"Rising public debt in the EU – Implications for economic policy”

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**Introduction**

2010 has witnessed the shift of attention from the financial crisis to the public debt crisis in the EU and especially in the eurozone. The first five months of the year were a period of suspense, as the Greek debt crisis escalated, threatening to engulf other eurozone countries. The suspense was at least temporarily ended in May 2010, when the EU leaders decided on a mechanism to support the euro and to hold at bay the prospect of default by a eurozone country.

“Fiscal consolidation” and “long-term sustainability” are two key words of current EU economic and social policy. Concerns over rising public debt levels across the EU have legitimized a frontal attack by the EU on worker rights of the past, present and future generations! The ‘stupid’ Stability and Growth Pact has been taken out of the closet. Public expenditure is being drastically curtailed, including pensions, while taxation is being raised, especially indirect taxation, which is easier and faster to implement.

In the following sections of this paper we shall argue that:

- Policy concerns over the risk of sovereign default are justified only under certain circumstances. In the case of a sovereign currency, such concerns are largely the result of ‘superstition’;
- It is a historical fact that financial, and especially banking, crises are followed by steeply rising public debt levels.
- Whereas the EU fiscal response may have averted a financial meltdown, its financial policy response, in terms of introducing the necessary reforms, has so far been at best hesitant;
- The euro support mechanism agreed by the EU leaders in May 2010 does not adequately defend the currency at a time of crisis;
- The architecture of the Economic and Monetary Union is in urgent need of being restructured, in order to survive the present crisis. This is imperative for the survival of the European integration project itself.

1. **The dangers of a rising public debt: fact or myth?**

Paul Samuelson has been quoted as saying the following:

“I think there is an element of truth in the view that the superstition that the budget must be balanced at all times (is necessary). Once it is debunked (that) takes away one of the bulwarks that every society must have against expenditure out of control. There must be discipline in the allocation of resources or you will have anarchistic chaos and inefficiency. And one of the functions of old fashioned religion was to scare people by
sometimes what might be regarded as myths into behaving in a way that the long-run civilized life requires. ... I have to say that I see merit in that view”1

So, how far are the dangers of rising public debt levels a ‘myth’? Are policy concerns over the “sovereign debt crisis” justified? Under what conditions?

Various theoretical arguments have been put forward with regard to the dangers implicit in rising public debt levels. In particular, it is feared that high public debt ratios reduce the rate of growth through a rise in savings and through the crowding out of private investment. In the first instance, it is assumed that as people perceive that taxes are going to rise, they increase their savings, thus lowering growth. Furthermore, increasing public debt competes with private debt for the allocation of savings, thus crowding out private investment from the capital markets2. If the resources employed by the state are less efficiently used by comparison to the private sector, there is going to be a loss in output.

Both the debt/tax neutrality hypothesis3, which has been intensely debated, and the crowding out effect of rising public debt ratios reflect a supply-side approach to growth, thereby ignoring the role of fiscal policy and the policy objectives of rising public deficit and debt ratios. Such an approach is clearly inadequate at a time of recession.

Additional policy concerns refer to the risk of sovereign default, due to escalating interest rates and loss of investor confidence in a government’s creditworthiness, ie, the sustainability of its fiscal position. This has been especially highlighted by institutions, such as the European Commission, the ECB and the BIS, in their most recent reports4. In particular, the European Commission defines a “sustainable public finance position” as follows:

“A pragmatic definition of what constitutes a sustainable public finance position is used in the assessment by the Commission and the Council, namely whether on the basis of current policies and projected budgetary trends Member States will: (i) meet the government’s intertemporal budget constraint so that the discounted value of future revenues matches the discounted value of future government expenditures and the level of outstanding debt;

2 According to the European Commission’s ‘Autumn 2009 Economic Forecast’, “… in a context of a generalized soaring of public debt, the global increase in supply of sovereign bonds is sizeable, increasing competition for the allocation of global savings. Furthermore a combination of high global risk aversion and a perception of low sovereign default risk despite public debt ratios ratcheting up can result in intensified crowding out of corporate sector investment, even in the face of low sovereign yield” (p.52)
3 Also known as the “Ricardian Equivalence Hypothesis”, as it was originally presented by David Ricardo in “The Principles of Political Economy and Taxation”.
and (ii) continue to comply with the budgetary requirements of EMU and in particular, the Treaty requirement to keep debt levels below the 60 percent of GDP reference value5.

The above definition suffers from a circular type of logic, whereby a stated policy objective – a balanced budget and public debt below 60 per cent of GDP under the SGP – is used to describe the process by which it is sought. Such an approach conceals the failings of the Economic and Monetary Union in dealing with high and rising public deficit and debt ratios.

More specifically, as Nersisyan and Wray have argued, “sovereign debt”, issued in a floating, non-convertible currency, needs to be distinguished from “non-sovereign debt”, issued with a promise of conversion at a fixed exchange rate6. In the first case, a sovereign government faces no insolvency risk, since it has undertaken no promise to convert its currency at a fixed exchange rate. It can thus increase the volume of its currency in the face of increased pressure from the financial markets. Although this carries the risk of inflation, it is not a principal concern at a time of recession.

On the contrary, a politically sovereign government, with a currency that is pegged or convertible at a fixed exchange rate, faces the risk of default under pressure from financial markets. The eurozone member states have surrendered their currency-issuing monopoly to a supranational institution, the ECB. Thus, they can only finance their spending through taxation and borrowing on the market. This makes them vulnerable to the pressures applied by financial investors looking for high risk/high yield securities. As soon as such investors sense possible default, they embark on a self-fulfilling prophecy!

