

Political Economy of the Sovereign Debt Crisis: The Limits of Internal Devaluation

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ABSTRACT

This article makes three interrelated arguments: first, the sovereign debt crisis is more complex than a simple story about fiscally irresponsible governments which now are being forced by international financial markets to tighten their belts. Ultimately, it is the result of a political decision to create a currency union among economically non-homogenous countries without making any provision for the use of democratically legitimated fiscal transfers to correct asymmetric shocks. Second, the internal devaluation policy which is being imposed on Greece, Ireland, Italy, Portugal and Spain is ineffective and counterproductive. Internal devaluation depresses growth, and the absence of growth requires further austerity for government to regain their fiscal credibility, thus generating a vicious cycle. Third, while national governments continue to be held electorally accountable by citizens, they have lost any meaningful ability to choose among alternative policy options and, as a result, implement everywhere pretty much the same, deeply unpopular austerity package. This situation threatens not just the future viability of the Euro but of the European project as a whole.

1. INTRODUCTION

A stylized account of the sovereign debt crisis—to be found both in the popular press and in elite discourse—emphasizes the fiscal laxity and administrative inefficiency of the GIIPS countries (Greece, Ireland, Italy, Portugal and Spain) and the need for them to make the necessary adjustments. Because they have a tendency to spend more than they earn and because they did not adjust when the economic cycle was favourable, their deficits and debts have grown beyond measure. Between 2009 and 2010, international bond markets began to price

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in the growing risks associated with the debt of these countries and to require increasingly higher interest rates to buy their bonds. As time went by, and in the absence of decisive measures by the countries concerned, these interest rates reached such high levels that they became no longer sustainable. The governments in question were forced to ask for support from the European Union (EU) and the International Monetary Fund (IMF). These organizations obliged but, understandably, made their support conditional on tough austerity programmes that would enable these countries to rebalance their budgets.

Paramount in this narrative is the divide between 'irresponsible' peripheral governments, which caused the crisis, and 'responsible' core governments, which are asked to repay the debts. According to this line of argument, the current woes are of the GIIPS's own making. It is up to them to regain market confidence. To do so, they need to engage in fiscal retrenchment. In addition, they need to pass labour market liberalization and welfare state restructuring reforms to boost their growth potential. The responsible governments are right to refuse to bail them out and to insist they mend their ways.¹

In this article, we argue that this account is only partially true. We amend it by proposing three interrelated arguments. First, the argument that fiscal profligacy caused the crisis fully applies only to one country: Greece. For other countries, fiscal imbalances were largely the result (as opposed to the cause) of the economic shocks that hit them from 2007 on. This is not to say that all was well with the GIIPS when they entered the crisis. They all shared the key problem of declining competitiveness relative to the European core, particularly Germany, and associated with that the problem of persistent current account deficits. However, these imbalances are the mirror image of increasing competitiveness and current account surpluses in Germany. The GIIPS countries cannot address these problems by devaluing their currencies and have few alternative tools to revamp economic growth. International financial markets are unwilling to lend to them, except at very high interest rates, because they doubt their ability to produce the economic growth necessary to repay the loans. Consequently, the GIIPS countries are mired in a self-fulfilling crisis of confidence, which would be much less disastrous if they could rely on their own lender of last resort.

Second, we argue that the current response to the crisis, 'internal devaluation,' is economically counterproductive. It is intended to act as a functional

¹ See J. Weidmann, 'Rebalancing Europe', speech at Chatham House in London, 28 March 2012: 'The typical German position could be described as follows: the deficit countries must adjust. They must address their structural problems. They must reduce domestic demand. They must become more competitive and they must increase their exports.' <http://www.bundesbank.de/download/presse/reden/2012/20120328.weidmann.en.php> (accessed 1 May 2012).

substitute to currency devaluation. Its goal is to reduce prices relative to other countries by cutting employment and wages and by introducing structural policies (especially labour market and welfare state liberalization) aimed to increase wage and price flexibility. Yet the gains in competitiveness have been marginal, and the measures taken to improve the primary balance have depressed nominal growth, which even rating agencies and market actors perceive at this point as the key indicator of long-term fiscal sustainability. As we argue later in the article, an internal devaluation is not the only possible response to the crisis. However, it is the one inscribed in the European treaties. These preclude an activist role by the European Central Bank (ECB) and rule out institutionalized fiscal transfers across states. In addition, it corresponds to the economic interests of a key player: the German government.

Third, we argue that the current policy response has brought the time-old problem of the democratic deficit of European institutions to new and previously unattained heights. Democracy means that citizens choose among policy options, either directly or through their representatives. In the case of the sovereign debt crisis, however, there is no real choice either for country governments or for their citizens. Unless they decide to leave the Eurozone, which for the time being would arguably be even more disastrous for their countries than staying in, all is left to them is to find ways to blunt popular opposition to austerity measures. They do so in different ways in different countries and with varying degrees of success. The most popular measures seem to be striking an alliance with the parliamentary opposition, empowering a technocratic government supported by a party coalition cutting across the political spectrum or (less frequently) persuading the unions to sign a concessionary corporatist deal. This has created a situation in which domestic politics matters much less than the views of international financiers and technocrats and has contributed to delegitimizing both domestic and European institutions.

The crisis has revealed a key flaw in the conception of the Euro. A currency union in which members are unwilling to countenance fiscal transfers to buffer asymmetric shocks is only viable if such shocks are highly unlikely, that is, if the union is composed of economically homogenous countries. If the members are not homogenous, then fiscal transfers should be part of the institutional architecture of a currency union. The current set-up—a large currency union with no fiscal transfers and minimal political integration—is a hybrid. It was adopted largely for political reasons but now shows all its limits. There are two sustainable idealtypical solutions: either the Eurozone moves closer to the model of an optimal currency area, by ejecting or forcing out some of the current members, or it evolves towards a true fiscal

union. This implies a sizeable European budget, possibly the ability to raise taxes, a common fiscal policy, and the deepening of political integration to ensure the democratic legitimacy of the above choices. If none of these solutions is feasible, little is left but muddling through. But muddling through may not be a sustainable solution in the medium-to-long term.

The remainder is divided into five sections. Section 2 examines the problem of competitiveness of the GIIPS countries and the difficulty created by the absence of a lender of last resort. Section 3 analyzes policy responses at the country level and problems of democratic legitimacy associated with them. Section 4 discusses alternatives to internal devaluation. Section 5 concludes.

