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Abstract

This paper examines the financial mechanisms that reflect and entrench the financial subordination of the Eurozone periphery within the monetary union. It argues that the exacerbation of financial asymmetries during the debt crisis and their relative softening during the pandemic are closely linked to the evolving Eurozone approach to government securities. It proposes a new framework centred on what is here termed the "Eurozone's contradiction", a concept that encapsulates the potential tension between the uneven discipline of finance and the monetary union's perpetuation. When this tension becomes unsustainable, institutional changes and shifts in economic policy are required to preserve the common currency area. These developments, in turn, influence regional government debt hierarchies and shape the variegated financial subordination of the Eurozone periphery.

Keywords Financial Subordination, Periphery, Eurozone, Public Debt.

JEL Classification: F33, E44, H63.

Introduction

The Eurozone's debt crisis exposed persistent financial asymmetries among Member States, ultimately threatening the existence of the Economic and Monetary Union (EMU). In contrast, the pandemic crisis prompted significant shifts in economic policy and institutional changes that prevented the re-emergence of fragmentation. These two crises triggered distinct responses from regional supranational institutions, impacting the core-periphery divide within the EMU differently. Alongside post-pandemic policy normalisation, these developments raise concerns about the potential resurgence of fragmentation in the region (Candelon, Luisi & Roccazzella, 2022; De Grauwe & Ji, 2022; Claeys, Demertzis & Guetta-Jeanrenaud, 2022), highlighting the topic's current relevance.

This paper explores the variegated character of financial subordination in the Eurozone periphery and its connections with the institutional approach to government debt. The motivation for this analysis stems from the persistence of financial asymmetries even within a region that

shares the world's second-strongest currency. The literature on financial subordination focuses on the Global South, highlighting the position of their currencies at the bottom of the global currency hierarchy as the basis for their financial vulnerability (De Paula, Fritz, & Prates, 2024; Alami et al., 2023; Bonizzi, Kaltenbrunner, & Powell, 2023; Bortz & Kaltenbrunner, 2018). The Eurozone periphery, despite not experiencing reserve shortages or volatile exchange rates, encounters financial subordination through the emergence of government bond spreads and capital flow volatility. The main question addressed in this article is which mechanisms allow for the reproduction of the Eurozone periphery's financial subordination within the EMU. The countries analysed are Southern Europe (Italy, Portugal, Greece, Spain) and Ireland - nations whose financialisation and subordination have evolved similarly due to their early participation in the EMU¹.

This article posits that a regional hierarchy of government debt, shaped by the Eurozone's institutional configuration and geopolitical power relations, underpins the financial subordination of Southern Europe and Ireland. It is argued that financial asymmetries between core and periphery are rooted in the potential tension between the discipline of finance, internalized in the regional supranational institutions, and the EMU's survival. Such tension is here named the "Eurozone's contradiction", and during moments it became unbearable – as the debt crisis and the pandemic – it was managed by institutional developments, impacting the government debt hierarchies and therefore the core-periphery divide. The argument is primarily supported by an analysis of countries' financial flows on balance of payments data, which includes cross-correlation analysis, ECB balance sheet data, and government bond spreads, along with an examination of institutional developments during the debt and pandemic crises.

This paper not only enriches various literature streams but also originally proposes a new framework centred on the "Eurozone's contradiction" and the institutional developments it prompted to address the financial subordination of the Eurozone periphery. In dialogue with the financial subordination literature (Alami et al., 2023; Lapavitsas & Soydan, 2022; Bortz, Kaltenbrunner, 2018; Bonizzi, 2013), we contribute to defining the unique aspects of this feature

¹ Other peripheral countries, such as those in the Eastern periphery, have followed distinct historical paths that shaped their subordination differently. According to Santos and Teles (2020), financialisation in Eastern Europe is influenced by its post-socialist trajectory, subsequent integration into the EU, and geographical proximity to the European core, resulting in patterns that differ from those in Southern Europe.

in Southern Europe and Ireland. We engage with research on the deepening interconnections between states and finance (Alami, 2018; Sotiropoulos, Milios, & Lapatsioras, 2013; Braun, Gabor, and Hübner, 2018; Braun, 2020; Santos, 2023; Schwan, Trampusch, & Fastenrath, 2021; Trampusch, 2019), emphasising the importance of government debt markets in structuring hierarchies between core and peripheral countries (Vasudevan, 2024). Additionally, a strand of literature highlights the significance of government debt dynamics and Eurozone institutional frameworks in explaining financial instability and the “flaws” of the monetary union (De Grauwe, 2013; Lavoie, 2022a, 2022b; D. B. Papadimitriou & Wray, 2012). We underscore the rationale behind these flaws and the geopolitical relations influencing the Eurozone's institutional evolution, aligned with the political economy tradition (Streeck, 2017; Cesaratto, 2020, 2013; Lapavitsas et al., 2011; Lapavitsas & Giordano, 2022; Baccaro, Bremer, & Neimanns, 2023).

The chapter is divided into six sections besides the introduction. The first discusses the interconnections between financialisation, asymmetries, and European integration, focusing on the institutional approach to government securities. The second illustrates that the emergence of a government securities hierarchy translated into uneven gross financial inflows between the core and periphery in the region. The third develops the concept of the Eurozone's contradiction and how institutional developments manage this tension. The fourth section analyses institutional and economic policy developments during the debt crisis, while the fifth section does so for the pandemic. The final subsection addresses the “normalisation” of economic policy in the post-pandemic era, illustrating the reinforcement of the market's uneven discipline. The last subsection concludes.

1. The Eurozone Institutional in Financialised Capitalism: Merging Asymmetries and Integration

Financialisation in in the European Union (EU) is widely recognised as having been enhanced by regional integration, particularly through the Maastricht Treaty and subsequent agreements such as the Stability and Growth Pact (SGP) in 1998 and the Lisbon Treaty in 2007 (Santos, Rodrigues, & Teles, 2018; Bieling, 2013; Pataccini, 2017; Streeck, 2017; Bieling & Jaguer, 2009; Pesendorfer, 2014). This combination of financialisation and regional integration has reinforced existing asymmetries within the Eurozone (Rodrigues, Santos, & Teles, 2016; Gambarotto, Rangone & Solari, 2019), further entrenching the financial subordination of its

periphery to the core and to the EMU institutions. Supranational institutions within the Eurozone emerged as intermediaries between the power of finance and national Member States, a process shaped by “highly asymmetrical” geopolitical disputes (Streeck, 2017, p. 41). The framework established rigid economic policy constraints that often passed through government debt dynamics.

The Maastricht Treaty inaugurated an institutional approach to government securities that granted financial markets unprecedented power to affect sovereign bond yields. The demand for and risk assessment of sovereign debt have the potential to impact states' funding costs, thereby acting as a mechanism to discipline states towards the neoliberal agenda (Sotiropoulos et al., 2013). This potential power materialises in the absence of effective institutional mechanisms to counterbalance it. In the Eurozone, financial empowerment was enacted through the prohibition of the European Central Bank (ECB) and National Central Banks (NCBs) from directly purchasing government debt (Official Journal, 2002). Although no legal restrictions existed for such purchases in secondary markets, the Eurosystem adhered to an informal convention of refraining from them until 2014 (Lavoie, 2015). Subsequently, government securities purchases became conditional on the presence of systemic risks affecting the entire Eurozone. In this framework, finance gains significant power to shape asymmetries, as its discipline over states is geographically uneven (Alami, 2018).