This is the situation EU member states, especially in the eurozone, currently find themselves in, starting with Greece in the early part of 2010 and followed by other high public debt member states. The fact that financial markets continue to operate unfettered adds to the pressures exerted on governments.

Overall, the risks associated with rising public debt levels need to be viewed in the particular institutional context, in which they arise. Their implications for growth are a function of the overall policy objectives. Further, the default risk these carry needs to be examined in relation to the currency in which they are expressed. Countries with a sovereign currency cannot be forced into default. This is not the case for countries with a non-sovereign currency. Thus, concern with rising public debt levels in the EU is justified on the assumption that the EMU architecture remains constant. However, such an assumption is too dangerous for the future of the European Monetary Union and indeed of the European integration project more generally.

2. The historical experience of financial crises

The present financial and economic crisis bears all the classic elements of a banking crisis-turned into a public debt crisis. In this sense, history provides some interesting insights with respect to both the triggers and the impact of such a crisis.

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A short account of the present crisis runs as follows.

- The crisis started in the USA, with the collapse of the subprime mortgage market in early 2007.
- Defaults on mortgages spread to investment banks and commercial banks in the US and across the world via an elaborate network of derivatives.
- Credit markets seized up, starting with interbank lending and spreading to other types of lending.
- The equity market collapsed as a result of the deleveraging of financial institutions under duress.
- Central banks across the world responded by flooding the financial markets with liquidity.
- Governments responded by providing significant amounts of funds in a variety of forms to banks and other financial institutions, to keep them solvent.

The financial crisis of 2007 followed a prolonged period of euphoria, over a business cycle upswing fuelled by accommodative monetary policy and by new financial instruments, which few people understood, but many bought into! In such a state, the dividing line between sound and unsound practices became blurred. Thus, overindebtedness ensued, exposing both financial agents and ordinary consumers to the risks associated with panic. The increase in interest rates by the Federal Reserve triggered such a panic, as uncertainty took over. There followed fire sales of assets, declining net worths, bankruptcies, bank failures and, last but not least, a recession, which became evident by 2009, mainly in the USA and in Europe.

The “mania-panic-crash” series of events described above fall neatly into the boom-bust pattern described by Hyman Minsky, Charles Kindleberger and others. There are of course some modern “twists”. According to Bordo (2008), a “key modern twist” was the growth of the shadow banking system, whereby the risk was shifted away from banks to hedge funds and other unregulated financial institutions. To the extent that these institutions hold low capital ratios, they had to deleverage fast, when the crisis hit. This put pressure on all types of financial assets, as well as on financial actors worldwide. By 2008, the subprime crisis of 2007 had turned into a fully fledged, global financial crisis.

So, what does history tell us about such crises? We shall look at certain historical accounts, although it should be pointed out that the results of these studies are not necessarily

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8 The repeal of the Glass Steagall Act in 1999, separating commercial from investment banking, was instrumental in such a shift.
directly comparable, as they vary in terms of the financial stress episodes covered, the time period they refer to, etc. For our purposes, these accounts are indicative, rather than definitive, with regard to the impact of financial crises on the economy.

Reinhart and Rogoff (2009) have found that the aftermath of severe financial crises shares three characteristics:

- First, asset market collapses are deep and prolonged. E.g., real housing price declines average 35% over 6 years, while equity price collapses average 55% over a downturn of 3.5 years.

- Second, banking crises are associated with profound declines in output and employment. In particular, the unemployment rate rises on average by 7% over the down phase of the cycle, which lasts for about 4 years, while output falls (from peak to trough) by over 9% over a period of approximately 2 years.

- Third, the real value of government debt tends to explode, while the main cause of this is the collapse in tax revenues following the prolonged output contractions, as well as ambitious countercyclical fiscal policies aimed at mitigating the downturn. More specifically, it was found that government debt rises by an average of 86% \(^9\).

Laeven and Valencia (2010) provide some further insights into the historical experience of banking crises in the more recent past (Table 1)\(^10\).

Table 1 - Summary of the Cost of Banking Crises

<table>
<thead>
<tr>
<th></th>
<th>Direct Fiscal Costs(^7)</th>
<th>Increase in Public Debt(^8)</th>
<th>Output losses(^9)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Medians (% of GDP)</td>
<td></td>
<td></td>
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<tr>
<td><strong>Crises 1970-2006(^1)</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Advanced economies</td>
<td>3.7</td>
<td>36.2</td>
<td>32.9</td>
</tr>
<tr>
<td>Emerging economies</td>
<td>11.5</td>
<td>12.7</td>
<td>29.4</td>
</tr>
<tr>
<td><strong>All</strong></td>
<td><strong>10.0</strong></td>
<td><strong>16.3</strong></td>
<td><strong>19.5</strong></td>
</tr>
<tr>
<td><strong>Crises 2007-2009(^2)</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Advanced economies</td>
<td>5.9</td>
<td>25.1</td>
<td>24.8</td>
</tr>
<tr>
<td>Other economies</td>
<td>4.8</td>
<td>23.9</td>
<td>4.7</td>
</tr>
<tr>
<td><strong>All</strong></td>
<td><strong>4.9</strong></td>
<td><strong>23.9</strong></td>
<td><strong>24.5</strong></td>
</tr>
</tbody>
</table>

1. ‘Crises 1970-2006’ include all systemically important banking crises over this period, viz. 42 such crises in 37 countries; 2. ‘Crises 2007-2009’ include Austria, Belgium, Denmark, Germany, Iceland, Ireland, Latvia, Luxembourg, Mongolia, Netherlands, Ukraine, UK and USA. 3. Direct fiscal costs include fiscal outlays committed to the financial sector, mainly through recapitalizations; output

