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A Europe of Coercion and Compulsion?
The Sovereign Debt Crises in the Eurozone

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A mere ten years after its introduction, Economic and Monetary Union was rattled to its core by the large public deficits and faltering economies of some of its members. The severity of the economic downturns prompted some commentators to predict the end of EMU and indeed of the entire European integration project, arguing that the union could no longer sustain the strains imposed by the working mechanisms of the single currency. While the EU might be able to avert such a doomsday scenario, it is unquestionable that a policy which was trumpeted as a bold achievement went spectacułary wrong and caused hithero inconceivable hardship to millions of European citizens. The key issues surrounding these extraordinary developments are the following:

1. *How severe were the economic downturns and which states were most affected?.*
2. *Why did these crises develop?*
3. *To what extent did the working mechanisms of EMU contribute to these crises?*
4. *What were the responses by EU institutions to improve economic and fiancial conditions and were these successful?*
5. *What lies ahead for EMU and European integration?*
6. *Are there any braoder lessons for the overall European integration project?*

The Economic Downturn in the Eurozone

The sovereign debt crisis that shook the Eurozone affected in particular the so-called PIGS – Portugal, Ireland, Greece and Spain. The acronym became obsolete when Italy and Cyprus also suffered a massive contraction to their economies. By the end of 2011, the economic and financial situation in these countries indeed revealed a grim picture (see Table 17.1). Greece's public debt was a staggeringly high 165.3% of GDP, which was particularly dramatic when compared with the Eurozone's benchmark of 60% as set out in the Maastricht Treaty's Stability Pact. Furthermore, all affected countries had annual account deficits that violated the Stability Pact's guideline of 3%. Ireland's annual debt of 13.1% was the highest, although this figure was a marked improvement to the 32.4% for 2010, when the country was forced to bail out its entire banking sector. Turning to GDP growth, the figures were equally sobering. Greece's economy had contracted by 6.2%, having shrunk by 7.4% in the previous year. As to unemployment, the governments in Spain and Greece in particular had to confront the prospect of intensified social unrest, since a quarter of their populations (and up to half of their youth population) was out of work. These dramatic circumstances were exacerbated by international financial markets that were reluctant to lend money to these countries and only did so by charging punishing interest rates. While the governments of Germany and the UK had to pay a relatively modest 2% in order to refinance their debts, the figures for instance for Greece (31.0%) heavily undermined the chances of a coherent economic recovery (see Table 17.2). The money markets' lack of confidence however, affected the whole of the Eurozone. By May 2012, the credit rating agency Standard & Poors granted its triple A status only to four states: Finland, Germany, Luxembourg and the Netherlands. Just a couple of years previously, this accolade had been granted to all members of the single currency.

Table 17.1: Economic Downturn in EU: Selected Member States

Country	Debt 2011 (% of GDP)	Account deficit 2011 (% of GDP)	Growth Q1 2012 (% of GDP) *	Unemployment March 2012
Greece	165.3	9.1	-6.2	21.7
Portugal	107.8	4.2	-2.2	15.3
Ireland	108.2	13.1	1.0 **	14.5
Spain	68.5	8.5	-0.4	24.1
Italy	120.1	3.9	-1.3	9.8
EU 27	82.5	4.5	0.1	10.2
Germany	81.2	1.0	1.2	5.6
France	85.8	5.2	0.3	10.0
UK	85.7	8.3	0.0	8.2

* Figures in comparison with the first quarter of 2011
** Figures for fourth quarter of 2011
Source: Eurostat

Greece: The New Sick Man of Europe

The attribute of Europe's sick man had originally been given to the United Kingdom in the 1970s. Some forty years later, Greece proved to be a worthy successor to this title. Prior to the introduction of the Euro, the country had become accustomed to high inflation (for instance eleven per cent in 1994) and a currency – the drachma – to which international investors hardly flocked to. With the introduction of the Euro in 2001 (two years after the currency was originally launched), interest rates fell to below two per cent. Greeks for the first time had the benefit of a stable and solid currency. Unfortunately, the country used this new found stability to fund wage growth rather than pay off its existing debt. Salaries in the public sector sky rocketed and nearly doubled within ten years. During the same time, 75,000 additional civil service jobs were created, whilst pensions in the public sector rose to an incredibly generous ninety-two per cent of pre-retirement salary rates. This spending spree could only be described as madness with an irresponsible political class using financial hand-outs to win over the electorate. These generous gifts stood in marked contrast to the performance of the Greek economy. The country was known for its rather reluctant tax payers and successive governments lost about thirty billion Euro each year because of uncollected tax receipts. Although the country had the second longest working hours amongst OECD countries (with 2,120 hours per year only trailing South Korea), productivity

was well below European standards. On top of this, Greeks enjoyed very early retirement levels, since it released its work force at an average age of 61.4 years.

Clearly, Greece had an unsustainable economic model. The country simply spent more than it earned, resulting in steadily growing public debt levels, which by 2009 had hit 127% – more than double the benchmarks of the Eurozone's Stability Pact. Add blatant corruption to the mix - for instance in the assignment of lucrative EU funded projects - and the spiralling debt caused by staging the Athens Olympics in 2004, it became evident that Greece was heading for a disaster. It was down to the newly elected Socialist government of George Papandreou to confront Greeks with the shocking yet unavoidable truth: only the combination of radical spending cuts and tax rises could save the country from financial collapse. In December 2009 and two months after assuming office, Papandreou admitted that previous Greek governments had 'cooked the books' and had presented falsified figures in order to gain entry into the Eurozone in the first place and to avoid potential fines from the EU in the subsequent years of Euro membership. It came as little surprise that Papandreou's disclosure was met with disbelief – both in Europe and in Greece itself, and his imposed tax rises and spending cuts resulted in widespread social unrest, often violent demonstrations and general strikes.

Table 17.2. Ten Year Bond Yield, November 2011 (in per cent)

Greece	31.00
Ireland	8.21
Portugal	14.01
Spain	6.67
Italy	7.04
Germany	2.04
France	3.68
UK	2.13

Source: Bloomberg

In March 2010 and with the international financial markets becoming ever more concerned about the growing possibility that the country might not be able to meet its financial commitments, Papandreou announced an austerity package. Being a member of the Eurozone, such speculation started to have an overall effect on the reputation of

the single currency. The pivotal figure was German chancellor Angela Merkel, who wanted to delay an EU response until the time after regional elections were held in the German state of North Rhine Westphalia. Merkel and other European leaders rightfully calculated that any rescue package for Greece was hugely unpopular amongst their citizens who argued that they should not foot the bill for excessive Greek spending patterns. Alas, international markets were becoming ever more jittery and in April 2010 – and just a week before the elections (which her party incidentally lost) – Merkel under pressure from French President Nicolas Sarkozy agreed to a 30 bn € rescue package, accompanied by widespread tax increases and spending cuts.[i]

By spring 2011, Papandreou had failed to reduce the rapidly accumulating public debt. Ever since his announcement in December 2009, social unrest had intensified, exacerbated by powerful unions that organised two general strikes. In a desperate attempt to reschedule some of its debt, Greece issued a two-year bond which traded at an astonishing rate of 23.6%. But the government could do little about the key design flaw of EMU. Membership of the Eurozone automatically eliminated the option to devaluate a country's currency. Hence, Greece did not have a short cut for dealing with its debt, or a path to regain, at least temporarily, competitiveness by offering its goods cheaper on the international markets. A devastating conclusion was starting to emerge: Given the economic parameters that the country was finding itself in, where could growth (and consequently an economic recovery) have come from?

The EU responded to the deteriorating situation by making even more funds available. In July 2011, the initial 30 bn € rescue was enlarged to a staggering 109 bn € (see Table 17.3). Apart from this cash injection, private banks were asked to write off 21% of the credit they had given to Greece. A longer time frame and lower interest rates to pay off debt had already been agreed in March 2011. This deal, at least in the short run, prevented the country from defaulting on its 350 bn € debt burden. On the other hand, analysts quickly pointed to a number of shortcomings. First, the so-called 'hair cut' of 21% by private banks was only on a voluntary basis. While 90% of creditors signed up to the deal (including Deutsche Bank, HBSC, BNP Paribas, Allianz and Axa) others, including Unicredit, Credit Agricole and the Royal Bank of Scotland did not. There was also uncertainty over hedge funds and their willingness to write off such substantial debts. In any case, the package did not address the underlying malaise of the Greek economy, and the question remained how the country would be able to raise productivity levels and gain competitiveness.

