore the health of the Greek economy through depreciation. Rather, the aim is to rescue the Greek economy from the destructive grip of the EMU – depreciation is an inevitable by-product of exit.

Default and exit, therefore, should be the preamble to a broad programme that would restructure Greek economy and society. By removing austerity and allowing competitiveness to be quickly recaptured, they would create propitious conditions for measures that could raise productivity, improve technology, streamline commerce by removing privileges and market-fixing practices, break the monopoly position of corporations in key markets, such as medicine and food, and so on. It is worth noting that productivity growth in Greece has been considerably faster

than Germany in recent years, as is shown in figure 2, indicating latent strength in the productive sector.

Exit from the EMU would thus make it possible to reshape the Greek economy in the interests of working people, while also creating conditions for sustainable growth. The aim of the programme would be to sustain high employment and to raise the share of labour in the national product. A vital element would be the expansion of public investment, particularly in view of the complete collapse of private and public investment since 2008. Resources could be generated in part through default on public debt: interest and principal payments are expected to fluctuate between EUR15bn and EUR20bn in the immediate future. Resources could be further generated through the nationalised banking system and as national saving recovers.

The requisite policy should also aim to rebalance the Greek economy in terms of industry, services and agriculture, but also tradables and non-tradables. Greece has had visible trade deficits for years, typically offset by surpluses of invisibles (tourism, shipping). The decline in competitiveness since joining the EMU has enlarged the visible deficit, while the invisible surplus has declined. The current account has gone even further into the red because interest payments on the debt have increased, as have profit outflows. The capital account has covered the current account deficit via borrowing from the banks of the core, as was discussed in chapter 1.

The shift away from industry and toward services in the Greek economy in recent years has been accompanied by a shift away from tradables and toward non-tradables, while productivity growth in the tradables sector has been insufficient. The Greek service sector has failed to generate rapid growth of exports, probably due to low productivity but perhaps also because it has lacked strategic direction and organisation. Services, in any case, are notoriously weak in generating exports. Thus, even from this perspective, Greek entry into the EMU (and the EU) has been a failure.

Exit from the EMU would offer the opportunity to rebalance the service and industrial sectors as well as tradables and non-tradables, but the rebalancing should not be left to the free market. Rebalancing should certainly not involve the decimation of the public sector on the assumption that this is where the inefficiencies of the Greek economy lie. This is pure neoliberal ideology that is currently causing

economic destruction in Greece, and which has had poor growth outcomes across the world during the last three decades.

A thorny issue in this respect would be the euro-denominated liabilities of Greek enterprises and households. One estimate of their size is in the region of EUR68bn, which is large enough to cause significant disruption due to foreign exchange risk and difficulty in renewing credit lines. [38] Both enterprises and households would need state guarantees of their private debt as well as of their ability to obtain international credit, if mass bankruptcies are to be avoided. On the other hand, on the assumption that most of these enterprises are export-oriented, their capacity to generate euro-receipts would probably increase, thus improving their ability to renegotiate terms with their creditors.

To sum up, Greece requires a sophisticated industrial policy capable of protecting and furthering the interests of labour and thus of society as a whole. The policy must place both the public and the private sector on a different footing by drawing on the strengths of each. A strategic plan would be necessary to rebalance tradables and non-tradables. Room should also be created for Greek industry to re-establish itself in the domestic market, shifting the economy toward more productive activities and tradables.

To support such a strategy it would be necessary to rely on a nationalised banking system and capital controls, but also on a thoroughly restructured state. Above all, it would be necessary to rely on the leadership of organised labour and civil society. The aim would be to shift the social balance drastically in favour of labour and against capital. If, finally, the strategy came into conflict with the EU, it would be up to the Greek people to re-consider their relations with the latter.

6.3 In lieu of conclusion

It is apparent that debtor-led default and exit from the EMU would be far from easy options for Greece, or any other country of the periphery. But what alternative is currently on offer to peripheral countries? Trapped within the Eurozone, they are threatened with continued austerity, low competitiveness, high unemployment, growing social tensions, and loss of national independence. Not least,

38 See Research on Money and Finance, 2010b. The Eurozone between Austerity and Default, C. Lapavitsas, A. Kaltenbrunner, G. Lambrinidis, D. Lindo, J. Meadway, J. Michell, J.P. Painceira, E. Pires, J. Powell, A. Stenfors, N. Teles, Occasional Report 2, September, www.researchonmoneyandfinance.org.

their democratic polity is likely to suffer as decision making would be transferred to the ECB, the EFSF and other unelected bodies of the EU. The prospect for the periphery is economic, social and political decline for the foreseeable future. This is the price that weaker economies would have to pay to remain within the confines of a new international reserve currency designed to serve the interests of big banks and big business.

Debtor-led default and exit offer a way for Greece and other peripheral countries to escape the trap of the Eurozone. Indeed, continuing membership of the Eurozone is creating impossible conditions that are already pushing the periphery in the direction of exit. But if Greece was forced to default and exit while its political system faced collapse and its society unravelled, the result could be chaotic.

If, on the other hand, default and exit were managed carefully by a decisive government that drew on grassroots support, they could lay the foundations for recovery. At the very least they would free Greece from the vice of austerity imposed by the EMU. They would also offer relief from the burden of debt as well as allowing the country immediately to regain competitiveness. They would, finally, allow Greece to reclaim national independence which has been battered in the course of the crisis.

Moreover, if the forces leading the country had a clear vision of social change and adopted an appropriate transitional programme for economy and society, the opportunity would arise decisively to alter the balance of forces in favour of labour. Greek society could rejuvenate itself by entering a path of sustainable growth with greater equality while cleansing its state. The shockwaves would be felt across Europe already reeling under the impact of the global crisis.

Greece thus faces a historic choice: surrender to the dominant powers of the Eurozone and face a bleak economic, social and political future, or find the courage to act, changing itself and even Europe. We will soon know the answer.

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