\(^9\) The historical comparison group includes five major postwar banking crises (Spain (1977), Norway (1987), Finland (1991), Sweden (1991), Japan (1992)), the 1997-98 Asian crisis (Hong Kong, Indonesia, Korea, Malaysia, the Philippines and Thailand), Colombia (1998), Argentina (2001), as well as two earlier historical cases, Norway (1899) and the USA (1929). Reinhart, C.M. and K.S. Rogoff, 2009, The Aftermath of Financial Crises, NBER Working Paper no. 14656

losses are computed as deviations of actual GDP from its trend; the increase in public debt is measured as the change in the public debt-to-GDP ratio over 2007-2009.

Based on the above observations, L&V conclude that the economic cost of the 2007-2009 crises is on average much larger than that of past crises, both in terms of output losses and an increase in public debt, although the direct fiscal costs of dealing with the crisis appears to be lower. These differences are attributed (i) to the fact that the recent crises are concentrated in high-income countries; (ii) to the increased size and interconnectedness of the financial systems in these countries; (iii) to the swift response by governments and central banks to the 2007 crisis, which limited the direct fiscal outlays\textsuperscript{11}; (iv) to the extensive indirect support provided to the financial system through expansionary monetary and fiscal policy, the widespread use of guarantees on liabilities and direct purchases of assets that helped sustain asset prices, which however bore heavily on the size of the public debt.

Overall, past experience of financial crises points to a prolonged period of distress, both in the financial sector and in the economy more generally, the social implications of which must not be underestimated. In such circumstances, public debt ratios are expected to increase as a result of the automatic stabilizers coming into play, falling output, as well as fiscal stimulus policies.

3. EU policy reaction to the crisis

We shall look into the policy response of the EU to the present crisis and its implications for public debt in the areas of financial policy reform, support provided to the banks and fiscal stimulus. The role of the ECB will also be examined.

- Financial policy reform

Generally, the financial crisis management arrangements of the EU as provided by its supervisory and regulatory framework are fragmented and diverse across both sectors and member states. Such co-ordination as exists concerns information flows and the distribution of roles. The global financial crisis that erupted in 2007 brought out the inadequacies of the present system. This is however not surprising in view of the fact that the financial integration policy, which was vigorously pursued in the past ten years, has had no counterpart in the area of stability. In the words of the European Commission, “The crisis has exposed unacceptable risks in the current governance of international and European financial markets, which have proved real and systemic in times of serious turbulence”\textsuperscript{12}.

In the autumn of 2008, as the full impact of the crisis was realised, a group of high-level experts – the De Larosière Group – was convened, with the urgent mandate of proposing measures to amend the supervisory and regulatory financial policy framework of the EU. The relevant Report was submitted in February 2009. Accordingly, a number of new policy initiatives are under way. These include the following.

\textsuperscript{11} E.g., in previous crises it took policy makers about one year to implement recapitalization measures, from the time liquidity support became extensive. This time, such measures were implemented at the same time that liquidity support became extensive.

i. **Macro-prudential supervision** – Completely neglected until now, it is going to be the responsibility of a European body. A European Systemic Risk Council is to be set up, consisting of the EU central bankers, the chairs of the three sectoral supervisory committees and the ECB President and Vice President, under the auspices of the ECB.

ii. **Micro-prudential supervision** – A new architecture is envisaged. A network of European financial supervisors - the European System of Financial Supervision – is to be set up, operating on the basis of harmonized rules.

iii. **Regulatory framework** – The Commission is to submit proposals pertaining to hedge funds and private equity (previously unregulated); tools for early intervention; increasing transparency for derivatives; increasing the quality and quantity of prudential capital for trading book activities and complex securitization.

iv. **Consumer/investor issues** – Measures include the strengthening of the effectiveness of marketing safeguards for retail investment products; reinforcing bank depositors; investor and insurance policy holder protection; ‘responsible lending’.

v. **Corporate governance** – Remuneration schemes in the financial services sector are to be brought within the scope of prudential oversight.

Most of the above measures were at the stage of the formulation of proposals by the Commission in the course of 2009. One year later, most are still being debated. This is indicative of the strength of the financial industry interests, which are lobbying vigorously against any changes to the status quo.

The influence of the financial industry is further illustrated by the timidity with which the EU approaches issues such as the financial transactions tax, proposed by James Tobin in the late 1970s and propagated by various social movements since the late 1990s. It is only in June 2010 that the European Council agreed that “... Member States should introduce systems of levies and taxes on financial institutions to ensure fair burden-sharing and to set incentives to contain systemic risk. Such levies or taxes should be part of a credible resolution framework. Further work is urgently required on their main features and issues of level playing field and cumulative impacts of various regulatory measures should be carefully assessed”\(^\text{13}\). A report is to be submitted by the Commission in October 2010.

Overall, EU and indeed global financial policy reform is lagging. The urgency with which such issues were discussed in 2008 and 2009 has been significantly toned down. This is implicit in the Declaration of the G20 Toronto Summit (26-27 June 2010), where it is stated that “... we pledge to act together to achieve the commitments to reform the financial sector made at the Washington, London and Pittsburgh Summits by the agreed or accelerated timeframes.”\(^\text{14}\) (emphasis added). In other words, no major financial policy reforms had been advanced, between November 2008, when the first G20 crisis summit was convened and June 2010.

