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The Break-Up of the Eurozone?

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Abstract

The euro project is now at the threshold of disintegration as the fault-lines between the core/surplus countries and the peripheral/deficit countries experience a profound rupture. In the absence of political union or fiscal federalism, these centrifugal forces appear to be irreversible. It is difficult to envisage the current system, with its internal contradictions, surviving the crisis that now engulfs the entire eurozone. The present crisis is to a large extent the continuation of the longstanding neoliberal policies favoured by Germany, which have informed the creation of the euro. This article examines the historical context of the debt crisis and the institutional design of this flawed monetary edifice.

JEL Codes: B5, B14, B16, B23

Keywords

Eurozone; finance; investment; monetary crisis; unemployment.

Introduction

The centrifugal dynamics set in train by the neoliberal strategy of 'negative integration' have set the stage for the disintegration of the eurozone in its current incarnation.[1] Still in its early phases, this process of dissolution could threaten the very foundations of the post-war European project and generate unpredictable political and social turmoil as popular sentiment clamours for the restoration of the primacy of national sovereignty. Since the outbreak of the debt crisis, large-scale bail-outs by the IMF/EU/ECB (Troika) have been imposed on Ireland, Greece, Portugal and Spain. Despite these massive bailouts, a dangerous feedback loop has emerged in which the banking crisis has morphed into successive sovereign debt crises. The subsequent austerity measures have merely pushed the eurozone into a vicious circle of falling government revenue caused by the recession, which in turn, only further increases their respective debt burden (Backburn 2011: 39). But the onset of a fiscal crisis provokes a downgrading of the creditworthiness of the debtor states and triggers further speculative attacks in the bond markets as government bond yields increase sharply.

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This perilous embrace between the bond markets and sovereign states creates further uncertainty and volatility as global investors frantically take flight into safe havens. The flight into US Treasury bonds has witnessed US yields falling to their lowest levels in 60 years. At the same time, the member states have attempted to mitigate the effects of contagion in the event of a possible default by the deficit countries, through the creation of several short-term financing facilities and by attempting to overcome the Maastricht Treaty's prohibition of the European Central Bank (ECB) acting as a lender of last resort. The extent to which these measures can ameliorate the impending sovereign debt crises will also be examined. Part 1 provides a very brief history of the recent sovereign debt crises in the eurozone. Part 2 examines the dangerously self-reinforcing logic between these speculative bond markets and the cascading, deflationary spiral imposed on those countries encountering severe debt crises. It will be argued that this deflationary dynamic resembles the worse features of the gold standard regime that was eventually abandoned in the early 1930s.

The Dominoes Tumble

The magnitude of the slump engulfing the peripheral states is summarised in Table 1. Greece received a Troika bail-out in May 2010, followed by Ireland in November 2010 and Portugal in May 2011.

Table 1: Economic indicators for Greece, Ireland, Portugal and Spain (2002–11)

Countries	Economic Indicators	2002	2004	2006	2008	2009	2010	2011
Greece	(a)	3.4	4.4	4.6	-0.14	-3.3	-3.5	-6.9
	(b)	10.3	10.5	8.9	7.7	9.4	12.5	17.3
	(c)	-6.5	-5.8	-11.2	-14.7	-11.0	-10.0	-9.7
	(d)	85.5	98.8	106.1	110.7	127.1	142.7	163.3
Ireland	(a)	5.8	4.5	5.3	-3.0	-7.0	-0.43	0
	(b)	4.4	4.5	4.4	6.3	11.8	13.6	14.4
	(c)	-1.0	-0.6	-3.5	-5.7	-3.0	0.5	0.1
	(d)	25.0	19.8	12.1	24.5	42.2	76.9	96.0
Portugal	(a)	0.8	1.6	1.5	0	-3.0	1.4	-1.5
	(b)	5.1	6.6	7.7	7.6	9.5	10.8	12.7
	(c)	-8.2	-8.3	-10.7	-12.6	-10.9	-10.0	-6.4
	(d)	48	53.1	58.6	67.4	78.8	89.2	100.4
Spain	(a)	2.7	3.3	4.1	0.9	-3.7	-0.07	0.7
	(b)	11.5	11.0	8.5	11.3	18.0	20.1	21.6
	(c)	-3.4	-5.2	-9.0	-9.6	-5.2	-4.6	-3.7
	(d)	44.0	38.6	30.7	30.8	42.5	49.7	56.9

