Economic Policy Reform Following Sovereign Debt Crises

A comparative study on reform packages following the European Sovereign Default Crisis and the United States Debt Ceiling Crisis.

Master Thesis

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Executive Summary

Introduction & Theoretical Background

Throughout the history of the global economy, financial crises have been many and frequent. Whether it involves currency crises, stock market crashes, asset bubbles or debt crises, the world has seen its fair share of crises but has not been able to learn how to avoid them from happening. Debt crises have recently gained enormous attention, mainly due to the recent sovereign debt crisis in Europe and the US debt ceiling crisis, which both took place in 2010 and 2011. These sovereign debt crises have proven that developed Western economies are not immune to the financial crises, a one-time prerogative for developing economies and Third World countries. The power and swiftness of the recent financial crises have raised the debate as to whether we are able to foresee and possibly avoid financial crises, or at the very least manage them properly. A world in which crises are becoming the norm instead of the exception merits an exploratory analysis of the of most recent financial crises that shook the world, being the European sovereign debt crisis and the US debt ceiling crisis, in an attempt to contribute to the theory on post-crisis reform. The central question of this research is therefore: "*What are the determinants of successful reform following sovereign debt crises?"* From the literature on policy reform a conceptual framework has been created to serve as a guide throughout this research by focussing on the *context*, *content*, and *process* of the reforms. Theory on public finance and international global economy is added to the conceptual framework to provide a sound theoretical foundation for analyzing both case studies.

Methodology

For this research the method of comparative case studies is chosen. Two recent sovereign debt crises that took place in 2010 and 2011 were chosen, being the European sovereign debt crisis and the US debt ceiling crisis. The conceptual framework, in combination with the theoretical model will be tested against these case studies. Through the comparison of two similar cases, being both the European sovereign debt crisis and the US debt ceiling crisis, it seeks to provide an extensive analysis on what took place in the years leading up to the crises, and especially how the effects of the crises were countered through reform packages. From this analysis, key success factors and potential weaknesses in the reform packages can be distilled, providing recommendations on how to counter such large-scale crises in the future.

Findings

	Europe	*United States*
Reform	EFSF/EFSM	Budget Reform Act
Period	2010-Present	2011
Aim	Avert sovereign default and collapse of the Euro.	Avert sovereign default.
Ideological inspiration	Unclear, strongly rooted in Keynesianism but with clear focus on austerity measures.	No ideological foundation for raising the debt ceiling, long-term discussion is ideological clash between Keynesianism (Democrats) and Neo-liberalism (Republicans).
Main contents	Providing financial safety net; support from IMF; increased fiscal governance at supra-national level; imposed austerity measures on PIIGS.	Raising the debt ceiling; agreements on deficit reduction; formation of committees on deficit reduction.
Success factors	Political will to further Europeanization; recognition of Euro-advantages.	Can-do mentality; execution power due to clear political structure.
Failure factors	Limited legal foundation; no political/fiscal union.	Ideological divide between Democrats and Republicans.

Conclusion & Recommendations

From the research we may conclude that while the short-term objective of the reform initiatives, averting sovereign default, has been reached in both cases, the real challenge is to provide for a sustainable long-term fiscal budget. The fiscal house needs to be put in order to be able to withstand future financial storms which will more than likely strike us more often and severely than we have experienced so far. The process in which the reforms took place, being arduous and incremental, and heavily influenced by politics, paint a gloomy picture for future reference. In the end though, both in Europe and the US, every stakeholder involved has understood the crucial point that abandoning cooperation is not the solution. Even though a long-term solution for both Europe and the US has yet to be designed, the willingness to at least take the appropriate short-term measures gives hope for the future.

The recommendations will elaborate in more depth on the central research question.

Characteristic	*Europe*	*United States*
Context	Establishing a strong political union, which is needed to enforce fiscal policies.	Increased regulation of financial markets in order to avoid out-of-control finance; Responsible tax policies.
Content	Ensuring legal foundation for reform mechanisms; Address long-term issues such as productivity differences between member states.	Address long-term sustainable finance issues, party-political ideas should be made subordinate to sound fiscal budgeting.
Context	Establishing a strong political union, which is needed to enforce fiscal policies.	Increased regulation of financial markets in order to avoid out-of-control finance; Responsible tax policies.

Chapter 1 Introduction

This introductory chapter will start with a brief overview of the concept of debt crisis. What is it, and why has it gained so much attention in 2011. It will then move on to the specific crises that took place in both Europe and the US in 2010 and 2011, including a brief explanation of the events that led up to the crises. The chapter concludes with the research purpose, the problem analysis and subsequent research questions, the conceptual framework, and the applied methodology of this thesis.

1.1 What is a Debt Crisis?

A debt crisis is a form of a financial crisis, a term that is applied broadly to a number of situations in which assets lose a great part of their value in a short amount of time. Financial crises include, among others, stock markets crashes (such as the Wall Street crash of 1929), the bursting of so-called 'economic bubbles' (such as the Dutch Tulipmania in the earlier 1600s), currency crises (such as the Asian Crisis in 1997) and sovereign defaults. The latter is often connected to debt crises which occurred in Latin American in the 1980s and, more recently, Russia in 1998, and is most often also a form of financial crisis that follows another financial crisis.

So what is debt? Debt seems to bring about a negative association whenever it is discussed, perhaps wrongfully so. After all, it is the concept of debt that allows for both people and organizations (and countries, for that matter) to do things that would not be possible without taking on loans. Buying a house, for example, would be very hard to do for people if it had to be done without taking on external debt. Similarly, companies also use debt to leverage their equity in order to achieve growth. In other words, through leverage you can move something you could not move on your own. Leverage has been the promise of economic growth and prosperity. Admittedly, this has been the case for decades, but it is build upon the shared belief that values must go up. As a result, the downside of using leverage for wealth creation has been the blind spot for the entire financial sector. Critics of leverage have argued against debt, whether on a personal, corporate of governmental level. Even today, the Islam forbids giving out loans with interest, whereas the Catholic Church only allowed it from the 19th century. The Torah, the scripture of Judaism, states that debt should be acquitted every seven and every fifty years, all based on the troubling feeling that while leveraging can take you higher that you could on your own, it also creates the possibility of crashing down faster and harder than without a lever.

Despite the risks that come with leverage, the rise of globalization has led the way to the emergence of global financial markets and better access to capital for everyone. This has lead to a dramatic increase in debt to GDP ratios around the world. The US, for example, has seen an increase in debt to GDP ratio from around 20% at the beginning of the 20th century to about 92% in 2010 (CIA Factbook). A rising debt to GDP ratio in itself is not necessarily a bad thing, except for when it reaches a point where the debt service exceeds the earning power of a country. This is what happened during the Latin American debt crisis in the 1980s. Following a worldwide recession in 1970s and 1980s, oil prices skyrocketed which led to an accelerated expansion in lending. Apart from putting inflationary pressure on the industrialized world, the increased prices of both oil and imported goods led to significant payment deficits for many developing countries. As a result, these countries turned to the international capital markets to finance these deficits, and began borrowing large sums of money against low but floating interest rates. Funding was boosted by the oil-producing countries, which were flush with cash after the oil prices rose and decided to invest their excess liquidity in dollar-denominated assets with major international banks. Their money was recycled in loans to Latin American governments. Once interest rates rose swiftly in the late 1970s, many countries were struggling to meet their debt services, which coincided with a broad deterioration in the exchange rates of national currencies with the US dollar, leaving Latin American countries with exploding amounts of debt (i.e. in their own national currencies) and decreasing purchasing power. Ultimately, countries were not able to meet their debt payments and had to default on their loans, resulting in lower incomes, a stagnation in economic growth, high unemployment and reduced purchasing power for the middle classes. A more elaborate explanation of the Latin American crisis will be given in Chapter 2.

The nature of sovereign defaults, in short, is the failure of governments or nation states to pay back its debt service, often triggered by a rising suspicion that they cannot. If lenders to or bond purchasers begin to suspect that a government may not be able to pay back its outstanding debt, the risk of default on such a debt becomes higher, and consequently so does the compensation, i.e. the interest rate that has to be paid over the debt outstanding. A dramatic rise in interest rates due to fear of default can lead to sovereign debt crises, like the Latin American debt crisis which was briefly described earlier. We have now learned that debt crises are no longer a prerogative for developing countries, judging from what we have seen evolve in both Europe and the US Europe experienced rising budget deficits and debt levels which led in turn to the downgrading of government debt, plunging the Eurozone in a full-blown sovereign debt crisis, whereas the US were dealing with their own debt crisis, specifically concerning the debate whether or not to increase the debt ceiling.

The nature of both crises seems to be similar as both the European sovereign debt crisis as well as the US debt ceiling crisis are the result of budget deficits and the perceived inability to pay the debt services. It is obvious that both sovereign debt crises stem largely from the consequences of the financial crisis that shook the world in the late 2000s, now commonly known as the Great Recession. A familiar account of what happened during the crisis is the following. In the US, the housing bubble got out of control somewhere around 2005 and 2006. People took out mortgages they really could not afford, and companies giving out mortgages were happy to do so, all based on a naive conviction that housing prices would rise indefinitely. However, at some point people could no longer service their payments and had to default on the mortgages. Having been securitized, those mortgages ended up infecting the entire global financial system, causing what we now know to be the worst financial crisis since the Great Depression of the 1930s. As briefly discussed earlier in this chapter, history has shown that financial crises can be followed by sovereign debt crises, which tend to play out in four stages. The first stage is rising fiscal deficits. Typically, a financial crisis forces governments around the world to increase spending dramatically in attempts to stabilize the financial system, bail out essential financial institutions, and trying to stimulate economic activity. Even worse, lessened economic activity lead to a fall in tax revenues, as international trade and consumption decrease. Obviously, this leads to huge fiscal deficits, potentially creating huge problems for governments. As governments have obligations to fulfil, they will need to resort to attracting loans from the market, and thus accumulate debt. A fast-rising debt to GDP ratio is the second stage, which can cause governments to get caught in a downward spiral, where reaching the 85% debt to GDP threshold hurts economic growth (Cecchetti et al., 2011). When debt reaches this threshold, the borrowing costs for government are starting to become too expensive, whereas market scrutiny becomes tighter. This ushers in the third stage, involving potential downgrades of a country's credit rating. When budget deficits run high and government debts rise to the point where it seems unlikely that a revival of economic activity (if any) will provide a solution for the fiscal problems, the credit rating of governments will become pressurized, leading the world's credit rating agencies (of which Moody's, Fitch and Standard & Poor's are the most influential) to downgrade such countries. This typically leads to the fourth and last stage, sovereign default, as downgrades only push countries in deeper trouble due to the vicious cycle of even higher borrowing costs and a growing dependence on external debt.

We can conclude that the Great Recession has had a major impact on both Europe and the US, and has played an enormous role in the sovereign debt crises that haunted both. However, due to the differences between Europe and the US from a socio-political and economical perspective, it seems fair to assume that the DNA of the two crises also differs quite substantially from one another, and therefore merit a distinct approach in structural problem solving. This thesis aims to examine the string of events that led up to both the European and the US debt crisis, and through a comparative study explain how the two crises differ in terms of how the crises were dealt with. Ultimately, by analysing both case studies we will hopefully be able to provide insights regarding success and failure factors of the post-crisis reform, and draw up recommendations for future reform packages.

1.2 Europe and the US: Comparable Situations?

Cross-continental comparison between Europe and the US can be done on multiple levels, including historical, cultural, social, political and economical aspects. As this thesis aims to examine the way in which both Europe and the US ended up in the crises and consequently dealt with them, the choice has been made to focus on comparing the political system, socio-economic forces and the administrative system. Naturally these factors account for a large part for the context, i.e. the environment that caused, or at least allowed for, both debt crises to take place. The context will be dealt with more elaborately in describing both case studies, for now we will focus on the question whether both cases are sufficiently similar to compare them with each other.

With respect to the political system, there are some obvious differences between Europe and the US but also some notable similarities. In this research, by 'Europe' we mean the European Union, which can be described as a economic and political union of (at the moment) 27 member states of which the roots trace back to the European Coal and Steel Community (ECSC) and the European Economic Community (EEC), formed in 1958 by the original six founding countries, the 'Inner Six': Belgium, France, (West) Germany, Italy, Luxembourg and the Netherlands. Ever since 1958, the European Union has grown both in size (by the accession of new member states) and in power (due to transferring areas of decision making and legislation from national governments to the EU). The United States of America (US) can be described as a federal constitutional republic, consisting of fifty states and a federal district. Much like the EU's Inner Six, the US was founded by the thirteen states (colonies) that rebelled against British rule and declared themselves independent from the British Empire on July 4, 1776.

1.3 Research Purpose

The scientific relevance of this research is to provide better insights in the effect of reform packages with regards to the aforementioned debt crises. The theoretical foundation of this research is based on the concept of public and administrative reform. Through the comparison of two similar cases, being both the European sovereign debt crisis and the US debt ceiling crisis, it seeks to provide an extensive analysis on what took place in the years leading up to the crises, and especially how the effects of the crises were countered through reform packages. From this analysis, key success factors and potential weaknesses in the reform packages can be distilled, providing recommendations on how to counter such large-scale crises in the future. As for the societal relevance, it has become obvious that the debt crises of the past year have put enormous strain on the world economy and that they are the accumulation of years of overspending. Simply bridging the spending gap by cutting costs in order to pay off debts seems unlikely, as public service reform requires a much more fundamental change than scaling down government spending or re-establishing public trust in the economic system through bailouts or raising debt ceilings. By comparing the two case studies, this research will provide recommendations for future reform, as ideas and best practices that have turned out to be efficient measures can be assumed to be transferable to similar situations. The final chapter will elaborate more on the recommendations for future reform programmes.

1.4 Problem Analysis & Research Questions

Debt has on many occasions proven to be a major obstacle to development. In third world countries, huge amounts of debt have been the impediment to sustainable economical development, security and political stability. Since the Great Depression of the 1930s, large-scale financial crises have seemed to be the prerogative of developing nations, often the consequence of the legacy of colonialism, the issuing of odious debt, or the earlier mentioned mismanagement of Western spending and lending in the 1960s and 1970s (leading up to the Latin American crisis). Subsequently, enormous debt repayments and interest payments have crippled many developing countries in their struggle for a better standard of living. Following years of intensive lobbying by NGO's and other bodies under the banner of Jubilee 2000, the Heavily Indebted Poor Countries (HIPC) programme was launched in 1996 by the World Bank and the International Monetary Fund (IMF), aiming to provide debt relief and low-interest loans to a group of 40 developing countries with high levels of poverty and debt overhang. Although international debt relief plans vary enormously in terms of scale and scope and therefore limit the ability to transfer best practices, the experiences and implementations of reform in developing countries provide few transferrable lessons learned. Also, the sovereign debt crises that have struck both Europe and the US are perfect evidence of the fact that developed, Western economies are not immune to financial crises, they were just not expecting it. In the words of Vice President Dick Cheney, when asked about why the Bush Administration had failed to foresee the largest financial crisis since the Great Depression: "Nobody anywhere was smart enough to figure it out, I don't think anybody saw it coming" (Roubini & Mihm, 2010, p. 1). A world in which crises are the norm instead of the exception (Roubini & Mihm, 2010) merits a exploratory analysis of two of the biggest and most obvious crises of the last two years, including its origins but especially the reform that followed, aiming at contributing to the theory on post-crisis reform. Therefore, two reform packages to the most recent and large-scaled debt crises, those in Europe and the US in 2010 and 2011, will be described, analysed and evaluated. The central research question of this thesis is:

"What are the determinants of successful reform following sovereign debt crises?"