In view of the G20 meeting in Seoul in November 2010, new global minimum capital standards, known as Basel III, were announced by the Basel Committee on 12 September 2010. These raise the minimum common equity requirement from 2% to 4.5% and Tier 1 capital requirement from 4% to 6.5%\(^\text{15}\). In addition, a countercyclical buffer of 2.5% of

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\(^{13}\) European Council Conclusions, 17 June 2010, p. 6  
\(^{14}\) G20 Toronto Summit Declaration, par. 16, p. 4  
\(^{15}\) Tier 1 capital consists of common equity and retained earnings or disclosed reserves.
common equity is introduced. The new requirements are to be phased in over a period of
time extending to 2019\textsuperscript{16}. The EU has announced that it will change the Capital Adequacy
Requirements Directive accordingly.

The Basel III requirements have been criticized for being too modest and for taking too long
to become implemented. For example, it is argued that a minimum requirement of 15% Tier
1 capital is necessary at the peak of the cycle, so that at a time of crisis, banks do not resort
to fire asset sales in a bid to survive\textsuperscript{17}. In this sense, it is believed that the Basel officials have
allowed the banks to frame the discussion, conceding to the latter’s claim that moving to
higher requirements quickly could reduce lending and damage growth.

Generally, the slow rate of financial policy reform both at the European and at the global
level exacerbates the pressures financial markets exert on governments in need of funding.
In the case of the eurozone countries, operating with a non-sovereign currency, such
pressures may give rise to fears of default.

- **Bank support**

Since the start of the crisis, EU member states have committed large amounts of funds to
their financial systems, mainly the banks. Table 3 below shows the asset relief, liquidity and
bank support schemes of EU member states in relation to GDP, by type of intervention.

Table 3 – Public interventions in the banking sector (% GDP)

<table>
<thead>
<tr>
<th></th>
<th>Capital injections</th>
<th>Guarantee on bank liabilities</th>
<th>Impaired asset liquidity and bank support</th>
<th>All approved measures</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Total Effective</td>
<td>Total Granted</td>
<td>Total Effective</td>
<td>Total Effective</td>
</tr>
<tr>
<td>Eurozone</td>
<td>2.7</td>
<td>1.7</td>
<td>20.5</td>
<td>8.0</td>
</tr>
<tr>
<td>EU-27</td>
<td>2.7</td>
<td>1.7</td>
<td>24.6</td>
<td>7.9</td>
</tr>
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</table>

Note: Effective figures are provisional; cut-off date: August 2009

We observe that the largest part of the measures European governments have taken to
support their banks consists of guarantees on bank liabilities. These are best described as
“contingent liabilities”, insofar as they determine an outlay only if and when they are called
upon. In view of the fact that less than one-half have been granted, it may reasonably be
expected that the continuation of the crisis will significantly augment the amount of funds
spent by EU governments to prop up their banks.

In addition to the above, bank support took the form of increased coverage of retail deposit
insurance. This is another type of “contingent liability”, which has not materialized in the
present crisis so far.

More generally, according to the above data, European governments on the EU-27 level are
committed to spending almost one-third (31.4\%) of their GDP to support the banking
system, while no expiry date has been attached to the duration of such measures. Of this

\textsuperscript{16} Basel Committee on Banking Supervision, Press Release 12 September 2010

\textsuperscript{17} Johnson, S. 2010 “Basel III: The fatal flaw”, NYT.com’s Economix blog, 16 September
amount, a little under half (12.7% of GDP) was dispensed by the third quarter of 2009. It should be noted that the mobilization of public funds in rescuing ailing private financial institutions was not accompanied by strengthened accountability standards. Neither was the voice of social actors, other than the financial industry, taken into account in searching for alternative measures.

Further, it is worth noting that in supporting the banks unconditionally, the EU member states have violated the “principle of the firm owners’/shareholders’ primary financial responsibility”, as stipulated in the 2003 Memorandum of Understanding on crisis management and confirmed by the ECOFIN Council of October 2007. Namely, that “(i) the objective of crisis management is to protect the stability of the financial system... not to prevent bank failures; (ii) in a crisis situation, primacy will always be given to private sector solutions and (iii) the use of public money to resolve a crisis can never be taken for granted”\(^\text{18}\).

- **Fiscal stimulus**

By contrast to the support provided to the banks, the EU institutions were slow to respond by way of a fiscal stimulus of the economy. It was only after the Lehman debacle in the autumn of 2008 that a “European Economic Recovery Plan” was officially approved in December 2008.

This was essentially an attempt at policy co-ordination, in view of the fact that member states were already handling the crisis on their own terms and with their own means. What was at stake was the long-standing competition framework of the EU, the custodian of which is the European Commission.

Thus, it was agreed that €200 billion would be spent by way of fiscal stimuli, financed by both the member states (€170 billion) and the EU (€30 billion). It is worth noting that such stimuli were regarded as temporary from the start, so that all member states are expected to return to the medium term budgetary objectives by 2011.

By the end of 2009, it was estimated that the fiscal stimulus measures taken or planned by member states amount to a total of 1.5% of annual GDP for 2009 and to 1.4% for 2010, while the actual size of the stimulus package varies across countries\(^\text{19}\). By comparison to the bank support measures, detailed in Table 3 above, the cost of the EERP fiscal stimuli is strikingly low. Further, it is time constrained, since such stimuli are expected to expire by 2011.