The monetary policy framework illustrates both the internalisation of market pressures within the EMU and its geopolitical unevenness. The Maastricht Treaty established price stability as the sole primary objective of the Eurosystem (Official Journal, 2002, p. 75), replicating the Bundesbank regime (Baun, 1995). German influence exemplifies how, since the Euro's inception, the country has “de facto governed the EMU as a German economic empire,” imposing a hard currency on the region (Streeck, 2017, p. 41). Additionally, the ECB adopted a market-based approach to collateral policy, defining minimum eligibility criteria, making margin calls, and applying haircuts to assets – including government securities – based on the ratings of private agencies (Gabor & Ban, 2016; Van't Klooster, 2023). Risk management and market-based practices are features of contemporary central banking (Gabor, 2016), illustrating a dependency on financial markets for executing monetary policy that empowers finance² (Braun, 2020). The

² Braun (2020, p. 3) describes “infrastructural power” as the “political power that accrues to private financial actors as a result of state actors seeking to govern through financial markets.”

particularity of the Eurozone is that the repo market is highly asymmetrical among member states, with the highest share of government collateral issued by Germany, followed by Italy and France, which together represent more than 40% of the market (International Capital Market Association, 2010; 2023). Instabilities in countries with a smaller share of the repo market pose a lower threat to the execution of monetary policy, which, along with the market-based approach, contributes to fragmentation in the government securities market.

Under the Treaty and the subsequent Stability and Growth Pact (SGP), fiscal policy was constrained by rigid and arbitrary limits on government deficits (3% of GDP) and public debt (60% of GDP), with non-compliance leading countries to an adjustment path under the Excessive Deficit Procedure (EDP). These limits often failed to ensure the convergence of EMU countries to such parameters; however, they compelled governments to sell assets and adopt privatisation and austerity measures to meet these requirements (Pataccini, 2017; Caselli & Wingender, 2021). Therefore, the EMU approach to public finance is “intended as a way of bringing in anti-Keynesian and deflationary policies” (Arestis & Sawyer, 2006). Moreover, institutional hesitance in imposing adjustment paths and sanctions on larger and more powerful members is evident, as illustrated by the lack of sanctions imposed when France and Germany exceeded budget deficit limits in 2003 (Tooze, 2018).

By setting limits and constraints on economic policy at the supranational level, states have prioritised gaining the confidence of financial markets, a feature deeply intertwined with financialisation (Streeck, 2014; Karwowski, 2019). This uneven process facilitated the emergence of an institutionally shaped hierarchy of government securities in the region, foundational to the EMU's financial asymmetries.

2. Government debt hierarchies and financial flows asymmetries

The Eurozone institutionality reinforced regional financial asymmetries which became evident in capital flows. Countries with volatile financial flows are over penalized by such framework, due to limited policy space to mitigate instability. This section demonstrates how financial gross inflows in the Eurozone reveal that these asymmetries were exacerbated during the debt crisis and significantly reduced during the pandemic, reflecting the varied institutional approaches to government securities during both periods of distress. Inflows into government debt played a crucial role in shaping these asymmetries.

Before the Global Financial Crisis (GFC), Southern Europe and Ireland experienced substantial gross financial inflows³ that positively influenced financial asset prices (Kohler, 2022) and credit demand (Borio and Disyatat, 2015), contributing to lower long-term interest rates, including those on government securities (Carvalho and Fidora, 2015). However, a decline in gross financial flows can adversely affect domestic asset prices and increase government funding costs, worsening the solvency of both private and public agents, thereby creating financial instability.

The procyclical and volatile demand from foreign investors for peripheral countries' assets is a well-documented manifestation of financial subordination (Alami et al., 2023; Bonizzi, Kaltenbrunner, & Powell, 2023; Bortz & Kaltenbrunner, 2018; Kaltenbrunner & Paineira, 2018). Peripheral countries count both with more volatile and procyclical gross financial inflows – portfolio and foreign direct investment (FDI)⁴ – and general government inflows when compared with Germany, as illustrated in Figure 1. Notably, there was a dramatic decrease in gross financial inflows and government inflows in peripheral countries starting in 2010, contrasting with an upward trend in Germany. During the debt crisis and the initial phase of the pandemic, Germany benefitted from increased foreign demand for its government bonds and assets. In the pandemic's wake, financial flows became less unstable when compared with the previous shock, with the discrepancy between Germany and the periphery less pronounced. Excluding Greece, peripheral countries did not experience significant decreases in gross general government inflows during the pandemic, and reductions in gross FDI and portfolio inflows remained moderate. In summary, gross financial flows reflect asymmetries among the countries analysed, which were exacerbated during the debt crisis and significantly reduced during the pandemic.

Table 1 further illustrates that peripheral countries generally exhibit higher volatility in portfolio gross inflows – especially in gross portfolio inflows – and general government inflows than the Eurozone core. The periphery also demonstrated a strong correlation between gross inflows and general government inflows, particularly during the debt crisis. This feature is supported by a higher share of government securities in portfolio flows and the interconnectedness

³ The emphasis on gross financial flows aligns with a body of literature suggesting that they better reflect financial instabilities than net financial flows, which merely mirror current account balances (Kohler, 2022; Wray, 2012b; Febrero, Álvarez & Xuó, 2019; Borio & Disyatat, 2015).

⁴ Here, gross capital flows exclude "other investments" (primarily bank flows) and "derivatives." As Kohler (2022) argues, while portfolio and foreign direct investment (FDI) flows directly impact asset prices, cross-border bank flows are more passive and demand-driven, thus having less effect. Additionally, derivatives pose challenges for national accounting and measurement, complicating their interpretation (Kohler, 2022).

of private and public financial flows. Ireland, in particular, experienced large and volatile financial inflows that inversely correlated with government inflows. This particularity can be explained by the fact that the Irish financial system is heavily influenced by the U.S. dollar, the British pound, and the U.S. and UK financial systems (Lane, 2015), leading to vulnerabilities tied to these currencies that add to regional imbalances. Southern Europe exhibits both volatile and pro-cyclical gross financial flows, which strongly correlate with inflows into government securities,

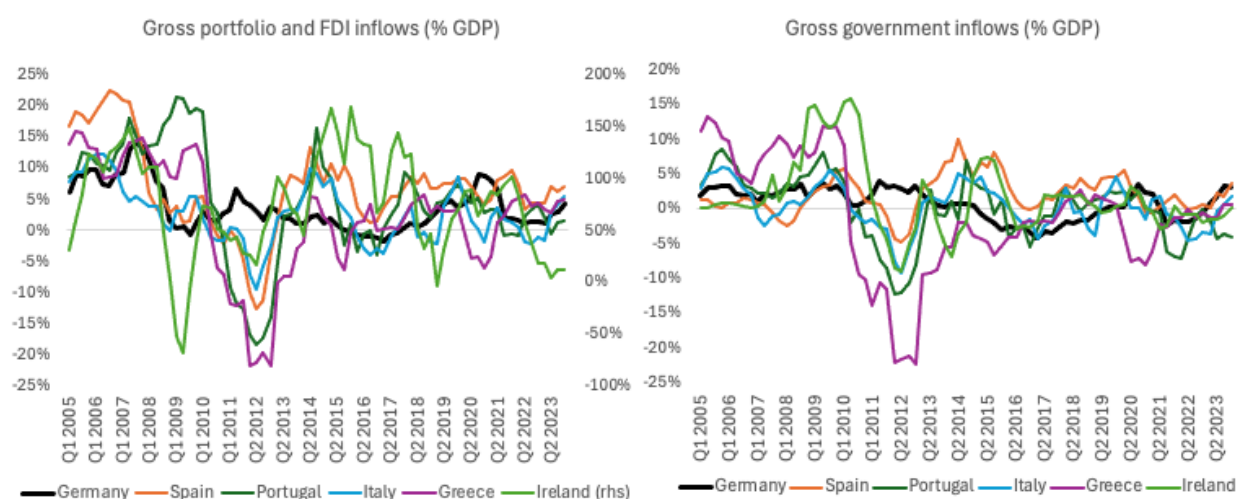


Figure 1 - Data: IMF/BoP. Gross direct and portfolio inflows comprise the sum of net incurrence of portfolio investment and direct investment liabilities. Gross government debt inflows comprise the debt securities issued by the general government (central, state or local government) and hold by nonresidents. Values are in four-quarter moving average.