Table 17.3. Time Line of the Debt Crisis in Greece

October 2009	Prime minister George Papandreou reveals extend of crisis; Budget deficit is 15.4% of GDP; public debt is 126.8% of GDP
May 2010	EU and IMF organise first rescue package of 30 bn € in return for tax rises and spending cuts
July 2011	Bailout package increased from 30 to 109 bn €
November 2011	Papandreou resigns Unelected care taker government under Lucas Papademos
February 2012	Private creditors write off 100 bn € 48 bn € recapitalisation package Second bailout package of 130 bn €
June 2012	New centrist coalition government under Antonis Samaras
January 2015	Alexis Tsipras elected as new prime minister
July 2015	Referendum rejects bail-out conditions Third bailout package of 86 bn €
July 2017	Return to international money markets selling 5-year bonds
April 2018	Budget surplus of 4.2% of GDP (excluding interest on debt)
June 2018	EU extends maturities on 100 bn € of debt by 10 years Greece promises to maintain budget surplus of 3.5% of GDP until 2022, then 2.2% of GDP until 2060
August 2018	Greece exists from bailout programme

The July agreement therefore only provided the EU with some momentary breathing space, and it was not before long, when another emergency summit had to be called to appease financial markets, which continued to charge unsustainably high interest rates on Greece's government bonds. In October 2011, EU leaders agreed on yet another Euro rescue which consisted of a voluntary write down of 50% of the country's debt. In an attempt to add a popular mandate to his negotiations with the EU, Papandreou announced a referendum on the conditions of the bailout; a move which was met with fury by Merkel and Sarkozy who threatened to stall the next tranche of rescue money.[ii] In the end, and amidst growing political unrest, the beleaguered prime minister resigned and a care taker government of technocrats under Lukas Papademos (a former Vice President of the European Central Bank) was put in place in November 2011.

But despite the unprecedented financial support, there was no sign of Greece turning the corner. By the beginning of 2012, the country found itself in its fifth successive year of recession. Economic output in 2011 had fallen by 6.8% in comparison with the previous year. The GDP drop in the last quarter of 2011 ran to 7%. It became ever more apparent, that Greece needed yet another rescue and EU leaders agreed in February 2012 to the second bail out – this time even higher with 130 bn €.[iii] It was not until June

of that year, when a democratically elected government was once more put in place. The established political forces under new prime minister Antonis Samaras from the centrist New Democracy party formed a coalition with the social-democratic PASOK party. But by June 2015, the widespread public resentment and outright despair over the severe austerity measures of the bailout packages brought to power the populist left wing party *Syriza* under Alexis Tsipras.

In the meantime, a series of rescue measures kept the country afloat. The numbers were staggering, turning Greece into the country that received the highest financial assistance in history. Throughout the crisis, a total of 300 bn € was committed by international organisations, out of which 260 bn € was taken up by successive Greek governments. It is worth noting though, that most of that money was instantly handed back to creditors in the form of debt repayments and thus did not represent a liquidity injection into the Greek economy. The often-reckless lending by northern European banks that poured speculative cash into Greece was therefore left largely unpunished. In return, the so-called troika of International Monetary Fund (IMF), the European Central Bank and the European Commission took control of the country's public finances and imposed a harsh regime of ever-increasing tax rises and budget cuts, whilst also attempting to privatise or sell off any remaining assets that the state might have had.

Greek citizens expressed their discontent with austerity through regular public demonstrations but also most notably in a referendum on the terms of the third bailout package which was called by Tsipras in July 2015. German Chancellor Angela Merkel in particular was heavily criticised, even demonised by Greece for her single-minded adherence to the neo-liberal principles of deficit reduction and balanced budgets which ultimately only could have been achieved through a privatisation of the country's economy and drastic reductions to the standards of living of the population. References to the war time occupation by Nazi Germany became ubiquitous with the EU being widely regarded as a capitalist plot designed to exploit ordinary people. But Merkel and the EU did not budge one inch. Germany even threatened to suspend Greek membership from the euro on a temporary basis, if the country refused to accept the bailout's terms. A couple of weeks later and with the tail between its legs, the Greek parliament ratified the highly controversial package (see Table 17.4). As a result, the country had to hand over 50bn € of public assets (such as ports, banks or airports) to a privatisation fund.[iv] Half the fund was used to recapitalise Greek banks with the other half earmarked to

repay public debt. In addition, tax rises and spending cuts were superimposed. Commentators referred to the establishment of an economic protectorate and a debt colony with all key financial and economic decisions now taken by the troika, and thus by unelected, foreign officials.[v]

Table 17. 4. Terms of the Third Bailout Package of July 2015.

Size	85 bn €
Transfer of assets	Up to 50 Bn € of assets to be transferred to a privatisation fund; assets include government-owned airports and other infrastructure, banks, as well as utilities
Pensions	Retirement age up to 67.
Sales and other taxes	Sales tax discount of 30% given to Greek islands to be removed; sales tax bands to be streamlined to bring more goods onto the 23% band.
Budget	Automatic spending cuts if annual budget is not balanced. Instant payment of 7 bn € by August 2015 before bailout cash can be handed out.
Reforms	Ambitious market reforms, including Sunday trading laws, the opening-up of professions, the privatisation of the energy sector, as well as a new tax system that demands higher contributions from the Greek oligarchy

But Greece was ill-prepared to steer the negotiations into a different direction. In the run-up to the finalisation of the package, Tsipras ought to have drafted a coherent alternative. With more fiscal flexibility, he could have raised wages in the public sector, slow down the pace to job cuts, and maybe even raise pensions to boost consumer spending and thus economic growth. Roping in wealthy Greek oligarchs into a more just tax system also would have been highly beneficial to such an economic recovery. The country could have pleaded with the EU over a different path on how to repay its debt. Instead of a flat-sum schedule, lowering public debt could have been achieved on a proportional basis, for instance as a percentage of export revenues. Such an approach would have been in the interest of EU creditors: the more the country prospers, the more debt would be repaid.[vi] In this way, Tsipras would have been able to implement

Keynesian reforms that were in line with the economic philosophy that had catapulted him into power half a year earlier.

It is speculative to argue whether a plan B would have broken fierce German resistance, but the absence of an alternative to austerity gave a glimpse of the power relations that underlined the negotiations at the European summit. In one corner was Tsipras, the new kid on the block, Greece's first ever far-left leader, representing a country whose reckless financial behaviour brought EMU - which after all represented the showpiece of European integration - on the brink of collapse. In the other corner was the EU establishment, led by the economic powerhouse of the continent, Germany and its long-serving chancellor Angela Merkel. It was no contest. A couple of weeks later and despite heavy opposition from within his own party, Tsipras agreed to the troika-imposed bitter medicine in order to receive further bailout money that safeguarded his country's liquidity. In the process, social democratic economics which after all had brought Tsipras to power was cast aside, poignantly illustrated by his dismissal of the outspoken and radical finance minister Yanis Varoufakis. It was as if Keynesian economic philosophy – the belief that to cut spending and to raise taxes during a recession are counterproductive since such measures reduce demand and thus worsen a recession – had never existed.

By 2018 Greece had turned a financial corner (see Table 17.5.) and reported its first budget surplus since 2007. It prompted EMU Commissioner Pierre Moscovici to declare Greece as 'a normal country in the eurozone'. But eight years of economic and financial drama left deep scars. Austerity pushed the country into a long-lasting recession and stifled economic growth. At the outset of the crises, Greece had debt levels of around 120% of GDP (double of what was permitted under the Stability Pact of the Maastricht Treaty). By 2018 that figure had risen to 180%. Welfare payments were slashed by a devasting 70%. Wages shrank by a fifth since the start of the crisis. The public sector shrank by a fourth. At one stage, unemployment rose to an eye-watering 27% with youth unemployment (those aged 25 and under) climbing over 50%. In a country of 10 million people, one million had lost their job. In 2015, levels of extreme poverty affected 15% of the population. In comparison to pre-crisis levels, the economy had shrunk by a quarter. Those with a chance to emigrate did precisely that, in particular the young and the most educated, resulting in a devastating brain drain. In 2010, the country was already bankrupt. But creditors pretended that Greece represented merely a cash flow problem, when what was required was a massive

restructuring and partial write-off of its colossal public debt. [vii] But such a move was simply never on the cards for fear of the potentially disastrous consequences for the balance sheets of creditors, most notably banks in France, Italy and Germany. The result was the implosion of the Greek economy and a society that was left traumatised. Many countries have historical crack-up moments: the winter of discontent in the UK in 1978-9. America's stock market crash of 1929, Germany's hyperinflations of 1923 and 1929. This was Greece's moment of national humiliation that could forever be imprinted on the public psyche.

The Greek crisis also had widespread ramifications for the European project. The treatment of Athens was unrelenting and brought the economy on its knees. In the attempt to discipline a fellow Eurozone member, the EU, led by Merkel and her finance minister Wolfgang Schäuble dismissed the public will of Greek citizens as expressed in the referendum on the bailout conditions. It also dismissed the economic philosophy of the ruling *Syriza* party, as if the political will of the Greek people was a mere inconvenience. Instead, and austerity was entrenched in the country for years to come. Casting aside democracy in such a fashion never bodes well for a union that is often criticised for being elitist and detached from its citizens. But the deal was not only about Greece. EU governments also had to pay reference to the will of their own voters. And any financial support for Greece was highly controversial, not only in Germany, but also in countries like Slovakia or the Baltic states, whose welfare systems were substantially less generous but whose tax payers now had to foot the bill of the perceived Greek decadence of years gone by. Resentment, frustration and anger were not only felt in the streets of Athens. It was felt across Europe, but for different reasons.

The governments and the media in northern Europe were very harsh in their assessment of Greece, its governments and its people, and there was little sympathy that years of living beyond one's means, of financial frivolity had come to a crushing end. There is some truth to this point of view. Greek voters had lapped up the lavish promises of their political leaders which were simply economic fantasy. But the sacrifices that the country had endured since 2010 deserve much recognition. Against the harsh social climate, growing poverty levels, mass unemployment, in particular amongst the young, it seems a miracle that the Greek state survived at all and that a democratic system prevailed and resisted any electoral temptations for instance by the fascist Golden Dawn movement. And lest not forget that throughout this time,

thousands of refugees mainly escaping the civil was in Syria arrived on Greek shores; a humanitarian crisis and financial challenge that spared EU countries further north.