- **The ECB response**

The ECB responded promptly with significant adjustments in its liquidity management operations, as early as in August 2007. When interbank trading came to a virtual halt in September 2008, the ECB started to engage in a new mode of liquidity provision, known as

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\(^{19}\) E.C. 2010 Report on Public Finances
“enhanced credit support”. This consists of (i) unlimited provision of liquidity through “fixed rate tenders with full allotment”; (ii) extension of the list of collateral assets; (iii) extension of the maturity of long-term refinancing operations, initially to six months and, in late June 2009, to twelve months; (iv) liquidity provision in foreign currencies, particularly US$, through swap lines with the Federal Reserve; and (v) outright purchases of covered bonds, aiming to revive that market\(^{20}\).

The crisis impaired the traditional transmission channels, including interest rate, bank lending, broad credit and expectations. Policy rate transmission was also weakened, as the cost of credit to both businesses and households declined much less than the policy rates. In 2008 and early 2009, policy rate changes were transmitted to the market rates, although the actual transmission rate took longer and it was often unclear\(^ {21}\).

While it is believed that the ECB policy measures have had certain beneficial effects on crisis management, they are far from what would be expected of a central bank safeguarding a sovereign currency. In particular, the ECB is constrained by the Treaty of the Union from lending directly to governments. This places the latter in the hands of the financial markets making them thus vulnerable to the pressures exerted by them at a time of crisis.

4. **The rising public debt in the EU**

Both the historical experience of past financial and banking crises and the policy measures taken to support the EU banks during the present crisis lead to the conclusion that public debt is expected to rise in the aftermath of the crisis. As Reinhart and Rogoff (2009) have observed, when a credit bubble bursts, private debt becomes public debt. Table 4 below shows the actual and forecast EU public debt as a percentage of GDP between 2005-2011.

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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Eurozone</strong></td>
<td>70.1</td>
<td>68.3</td>
<td>66.0</td>
<td>69.4</td>
<td>78.7</td>
<td>84.7</td>
<td>88.5</td>
<td>18.4</td>
</tr>
<tr>
<td><strong>EU-27</strong></td>
<td>62.7</td>
<td>61.4</td>
<td>58.8</td>
<td>61.6</td>
<td>73.6</td>
<td>79.6</td>
<td>83.8</td>
<td>21.1</td>
</tr>
</tbody>
</table>

Source: European Economic Forecast Spring 2010, Table 42, p. 202

As we can see, public debt as a percentage of GDP is expected to rise significantly in the EU, as well as in the eurozone, which is going to have a higher debt ratio by comparison to the EU average. Furthermore, in certain member states a particularly large increase in public debt is expected, as follows (change in debt ratio over GDP between 2005-2011):

- Ireland – 59.7 (87.3 from 27.6)
- Greece – 33.9 (133.9 from 100.0)

\(^{20}\) Covered bonds are debt securities backed by cash flows from mortgages or public sector loans. They are similar in many ways to asset-backed securities created in securitisation, but covered bond assets remain on the issuer’s consolidated balance sheet.

• Spain – 29.5 (72.5 from 43.0)
• Portugal – 27.5 (91.1 from 63.6)
• Latvia – 44.9 (57.3 from 12.4)
• Lithuania – 27.0 (45.4 from 18.4)

The increasing public debt and its differentiation across EU member states has meant that sovereign credit default swap (CDS) premia for euro area countries have increased sharply, while certain countries have been more affected than others. This is evidenced by the trend in government bond yields relative to Germany, which reflect liquidity and credit risks. Compared to the start of the crisis (2007), by 2009 ten-year bond yields had fallen for Germany, France, the Netherlands, Belgium and Finland, remained broadly stable for Austria, Spain, Italy and Portugal and increased for Greece and Ireland\textsuperscript{22}. In this respect, the ECB has pointed out that “...although all countries have announced broad-based bank rescue packages, investors have differentiated between countries mainly on the basis of other, more country-specific factors” (ECB, 2009:70).

The above ECB statement implicitly underlines the role of speculation, whereby financial actors exert pressure where they sense a risk of default. In other words, while the problem of the rising public debt is a serious one, it is exacerbated by the games financial markets and actors play. Such games are mostly of a speculative nature. It is in this respect that the delay in financial policy reform has been critical in not providing governments with the necessary instruments to deal with an extraordinary situation.

• **The Greek debt crisis**

In the first half of 2010, a massive speculative attack on Greek government bonds almost led to the destabilization of the eurozone. According to the Laeven and Valencia (2010) typology of countries by type of banking crisis, Greece is considered to be a “borderline case”, i.e., one in which the crisis was not systemic, in the sense that there were no significant signs of financial distress in the banking system (as indicated by significant bank runs, losses in the banking system and bank liquidations), neither were there any significant policy intervention measures in response to significant losses in the banking system. For example, the fiscal cost of public interventions in the Greek banking sector amounted to 11.6% of GDP, of which 4.7% became effective, by comparison to 25.3% and 11.2% respectively in the eurozone (Table 3 above).

Greece entered the crisis with a high public debt and deficit (-5.1% and 95.7% of GDP respectively in 2007), as well as a large current account deficit in relation to GDP (-14.7% of GDP in 2007). It is these twin deficits that exposed Greece to the pressures of the financial crisis and to the vagaries of the financial markets. Thus Greece attracted investors in pursuit of risky, high-yielding assets, while speculators found an easy target. The fact that Greece was revealed to have fiddled its national accounts statistics further exposed government bonds to financial pressures. At the same time, the hype created by the media, especially in

\textsuperscript{22} ECB Monthly Bulletin, July 2009, pp. 63-74
Germany, against the “lazy” Greeks and so on, served to conceal the fact that the real target was the eurozone, rather than Greece. It was the missing links in the eurozone architecture that attracted investors’ attention to the potential gains to be made from betting against it.

