Sovereign Debt Crisis in the Euro Area and the European Central Bank. Thoughts for a Progressive Alternative

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1. Introduction

Jean-Claude Trichet, as President of the European Central Bank (ECB), noted in a press conference in March 2008: "The fundamentals of the euro area economy remain sound and the euro area economy does not suffer from major economic imbalances". When asked about the implications of the US subprime crisis into the euro area (EA) economy, he along with other European officials only raised concerns about inflation. Six years later, all these statements sound like black humor. The EA is experiencing a severe sovereign debt crisis. Growth prospects are weak and fragile. Unemployment levels in the countries of the so-called European 'periphery' have reached hitherto unthinkable levels and the risk of deflation is by no means negligible.

The monetary aspect of the EA is unique. No solid and uniform fiscal authority stands behind the ECB. The latter, thus, cannot be effective in its role as lender of last resort and market maker of last resort. Member states issue debt in a currency that they do not control (they are not able to 'print' euros or any other type of currency, at least not for an extended period). In this context, governments are exceptionally restricted in securing liquidity to pay off bondholders. Financial stability can be thus safeguarded only through fiscal discipline, i.e. through preserving fiscal policies within the neoliberal corset. Dismantling of the welfare state can be presented by the political and economic elites as the only route to financial stability. This may be a beneficial condition for the interests of capital but is also dangerous: it imposes the neoliberal agenda by elevating default risk.

This paper has three aims. The first is to discuss the sui generis structure of the European Monetary Union (EMU) and point out how it jeopardizes the economic symbiosis between member states (Section 2). The second aim is to explain how the present structure of the ECB, which does not favour effective monetary policies in the midst of recession, complies with the neoliberal strategy of European financial and political elites. On this basis, the paper addresses an alternative plan to the sovereign debt crisis in the EA, in line with the interests of labour (Section 3).

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2. The vulnerability of the EA symbiosis

A single currency area is not identical with a zone of fixed exchange rates. One usual mistake in the relevant discussions is the following: Many scholars seem to think that EA states just peg their national currencies to the euro as if the latter was a mere foreign currency. This assumption usually leads to the most grotesque explanations. Nevertheless, the euro *is* the national currency of each and every member state of the EA. But it is more than that: It is a national currency of a peculiar kind. It is a currency without traditional central banking. And this is a major change.

2.1 More discipline in exchange for more instability: The dangerous trade off in the case of the euro

In the usual nation state setting, a single national fiscal authority stands behind a single national central bank. As we know, this is not the case with the EMU: there is no solid and uniform fiscal authority behind the ECB. Member states issue debt in a currency that they do not control in terms of central banking.[3] In this context, governments will not always have the necessary liquidity to pay off bondholders. Financial stability can be thus safeguarded only through fiscal discipline, i.e. through preserving the neoliberal policy agenda.

This should not be taken as a real sacrifice on the part of sovereign states, i.e. the ruling economic elites. On the contrary, it is considered as a welcome condition for the organization of neoliberal strategies, because *the disintegration of the welfare aspect of the state can be presented by the political elites as the only route to financial stability*. Nevertheless, this institutional arrangement comes with a serious cost, a danger that the old discussions with regard to the EA strikingly underestimated. The economies of the EA have voluntarily subjected themselves to elevated default risk:

When a EA government with a large amount of sovereign debt faces a change in the 'mood' of the markets – that is, a re-pricing of risks associated with its assets and liabilities, possibly expressed as a sudden freezing of the inflow of capital (a liquidity crisis, let's say) – it will experience an explosion of debt servicing costs on the foreign currency and the derailment of its budget balance. This is bad news for debt sustainability (and financial stability). The government must immediately tighten fiscal policy in the midst of a recession

3 Under the Emergency Liquidity Assistance (ELA) – integral part of the European System of Central Banks – national central banks can in exceptional circumstances provide liquidity (against collateral) to distressed credit institutions under terms which are not publicly disclosed. During the recent crisis this liquidity channel was put in motion with the cases of Germany and Ireland as the most indicative examples.