(a) GDP (constant prices); (b) Unemployment (% of workforce);
(c) Current Account Balance (% of GDP); (d) Net Government Debt (% of GDP)
Source: IMF Statistics 2012

Celebrated as the 'Celtic tiger', Ireland attracted an enormous inflow of foreign investment in the decades preceding the crisis as it re-invented itself as a dynamic information technology hub. Leading high technology multinational corporations were lured by generous tax concessions and a skilled workforce, which transformed Ireland into an export platform. At the same time, Ireland

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also became a major offshore financial centre as successive governments enacted policies of financial deregulation. The boom spilled-over into the property market as the Irish banking sector over-invested in the real estate market, fuelling an unprecedented property bubble. The over-heating construction sector had accounted for about 23 per cent of GNP by 2007 (Finn 2011: 11). At the end of 2003, the net foreign indebtedness of Irish banks was estimated at 10 per cent of GDP. By early 2008, this figure had increased dramatically to over 60 per cent of GDP (Kitromilides 2012: 170).

After the collapse of the property market, the Irish banking system was effectively insolvent. In late 2008, the government intervened with a recapitalisation plan worth €3.5 billion for Ireland's three major commercial banks: Allied Irish Bank, Bank of Ireland and Anglo Irish Bank. This blanket guarantee for the banking system inevitably caused the sovereign debt crisis as the budget deficit and public debt exploded. From a balanced budget in 2007, the Irish fiscal deficit increased to 14 per cent of GDP in 2009. The Irish government had guaranteed €785bn of Irish and foreign bank liabilities. These toxic assets were now purchased by the National Asset and Management Agency (NAMA) in exchange for government bonds. In short, the bad debts of the banks and developers were socialised (McArthur 2011: 48). The eventual bail-out of the Irish banks by the Troika in November 2010 was estimated at €130bn. In the wake of the bail-out, the government imposed a severe programme of austerity, which represented the largest spending cuts in the history of the Irish Republic.[2]

The next domino to fall was Greece.[3] Between 2007 and 2009, the Greek budget deficit increased from 6.4 per cent to 15 per cent of GDP. As speculation on an impending Greek default intensified, eurozone leaders agreed to a €130bn bail-out deal but have demanded that the loan would be conditional on the Greek government enacting quite savage austerity measures. In return for the loan, the Socialist government agreed to reduce the public debt to 120 per cent of GDP by 2020. Private bondholders were forced to accept a 'hair cut' of 53 per cent of the face value of their Greek government bonds in the bond swap engineered by the Troika. The outstanding 85 per cent of Greek government debt, equivalent to €280bn was to be held by the ECB, the European Financial Stability Fund (EFSF), the IMF, as well as by Greek state pensions and its banks (Christie 2012: 16). Indeed, the Troika's intervention was motivated almost entirely by the threat of financial contagion to the rest of the eurozone in the event of a Greek default. Under these circumstances, it was necessary to declare that the loss to bondholders was voluntary and that the agreement would allow new loans to be issued to Greece on the condition that the Greek government would implement severe austerity measures (Lapavitsas 2012).