But austerity is not finished. The deal of July 2018 between the troika and Greece committed the country to budget surpluses of 3.5% of GDP until 2022, and 2.2% of GDP until 2060; nearly two generations from now. Further budget cuts worth 1.8 bn € were implemented in January 2019. In an economy blighted by low productivity and innovation one can safely assume that spending on welfare will be kept in check for a long time to come. Yes, an economic and financial Armageddon had been averted but at what price to social cohesion? Despite the positive developments of 2018, a potential return of the economic crisis and with it a threat to the livelihoods of normal people cannot be discounted.

Table 17.5 Economic and Financial Data in Greece 2011 – 2017

	GDP Growth (%age change from previous year)	Unemployment (%age)	Annual Deficit (%age of GDP)	Government Debt (%age of GDP)
2011	-9.1	17.9	- 9.1	172.1
2012	-7.3	24.5	- 8.9	159.6
2013	-3.2	27.5	-13.2	177.4
2014	0.7	26.5	- 3.6	178.9
2015	-0.4	24.9	- 5.6	175.9
2016	-0.2	23.6	0.5	178.5
2017	1.5	21.5	0.8	176.1

Source: Eurostat

Italy: The End of Dolce Vita

Massive public debt had been a fixture of Italy's public finances for a long time; at least since the expansion of the welfare state from the 1970s onward. Unlike most of its partners, in the first years of the Euro, Italy was one of the few countries that did not experience a boom, and per capita income stayed flat during the last twenty years. Lack of reforms to a stifling economic structure were not implemented, which left the country utterly unprepared when the collapse of Lehmann Brothers in 2008 signalled the start of the global financial crisis. By 2011, prime minister's Berlusconi's inability to

implement much needed reforms to support Italy's competitiveness within the EU's Single Market resulted in a sudden loss of confidence by the international financial community. Some structural economic characteristics were simply appalling: a vast black market accounting for around 20% of the country's economic activity; endemic corruption which meant that goods and services sold to the public sector were subject to 'side payments' that were siphoned off by the political establishment; widespread tax evasion to which successive governments turned a blind eye; poor school and university systems with a sub-standard research output; a web of vested interest groups and closed professions, which severely undermined innovation.

In the end, it was of considerable irony that the markets imposed ever higher interest rates on Berlusconi which ultimately led to his downfall caused by an industry which he once had assumed to be a master of. In the run up to an EU summit in October 2011, Berlusconi received a firm demand from other Eurozone leaders to commit to firm spending cuts and other austerity measures. The Italian government responded with a 'letter of intent'. In a press conference, Merkel and Sarkozy were asked about the likelihood of Italy being able to stick to its promises. Both leaders were only able to muster an embarrassed smirk. In the following days it became ever clearer that Berlusconi had lost the support of his coalition partners. Given his devastatingly poor record and economic policies that shamelessly benefitted his personal business interests, it was with great relief amongst investors and EU leaders, that Berlusconi resigned in November 2011 to be replaced by yet another un-elected government of technocrats, led by the highly respected former EU commissioner Mario Monti.

Monti instantly introduced austerity measures to calm financial markets. Tax rises, modest reforms to the pension system and the labour market were also implemented, and the country – at least temporarily – returned to some degree of stability. Monti's centre-right coalition contested the parliamentary elections in February 2013, only to be replaced by a grand collation under Enrico Letta who himself was succeeded barely a year later by the moderate left winger Matteo Renzi in February 2014. For what seems as an eternity in Italian politics, Renzi held on to office for 34 months backed by a coalition of centrist parties. His tenure as prime minister was cut short by losing a referendum on electoral reform[viii] which prompted him to resign. His foreign minister Paolo Gentiloni stepped in, but in June 2018 he too was swept aside by an electoral storm which brought to power a coalition of the populist Five Star

Movement under prime minister Guiseppe Conti and the right-wing *Lega* fronted by the interior minister Matteo Salvini.

Table 17.6. Time Line of the Eurozone crisis

June 2009	ECB's liquidity injection of 442 bn €
April 2010	EU bailouts for Greece begin with initial 30 bn €
May 2010	EU and IMF establish European Financial Stability Fund (EFSF): 750 bn €
November 2010	Bail out for Ireland: 85 bn €
December 2010	European Stability Mechanism (ESM) established
March 2011	Intergovernmental Euro Plus Pact
May 2011	Bail out for Portugal: 78 bn €
July 2011	Bail out for Greece raised from 30 to 109 bn €
Oct 2011	Euro Rescue Deal
November 2011	Italian prime minister Silvio Berlusconi resigns
December 2011	ECB's offers cheap three-year loans worth 489 bn €
January 2012	Intergovernmental fiscal compact
February 2012	ECB's offers cheap three-year loans worth 529 bn €
February 2012	Second bail out for Greece: 130 bn €
June 2012	Bailout to rescue Spanish Banks: 100 bn €
June 2012	EU leaders agree to set up a supervisory system for Eurozone banks
March 2013	Cyprus starts bailout package of 10 bn €
December 2013	Ireland graduates from its bailout programme
January 2014	Spain exits bailout programme
May 2014	Portugal exits bailout programme
July 2015	Third bailout package for Greece of 86 bn €
March 2016	Cyprus bailout programme ends
June 2018	New coalition government in Italy with Matteo Salvini is interior minister

Salvini in particular shook the foundations of European Integration. He regarded himself as a friend of Russia's autocratic President Vladimir Putin and his speeches were peppered with admiring references to Italy's fascist dictator Benito Mussolini. He blamed Economic and Monetary Union and the German government under Angela Merkel for the country's economic malaise, which was often complemented by an inflammatory rhetoric against refugees and migrants. As troublesome as the case of Greece was for the EU, Italy assumed a different dimension altogether and a worst-case scenario potentially could have had hazardous consequences for European integration. The country is the world's eighth biggest economy (and number three amongst Eurozone countries after France and Germany). What if Salvini and Conti had kept their electoral promises to abandon austerity and to increase public spending, thereby effectively reneging on the EMU's Stability Pact?

The European Central Bank would then have found it legally impossible to continue to buy up Italian bonds. Financial markets would have been ever more reluctant to lend the country money. Bond yields would have risen, making the government insolvent. The country then would have little choice but to ask to be bailed out by the European Stability Mechanism. The troika would then take over the finance ministry in Rome. Apart from public outrage and potential civic unrest, Italy's colossal public debt of 2.3 bn € Euro would push the troika to the edge of its financial capabilities, as the country would simply be too big to be rescued. This horror scenario would have resulted in the ultimate failure of politics; of a union where fiscal rules and legal commitments were thrown out the window by a member digging its own grave, eventually resulting in state failure. A financial collapse of Italy almost certainly would have led to the collapse of the Euro in itself.

Cyprus: bailing in before being bailed out

The first signs of a financial crash emerged on the small eastern Mediterranean island in 2012. In January of that year, Russia had come to the country's temporary rescue with a loan facility of 2.5 bn €. In November, the government announced that it would need up to 17 bn € to keep the country afloat, and negotiations with the troika over yet another bailout commenced. The island was a tax haven which allowed global investors, predominantly from Russia to deposit money without too many questions being asked. It represented a convenient way to launder money into the Eurozone. At one stage, the banking system had assets equivalent to eight times the country's GDP. But Cyprus's banks had also offered sizeable loans to Greece. With the financial meltdown of that country, and with little revenue coming from its citizens who enjoyed ultra-low taxes, the economic model became fragile and ultimately unsustainable.

By March 2013 financial panic ensued. The Cyprus government was just weeks away from running out of money. In a radical departure from previous crisis management, the troika demanded a 'bail in', whereas the government had to come up with 5.8 bn € before a bailout of 10 bn € could be granted. This prompted president Nicos Anastasiades to propose a 6.75% tax on all bank deposits below 100.000 € and a

9.9% levy of investments above that sum. Such a move would have mitigated the impact on affluent investors, most notably wealthy Russians who had deposited around 20 bn € on the island. But in return the deal would have represented a massive financial blow to ordinary citizens. Not surprisingly, the Cypriot public was outraged, and widespread protests ensued. People rushed to banks and cash machines to get as much money out before the legislation might come into force. Banks subsequently were forced to close and a minimum cash withdrawal of 100 € per day was imposed. But Anastasiades failed to get his package through parliament. A desperate attempt to reach out to Moscow for further financial support also failed. The European Central Bank added pressure to the negotiations, threatening to switch off liquidity to Cyprus's banks if a deal was not concluded.

The government ultimately backed down and reached an agreement with the troika on a series of measures. The struggling *Laiki* bank was closed and the island's biggest commercial bank, the Bank of Cyprus restructured. Deposits over 100,000 € were subject to an eye-watering haircut of up to 80% in order to raise 5.8 bn € for the 'bail in', although less-affluent investors saw their assets untouched. Usual austerity measures, such as tax rises and spending cuts completed the package.[ix]. In the end, Cyprus needed only 7.25 of the earmarked 10 bn € and returned to growth in 2015. Two years later, the country seemed stable. The re-orientation of the economy towards tourism (the island is a year-round destination for sun-seekers), shipping, construction and business services, such as consulting or accounting paid surprising dividends. As shown in Table 17.7. in 2017 the economy grew by an impressive 4.2%, and the country ran a budget surplus of 1.8% of GDP. Critics of the rescue plan who predicted an economic meltdown were also silenced. The overall debt - though high at 107% of GDP - was nowhere near the catastrophic levels of Greece, while unemployment levels remained steady at just over 11% which was in line with Italy but less than the figures for Spain (17.2%) or Greece (21.5%).