2. THE PROBLEM OF COMPETITIVENESS AND THE LACK OF A LENDER OF LAST RESORT

There is one country for which fiscal profligacy was really at the root of the crisis: Greece. The Greek problem really started in January 2001 when the country joined the Eurozone on the basis of cooked-up figures on its public finances. Greek statistics remained unreliable afterwards. However, even counterfeited data were bad enough to trigger a first excessive deficit procedure by the European Commission in 2004, which was dropped in 2007. In 2007, Greece had the worst fiscal fundamentals of the GIIPS group with public deficit exceeding 6% and public debt 107%. Other countries, however, appeared to be in a much less worrisome fiscal situation at the onset of the crisis (Table 1). In particular, Ireland and Spain's public deficit and debt were well within the parameters of the Stability and Growth Pact.

The fiscal responses of the five countries to the first stage of the crisis in 2008–09 were also very different: strongly counter-cyclical in Spain, moderately counter-cyclical in Portugal, slightly pro-cyclical in Greece (although with limited implementation of announced austerity measures) and strongly pro-cyclical in Ireland. In Italy, the government was able to maintain public expenditures broadly in line with receipts by essentially forfeiting any stimulus package. The Spanish stimulus package (4.5% of Gross Domestic Product) contributed to creating fiscal problems in this country. However, given the dramatic increase in unemployment (see Table 1) and in particular in youth unemployment, fiscal passivity would have been hard to defend, especially for a Socialist government. In Ireland, the deterioration of public finances was caused both by the effects of the recession and, especially, by the decision of the Irish government to guarantee the liabilities of Irish banks. In January 2011, the Irish state had spent €46 billion (29% of GDP) on a failed attempt

Table 1. Macroeconomic Indicators for France, Germany and the GIIPS Countries

Country	Year	Deficit	Debt	Unemployment	GDP Growth
France	2007	-2.75	64.21	8.40	2.29
	2008	-3.34	68.21	7.80	-0.08
	2009	-7.57	79.01	9.50	-2.73
	2010	-7.08	82.32	9.80	1.48
Germany	2007	0.23	65.16	8.70	3.27
	2008	-0.06	66.66	7.50	1.08
	2009	-3.21	74.45	7.80	-5.13
	2010	-4.28	83.24	7.10	3.69
Greece	2007	-6.80	107.42	8.30	3.00
	2008	-9.91	112.97	7.70	-0.16
	2009	-15.79	129.31	9.50	-3.25
	2010	-10.76	144.89	12.60	-3.52
Ireland	2007	0.06	24.93	4.60	5.18
	2008	-7.34	44.35	6.30	-2.97
	2009	-14.19	65.21	11.90	-6.99
	2010	-31.31	94.87	13.70	-0.43
Italy	2007	-1.59	103.08	6.10	1.68
	2008	-2.67	105.81	6.70	-1.16
	2009	-5.36	115.51	7.80	-5.05
	2010	-4.51	118.43	8.40	1.54
Portugal	2007	-3.21	68.27	8.90	2.39
	2008	-3.71	71.58	8.50	-0.01
	2009	-10.17	83.01	10.60	-2.51
	2010	-9.79	93.32	12.00	1.39
Spain	2007	1.92	36.21	8.30	3.48
	2008	-4.49	40.07	11.30	0.89
	2009	-11.18	53.81	18.00	-3.74
	2010	-9.34	61.05	20.10	-0.07

Source: AMECO Database.

to redress the banks' crisis.² In Portugal, the recession caused a sudden jump in the public deficit from 3.7% in 2008 to 10.2% in 2009.

²European Commission, *The Economic Adjustment Programme for Ireland*, Directorate-General for Economic and Financial Affairs, Occasional Paper No 76 (2011), at p 13.

In brief, fiscal irresponsibility was not a common characteristic of the GIIPS countries. When the crisis hit, their fiscal positions differed considerably. This is not to say that these countries had no economic problems. On the contrary, they all had a serious competitiveness problem which had developed since at least the year 2000.³ Nominal unit labour costs (nominal wages divided by a volume measure of labour productivity) had increased faster than in Germany, where they had remained virtually stable, even declining slightly in mid-decade (see Figure 1). The diverging trends in competitiveness were reflected in persistent current account deficits in the GIIPS countries—with the exception of Ireland—and persistent current account surpluses in Germany. In 2012, Germany's net export of goods and services amounted to €105 billion, while the combined net imports of Italy, Spain, Greece and Portugal were €43 billion. Germany's current external balance surplus—which covers in addition to goods and services primary incomes and current transfers—was €116 billion, roughly the same amount as the combined current balance deficits of Greece, Italy, Portugal and Spain, which corresponded to €106 billion.⁴ As a matter of accounting identity, a current account deficit implies a capital account surplus and vice versa. Capital flew out of countries where exports exceeded imports, such as Germany, to purchase assets located in countries that had the opposite situation, such as the GIIPS countries. This inflow of speculative capital from surplus to deficit countries contributed to fuel real-estate bubbles in deficit countries such as Ireland and Spain and to inflate domestic prices elsewhere.

The phenomenon of competitiveness loss is usually blamed on union wage militancy. However, there is not a lot of evidence of wage militancy at work. The average nominal wage increase in the GIIPS countries between 2000 and 2010 has been 42% as compared to 31% in Austria and 35% in Sweden.⁵ Germany recorded a (much) lower increase. Focusing on hourly wages, wages in Greece, Italy and Spain, the countries for which hourly wage data are available, continued to be much lower than in Germany. In the period in question, they rose in line with German wages, with no sign of convergence. Instead, productivity trends were very different. While productivity continued to grow in Germany at approximately the same pace as before, it grew more slowly in Greece, was practically flat in Spain and even declined in Italy. Low

³F. Scharpf, 'Monetary Union, Fiscal Crisis and the Preemption of Democracy', Max-Planck-Institute Cologne Working Paper (2011).

⁴AMECO database, http://ec.europa.eu/economy_finance/db_indicators/ameco/index_en.htm, accessed on 6 May 2012; see also K. Whelan, 'Macroeconomic Imbalances in the Euro Area', European Parliament: Directorate General for Internal Policies, Policy Note (2012), at p 7.

⁵AMECO database (accessed 24 April 2012).