Despite official denials, the Greek government effectively defaulted on its debts to private bondholders, estimated at €173bn. The so-called 'voluntary' agreement was negotiated with Europe's banks, pension funds and hedge funds. What ultimately prevented a full-scale default was the swap agreement with bondholders to switch their holdings to 30-year maturities in which they were guaranteed a return of 3–5 per cent per annum by the EFSF. By late 2011, the eurozone debt crisis had escalated and threatened to engulf the larger econo-

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mies of Spain and Italy. The Greek socialist Prime Minister announced plans for a referendum over the punitive and harsh terms of the bail-out agreed at the European Summit in October. After the G-20 Summit in Cannes in November 4, the plan for a national referendum was abandoned after opposition from the French President Sarkozy and German Chancellor, Merkel. Papandreou resigned two days later and on November 10, Papademos, a former President of the Bank of Greece and Vice President of the ECB, was installed as the new Prime Minister of a national unity government formed by the conservatives and socialists. This Greek drama had now turned into a tragic farce. The country that had invented the very idea of democracy witnessed its temporary suspension by the financial oligarchy.

The overall effect of the austerity programme was devastating. After the signing of the Memorandum of Agreement with the Troika, salaries and pensions were cut by a quarter and public spending slashed in order to secure an initial €110bn loan. The unemployment rate skyrocketed to more than 24 per cent in 2012, whilst GDP plunged, changing by -3.3 per cent in 2009, -3.5 per cent in 2010 and -6.9 per cent in 2011 as Greece descended into a deep depression (Kouvelakis 2011: 23). The very wealthy escaped taxation through tax loopholes and offshore tax havens, while most of the burden of taxation was imposed on public sector employees. Indeed, under the system of 'clientelism' described below, the growth of public sector employment had disguised the underlying structural problems of rampant tax avoidance. The logic was quite perverse and self-reinforcing: increasing public sector employment had merely reinforced the state's dependence on public sector tax revenue, which then encouraged the very growth of unproductive public sector employment itself. Widespread tax avoidance by the private sector reinforced this logic and promoted the 'regulatory capture' of private enterprises through the various public subsidies and tax concessions.

In other words, the whole system of mutual private-public clientelism reproduced a network of cronyism and state support for unproductive private sector employment known as 'diaploki' in Greece (Pitellis 2012: 81–82). This intricate web of corruption and patronage formed the very core of the Greek political system in which productive investment was discouraged. The system bred a culture of redistribution and corruption. The size of the Greek underground economy accounts for an estimated 30 per cent of GDP, while services and tourism account for over 73 per cent of GDP (Karagiannis and Kondeas 2012: 58). Ultimately, the savage cut-backs in government spending swelled the ranks of the unemployed and through the automatic stabilisers, led to a collapse in government revenue and spiralling net public debt.

Portugal was also drawn into the turmoil of the debt crisis engulfing the peripheral countries. After an impressive phase of economic expansion in the years preceding the birth of the euro in 1999, Portugal's current account deficit blew out to over 12.6 per cent of GDP in 2008. The excessive growth of domestic effective demand had contributed to the worsening external balance as Portugal's real effective exchange rate (REER) was highly over-valued when Portugal entered the eurozone. Portugal's higher rate of inflation relative to Germany

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translated into lower real interest rates set by the ECB, which induced high levels of private debt and ignited a real estate boom (Lead and Palacio-Vera 2012: 203). This structural problem continued to deteriorate over the first decade of Portugal's entry into the eurozone with unemployment rising to 15.4 per cent in June, 2012. At the same time, net public debt increased inexorably to exceed 100 per cent of GDP in 2011. In response to these burgeoning twin deficits, successive governments embarked upon a programme of severe austerity. By May 2011, the Troika approved a bail-out worth €78bn. Under the terms of this bail-out, Portugal agreed to reduce its budget deficit to 4.5 per cent of GDP in 2012 and 3 per cent in 2013. In 2011, the ruling conservative government reduced the budget deficit of 7.7 per cent to 4.2 per cent of GDP by simply transferring state pension assets from the domestic banks. Despite severe cut-backs in government spending and increased taxes, the fiscal target of 4.5 per cent of GDP is unlikely to be reached in 2012.