The Cyprus deal was the first bailout package to hit savers and represented a marked departure from previous models applied in Greece, Portugal, Ireland and Spain, where liquidity was offered by the troika in return for austerity measures and sustainable public finances. In Cyprus, the government first had to apply tax rises and spending cuts before the financial life line arrived. This left a lasting impression since in any future bailouts, privately held bank accounts could now form part of the equation. The Dutch finance minister Jeroen Dijsselbloem, chair of the so-called Eurozone group

of EU members who had adopted the single currency, admitted that the Cyprus rescue was ‘pushing back the risks’. Referring to the struggles of Cyprus’s two biggest banks *Laiki* and Bank of Cyprus, he argued: ‘If the bank can’t do it, then we’ll talk to the shareholders and the bondholders, we’ll ask them to contribute in recapitalising the bank, and if necessary, the uninsured deposit holders.’[x]

Dijsselbloem certainly made a valid point, arguing that it would be unfair to European tax payers to continue to pick up the tap for bank losses. But Cyprus’s economic model certainly played a prominent role in the thinking of the Eurozone countries, but also within the IMF and the Commission. For years, the island was a persistent thorn in the eye of its European partners. Allowing laundered cash to enter the EU might have been highly lucrative for Cyprus, but it also enhanced the geostrategic position of Russia and thus was not welcome by most member states. The bail in/ bail out nature of the package fundamentally undermined that status. Cyprus had built a reputation based on confidence in its banking sector. That confidence was now obsolete and shred to pieces. It represented a fatal blow to the country’s status as a low regulation and low-tax haven. Even more so than in Greece, this was policy making by coercion. It did the financial trick: the Eurozone was kept intact, and a rogue state had come to heel. But the Cyprus saga also provided ample evidence of a divided union where prosperous northern European states under the leadership of Germany, EU institutions such as the European Central Bank and the Commission as well as the IMF are able and willing to shape a country’s economic and financial structures. It is too early to determine whether Cyprus represents a special case, or indeed a new template. To reach an answer to this question, a new financial crisis of an EU member needs to occur.

The Sovereign Debt Crises in Spain, Ireland and Portugal

Unlike Greece and Italy, Spain, Ireland and Portugal have seen a relatively swift return to growth and more stable finances. Yet, the reasons behind the downfall of so many of the Eurozone’s economies were startlingly similar. Across the region, the arrival of the Euro resulted in low interest rates and a stable currency which prompted an economically hyperactive spending and consumer boom.

In *Spain*, greedy banks handed out ever cheaper mortgages. At one stage the Spanish construction industry accounted for a quarter of the country's GDP, and was counting on the illusion, that an ever increasing number of foreigners and affluent Spaniards would snap up more and more holiday and retirement homes. With the sub-prime mortgage crisis of 2008 and 2009, this economic model proved to be short sighted and foolish. In 2012, one out of five Spanish workers were without a job, and in a country of forty million, one million families had no steady source of income. Gradually a tale of corruption and mismanagement emerged. Banking executives received multi-million pay-outs just prior to the collapse of their banks. Board members - often politically driven appointees - admitted that they did not possess the necessary skills to read balance sheets. In the case of the *Caja de Ahorros del Mediterraneo* (CAM) board members, senior executives and their families were granted loans of 161 million € during a six-year period. The board of CAM included a sociologist, a check-out worker, a dance teacher, an artist and a psychologist, which did not suggest an abundance of accounting financial, or legal expertise.[xi] Not surprisingly, the government of Socialist Prime Minister José Luis Rodríguez Zapatero experienced an electoral melt down. In November 2011, Zapatero was replaced by the conservative Mariano Rajoy who like Papandreou in Greece embarked on a brutal austerity course, in order the cut the public deficit to 3% by 2013.[xii]

The conundrum for Spain was similar to that of Greece: where could growth have come from? The country suffered from extremely high unemployment which prompted widespread social unrest. Furthermore, Spain's banks were shackled by the excesses of the previous property boom with balance sheets that were full of properties that no one wanted to buy. The markets reacted accordingly. Bond yields rose steadily to over 7%, a rate widely regarded as unsustainable. The Spanish bailout of 100 bn € to shore up the country's financial sector therefore did not take the EU by surprise.[xiii] By 2014, austerity had done what it set out to do: public finances were balanced and after years of a contracting economy, growth returned, averaging round 3% between 2015 and 2017. But healthier public finances were achieved though declining real wages and unemployment remains a worrying and widespread phenomenon. Yes, in 2017, the figure had dropped to 17.2 (see Table 17.7.) but for young people the future remained grim with just under half of workers under the age of 25 without a job (see Table 17.8.).

Table 17.7. Financial and Economic Data in Crisis-Hit EU Countries 2012 and 2017

	GDP Growth (%age change from previous year)		Unemployment (%age)		Annual Deficit (%age of GDP)		Government Debt (%age of GDP)	
	2012	2017	2012	2017	2012	2017	2012	2017
Cyprus	-2.9	4.2	11.2	11.1	- 5.6	1.8	80.1	107.1
Ireland	0.2	7.2	14.5	6.7	- 8.1	-0.2	119.9	68.4
Italy	-2.8	1.6	9.8	11.2	- 2.9	-2.4	123.4	131.2
Portugal	-4.0	2.8	15.3	9.0	- 5.7	-3.0	126.2	124.8
Spain	-2.9	3.0	24.1	17.2	-10.5	-3.1	85.7	98.1
Germany	0.5	2.2	5.6	3.8	0.0	1.0	79.9	63.9
EU average	-0.4	2.4	10.2	7.6	- 4.3	-1.0	83.8	81.6

Source: Eurostat.

In *Ireland*, it was once again banks, working cosily in tandem with the political establishment and the construction industry, that failed to read the signs on the wall and foolishly believed in a never-ending economic miracle fuelled by low Eurozone interest rates. At the prime of the property boom, Dublin had become Europe's most expensive city. Irish people were now paying the price for this megalomania. In November 2010, the EU bailed out this small country of some 4.5 million people to the tune of 85 bn € (at an interest rate of 5.8%); 35 bn of which was spent on recapitalising failing banks, ten billion was needed to pay for on-going commitments, while 40 bn was set aside to keep the country afloat for the next three years. In the meantime, the government had embarked on massive spending cuts (a notable 18% pay cut for civil servants) and tax rises, with the aim of bringing the annual public deficit which ran at 13% at the end of 2011 in line with the Stability Pact’s target of 3%. Three years on, in 2013 Ireland told the IMF that its help was no longer needed.

Before the crisis, Ireland had a much-admired economic model by establishing a knowledge-based economy that attracted multi-nationals because of the country’s rock-bottom corporate tax rate, which at 12.5% is one of the lowest across Europe. Once the banking system was liquid once more and sustainable public finances were restored, the country was able to simply tap into the successful formula of pre-crisis times. But a return to growth came at a harsh price. Although unemployment levels dipped below 7% in 2017 (see Table 17.7), this was not achieved by establishing more

jobs, but instead through wide-spread emigration of young workers. The Irish public was reminded of an almost-forgotten time prior to the establishment of the Celtic tiger economy at the turn of the century, when financial security was often only achieved by sending family members abroad.

Table 17.8 Youth Unemployment in Crisis-Hit EU countries 2007 and 2017

	2007	2017
Greece	22.7	47.3
Spain	18.1	44.4
Italy	20.4	37.8
Cyprus	10.2	29.1
Portugal	21.4	28.2
Germany	11.8	7.1
EU Average	15.8	16.8

Unemployment of people aged 15 to 24
Source: Eurostat

In *Portugal*, a laggard economy which had already found it difficult to compete within the Eurozone and the Single Market was further exposed by the credit crunch. The EU came to the rescue in May 2011 with a package of 78 bn € (at an interest rate of between 5.5% and 6%) and demands for widespread privatization. Portugal too turned a corner and exited the bailout programme exactly three years later in May 2014. At first glance, financial and economic figures looked promising. As seen in Table 17.7. by 2017 healthy growth returned, unemployment dipped to below 10%, and even the annual budget deficit for once did not breach the rules of Maastricht's Stability Pact. The high overall debt levels, however remained a concern and could potentially affect the public finances in the future in case a loss in market confidence results once more in higher bond yields.

All three countries had mastered the crisis to a more or lesser extent, but except for Ireland, describing these economies as healthy might be a step too far. Still, any of

these countries leaving the Eurozone or bringing the single currency to its knees are prospects that are far from likely. The crucial difference to Greece was the structural cause that started the crisis. Spain, Ireland and Portugal had excessive housing booms, fuelled by banks that could have done with more regulation and supervision, if not more financial prudence and restraint when lending to customers. Although house prices in Greece also increased, it was the country's unsustainable public finances and irresponsible wage and salary growth, that descended into financial chaos. The absence of these in Spain, Ireland and Portugal explained the relatively short-lived nature of the bailout programmes, and why the stabilisation of Greece lasted that much longer.