(an economic recession is likely to be the result of such risk revaluation since the terms of state borrowing reflect the terms of private borrowing), communicating to the markets its ability and willingness to continue servicing its foreign debt. The government has to convince the markets that it can secure a social consensus to the neoliberal corset; or, in other words, policy makers must ensure that they can impose fiscal prudence *in the way markets dictate it, according to the mainstream line of reasoning* (securing the interests of capital). Such policies, in the midst of a recession, are not unlikely to lead to a severe crisis.

Things would not necessarily be this way if the economies of the EA had not abandoned their former national currencies. Even in the extreme case of financial distress, the national central bank could simply 'print' money (this is a notional electronic transaction), thereby lending directly to the government in order to prevent sovereign default.

By adopting the euro as their new common currency, the participating countries (i.e. their ruling classes) have made a 'dangerous' choice. They have voluntarily curtailed their capacity to deploy meaningful welfare policies, subjecting themselves at the same time to a high degree of sovereign default risk. This has turned out to be a risky trade-off. A moderate exodus from the sovereign debt market (i.e. a moderate risk re-pricing) now distorts the liquidity conditions in the economy and leaves the state with only one path: fiscal tightening, high interest rates, recession, debt un-sustainability, crisis, and default. Economies that face liquidity problems in their sovereign debt markets may not go all the way down this path (given the policy responses at a European level) but, in any case, recessionary policies are the only route suggested by the existing shape of the EA. If sovereign states are massively caught by the unfortunate spin of this vortex, *crisis is just the other way to implement the neoliberal strategies*, more unorthodoxly and violently this time. European states (in other words European ruling classes) have voluntarily placed themselves in a predicament where markets can actually force them into default but this is an issue within the European policy setting.

2.2 Market discipline as avoidance of 'moral hazard'

After the outbreak of the 2008 crisis, European officials, along with the participating governments, were faced with a very difficult puzzle: First, how to deal with the enormous economic problems and contradictions without undermining the neoliberal context of the EMU; second, how to create proper policy mechanisms for intervening in the mess, turning the crisis into a chance for further boosting of the neoliberal agenda; third, how to set up new rules to overcome the vulnerabilities of the past without negating the conservative edifice of EMU; fourth, how to correct the problems while avoiding the 'overcorrection' that would make room for the implementation of social welfare policies in the future; finally, how to use the tremendous fire power of the ECB without turning it into a 'traditional' central bank.

The European capitalist powers have jointly decided to exploit the crisis so as to extend the neoliberal agenda. And since the EMU is not an integrated political union, in the light of the above reasoning: *the capitalist responses to the crisis have necessarily to be complementary to the functioning of the markets*. If not, the markets cannot play their disciplining role and the central authorities are unable to mandate the neoliberal reforms. In plain terms, interference with the market in the context of the EA would block or undermine the plan of recession-led reforms. In this context, the ruling European political elites have presented any deviation from austerity and neoliberal reforms as 'moral hazard', i.e. as a reckless and populist policy that undertakes high risks, expecting others (the other European countries or future generations) to pay for these risks.

This strategy justifies the principle of austerity in the context of the EA: the crisis (low growth) is by and large being used as a means to further neo-liberalize state governance. Given the inelastic parts of public expenditure and the lower tax incomes, recession is now approached and used as a tool for further reductions in total expenditure and further relative fiscal burdens to labour. This is the result of the abovementioned type of governance: official responses complementary to the role of the markets.

The commentators or analysts who blithely criticize European leaders for following irrational or 'wrong' decisions misunderstand this point. Not only do European officials always have a second and a third plan in reserve (given the correlations of power), but their decisions must impel the neoliberal agenda without violating the functioning of the markets. Otherwise the crisis cannot be exploited as opportunity for capital. In simple terms, aggressive neoliberal measures and reforms would not be implemented in the participating countries if the ECB had worked as a fiscal agent from the beginning, if its intervention in the secondary sovereign debt markets had been deeper and more persistent, if the fire power of EFSF or ESM had been sufficient to deal with the core needs of the sovereigns, etc. *The grave character of the crisis might have been avoided but in a totally different direction: one ensuring some protection to the living standards and the labour rights of the working classes.* This would have been a different Europe, though: a Europe promoting less drastically the interests of capital.