The sub questions that need to be addressed in order to be able to answer the central research question are listed below.

1. In which context were the debt crisis reform packages in both Europe and the US launched, i.e. an analysis of the event leading up to (causing) the crises.
2. What were the contents of both reform packages?
3. In what way did the process of both reform packages come about?
4. Were the reform packages successful in terms of meeting its objectives, i.e. have they accomplished structural debt relief?
5. What contributed to the success of the reform, or stood in the way of its success?

1.5 Methodology

The question as to how debt crises can be countered more effectively in the future is researched by conducting qualitative, comparative case-study research on two comparable debt crises which took place in the recent past; the European Sovereign Debt Crisis and the United States Debt Ceiling Crisis. This research can be described as inductive, qualitative research; meaning that it uses the obtained data to establish a pattern of categories, dimensions and interrelationships. Consequently, rather than testing hypotheses, this research opts for exploration with (semi) open questions. According to Collis and Hussey (2003), such explorative research is aimed at looking for patterns or ideas, rather than to test or confirm hypotheses. The qualitative nature of the research allows us to focus on the meanings, perceptions, symbols and description of the subject matter.

1.5.1 Research Strategy & Material

The next step is to define the research strategy design. A coherent body of decisions about the design of the research is essential in order to successfully carry out the project. Issues regarding the chosen research strategy, methods of data collection and the way in which this data will be analysed are presented below.

This research can be qualified as being theory-building or theory-developing. According to Dul & Hak (2008), the objective of theory-building research is "to contribute to the development of theory by formulating new propositions based on the evidence drawn from observation of instances of the object of study” (p. 175). Naturally, the study of financial crises and subsequent reform is not entirely new. However, through analysing two separate case studies alongside a complex, interrelated conceptual framework focussed on, among others, the socio-economic environment, the political system, and the impact of elite decision-making, may address a rather untouched part of the theory on post-crisis reform, which therefore merits a theory-building approach (Verschuren & Doorewaard, 1999). By describing, comparing and analyzing the two reform packages that were implemented following the sovereign debt crises in both Europe and the US, we will be able to distil the success and failure factors, as well as the weaknesses and strengths of both packages. This will then provide us with a better insight in post-crisis reform, adding to the existing theory on the matter.

The appropriate research strategy for the research objective is by conducting a comparative case study. Why case studies? According to Dul and Hak (2008), case study research is a useful research strategy (i) when the topic is broad and highly complex, (ii) when there is little theory available, and (iii) when context is very important (Dul and Hak, 2008, p. 24). The debt crises described in this research are complex by nature. In both the European as well as the US debt crisis, the root causes are hard to detangle from the web of actors involved, including governments, the private sector, supranational governing bodies, each of which influences the other actors. It seems clear that the debt crises are part of a complex set of influences and that they are very dependent of their context. Moreover, due to the fact that both crises took place in the very recent past, there is little or no academic theory available on the matter. Hence the choice for conducting a case study research, which “consists of a detailed investigation that attempts to provide an analysis of the context and processes involved in the phenomenon under study” (Johnston et al., 1999, p. 203). Case studies are characterized by a small number of cases. Using a small number of research units has a number of consequences for carrying out the project. First of all, the research has to be qualitative, meaning that the focus will not be on calculations based on the observation results (as is done when performing quantitative research), but rather on comparing and interpreting these results (Verschuren and Doorewaard, 1999). Yin (2003) defines a case study method as investigating a contemporary phenomenon within its real-life context. A case study is appropriate for this research due to the qualitative nature of the selected characteristics. A case study method also offers the opportunity to include environmental factors in the investigation. This is recognised by Yin (2003) who argues that a case study is especially applicable when the boundaries between phenomenon and context are not clearly marked. In other words, the use of the case study is appropriate when you deliberately want to cover contextual conditions believing that they might be highly pertinent to the phenomenon under study (Yin, 2003). This case study is a comparative case study. It distinguishes itself from the single case study by the fact that several interrelated cases are studied and compared, as opposed to examining an individual case. The sub-variant of the comparative case study that is used in this particular research is the hierarchic method, which is carried out in two stages. In the initial stage, the cases under examination are treated as being a series of separate single case studies, studied independently from each other. The results are to be analysed and described following an established pattern, as to facilitate the second stage of the research, which is a comparison between the various case studies. (Verschuren en Doorewaard, 1999).

Research Materials

After having established the appropriate research strategy we will now discuss the research materials. In other words, what sources should be used, and how should these sources be accessed? This research is focussed on the level of success of implemented reform packages to counter debt crises. As we have established, debt crises are a rather complex phenomenon, and much dependent on its environment. This and the lack of academic literature on the matter has lead to the choice of a comparative case study as the research strategy. According to Verschuren and Doorewaard (1999), case study research is characterised by (i) a small number of research units, (ii) labour-intensive data generation, (iii) more depth than breadth, (iv) a selective, strategic sample, (v) qualitative data and research methods, and (vi) an open observation on site (p. 164). Information will be derived from sources such as literature, secondary data, and the media. Using multiple sources of data is called the triangulation of sources, which is used to achieve depth (Verschuren and Doorewaard, 1999). Literature is understood to mean a variety of books, articles, reports and other sources that build on the knowledge of scientists. Documents includes empirical data gathered by other researchers, such as records of interviews, reports or case studies. A third source of data is the media; data gathered periodically for a broader public (Verschuren and Doorewaard, 1999).

1.5.2 Data Analysis

This data analysis of this research can be divided in three stages. First of all, the two selected cases were studied independently from each other. In the second stage, the results from the first stage were used for a comparative analysis of the coherent body of all both cases studied (Verschuren and Doorewaard, 1999, p. 167). By doing this, an explanation for possible differences and similarities that emerged from the independent case studies in the first stage can be obtained. The last stage entails combining the results from the second stage and presenting a overall picture of the issue at hand. As mentioned, data sources for this research have been literature, documents, and the media. The way in which this data has been analysed will be briefly explained now. As case study research give a large amount of unstructured data, a method to properly analyse the data, establish patterns, and draw the appropriate conclusions is essential. Content analysis is a way of systematically categorizing qualitative data. Three different stages of content analysis can be distinguished, being:

- Data reduction
- Coding
- Analysis

Any kind of data collection is, de facto, prone to result in collecting a lot of rather irrelevant information. The large amount of data is difficult to analyze, especially if not all data is useful. Data reduction enables the researcher to focus on the relevant data by extracting only the data that is important for phenomenon under investigation. Reduction should be carried out very carefully though, as important contextual information could be lost. In this particular research, very few data was held back. Regarding the concept of coding, two types of codes can be distinguished; deductive codes and inductive codes. Deductive coding basically means that the codes are determined before the data has been collected; they stem from the literature. Inductive coding means that codes are determined as they emerge from the collected data (Johnson and Christensen, 2004). In this research, only deductive codes were used, which were deducted from the literature study. Based on the conceptual framework and using the coded information from the examined literature and available documents, a table was created that includes both the two selected case studies under examination on the horizontal axis, and the determinant factors of successful reform package implementation on the vertical axis. This table can be found in Chapter 2, based on the theoretical background.

1.5.3 Quality of the Research Design

The quality of the design of a research project is essential in carrying out the research successfully and being able to draw the appropriate conclusions. The quality of research design in case studies, according to Yin (2003), can be judged by looking at internal validity, external validity, and reliability. Internal validity is "the extent to which the outcome of an analysis is justified by the scores obtained in the study" (Dul and Hak, 2008, p. 283). In other words, intern validity concerns the proper demonstration of causal relationships. In this comparative case study research, in which the main source of data is literature and documents on the debt crises, internal validity is rather high as a profound understanding on the phenomenon under investigation has been developed by the researcher. External validity is "the extent to which the outcome of a study in one instance or in a group of instances applies (or can be generalized) to instances other than those in the study" (Dul and Hak, 2008, p. 282). In case study research, external validity is often under pressure (Verschuren and Doorewaard, 1999). After all, one or few cases make it more difficult to declare the results to be applicable universally, regardless of the situation. Reliability is the consistency of a set of measurements. In other words, to what extent the measure of a concept would generate the exact same results regardless of the number of times it was applied to random occasions. Reliability in case study research is especially problematic due to the perceived possibility of investigator subjectivity. The main remedy to counter this, according to Yin (2003), is by designing and sticking to a case study protocol. In this particular research this has been achieved by applying the conceptual framework adapted from Pettigrew et al. (1992) in combination with Pollitt & Bouckaert (2004).

Chapter 2 History of Crisis Economics – Theory & Practice

This research is about the successfulness of implemented reform packages countering the debt crises that hit both the US as well as Europe in 2010 and 2011. The underlying conceptual framework supporting this research is based on the work of Pettigrew et al.. (1992), focussing on the *context*, *content*, and *process* of the reform packages involved, supported by Pollitt & Bouckaert's (2004) framework of public management reform. In explaining the context, i.e. the environment in which the crises took place, it is important to review the development of different schools of macroeconomic thought. As will be explained, it matters a great deal whether governments adhere to Keynesian economics or neo-liberalism, to name but two of the most influential theories, as it determines the structure, behaviour and decision-making of an economy, especially regarding the role of the government. Also, depending on the economical ideology, policy responses such as monetary and fiscal policy tools can differ, in turn determining the content of crisis reform measures. In order to provide us with insight in how other crises were countered in the past, this chapter will elaborate on some debt-crises from the past and distinguish the set of tools that made up the reform packages. To summarize, this chapter will provide a theoretical model of post-crisis reform that can then be used to analyze both case studies.

2.1 Theoretical Foundations of International Political Economy

The earliest accounts of economic writings date from the ancient civilizations such as the Greek, Romans, Persians and Arabs. Each civilization developed its own bureaucracies and methods of operation, and despite differences in these arrangements, each shared a common purpose of some sort of territorial security, domestic control and wealth. As will be explained, the rise of nation states, combined with a developing middles class and significant scientific and technological advancements have had a significant impact on the development of economical theories. A few of the main economical theories will now be explained. Please note that the underlying assumptions of the study of economics have changed throughout history, and that there are many variances on the paradigms presented here. The focus is being put on the main paradigms of international political economy, culminating in an elaboration of those schools of thought which are closest to the economical and political environment in which both the US and the European debt crises took place.

2.1.1 Mercantilism, Classical Liberalism & Marxism

However, overarching theories trying to explain the guidelines in economics did not emerge until the rise of mercantilism in the sixteenth century. According to Pearson & Payaslian (1999), mercantilism dates back to the accession of King Charles V to the Spanish throne in 1516, referring to his aggressive economical policies against the commercial trade monopoly held by Venice in those days. Corresponding with the development of the nation-state and consequently, the development of a centralized national economy, mercantilism was based on the premise that a nation's wealth was based on the its accumulation of gold and silver. Therefore, the primary goal of a mercantilist state was to strengthen its financial base by enhancing its revenue-raising capabilities, e.g. by imposing taxes on the state's subjects and focussing on exporting manufactured products.

In a reaction to mercantilism, classical liberalism emerged as the dominant school of economic thought in the eighteenth century, mainly fuelled by proponents of limited government and free enterprise. Among the many scholars advocating classical liberalism were Thomas Malthus (known for the Malthusian Trap, suggesting that throughout history, standard of living remained stagnant as human population outgrew returns to labour), David Ricardo (famous for his theory on comparative advantage), but most notably Adam Smith. Smith's *The Wealth of Nations*, published in 1776, is a fundamental work in the field of economics and argues that a free market economy is more productive to society at large, and that governments should minimize involvement in human affairs. In essence, classical liberalism sought to eliminate government imposed barriers to economic activity, based on the premise that each individual can best determine for itself how to pursue his or her interests (Pearson & Payaslian, 1999). Whereas mercantilism had sought sources of wealth in accumulation of precious metals and resources and through foreign trade, classical liberalists stressed the importance of labour as the primary source of wealth. As stated by Smith (1776), "the annual labour of every nation is the fund which originally supplies it with all the necessaries and conveniences of life which it annually consumes and which consists always either in the immediate produce of that labour, or in what is purchased with that produce from other nations" (p. 1). The foundations of the classical school was eventually challenged by the works of Karl Marx in the mid-nineteenth century. Marx dismissed capitalism, the underlying ideology of the classical liberalists, as being but a mere evolutionary phase in economic development, a thought which was primarily driven by an ongoing class struggle. After all, the spread of industrialization in the nineteenth century led not only to economic growth and the creation of countless of jobs, but also to deteriorating working and living conditions for the masses whereas a small elite seemed to be the only ones profiting from capitalism. Based on the notion of class conflict, Marx believed that capitalism would ultimately destroy itself and make way for a society in which private property would be non-existent. Even though Marx's ideas launched social change around the world (most notably in Russia), general consensus is that Marx has had little impact on the development of economics (Stigler, 1988).

2.1.2 Keynesianism

At the end of the nineteenth century, and for some time during the early twentieth century, it seemed as if capitalism was indeed the prevailing idea, as most mainstream economists in advocated the idea that the economy is a self-regulating, self-correcting entity, able to find a state of equilibrium with stability and full employment as the result (Roubini & Mihm, 2010). This conviction lasted until the Great Depression of the early 1930s, an event which transformed the discipline of both economics and government policy alike, as the near breakdown of capitalism led to a renewed discussion concerning the connection between the two. Until then, the general belief held by classical liberalists was the causal relationship between politics and economics was limited, if present at all (Pearson & Payaslian, 1999). Posing a great threat to political stability, the Great Depression paved the way for the emergence of Keynesianism economics, primarily advocated by British economics John Maynard Keynes through his work *The General Theory of Employment, Interest, and Money* (1936). Keynes criticized classical liberalism as being incapable of preventing cyclical trends such as the Great Depression or aptly addressing social and economic problems emerging from it. According to Keynes (1936), as an alternative to a passive attitude towards economics, governments should actively engage in steering the economy through applying fiscal and monetary instruments, trying to remedy to imbalances between supply and demand. Two notable examples of such active engagement are increasing public expenditures (e.g. in the form of public works) in times of economic downturn to provide employment, as well as increasing taxes in times of economic growth to curb inflation (Pearson & Payaslian, 1999). Broadly speaking, Keynesian economics advocate a mixed economy which is dominated by the private sector, but with an important role for governments and the public sector. Keynesianism was the main economic model used in the aftermath of the Great

Depression and the post-war economic expansion. By the 1970s it lost some of its influence to Monetarism due to occurrence of stagflation (i.e. the situation in which the inflation rate is high and the economic growth is low), as Keynesianism economics dictated that inflation and recession are mutually exclusive. Even so, the Marshall Plan to rebuild post-war Europe as well as the creation of international financial institutions such as the International Monetary Fund (IMF) and the World Bank were influenced by Keynesian economic theory, making a mark on economic policy ever since.