Given the relative size of Spain as the fourth largest in the eurozone, its impending fiscal crisis poses an existential threat to the entire Euro-system. In the decade 1996 to 2007, Spain had experienced a rapid expansion of GDP, estimated at 51.5 per cent in real terms. Much of this boom, however, was driven by excessive investment in the financial sector and in private construction. For instance, the construction sector had grown from 7.8 per cent to 9.5 per cent of GDP between 1997 and 2007, while the finance sector, which financed the real estate boom, had expanded from 18.3 per cent to 22.3 per cent of GDP over the same period (Ferreiro and Serrano 2012: 240). At the same time, the level of aggregate demand expanded had even faster than the growth of real GDP. Similar to the Portuguese experience, this excessive growth of domestic demand led to the blow-out of Spain's current account deficit. From a small surplus of 0.5 per cent of GDP in 1997, the trade deficit reached 10.4 per cent of GDP in 2007. The massive inflow of capital, which had financed this real estate boom, was reflected in the extraordinary increase in Spain's foreign debt. If one excludes direct investment, the external debt increased from €253bn or 53.4 per cent of GDP in 2006 to an estimated €1.8 trillion or equivalent to 171.4 per cent of GDP in 2009. The external debt generated by foreign borrowings by domestic banks accounted for 116 per cent of GDP in 2007 (Ferreiro and Serrano 2012: 253). The eventual crash of Spain's property market in the wake of the global financial crisis of 2007–08 caused a prolonged economic slump from which it has yet to recover.

The neoliberal policies enacted by the Spanish Socialist government during its 14 year rule (1982–96), which included mass privatisations, the liberalisation of the telecommunications and energy sectors, the deregulation of the labour market and the severe cut-backs in government spending. The severe recession in 2009–10 caused the budget deficit to deteriorate quite rapidly through the operation of automatic stabilisers. At the same time, the large-scale recapitalisation of Spain's largest banks also contributed to Spain's burgeoning fiscal crisis. From a small budget surplus of 1.9 per cent of GDP in 2005, Spain's budget deficit reached 11.1 per cent of GDP in 2009 (Polychroniou 2012: 9). Spain's 17 autonomous regional governments, which provide essential services like edu-

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cation and health, have experienced quite serious financial distress with many of them in a state of technical default after the massive recapitalisation of the banking system. The new austerity programme introduced in September 2012 has prolonged Spain's deep recession as unemployment has exceeded 25 per cent. In mid-2012, the Spanish government reluctantly accepted a €100bn European bail-out of insolvent Spanish banks.

Greece, Spain and Portugal share a common historical lineage. All three countries experienced a post-dictatorship democratic revival and were quite recent in their respective gravitation as peripheral and subaltern states into the orbit of Europe's northern growth poles. Their peripheral status within the European division of labour has limited their development as advanced capitalist social formations, while their political institutions continue to be plagued by regimes of patronage and clientelism. The lack of open and transparent political institutions has been characterised by highly inefficient and corrupt public bureaucracies. Rampant tax evasion and the close ties between the upper echelons of the state with the dominant business interests have created a political culture of vested interests, which has stifled the demands for democratic renewal. The pathologies of 'crony capitalism' contributed to the massive waste associated with corruption and the propagation of social inequalities and persistently high rates of poverty. Under these political circumstances, the imposition of quite harsh neoliberal policies merely perpetuated these social contradictions and exacerbated the growing debt crises that have engulfed these peripheral states. In the words of Polychroniou:

> As such, the debt crisis in the eurozone periphery is as much political as it is economic, and problems facing countries like Greece, Portugal and Spain are related as much to the macroeconomic environment created by their domestic regimes as to the flawed architecture of the euro-system and Germany's aggressive export policies. The regressive policies these countries adopted during the past 2 to 3 decades produced macroeconomic environments that were extremely weak, lacking a foundation for sustainable growth and job creation, and loaded with all kinds of social contradictions. (Polychroniou 2012: 10)

Quite apart from their burgeoning public debts, the accumulation of private debt has been even more pernicious in these peripheral countries. Table 2 summarises the growth in private sector debt in the countries of Greece, Portugal and Spain during the years 1995 to 2008.