Standard deviation of capital flows (2005-2023)			Correlation (2005-2023)		Correlation (2008-2014)	
Gross general gov. inflows (% GDP)	Gross portfolio inflows (% GDP)	Gross FDI and portfolio inflows (% GDP)	Gross FDI and portfolio inflows and general gov. inflows (% GDP)			
Greece 8,3%	Ireland 38,7%	Ireland 49,6%	Greece 0,98	Greece 0,99		
Ireland 5,3%	Portugal 9,6%	Netherlands 30,6%	Portugal 0,89	Portugal 0,97		
Portugal 4,7%	Netherlands 9,1%	Belgium 12,5%	Italy 0,86	France 0,93		
Italy 3,2%	Greece 8,8%	Greece 9,0%	France 0,79	Italy 0,92		
Finland 3,1%	Spain 7,1%	Portugal 8,9%	Germany 0,61	Spain 0,82		
Netherlands 2,9%	Austria 5,8%	Spain 7,2%	Austria 0,58	Germany 0,40		
Spain 2,8%	Finland 4,5%	Austria 5,8%	Finland 0,31	Finland 0,17		
Belgium 2,7%	Italy 4,4%	Italy 4,6%	Spain 0,29	Netherlands -0,06		
Austria 2,6%	Belgium 4,1%	France 4,2%	Belgium 0,03	Belgium -0,08		
France 2,4%	France 4,0%	Finland 3,9%	Ireland -0,10	Ireland -0,25		
Germany 2,2%	Germany 3,7%	Germany 3,8%	Netherlands -0,14	Austria -0,33		

Table 1 - Author's calculation based on IMF/BoP data.

underscoring the latter's importance to financial instability. The institutional approach to government securities and its evolution over time is central to these dynamics.

The strict controls imposed by Eurozone institutions on government debt and deficits contrasted with the relative freedom of international financial flows, intensifying the effects of the free reallocation of investors' portfolios from the periphery to the core during periods of distress. Core countries, epitomised by Germany, benefit from the safe-haven status of their government debt and experience less volatile financial flows. In contrast, the periphery faces procyclical and volatile financial flows, with government securities playing a critical role in financial instability. The intensification of these asymmetries during the debt crisis and their subsequent easing during the pandemic reflect shifts in the institutional approach to government debt, which will be addressed in detail in the following sections.

3. The Eurozone's contradiction

In this section, we introduce a new framework to assess the interconnections between financial asymmetries and institutional developments in the Eurozone. The EMU embodies a fundamental contradiction that became unsustainable during the debt crisis, prompting institutional changes aimed at saving the euro, which ended by reshaping financial asymmetries. The management of such contradiction by the Eurozone institutions was further refined during the pandemic, leading to more contained asymmetries. Our framework also evidences that government debt hierarchies served as a vital link in connecting these institutional developments with the financial subordination of the periphery.

A significant body of literature emphasises the “flaws” in the Eurozone’s institutional framework as the main cause of the debt crisis (Lavoie, 2022; Papadimitriou & Wray, 2012; De Grauwe, 2013). Lavoie (2022) argues that the crisis was “essentially the consequence of flawed institutional arrangements,” pointing to the lack of a federal government and the absence of outright public debt purchases by the ECB. According to proponents of MMT, the Eurozone's flaw lies in its members becoming users of an “external currency” without proper institutions to back government debt (Ehnts & Wray, 2024; Papadimitriou & Wray, 2012).

However, the flaws of the Eurozone framework can be better understood by making explicit the power relations embedded within it. The euro is not flawed simply because it allows financial markets to speculate against government securities, leading to recessions, particularly in

peripheral economies. These are exactly – it could be argued – one of the purposes of the euro. As a disciplinary tool, it can be said it “is untrue that the euro is a failure; it is a success” (Cesaratto, 2020, p. 188). More than technical errors, “at the root of the turmoil in the Eurozone lie class and imperial interests” (Lapavitsas et al., 2011, p. 22). As stated by Lavoie (2022, p. 550), the ECB’s late action was also a consequence of huge pressure from German institutions. For some political actors the flaw was, for a time, a virtue. However, shifts in the Eurozone’s institutional framework emerged as a necessity to save the euro (Giordano & Lapavitsas, 2022), revealing that there was indeed a problem with the original institutional setup.

The deepening of the debt crisis indeed highlighted a significant problem: the prior institutional incapacity to manage the increasingly unbearable tension between the reproduction of regional asymmetries and the perpetuation of the EMU. The potential tension between these two poles – on one side, financial asymmetries, and on the other, the reproduction of the common currency – illustrates the fundamental contradiction of the Eurozone. In a single currency area, financial asymmetries might pose risks to the entire region due to the potential for economic contagion and political resistance from the most affected nations. Ultimately, this contradiction could threaten the very existence of the monetary union. During moments when such tension became unbearable – such as the debt crisis and the pandemic – the Eurozone’s contradiction was managed through developments in supranational institutions and shifts in economic policy, shaping the subordination of its periphery. Understanding the determinants of this contradiction allows for a more precise examination of the financial subordination of the Eurozone periphery and its connections to regional institutional developments.

As De Grauwe and Ji (2022) argue, no single Eurozone economy can “force the ECB to provide liquidity in times of crisis”, creating uncertainty about future liquidity support. However, the institutional backstop is not only uncertain but also uneven, depending on the political and economic weight of each country. The power asymmetry within the EMU is reflected in decision-making, shaping policies that both express and reinforce asymmetries (Maris & Sklias, 2020). The risk that instability in one country could affect the broader Eurozone is, to the country in vulnerability, a source of indirect power⁵. Given the different sizes and levels of

⁵ Empirical evidence of bargaining power arising from contagion risk in the Eurozone is presented by Fotiou, Bonk, and Manalis (2022, p. 6), suggesting that debtor countries may fare better in the long term under lending contracts with high spillover effects between parties.

interconnectedness between member states, they pose varying risks to the Eurozone. Consequently, the EMU tolerates differing levels of financial instability in peripheral countries, depending on the threat each poses to the entire region.