2.1.3 Neo-Liberalism

Neo-liberalism, mainly formulated by Nobel-prize winning American economist Milton Friedman, can be described as a return to *laissez-faire* economics, swiftly gaining popularity in the 1970s when Keynesian theories did not seem to be able to explain or address the problem of stagflation. While Keynes's ideas were primarily focused on an active role of the government in both monetary policy (i.e. the control of money supply) as well as fiscal policy (mainly government spending), Friedman argued that governments should limit themselves to only neutral monetary policy by controlling the money supply in order to ensure price stability as active monetary policy (e.g. easy credit) or fiscal policy (e.g. taxation and public spending) could lead to unintended negative effects. In the words of Friedman (1948): "There is likely to be a lag between the need for action and government recognition of the need; a further lag between recognition of the need for action and taking of the action; and a still further lag between the action and its effects" (p. 255) Monetarist economists emphasized the failure of demand-driven fiscal policies to restrain inflation and produce growth, and opposed to government regulation and interference. Another strong proponent of the neo-liberalistic school of thought was Austrian-born Friedrich Hayek. Coincidentally, both Friedman and Hayek received the Nobel prize for economics (respectively in 1976 and 1974), a clear signal of the ideological paradigm shift that was taking place. Hayek's principal argument was that the market was complex, self-regulating information-processing system, resulting in efficient price stability. Hayek's main work, *Road to Serfdom*, published in 1944, strongly opposes central planning of economies as this can only lead to inefficient distribution of wealth and totalitarianism. Many of the ideas of Hayek, Friedman, and the monetarists have been implemented by western governments, especially in the 1980s, leading to waves of privatization and deregulation (e.g. during Margaret Thatcher's reign in the United Kingdom and Ronald Reagan's presidency in the United States).

2.1.4 Synthesis

The main economical ideologies of the past centuries have now been described, two of which are still widely accepted as dominant economic theories; Keynesianism and neo-liberalism. As both ideologies share a common foundation (capitalism), there are some notable differences concerning how economies should be steered. In trying to avoid major economic shocks, such as the Great Depression for example, governments chose to intervene through macroeconomic policies, which basically come in the two flavours which we described earlier; fiscal policy and monetary policy. According to Palley (2004), "fiscal policy refers to government management of spending and taxation to affect economic activity, whereas monetary policy is conducted by central banks, who manage interest rates to affect the level of economic activity" (p. 1). For the past thirty or so years, neo-liberalism has been the dominant school of thought, based on the concept of *laissez-faire* economics, whereas Keynesianism was the driving economic ideology that shaped the world after the Great Depression, and more importantly in the post-war period. Neo-liberalism advocates the belief that a free market is a self-regulating, self-correcting entity and should therefore best be let alone, but for incidental neutral monetary involvement. Keynesians on the other hand insist that the level of economic activity is determined by aggregate demand, and that capitalist economies are subject to incidental economically weak periods (i.e. crises). They belief that in such an environment, active government participation in the economy through both fiscal and monetary policy is needed. Regarding the *context* in our conceptual framework, the economical ideology and its macroeconomic policy tools can thus be depicted as follows.

Economical Ideology	*Keynesianism*	*Neo-liberalism*
Dominant Period	1930-1975 (approximately)	1970-Present
Founders	Keynes	Friedman, Hayek
Role Government	Substantial, active	Minimal, passive
Macroeconomic Policy	Active fiscal and monetary policy	Neutral monetary policy

Table 2.1 Paradigms of Economic Ideologies

2.2 The Rise of Capitalism & Crises

According to Roubini & Mihm (2010), in the history of modern capitalism, crises are the norm, not the exception. Not only in emerging markets, but also in advanced industrial economics. Crises – unsustainable booms followed by calamitous busts – have always been with us and will always remain. Also, although they are not exclusively linked to capitalism, there does seem to be a strong relationship between the two, arguably because capitalism's power of innovation and tolerance for risk can "set the stage for asset and credit bubbles and eventually catastrophic meltdowns whose ill effects will reverberate long afterward" (p. 4). A closer look at crises that occurred in the past will shed some light on the very nature of crises and their characteristics. The focus will particularly be put on the connection between capitalism and crises, starting in the Netherlands in the seventeenth century during the speculative bubble in tulips, also known as Tulipmania.

Before capitalism, governments used simple methods of currency depreciation to discharge debts, literally printing their way out of debt as soon as paper money was invented. The Chinese pioneered this practice as early as 1072 (Bernholz, 2003), European nations followed suit in the eighteenth century. Another option was simply defaulting on debt owed to (often foreign) creditors. Examples of this phenomenon are plenty, such as King Edward III of England who refused to pay back money he borrowed from Florentine bankers in the mid fourteenth century. Defaulting on loans became common practice for governments throughout the late medieval period, including countries such as Austria, France, Portugal and Spain. According to Roubini & Mihm (2010), it is important to note that even though these episodes led to substantial instability, these crises were merely associated with overconfidence in heavily indebted governments and have nothing to do with an overarching economic ideology such as capitalism (p. 20). It was not until the sixteenth century until the first capitalist nation, The Netherlands, emerged in what came to be known as the Dutch Golden Age. The rise of capitalism also gave birth to a new kind of crisis: the asset bubble. In the 1630s, "Tulipmania" was the period in prices for bulbs of the newly introduced tulip (from present day Turkey) soared to and then suddenly collapsed. At its peak, some bulbs sold for more than ten times the average annual salary of a craftsman. According to Garber (1989), "that prices of intrinsically useless bulbs could rise so high and collapse so rapidly seems to provide a decisive example of the instability and irrationality that may materialize in asset markets" (p. 535). Although historians still debate whether the tulip bubble was driven by market fundamentals, the bust surely set the stage for large bubbles to come (Roubini & Mihm, 2010). Other countries soon caught up in the field of speculative bubbles, such as France and England in the early 1700s. Around that time John Law, a Scottish economist and business man, set up a private bank of which the capital consisted for three quarters of government bills and government accepted notes, practically making it a central bank. Law used the funds to buy the Mississippi Company, helping the French to colonize Louisiana. At its peak, Law's company controlled several trading companies, the national mint, the national bank, the entire French national debt, and much of the land that later came to be known as the United States. Rather fraudulent in nature, Law greatly exaggerated the wealth of Louisiana through effective marketing, leading to wild speculations on the shares of the company. The bubble exploded in 1720 after investors tried to convert the shares to money, which turned out to hamper the development of French financial institutions for decades (Murphy, 2007; Roubini & Mihm, 2010). A similar development took place in Britain through the rise and fall of the South Sea Company, a joint stock company that trade in South America in eighteenth century. As part of the treaty during the War of Spanish Succession, the South Sea Company was granted an exclusive trading monopoly in Spain's South American colonies. In return, the company assumed the national debt that England has incurred during the war. Share speculation gave rise to a mania for all kinds of stock, and shares of the South Sea Company rose to record highs before collapsing entirely, "leaving the economy in shambles and a generation of British investors wary of financial markets" (Roubini & Mihm, 2010, p. 21).

Evidently, the aforementioned examples show that crises are recurring events throughout history. However, these specific examples share a common characteristic in the fact that the impact was felt domestically, they did not trigger global financial crises. By contrast, the Panic of 1825 did spread globally. Like most crises, the Panic of 1825 had all the hallmarks of a classic crisis; easy money, made available by the Bank of England, and an asset bubble, being stocks and bonds related to investments in Peru, a newly independent state and emerging market at the time. When the bubble burst, numerous banks in England collapsed, but its effects were also felt throughout Europe, Latin America and the United States (Neal, 1998). This is just one account of a crisis in the nineteenth century, which was plagued by many more. One of the most dramatic was the Panic of 1873. Following the American Civil War, the newly formed United States saw a boom in railroad construction, sparking a craze in speculative railroad investments. In the meantime, post-war reparation payments from France to Germany following the Franco-Prussian War led to similar booms in both stock and real estate in Germany and Austria. When the bubble burst, the stock market of Vienna imploded, as did the stock markets in Amsterdam and Zürich. In a reaction, European investors decided to liquidate overseas investments, ultimately leading to the collapse of Jay Cooke & Company (a leading US bank at the time) and the railroad company Northern Pacific Railroad. This triggered a massive panic at Wall Street, setting off a chain reaction of bank failures and many thousands of failed business, including many of the railroad companies. The chaos quickly spread around the world, severely hurting the global economy and plunging it into a severe depression which was known as the Great Depression until the 1930s (Bordo, 1990; Roubini & Mihm, 2010).

The twentieth century has seen its fair bit of crises too, such as the crash of 1907, where a speculative boom in both stocks and real estate collapsed and caused a bank run, spreading panic throughout the United States. This particular crisis merits special attention, as it effectively led to the creation of the Federal Reserve System some six years later, initiated by one of the most powerful bankers at the time, J.P. Morgan (Bruner & Carr, 2009). In theory, the Federal Reserve should have served as the guardian of financial stability, providing lender-of-last-resort support in the event of a financial crisis. However, in the next crisis to hit the United States (and the rest of the world), the Federal Reserve did not intervene. Instead of pursuing an expansionary monetary policy by pumping additional money into the system, the Fed tightened the reins, allowing the crash of 1929 to evolve in a full-blown banking crisis and eventually into a severe economic depression which we now call the Great Depression (Roubini & Mihm, 2010). Originating in the United States with the fall of stock prices throughout September 1929, culminating in *Black Tuesday* (October 29, 1929), the day that the Wall Street stock market crashed and plunged the United States in the worst depression in its history (Kennedy, 1999). From that moment, the depression quickly spread to almost every country in the world, with devastating effects. International trade dropped by as much as 50%, while unemployment soared to as high as 30% in some countries (Frank & Bernanke, 2007, p.98). A substantial part of the world's financial systems had effectively collapsed, and currency wars evolved into trade wars. The enacting of the Smoot-Hawley Tariff Act in 1930 caused a breakdown of international trade, forcing many European (export-driven) countries to "depreciate their currencies, debase their debts via inflation, and even formally default on their debts, including Germany, where the crisis paved the way for Hitler's rise to power and the worst war in human history" (Roubini & Mihm, 2010, p. 24).

The impact of World War II to the world's financial system have been immense, as it made possible an entire transformation in creating a world economic order, including the creation of international financial institutions such as the International Monetary Fund (IMF) and the World Bank. Now, an overview of some of history's most significant sovereign debt crises is presented to provide us with some insights on how these crises came about, and what was done to deal with them.

2.3 Theory & Practice of Historical Sovereign Debt Crises

We have established now that the world has seen its fair share of financial crises throughout its history. In the previous paragraph, the focus has been put on capitalism as a catalyst for financial crises, regardless of the nature of the crisis. Some of the previously mentioned crises have eventually led to sovereign defaults, but this is not necessarily the case. Regardless, sovereign debt crises have a history that span centuries and cut across all regions in the world. According to a study by Reinhart & Rogoff (2009), dozens of countries around the world (including practically all Western nations) have experienced sovereign defaults or debt restructuring at least once from the 1300s and onwards (p. 23, 87, 91, 95, 96). Sturzenegger & Zettelmeyer (2006) provide us with similar information, while also arguing that sovereign defaults "are bunched in temporal and sometimes regional clusters, which correspond to boom-bust cycles in international capital flows" (p. 4). Based on Lindert & Morton (1989), Marichal (1989) and Suter (1989, 1992), they distinguish eight lending booms since the early nineteenth century. An overview of government defaults and restructuring within these lending booms can be found in Appendix I. In order to determine the causes and effects of sovereign debt crises and potential means of reform, we will now provide a brief overview of some of the most severe and most documented sovereign debt crises of the recent past, the Latin American debt crisis (or 'La Década Perdida', the lost decade) of the early 1980s and the Russian debt crisis (or 'Ruble' crisis) of 1998.

2.3.1 Latin American Debt Crisis – 1980s

In the 1960s and 1970s, while experiencing strong economic growth and with a great outlook on future developments, many Latin American countries started to attract enormous loans in order to finance their development. Due to the favourable outlook of the Latin American economies, creditors were more than happy to make money available by providing the loans. According to Cohen (1993), “the years between the oil crisis and the early 1980s may indeed be characterized as period of relatively free access to the world financial markets in which an extremely low – indeed, perhaps negative – real interest rate has prevailed” (p. 437). In short, the strong growth rates of the Latin American countries (and less-developed countries in general), the emergence of an international financial system (the Eurodollar market), and the cash-rich petroleum-exporting countries made for a steady increase in of total outstanding debt by Latin American countries. According to the World Bank (in Curry, 1997), in Latin America, total outstanding debt from all sources rose from approximately USD 29 billion at year-end 1970 to a whopping USD 159 billion by year-end 1978, an annual compound growth rate of almost 24 percent (p. 193). Needless to say that with growing numbers of outstanding debt, the debt service (i.e. interest that needs to be paid over the outstanding debt) obligations also rose. Moreover, the typical loan that was attracted had a floating-rate contract, linked to the London Interbank Offering Rate (LIBOR), a benchmark short-term interest rate, posing another threat for the Latin American countries as the risk of rising interest rates was quite substantial. According to Curry (1997), “during the late 1970s, the signs of an impending crisis began to become clearer and were more widely recognized” (p. 199). Despite warning signs, including capital flight due to fear of currency devaluation and illiquidity, Latin American countries kept on borrowing huge sums of money, causing the Latin American debt to almost double from USD 159 billion by 1979 to USD 327 billion by 1982 (Curry, 1997, p. 199). In the meantime, the United States were experiencing periods of stagflation, a combination of inflation and recession, following the oil shocks in 1973 and 1979. It led Paul Volcker, the then newly installed chairman of the Federal Reserve, to sharply increase interest rates. While his shock treatment triggered a severe double-dip recession, it also ended the stagflation crisis and marked the beginning of a decade of economic growth (Roubini & Mihm, 2010). Unfortunately, the sharp increase of interest rates meant an similar increase for LIBOR rates, making it impossible for Latin American countries to continue to service their debts. Worse even, many countries experienced deteriorating currencies exchange rates with the US dollar, effectively meaning that the real value of the outstanding debt rose even higher. In August 1982, the Mexican government indicated that it could no longer service its debts, starting off a chain reaction amongst Latin American countries, most notably Brazil and

Argentina. The crisis had severe consequences for the region, including political instability, social unrest, lower incomes, higher unemployment, and of course, a stagnation in economic growth.