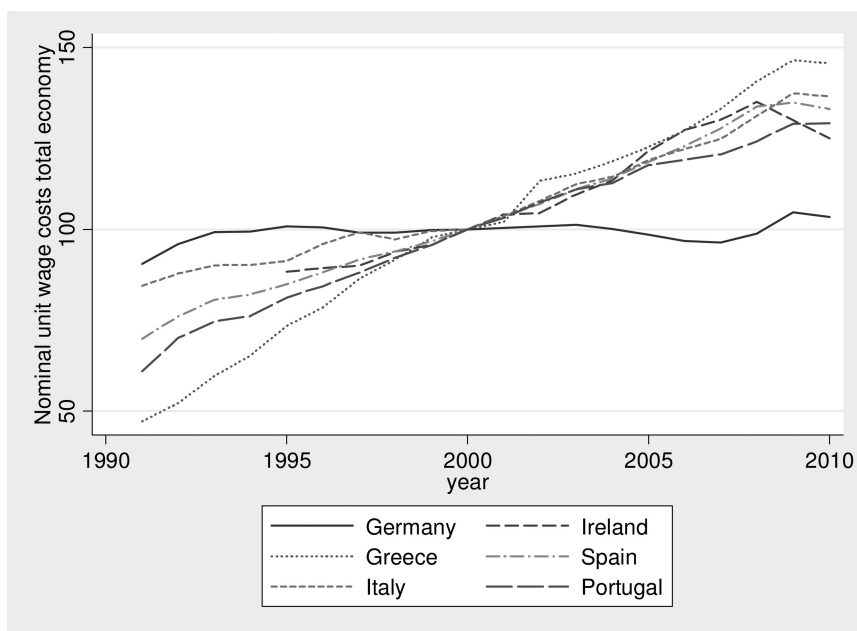


Figure 1. Nominal Unit Wage Costs, Total Economy (2000 = 100).

Source: AMECO Database.

productivity growth in Spain is probably due to the construction boom and the resulting expansion of employment in a traditionally low-productivity sector. More difficult is to explain the productivity slowdown in Italy. Recent research suggests that excessive wage compression and labour flexibility played a role by providing fewer incentives for firms to engage in efficiency-enhancing reorganizations.⁶ This suggests that standard recipes for increasing labour market productivity—such as speeding up labour market liberalization reform—may actually be counterproductive. At any rate the productivity problem is unlikely to be solved simply by cutting wages.

⁶E. Saltari and G. Travaglini, *Le radici del declino economico: occupazione e produttività in Italia nell'ultimo decennio* (Novara: UTET, 2006); L. Tronti, 'La crisi di produttività dell'economia italiana: scambio politico ed estensione del mercato' (2009) 43 *Economia e Lavoro* 139; F. Lucidi and A. Kleinknecht, 'Little Innovation, Many Jobs: An Econometric Analysis of the Italian Labour Productivity Crisis' (2011) 34 *Cambridge Journal of Economics* 525; E. Hein and A. Tarassow, 'Distribution, Aggregate Demand and Productivity Growth: Theory and Empirical Results for Six OECD Countries Based on a Post-Kaleckian Model' (2010) 34 *Cambridge Journal of Economics* 727; R. Vergeer and A. Kleinknecht, 'The Impact of Labour Market Deregulation on Productivity: A Panel Data Analysis of 19 OECD countries (1960–2004)' (2011) 33 *Journal of Post-Keynesian Economics* 371.

The standard solution to a competitiveness problem is exchange-rate devaluation. This would allow countries to stimulate their exports while making imports more expensive. In addition, exchange-rate devaluation would probably be more effective in reducing real wage wages than nominal wage cuts, as wages tend to be sticky. Furthermore, devaluation would probably increase domestic inflation and this in turn would alleviate the debt problem.

By ruling out exchange-rate devaluation, membership in the Eurozone severely limits the GIIPS countries' ability to adjust. International economic observers have drawn attention to the situation of countries outside the Eurozone, such as Iceland or the UK, which have been able to avoid the pressing financial problems of the GIIPS countries despite similar and sometimes even more serious fiscal problems. For example, Paul Krugman has contrasted the experiences of Ireland and Iceland after the crisis.⁷ Both are small open economies. In both cases, the crisis was due to deregulated national banks dramatically expanding their balance sheets by borrowing in foreign markets to finance a domestic real-estate boom. In Iceland, bank assets grew from 170% of GDP at the end of 2003 to 880% at the end of 2007, an OECD record.⁸ When interbank markets froze after the collapse of Lehman Brothers in September 2008, banks collapsed due to creditors' demands repayment and the unwillingness of other banks to issue new loans. This led to devastating crises. The policy response was, however, very different in the two countries. The Irish response was fully orthodox: the sovereign guaranteed the debt held by foreign lenders, slashed public expenditures, increased taxes and engaged in structural reforms involving, inter alia, public sector wage cuts and cuts in the minimum wage and unemployment benefits. In Iceland, the government refused to guarantee the debt owned by non-foreign residents (which means that they had to take sizeable 'haircuts' on their claims); it introduced capital controls to stop capital flight and let the national currency devalue markedly against other currencies. In January 2007, 1,000 Icelandic Kronar could buy about 11 Euros; two years later it purchased less than 6 Euros. At the time of writing (April 2012), Iceland sees the light at the end of the tunnel while Ireland is still deep in the tunnel.

In addition to being unable to use exchange-rate devaluation for current account adjustment, the GIIPS countries are also penalized by the lack of a lender of last resort. To illustrate this point, Paul De Grauwe⁹ has compared

⁷P. Krugman, 'Lands of Ice and Ire,' *The Conscience of a Liberal*, <http://krugman.blogs.nytimes.com/2010/11/24/lands-of-ice-and-ire/> (accessed 10 June 2011).

⁸OECD, *Economic Surveys. Iceland 2009* (Paris, OECD, 2009), at p 20.

⁹P. De Grauwe, 'The Governance of a Fragile Eurozone', CEPS Working Document No. 346 (2011).

the likely policy responses of two hypothetical countries, say the UK and Spain. Both are faced with unfavourable shocks which increase public deficit and debt but while one country controls its own currency, the other does not because it is a member of a monetary union. In the former country, if investors become nervous about the solvency of government, they are likely to respond by selling government bonds and then the currency in which the bonds are denominated. However, the liquidity is trapped in the country, where it might be used to purchase the outstanding government bond stock. Even if private investors are unwilling to do so, the national central bank may be persuaded to purchase them. In other words, international financial markets cannot cause a liquidity crisis in a country like the UK which has its own currency. Also, the investors' selling the national currency sets in motion an equilibrating mechanism. The exchange rate tends to depreciate, which makes exports cheaper and imports more costly. This in turn both stimulates GDP growth and pushes domestic inflation up.