Table 2: Private sector debt as a percentage of GDP, 1995–2008

	Households		Businesses	
	1995	**2008**	**1995**	**2008**
Greece	13	61	38	62
Portugal	42	108	53	134
Spain	42	88	47	122

Source: Milios and Sotiropoulos 2010: 232

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The 'Dance of Death' between States and Markets

Between 1999 and 2008, before the outbreak of the global financial crisis, household debt in the eurozone increased from about 50 to 70 per cent, while the increase in bank debt was even more severe, estimated at 250 per cent of the combined eurozone GDP in 2008. During the same period, public debt had fallen from an average of 72 per cent to 68 per cent of the combined eurozone GDP (De Grawe 2010: 1). In the wake of the global financial crisis of 2008–09, the ensuing credit crunch witnessed a severe process of deleveraging by the private banks in order to restore their respective balance sheets. Most governments in the eurozone attempted to counter the liquidity crisis by pursuing more expansionary fiscal and monetary policies. At the same time, the massive bail-outs of the private banks by national governments also led inexorably to burgeoning fiscal deficits. The onset of recession and growing unemployment merely served to increase these national budget deficits through the operation of automatic stabilisers. In short, the private debt has now morphed into escalating government deficits. An excellent summary is provided by Arestis and Sawyer:

> In terms of competitiveness (as measured by unit labour costs), Greece, Ireland, Portugal and Spain have lost 25–30 per cent since the creation of the EMU in January 1999. The current account deficits of the south European countries required these countries to borrow heavily from other countries, and from north European banks as well as British and American ones. Because south European countries had much lower interest rates than previously, they rapidly built up their debt. The debts were mainly, though not exclusively, private sector rather than public sector. However, when the Great Recession hit, borrowing was increasingly done by government. (Arestis and Sawyer 2011: 7–8)

The ultimate irony was that as soon as the threat of a sovereign debt default emerged, bond markets began to demand higher risk premiums reflected in higher yields for public borrowings. In the absence of financial solidarity in the event of a sell-off of government bonds, the entire eurozone became vulnerable to escalating bond yields and rising interest rates. The flight from the high deficit countries to the low deficit/surplus countries is reflected in diverging bond yields within the eurozone. This self-reinforcing dynamic has parallels with the Exchange Rate Mechanism (ERM) crisis of 1992 in the sense that the failure of governments to maintain exchange rate parities triggered the subsequent speculative attacks (Lucarelli 2004). Under the euro, however, exchange rate devaluations are not possible. The exchange rate crisis now becomes a sovereign debt crisis in which bond markets encounter the threat of a devaluation of government bonds. The spectre of contagion caused by cascading sovereign debt defaults threatens the very survival of the eurozone.

It can be surmised that the crisis in the eurozone is more a banking crisis than a sovereign debt crisis. Indeed, the crisis might be one of solvency rather than liquidity in which most of the non-performing loans incurred during the crash of 2008, have yet to be cleansed from the balance sheets of the banks

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themselves. Interbank lending has contracted quite sharply as the commercial paper market begins to evaporate. A liquidity trap could also emerge in the wake of the desperate attempts by banks and firms to deleverage and restore their respective balance sheets. A vicious circle has been set in train as risk premiums demanded by the banks to purchase government bonds escalate (Soros 2012: 86). This negative feedback loop only further aggravates the sovereign debt crisis in a self-reinforcing logic. In order to circumvent this vicious circle, the ECB has attempted to intervene in secondary bond markets to ease the pressure of rising bond yields on government re-financing operations. But the question of how the costs and funding for these bail-outs are to be shared between national governments becomes critical (James 2009: 217). In the absence of fiscal federalism or a common European Treasury, the German government has doubtless been very reluctant to incur the main burden of financing these operations.