More specifically, the eurozone is a rules-based economic union of sovereign states, within a market-oriented economic environment. Fiscal discipline by peer pressure is at the centre of the euro construct. It has been shown to be dramatically short of the needs of dealing with a crisis. Greece may have been an extreme case. However, it laid bare the inadequacies of the foundations of the euro.

The EU leaders realised this fact many months after the Greek debt crisis had hit the headlines worldwide. On 2 May 2010, the Eurogroup (the finance ministers of the eurozone countries) formally launched a financial assistance mechanism, conditional on the implementation of a programme of economic adjustment negotiated with the Greek authorities, in liaison with the ECB and the IMF. Accordingly, Greece has undertaken to reduce its public deficit from 13.6% of GDP in 2009 to below 3% by 2013 and to keep primary balances in surplus of at least 5% of GDP up to 2020, in order to reduce its public debt. The programme is front loaded, while further privatisation and market liberalisation are being pursued in relation to pensions, healthcare, and education. A public financing gap of €110 billion has been projected for the period 2010-2013, to be covered through matching bilateral loans from eurozone member states (€80 billion) and the IMF (€30 billion).

- The European financial stabilization mechanism and facility

The Greek rescue package was soon followed by the establishment of a eurozone-wide financing mechanism, aimed at stabilizing the euro, as the risk of contagion of the sovereign debt crisis spread to other vulnerable member states. On 10 May 2010, the European Council decided on a comprehensive package of measures, including a European Financial Stabilisation Mechanism and a European Financial Stability Facility, providing a total support of €500 billion.

The Mechanism, which is based on Art. 122.2 of the Treaty, allows the Commission to borrow in financial markets up to about €60 billion on behalf of the Union under an implicit EU budget guarantee. The Commission then on-lends the proceeds to the beneficiary member state. All interest and loan principal is repaid by the beneficiary member state. Further, eurozone member states may complement the resources of the Mechanism through the Facility, up to a volume of €440 billion.

The European Financial Stability Facility takes the form of a Special Purpose Vehicle that will issue bonds on the markets with the pro rata guarantee of euro area member states, in accordance with their share in the paid-up capital of the ECB. The Facility then on-lends the proceeds to the beneficiary member state. The activation of these mechanisms is subject to strong policy conditionality. i.e., in order to receive the installments of assistance, the concerned member state has to implement a wide ranging set of policy measures designed
to restore its fiscal viability. The IMF will also participate in financing arrangements and is expected to provide at least half as much as the EU contribution.\textsuperscript{23}

The newly established euro stabilization mechanism remains to be clarified as to the way it will actually be put into operation, the final number of member states participating (Slovakia has refused to participate), the seniority of debt in relation to national bonds, etc. It is a slow moving mechanism, the impact of which remains to be seen. Although it indicates that the EU leaders have come to realize the missing links in the euro architecture, it does not make up for these links.

- The ECB in a new role?

On 9 May 2010, the ECB launched its Securities Markets Programme, in response to the tensions in the sovereign debt markets. This is a time bound policy measure, consisting of interventions in the euro area’s public and private debt securities markets and focusing on those markets which are worst affected by severe disruptions. In order to sterilize the impact of these interventions on the liquidity conditions in the banking system, the ECB intends to re-absorb the liquidity injected. In the words of the President of the ECB, “In view of these exceptional circumstances prevailing in the financial markets, we decided that exceptional intervention was necessary” (speech at the 38\textsuperscript{th} Economic Conference of the Oesterreichische Nationalbank, 31-5-2010).

The ECB’s Securities Markets Programme effectively means that the ECB has started buying government bonds of the fiscally more vulnerable eurozone member states. This is the so-called “nuclear option”\textsuperscript{24}. The ECB insists on emphasizing its two different functions, that of liquidity management and that of the pursuit of price stability. However, as the sovereign debt crisis has unfolded, the ECB has taken on further responsibilities in the area of liquidity provision. So much so, that Barry Eichengreen has remarked that “The ECB, recent events remind us, is a lender and market maker of last resort and not just the steward of a monetary rule”\textsuperscript{25}.

In moving in this direction, the ECB is in fact making up for a major missing link in the euro architecture. However, to the extent that this is a temporary measure due to extraordinary circumstances, speculation is not to be abated easily, as the continued fiscal fragility of the EU member states shows.

5. Implications for policy

- The EU “exit strategy”

\textsuperscript{23} EC, 2010 Report on Public Finances, Box II 1.2, p. 90
\textsuperscript{24} Baldwin and Gros (2010: 16)
At the first sign of “green shoots”, the EU leaders laid down the policy principles of exiting from the fiscal measures necessitated by the crisis. At the ECOFIN October 2009 meeting, these principles were specified as follows:

- The exit strategy should be coordinated across countries in the framework of the Stability and Growth Pact;
- Fiscal consolidation should start in 2011 at the latest. A number of countries need to consolidate even earlier.
- The pace of consolidation should be well above the benchmark of 0.5% of GDP per annum;
- National budgetary frameworks need to be strengthened and structural reforms should be undertaken to enhance productivity and support investment.

The exit strategy of the member states is to be reflected in the member states’ stability and convergence programmes.

By June 2010, the EU Council affirmed that “The EU has met the worldwide financial crisis with united resolve and has done what was necessary to safeguard the stability of the Economic and Monetary Union” 26. In the spirit of “business as usual”, the EU Council adopted a set of policy orientations regarding economic governance in relation to budgetary and macroeconomic surveillance, as well as the new strategy for the forthcoming decade 2010-2020, labeled “Europe 2020”.