In the case of a member of a currency union the situation is very different. When the unfavorable shock hits, international investors sell government bonds just as in the previous case. However, the liquidity is denominated in the common currency, ie is not bottled up in the country in question but migrates elsewhere and is used to purchase, for example, German bonds. The government of the country has no way to force the central bank to provide the needed liquidity because it has no control over it. It has to ask private financial markets to provide the needed liquidity. These may demand prohibitively high interest rates and in so doing may render the prospect of insolvency and eventually default more likely. In these circumstances, the government may try to boost the markets' confidence by engaging in austerity policies, that is, cutting public expenditures and/or increasing taxes. The problem is that by doing so, the government risks setting in motion a vicious cycle of austerity worsening the recession, requiring even more austerity, etc. What started off as a liquidity crisis may through self-fulfilling expectations become a solvency crisis.

To see the potentially perverse effects of austerity policies, it suffices to consider a formula expressing the necessary condition for fiscal solvency,¹⁰

$$S \geq (R - G) D$$

where S is the primary budget surplus (current receipts minus current expenditures net of interest payments in percent of GDP); R is the nominal interest rate the government pays on its debt; G is the nominal growth rate and D is the stock of debt in percent of GDP.

¹⁰De Grauwe, 'Fragile Eurozone', above n.9, at pp 6–7.

This formula says that to be solvent a country has to grow in nominal terms at least as fast as the nominal interest it pays on its stock of debt. If it is unable to do so, it has to increase its primary surplus by either cutting expenditures or increasing taxes or both. However, this may reduce growth even further and unleash a vicious circle.

The above considerations suggest that the situation of the GIIPS countries is made particularly difficult by their membership in the Eurozone: they cannot devalue their currency. Also, they are unlikely to pull themselves out of their debt problem through inflation, given the ECB's well-known inflation aversion. Their priority should be to resume nominal growth as quickly as possible. Instead they are being forced into an internal devaluation programme by which they are expected to lower wages and prices relative to other countries and thus make up for lost competitiveness. In addition, they are being asked to implement structural measures to increase the degree of competitiveness of the labour and product markets. This policy approach worsens the liquidity problems being experienced by these countries rather than alleviating it. Markets doubt that the countries in question will be able to generate the growth necessary to repay the debt and therefore ask for higher interest rates, which worsens the fiscal position of these governments. In the absence of a lender of last resort that could guarantee the necessary liquidity, these expectations tend to become self-fulfilling.

There is increasing consensus in the academic and policy community that fiscal contraction policies depress output (particularly when interest rates are close to the zero bound) and are therefore counterproductive. Even proponents of conservative fiscal policies are beginning to admit that there should be limits to austerity. For example, in its fiscal monitor of April 2012, the IMF cautions against a large and rapid fiscal consolidation, pointing to the unintended economic consequences for growth and employment.¹¹ However, this emerging consensus has so far had little impact on European policymakers, who continue to emphasize the need for the GIIPS countries to implement austerity and structural adjustment programmes.

3. CRISIS RESPONSE AT THE COUNTRY LEVEL

The sovereign debt crisis has challenged the traditional comparative political economy view of crises and crisis response. Following Peter

¹¹ IMF, *Fiscal Monitor. Balancing Fiscal Policy Risks. April 2012* (Washington, DC: IMF, 2012).

Gourevitch's seminal *Politics in Hard Times* (1986),¹² most comparative political economists would anticipate that faced with a common shock countries would respond in different ways and that the specific features of the policy response would be determined by coalitions and domestic political processes. Similarly, they would expect that institutional differences at the country level, for example, different 'varieties of capitalism'¹³ would matter for the type of strategic response that gets selected, with countries closer to the coordinated market economy pole, such as Italy (at least as far as industrial relations are concerned¹⁴), reacting differently from countries closer to the liberal market economy camp, such as Ireland, and differently again from countries that cannot be neatly assigned to either type, such as Greece.

Yet domestic institutions and politics, either party- or interest group-based, have ostensibly played a minor role in selecting the policy response to the sovereign debt crisis. To be sure, there has been and there continues to be a lot of variation in the policy process through which domestic actors have sought to blunt and diffuse popular opposition to the proposed measures. However, none of the country-level variation has (so far) made any difference for the content of the policy packages, which has been very similar across countries and has been imposed from outside. In the case of Greece, Ireland and Portugal, it was imposed by the *troika* (composed of the ECB, EU and IMF) as a condition for financial assistance. In the case of Spain and Italy, it was 'voluntarily' adopted in an effort (so far ineffective) to reassure financial markets. This is not to say that policy discretion has disappeared everywhere in Europe. As we explain later in the article, core Euro-area countries, particularly Germany, fully retain the ability to choose among alternative options and determine the course of policy according to their preferences. But for peripheral countries, the policy space and the amount of discretion have shrunk dramatically.

What has therefore emerged is a form of policy convergence across states. The common response involves public sector expenditure cuts (including cuts in educational expenditures), pension reform, easing of employment protection legislation, weakening of unemployment insurance and flexibilization of collective bargaining rules. The specific mix has been different

¹² P. Gourevitch, *Politics in Hard Times: Comparative Responses to International Economic Crises* (Ithaca, NY: Cornell UP, 1986).

¹³ P. Hall and D. Soskice, 'An Introduction to Varieties of Capitalism' in P. Hall and D. Soskice (eds), *Varieties of Capitalism. The Institutional Foundations of Comparative Advantage* (Oxford: OUP, 2001).

¹⁴ Thelen, Kathleen 2001: "Varieties of Labor Politics in the Developed Democracies", in: *Varieties of Capitalism. The Institutional Foundations of Comparative Advantage*, n 13 above.

in different countries. Some of the plans are more front-loaded; some put more emphasis on tax increases as opposed to expenditure cuts. All claim to spare the most vulnerable social groups without really doing so as the measures apply across the board. Overall, the bottom line has been an effort to bring about internal devaluation through a combination of fiscal austerity and structural reform. The size of the adjustment in the structural primary balance has been of at least 5% of potential GDP over three to five years.¹⁵ Between 1980 and 2010, programmes of similar size were introduced in the EU15 plus Japan and the USA only in four cases.¹⁶

These programmes have had important political repercussions in the countries concerned. In Ireland, Portugal, Spain and Greece, the crisis and the policy response associated with it caused early elections, which in turn led to new governments. However, changes in the partisan composition of governments have not produced changes in policy. This is perfectly illustrated by the Spanish case. When the economic crisis started, a socialist government was in charge in Spain. In 2008, it argued that it would use the crisis as an opportunity to upgrade its growth model, shifting it from low value-added sectors (like construction) to more knowledge and technology-intensive sectors. By the end of 2009, however, its policy approach had shifted and the socialist government was doing pretty much the same things (that is, labour market liberalization and austerity) as other governments involved in the sovereign debt crisis. Unsurprisingly, the socialist party suffered a historic defeat in the general elections of November 2011. The elections were won hands down by the conservative party which promised to pursue the same austerity policy, only more rigorously.