To be sure, after the outbreak of the crisis, the aggregate private sector financial balance turned into a surplus as investment was curtailed and deleveraging accelerated. In stark contrast, the state sector experienced rising deficits as governments attempted to compensate for the collapse of private investment and were obliged to bail-out the private banks. The causation, therefore, ran from unsustainable private sector debt to public sector debt. It would be a misconception to characterise the crisis as solely a sovereign debt crisis (Hein et al. 2012: 41–42).[4] The existing architecture of the eurozone — informed by monetarist doctrines of 'sound finance' and monetary neutrality inscribed in the Maastricht Treaty — essentially imposes constraints on national governments that experience persistent budget deficits. Under these circumstances, national governments are at the mercy of international bond markets. In a very real sense, the introduction of the euro resolved the incessant problem of exchange rate speculation but merely replaced it with the problem of bond market speculation. According to Palley:

> In effect, national monetary systems make national governments masters of the bond market, whereas the euro's architecture makes the bond market master of national governments. Given the dominance of neoliberal economic thinking, this was an intended outcome of the euro's design. (2011: 7)

The dynamics of these recurrent bond market speculative crises increasingly impart a perverse logic of fiscal austerity imposed by national governments in order to avoid a sell-off of government bonds and incur crippling interest rates on their borrowings. Bond markets will tend to favour those countries with lower budget deficits and punish so-called 'profligate' governments. This depressive tendency only aggravates the recession and dampens the level of effective demand in the deficit countries (Palley 2012: 169–170). Indeed, this self-defeating logic resembles the highly deflationary features of the gold standard regime, which wreaked economic havoc during the inter-war crisis (Farrell and Quiggin 2011: 97). During the 1930s, the existence of the gold standard regime made it more difficult for deficit countries to adjust to external shocks. Under this regime it was not possible, in theory at least, for countries to adjust their respective

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exchange rates in the event of a capital flight or adverse terms of trade. Since the relative value of all currencies was kept stable in terms of the gold standard, any imbalances in their international payments could not be corrected by an adjustment in the exchange rate but had to be corrected by an adjustment of national price or income levels. In other words, the fixed exchange rate pegged to the gold standard, tended to impart a powerful deflationary tendency in the deficit countries. The whole edifice of the gold standard had been constructed on the foundations of a competitive market economy. In this regime, the price mechanism constituted the sole means of exchange rate adjustment. If a country incurred a trade deficit, it would automatically experience a deflationary adjustment and an outflow of gold reserves. Conversely, a trade surplus would attract an inflow of gold reserves and a rise in nominal incomes and prices. In the words of Aglietta:

> The euro is essentially a foreign currency for every eurozone country. It binds them to rigidly fixed exchange rates, regardless of their underlying economic realities, and strips them of their monetary autonomy … Put another way, as a system the euro is akin to the gold standard: an external currency whose overall supply was out of reach of national governments, but fiat money nonetheless, trusted within the financial community because the rules of convertibility were deemed inviolable. (Aglietta 2012: 20)

Since Germany pursues a neo-mercantilist policy of austerity and wage repression, the deficit countries, in the absence of exchange rate policy, are compelled to pursue a similar strategy in order to prevent the loss of their international competitiveness (Lucarelli 2011). Consequently, at the very epicentre of this deflationary spiral has been the role performed by Germany. The growing divergence between burgeoning German trade surpluses and the trade deficits of the peripheral countries threatens the internal coherence of the euro zone. As real wages lag behind productivity growth in Germany, this deflationary tendency has spilled over into the rest of the eurozone as each country pursues similar policies of internal devaluation. Wage repression in Germany has therefore set in motion a 'race to the bottom' in the eurozone.

During the course of the debt crisis, several important emergency measures have been implemented to stabilise financial markets and prevent sovereign defaults. These measures included the introduction of the European Financial Stability Fund (EFSF), the European Financial Stability Mechanism (EFSM) and its successor, the European Stability Mechanism (ESM), which will acquire the role of providing external financial assistance to distressed member states of the eurozone after June 2013. Access to these funds, however, are conditional on the recipient governments imposing austerity and wage repression (Hein et al. 2012: 37). Critics have argued that these funds are not adequately capitalised and their functions have been confined to temporary, short-term interventions. Indeed, in late 2011, these financial resources only amounted to €440bn, which would be inadequate to bail-out the larger countries of Spain and Italy in the event of a sovereign default (Lapavitsas et al. 2011: 32). In other words, as Soros has argued,

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the proposed EMS falls short of evolving into an embryonic common Treasury (Soros 2012: 126–127). The other major shortcoming is that the existing EFSF is only a fund-raising mechanism and the authority to spend money is governed by the short-term needs of member states rather than acting as an automatic mechanism that can be deployed in the event of cascading sovereign defaults.

