

# RMF



## Research on Money and Finance

### EUROZONE CRISIS: BEGGAR THYSELF AND THY NEIGHBOUR

#### Executive Summary

#### Background

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

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

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

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

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

## The mechanisms of crisis

### *Gains for German capital, losses for German workers and periphery*

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

### *Finance creates a crisis and then takes advantage of it*

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

## Alternatives

There are three strategic alternatives available to peripheral countries.

1. The first is austerity accompanied with further liberalisation. This is the preferred choice of the eurozone and of the ruling elites across the periphery. It is also the worst option. It will achieve stabilisation through recession, imposing huge costs on working people. It offers little prospect of sustained growth in the future since productivity is expected to rise

spontaneously following liberalisation. And it does not address the structural bias at the heart of the eurozone.

2. The second is radical reform of the eurozone. It would involve greater fiscal freedom by member states; a substantially enlarged European budget; fiscal transfers from rich to poor; protection for employment; support for wages; and cross-European investment in sustainable industries. The strict regulations applying to ECB purchases of state debt would also be relaxed. This might be called the 'good euro' option. Political problems aside, this strategy is likely to threaten the international role of the euro by leading to a fall in its value. It could thus threaten monetary union itself.
3. The third is radical exit from the eurozone. There would be devaluation followed by cessation of payments and restructuring of debt. Banks would have to be nationalised and public control extended over utilities, transport, energy and telecommunications. Industrial policy would be introduced, including strategies to improve productivity. Infrastructure and environmentally sensitive investment could support equitable growth. This option requires a decisive shift in the balance of political power in favour of labour. To avoid veering toward national autarky peripheral countries would need to maintain access to international trade, technology and investment.