In June 2011, the conservative party ousted the socialist government in the Portuguese general elections. In Portugal, too, no major policy change occurred. This was to be expected as the first three austerity packages implemented in Portugal had been supported by an informal grand coalition between government and opposition. The IMF and the EU actively contributed to bringing the parties closely together. In 2011, they requested as a condition for financial assistance that the adjustment plan be subscribed to not only by the parties in government but also by those in opposition.

New elections were held in Ireland in February 2011, soon after the negotiation of a bailout package with the troika. The electorate delivered an historic

¹⁵IMF, *Balancing Fiscal Policy Risks*, at pp 40–45.

¹⁶Sachverständigenrat zur Begutachtung der wirtschaftlichen Lage, *Chancen für einen stabilen Aufschwung. Jahresgutachten 2010/11* (Wiesbaden: Statistisches Bundesamt, 2010), at pp 87–88.

defeat for the Fianna Fail party, which it perceived to be largely responsible for the financial crisis. This party fell from 77 to 20 seats in the lower chamber and became the third party in the country by electoral strength. The election was won by the Fine Gael and Labour parties, which formed a coalition government. One of the themes of the electoral campaign had been the promise made by the incoming government parties to renegotiate the financial package with the EU and ECB and obtain less prohibitive interest rates and/or 'haircuts' for bank creditors. After the election, the new government made a timid attempt to put the issue of loan renegotiation on the European agenda, but the request was denied by the German chancellor.

In Greece, the main parties took turns accusing each other of proposing policies that they would continue or even deepen when in government. The socialist party won the 2009 election by campaigning to reverse the pro-cyclical policies of the conservative government. After the election, it announced that the previous government had lied about the numbers and that the public finances were really in much worse shape than expected. At this point, the conservative party took to criticizing the socialists for making too many concessions to the IMF, the ECB and the EU, with which the government had negotiated a bailout programme in 2010. The socialist government resigned in 2011 over protests against austerity policy. It was replaced by a technocratic government which included both the socialist and conservative parties and a right-wing populist party. This government committed to implementing the austerity measures agreed upon with IMF and EU.

A technocratic solution was also adopted in Italy, where the sovereign debt crisis started later than in other GIIPS countries. In the summer of 2011, the centre-left opposition decided to support the centre-right government's emergency austerity package, thus favouring its swift approval. Yet despite these measures the pressure on Italian bonds did not abate. Mounting tensions led to a change of government in the autumn of 2011. The centre-right government was replaced by a government of technocrats, supported by a three-way grand coalition among centre-right, centre and centre-left parties. The new government engaged in a thorough programme of labour market and product market liberalization with the explicit support of European elites. Interestingly, the content of the governmental programme largely coincided with the text of a supposedly confidential letter signed jointly by both the incoming and outgoing presidents of the ECB and addressed to the Italian prime minister prior to its resignation. The letter was later leaked to the press.¹⁷

¹⁷ See http://www.corriere.it/economia/11_agosto_08/lettera-trichet_238bf868-c17e-11e0-9d6c-129de315fa51.shtml, (accessed 3 May 2012).

Governments of different political orientations and of different parliamentary strength found themselves implementing essentially the same structural adjustment programme. The only type of choice left to them concerned the process used to mobilize popular consensus for, or at least blunt hostility against, austerity policies. In Portugal and later in Greece and Italy, this involved the forming of grand coalitions and the empowering (in Greece and Italy) of technocratic governments. In Ireland and Spain, the government resorted to signing corporatist agreements with the trade unions. A social pact on pension reform was signed in Spain in February 2011. With it, the unions accepted several provisions against which they had mobilized one year before. In exchange, they obtained some measures aimed to increase stability of employment, such as a reduction of social security contributions for companies hiring young workers and long-term unemployed and €400 per month for the unemployed whose benefits had ceased.¹⁸ In Ireland, the government unceremoniously jettisoned 20 years of social partnership in 2009, but in 2010, the public sector unions signed an accord, known as the 'Croke Park' agreement, by which the government committed not to cut public sector wages again and to reduce payroll through attrition only, in exchange for an industrial peace guarantee of four years.

These are clearly concessionary agreements. With them the unions limit the damage inflicted to their core constituencies such as public sector workers, but obtain little else. Furthermore, there is no strategic commitment by governments to collaborate with trade unions in future. If the unions do not agree with the government proposal, the government proceeds unilaterally. In fact, the Spanish government unilaterally reformed employment protection a few weeks after signing a social pact on pensions.

These developments signal serious problems of democratic legitimacy. A viable national democracy presupposes that different political parties adopt different programmes and that by choosing among them citizens can influence policy.¹⁹ In the GIIPS countries, this seems no longer to be the case. Current governments such as the Irish Fine Gael & Labour government, the conservative governments in Portugal and Spain and the technical governments in Italy and Greece have no choice but to continue the policies of the previous governments. This became absolutely clear in May–June 2011 when the EU and the IMF insisted on settling the terms of the austerity Memorandum with all major Portuguese parties that stood a chance of being elected into government in 2011. The same thing happened in Greece in November 2011.

¹⁸ EIRO online, 'Agreement Signed on Growth, Employment and Guaranteed Pensions,' <http://www.eurofound.europa.eu/eiro/2011/02/articles/es1102031i.htm>, (accessed 27 July 2011).

¹⁹ D. Held 1991: *Political Theory Today* (Palo Alto, CA: Stanford University Press).

In addition, most European democracies depend on the support of organized interests. Both the 'corporatist' and pluralist approaches to interest group politics are premised on the idea that citizens influence policy by establishing and joining organizations that have an impact on the policy process. This happens either through pressure politics (pluralism) or through institutionalized participation in policy formulation and implementation (corporatism). The recent experience of the GIIPS countries suggests that interest groups can now choose between entering into agreements where they agree to concessions—the most recent example being the Portuguese agreement between UGT and government—or mobilizing members for fights that do not produce any concrete results.