EU Responses to the Crises

The credit crunch of 2008 and 2009 - which after all was caused by a massive contraction of the world's banking system - already forced European leaders to reconfigure economic and monetary institutions even before the extent of the Greek malaise became known. As such, at the March 2009 summit, EU leaders discussed new mechanisms to regulate and supervise the financial sector. Credit agencies, solvency of insurance companies, capital requirements for banks and cross-border payments, and electronic money were high on the agenda. More important than these discussions, however, was the establishment of a High Level Group on Financial Supervision under the chairmanship of the former French central banker Jacques de Larosière. At the end of their deliberations, the group advocated the establishment of a European Systems Risk Council (ESRC), an early-warning unit that operates under the guideline of the ECB and all EU countries as members.[xiv]

The Larosière plan would have resulted in a supranational setup that would not only have offered advice and guidelines but would also have formed a coherent supervisory body with direct powers to regulate the banking and insurance sectors of the member states. The plan prompted instant criticism from some member states, most notably Great Britain which saw its highly lucrative hedge fund industry under threat. At first, the EU only partially agreed with Larosière: the Systems Risk Council as a supranational authority was indeed put in place. But Larosière's idea of granting this body the supranational power to supervise national financial markets was downscaled

to mere supranational advice, thus giving the member states the final say in the regulation of their national banking, insurance, and securities sectors. It was not until the summit of June 2012, when Eurozone leaders finally agreed to establish a supranational supervisory system for banks. UK prime minister Cameron however stated that his country would not be part of such a set-up which provided further evidence of the growing policy and institutional asymmetry within the EU.

Larosière's initiative paved the way for the gradual formation of a *European Banking Union*. As of 2019, significant steps have already been taken. For a start, Eurozone countries agreed to the establishment of a so-called Single Supervisory Mechanism (SSM), which gave the ECB the power to monitor the implementation of a single rulebook for all Eurozone banks.[xv] The SSM entered into force in November 2014. Step two consisted of a Single Resolution Mechanism (SRM) based on a Single Resolution Fund that within 8 years, will ultimately reach 55 bn € by charging a 0.8% leverage on deposits of all eurozone credit institutions. The SRM aims to help banks in trouble by going through a process of restructuring and potential bailouts. Most importantly, the SRM applies a new procedure – heavily influenced by developments in Cyprus – on how to deal with a financial collapse. A failed bank first must approach its shareholders, followed by its creditors. Only then will other depositors be asked to shoulder the losses, but the first 100,000 € of every person's asset in a bank remain untouched. If all these collected assets are still not enough to shore up a bank, then and only then will the Single Resolution Fund come to the rescue.

With regards to the sovereign debt crises, the first 30 bn € rescue package to save Greece resulted in the establishment of the *European Financial Stability Fund* (EFSF) with a volume of 750 billion Euro (see Table 17.9). Agreed in May 2010, the fund included contributions of 60 bn € from all EU members (even those that do not have the Euro), 440 bn € from Eurozone members, as well as 250 bn € from the International Monetary Fund.[xvi] It is important to note that the fund offered loans, not grants. Hence, countries contributing to the fund would receive their money back (default permitting), including interest. In December 2010, the EFSF was placed on a firmer, long-term footing with the establishment of the *European Stability Mechanism* (ESM). Operational since July 2012 and with a lending capacity of 500 bn €, the fund could be tapped into but only as a last resort. The ESM required a change to the Lisbon Treaty. It was set up as an intergovernmental institution located in Luxembourg and

gave future bailout mechanisms a firm legal base. It was not however, a stimulus package, as countries in financial distress first had to look for other refinancing sources, such as international money markets.

Table 17.9. EU Agreements during the Sovereign Debt Crises

April 2010	First Greek Rescue: 30 billion Euro
May 2010	European Financial Stability Fund (EFSF) EU and IMF as partners volume of 750 billion Euro
December 2010	European Stability Mechanism (ESM) established Successor to EFSF Intergovernmental institution located in Luxembourg Start date of July 2012
March 2011	Euro Plus Pact Rules related to economic governance, including public finances, financial stability and tax co-ordination
October 2011	Euro Rescue Deal Writing down of Greek debt by 50 per cent Recapitalisation of banks Increase of EFSF
January 2012	Fiscal Compact Debt reduction to 60 % of GDP by end of 2013 Violation results in automatic fines Enforced by European Court of Justice
November 2014	Single Supervisory Mechanism ECB monitors the implementation of single rulebook for all Eurozone financial institutions
January 2016	Single Resolution Mechanism Single Resolution Fund to help troubled banks Anticipated volume of 55 bn € by 2024

Beyond bailout mechanisms, the EU – and here in particular the tandem of Angela Merkel and Nicolas Sarkozy convinced their European partners to agree to a set of structural reforms which aimed to prevent a recurrence of the unsustainable economic models as witnessed above all in Greece. Negotiated in March 2011, the *Euro Plus Pact* addressed three key elements: sustainable public finances, financial stability

and tax policy co-ordination.[xvii] The *Euro Plus Pact* was yet another example of the ever increasing asymmetry within the European Union, as not all countries signed up to it which henceforth turned the pact into merely an international treaty. Sweden, Hungary, the Czech Republic and the UK – all of which are outside the Eurozone - decided for yet another opt-out. All other countries, including the non-Euro users at that stage, namely Bulgaria, Denmark, Latvia, Lithuania, Poland and Romania, signed the pact and abided to what could cynically have been referred to as Merkel's and Sarkozy's dictum on sound economic governance.

Given the continued liquidity crisis in Greece and increasingly also in Italy and Spain, the autumn of 2011 was characterised by much discussion on the next necessary steps to prevent the European house from collapsing. After frenetic consultations, an emergency summit in October 2011 agreed on the *Euro Rescue Deal,* [xviii]. which further wrote down Greek debt by 50%. The agreement also gave specific guidelines for the re-capitalisation of European Banks, while also asking state investment funds (and here in particular those in China) for a boost to the EFSF. [xix]

The almost perpetual summitry of the previous two years continued with the gathering in Brussels in December 2011. Merkel and Sarkozy (by then often simply referred to as Merkozy) aimed to enforce tighter budgetary rules on Eurozone members in order to appease financial markets which continued to threaten to undermine the performance of the single currency. After the usual acrimonious negotiations lasting long into the night, the so called *Fiscal Compact* allowed EU institutions to enforce austerity measures should a Eurozone country overspend its budget. Countries were now obliged to get their debt to below sixty % of GDP by the end of 2013. If not, automatic fines would be imposed. Moreover, in order to reach the sixty % mark, Eurozone members had to have an annual reduction of $1/20^{th}$ of the difference between that target and their actual debt. At a follow-up summit in January 2012, when the *Fiscal Compact* was signed, member state governments further agreed to empower the European Court of Justice as the enforcer of these fiscal rules. The Court therefore received the entitlement to impose fines against countries that continued to breach the agreement.

The summit became notorious for the veto used by UK prime minister Cameron.[xx] President Sarkozy very much wanted this agreement to be part of a new EU treaty. However, Cameron in return insisted on concessions for the UK's finance industry in the wake of potentially stricter EU regulations. His demands were flatly

refused, although in the run-up to the summit Merkel had already sensed that the UK might not sign up to any agreement. In the end, Cameron temporarily pleased the sizeable Eurosceptic wing in his own conservative party, avoided a potentially acrimonious ratification process at home and henceforth stabilised his premiership.

The *Fiscal Compact* marked the true arrival of a two-speed Europe. While opt outs (for instance for the Human Rights Charter or Schengen) have been common for nearly thirty years, the Eurozone was now moving towards a fiscal union with uniformed budget rules. The Stability and Growth Pact of the Maastricht Treaty was toughened up by imposing a regime of fiscal discipline that further undermined fiscal and monetary national sovereignty.

Not only European leaders tried in an increasingly desperate fashion to prevent the crises from spinning out of control. The performance of the *European Central Bank* also came under intense scrutiny. The ECB had reacted slowly in lowering interest rates when the first effects of the credit crunch started to come to the fore. While the U.S. Federal Reserve lowered rates for the first time on September 18, 2007, it took the ECB a further three weeks (October 8) to respond. Also, while both the U.S. Fed and the Bank of England used quantitative easing as a widespread method to add liquidity to struggling economies, the ECB's hands were tied in this respect.[xxi] Quantitative easing in the EU however was more complicated given that the ECB had to look after the monetary well-being not just of one, but of 19 entities. This meant that if the ECB had decided to help for example Greece, then countries such as Portugal, or Ireland justifiably would have argued for help too. Furthermore, quantitative easing had to be agreed by all Eurozone members, and it therefore came as little surprise that this financial vehicle was only used to limited effect.

On a more positive note, the ECB made three very significant liquidity injections. In June 2009, the bank set aside 442 billion Euro worth of cheap loans for EU banks which had to be repaid within one year. This was during the height of the credit crunch when banks had stopped lending to one another and to businesses, resulting in a shortage of cash. An even more ambitious injection took place in December 2011 under the tutelage of newly appointed ECB president Mario Draghi. On this occasion, 489 billion Euro were made available. Given the very low interest rate of one % and a generous repayment period of three years, 523 financial institutions across the continent applied. In contrast to the first injection two years earlier, some of

the money was invested straight away in buying government bonds from distressed Eurozone members, such as Spain or Italy. Hence, Draghi's move not only helped banks and businesses, but also the struggling under performers of the Eurozone. A couple of months later, in February 2012, Draghi made available a further 529 billion Euro under the same conditions in what the ECB referred to as its long-term repo operation (LTRO). Again, as in December borrowing costs on the international markets fell for the crisis-ridden states, as banks bought up sovereign debt which offered higher returns.