The EFSF and the design of the future ESM resembles the notorious Special Purpose Vehicles (SPVs) that allowed banks to remove their toxic assets from their balance sheets during the subprime crisis in the US. As a private, independent entity, the EFSF has been given the power to issue bonds in the capital markets in order to raise funds to bail-out sovereign states encountering the threat of default. At the same time, these bonds issued by the EFSF are guaranteed by the European member states based upon their respective capital contributions to the ECB. The market for these bonds includes the IMF and the surplus countries with large foreign exchange reserves such as the wealthy OPEC states, Japan and the so-called BRIC countries (Brazil, Russia, India and China). During the Euro-summit in July 2012, member states (with the exception of Germany) eventually succumbed to pressure by Spain and Italy to provide financial assistance through the EFSF/ESM in order to recapitalise their commercial banks and support their government bonds *without* having to submit to the onerous Troika programme of austerity that had already been imposed on Greece, Portugal and Ireland. This imposition of austerity would now be the sole preserve of national governments. The summit also agreed to establish a single banking supervisor for the eurozone as a whole. The ESM would have a banking licence that would allow the ECB to issue 3-year loans to the ESM and support its financing operations In other words, Italy and Spain would acquire access to unlimited funds via the ECB. Although trenchantly opposed by the German representatives of the summit, this agreement culminated in the Draghi Plan, announced in September 2012, which effectively codified the ECB's de facto role as lender of last resort.[5]

In short, Germany and other eurozone countries with a triple-A bond rating, had now reluctantly agreed to support the deficit countries and avoid the possible breakdown of the eurozone. Ultimately, the survival of the euro will depend upon Germany's willingness to support the ECB/ESM mechanism. The fate of the euro therefore increasingly rests upon the domestic political support within Germany, which continues to be very hostile to the idea that Germany should extend credit to the deficit countries. Given this political reality, the dynamics of disintegration within Europe will only gain momentum over the next few years. The real Achilles' heel of the existing eurozone banking system is the inter-bank transfer of deposits, known as the TARGET-2 facility (Trans-European Automated Real Time Gross Settlement Express Transfer System), which allows the automatic and costless transfer of deposits from one bank to another within the eurozone. The possible breakdown of the European financial system could be hastened by a stampede out of deposits in the peripheral states into the safe haven of high yielding deposits in German banks (Papadimitriou and Wray 2012: 2). This scenario could trigger a major banking crisis and could quite easily prefigure the eventual demise of the euro project.

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In order to resolve these longstanding contradictions, a possible future scenario would be the 'imagined community' of European federalism. Despite the ideals and aspirations of European federalists, the likelihood of European statehood appears as remote as ever. Indeed, much of the ostensible progress toward European federalism has been imbued with mythology. One of the central aims of the post-war political settlement was to reconcile inter-state rivalries within a pan-European framework. German militarism, in particular, could now be contained and to paraphrase Schuman, France's post-war Foreign Minister: 'make war not only unthinkable but materially impossible'. To this end, supranationalism has succeeded in fostering peace and prosperity within Western Europe. Indeed, as Milward has argued, post-war European union represented the 'rescue of the nation-state' after the depredations of depression and war (Milward 1992). European statehood could conceivably resolve some of the deep-seated and longstanding contradictions that have destabilised the eurozone in the wake of the recent debt crisis. Political union could represent a possible way out of the present impasse. The creation of a European Treasury endowed with a broad tax base, presided over by a European parliament with real legislative and executive powers, could provide the basis to re-launch a sustained Keynesian-type recovery through a European Marshall Plan. Unfortunately, at present, neither the historical conditions, nor the political consensus exists to realise such an ambitious programme for recovery.