Unsurprisingly, the level of trust in national governments as reported by opinion polls has dropped dramatically during the crisis: in May 2011, it was 16% in Greece; 42% in Ireland (up from 21% in June 2010); 24% in Italy; 20% in Portugal and 24% in Spain.²⁰ The democratic systems of the Southern European countries are experiencing a major loss of legitimacy and active support by citizens.

Developments at the European level do nothing to reduce the democratic deficit. On the contrary, the new fiscal treaty of the EU, which was agreed upon in March 2012 and is under ratification at the time of writing, arguably makes it worse. Countries are required to include in their constitutions a balanced budget rule which provides for automatic fiscal correction mechanisms if their structural deficit exceeds 0.5%. This extends and further tightens the provision of the previous Stability and Growth Pact. Once ratified, it will force member states to follow a rigid pro-cyclical policy. Furthermore, it dramatically reduces the discretion of national parliaments in the fiscal policy field, which is crucial for national democracy. Having lost monetary autonomy, the countries of the Eurozone will now lose considerable parts of their fiscal autonomy as well. This loss of discretion at the national level is not compensated by greater democratic accountability at the European level. Policy formation is left to self-executing rules and to institutions (like the European Commission) which have no democratic mandate.

The decision to create a common currency was never a purely economic decision but was strongly motivated by political considerations. There were many doubts about the economic wisdom of creating a currency union within a region that was not politically integrated and was far from being an optimal currency area with labour mobility and price and wage flexibility

²⁰ Calculated from http://ec.europa.eu/public_opinion/cf/index_en.cfm.

across regions. The main motivation behind the Euro was always political: it was hoped that it would drive the integration project towards political integration. However, the Euro is not bringing the peoples of Europe any closer to one another. On the contrary, it is producing not just deep divisions among European partners but also disenchantment and frustration towards European integration and national democratic institutions.

4. ALTERNATIVES TO INTERNAL DEVALUATION

Notwithstanding the disappointing results of the internal devaluation/austerity approach—so far it has not reduced interest rates on GIIPS debt, it has precipitated them in (often multi-year) recessions and has created problems of democratic legitimacy—numerous commentators and policymakers insist that there is no alternative to it.²¹ Yet there are alternatives. Clearly, there is no guarantee that they would work. That they are not even being seriously considered by European elites, let alone tried out, is due to a combination of path-dependent institutions, ideas and interests.

As argued in section 2 above, the best way to ensure debt sustainability would be for the GIIPS countries to return to high nominal growth as quickly as possible. Yet this is not the approach followed by the European policymaking elites. These focus solely on the primary surplus to be obtained preferably through lower public expenditures and, as a second best, through increased taxes. The problem with this approach is that imposing restrictive fiscal policies to a country already in recession may unleash a vicious cycle of consolidation followed by contraction, which requires further consolidation and so on.

The GIIPS countries cannot have resort to exchange-rate devaluation to reduce current account deficits, increased competitiveness and stimulate growth. Exiting the common currency would enable them to regain exchange-rate flexibility but would arguably have very high costs. One of the most formidable problems would be capital flight in anticipation of exit and of the subsequent devaluation of the new currency. Although countries are unlikely to make the autonomous choice to exit the Euro, they may be forced to leave if the recession deepens or if a popular backlash against austerity causes major political realignments in the countries concerned.

²¹For recent examples, see J. Weidmann, 'Rebalancing Europe', n 1 above; W. Schäuble, 'Why Austerity is Only Cure for the Eurozone', *Financial Times*, 5 September 2011; G. Rachman, 'No Alternative to Austerity', *Financial Times*, 30 April 2012; R. Rajan, 'The True Lessons of the Recession: The West Can't Borrow and Spend Its Way to Recovery' (2012) 91 *Foreign Affairs* 69.

Within the framework of the current Eurozone, returning to nominal growth is not impossible, but it would require the ECB to reconsider its strict anti-inflationary stance.²² If the ECB were to be more tolerant of inflation, it would continue with a policy of easy money for some time and even commit to it. This would raise inflation, and initially the rise would be higher in the core Eurozone countries, especially Germany, while it would be modest in the countries such as the GIIPS which are stagnating. This would be equivalent to a real appreciation of the core economies vis-à-vis the peripheral economies: the competitiveness gap would become smaller through this channel. In other words, the alternative to the 'internal devaluation' of the GIIPS countries currently being pursued would be an 'internal re-evaluation' of the core Euro countries.

A standard policy of easy money could not go very far in current conditions as it would be limited by nominal interest rates close to the zero lower bound.²³ The ECB's official interest rate is currently only 1% and so it cannot go much lower. Also, a lower official interest rate would do little to address the most pressing problem: the GIIPS countries' inability to finance themselves at acceptable interest rates in private bond markets. In these circumstances, the ECB would have to engage in 'quantitative easing' as well, namely expand the bank's balance sheet by buying sovereign debt of the GIIPS countries. By doing so, it would boost bond prices and lower interest rates in those countries. Such a policy would cause the interest rates on Italian and Spanish debt to fall. In December 2011, the ECB moved in this direction by launching a Long-Term Refinancing Operation: with it the ECB lent money to European banks for three years at 1% interest rate. Since the private banks used part of the money to buy government bonds, this contributed to reducing the pressure on the interest rates of Spanish and Italian bonds²⁴ but also increased the dependency of the GIIPS banking system on ECB financing and hence their vulnerability.²⁵

²²O. Blanchard, G. Dell'Ariccia, and M. Paolo, 'Rethinking Macroeconomic Policy', *IMF Staff Position Note*, SPN/10/03 (2010).

²³P. Krugman, 'It's Baaack: Japan's Slump and the Return of the Liquidity Trap', *Brookings Papers on Economic Activity*, 1998, 137–205; G. B. Eggertsson and P. Krugman, 'Debt, Deleveraging, and the Liquidity Trap: A Fisher-Minsky-Koo Approach' (2011), unpublished manuscript, on file with authors.

²⁴See http://www.nzz.ch/nachrichten/wirtschaft/aktuell/der_regenmacher_1.15284742.html (accessed 26 February 2012); <http://epaper.nzz.ch/nzz/forms/page.htm> (accessed 26 April 2012).