The period needed to deal with the aftermath of the crisis proved to be long and weary, as there was not only a need to restructure the existing loans, but also a need to set aside huge loss reserves and protect the solvency of Western financial systems, among which that of the US (Curry, 1997). In an attempt to address all stakeholders' needs, a standard of post-crisis reform was being created, generally known as the 'Washington Consensus', leading to a paradigm shift in economic policy making in Latin America and other less-developed countries alike. According to Cypher (1998), "the intellectual impetus behind the consensus view clearly flowed from Washington, the locus of US Treasury, the International Monetary Fund, and the World Bank" (p. 47). In short, the Washington Consensus can be seen as a set of ten specific policy recommendations, as originally stated by economist John Williamson (1989). Appendix II provides an extensive elaboration on each of the ten recommendations. For now, it will suffice that the Washington Consensus is very neo-liberal in nature, focussing on neutral fiscal policy, trade liberalization, privatization of state enterprises and deregulation, amongst others. Cypher (1998) argues that through the Washington Consensus, "the neoliberal, free-trade, 'market-friendly' policies have become the norm in virtually every Latin American nation" (p. 47), effectively weakening the role of the state, a view that is shared by Dietz (1989). Regardless, in response to the crisis most countries chose for the neoliberal, IMF-induced, reform strategies, effectively abandoning their previous 'import-substituting industrialization' economic policy and replacing it with the 'export-oriented industrialization' alternative.

2.3.2 Russian Debt Crisis – 1998

Russia's turn of suffering a severe sovereign default crisis came in 1998, due to a combination of declining productivity, an artificially high exchange rate and years of running fiscal deficits (Roubini & Mihm, 2010; Chiodo & Owyang, 2002), fuelled by the huge costs associated with the war in Chechnya in the mid-nineties. The crisis was triggered by two external shock events, being the Asian financial crisis of 1997 and the subsequent decline in commodities such as crude oil and non-ferrous metals, severely impacting the foreign exchange reserves of commodity-rich Russia.

Initially, the years following the Chechnya years left room for some cautious optimism, as Russian officials began to reschedule the foreign debt payments that were inherited from the former Soviet Union. According to Chiodo & Owyang (2002), “the negotiations to repay its sovereign debt were a major step towards restoring investor confidence” (p. 9). There were a couple of arguments that made it seem that by 1997, Russia was moving toward economical stability. Amongst others, the trade surplus was reaching a state of equilibrium between exports and imports, the Russian government had managed to strengthen its political ties with the West (including the financial institutions such as the World Bank and the IMF), and inflation was brought down from 131 percent in 1995 to 11 percent in 1997 (Chiodo & Owyang, 2002, p. 9). Moreover, the exchange rate was being kept at a stable course and oil, being one of Russia’s prime export commodities, was being sold at a relatively high price. However, despite these optimistic prospects, Russia was facing some serious problems. Apart from low productivity and limited foreign direct investments, the Russian government seemed unable to efficiently collect taxes, fuelling the overarching problem of high federal budget deficit (Desai, 2000). According to Desai (2000), “monthly interest payments from the budget, 23 percent of the revenues in January 1998, had jumped to a whopping 51 percent in July 1998” (p. 48). It should not come as surprise to learn that suspicion rose about Russia’s ability to maintain the value of the ruble and its commitment to continue to adhere to its debt service obligations. As a consequence, on 13 August 1998, the Russian stock market collapsed as investors feared for a devaluation of the ruble and the Russian government to default on its debts. Eventually, on 17 August 1998, the Russian government indeed devalued the ruble, defaulted on its debt, and declared a 90-day moratorium (a legal delay of payment) with its foreign creditors (Chiodo & Owyang, 2002). The crisis led Russia to end the year with an economic contraction instead of the earlier predicted, but managed to boost Russia’s exports due to the collapse of the ruble. However, the reputation loss was severe to say the least, which translated in limited and inconsistent foreign direct investments in the years to follow (Chiodo & Owyang, 2002). According to Shleifer & Treisman (2000), “the crisis of August 1998 did not only undermine Russia’s currency and force the last reformers from office...it also seemed to erase any remaining Western hope that Russia could successfully reform its economy” (p. 177). Nevertheless, the Russian government seemed to have been able to keep the country's social and political situation under control, and now boasts one of the fastest-growing economies in the world.

Chapter 3 Theoretical Framework

This chapter has provided us with an elaboration on the development of economic theory throughout history, leaving us with two dominant economic ideologies which are still predominant in determining macroeconomic policy; Keynesianism and Neo-liberalism. The first main difference between the two ideologies involves the role of the government, ranging from an active, substantial role in Keynesian economics to a passive, minimal role in Neo-liberalism. Secondly, the two ideologies differ greatly when it comes to the policy tools government should use to prevent or counter financial crises. Furthermore, two of the most recent and severe sovereign debt crises, the Latin American debt crisis of the early 1980s and the Russian debt crisis of 1998, have been discussed in order to distil some of the main characteristics of these crises. Combined with the insights gained from analyzing the economic ideologies and two actual crises of the past we are able to construct a framework with which both the context and the content of post-crisis policy reform can be studied. Naturally, the process of post-crisis reform is equally important and therefore also included in the framework. Conclusively, the framework combines the theory of policy implementation of Pettigrew et al. (1992) and Pollitt & Bouckaert (2004) with theoretical foundations of international political economy.

3.1 Conceptual Framework

This thesis builds upon the theory of both administrative reform and public finance, both of which will be dealt with more elaborately in Chapter 2. For now, it will suffice to provide a brief summary of the conceptual framework that will be applied. A concept is a visual representation of an abstract idea. According to Chinn & Kramer (1999) a concept is "a complex mental formulation of experience". The conceptual framework is the operationalization of the theory, which will be discussed in Chapter 2, and serves as a 'guiding light' throughout this thesis. Aside from showing the direction of the study, the conceptual framework can be used to the relationships of the different constructs under investigation. We have established that this particular research will focus on analyzing two case studies in which policy reform packages were implemented following a debt crisis. As the context in which the debt crisis were allowed to take place in the first place plays an essential role, the framework for analysis needs to incorporate this particular intervening variable. For that particular reason it has been decided to use the model of Pettigrew et al.. (1992), in which *context*, *content*¸ and *process* are the three dimensions along which case studies are being examined. Regarding the *context*, Pettigrew's model is combined with the model of Pollitt & Bouckaert (2004), of which a visual representation can be found in figure 2.1. Important to note is that the cornerstone of this particular model is the process of elite decision-making, assuming that most decision-making is conceived and executed by top-tier politicians and government officials. This conceptual framework will be supported by the theoretical framework (Chapter 2), involving, amongst others, the theoretical foundations of international political economy, as it gives additional insights in the macro-economic environments in which the crises under examination took place and provide a subtle difference between the economic ideologies of both Europe and the US.

3.1.1 Context

Context has received attention from researches in a number of outfield as being an influential factor in the successful implementation of theory into practice (Dopson & Fitzgerald, 2005). In particular when the case study has been elected as the means of analysis, an extensive review of the context should be provided given the differences between the subjects under examination. In this research, context will be examined based on the conceptual model of public management reform as designed by Pollitt & Bouckaert (2004), its purpose being "to provide a framework for the subsequent discussion by depicting the broad forces that have been at work in both driving and restraining change" (p. 25). An important characteristic of the context is which economic ideology has played a dominant role throughout history. In order to provide the necessary insights regarding economic ideologies, Chapter 2 will provide an history of modern international political economy, from briefly touching upon early days of Mercantilism in the 1600s to modern day Capitalism in its different forms. Moreover, the model also takes into account the socio-economic forces as well as the political and administrative systems in which reform takes place.

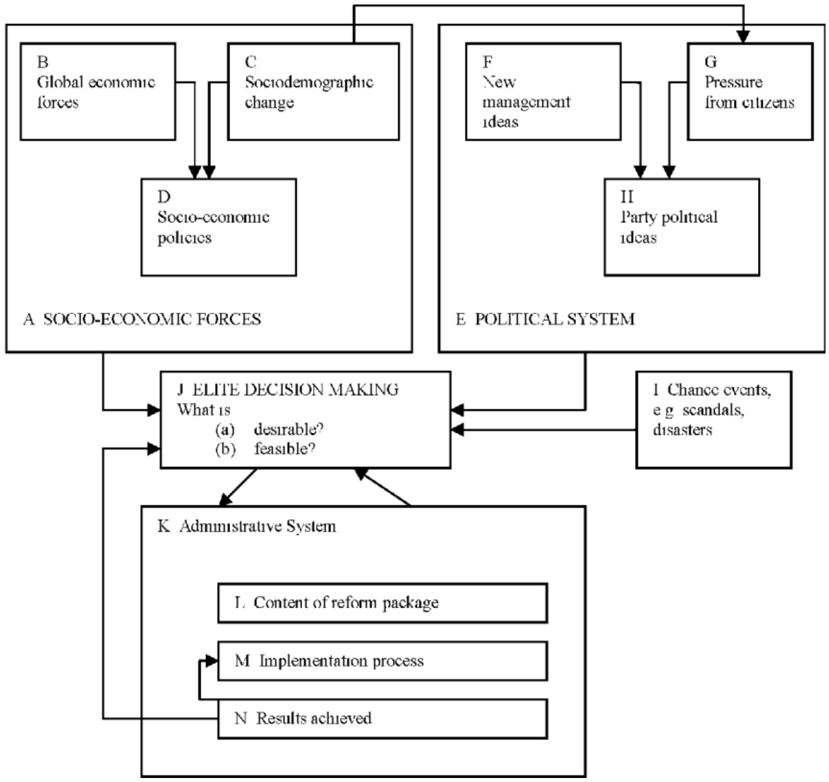

Figure 2.1 Conceptual Model of Public Management Reform (Pollitt & Bouckaert, 2004)

3.1.2 Content

The reform programmes under examination make up the *content* of the model. The model of Pollitt & Bouckaert (2004), apart from allowing us to explain the context in which reform takes place, also allows for examination of the content of reform packages (box 'L'). The content of reform packages is "the product of the interaction of the desirable and the feasible" (Pollitt & Bouckaert, 2004, p. 35). Specific attention needs to be addressed the policy tools that governments have available to adjust policies on the macroeconomic level. These tools available for stabilizing economies will be discussed in Chapter 2, primarily fiscal and monetary policy. The content of both reform packages will then be analyzed along these dimensions.

3.1.3 Process

Lastly, the process of the implementation of the reform packages will be discussed, corresponding with box 'M' in the model. According to Pollitt & Bouckaert (2004), "much is learned during the attempt to put reform ideas into practice, and some of that learning frequently translates into departures from the original design" (p. 36). In other words, in the process of policy implementation one may encounter obstacles which force a change of direction. One particular example of an obstacle in policy implementation might be that it is politically influenced, where actors involved are more preoccupied with the next elections than with designing and executing the most suitable solution to a problem. As stated by Hojnacki (1996), "as far as most countries are concerned, the possible dominance of the civil service by political regimes seems to be of greater concern than the possible dominance of the political regime by the civil service" (p.144, as published in Pollitt & Bouckaert, 2004, p. 144). The build-up of the conceptual framework can now be visualized in the flow scheme in Figure 2.2.

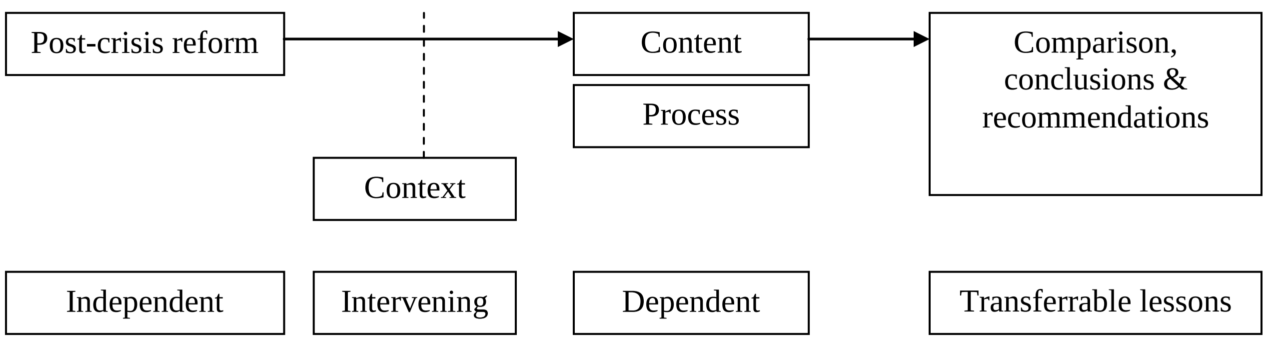

Figure 2.2 Flow Scheme of the Conceptual Framework

3.2 Assessment Criteria

This framework will be used as the assessment criteria along which the in-depth case studies of both the European sovereign debt crisis and the US debt ceiling crisis will be examined, and can be found below in Table 2.2.

Characteristic	*Description*
Context	Socio-economic situation in which led up to the reform initiative (Keynesianism vs. Neo-liberalism); change events inciting the reform (financial crisis); political system which was in place.
Content	Components of the reform package; economical ideology behind the reform package content; macro-economic policy tools put in place.
Process	Actions and reactions of involved stakeholders (governments, international financial institutions, media, civil society); to what extent the envisioned reform package has reached its objectives.

Table 2.2 Research Model of Post-Crisis Reform (Pettigrew et al., 1992; Pollitt & Bouckaert, 2004; own findings)

Reflecting on the model for public management reform by Pollitt & Bouckaert (2004), it is important to note that in using this model for studying post-crisis reform we are effectively putting a huge emphasis on change event as the crises under examination themselves are the trigger for policy reform in the first place, creating huge momentum for change. Consequently, due to the fact that both case studies involve sovereign default situation which could potentially create unprecedented economic chaos, elite-decision making is also emphasized greatly.