Figure 2 illustrates the key framework of our argument. Both core and peripheral countries benefit⁶ from the Eurozone and are, *ceteris paribus*, invested in the perpetuation of the regional currency. Core countries are committed to the euro perpetuation, as they benefit from an open market and overvalued real exchange rates that support their export-led growth model (Kohler & Stockhammer, 2022). The periphery, meanwhile, benefits from climbing the hierarchy of currencies (Prates & Pereira, 2020), specifically by reducing exchange rate volatility and diminishing the necessity to accumulate foreign reserves⁷. However, the Eurozone’s approach to

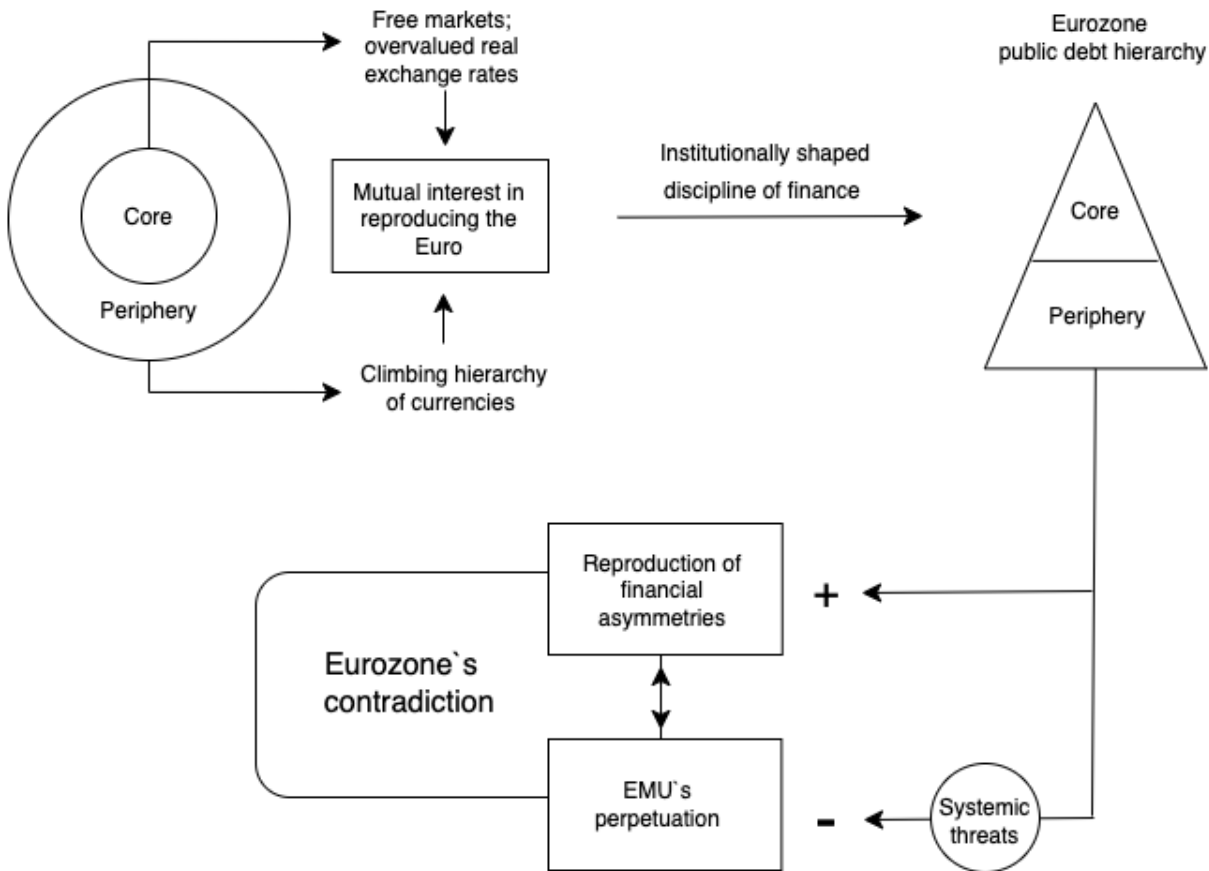


Figure 2 – The Eurozone’s contradiction. Author’s elaboration.

⁶ This analysis highlights the benefits stemming from a degree of national cohesion among social classes. For instance, remaining in the Eurozone advantages the capitalist classes in both the core and periphery by reinforcing austerity and imposing strict discipline on the labour force. However, this situation may also provoke labour unrest and internal political resistance.

⁷ The creation of TARGET2 allows the accumulation of growing trade imbalances and financial outflows without depleting foreign reserves. For further details on TARGET2, see the debate between Cesaratto (2013) and Lavoie (2015).

public debt renders Member States' liabilities vulnerable to the uneven discipline imposed by financial markets, as expressed by the financial gross inflows asymmetries. Insolvency risk, therefore, reflects not only market fundamentals but also the perceived likelihood that supranational institutions will back a country in crisis⁸. This reinforces a hierarchy of government securities, in which peripheral countries consistently rank at the bottom. Such framework perpetuates the financial subordination of peripheral countries based on their weaker position in the hierarchy of regional government securities.

Nevertheless, in such a deeply integrated region, the risks of financial contagion and political resistance from the periphery present significant challenges to the entire Eurozone. When systemic threats arise, EMU and EU institutions must navigate the tension between financial discipline and the sustainability of the euro. During the debt crisis, contagion was the primary concern, whereas the pandemic also posed a political threat to EMU cohesion due to the potential asymmetrical impacts of a global health emergency. Supranational developments and economic policy shifts arise in response to risks affecting the entire EMU, particularly when these risks impact core economies due to their regional hegemonic power and influence over such institutions.

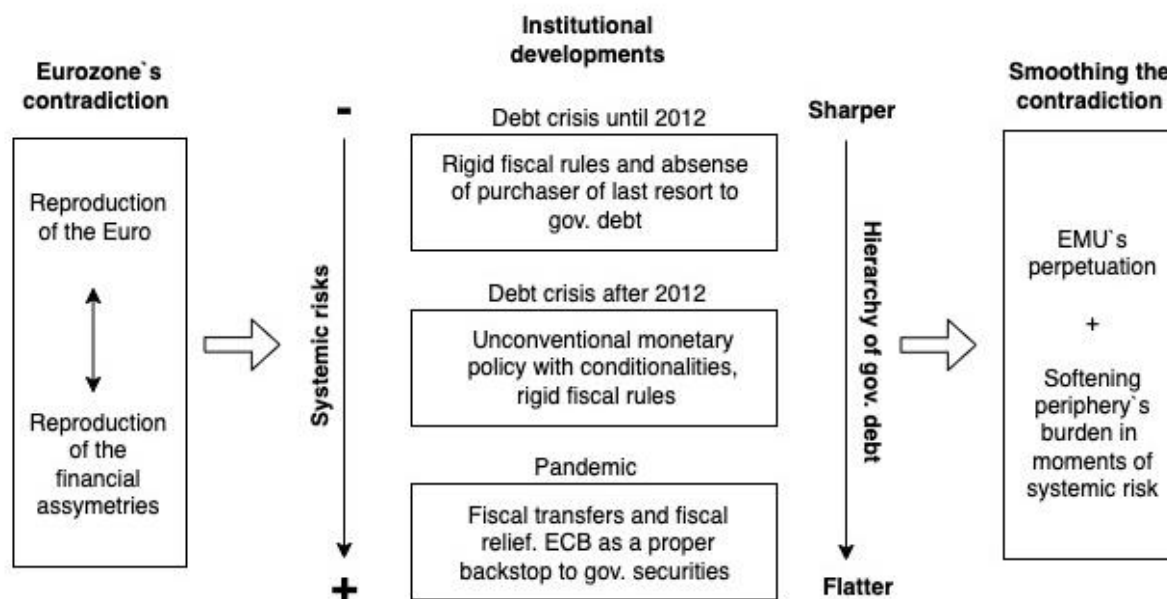


Figure 3 – Institutional management of Eurozone's contradiction. Author's elaboration.