²⁵S. Merler and J. Pisani-Ferry, 'Sudden Stops in the Euro Area' (2012) *Bruegel Policy Contribution* 2012/06.

A more activist stance by the ECB is not the only option. An alternative would involve the introduction of 'Eurobonds' to be jointly guaranteed by Eurozone members, at least up a certain proportion of GDP for each member country. Yet another solution would involve strengthening the monetary 'firewall' erected progressively from 2010 on, in the form of the European Financial Stability Facility and its successor the European Stability Mechanism (ESM). For the firewall to be effective, markets would have to be convinced that it would have the capacity to prevent formal default not only of the small GIIPS states but also of Italy and Spain. This implies a massive increase of the financial guarantees committed by EU member countries.

All these proposals would mutualise (and hence reduce) the risks associated with GIIPS sovereign debt, thus lowering the interest rates demanded by bond markets. However, they would violate either the letter of the European Treaties or the shared understanding of how European institutions are supposed to operate. The ECB-as-lender-of-last-resort proposal conflicts with Article 123 of the Treaty on the Functioning of the EU, which prevents the ECB from directly purchasing government bonds. In addition, it would contradict the widely shared understanding that the ECB should in effect act as the German Bundesbank and only concern itself with price stability. The Eurobond proposal conflicts with Article 125 TFEU, which provides that member states shall not be liable for financial commitments assumed by other member states. Financial guarantees voluntarily provided by governments are not incompatible with the EU Treaties *per se*: treaty modifications were negotiated in late 2010 especially to provide the various stability mechanisms with a legal basis.²⁶ However, numerous countries vehemently oppose their extension. In addition, even if the ESM was strengthened further, the conditions under which governments could receive money from the fund would not change, and they would remain dependent on the implementation of strict austerity measures.

Thus, the argument that austerity and internal devaluation are the sole possible responses to the sovereign debt crisis rests on solid legal and institutional foundations. In addition, economic ideas and interests also play a role. With respect to the former, European elites seem to have embraced the so-called

²⁶The change agreed to Article 136 TFEU, which is designed to provide a legal basis to the European Stability Mechanism, was agreed at the European Council meeting of 16–17 December 2010, and is due to come into force in January 2013. The amendment was made under the simplified revision procedure set out in Art 48(6) TEU, which allows Treaty changes which do not involve an extension of the Union's competences to be agreed by the Council.

expansionary fiscal contraction doctrine,²⁷ that is, the idea that fiscal contraction has expansionary consequences through non-Keynesian channels such as the expectation of lower future taxes.²⁸ The problem with this doctrine is that the evidence supporting it is weak at best. Unsurprisingly, recent work by the IMF concludes that fiscal contractions are typically contractionary.²⁹

With regard to interests, the current policy approach—one in which the ECB does not compromise its independence and anti-inflationary stance, restrictive fiscal policies are further institutionalized by tightening fiscal rules, and countries are left to seek to regain market confidence through austerity policy—suits the interests of key Euro players well, particularly Germany. Over the last several decades, the German economy has been evolving in the direction of a neomercantilist model. Private consumption has been compressed and its contribution to growth has become negligible (see Figure 2). Instead, exports have become the main driver of growth, especially from the early 1990s on (see Figure 3). Although Germany is diversifying its exports towards China and the other BRICS, the 10 early members of the Eurozone plus Greece are still by far its main trading partners and account for about 40% of German exports and 35% of its imports. In other words, Germany owes much of its recent economic success to exports to the Eurozone. As an export-driven economy Germany has a strong interest in keeping intact a macroeconomic regime in which monetary and fiscal policies remain credibly conservative and is especially wary of fiscal lassitude, which would lead to real exchange-rate appreciation and would thus impair export competitiveness.³⁰

However, such a neomercantilist model of growth can work for one country (if it is not too big), perhaps a few, but by definition not all countries

²⁷F. Giavazzi and M. Pagano, 'Can Severe Fiscal Contractions Be Expansionary? Tales of Two Small European Countries', NBER Working Paper No 3372, 1990; A. Alesina and R. Perotti, 'The Welfare State and Competitiveness' (1997) 87 *American Economic Review* 921; A. Alesina and S. Ardagna, 'Tales of Fiscal Adjustments' (1998) 27 *Economic Policy* 489; A. Alesina and S. Ardagna, 'Large Changes in Fiscal Policy: Taxes Versus Spending', NBER Working Paper No 15438, 2009.

²⁸For textual evidence that the ECB subscribes to the expansionary fiscal contraction thesis, see J.-C. Trichet, 'Central Banking in Uncertain Times: Conviction and Responsibility' Symposium on *Macroeconomic Challenges: The Decade Ahead*, Jackson Hole, Wyoming, 27 August 2010.

²⁹IMF, 'Will It Hurt? Macroeconomic Effects of Fiscal Consolidation' in IMF (ed), *World Economic Outlook: Recovery, Risk, and Rebalancing* (Washington, DC: IMF); R. Perotti, 'The "Austerity Myth": Gain without Pain?', unpublished manuscript, Bocconi University (2011), on file with authors.

³⁰T. Iversen and D. Soskice, 'Modern Capitalism and the Advanced Nation State: Understanding the Causes of the Crisis' in N. Bermeo and J. Pontusson (eds), *Coping with Crisis: Government Responses to the Great Recession* (New York: Russell Sage, 2012).

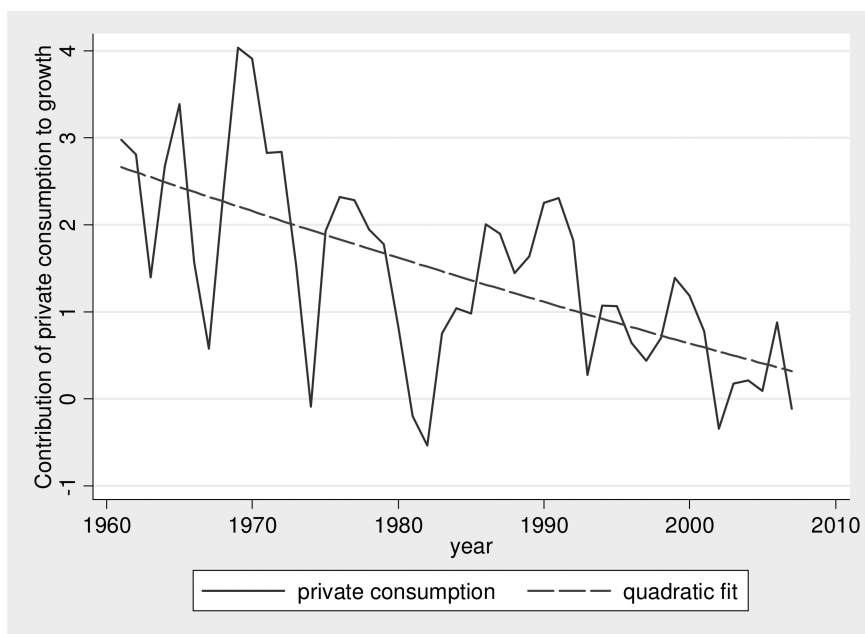


Figure 2. The Contribution of Private Consumption to Growth in Germany (1961–2007).