We mentioned both crises as being facilitators for reform. This is supported by the work of Heyse et al. (2006), who argued that there are three dominant facilitators for reform found in literature on the matter. First of all, the emergence of a crisis can be a catalyst for reform, as its disruptive force (especially when combined with the power of mass media) can force one to changes. A second facilitator for reform is the emergence of a ‘window of opportunity’, which can be but is not always triggered by a crisis. When a ‘window of opportunity’ comes around, possibly by decline in support for a particular policy, the moment of opportunity should be seized by a so-called policy entrepreneur, connecting closely to a third facilitating agent, being leadership. Unfortunately, “current literature does not tell us how and which barriers will diminish, how remaining barriers are overcome, and how reformers can use the window of opportunity” (Heyse et al., 2006, p. 12). Therefore we will for now discard the generic observations on public reform and progress to the in-depth case study analyses of both post-crisis reform programmes which were implemented following the European sovereign debt crisis and the United States debt ceiling crisis. The converged model of Pettigrew et al. (1992) and Pollitt & Bouckaert (2004) provide us with a solid framework to compare both case studies, especially with the contextual synthesis of the theory of economical ideologies and the theory and practice of historical sovereign defaults.

Chapter 4 European Sovereign Debt Crisis

This chapter will provide a study of the measures that the European Union took to ensure financial stability in Europe by providing financial assistance to Eurozone states in difficulty. It will begin with a description of the context in which the reform took place, i.e. an elaboration on the European sovereign debt crisis of 2010. Secondly, the focus will be put on the actual content of the reform packages, providing insights in the aim of the reform and how the reform package was structured to ensure the goal would be reached. Thirdly, the process of the reform package implementation will be discussed, including a chronological overview of events and the reception of the programme. Finally, the results of the reform will be discussed. Due to the fact that European sovereign debt crisis has proven to be an on-going matter throughout late 2011 and probably for a while to come, this research limits itself to the Euro Summit that took place at the end of October 2011. Developments which took place after the summit will be discussed briefly in concluding chapter, but are not part of the case study analysis.

4.1 Context

In late 2009, suspicion of a sovereign debt crisis in Europe began to emerge among investors, particularly concerning the Eurozone members Greece, Ireland, Italy, Spain and Portugal (also knowns as the PIGS or PIIGS countries), who have been caught in a threatening vicious cycle ever since: doubts concerning financial stability leads to higher borrowing costs, which in turn leads to greater doubt and even higher borrowing costs. To some, the trouble in Europe was to be expected. According to Roubini & Mihm (2010), fiscal recklessness led to financial instability in Greece, whereas the collapse of Ireland’s housing bubble and banking system left the country’s economy in shambles. Portugal, Italy and Spain are struggling, the latter two “being in the unenviable position of being both too big to fail and too big to save (Roubini & Mihm, 2010, p. 304). Being the first crisis in the Eurozone since its creation in 1999, one may argue that this crisis shows that the it is far from an optimal currency area (Manolopoulos, 2011). In order to understand how Europe ended up in its sovereign debt crisis, it is important to elaborate on both the creation of the European Monetary Union on the hand, and the consequences of the financial crisis of 2008 and its impact on Europe on the other hand.

4.1.1 The Rise of the European Monetary Union

In post-war Europe, French foreign minister Robert Schuman proposed to unify Europe through the foundation of the European Coal and Steel Community, the first organization based on the principles of supranationalism. On 9 May, 1950, Schuman announced a plan to place "the whole of Franco-German coal and steel production under a common High Authority, within the framework of an organization open to the participation of the other countries of Europe" (Fontaine, 1990, p. 44), giving substance to the hitherto unprecedented notion of European integration (Dinan, 2005). In the history of European integration, there have been three major policy initiatives: (i) the Werner plan, designed to achieve economic and monetary union (EMU), (ii) the European Monetary System launched in 1979, and (iii) the Maastricht Treaty of 1992, which created the European and led to the introduction of the euro. The first two initiatives were launched in a reaction to international currency crises, respectively the collapse of the Bretton Woods system and the destabilizing impact of foreign currencies. Monetary union, as proposed in the Maastricht treaty, marks a highly advanced stage of European integration but also poses a substantial risk as "monetary union without a complete economic union is a daunting task" (Dinan, 2005, p. 482). This view is underlined by Roubini & Mihm (2010), who state that "though [Europe] has always been a monetary union, with member states ceding control over monetary policy and exchange rates, the member nations have never embraced a true fiscal or political union" (p. 305). In times of economic prosperity and growth this does not pose many challenges, but as soon as problems emerge the lack of unity allows for individual member states to take on a 'own country first' attitude. The solution seems to be adopting the concept of a true fiscal union by creating a new, centralized body that levies taxes throughout Europe and takes control over the fiscal budget. That way, the stronger regions (e.g. Germany) can carry some of the load of the weaker regions (at this point, the PI(I)GS).

4.1.2 The Aftermath of the 2008 Financial Crisis

One of the origins of the European sovereign debt crisis is the financial crisis of the late 2000s, which, considered by many economist to be the worst financial crisis since the Great Depression of the 1930s. This crisis, triggered by a housing bubble in the US, led to the collapse of large financial institutions (such as investment banks Bear Sterns and Lehman Brothers), the bailout of many other financial institutions by national governments, and crashing stock markets around the world. In the European Union (EU), this has lead to a huge crisis in confidence, especially in countries where sovereign debts have increased sharply due to the bailouts and stimulus packages following the financial crisis. This confidence crisis is easily shown by looking at two indicators of financial stability; bond yield spreads and credit defaults swaps (CDS). The first involves the difference in yield (return) on government bonds. If the credit rating of a country goes down, its yield rate goes up as the investment in that particular government bond is considered to be far more riskier, and thus merits a higher yield. One can imagine that in times of sovereign debt turmoil in Greece, the yield spread between Greek bonds and those of, e.g., Germany is widening. The same goes for credit default swaps, which effectively are insurance policies against loan defaults. Much like the bond yield spreads, the credit default swap spreads of Greece have exploded the last years. The same goes, to a lesser extent for countries such as Ireland, Portugal, Italy and Spain. However, it started with Greece, who suffered the hardest from the financial crisis, partly due to the fact that its main industries, tourism and shipping, were severely hit by the effects of the crisis, but also due to years of fiscal recklessness (Manolopoulos, 2011). In general, Greece has a extensive record of fiscal deficits, and has spent the better part of the last two centuries in default (Reinhart & Rogoff, 2009). Even upon accessing the Euro in 2001, many believed that Greece's budgetary mismanagement might pose a threat to the stability of the newly formed currency, as Greece's debt to GDP ratio was already over 100% (Reinhart & Rogoff, 2009). See Table 4.1 for an overview of both the budget deficits and the debt to GDP ratio of the PIIGS countries at end of 2010.

Country	*Budget deficit, as % of GDP*	*Debt as % of GDP*
Greece	10,6%	144,9%
Ireland	31,3%	94,9
Italy	4,6%	118,4%
Portugal	9,8%	93,3%
Spain	9,3%	61,0%
Euro Area	6,2%	85,4%

Table 4.1 Budget deficit and debt as % of GDP, 2010 (Source: Eurostat)

You can tell from the chart that Greece and Italy in particular already suffered from huge debts by 2009, whereas Greece was also struggling with a severe budget deficit. Looking back on Greece's recent history, it becomes clear that running structural deficits, fuelled by financing public sector jobs, pensions and other social benefits, has been a deliberate policy for successive governments for years, which was allowed for by strong economic growth (approximately 4% per year between 2000 and 2007 (Manolopoulos, 2011)). However, since accession to the European Monetary Union in 2001, Greece has also experienced above average inflation rates, causing a breach in purchasing power parity compared to other European nations, as well as substantial loss in competitiveness and the aforementioned budget deficits (Arghyrou & Chortareas, 2008). Overall, one may conclude that Greek would have suffered a currency crisis following the effects of the financial crisis had it ran a currency of its own (Arghyrou & Tsoukalas, 2010).

4.2 Content

On 9 May, 2010, all 27 member states of the European agreed upon creating the European Financial Stability Facility, an emergency measure put into place to counter the negative turmoil surrounding the perceived sovereign debt crisis that Europe, and Greece in particular, was facing. The official content of reform package that was implemented to counter the looming sovereign debt crisis in Europe consisted of a combination of creating a safety net while allowing the European Central Bank (ECB) to use the policy tools at its disposal to reduce market volatility. On the one side, the safety consisted mainly of the special purpose vehicle EFSF, a legal instrument aimed at preserving financial stability in Europe by being a lender of the last resort for countries in financial needs. The facility, originally limited to EUR 440 billion, was complemented by another EUR 60 billion from the European Financial Stabilization Mechanism (EFSM) and a EUR 250 billion loan from the International Monetary Fund, totalling a safety net of EUR 750 billion.

4.2.1 Stability and Growth Pact

In order to have a good understanding of the content of the reform package, it is important to first focus on the existing set of agreements in Europe focused on maintaining economic stability in the EMU, the Stability and Growth Pact (SGP). According to Buti et al. (2003), the SGP is a form of discipline design which is aimed at maintaining sound budgetary balances (budget deficits may not exceed 3% of GDP) and low public debts (national debt may not exceed 60% of GDP). The aim of the SGP was to facilitate and maintain the stability of the EMU. Even though hindsight wisdom tells us that the guidelines as prescribed by the SGP have not prevented Europe from ending up in the current sovereign debt crisis, the SGP has been widely regarded as a major innovation. According to Artis (2002), the SGP is seen as "one of the most remarkable pieces of policy coordination in world history. Its construction makes it in some respects comparable to the Bretton Woods system" (p. 115). Ever since the creation of the SGP in 1997, it has been the focus of heated discussion, especially in 2002 when some euro area countries failed to comply with the basic rule of the SGP; keeping the budget deficit under 3% of GDP. Some have argued against the strict 3% rule, stating that numerical rules could potentially draw attention away from actual budgetary mismanagement (Wyplosz, 2002; Wren-Lewis, 2000; Von Hagen, 2002), while others question the SGP's lack of attention to the quality of public finance in general (Milss & Quinet, 2001; Von Hagen, 2002; Fitoussi & Creel, 2002). All in all, the general conclusion was that the SGP, although not perfect, served Europe rather well within the boundaries of supranationalism (Buti et al., 2003). However, the general consensus indicated that a higher degree of fiscal integration would be welcomed, even though the limited degree of political integration probably means that "the changes are likely to be incremental rather than radical" (Buti et al., 2003, p. ii).

4.2.2 EFSF, EFSM & ESM

On 2 May, 2010, a week before the much anticipated EFSF was officially created, the Eurozone countries together with the IMF decided to grant Greece a bailout loan of EUR 110 billion, to be given out in parts under the condition that Greece adheres to strict austerity measures. The Hellenic bailout was followed by a EUR 85 billion in Ireland in November 2010 and a EUR 78 billion bailout in Portugal in May 2011. Of Greece's bailout package, a EUR 45 billion loan was given out immediately, as Greece needed money before 19 May, 2010, when it was facing a debt rollover of EUR 11,3 billion. Much in need of the money, Greece has no choice but to agree to severe austerity measures, mostly focused on limiting spending on pensions, increasing average retirement age, and tax increases. A subsequent strike held in Athens on 5 May 2010 to protest against these measures resulted in numerous arrests, many injured, and three killed. As mentioned, the emergency measures against the sovereign debt crisis in Europe also consists of the creation of the EFSM, a temporary emergency funding programme with the authority to raise up to EUR 60 billion. Funds raised through the EFSM are guaranteed by the European Commission, which in turn is backed by all 27 member states of the European Union. Both the EFSF and the EFSM were designed as temporary measures, both to expire in 2013, mostly due to a lack of legal foundation within the currently ratified EU treaties. In order to solve this problem, it was decided on 16 December 2010 that a short amendment would be inserted in Article 136 of the 'Rome Treaty' (Treaty on Functioning of the European Union), stating that "The Member States whose currency is the euro may establish a stability mechanism to be activated if indispensable to safeguard the stability of the euro area as a whole. The granting of any required financial assistance under the mechanism will be made subject to strict conditionality" (European Council, 2010, p. 6). In addition to the previous amendment, the European Stability Mechanism (ESM) will be established based on a newly ratified treaty by Eurozone countries only; the Treaty Establishing the European Stability Mechanism. This treaty dictates that the ESM, to be established in 2013 as a substitute of the temporary EFSF and EFSM, will be a intergovernmental organization under public international law.

4.2.3 Euro-Plus Pact

Advocated by the French and German government, the member states of the European Union made an effort in 2011 to commit themselves to a list of policy reforms aimed at improving the fiscal strength and competitiveness of each country individually, and subsequently the European region as a whole. The Euro-Plus Pact (EPP), also called the Competitiveness Pact or the Pact for the Euro, can be seen as a more stringent successor of the SGP. Adopted in March 2011 following the EU's open method of coordination, the EPP is focused on (i) fostering competitiveness, (ii) fostering employment, (iii) contributing to the sustainability of public finances, (iv) reinforcing financial stability and (v) tax policy coordination. Originally penned up by French president Sarkozy and German chancellor Merkel, the Euro-Plus Pact can be seen as a step forward in Europeanization, steering it into the direction of higher integration of labour markets, public finances and tax policy.

All in all it seems that the original set of policy instruments that build up the EMU, being exclusive monetary by nature, have in hindsight allowed for the huge differences in fiscal policy between euro zone nations to occur. The SGP, originally designed to curtail both budget deficits and debt to GDP ratios, has proven to ineffective in reaching this goal, largely due to limited enforceability (Buti et al., 2003). The sovereign debt crisis has now forced Europe to create a safety net, made up of the EFSF, the EFSM and support from the IMF. Making use of the safety net, such as Greece had to do, means that Europe has a say in previously domestically decided issues, such as fiscal policy and macroeconomic policy. In the case of Greece, this has resulted in severe spending cuts in the public sector, tax increases and a wave of privatization of state enterprises. Active fiscal policy seems Keynesian in nature, with the difference that in this particular case it involves spending less instead of more, in line with the orthodox theory of balanced budgets that underpins the EU (Farrell & Quiggin, 2011). Privatization is a trademark policy for neo-liberalism, although in this particular case the decision to privatize on a large scale seems more fiscal-driven than ideologically induced. Conclusively, it seems that there is no dominant economical ideology driving the reform. What is important to note however, is that some argue that the sovereign debt crisis can prove to be a catalyst for further European integration (Glöckler, 2011).

4.3 Process

Now that we have taken a look at both the context in which the reform took place, and the actual contents of the reform package, it is now time to reflect upon the process of the reforms. The reforms began 2010 following the first signs of Greek illiquidity, and are still ongoing at the present time (late 2011). Instead of providing a detailed timeline of the most important events the last years, we will focus on the main aspects of the process as presented in Table 2.2.; *actions*, *reactions*, and *results*. This will not be done in a sequential fashion; instead the most important characteristics of the process will be elaborated on. When describing the *actions*, we will focus on the main decision-makers involved in the process and their actions. Regarding *reactions*, the aim is to analyze the reception of the reform initiatives by various stakeholders such as civil society, the media, and the global political arena. Finally, the *results*, or in this case, preliminary results of the reform initiatives will be evaluated.