In brief, the European strategy for dealing with the crisis will always stay one step back from the 'real' needs of the time so as to lead states onto the path of conservative transformation by exposing them to the pressure of markets. This strategy has its own rationality: It perceives the crisis as an opportunity for a historic shift in the correlations of forces to the benefit of the capitalist power, subjecting European societies to the conditions of the unfettered functioning of markets.

3. The ECB as vehicle of a progressive alternative

As it was explained above, austerity policies are not only unable, but they actually do not aim at resolving the sovereign debt overhang in the EA. Austerity strategies use debt as means to reinforce neoliberal reforms throughout Europe.

Technically, there are three alternative ways to deal with the problem: (i) Persistent primary surpluses, which though cannot be achieved in an environment of falling incomes, recession and contracting demand caused by austerity programs. (ii) Nominal growth rates higher than implicit interest rates, which again cannot be the case in the present environment. (iii) Unconventional policies and debt restructuring. Growth prospects are weak and fragile, in particular under the current predicament in the EA. Recession-led reforms may satisfy the interests of capital but are unable to put growth back on track, at least in the medium turn. Hence, a serious solution to the debt problem should necessarily come from debt restructuring and unconventional policies.

The case of Greece is a very good example to illustrate why a trivial debt hair-cut may be an inappropriate solution for debt sustainability, especially when it takes place in a deflationary environment and does not protect pension funds and individual depositors. Furthermore, as bank balance sheets contain a significant portion of existing public debts, traditional debt write-offs will leave the economies with vulnerable financial sectors. In the worst scenario, debt write-offs will trigger a new financial crisis. Governments will need to seek resources for bank recapitalization. This would easily cancel any relief offered by the write-offs, paving the way for fundamentalist neoliberal policies that would seek outside 'help' and 'supervision', i.e. would condition this outside 'help' to a new austerity agenda. This is the reason why SYRIZA and the European Left insist on a political resolution of the country's debt problem, which should contain on the one hand the writing-off of the biggest part of the – unsustainable – Greek sovereign debt, and on the other a revised repayment schedule of the rest of the debt, based on the concept of a 'growth clause', according to the 'model' put forward by the London Debt Agreement in the year 1953, regarding the restructuring of the sovereign debt of the Federal Republic of Germany.

However, what is appropriate for Greece and other small over-indebted EA economies may not be appropriate for big European economies. In other words, debt forgiveness all over EA is rather unfeasible, given the magnitude of the overall EA sovereign debt (9.2 trillion euros, which means that writing-off 50% of it would amount to forgiving at least 4.6 trillion euros). Also, such a resolution finds strong resistance from European working classes in creditor countries. It is also a complicated solution that cannot easily negate the external supervision of the debtor countries. This is an important issue for those who favour progressive policies because debt restructuring should not, by any means, be conditional on austerity policies.

The radical Left shall embed the strategy for sovereign debt restructuring in the perspective of a political shift, which can create the room for alternative policies against austerity at the European level. This political strategy shall focus on the status of the ECB. There are two basic reasons for proceeding in this manner. First, the ECB is the only institution that can easily implement on a massive scale intervention in the sovereign debt market. Second, the ECB practically faces no solvency constraint and cannot go bankrupt; it enjoys unique credibility, which hinges partially upon its ability for self-recapitalization (i.e. write checks to itself). However, a radical change in the policy orientation of the ECB has to take place. For this to happen, a new relation of political forces in Europe is necessary.

In the wake of the crisis, monetary policies in most of the advanced capitalist economies are widely seen as 'unconventional.' This makes the ECB unconventional in the double sense.