Conclusion

The survival of the existing euro-system appears to be increasingly problematic. The internal contradictions between the core surplus countries and the peripheral deficit countries threaten the very existence of the euro project in its present form. These centrifugal and discordant elements could eventually destroy the whole European project. At present it might be premature to declare its eventual demise. In this context, the rather piecemeal and ad hoc responses to the crisis so far might prolong the life span of the euro for a while yet, perhaps several more years. The problem is essentially political. At the core of its resolution lies the willingness of Germany to accept the burden of financing the deficit countries and undertaking a sustained programme of expansionary fiscal policies to counter-act the tendencies toward economic stagnation and the possible onset of a debilitating phase of debt-deflation. In the absence of political union and fiscal federalism, these centrifugal forces appear to be irreversible. Either the peripheral states default and exit the euro, or Germany itself comes to the conclusion that the existing burden of financing the deficit countries can no longer be justified and declares its intention to construct its own exclusive currency bloc or simply restores the Deutsche Mark to its pre-eminent role. There are, of course, several other scenarios in between these two extremes that might involve the creation of a new informal monetary architecture resembling an intra-European payments union in which the euro is declared non-convertible except as a unit of account between central banks. Whatever the final outcome, it is difficult to envisage the current system surviving the crisis that now engulfs the entire eurozone. The

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present crisis is to a large extent the continuation of the longstanding neoliberal/monetarist policies favoured by Germany, and inscribed in the Maastricht Treaty, which have informed the creation of the euro.

Notes

1. The process of European integration has been characterised by a gradual transfer of national sovereignty over the economic and political instruments of state power to an emergent supranational regime of governance. Negative integration implies that the process of economic integration should prefigure political union. The whole process is ostensibly governed by the dynamic of economic 'spill-over'. In other words, as strategic sectors of the national economy come under the auspices of supranational institutions, the logic of cumulative causation will impel member states to relinquish their national sovereignty over other related sectors of the economy. Enshrined by the Single Market Act of 1987 and the Maastricht Treaty of 1992, the neoliberal strategy of negative integration sought to abolish all existing barriers to the free movement of goods, services, labour and capital across national frontiers.
2. According to McArthur : 'With an interest rate of 5.8 per cent in the ECB-IMF bail-out package, interest payments alone on the state debt will be more than 20 per cent of tax revenues in 2014' (2011: 45).
3. A very succinct summary of Greece's fall from financial grace is provided by Norfield: 'All the evidence shows that the Greek debt crisis has been long in the making. The root causes were a mixture of widespread tax-evasion, the misuse (since the 1980s) of EU development funds to finance current government spending, a private-sector credit-boom based on borrowing rates not far above Germany's after joining EMU in 2001, and declining competitiveness. The Greek government — assisted by Goldman Sachs and other banks — used derivatives to hide its weak finances and qualify for EMU' (2012: 124–125).
4. According to Arestis and Sawyer (2012: 17): 'There is a well-known accounting relationship of $(G - T) = (Q - X) + (S - I)$ (where G is government expenditure, T tax revenues, Q imports, X exports plus net income from abroad, S private savings and I private investment). The scale of the budget deficit (or indeed budget surplus) then depends on the size of the current account deficit, private savings and investment at a high level of economic activity. It then follows that the appropriate budget deficit depends on the conditions surrounding the current account (propensities to import, exports) and the net savings position (savings – investment). For a country with a current account deficit and a tendency for savings to exceed investment would require a large budget deficit, while in contrast for a country with a current account surplus, and investment to exceed saving, a large budget surplus would be appropriate.'
5. The aim of the ECB's plan to buy sovereign bonds in secondary bond markets is to ease fears over the threat of country default and lower the bond yields in order to allow the indebted peripheral countries to service their debts. The ECB will also 'sterilise' its purchases to avoid re-igniting inflationary

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pressures. In other words, these open market operations will be offset by reducing the issuing of euros from circulation. The operation — known as the Outright Monetary Transaction — was eventually approved by the German Constitutional Court on 12 September 2012.

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