4.3.1 One for all?

By the time the financial crisis spilled over to Europe, after having emerged in the US, general consensus was that Europe could be considered to be a safe haven (Jones, 2009; Wyplosz, 2009). Despite some concerns regarding the euro’s resilience against its first major crisis, the Eurozone’s single currency was “generally viewed as a protective force against the financial storm shaking the world” (Leblond, 2011, p. 1). The first emergence of the Greek sovereign debt problems led to a completely different belief, namely that the euro should be held responsible for the debt crisis that was looming over Europe and that there was no future for the Eurozone as a whole (Leblond, 2011). According to Financial Times journalist Gideon Rachman, “increasingly the Euro looks less like an indissoluble union, and more and more like an unhappy marriage between incompatible partners" (Rachman, 2010). This last observation has much to do with the way in which the political debate took place between EU leaders. Throughout the discussion there were moments when the unity between the European countries seemed non-existent, especially regarding a potential north-south divide. After all, for some, it seemed that the so-called Euro-Med countries (such as Greece, Italy, Spain and Portugal) were heading for debt default. Such a scenario would have meant leaving the Eurozone, and possibly even the EU (Leblond, 2011). It was suggested that, as an alternative for the bailouts of troubled economies, the Eurozone would be disbanded by allowing Germany to reinstate the Deutsche Mark and save the Euro by depreciation instead of austerity. Alternatively, Germany would take the lead in creating another currency union with their northern European counterparts (such as The Netherlands, Finland, and Austria), leaving the southern European countries in a separate French-led union. At the heart of this discussion is the theory that the Eurozone is not a so-called optimal currency area (OCA). According to Kenen & Meade (2008), we can speak of an OCA if its members possess at least one of three characteristics:

- Facing similar economical shocks and react to them in a likely fashion;
- In the absence of such similarity, members should have free movement of both capital and labour so that member states can balance each other's up- and downturns;
- If none of the above characteristics are in place, there should at least be a high degree of price flexibility (in wages in particular) in member states.

(Source: Kenen & Meade, 2008)

In the case of the EU, Bayoumi & Eichengreen (1997) established that in the EU, there are in fact two core OCAs, one centred around Germany and another around the southern European countries. This explains the heated debate between European leaders, with French president Sarkozy and German chancellor Merkel at the heart of it. Basically, Sarkozy urges Merkel to go along with a proposal empowering the ECB, whereas Merkel is worried this will cost Germany too much, effectively picking up the bill on the expense of German taxpayers. In the periphery, a tough discussion about the role of the big European banks and their responsibilities is ongoing, creating a 'game of chicken' among bankers, political leaders and parliaments (Kirkegaard, 2011). As the public has had little or no say in the matter so far, we may conclude that the decision-making process in this reform is strictly top-down, and a prerogative for the political elite.

4.3.2 Influence of National Politics

Kindleberger (1986) established five functions that are deemed essential for stabilizing an economic system; (i) maintaining an open market for distressed goods, (ii) stabilizing exchange rates, (iii) acting as a lender of the last resort, (iv) providing countercyclical long-term lending and (v) coordination of macroeconomic policies, all to be performed by a single authority. Regarding the latter two, responsibility within the EU is decentralized, effectively giving way to nationalism and the influence of domestic politics (Glöckler, 2011). As we have witnessed, the pending crisis in the Eurozone has developed into bargaining process between individual member states, while “we are seeing the inability of the European authorities to act” (Kirkegaard, 2011). The current crisis in Europe is as much a political crisis as it is a financial crisis, painfully exposing the gaps in Europe’s ever on-going quest for integration. Without a empowered supranational governmental body, EU politics are mostly national politics which are addressed in a European dimension, rather than truly European politics. The danger is that instead of choosing to cooperate, European countries turn at each other, playing a blame game as for who is responsible for the crisis. This has sparked populist nationalism in domestic politics, e.g. in the Netherlands where right-wing politician Geert Wilders is using the Eurocrisis in his favour, fuelling a misguided belief that ‘hard-working Dutch taxpayers’ have to finance the ‘lazy and corrupted Greek’.

4.3.3 The Future of the Euro

Regardless of the ongoing discussion around its credibility, a year and a half after the first Greek bailout the Eurozone (and the EU, for that matter) is still intact. Moreover, the crisis seems to have given way to increased economic integration, such as the earlier mentioned Euro-Plus Pact. This is also reflected in the decisions made at the much anticipated Euro Summit of October 2011. The summit, held to address the building tensions in the financial markets and to restore confidence, resulted in an broadly supported set of guideline regarding Greece’s debt issues (including a fifty percent ‘haircut’ on notional Greek debt by private creditors), raising the EFSF to around a trillion euro, strengthening the banking sector and further integration of economic and fiscal coordination and surveillance. In a statement made by EU president Herman van Rompuy, he states that "the Euro Summit decided to reflect on a further strengthening of economic convergence within the euro area, on improving fiscal discipline and deepening economic union, including exploring the possibility of Treaty changes" (Van Rompuy, 2011, p. 2). Despite the arduous process that has characterized the EU's reforms, it seems that European leaders and institutions share a common conviction that disbanding the Euro is not the optimal solution. As the EU tries to balance efficiency and legitimacy, in the end it seems to get the job done (Kirkegaard, 2010; Glöckler, 2011).

4.4 Chapter Synthesis

In this chapter, the European sovereign debt crisis has been analyzed by applying the theoretical framework which was presented in Chapter 2. We will now connect the findings of the case study with the framework. Regarding *context*, it has become obvious that the financial crisis of 2008 has been the trigger for the sovereign debt crisis. Starting with the Greek bailout, Ireland followed suit, and also worries about the financial health of Portugal, Spain and Italy started to emerge. Prior to the debt crisis, these PIIGS countries had seen their debt soar for years while their competitiveness declined, leaving them vulnerable for default and threatening the wealthier members of the EU. As a consequence, the EMU is facing a profound threat to its very existence, largely due to the fact that while member states have ceded control over their monetary policy and exchange rate regime, they never formalized a true fiscal or political union. The SGP, formally constraining budget deficits and debt, was designed to lead to economical convergence in Europe but has obviously failed to do so. In reality, countries continuously dodged the rules regarding budget deficits and public debt and postponed promised structural reforms. On top of that, the 2008 financial crisis put an even heavier load onto the back of national governments as banks needed large-scale bailouts and stimulus packages were put into place to resuscitate the economy, consequently leaving national governments with ballooning debts.

Regarding *content*, the core element of the reform packages which was put into place following the emerging debt crisis was the creation of the EFSF and the EFSM. The creation of these institutions shows the high level of international cooperation, as each of the Eurozone members, the IMF and the EU have agreed upon the terms and conditions of the facility. Another significant component of the post-crisis reform is the increased focus on budget and debt management. Whereas the original SGP was unsuccessful in getting the Eurozone members to adhere to its rules and regulations regarding budget deficits and debt due to limited enforceability, the newly created institutions (and their substitute as of 2013, the ESM) will include more stringent rules on fiscal coordination and surveillance. Regarding economical ideology, the reform packages focus on active fiscal policy and a rather large role of the (supranational) government, hinting at Keynesianism. However, the fiscal policy is centred around spending cuts instead of increased expenditures, which has led to a heated debate of the successfulness of austerity measures, with antagonists stating that enforced spending cuts in troubled economies such as Greece's will only worsen the situation. In the case of Greece, austerity measures are combined with large-scale privatization in order to liquidize some of the government's assets, bearing the hallmark of neo-liberalism. It seems there is no overarching economical ideology that drives the reform in Europe. Instead, the political will to keep Europe unified seems to be the driving force, fuelled by the belief that "effective cooperation, coordination and burden-sharing, whether regional or global, still remain a better way to deal with cross-border problems" (Leblond, 2011, p. 20). Conclusively, it seems the crisis and the subsequent reform have paved the way for increased European economical convergence regarding fiscal and political unity to a level that seemed unlikely in pre-crisis times.

The *process* in which the reform took place can be described as arduous and incremental, and driven forward by the decision-making of Europe's political elite. The fact that the Eurozone is no true OCA has made it extremely hard to put effective measure into place swiftly, simply because is there is no underlying legal framework which legitimizes such measures. Throughout the process, the future of both the Euro as well as the EU have been the subject of heated debated, varying from total disbandment to a two-currency scenario, splitting the Eurozone in a north-south divide. Also, national politics have played a significant role in the process, as Europe's political leaders, despite pro-Europe beliefs, also had to take into accounts more nationalistic sentiments from their own constituents. Despite all the criticism and suspicion around the Euro, a year and a half after the first Greek bailout, the European leaders came together once more during the Euro Summit of October 2011 to show their shared commitment to a unified Euro, laying out an extended rescue plan to stabilize the financial markets and restore confidence in the EU and the Eurozone.

Chapter 5 United States Debt Ceiling Crisis

On August 2, 2011, United States President Barack Obama signed the Budget Control Act of 2011 into law, bringing conclusion to the 2011 United States debt ceiling crisis which had loomed over the country for months, threatening to lead the United States into sovereign default around early August 2011. In this chapter, the reform package will be analyzed in the same way as has been done with the European sovereign debt crisis. Context, content and process of the reform package will be discussed, followed by a chapter conclusion. Like the European sovereign debt crisis, the United States debt ceiling crisis is also a pending issue. Even though the short term problems for the 2011 budget were solved at the last minute, similar debates are expected for the federal budgets of 2012 and further. For this particular research, only the 2011 budget is in scope, although the final chapter will address the long-term issues the US faces regarding its federal budget.

5.1 Context

The US debt ceiling crisis was a 2011 financial crisis that centred around increasing the debt ceiling by the US Congress. US law dictates that an administration can only spend what it has available in funds, which either come from tax receipts or from borrowing from the US Department of Treasury, the latter being limited to the debt ceiling. Years of budget deficits in the US, fuelled by the costs of war, financial stimulus packages, and the bailout of financial institutions following the 2008 financial crisis were the direct triggers of the debt ceiling crisis. However, even before the financial crisis, the US has experienced substantial budget deficits and has had to raise the debt ceiling on numerous occasions. In order to understand the context in which the debt ceiling crisis and its subsequent reforms took place, we will analyze the history of the US' financial politics from the Great Depression until now, taking into account the paradigm shift from Keynesian economics to neo-liberalism and the effect this has had on the current state of the US' financial situation.

5.1.1 The Great Moderation

In the aftermath of the Great Depression, the general opinion was that capitalism had failed, forcing western economies to look for alternative forms of economic policy. From 1929 to 1933, the US experienced the worst depression in its history. Unemployment rates exploded from 3.2 percent to 24.9 percent, thousands of banks around the country had gone bankrupt, and the country's financial system had pretty much come to a cardiac arrest by the time that Franklin D. Roosevelt took office in 1933 (Kennedy, 1999). In an attempt to counter the depression, the New Deal democrats tried to resuscitate the economy by actively getting the government involved through Keynesian economics, e.g. by focussing on relief for the poor and unemployed (e.g. by introducing the Social Security Act of 1935), but also stricter regulation of the country's financial sector which had failed completely in the wake of the Great Depression. The most significant regulation measure was the Glass-Steagall Act of 1933, which was aimed at controlling speculation by creating a separation between investments banks (which issued securities) and commercial banks (which accepted deposits). World War II, despite its horrific consequences, also marked the true end of the Great Depression, whereas war meant massive spending and thus an enormous growth in GDP and a huge reduction in unemployment. Moreover, World War II paved the way for a transformation of the world's financial system (Roubini & Mihm, 2010). In 1944, when the war was nearing its end, economist and policy makers of the allied nations reached an agreement on a new world economic order in Bretton Woods, New Hampshire, which included the construction of (frontrunners of) the International Monetary Fund and the World Bank, as well as the Bretton Woods system, a new system of currency exchange rates. Together with the General Agreement on Tariffs and Trade, signed in Geneva in 1947, the Bretton Woods system provided fertile ground for unprecedented economic growth, especially within the economical framework in which governments, capital and labour had an equilibrium. The post-war economic expansion, which lasted approximately to the late 1970s, marked a period of worldwide economic growth, prosperity and low unemployment. The collapse of the Bretton Woods in 1971 marked the end of the economic boom. The main reason behind the collapse was the twin US fiscal and current account deficits, which was in turn the consequence of the enormous costs of the Vietnam war and the unsustainable accumulation of dollar reserves by the US' creditors (primarily Western Europe and Japan). This forced president Nixon to choose between two evils; either defend or devaluate the dollar. As defending the dollar would lead to higher interest rates, governmental spending cuts and ultimately recession and with presidential elections coming up, Nixon chose to terminate the convertibility of the dollar to gold, effectively ending the Bretton Woods system. The collapse of the Bretton Woods system ushered in a period of social unrest and economical instability. Freed of the constraints of fixed exchange rates, monetary authorities were free to print money as they pleased, resulting in rising inflation and commodity prices. Stagflation followed the oil shocks of 1973 and 1979. In the meantime, Nixon ("We're all Keynesians now") was introducing a number of very progressive reforms, such as the Tax Reform Act, and created a number of regulating institutions such as the Occupational Safety and Health Administration and Mine Health and Safety Administration. In hindsight, the Republican president Nixon could be seen as very progressive in contemporary politics, an clear indication of how the political climate in the US has changed over time. Regardless, the Watergate scandal and subsequent resignation of Nixon paved the way for a policy revolution and the rebirth of neo-liberalism, essentially initiated by the administration of president Ronald Reagan.

5.1.2 Renaissance of Neo-liberalism

The main proponent of free market ideology in the post-Keynesian era was US president Ronald Reagan, who was in office from 1981 until 1989. Reagan's economic policies, commonly known as 'Reaganomics', were an example of supply-side economics, focussed on the principal idea that by lowering barriers to produce goods and services, economic growth can be achieved more effectively, especially in combination with deregulation. According to Jacob (1985), "the first year of the Reagan Administration produced a set of changes in political-economic relationships so novel as to merit the denomination revolutionary" (p. 7), and was firmly based on the neo-liberalistic ideology coined by Hayek and Friedman. Reaganomics, the biggest paradigm shift in US economic policy since the New Deal (Niskanen, 1988), was based on four pillars, being:

- Reduce growth of government spending;
- Reduce income tax and capital gains tax;
- Reduce government regulation;
- Control the money supply to reduce inflation.