⁸ We introduce a new determinant to this risk assessment, which helps explain why spreads can become independent of economic fundamentals, as evidenced by empirical research conducted by De Grauwe and Ji (2022).

These institutional changes have shaped the hierarchy of government securities, making it sharper or flatter depending on systemic risks, thereby ensuring the perpetuation of the euro and the EMU.

As illustrated in Figure 3, when there is a lower economic or political threat to the Eurozone, economic policies such as rigid fiscal rules and a market-based approach to government securities favour a sharper regional hierarchy of government debts. When a shock presents an economic or political threat to the Eurozone, the tension between the uneven discipline of finance and the reproduction of the regional currency must be managed to overcome systemic risks. The cases of the debt crisis and the pandemic illustrate the different institutional reactions to these various types of shocks. Institutional developments and shifts in fiscal and monetary policy shaped the regional hierarchy of government securities and financial asymmetries during both crises, ultimately smoothing regional tensions. When systemic risks are overcome, efforts to reestablish financial discipline tend to prevail once again, laying the groundwork for future instability.

4. The Management of the Eurozone`s Contradiction in the Debt Crisis

The debt crisis gradually affected the Eurozone, posing increasing - though not immediately systemic - risks to the region. As a result, the institutional response was also gradual, focusing

Economic policies		Hierarchy of gov. debt	
		Smoothing hierarchy	Reinforcing hierarchy
Monetary policy	Pro-cyclical and market-based collateral policy		Reinforcing risk downgrades of gov. securities
	Security Market Program (SMP)	Outright purchases of gov. securities	Limited and insufficient amount of purchases
	Outright Monetary Transactions (OMT)	Compromise to unlimited purchases of gov. securities	Conditional on joining adjustment programmes
	Asset Purchase Programme (APP)	Unlimited and unconditional purchases of gov. securities	Exclusion of Greece
Fiscal measures	Fiscal rescue packages and creation of the European Stability Mechanism (ESM).	Avoiding sovereign default	Economic policy shaped by the interest of State bondholders/bank creditors
	Six-pack, the Fiscal Compact, Two-pack		Reinforcing institutional discipline on debt and deficit limits

Table 2 - Economic policies and institutional developments during the debt crisis and its impacts on the regional hierarchy of government securities

primarily on preventing contagion and safeguarding the interests of major periphery bondholders and bank creditors. As the crisis deepened, it required significant shifts in monetary and fiscal policies to sustain the EMU. As shown in Table 2, these policy shifts and institutional developments were mixed, with enforcement measures dominating until 2012, followed by a softening of the regional public debt hierarchy.

The financial rescue programmes

The first supranational response to the Eurozone's contradictions came through financial rescue programmes, initially led by the Troika⁹ and later institutionalised by the European Stability Mechanism (ESM)¹⁰. These programmes aimed to prevent contagion, given the Eurozone's exposure to peripheral sovereign debt (IMF, 2013a; EC, 2023), and helped avert sovereign defaults, ensuring the EMU's perpetuation. They reinforced the hierarchy of government debt by steering peripheral economic policy in a neoliberal direction, aligning with the interests of core Eurozone bondholders (Table 2).

The conditionalities primarily involved austerity and structural reforms, varying in emphasis and intensity. In Greece and Portugal, the focus was on fiscal consolidation and labour/pension reforms (EC, 2023; 2016a), while in Ireland and Spain, the emphasis was on banking reforms (IMF, 2015; EC, 2016b). Greece faced the harshest measures justified by its "weak administrative capacity" (IMF, 2013b), whereas Ireland's adjustment was "more streamlined" (IMF, 2015). These programmes triggered deeper-than-expected recessions (Uxó, Febrero, & Bermejo, 2016; IMF, 2016; Lagoa & Barradas, 2020), with Greece being the most extreme case. The EC and IMF acknowledged the significant negative economic and social impacts, despite preventing spillover to the rest of the Eurozone (Commission, 2023, pp. 18-29; IMF, 2013b). Therefore, spreads remained high in the Eurozone following the rescues (Figure 3).

Financial assistance was also shaped by the exposure of core Eurozone creditors to each country. The ECB denied Ireland's proposal for a haircut on its bank's senior bondholders due to significant Irish liabilities held by core creditors (Breen, 2012). In contrast, a bail-in was approved for Cyprus banks, partly due to their liabilities being largely owned by Russian residents (Papadimitriou & Pegasiou, 2023). In Spain, losses were shared with the private sector, but

⁹ Formed by the European Commission (EC), the ECB, and the International Monetary Fund (IMF).

¹⁰ Two temporary funds were established prior: the European Financial Stabilisation Mechanism (EFSM) and the European Financial Stability Facility (EFSF).

haircuts mainly impacted domestic households and pensioners (EC, 2016b, p. 53), preserving the interests of foreign and institutional creditors.

Being at the top of the currency hierarchy did not prevent the Eurozone periphery from facing strict adjustment paths, similar to developing economies when turning to the IMF. However, in the Eurozone, the surveillance institutions were primarily regional, directly invested in the perpetuation of the common currency. This influenced the rescues, guiding each country towards adjustments focused on avoiding contagion and safeguarding the interests of core Eurozone creditors.