Generally, the focus of EU policy has shifted from the provision of fiscal support to avert the crisis to fiscal consolidation to mitigate the impact of the increasing public debt. Special concern is further expressed in relation to age-related expenditure, which is expected to increase as a result of the ageing population. The need for structural reform, meaning further privatization and market liberalization, is part of the long-run EU fiscal consolidation policy.

The rationale of the fiscal consolidation policy pursued by the EU at the present time is that “Rising government debt ratios may harm growth prospects through reduced capital accumulation, i.e. via a crowding out of private investment” 27. As argued above (section 1), this view overlooks certain facts, pertinent at a time of recession. Namely, (i) low interest rates do not necessarily induce productive investment; (ii) central banks can influence interest rates by creating credit; (iii) public revenues may be boosted by a variety of taxes which do not lead to efficiency losses, such as property taxes, etc.

The concern over fiscal consolidation permeates EU economic policy more generally. Thus, ‘Europe 2020’, the successor to the Lisbon Strategy (2000-2010), is to be implemented in direct association with the Stability and Growth Pact and the fiscal upper limits set therein. Further, a new EU economic governance system is being discussed, aiming at preemptive,  

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26 European Council, Conclusions, EUCO 13/10/17-6-2010 (p. 1)  
27 EC, 2009, European Economic Forecast, Autumn 2009:50
rather than proactive, action with regard to member-states’ fiscal policy, including imposing sanctions on member states that do not comply with the Stability Pact norms.

- *A fragile recovery*

In view of the fact that the recovery is considered to be “tentative”, “sluggish” and “unevenly distributed across the EU member-states”, as well as “jobless”, the emphasis placed on fiscal consolidation runs the danger of producing a double dip recession, while it will certainly increase economic and social inequalities within and amongst regions, at the obvious expense of social cohesion. Table 5 below displays the main features of the 2010 spring forecast for the EU-27 and for the eurozone.

Table 5 – Main features of the 2010 spring forecast for EU-27 and EU-16

<table>
<thead>
<tr>
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</thead>
<tbody>
<tr>
<td>GDP (% annual change)</td>
<td>3.2</td>
<td>3.0</td>
<td>2.9</td>
<td>2.8</td>
<td>0.7</td>
<td>0.6</td>
<td>-4.2</td>
<td>-4.1</td>
<td>1.0</td>
<td>0.9</td>
<td>1.7</td>
<td>1.5</td>
</tr>
<tr>
<td>Unemployment (% of the labour force)</td>
<td>8.2</td>
<td>8.3</td>
<td>7.1</td>
<td>7.5</td>
<td>7.0</td>
<td>7.5</td>
<td>8.9</td>
<td>9.4</td>
<td>9.8</td>
<td>10.3</td>
<td>9.7</td>
<td>10.4</td>
</tr>
<tr>
<td>Inflation (HICP nom. change)</td>
<td>2.3</td>
<td>2.2</td>
<td>2.4</td>
<td>2.1</td>
<td>3.7</td>
<td>3.3</td>
<td>1.0</td>
<td>0.3</td>
<td>1.8</td>
<td>1.5</td>
<td>1.7</td>
<td>1.7</td>
</tr>
<tr>
<td>Government balance(% GDP)</td>
<td>-1.4</td>
<td>-1.3</td>
<td>-0.8</td>
<td>-0.6</td>
<td>-2.3</td>
<td>-2.0</td>
<td>-6.8</td>
<td>-6.3</td>
<td>-7.2</td>
<td>-6.6</td>
<td>-6.5</td>
<td>-6.1</td>
</tr>
<tr>
<td>Government debt (% GDP)</td>
<td>61.4</td>
<td>68.3</td>
<td>58.8</td>
<td>66.0</td>
<td>61.6</td>
<td>69.4</td>
<td>73.6</td>
<td>78.7</td>
<td>79.6</td>
<td>84.7</td>
<td>83.8</td>
<td>88.5</td>
</tr>
<tr>
<td>Current a/c balance(% GDP)</td>
<td>-1.2</td>
<td>-0.1</td>
<td>-1.1</td>
<td>0.1</td>
<td>-2.0</td>
<td>-1.1</td>
<td>-1.4</td>
<td>-0.8</td>
<td>-1.4</td>
<td>-0.6</td>
<td>-1.3</td>
<td>-0.5</td>
</tr>
</tbody>
</table>

Source: EC, 2010, European Economic Forecast, Spring 2010, Tables 1.1.3 1 and 1.1.4

As we can see, GDP growth dipped heavily in 2009, while it is expected to resurface in 2010 and to increase slightly in 2011. The rate of inflation is low and expected to remain so. Unemployment, on the other hand, is on an increasing path, as is the government balance and debt. The current account balance does not display any major changes over the period under review.

Overall, the economic outlook is at best uncertain. The economy of the EU appears to have recovered from the plunge it took in 2009. However, it is a fragile recovery, based to a great extent on the fiscal support provided by governments over the past year. Withdrawing such support will add to the strains imposed by the global crisis, which is in no way over yet. Thus, the prospect of a double dip recession cannot be excluded. Should

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28 EC, 2010, European Economic Forecast, Spring 2010
29 It is indicative of such uncertainty that the Interim Forecasts of the OECD and of the European Commission, both published in September 2010, move in opposite directions. Well into the forecast period, the third quarter of 2010, the OECD expects France and Germany to grow by only 0.2 per cent and Italy to shrink slightly. On the contrary, the E.C. forecast has all three increasing by approximately 0.5 per cent!
30 The G20 Toronto Summit Declaration (June 26-27, 2010) stresses that: “While growth is returning, the recovery is uneven and fragile, unemployment in many countries remains at unacceptable levels, and the social impact of the crisis is still widely felt. Strengthening the recovery is key.” (par. 4, p.1)
this happen, the social and political implications of a yet again run-down economy should be taken into account at least as seriously as the projected pension expenditure in 2060.