While campaigning for presidency, Reagan presented his economical proposals as a return to the principles of free enterprise which were common in the days prior to the Great Depression, thereby effectively opposing the Keynesian ideology of the Great Moderation era. One of Reagan's main political achievements concerned the lowering of taxes, which was based primarily on the Laffer curve theory. Coined by Chicago School economist Arthur Laffer, the Laffer curve dictates that there is an optimal tax rates. Laffer argued that if the tax rate would be zero, tax income would also be zero. Vice versa, if the tax rate would be a hundred percent, tax income would also be zero as there would be no economic activity. Theoretically, this bell curve had an optimal tax rate which would lead to a maximization of tax income, and it was generally believed that the US tax rates were higher, meaning that taxes should be lowered to increase tax income. The signing of the Economic Recovery Tax Act (ERTA) of 1981 proved to be the beginning of severe tax cuts under the Reagan reign. However, this did not result in the expected tax revenue increase as predicted by Laffer, and Reagan's taxation policy was later referred to as *voodoo economics* by Reagan's successor George Bush. Moreover, slower economic growth, an increase in defense spending and marginal spending cuts led to increased budget deficits and a larger national debt. Under Reagan, gross federal debt as a percentage of GDP grew from 32.5% in 1981 to 53.1% in 1989 (Office of Management and Budget, 2010). More importantly, during Reagan's reign, the power of unions diminished while the private sector started to gain power, especially due to the growing influence of well-organized business lobbies, especially the ones focusing on the financial sector.

The influence of the lobby merged perfectly with another one of Reagan's pillars for his economic policy; deregulation. Continuing on the path laid out by his predecessor president Carter, Reagan specifically emphasized the deregulation of the financial sector (Niskanen, 1988). Exemplary of this was the signing of the Garn-St. Germain Deposity Institutions Act in 1982, in which savings banks were given permission to broaden their product range, e.g. by giving out mortgages and loans. Without proper regulation and control mechanisms in place, lending spiraled out of control and hundreds of savings banks were liquidated or declared bankrupt in the late 1980s and the early 1990s in what now is called the Savings and Loan Crisis. Instead of reinstating regulatory control mechanisms, deregulation in the US continued, even under the administration of democratic president Bill Clinton. In his State of the Union speech in 1996, Clinton effectively embraced the republican ideology by stating that "the era of big government is over" (Clinton, 1996). One of the most critical decisions made by the Clinton administration regarding the deregulation of the financial services industry was the signing of the Gramm-Leach-Bliley Act in 1999, which removed the barriers between commercial banks and investment banks, effectively repealing the Glass-Steagal Act of 1933 and creating an environment that led to the financial crisis of 2008 (Krugman, 2008; Baram, 2009).

5.1.3 The 2008 Financial Crisis

As discussed in the previous chapter, the financial crisis of the late 2000s was the trigger for the European sovereign debt crisis. Pettifor (2003) already predicted years ago that the world's next big seismic debt crisis would take place in western economies instead of developing economies due to their unsustainable, unbalanced and unfair financial system. According to Pettifor (2003), "American and British consumers have been actively encouraged in their borrowing by the financial deregulation policies of both central bankers and governments" (p. 1). In the US, the combination of asset prices bubbles, high leveraging, limited regulation and financial innovation were the main ingredients for the crisis. Regarding the last, "many bubbles begin when a burst of innovation or technological progress heralds the dawn of a new economy (Roubini & Mihm, 2010, p. 62), an example of which is the dot-com boom and subsequent boost in the early 2000s following the widespread introduction of the internet. The primary innovation that was driving the housing boom was anchored in the financial services industry, and is called securitization. Through securitization, illiquid assets such as mortgages could now be pooled and traded through open markets. Mortgage-backed securities proved to be a raving success, quickly giving way to the securitization of both consumer loans (credit cards, student loans) and corporate loans. The main problem with securities is that the originator of the loan (e.g. the bank giving out the mortgage) had no incentive to conduct the necessary risk assessment and due diligence, and neither had the investments banks responsible for the securitization as they quickly sold their bundled loans to other investors. Also, compensation schemes, based on short-term gains led to disproportionate risk-taking. All this was based on the premise that the prices of houses would go up forever, which turned out not to be the case. In the US, the implosion of the housing market led to bankruptcy of the investment bank Lehman Brothers, and consequently to one of the largest sets of bailouts and stimulus packages ever implemented by any government throughout history. In 2008 and 2009, the US government and the Federal Reserve System had to bail out numerous financial services companies, as well as major car manufacturers such as General Motors and Chrysler. Consequently, the US has seen its current accounts deficits and debt levels soaring, and is much dependent on foreign creditors to keep supporting its economy. Doubts regarding the sustainability of the American economy has made raised suspicion among creditors, and have even led to domestic anxiety regarding US debt, which broke out into the open during the 2011 debt ceiling crisis.

5.2 Content

The Budget Control Act of 2011 brought the looming debt ceiling crisis of 2011 to an end. Apart from raising the debt limit, the law also includes agreements on deficit reduction and other provisions, which will be dealt with in this paragraph. However, the main component of the law concerns raising the debt ceiling, which is why we will provide an overview of the debt ceiling, dealing with its nature and its historical track record.

5.2.1 Historical Development of the Debt Ceiling

The federal government of the US is bounded by law when it comes to public spending as expenditures need Congressional approval. Naturally, if the total of expenditures exceeds the total revenues, there is a budget deficit. In the US, the budget deficit is then compensated for by borrowing the money through issuing debt instruments (such as government bonds), which is the responsibility of the Department of Treasury. The debt ceiling was implemented in 1917 in an attempt to provide the government with a more flexible way of financing US involvement in World War I. Since the introduction of debt ceiling, the Department of Treasury may borrow any amount of money as long as total debt is kept within the boundaries of the debt ceiling. The amount of money that the government can borrow is limited by the debt ceiling, which also can only be increased by Congressional vote. Debt ceiling increase has been often, and has traditionally been considered to be a mere formality. Table 5.1 gives an overview of the development of the debt ceiling under the last five presidential administrations.

President	*Term*	*# of Increases*	*Starting limit*	*Ending limit*
Ronald Reagan	1981-1989	18	$ 935 trillion	$ 2.800 trillion
George Bush	1989-1993	9	$ 2.800 trillion	$ 4.145 trillion
Bill Clinton	1993-2001	6	$ 4.145 trillion	$ 5.950 trillion
George W. Bush	2001-2009	7	$ 5.950 trillion	$ 11.351 trillion
Barack Obama	2009-Present	5	$ 11.351 trillion	$ 15.194 trillion

Table 5.1 US Debt Ceiling since 1981 (Source: Office of Management & Budget, 2010)

Evidently, the heated debate that surged around the proposed debt ceiling increase in mid-2011 had little to do with the number of times that president Obama had increased the ceiling already (Reagan outnumbers him quite substantially), nor was it driven by the size of the increase (George W. Bush has signed off bigger increases). Instead, doubts around the US debt started to arise since the late-2000s financial crisis considerably boosted both federal budget deficits as well as increase the federal debt. Years prior to the financial crisis, there was already a looming suspicion that US debt was not sustainable (Roubini & Setser, 2004), arguing that "at some point, the interest rate that US needs to pay to attract the external financing it needs to run ongoing deficits will rise, slowing the US economy and improving the trade balance even as higher interest rates increase the amount the US must pay to its existing creditors" (p. 3). In short, it seems that politics play a rather large role in the debate surrounding the debt ceiling crisis of 2011. We will elaborate on this in a more detailed manner when discussing the *process*.

5.2.2 Budget Control Act of 2011

The Budget Control Act consists of multiple components, each of which had been subject to a heated debate between Democrats and Republicans. The debate did not centre around the discussion whether or not to raise the debt ceiling and by how much, but rather on the contents of the reform package (i.e. spending cuts, revenue increases) that automatically comes with it. The law as it was finally enacted in on August 2, 2011, consists of the following:

- Direct debt ceiling increase of USD 400 billion;
- Additional initial increase of USD 500 billion, which can be disapproved by Congressional vote. This vote however is purely symbolic, as president Obama can (and will) veto the vote;
- Spending caps will reduce the deficit by USD 917 billion over ten years, starting with a modest USD 21 billion in 2012;
- A special Joint Select Committee on Deficit Reduction will be formed. The 12-member House-Senate committee will have to come up with additional cuts (or revenues) between USD 1.2 trillion to USD 1.5 trillion before 23 November 2011, which will be voted on by December 23 2011. If not enacted, this will trigger a pre-determined set of across the board cuts, mainly concerning spending in national security and defence. Social security and Medicaid are excluded;
- Before December 31 2011, both chambers of Congress will have to vote on the balanced budget amendment. If enacted, president Obama can raise the debt ceiling again by another USD 1.5 trillion. If not enacted, the debt ceiling may be raised by USD 1.2 trillion.

The short-term goal of the reform package was to end the pending debt ceiling crisis. After all, if no agreement was reached, the US would not be able to meet its payments by early August 2011 (or perhaps a few days later, depending on accounting gimmicks), and effectively default on its debt. Former Treasury Secretary Larry Summers warned that such a default would probably result in higher borrowing costs and expected bank runs on both money markets as well as financial markets, equal to or worse than those that we experienced during the financial crisis of 2008 (Zakaria, 2011). However, the underlying doubts regarding the sustainability of the US government's financials provide a second, long-term goal for the US in its budget reforms.

Although the general belief is that the debt ceiling deal cuts federal spending, this is actually not the case. Instead, it will merely slow down the existing projected growth rate of the debt (Appelbaum, 2011). At the end of the ten year deal, the US' government debt will be much larger than it is today, primarily because the law does not include the ever-increasing spending on healthcare. This is also the reason why rating agency Standard & Poor's decided to downgrade the US' credit rating for the first time in its history. It is also the reason why conservative Republicans refused to vote for the agreement, as they felt the proposal was by no means sufficient to address the pressing problems. However, as long as revenue increase by means of increased taxation is not negotiable, the only alternative left is a compromise regarding spending cuts which may not prove to be sufficient in the long term. When announcing the agreement, president Obama mentioned his own hesitations: "Is this the deal I would have preferred? No, but this compromise does make a serious down payment on the deficit reduction we need, and gives each party a strong incentive to get a balanced plan done before the end of the year".

5.3 Process

The previous paragraphs have provided a summary of the context of the debt ceiling crisis, and what the Budget Reform Act intended to make happen. This section will focus on the process of the program, first by specifically addressing the ongoing bipartisan debate regarding how to put the US' financials back in order, and what actions were taken in the reform negotiations. Secondly, we will take a look at the reactions from both the press and the international community before concluding with the preliminary results of the reform act.

5.3.1 Bipartisan Differences

Some of the major issues in the debate between both parties were timing, taxes, balanced budget amendment, social welfare and military spending. Regarding timing, Democrats were very keen on pushing a deal that would suffice until after the next presidential election on November 6, 2012. Naturally, the Republican party were aiming for a short-term solution that would reopen the debt ceiling discussion prior to the elections, making it excellent campaign ammunition. Secondly, taxation is still the main divide between Democrats and Republicans (Reed, 2006). As could be expected, Republicans ruled out tax increases as a possibility in the deal making process whereas Democrats were open for tax increases and closing loopholes in government revenues streams. Thirdly, under the influence of the Tea Party movement, the Republicans pressed for included a balanced budget amendment. The Democrats opposed to including such an amendment in the deal. The concept of balanced budget amendments (common for most US states, as well as Germany and Switzerland) is basically a constitutional rule that keeps countries (or states) from spending more than its income. Balanced budget amendments have traditionally been criticized by Keynesian economists (e.g. Krugman) as deficit spending can prove to be beneficial in times of recession. Also, the concept of balanced budget amendment is often seen as a means of populist politics, as its supporters come across as being in favour of balanced budget without wanting to resort to unpopular measures such as increased taxation. Regarding social welfare, the Democrats opposed to severe cuts in social security and healthcare whereas the Republicans would not mind to include aggressive cuts as a means of long-term savings. Lastly, military spending on wars fought in Afghanistan and Iraq could be lowered by as much as USD 1 trillion according to Democrats, Republicans beg to differ as they do not see military spending as part of the deficit reduction package.

Consequently, the debate, which was primarily led by president Obama on behalf of the Democrats and Speaker of the House John Boehner on behalf of the Republicans, was heated and tight, especially with the projected deadline of 3 August 2011, the day on which the US Treasury Department estimated that the administration would have exhausted its borrowing authority. Interestingly, while Obama and Boehner were trying hard to strike a deal to avoid default, they were hampered in their efforts by unwilling party members. Democrats for instance, were unhappy with the originally proposed deal as it was focussed too much on spending cuts. The

Senate majority leader, Democrat Senator Harry Reid: "The president always talked about balance: there had to be some fairness in this, it can't be all cuts" (Hulse & Calmes, 2011). On the other, Republicans were simply not accepting any increase in taxes, leaving the both parties at a stalemate. The 'grand bargain' that Obama and Boehner had conjured up in secrecy, consisting of more than USD 3 trillion in savings over the next ten years, including a USD 800 billion increase in revenues by overhauling the tax code and significant future savings in social security programs, was therefore rejected as both parties rebelled against the package. Again, Democrats accused Obama for being too willing to compromise, whereas Republicans seemed too worry about upcoming party primaries in which they could potentially lose to more conservative rivals by striking a deal with Obama. Regarding the latter, former Republican Senator Alan Simpson, co-chairman of the bipartisan fiscal commission that Obama set up in 2010 to investigate budget reforms, says the following: "If that means more to you than getting a plan and stabilizing this economy, you've really got to wonder why you're there" (Calmes, 2011).

Due to party politics, the deal that eventually passed is considerably less ambitious than the original plans for additional cuts and revenues, however, it is the only one that both the House of Representatives and Senate would accept. Upon signing the bill on 2 August, 2011, president Obama stated that "voters may have chosen divided government, but they sure didn't vote for dysfunctional government" (Steinhauer, 2011), hinting at the political impasse between Democrats and Republicans. The impact of the deal is abundantly clear; continuous fighting over budget issues will dominate the remainder of 2011 and all of 2012 until the presidential election.

5.3.2 One Step at a Time

After the announcement of the debt ceiling deal, the general consensus among both domestic as well as international media was that the deal, while effectively ending the debt ceiling crisis and thus providing the necessary results, is merely an ineffective compromise when it comes to long-term financial health of the US government (Appelbaum, 2011; Schmitz, 2011). Republicans, as mentioned, were aggravated by the deal as the spending cuts were considered to be not nearly enough to reduce the deficit. In an open letter, Republican Senator Rand Paul used the following analogy to describe the debt ceiling compromise: "When you're speeding toward the edge of a cliff, you don't set the cruise control. You stop the car. The current deal to raise the debt ceiling doesn't stop us from going over the fiscal cliff. At best, it slows us from going over it at 80 mph to going over it at 60 mph" (Paul, 2011). Liberal Democrats on the other are equally disappointed by having had to make concessions regarding spending cuts in programmes "that are particularly coveted by the left-wing of the Democratic Party – programmes aimed at seniors, the poor, children and young people" (Schmitz, 2011). However, the compromise can be seen as "an important first step, constrained by the political realities of divided government" (Appelbaum, 2011).