Proper quantitative easing, often referred to as the bazooka of central bank instruments arrived on Eurozone shores in January 2015, when the ECB's president Mario Draghi stunned the finance world with a stimulus package estimated to be at least 1,100 bn € by buying up government bonds to the tune of 60 bn € a month. Consequently, the cost of borrowing for governments decreased substantially.[xxii] This of course was highly welcome by EU members as balancing their books now became just that little bit easier. The main impact however was seen in the currency devaluation of the Euro. While the dollar traded at 1.35 € in the summer of 2014, it rose to 1.13 € after Draghi's announcement and remained at that level until the end of 2018. This boosted exports across the EU. But the programme went way beyond its anticipated duration of two years and was only stopped at the end of 2018 nearly 4 years after its inception. Sluggish wage growth was cited as the main reason [xxiii] of this slow recovery. And it was not only the time scale that needed to be expanded. The same applied to the size of the stimulus which ultimately reached a staggering 2,500 bn €.

The future of EMU

If one believes in European integration, in giving up certain aspects of a country's national sovereignty for the sake of European solidarity, in improved relations amongst neighbors, in shared and sustained prosperity across the continent, then Economic and Monetary Union had the potential to form a vital cornerstone for such an idea. However, EMU in its present shape dramatically undermined and jeopardised European integration and threatened the very viability of such a vision, unless – of course – it undergoes a process of drastic reform.

What if Greece – or indeed other countries – had decided to leave the Euro, as was advocated by a growing number of politicians and commentators? Economic meltdown and a financial collapse would almost certainly be the outcome. Proponents of a Greek exit often cited the example of Argentina, which at the beginning of this century unpegged its Peso from the U.S. Dollar which resulted in a massive devaluation of its currency. It worked for Argentina, chiefly because the country possessed significant deposits of minerals, which it could now sell cheaply within a booming world economy. In short, the country unlike Greece had something viable to offer.

If Greece had left the Euro, the value of a re-invented Drachma would almost certainly have collapsed in relation to the Euro, maybe by as much as 50%. The country would have found it impossible to meet its credit commitments (which are in Euros). This would have brought about more bank collapses and subsequent nationalisations across the EU as Greek debt was now worthless. Surviving banks which throughout the crisis were reluctant to lend, would have to reduce their exposure even more, resulting in a further credit crunch. Investors would have to pull out of Greece, the European Central Bank would have to intervene by buying up Greek drachma in order to keep that currency at an artificially higher level which would have hit the ECB's currency reserves hard. Capital controls would have to be imposed and borders would have to be closed down in order to prevent money from pouring out of the country. There might also be have been a run on the Euro as investors began to speculate which country would be the next victim.

Given this apocalyptic scenario the only viable alternative was to reform EMU; for the sake of the financial and economic survival (not just of Greece but of all EU countries), as well as the moral sake of the entire European integration project, which after all rests on the notion of European solidarity, of a mind set which can transcend a focus on purely national interests. The EU therefore had no choice but to move ever closer towards fiscal and economic harmonisation. *The Euro Plus Pact* of March 2011, as well as the *Fiscal Compact* of January 2012 already prescribe a narrowly-defined path on how national economies ought to be organised. The former introduced tighter rules on public finances, pensions, health care and other welfare provisions which now have to be translated into national law. The latter concentrated on a balanced budget rule, which if violated would result in automatic fines and a loss of budgetary sovereignty. Furthermore, the *banking union* established a single rulebook which every EU bank now must abide by. The ECB is also now the single supervisory body that

monitors the implementation of those rules. There is also now a clear procedure in place on how to restructure or even bail-out failing banks, backed up by the Single Resolution Fund which will be gradually build up until 2024. So far so good.

What EMU still needs however, is a mechanism that can facilitate the transfer of money from richer European states to their poorer southern partners. The *European Stability Mechanism* offers a last-resort credit facility for countries in financial peril. However, this might not be enough. One might want to look at the example of German unification, where a poorer entity (eastern Germany) was shored up by a richer one (western Germany). The government organised this by imposing a so-called solidarity tax which was deducted at source from capital investments and pay slips of western employees. Thirty years after unification, workers in the west continue to pay this tax with latest figures reaching almost 18 bn € annually. The total money the country spent on rejuvenating the east now stands at over 2,000 bn €. Incidentally the total amount that the German government transferred to Greece was 914 million €. [xxiv]

But having a straightforward fiscal transfer from richer northern taxpayers to poorer southern citizens might be impossible to achieve given the growing EU scepticism amongst European electorates. The fact is that the EU already transfers money – albeit in a limited fashion - through its cohesion and agricultural policies. The EU budget is financed through member state contributions, and this pot of money is then handed out in large parts to farmers, and to economically backward regions. In 2012, former French President Francois Hollande called on other leaders to agree to an increase in the seven-year EU budget for 2014 – 2020. The chorus for growth-stimulating measures grew louder with Spanish Prime Minister Mariano Rajoy and Italian Prime Minister Mario Monti backing Hollande’s call. Even ECB President Mario Draghi argued that the *Fiscal Compact* ought to be complemented by a ‘Growth Compact’. In the end though, the EU budget was only tweaked a little without any substantial increases. The EU spends just under 100 bn € per year on redistributive programmes. Such an amount would merely represent a drop in the ocean given the severity of another potential crisis. Budgets however have to be agreed on a unanimous basis by all member states. Therefore, there is every reason to doubt a massive increase in the EU’s next financial perspective which runs from 2021 to 2027.

Given the limited options available to the EU, it was only compelling that commentators and political leaders frequently called upon the European Central Bank to assume a more pivotal role. Granted, ECB President Mario Draghi embarked on a

more proactive course than his predecessor Jean-Claude Trichet when he injected liquidity into southern Europe by offering 1,000 bn € Euro in bank loans, and by applying the bazooka of a 2,500 bn € programme of quantitative easing. But bazooka and liquidity injections ought to be temporary remedies. What the EU needs is a central bank that is capable of issuing Eurobonds that are guaranteed by the Eurozone members. This would enable countries like Greece or Italy to access money at a cheaper rate than those offered by the international financial markets. Germany however was vehemently opposed to such an idea as it would undermine the ECB's independence; a sacrosanct relic which had its origins in the way the German *Bundesbank* was set up which in itself was a reflection of the financial collapse of the Weimar Republic that resulted in the rise of Nazi Germany. However, if Germany (and indeed other EU countries) is committed to a supranational economic and monetary union, then supranational mechanisms ought to be put in place to alleviate discrepancies in the economic structure of other Eurozone members. Simple rules on how to run an economy are not enough. These ought to be complemented by financial mechanisms that allow for a transfer of funds. A straight forward solidarity tax along the lines of German unification might be a step too far for the mind sets of European citizens. But call it fiscal federalism or call it financial solidarity, the EU has to find established and permanent ways of transferring money from richer to poorer parts for Economic and Monetary Union to succeed.

Lessons Learned

The sovereign debt crises demonstrated that a number of countries had embarked on utterly unsustainable economic models. Easy access to cheap money and low interest rates proved too much of a temptation for politicians and citizens alike to embark on a spending and consumption spree without looking at the fundamental working mechanisms and potential flaws of their national economies. Instead of improving economic parameters, of investing in research and education, of building up coherent infrastructures, of establishing conducive industrial relations, the order of the day was spend, spend, spend without worrying how countries would fare during an economic

downturn. This behaviour was irresponsible and the political establishment in Greece, Ireland, Spain, Portugal, Cyprus and Italy had much to answer for.

But irresponsible behaviour was not only confined to the governments in the countries affected by a sovereign debt crisis. Across the continent, other governments but also EU institutions turned a blind eye to what was going on. What had been agreed at Maastricht, when the key principles of Economic and Monetary Union were set out in the Stability Pact represented a worthless piece of paper that no one felt obliged to adhere to. Ever since the start of EMU in 1999, France and Germany had persistently violated the Stability Pact by accumulating more debt than was allowed. The Commission would have been entitled to impose fines, but failed to do so, fearing a tarnished reputation for the young currency on the international markets. So if France and Germany regarded the Stability Pact as more of a guideline than a legal obligation, why should other countries have obeyed? And given that the start of EMU coincided with a time of calm economic conditions, why would anyone indeed have bothered?

The financial sector too enjoyed a period where regulation was shockingly neglected. How else can one explain the arrival of the now infamous 110% mortgages given out to bank customers with an insufficient capital collateral? The Euro worked fantastically well in a time of economic plenty. The realisation, that EMU was shockingly ill-equipped to handle a financial crisis came – for many countries and their citizens –too late. EMU ought to have been a firm prescription on how to keep spending and inflation under control but turned into a temptation to give in to easy access to cheap money. It all ended in unsustainable economic models, unbalanced growth, wage and spending excesses and a reliance on bubble revenues.