First, the ECB is an unconventional central bank in its origin, being without the backing of a uniform fiscal authority. The fundamental conception of the EA authorities is that focusing on inflation is the most efficient way to pursue full employment, fiscal stability and financial stability. Every attempt to allocate more responsibilities to the central bank would 'politicize' it, undermining its effectiveness. Short terms interest rates are acknowledged as the key monetary policy instrument.

Second, the ECB, like other central banks in the wake of the crisis, has been engaged in 'unconventional' monetary policies, adopting the much wider range of instruments made feasible by its balance sheet. Nevertheless, unconventional monetary policies can be effective only when executed by *conventional* central banks. This describes actually the *trap* that the ECB has fallen into. The ECB is called to take unconventional action while lacking the institutional standards of conventional central baking.

The ECB has expanded its balance sheet by taking on long-term refinancing operations. Practically, these are liquidity ejections into the financial sector equivalent to the quantitative easing pursued by the Fed and the Bank of England. The only difference is that unlike the latter, the ECB has very tight limits in its purchase of government bonds. Hence, unconventional monetary policies in the EA take the form of repos operations for short and medium term time windows (LTRO, OMT).

This type of liquidity injections to the financial sector has been primarily absorbed by the banking systems in the so-called European 'periphery'. However, liquidity seeks for safe heavens eventually flowing to the core economies as it is obvious from the deposits drains and the cumulative TARGET2 imbalances. Large portions of this liquidity return thus as overnight deposits to the ECB. Bank loans are contracting in the economies under recession while domestic banking sectors are increasing their exposure to sovereign debt that cannot be purchased by the ECB. It is quite obvious that the restricted bond purchase program of the ECB and the liquidity provision (co-opting banks into securing funds for fiscal distressed governments) is not enough to deal with the problem. The different financial tiers that emerge within the EA undermine the results of the ECB monetary interventions (which are very cautious indeed: ECB is more concerned with the issue of 'moral hazard' which is the cornerstone of the European governance model).

ECB monetary policy is thus not expansionary enough, not unconventional enough (tight limits on the purchase of government bonds) and it is implemented in a heterogeneous context that undermines its effectiveness having significant effects on demand, growth and employment. This framework is only suitable for the continuation of austerity policies that reorganize European societies according to the neoliberal agenda and the interests of capital.

While the aim of this paper is not to go through the details of an alternative progressive plan as regards the ECB (many different authors, who do not necessarily come from the Left, openly flirt with similar ideas), it shall outline the basic idea. *The ECB acquires significant part of the outstanding sovereign debts (in market prices) of the countries in the EA and converts them into zero interest perpetuities*. These will appear as assets in its balance sheet while there will be a proportional increase in the monetary base in the side of liabilities. Many authors have argued that this type of transaction is unlikely to be inflationary in the current economic environment. Debts will not be forgiven. Individual states will agree to buy them back in the far future. Hence, ECB's intervention in the sovereign debt market will have a necessary counterpart swap agreement with individual states. The latter will agree to buy back the perpetuities from ECB's balance sheet in a few decades time.

A simple illustration can clarify the point. Let's suppose that the ECB buys at market values a significant part of the Italian sovereign debt (accounting now to 132.7% of the country's GDP). Let us thus assume that the ECB buys Italian sovereign debt to the level of 100% of the country's GDP, and carries its nominal value forward for 7 decades (with a discount rate of 1%). Assuming a 3% average annual nominal growth for the next 70 years, by the time that Italy buys back the debt from the ECB its nominal amount will correspond approximately to 25% of its future GDP. This would be a manageable addition to the existing debt of the time. Italy will grow its way out of the debt overhang without any significant forgiveness and without any sacrifice from the working people in Europe. The same condition should be applied to other European countries as well.

This model of unconventional monetary interventions will give to progressive governments in the EA the necessary condition to develop social and welfare policies to the interest of the working classes, i.e. to reverse the policy priorities, to replace the neoliberal agenda with a program of social and economic reconstruction and to let the elites pay for the crisis, in the perspective of a more cohesive and more just society, in which social needs and the interests of the working majority will function as a policy prerequisite.