- **Alternative views**

The discussion on the rising public debt in the EU and its implications for economic policy goes beyond the boundaries of economics. It encompasses politics, ideology and last, but not least, a vision of Europe. It is closely linked to the future of the eurozone and indeed of European integration, as the spreading and deepening of social discontent will endanger the already fragile legitimacy of the Union.

This is a broad discussion which has attracted many interesting contributions. We shall briefly mention some of these, selected for the panorama of views they represent.

- **Eichengreen (2010)** proposes four actions for the EU to draw a line under the crisis. Namely, (i) bank stress-tests to end uncertainty about the banks’ actual state; (ii) clarify how the Special Purpose Vehicle will work; (iii) deal effectively with the Greek situation (debt restructuring); (iv) allow the euro to devalue and support growth. Accordingly, he stresses that “the only pain relievers on the horizon are Germany and the ECB”.

- **Davidson (2009)**, albeit not speaking on the EU, considers two key aspects to end the financial and economic crisis: financial market regulation and creating jobs primarily in the private sector.

- **Arestis and Sawyer (2010)** are especially pessimistic about the future of the eurozone. This is due to the fact that the Economic and Monetary Union completely lacks any mechanisms by which countries can resolve their deficit problems. The choice for member states with fiscal problems is between deflation and high unemployment and exiting the eurozone. Since the euro project, embedded in the Treaty of Lisbon, is unlikely to be restructured, eurozone countries face a bleak future.

- **Onaran (2010)** regards the fiscal crisis in Europe as a crisis of distribution. It is argued that “the financial speculators and corporations are relabeling the crisis as a “sovereign debt crisis” and pressurizing the governments in diverse countries to cut spending to avoid taxes on their profits and wealth.” Onaran concludes that a major change in the EU policy framework is needed, as well as the reversal of inequality at the expense of labour.

- **Lapavitsas et al (2010)**, on reviewing the recent eurozone crisis, suggest that there are three alternatives open to peripheral eurozone countries: (i) austerity accompanied with further liberalization, which will deepen the recession; (ii) radical

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31 Eichengreen, B., 2010, Drawing a line under Europe’s crisis
32 Davidson, P., 2009, Interview with Paul Davidson regarding the crisis, www.mecpoc.org
33 Arestis, Ph. And M. Sawyer, 2010, The problems of the Economic and Monetary Union: is there an escape?
34 Onaran, O., 2010, Fiscal Crisis in Europe or a Crisis of Distribution?, RMF Discussion Paper no. 18
reform of the eurozone, which will weaken the euro; (iii) radical exit from the eurozone. The authors favour the third option, although they realize that it “requires a decisive shift in the balance of political power in favour of labour”35.

- Papadimitriou, Wray and Nersisyan (2010) propose a “more perfect union”, whereby the ECB provides relief support to the EU member states in the short run, while the equivalent of a national treasury responsible to the European Parliament is appointed to oversee a permanent fiscal arrangement in the long run36.

- Rodrik (2010) considers the crisis as a manifestation of what he calls “the political trilemma of the world economy”, whereby economic globalization, political democracy and the nation-state are mutually irreconcilable37. By analogy, the EU has to make a choice: either integrate politically, or ease up on economic unification.

A common thread runs through the views presented above. It is that the current EMU architecture is faulty and that it cannot deal with the implications of the rising public debt of EU member states, without endangering social cohesion and democracy in the EU. Apart from Lapavitsas’ suggestion that the euro project be eliminated, the other views converge on the need for a radical change of the EMU project, which is seen as critical for its long term survival, even if this implies a ‘soft euro’ in the medium term.

Concluding remarks

The eurozone is faced with its first major crisis in its 10-year existence and the EU with a very serious one in its more than 50-year existence. The two projects and the two crises are closely interconnected. Failure to deal with the eurozone crisis will have serious repercussions on the process of European integration itself.

The exit strategy selected by the European leaders and the long-term, economic and social policy they have adopted, under the general heading of ‘Europe 2020’, suggest that they are seriously discounting the dangers of the present situation for the economic, social and democratic cohesion of the Union.

The rising public debt of the EU member states presents one of the most demanding challenges. Containing the public debt crisis within the EMU framework is an even more challenging task. Nothing less than restructuring the euro architecture is going to suffice. Pushing forward with long-overdue financial policy reforms is going to gain governments the necessary time to proceed with the radical reform of the euro project, as well as averting further risks to the stability of the financial sector and of the economy at large.

The crisis is still working its way through the EU, turning from finance to the rest of the economy and back again. Unemployment and social discontent are on the increase. The

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36 Papadimitriou, D., L. Randall Wray and Y. Nersisyan, 2010, “Endgame for the euro? Without major restructuring, the eurozone is doomed”, Public Policy Brief no. 113, Levy Economics Institute of Bard College
already fragile legitimacy of the EU is coming into question. It is the responsibility of the European leaders to realize the seriousness of the situation and to rise up to it. While a number of measures may be taken in the short term to alleviate the situation, radical changes are needed in the long run, which can only be the outcome of pressure applied by the social actors, the trade unions and the social movements.