The rationale of politics and of politicians is to improve people's lives, to guarantee peace and safety, to secure standards of living and increasingly to offer environmentally sustainable conditions. For a great part of its existence, the European Union and member state governments did precisely that. The founding treaties of the 1950s ushered in a period of peace amongst former enemies. Free trade across borders brought a remarkable level of prosperity. The Maastricht Treaty of 1993 paved the way for the re-unification of a once divided continent. But Economic and Monetary Union? It conveyed potentially irreparable damage to the European idea and a loss of moral authority. What started out as a project to achieve an ever closer union brought hardship to great many people. Behind the unemployment statistics and falling GDP levels are

people who had lost their livelihood, whose businesses went bankrupt, whose pensions had been eroded, whose welfare state had become sclerotic. Who would have thought that eighty years after the implosion of the Weimar Republic in Germany – one of the historical memories which after all prompted European governments to found the EU, we saw the return of Fascists marching in the streets (of Athens).

The sad case of Italy laid bare the current twin challenges of the European project: protecting the economic and financial livelihood of Eurozone members whilst maintaining a core set of values and norms shared by all governments. Salvini potentially embarked on a path to destroy both. In a world of growing iron-fist, nationalist, isolationist and anti-globalist politics, the EU ought to represent a haven of reason, of international collaboration, of evidence-based policy making; something that is hard to achieve with politicians of the ilk of Salvini. But Italy has also shown that large parts of the European electorate have lost faith in their politicians. Populist, right-wing movements have a firm grip on power not only in Italy, but also in Poland and in Hungary and are causing political turmoil in the UK, in Finland, Sweden, Denmark, Germany, the Netherlands, Austria and France. It seems as if the one thing that unites allot of European citizens is their disdain for Brussels (and for rich and austerity-imposing Germany).

The longer the union has been together, the more the people are distancing themselves from its objectives of unity and transnational co-operation; a paradox which European populists, united only in their hatred for Brussels are only too keen to exploit. The EU's austerity-enforcing handling of the Greek crisis and an Italian economy that – at least according to Salvini – is suffocated by EMU rules provided the starting gun for the oratory boost that these very worrying developments needed in order to gain such widespread support. Austerity measures are never popular and always seem to offer political opportunities for demagogues and political insanity could yet return to Europe with even greater force should politics fail in its attempt to bring the economic and financial situation under control. What leaves a sour taste is also the fact that Greece and Italy were governed by unelected officials during the height of the crises – hardly a ringing endorsement for legitimacy and democratic accountability.

In the run-up to the start of EMU, many analysts and in particular the economists of the German *Bundesbank* warned that the Eurozone would not be an optimum

currency area (OCA) where economic structures and financial parameters of the participating countries are by and large in line with one another. The *Bundesbank* warned repeatedly against the inclusion of such countries as Greece or Italy. Both were allowed to join despite the fact that one of the key ingredients of EMU – that of an overall budget deficit of no more than 60% of GDP – was not met. Furthermore, an optimum currency area relies on labour mobility. In the United States, a recession in one part of the country might be offset by workers moving to a more prosperous one. Labour mobility in the EU though, is very limited and only 3.8% of citizens live in a member state other than their country of birth.[xxv] An OCA also requires some form of mechanism to transfer funds from one region to another. The EU budget however is very limited (only about 1% of each member state's GDP), while Germany agreed to EMU under the explicit condition that fiscal union would not be part of it. In the US, monetary union took place alongside a political (and thus fiscal) union. German and other leaders however argued that a monetary union could be established without the accompanying unifying political measures. They proved to be wrong.

A decade later and the doomsday preachers of the *Bundesbank* had won the argument. The key point here is that with a single currency, countries lose their monetary autonomy. It seems too obvious to mention, but once you are a member of the Eurozone you lose a crucial instrument on how to keep your economy competitive: that of devaluating your currency. Hence, once a country adopted the Euro it could no longer compete by offering lower prices. It had to compete on quality and innovation, which turned out to be next-to-impossible given the high levels of efficiency, innovation and productivity of northern European economies such as Germany, the Netherlands, Luxembourg or Finland. In return, these countries enjoyed a benign competitive advantage based on the exchange rate parity. EMU allowed countries such as Germany to build up a vast trade surplus on the back of consumption-hungry yet less competitive southern European Eurozone partners.

Blaming irresponsible governments and greedy citizens in crisis-affected countries did not solve the Euro dilemma. The fact remained that the struggling member states were not in a position to get out of their economic and financial mess by themselves. The option of devaluation does not exist in EMU. Defaulting on debt would have affected banks and governments across the EU, while a collapse in demand would have consequences for export orientated member states such as Germany. The EU therefore had no choice but to stay the course.

Given the current set of instruments available to the ECB and the troika, Italy might be too big to be rescued. The volatile political situation might result in two scenarios. One the one hand, Italy could continue with austerity, which would be against the political will of most Italians, and also against the majority of members of the Italian parliament. On the other hand, the government could give in to demands from its citizens to end the cycle of tax rises and spending cuts, which might prompt a panic by international financial markets. In both scenarios, the future of Italy's membership of the Eurozone and that of the single currency project altogether could be at stake.

At the moment, every country in the Eurozone is responsible for managing and servicing its own debts. There is no European solidarity fund that helps countries in crisis. What has been set up is a bailout fund that injects liquidity in return for harsh austerity measures. What Europe therefore needs is a different approach, provided by the third, and so far, unimplemented step of the *banking union*: a common system for deposit protection. Money markets buy up government bonds based on a country's perceived economic and financial health. The worse the state of a country, the higher the bond rates, and therefore, the higher the costs for that country to service its debts, pay wages or invest in infrastructure. More importantly, money markets also speculate against the potential collapse of a national economy. A solidarity fund which goes beyond the 55 bn € reserved for any bank collapses could put an end to this. No investor will place a bet for the financial implosion of governments or banks in the knowledge that a trustworthy European fund would come to the rescue of ailing actors.[xxvi] The betting would most likely stop, thereby offering a steady re-financing of country on the bond market. A storm has brewing in Italy for some time now. Yet the Eurozone is still ill-equipped, whether politically or institutionally.

The crisis in Cyprus has potentially resulted in a new formula on how to deal with failing banks. These used to be kept alive, while the assets of creditors and shareholders were largely unaffected. This of course was excellent news for players on the international money markets and for financial centres such as London or Luxembourg who could count on the fact that governments and thus tax payers would foot the bill for gross financial mismanagement. Ever since *Laiki*, this is no longer the case. In Cyprus, the Eurozone demonstrated for the first time, that the onus of dealing

with a collapsing bank should first fall on shareholders and creditors of that bank. Not only does Cyprus set a precedent how collapsing banks worldwide might be dealt with in the future. This approach was also fair and long overdue, as was the establishment of the Single Supervisory Mechanism and the Single Resolution Mechanism, which now gives the ECB concrete powers on how to deal with bank failure. The decision to protect the first 100,00 € of assets is also a much-needed pillar of security for less privileged investors.

But the crises also revealed a darker picture, most notably in Greece. The Euro works very well for northern European countries in particular Germany. The low exchange rate brought about by the long-lasting economic downturn benefitted German exports. In return, the fact that most European countries have adopted the single currency meant that poorer countries have lost the option to devalue their former national currencies and thus to regain competitiveness resulting in an uneven playing field that once again benefits Germany. Even more striking, yes it was the reckless behaviour of political elites in Greece, Ireland, or in Spain that brought about the debt crises. But these were also galvanised by reckless lending from banks in France and Germany. And what most of the bailout money was used for? Not for invigorating the economy, not for an increase in infrastructure spending, not for investment in science, research, education? It was spent mostly to meet creditor demands. The *Euro-Plus Pact* of 2011 and the *Fiscal Compact* of 2012 demonstrated that Keynesiasm – the proactive engagement in the economy to address its shortcomings – is dead, at least for now. *Syriza and* Alexis Tsipras tried to convince their EU partners that a new approach was desperately needed. They failed. The crises management– in Greece and elsewhere - was done through austerity at the expense of national sovereignty. It does not bode well for the European project, when the explicit wishes of the electorates in Greece and in Italy were steamrollered in such a fashion.

A monetary union without a fiscal and thus political union is the *Gründungsfehler* (the German word for design fault) of EMU. This are the words of Angela Merkel to fellow members of the German parliament in 2011. And she was right. On the one hand we have advocates of consolidated public finances, of adhering to the Maastricht criteria of limited public debt (60% of GDP) and a relatively balanced budget (annual debts of no more than 3% of GDP). For countries like Germany, the

Netherlands, Finland, Austria, Estonia, Latvia Lithuania and Ireland, the stability of the Eurozone is paramount which is why budgetary rules ought to be followed regardless of any negative repercussions this might have on a national economy. But then we also have countries including France, Italy, Spain, Greece and Portugal who regard Maastricht as a dictum that strangulates national sovereignty and the political will of its citizen should they choose to elect a more left-leaning government. Germany and Merkel were caught in the middle. As pillars of European integration, a conflict with France and Italy (at least before Salvini was voted into office) would seem an anathema to Berlin. Yet, Germany was also on the same ideological side as northern and eastern European member states. In the end, the handling of Greece represented in a harsh compromise. The country was allowed to stay in the Eurozone, and the European project was – at least for now – safe. This pleased the governments in Paris, Rome and Madrid. But the other EU partners were also taken on board with the insistence on severe austerity measures, despite ignoring evidence, that the economic and fiscal measure imposed on Greece had highly counterproductive elements (such as a rise in sales taxes) which made a recovery all the harder. This formulaic approach to solving the Greek crises was subsequently also applied to Ireland, Spain, Portugal and Cyprus. The deeper, and essential question, of whether a single currency is practical for states with such diverging economies, but also with a different understanding of the rationale of *Maastricht's* Stability Pact, remained unanswered. What the EU ought to have done was to reach a compromise that allowed for a fiscal consolidation of crisis-ridden countries accompanied by measures that facilitated economic growth. It remains to be seen whether the potentially much more serious and devastating case of Italy might force a rethink across Europe. Austerity does not guarantee prosperity. Greek citizens were made to suffer for this mis-conception and there might come a breaking point were European citizens reach the end of what they are willing to bear.