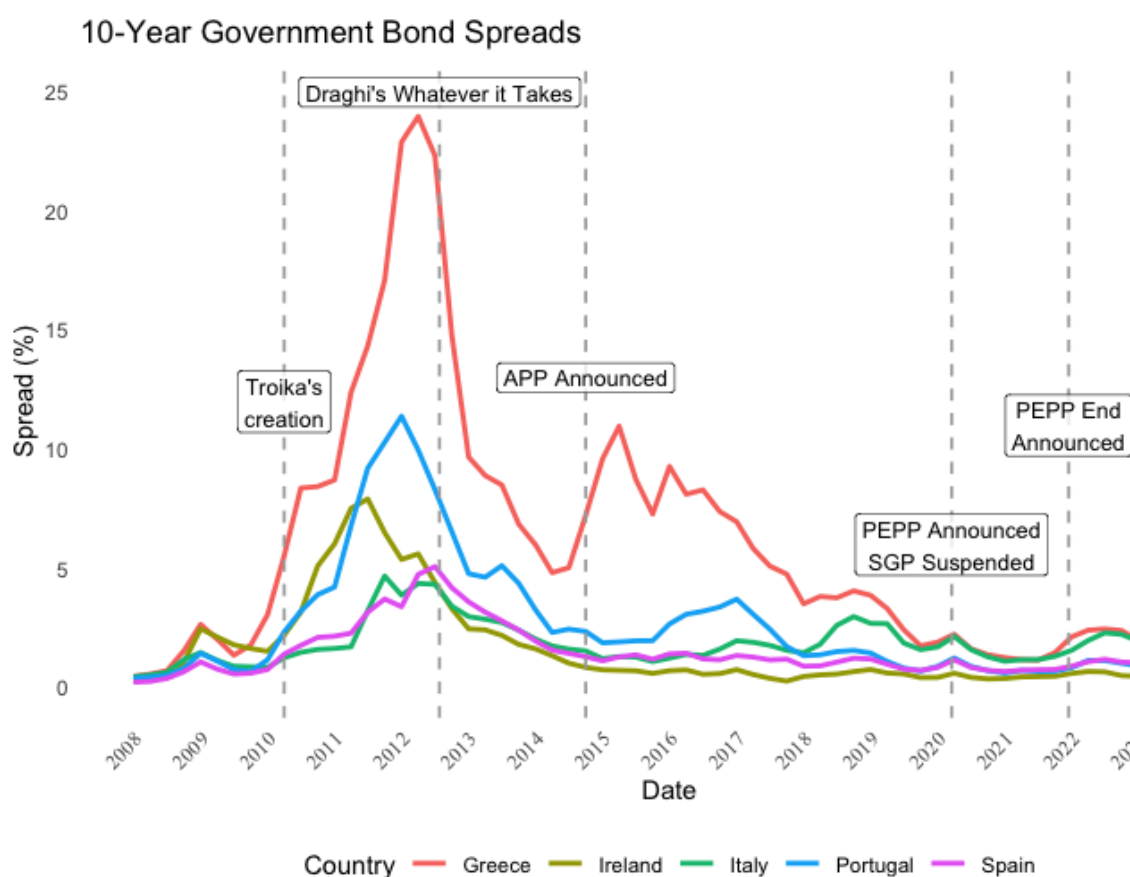


Figure 3 - Data: FRED

Monetary policy shifts and strict fiscal policy

The fiscal rescue programmes could not address the increasing systemic risks to the Eurozone, necessitating further economic policy measures. While the fiscal framework continued to reinforce market discipline, shifts in monetary policy became the primary mechanism to ease

the tension between financial discipline and the EMU's continuation. These changes influenced the regional hierarchy of government debt, eventually softening it as needed to combat systemic risks (Table 2).

In the early years of the crisis (2010-2012), monetary policy mainly relied on liquidity provided against eligible collateral. The ECB, through its collateral policy, imposed additional haircuts on downgraded government securities (Adler et al., 2023), made margin calls when bond prices fell (Gabor & Ban, 2016), and temporarily declared some government bonds ineligible as collateral¹¹. The ECB justified this as risk management, passively reflecting the market's view of credit quality (Gabor & Ban, 2016). Such justification contrasts with the unique role played by the ECB as a liquidity provider, having the power to reinforce or smooth the risk assessment by private investors and therefore the risk of its portfolio, unlike other market participants. As a result, its collateral policy contributed to sharpening regional hierarchies.

The ECB's unique role as a financial market maker, capable of reinforcing or softening regional asymmetries, became evident when it had no choice but to compromise by purchasing government securities to preserve the EMU. These purchases were gradual, reflecting institutional reluctance to reduce financial disparities. In early 2010, limited government purchases were made through the Securities Market Programme (SMP), which failed to offset widening bond spreads until mid-2012 (Figure 3). The spread only narrowed after Draghi's statement that the ECB would do "whatever it takes" to save the euro, highlighting its power to boost market confidence in the currency and Member States' solvency (Figure 3).

Following Draghi's statement, the ECB introduced Outright Monetary Transactions (OMT), committing to unlimited purchases of government securities if necessary, contingent upon participation in an ESM programme. The OMT was never activated, and the recession's effects prompted the launch of the Asset Purchase Programmes (APP) by mid-2014. The APP enabled large-scale, unconditional asset purchases, primarily government securities under the Public Sector Purchase Programme (PSPP), resulting in further yield convergence (Figure 3). However, Greece and Cyprus¹² were excluded from the PSPP as it did not meet the necessary criteria¹³. After the

¹¹ As in the cases of Greece (ECB, 2012) and Cyprus (Riecher, 2013).

¹² Cyprus was later included in the PSPP but received minimal purchases until September 2018.

¹³ Countries were required to undergo a minimum credit quality assessment by private rating agencies. Purchases were capped at a maximum of 33% of a particular Member State's (issuer's) outstanding securities and limited to 25% of each individual security.

Greek EU/IMF programme ended and with Greece still excluded from the PSPP, the ECB's Executive Board warned, in a context of intense government securities purchases from the remaining countries, that the "burden of gaining the trust of markets and depositors has now fully shifted to the Greek government" (Cœuré, 2018). This illustrates how the Eurozone institutions manage market discipline, perpetuating regional asymmetries as long as they do not threaten the EMU's perpetuation.

The first quantitative easing (QE) came alongside the introduction of stricter European fiscal rules – the Six-pack, Fiscal Compact, and Two-pack¹⁴. Within this framework, which combined strict fiscal control with asset price increases, QE had a greater impact on intra-financial activity than on the relationship between finance and the real economy – a pattern "consistent with the process of progressive financialisation" (Perillo & Battiston, 2020, p. 1424). Thus, the Eurozone's contradictions were managed according to the primacy of finance.

Shifts in monetary and fiscal policy allowed the dynamic reproduction of financial asymmetries among Member States, pushing these asymmetries to the limit tolerated by the EMU's perpetuation. The evolution of the Eurozone's institutional approach to sovereign debt ensured that the power of finance remained aligned with the euro's maintenance, though it occasionally eased – unevenly - the burden on peripheral countries.

5. Further Managing the Eurozone's Contradiction in the Pandemic

The pandemic was a symmetric shock with potentially asymmetric consequences, impacting all countries simultaneously and posing systemic threats to the EMU from the outset. The supra-institutional response was faster and more effective in combating the crisis compared to the sovereign debt turmoil of the previous decade. The ECB acted as a purchaser of last resort for government securities from the beginning, and fiscal constraints were eased. Some authors suggest that this shift may indicate "a more structural change in the Eurosystem's approach to regional development and recovery" (Eichacker, 2022). Ehnts and Wray (2024, p. 13) take this further, asserting that the transformations during the pandemic might become permanent since "[m]aybe

¹⁴ The Six-pack, introduced in December 2011, aimed to enhance macroeconomic surveillance. The Fiscal Compact, enacted in March 2012, set a structural deficit limit of 0.5% of GDP for countries with public debt over 60% of GDP, and 1% for those with higher ratios. The Two-pack, introduced in 2013, strengthened budgetary supervision for financially distressed member states (Pappa, 2020).

there is no alternative,” justifying this view by noting that there have been “[t]here have been no calls for austerity.”

This section argues that the recent changes in the ECB’s conduct of monetary policy and the lifting of fiscal austerity do not signify a permanent or structural change in the region. During the pandemic, as during the debt crisis, the institutional changes once again represented a management of the Eurozone’s contradiction, this time in an extreme scenario: a health emergency posing a political threat to the region’s cohesion. This prompted robust and temporary changes in monetary and fiscal policies, softening the institutional mechanisms that shape the regional hierarchy of government securities and alleviating the burden on the periphery (Table 3).

Economic policies		Hierarchy of gov. debt	
		Smoothing hierarchy	Reinforcing hierarchy
Monetary policy	Collateral policy Easing the conditions for the use of credit claims as collateral A general reduction of 20% in collateral valuation haircuts Waiver to the Greek sovereign debt instruments Flexibility of credit quality requirements	Softening the disciplinary impacts of risk assessment by financial market players on gov. securities	Temporary measures restrict to the covid-19 health emergency
	Unconventional monetary policy Pandemic Emergency Purchase Programme (PEPP) Restart of APP	Unlimited and unconditional purchases of gov. securities	
Fiscal policy	Suspension of SGP	Suspending institutional discipline on debt and spenditure limits	
	Next Gen EU	Debt mutualization and risk sharing	

Table 3 - Economic policies and institutional developments during the pandemic and its impacts on regional government debt hierarchy.

Monetary policy

The Eurosystem's monetary response to the pandemic focused on increasing banking liquidity, with a crucial role played by a more flexible collateral policy and substantial purchases of government debt securities, primarily by the NCBs.