Source: AMECO Database. West Germany between 1961 and 1992. The contribution of private consumption to GDP growth is defined as the annual change in private consumption divided by GDP at constant prices of the previous year.

simultaneously. By systematically compressing real wage growth below productivity increases, Germany, the largest economy of the Eurozone, has for the past 10 years engaged in the equivalent of real exchange-rate devaluation which has created serious problems for its main trading partners. A decision to reverse this trend would help to assuage the economic imbalances of the peripheral countries. In addition it would contribute to redressing macroeconomic imbalances at the global level.

In the long run, the smooth functioning of the common currency requires coordinated wage bargaining policies which would enable productivity increases to feed into wage increases and through this channel into domestic demand. In the short run, there is space for German firms to pay their workers more and for the German government to engage in more expansionary fiscal policies. This strategy could be perceived to be in the best long-term interests of German actors. In fact, Germany would suffer considerably

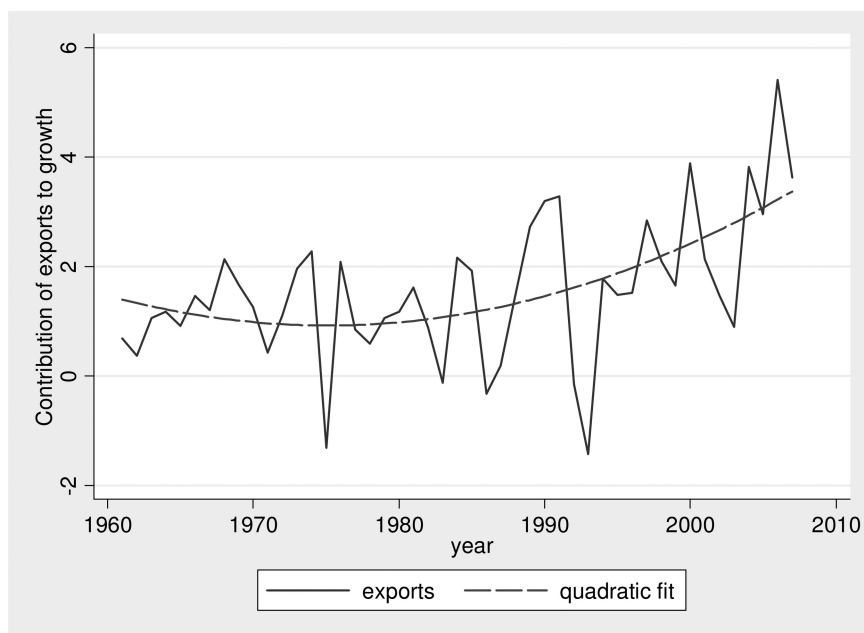


Figure 3. The Contribution of Exports to Growth in Germany (1961–2007).

Source: AMECO Database. West Germany between 1961 and 1992. The contribution of exports to GDP growth is defined as the annual change in exports divided by GDP at constant prices of the previous year.

from a break-up of the Euro. The new Deutsche Mark would appreciate and endanger the export industries.

However, given the risks of job losses in the export sector, the resistance of employers, the tepid support of the German unions and the firm stance of the current German government, the prospects for spontaneous German reflation are slim. Yet other countries like France do not have the institutional infrastructure needed for export³¹ and do not benefit from the status quo. It is surprising that they have been willing to go along with it so far. Electoral realignments in France and other countries may lead to attempts to renegotiate the macroeconomic framework and possibly to major changes in the economic ideology undergirding the Euro.

³¹D. Soskice, 'Divergent Production Regimes: Coordinated and Uncoordinated Market Economies in the 1980s and 1990s' in H. Kitschelt, P. Lange, G. Marks and J. D. Stephens (eds), *Continuity and Change in Contemporary Capitalism* (Cambridge: CUP, 1999); Hall and Soskice, 'Varieties of Capitalism, n 13 above'.

5. CONCLUDING REMARKS

This article has developed three interrelated arguments. First, the sovereign debt crisis is more complicated than a simple morality tale pitting fiscally responsible governments to fiscally profligate ones. While the argument about fiscal irresponsibility is not without merit, it is only applicable to Greece. In addition, the argument glosses over the role played by Germany and other core European countries in creating the interrelated macroeconomic imbalances that have led to the crisis. Ultimately these macroeconomic imbalances are the result of a political decision to create a currency union among economically non-homogenous countries without making provisions for the use of institutionalised fiscal transfers to correct asymmetric shocks. These institutionalised fiscal transfers need to be democratically legitimated. In other words, European citizens must authorise the transfers to structurally weak regions of Europe. For example, German citizens supported massive subsidies to the former German Democratic Republic after re-unification. The major difference is that in case of the German re-unification, there was at least a rudimentary feeling of national identity among citizens and elites. Without such a European identity, German capital and labour see no reason to sacrifice their competitive advantage, even if this may be self-defeating in the long run.

Second, we have argued that the internal devaluation policy being imposed on the GIIPS countries is ineffective. Internal devaluation depresses growth, and the absence of growth requires further austerity for governments to regain their fiscal credibility, thus generating a vicious cycle.

Third, the political repercussions of the internal devaluation policy are even more worrisome than the economic repercussions. While national governments and parliaments continue to be held responsible by citizens for their economic and social well-being, they have lost any meaningful ability to choose among alternative options. In all countries, they implement pretty much the same deeply unpopular, as well as ineffective, austerity package. Frustration and political alienation are running high. For the time being, they target discredited national political parties. However, if Europe continues to respond by offering stronger doses of the same, one cannot exclude the possibility that popular resentment will begin to be directed at European institutions as well. There are already signs that such a shift is happening. At that point, the collapse of the European project will become a realistic possibility.