Instead of pushing for an 'Ever Closer Union', the crises made countries drift further apart. Old war-time antagonisms re-emerged, and the EU did not become more European, but paradoxically more nationalistic. Brussels – as the incarnation of the EU's faceless unelected institutions - had little say in the handling of the crises. This was intergovernmentalism par excellence with member states at the centre of crucial decisions. Throughout these challenging years, the role of Germany and its position with the European integration project was heavily scrutinised. A country which for

decades was quite content to offer generous funding whilst leaving the institutional and policy design of the EU to countries like France and the UK, arguably took a proactive leadership role for the first time when the Greek drama began in 2010. As a reflex, a historic question started to re-emerge: how to deal with German might? It seems that the focus of this question is too narrow. It is not necessarily Germany's position within Europe that needs re-evaluating. While we had the widening of the union in the first decade of the 21st century, member states still have not found an answer on how to define the deepening aspect of the European project. The sovereign debt crises presented up with a ruthless lesson: This was not a Europe built on consensus; instead it was one of coercion and compulsion.

Endnotes

[i] The bailout came with the following conditions:

- Thirty billion Euro in loans up to a maximum of 110 bn €
- Interest rate of 5.2% (which was reduced in March 2011 to 4.2%)
- Privatization of fifty billion Euro worth of public assets
- Raise of the retirement age to sixty-seven for men and sixty-five for women
- Tax increases on cigarettes, alcohol and fuel
- Higher sales tax
- Demands to tackle tax evasion, to cut health care and pensions provisions
- Involvement of the EU's statistical office Eurostat in monitoring Greek accounts
- Loss of control over tax and spend should Greece fail to meet these conditions by March 2012.

[ii] Bail out money was not paid out in one instalment. Instead, it was divided into several tranches which were released at certain intervals and subject to the bailed-out country meeting its tax and spend commitments.

[iii] The terms of the deal were harsh and included:

- Acceleration of privatization of state-owned businesses
- Slashing of 150,000 public sector jobs by 2015
- Cut in the minimum wage by 22% for new employees
- Public spending cuts of 3.3 bn € in 2012

[iv] The privatisation fund was heavily influenced by Germany. During the country's unification in the 1990s, all assets of the now defunct German Democratic Republic were organised into a public trust fund called *Treuhand*, with assets subsequently being sold off to the private sector. When the programme was disbanded in 1994, a staggering 14,000 businesses had been transferred in such a manner.

[v] See: Seumas Milne. The crucifixion of Greece is killing the European Project'. The Guardian, July 17, 2015, p.33.
www.theguardian.com/commentisfree/2015/jul/16/crucifixion-greece-killing-european-project-debt-colony-breakup-eurozone.

[vi] The EU did not have to go back too far in history to find a precedent. In 1953, West Germany secured a debt forgiveness of 15 bn *Deutschmark*, much of it accrued as part of the reparations emanating from World War I. The remaining debt only needed to be repaid, once the country ran a trade surplus. It therefore was in the interest of western powers for the German export machine to kick into action, and the deal was widely regarded as offering the impetus for the German economic miracle of the 1950s.

[vii] This assessment was offered by Loukas Tsoukalis, a prominent scholar of EMU from the University of Athens. See www.theguardian.com/world/2018/jul/15/greece-exit-final-international-bailout-debt-catastrophe. The article furthermore offers a haunting account of the devastating effects of the crisis on the Greek people.

[viii] Ever since the end of World War II, Italian politics had been undermined by the plethora of political parties that managed to gain seats thus making the formation of viable coalition governments an often-insurmountable challenge. Renzi's proposal would have given those parties gaining more than 40% of votes a higher share of seats. Renzi linked his political career to the passing of a referendum on these electoral reforms. With Italian citizens voting down his proposal he was left with little choice but to resign from office.

[ix] Cyprus agreed to tax rises (most notably an increase of the country's rock bottom corporation tax from 10% to 12.5% and a rise in the tax on interest from 15% to 30%), as well as cuts to pensions and welfare benefits.
See: www.ft.com/content/118d8034-e49f-11e5-ac45-5c039e797d1c.

[x] See: The Guardian, March 26, 2013, p,30.

[xi] See: The Guardian, June 9, 2012, p.4. The article can be accessed at:
www.theguardian.com/world/2012/jun/08/spain-savings-banks-corruption

[xii] Rajoy's first budget called for 12 bn € worth of spending cuts and 15bn € of tax rises with the aim of bringing the annual deficit down to 5.5% in 2012 and to 3% a year later; the latter being an EU-wide benchmark to which Spain had agreed to in the *Fiscal Compact* of January 2012. This amounted to 570 Euro of either spending cuts or tax rises per citizen. Government departments were asked to slash their budgets by 17%. The wages of civil servants which had been reduced by 5% in 2010 were kept frozen.

[xiii] Shortly after asking for bail out money, Rajoy announced further spending cuts and tax rises amounting to 65bn € in austerity measures. The sales tax was raised by 3% and civil servants saw their salaries reduced. The reduction of social security contributions, which had been Rajoy's only stimulus to the economy was scrapped.
[xiv] De Larosière also pressed for the establishment of European Supervisory Authorities (ESA) based on a European System of Financial Supervisors (ESFS). Members of the ESFS are representatives from the twenty-seven national supervising authorities with the objective to oversee micro-prudential risks. The ESFS in itself would consist of three further sub-bodies, namely, the EBA (European Banking Authority), EIOPA (European Insurance and Occupational Pensions Authority), and ESA (European Securities Authority).
[xv] While all financial institutions inside the Eurozone were automatically subject to the ECB's authority, non-eurozone countries could also seek a close collaboration.
[xvi] During the crisis, Christine Lagarde, the Head of the IMF asked for an increase in contributions from its members. During 2011 and 2012, she managed to raise the Fund's lending resources by 430 billion US Dollars, 200 billion of which came from the Eurozone. The largest shareholder of the IMF, the United States, declined to contribute more money at that particular moment.
[xvii] With regards to public finances, the fiscal rules of the Stability Pact of the Maastricht Treaty had to be written into national law. Pensions, health care and other welfare state provisions had to be kept at financially sustainable levels. As to financial stability, the debt for banks but also for households and non-financial firms had to be sustainable and were monitored by the recently established European Systemic Risk Board. Lastly, the pact aimed for the development of a common corporate tax base, and the common tackling of fraud and tax evasion, although direct taxation would remain under the competence of national governments.
[xviii] The key points of the *Euro Rescue Deal* were:

- The writing down of Greek debt by 50 % with the remaining debt to be secured by member states.
- A recapitalization of European banks with the requirement to raise their capital ratio to 9%. Banks were required to raise their capital by first going to private markets. If this initiative proved to be unsuccessful, banks were then obliged to apply to their national governments for financial support. The European Financial Stability Fund (EFSF) was seen as the last resort in order to reach the 9% target.
- Increase the resources of the EFSF: By establishing a so-called Special Purpose Vehicle, EU leaders aimed to raise money by approaching wealthy state investment funds (such as those held by China) to boost the ESFS's capacity to 1,500 Bn €.

[xix] In the immediate aftermath of the summit, the response by global investment funds, in particularly those of China to become involved in the EFSF was at best lukewarm, which made the target of 1,5000 bn € Euro look rather ambitious.
[xx] It was not only the UK that did not sign up to the treaty. The Eurosceptic governments of the Czech Republic, Hungary and Sweden all indicated that they first had to consult their national parliaments. We therefore saw the emergence of the awkward acronym CHUCKS for four countries that did not – at least from the start - committed to tighter budgetary rules. In the end, it was only the UK and the Czech Republic who decided on the latest opt-out of the EU's treaty agenda.
[xxi] Quantitative easing (QE) is a process whereas a central bank is buying up assets – most often government bonds – from banks and other financial institutions, such as pension funds. The aim is for banks to use the generated cash to increase their lending to private households and also to businesses. Thus, QE is a way to inject cash into a struggling economy.
[xxii] On the day of Draghi's announcement on January 22, 2015, the rate of 10-year German bonds fell to a new low of just 0.377%. France's 30-year yield dropped to just 1.5%, while that of Italy went below 3% for the first time.
[xxiii] See: www.ft.com/content/c55dbfaa-a6c8-11e8-8ecf-a7ae1beff35b.
[xxiv] Germany has done very well out of the Greek crisis. Ever since the start of the economic downturn, the German government bought up Greek bonds. In total, Germany collected 2/9 bn € in interest during this time.
See: www.euractiv.com/section/economy-jobs/news/germany-earned-2-9-billion-euros-from-greeces-debt-crisis/
[xxv] Source: Eurostat, May 2018.
[xxvi] See: Henrik Enderlein: 'Noch ist Zeit, aber nicht mehr viel'. Der Spiegel, No.23, June 2, 2018, p.18-19.