The collateral easing measures aimed to support credit through a “[t]emporary increase in the Eurosystem’s risk tolerance” (ECB, 2020a) and highlighted the institution’s role as a financial market maker. These measures directly influenced the use of government securities – especially those with lower ratings – as collateral, helping to mitigate the impacts of rating downgrades on demand and overall liquidity (Bakker et al., 2022). By relaxing institutional discipline around risk assessments, lifting limits on credit requirements, and reducing haircuts, these measures contributed to smoothing financial asymmetries by flattening the regional sovereign debt hierarchy (Table 3).

Regarding the unconventional monetary policy, with the Pandemic Emergency Purchase Programme (PEPP), the ECB made clear its commitment to flexibility, stating it was “fully prepared to increase the size of its asset purchases (...) for as long as needed” and was willing to revise any self-imposed limits that could hinder the programme's goals (ECB, 2020b). The focus remained on government securities, which accounted for about 90% of total purchases, with the PEPP designed as a “response to a specific, extraordinary, and acute economic crisis” (ECB, 2020c).

The short-lived upward trend in spreads at the beginning of 2020¹⁵ was reversed following the launch of the PEPP and the introduction of measures to enhance bank liquidity (Figure 3). These measures allowed the Eurosystem to effectively support the government securities of each country, preventing the pandemic crisis from leading to systemic fragmentation in the region’s government bond markets (De Grauwe & Ji, 2022). The ECB acted swiftly, making liquidity unconditional on economic reforms and sidelining the limitations that, while presented as “technical,” were in fact political, which had previously excluded Greece and Cyprus from participation.

The ECB’s different approach to the pandemic crisis illustrates how “[t]he nature of the pandemic shock relegated moral hazard concerns to the back of the queue” (Tesche, 2022). The economic and political risks posed by the pandemic made it untenable to oppose the ECB’s backing of government securities. A notable example is Bundesbank President Jens Weidmann, who had previously critiqued the SMP, OMT, and PSPP under the APP, arguing that these measures undermined capital market discipline over government securities (Bundesbank, 2017; Spiegel, 2012a). During the pandemic, his rhetoric softened, and he acknowledged the necessity

¹⁵ Also supported by Lagarde's statement on 12 March 2020 that the ECB is not “here to close spreads.

and correctness of the monetary policy steps taken (Bundesbank, 2020). However, he insisted that these measures should end as soon as the emergency passed (Bundesbank, 2021).

The shifts in monetary policy during the pandemic reflect how calls for stricter capital discipline became politically untenable, even for core countries, in the context of the COVID-19 crisis. The robustness and exceptional nature of monetary policy during this period represent both the ECB's commitment to combating systemic risk and the limits of this commitment to situations threatening the EMU.

Fiscal policy

The Eurozone's response to the pandemic crisis included shifts in fiscal policy, primarily through the exceptional conditions permitted under the Stability and Growth Pact (SGP) and the creation of the Next Generation EU (NGEU). Both measures were innovative; for the first time, the SGP's flexibility clauses for abnormal times were activated, and the NGEU represented a pioneering, albeit provisional, step towards debt mutualisation by issuing bonds backed by the EU.

The SGP contains a "general escape clause" that allows for budgetary flexibility during exceptional circumstances, which was activated during the COVID-19 crisis (EC, 2020). Consequently, governments could diverge from their fiscal adjustment paths in response to increased debt and expenditure ratios, allowing more flexibility to mitigate the pandemic's negative impacts¹⁶. However, important questions remained, such as the future burden of these deficits, their impact on national government debt, and the insufficiency of national fiscal stimuli within the EU context.

In the early months of the pandemic, political disputes arose among Member States regarding the establishment of a common recovery plan to complement national fiscal stimuli. Peripheral countries and higher-indebted core nations¹⁷ called for European solidarity, advocating for a common debt instrument issued by the EU to address the pandemic's effects. This idea faced initial opposition from other core countries¹⁸, which relied on the conventional "moral hazard" argument (Baccaro et al., 2023). Regional tensions were evident in the comments of the Dutch finance

¹⁶ According to Eurostat, the general government deficit in the euro area was 7% in 2020, remaining above the 3% limit until 2023. Under the general escape clause, Member States were not subject to an excessive deficit procedure, which would have required adjustments for the entire region.

¹⁷ Belgium, France, Greece, Ireland, Italy, Luxembourg, Portugal, Slovenia and Spain.

¹⁸ Germany, Austria, Denmark, Netherlands and Sweden.

minister, who suggested “investigating” countries like Spain that lacked the budgetary margin to respond effectively, sparking outrage from Southern European nations like Portugal (Donn, 2020). Political resistance also surfaced in the Eurozone periphery, evidenced by declining support for euro membership in Italy (Baccaro et al., 2023). However, Italian Prime Minister's assertion that “the European Union risks failing as a project in the coronavirus crisis” (Lowen, 2020) turned into a regional concern, shaping the consensus around risk-sharing.

Solidarity became a matter of self-interest for all countries concerned with the Eurozone's cohesion and survival, enabling significant yet temporary fiscal policy changes. In this context, a Franco-German initiative proposed the creation of a recovery fund on 18 May 2020, marking a significant shift in Germany's stance on debt mutualisation and fiscal transfers. Angela Merkel, who previously stated that debt-sharing would not occur during her lifetime, defended the proposal as an “unprecedented one-off effort,” necessitated by a moment that could, in her words, “endanger the European Union's cohesion” (Bundesregierung, 2021; Mallet, Chazan, & Fleming, 2020). Nonetheless, leaders from Austria, Denmark, Sweden, and the Netherlands contested the plan, arguing it could set a concerning precedent (Hill, 2020). This shift in Germany's position reflects the country's willingness to act towards stabilisation “when the European project is faced with an existential shock” (Tesche, 2022, p. 488). The consensus culminated in the European Commission's proposal for the NGEU¹⁹, comprising loans and grants backed by Eurobonds to address the crisis's impacts, particularly focusing on the most affected countries²⁰. In line with Franco-German arguments, the NGEU is characterised as “an exceptional response to those temporary but extreme circumstances” (Council, 2020, p. 3).

The approval of the Next Generation EU (NGEU) and the associated fiscal relief emerged from geopolitical disputes, with the extraordinary circumstances of a global health emergency providing bargaining power to the countries most affected. However, the strength of these changes is tempered by their temporary and exceptional nature. The absence of permanent fiscal mechanisms suggests that future collective fiscal efforts will once again depend on the political strength of the most impacted Member States. Future crises may not offer similar opportunities,

¹⁹ The proposal included a reinforced multiannual financial framework for 2021-2027 with a budget of €1,100 billion, along with the SURE instrument for mitigating unemployment risks, the ESM Pandemic Crisis Support, and the European Investment Bank Guarantee Fund for Workers and Businesses (Commission, 2020).

²⁰ The allocation key for the funds of 2021 and 2022 was based on GDP per capita and past unemployment rates, while the allocation for 2023 depended on the decline in real GDP in 2020 and 2021 (Council, 2020).

as it is “[i]t is hard to imagine a shock better suited to elicit European fiscal solidarity than a deadly pandemic” (Tesche, 2022). While some may interpret it as a “first step towards a budgetary union,” as suggested by De Grauwe and Ji (2022), it also highlights the limitations of a fiscal union if such mechanisms are activated only in response to systemic threats to the region.

6. The post-pandemic: reinforcing market discipline

Recent moves towards monetary and fiscal normalisation in the Eurozone illustrate that, as systemic risks from the pandemic have receded, there is now room to deepen market discipline in the region. The normalisation of fiscal and monetary policies is characterised by the reversal of collateral easing measures, the implementation of Quantitative Tightening (QT), and the reform of the SGP. Additionally, a new instrument has been created to minimise fragmentation risk: the Transmission Protection Instrument (TPI).

The reversal of collateral easing and the shift towards QT signal the ECB's transition from combating systemic risk to focusing on market-based risk management. The ECB announced a gradual phasing-out of collateral easing, re-establishing haircuts and credit requirements to return to pre-pandemic risk tolerance (Bakker et al., 2022). The waiver for Greek government bonds will remain in place until reinvestments under the Pandemic Emergency Purchase Programme (PEPP) are completed. Conversely, the shift towards QT²¹ is presented as a necessary tool to combat inflation and reduce the Eurosystem's balance sheet. From January 2023 to March 2024, the value of asset holdings under the Asset Purchase Programme (APP) and PEPP decreased by €339.6 billion. Following the announcement of QT, spreads increased, particularly in Italy and Greece (Figure 3). To address fragmentation risk, the ECB Governing Council decided to rely on two mechanisms: reinvestment flexibility under the PEPP and the newly created TPI (ECB, 2022a).

The PEPP was designed to allow flexibility in purchases and disinvestments, serving as the “first line” of the ECB's strategy to counter fragmentation risks in the government bond markets (ECB, 2022b). Reinvestments under the PEPP resulted in positive net purchases in some countries and negative in others. From June 2022 to March 2024, this led to an increase of €9.9 billion in public sector holdings from Italy and €5.3 billion from Spain, while holdings of German public

²¹ The first step towards QT was the cessation of net purchases under the PEPP in March 2022 and the APP in July 2022. This was followed by a planned reduction in the reinvestments of maturing securities, with APP reinvestments discontinued in July 2023 and PEPP reinvestments expected to cease by the end of 2024.

securities decreased by €19.3 billion. This illustrates the ECB's efforts to mitigate fragmentation risk, particularly in Italy and Spain, which are crucial due to their potential contagion risk to the region. As reinvestments under the PEPP are scheduled to end in late 2024, the flexibility they provide will also diminish as a tool to combat fragmentation.

The second mechanism aimed at offsetting fragmentation, the TPI, was introduced by the ECB to "ensure that the monetary policy stance is transmitted smoothly", particularly during the ongoing QT (ECB, 2022b). This instrument for purchasing government securities in the secondary markets is conditional on fiscal sustainability and a sustainable trajectory for public debt. The TPI targets countries experiencing a "deterioration in financing conditions not warranted by country-specific fundamentals" (ECB, 2022b). However, it remains unclear how the ECB will differentiate between deteriorations based on country-specific fundamentals and those that are not, as purchases will cease if "persistent tensions are due to country fundamentals" (ECB, 2022b). Consequently, uncertainty and asymmetries surrounding the ECB's role as the purchaser of last resort are likely to persist, continuing to shape the Eurozone's hierarchy of government securities.

The latest change paving the way for a return to "normality" in the Eurozone is the reversal of fiscal relief, as reflected in the reform of fiscal rules approved by the European Council and Parliament on 10 February 2024 (Council, 2024). The arbitrary limits on government debt (60% of GDP) and government deficits (3% of GDP) remain central to this reform. Flexibility is often cited as a virtue of the reform, as the adjustment plans are country-specific and can be extended from four to a maximum of seven years, conditional on implementing reforms. However, this flexibility is controversial. According to Fitch Ratings, the flexibility within the SGP reform is "inherently limited by quantitative safeguards" (Fitch Ratings, 2024). The "debt sustainability safeguard" requires a reduction in debt by at least 1% of GDP per year if it exceeds 90% of GDP and by at least 0.5% if it falls between 60% and 90% of GDP. The "deficit resilience safeguard" establishes a "common resilience margin" lower than the 3% of GDP limit for government deficits, set structurally at 1.5% of GDP, to create "fiscal buffers" (Council, 2024). To achieve this margin, an annual improvement in the structural primary balance of 0.4% of GDP is required, which may be reduced to 0.25% if the adjustment period is extended. The annual targets for reducing public debt, limiting public spending, and maintaining a deficit below 3% were key demands from Germany (Strupczewski, 2023). The recessionary impacts of the new SGP are likely to be more

pronounced in highly indebted economies, as demonstrated in the cases of Italy and Spain by Heimberger et al. (2024).

The normalisation of fiscal and monetary policies indicates that as the impacts of the pandemic crisis begin to be overcome and systemic risks to the Eurozone are brought under control, the process of normalisation once again favours a direct and institutionally shaped discipline of finance in the region. The latter, by instance, supports a sharper hierarchy of public debt in the region to the detriment of peripheral countries. The maintenance of mechanisms reinforcing such hierarchy suggests that financial asymmetry remains a fundamental component of the monetary union.

Conclusion

This paper demonstrates that a hierarchy of government securities, shaped by the Eurozone's institutional framework and its underlying geopolitical disputes, underpins the EMU's financial asymmetries. The proposed framework, centred on the notion of the Eurozone's contradiction, captures the unique nuances of financial subordination in its periphery. Institutional developments and shifts in monetary and fiscal policy during the debt crisis and the pandemic aimed to reconcile tensions between uneven financial discipline and the survival of the EMU, highlighting the institutional management of the Eurozone's contradiction. Rather than breaking away from mechanisms that create financial unevenness, this process has shown that alleviating the burden on the periphery became conditional on the emergence of systemic risks. Instead of paving the way for a more “solidary” and equitable Europe, it illustrates the subordination of the periphery to the core countries' interests in perpetuating the EMU – especially those of Germany, the hegemonic power. As systemic threats posed by individual countries to the region are not homogeneous, supra-institutional support is discretionary, leading to varying degrees of fragility among the Member States.

Breaking the mechanisms that lead to financial unevenness in the Eurozone requires significantly more robust changes. Relying on conditional backstops for government securities – as suggested by the newly created TPI – or moving towards a fiscal union that activates only in response to systemic threats, as seen with the NGEU, may restore short-term financial stability. However, once systemic risks are resolved, financial asymmetries are likely to re-emerge. Could the situation be different? Recent developments in economic policy indicate that there are no

technical constraints to achieving this goal, only political ones. Since maintaining the Eurozone is a crucial self-interest for core countries, peripheral nations can leverage this bargaining power, building on what was established during the pandemic to create a more solid alliance among the most fragile Member States. However, as market discipline reinforces not only regional asymmetries but also power relations within each country in favour of capital over labour, such changes would also depend on significant internal political disputes. Future research could focus on the economic and political interests within Eurozone peripheral countries, where some actors may benefit from their subordinate position, given it facilitates the implementation of neoliberal economic policies.

The present paper demonstrates that the financial subordination patterns of the Eurozone periphery differ significantly from those of other peripheral countries worldwide. While these countries can depend on the political will of internationally credible institutions for financial stability, this reliance presents both strengths and weaknesses. The ECB, by issuing a strong currency, plays a fundamental role in distinguishing the European periphery from other peripheral nations that depend on fragile currencies and central banks with limited capacity to withstand speculative attacks. However, the Eurozone's tolerance for managing financial distress in peripheral countries means that this room for manoeuvre can operate in both directions – sometimes to their advantage and at other times to their detriment. Although the existence of a hierarchy of sovereign bonds facilitates the uneven disciplining of national states within the EMU, the willingness and ability of Eurozone institutions to perpetuate the euro sets out the *sui generis* character of the Eurozone periphery's financial subordination.

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