5.4 Chapter Synthesis

In this chapter, the US debt ceiling crisis of 2011 has been analyzed by applying the theoretical framework which was presented in Chapter 2. We will now connect the findings of the case study with the framework. Regarding *context*, it seems that the financial crisis of 2008 has had great influence on the debt ceiling crisis, as huge bailouts and stimulus packages led the budget deficit to explode. However, the US have always been big spenders, and the debt ceiling has been raised dozens of times since its inception. A paradigm-shift from Keynesian economics during the Great Moderation to neo-liberalism in the Reagan years and thereafter also have had significant impact on contemporary US budget discussions. The renaissance of neo-liberalism, and with it the concepts of tax cuts, small government and deregulation have both send the US' debt soaring while also creating an environment in which the housing boom that caused the financial crisis in 2008 could take place. Throughout recent history, taxation seems to be the one issue that creates the political divide in the US between Democrats and Republicans, and is therefore often approached from political (populist?) pragmatism instead of a financial sustainability perspective. To illustrate, in the middle of the 1984 presidential campaign, Reagan's chief of staff James Baker wrote a note to the president saying that "taxes are a big picture issue. If we want to win – and win big – the exigencies of the election force us to solemnly swear that Mondale is the tax increase candidate and Reagan is the no-tax increase candidate" (Reeves, 2011). According to Roubini & Mihm (2010), "with its reckless tax cuts and its unwillingness to rein in the housing boom, the United States has dug itself deep into a hole" (p. 250).

Regarding *content*, the core element of the reform packages which was put into place following the emerging debt crisis was the enactment of the Budget Control Act of 2011. The law's goals were twofold. On the short-term it was essential that the pending debt ceiling crisis was put to an end to avoid sovereign default, while in the long-term the US's financial house needed to be put in order to assure long-term financial sustainability. In order to do so, Democrats and Republicans tried to find enough middle ground on which to build the reform plan. The main component of the enacted law was to raise the debt ceiling to allow the government to be able to fulfil its obligations. That the debt ceiling needed to be raised was actually a mere formality, both for Democrats and Republicans alike. However, the conditions under which the debt ceiling could be raised was the main reason for the long and arduous debate that is still ongoing and probably will do so until at least the next presidential election. In the end, the compromise that was made is by no means sufficient to put the fiscal house into order again, which led rating agency Standard & Poor's to downgrade the US' creditworthiness for the first time in history. Essentially, the clash of Republicans vs. Democrats is in fact a clash between neo-liberalism and Keynesianism. The fact that the final product, the Budget Control Act, is focused mainly around spending cuts without giving way to increased stimulus from the government or tax increases makes it more neo-liberal in nature.

The *process* in which the reform took place is similar to the process during the European sovereign debt crisis, in the sense that the debate was arduous and incremental, and driven forward by the decision-making of the political elite. However, the role of political differences in this particular crisis is huge, as Republicans and Democrats simply are each other's principal antagonists when it comes to issues such as taxation, social welfare and national security. Moreover, the presidential elections of 2012 are looming at the horizon, which is why both political parties seem more worried about political repercussions of unpopular measures than with actually trying to implement a plan that will prove to be beneficial for the country and its people in the long-term. In that sense, while the decision-making is very much elitist, it does indeed take into account the wish of the constituency, the people of the United States. In the end, the short-term goal of ending the debt ceiling crisis has been reached, leaving the long-term goal of stabilizing the US fiscal budget and bringing down its debt. This particular reform package will not provide the necessary results, and seems like a dangerous road to go down. A view shared by Roubini & Mihm (2010), who state that "if the United States doesn't get its fiscal house in order and start saving more, it's headed for a nasty reckoning. When that reckoning will come is anyone's guess, but the notion that it might be put off for decades is delusional" (p. 251).

Chapter 6 Comparison & Conclusions

This final chapter will start by comparing the two reform packages, followed by conclusions. These conclusions will answer the main research question as well as the sub questions which were formulated in Chapter 1. Moreover, recommendations for future research and limitations to this research will be discussed. Lastly, a general discussion regarding issues which were out of the scope for this research will be presented.

6.1 Comparison of the Case Studies

A quick overview of the comparison between the analysis of the reforms following the European sovereign debt crisis and the US debt ceiling crisis is presented in Table 6.1. Subsequently, in answering the sub questions from Chapter 1 we draw further on the observations from the case studies. The purpose of the table is to give an overview of the most striking observed similarities and differences by presenting the concepts of Pettigrew et al. (1992); *context*, *content* and *process*, while taking into account the specific building block of Pollitt & Bouckaert (2004).

	Similarities	*Differences*
Context	• Budgetary difficulties had been looming in both Europe and the US for years; • The 2008 financial crisis was the trigger that caused both debt crises and subsequently provided the window of opportunity for reform.	• The European crisis is regional; problem states like Greece drive an entire continent into problems; • The EMU is merely a monetary union without the necessary political backup; • The US debt crisis is substantially rooted in the economic ideology of neo-liberalism.
Content	• Short-term goals of both programmes are aimed at preventing sovereign default; • Long-term goals of both programmes focus on sustainable fiscal budgeting. • Austerity measures are the main component of both packages.	• EFSF/ESM, apart from being a bailout programme, has limited legal foundation due to political constraints; fiscal policy is delegated to member states; • The European bailout packages needs backup from the IMF and international allies; • In the US, raising the debt ceiling itself was not an issue, debate regarding the content of the conditions under which it was to be raised was the main issue.

Process	• Elite-decision making plays an important role, the public has little saying in the matter; • Long and arduous debate leading up to the reform, heavily influenced by political agendas (nationalistic populism in Europea, pre-election campaigning in the US); • General opinion is that the heavy compromises have left both reform packages unable to fulfil long-term goals.	• European discussion is centred around nationalism vs. Europeanism, and has relatively little to do with differences in economic policy; • Discussion in the US is heavily drenched in ideologies; ranging from Keynesian (Democrats) to neo-liberalism (Republicans).

Table 6.1 Comparison between post-debt crisis reform in Europe and the US

Now that the main similarities and differences that emerged from the case studies have been examined, we will now move on to the next paragraph, which will provide an answer to each of the sub questions and ultimately the central research questions as formulated in Chapter 1.

6.2 Conclusions

1. *In which context were the debt crisis reform packages in both Europe and the US launched, i.e. an analysis of the event leading up to (causing) the crises.*

The European debt reform package was launched in a time of great economical turmoil, where economies such as the Greek were on the brink of defaulting on its debts. The sovereign debt crisis that hit Europe in 2010 and 2011 was triggered by the financial crisis of 2008, but was actually the result of years of irresponsible fiscal policy by the Greek government, offset by a GDP growth that was purely driven by an asset bubble, which naturally collapsed once the financial crisis shook the world. A great sense of urgency called for swift and immediate measures, not only regarding putting Europe's fiscal house in order but also involving measures for increasing European political and economical integration. The sense of urgency in the US was initially much less, as the US government was fully aware of reaching the debt ceiling well in advance, and the US has had a long track record of raising the debt ceiling successfully. However, fuelled by social unrest regarding Europe's financial stability and an ongoing power-shift from West to East, effectively eroding the US' supremacy as the one economical powerhouse in the world, the conditions under which the debt ceiling would be raised this time led to heavy debates between Republicans and Democrats and a clash of economical ideologies.

2. What were the contents of both reform packages?

The most evident commonality between the two cases is the fact that the reform has both a short-term (averting imminent sovereign default) as well as a long-term component (sustainable fiscal budgeting). Europe responded to the debt crisis by putting into place a complex combination of back-up facilities, the EFSF and the ESM, in combination with a new set of policy guidelines to which all EMU member states should adhere, to be implemented under the supervision of improved governance structures. In the US, enacting the Budget Control Act allowed the US government to raise the debt ceiling while also creating a window of opportunity for long-term fiscal reform aimed at financial sustainability. In both cases, austerity measures are the main fiscal policy adaptations, and in both cases, these austerity measures do not seem to be enough to avert similar crises in the future as budget deficits will remain. Ironically, despite the discussion about the sustainability of the Euro (or Europe in general), the crisis seems to have been the catalyst for further European integration, whereas in the US, the discussion around how to solve the long-term financial stability problem has created a bigger than ever divide between the two main political parties.

3. In what way did the process of both reform packages come about?

In Europe, the process of trying to contain the crisis has been going on for quite some time. Starting with the first round of bailout in May 2010, Europe is currently still trying to get the crisis under control as there is still a looming suspicion that the European bailouts will prove to be insufficient to save Greece, and possibly other PIIGS countries such as Portugal, Spain and Italy. A lack of political unity in Europe and nationalistic politics ('own country first') have made the process extremely difficult. In the US, politics have also played a substantial role in the sense that the debt ceiling crisis of 2011 was used by the two main political parties two take a stand while taking the 2012 presidential election into account. Another striking similarity is the fact that decision-making in these post-crisis reforms has been the prerogative for the political elite, the public has had no say in the matter. A referendum proposed by Greek prime minister Papandreou was shot down by European political heads and Greek politician alike, mostly due to the fear that letting the people decide would mean giving way to short-term (i.e. national) interests instead of long-term (global) interests (Kitsantonis & Donadio, 2011). Regardless, the general consensus is that due to heavy compromise in both deals have affected the ability to reach the set long-term goals.

4. *Were the reform packages successful in terms of meeting its objectives, i.e. have they accomplished structural debt relief?*

The short-term goal of the European bailout package was to avoid bankruptcy of Greece, which automatically would have meant Greece's departure from the Euro, and would have devastating rippling effects across Europe and the rest of the world. The short-term goal seem to have been reached after the agreement on October 27, 2011, when European leaders, banks and the IMF agreed upon enlarge the bailout, accept a fifty percent loss on outstanding bank debt, and raising capital standards for key continental banks to weather the storm. However, some wonder whether the new bailout package would be enough (Schwartz & Dash, 2011), although for now, the Eurozone seems saved and thus the short-term goal of the bailout package has been reached. The US' short-term goal for the Budget Control Act, raising the debt ceiling, has also been reached on the verge of the deadline. However, in both cases the long-term goals of financial sustainability seem very unlikely to be reached under the proposed reform agenda, as compromises between all parties involved have decimated the reform packages in terms of effectiveness. Also, in Europe, the fact that fiscal policy is still a matter of national politics has proven to be an extra hurdle to take. In Italy for example, prime minister could only win provisional support from his government for the economic reforms demanded by his European counterparts (Erlanger & Castle, 2011). In short, the successfulness of the reform packages on the long term is yet to be seen, although the fact that the sense of urgency has reached those in charge is a reassuring thought.

5. *What contributed to the success of the reform, or stood in the way of its success?*

Throughout the process of the European sovereign debt crisis it has become clear that the 'Europe' itself has been both the contributing factor for success as well as the biggest obstacle. To start with the latter, it has become clear that the lack of political union and more sophisticated economical integration in the Eurozone has proven to be detrimental when it comes to dealing with financial crises. Ideally, the Eurozone would have had means of labour mobility, wage and price flexibility, synchronised business cycles and a risk-sharing system. This way, 'weaker' countries such as Greece would automatically be offset by 'stronger' countries such as Germany, much like what is broadly accepted when it comes to regions within nation states (e.g. western German *Bundesländer* picking up the tab for their eastern German counterparts). However, this is not the case, which is why in the heat of the moment, nationalist politics takes full advantage of the room it has been given. In the end, it seems that the majority of Europeans is very much in favour of extended 'Europeanization', and as the EU tries to balance efficiency and legitimacy, in the end it seems to get the job done (Kirkegaard, 2010; Glöckler, 2011).

In the US, the main success factor is the can-do mentality that seems to get the job done in the end. Although international media characterized the debate between Republicans and Democrats nearing the deadline as game of chicken (Cookon, 2011) and the behaviour of the political party wildly irresponsible, both parties managed to get together in the end and have shown execution power in rolling out the guidelines put forward in the reform package (Pear & Steinhauer, 2011). In a reaction from Senate Minority Leader Mitch McConnell, Republican, on the standpoint of his party on this deal; "I think some of our member may have thought the default issue was a hostage you might take a chance at shooting. Most of us didn't think that. What we did learn is this – it's a hostage that is worth ransoming. And it focuses the Congress on something that must be done (Jenkins, 2011). The biggest obstacle in the process has been the ideological divide between the two political parties, in particular in the context of the upcoming presidential elections in 2012. In trying to solve the debt ceiling problem, Republicans simply refuse to discuss revenues increases through higher taxes, and a therefore limited by austerity measures to balance the budget. However, this cuts into the very heart of the Democratic party, as spending cuts also involved limited budgets for social welfare.

In having answered the sub questions, we will now address the central research question as formulated in Chapter 1:

"What are the determinants of successful reform following sovereign debt crises?"

The central question is one that encompasses many elements. On the one hand, a technical analysis of the reform initiatives could lead to the conclusion that in achieving its set goals, the reform has been successful. After all, both the American as well as the European debt crises were averted, albeit at the last minute. However, one layer deeper lie a number of interesting sub-issues. For one, analyses of both post-crisis reform initiatives in both Europe and the US have shown that prerequisites for successful reform are strong political vision and leadership, not only regarding the content of the reform but maybe even more so when it comes to guiding the process of reform towards the intended objective, especially when the pressure of the various stakeholders keeps building and the possible consequences of failed reform are disastrous beyond imagination. Moreover, in times of crisis it seems that political leaders seem to be receptive to receding to nationalistic populist politics, such as was the case during the European sovereign debt crisis. Successful reform following debt crises is therefore not so much an issue of technical, administrative reform, but has more to do with political reform. Strong political leadership and a common purpose among those involved is essential for successful reform.

Moreover, the successfulness of reform initiatives is largely dependent on political mandate. Whereas the European leaders struggled with the lack of delegated European decision-making power and the appropriate instruments, the Americans seemed to benefit from embedded political power structures. Even though the process in solving the US debt ceiling crisis has been arduous to say the least, mainly due to party-political ideas and an unnecessary complex political system, at the very least every stakeholder knows exactly what is expected and within what political structure one is supposed to operate. In Europe, the sovereign debt crisis has painfully laid bare the flaws in the Eurozone's institutional mechanisms. In the end though, both in Europe and the US, every stakeholder involved has understood the crucial point that abandoning cooperation is not the solution. Even though a long-term solution for both Europe and the US has yet to be designed, the willingness to at least take the appropriate short-term measures gives hope for the future. As mentioned by Leblond (2011), "effective coordination, coordination and burden-sharing, whether regional or global, still remain a better way to deal with cross-border problems" (p. 20). The recommendations will elaborate in more depth on the central research question.

6.3 Recommendations

After having analyzed the two case studies of the European and the American debt crises it is now time to assess into more detail the central research question on what the determinant factors in successful post debt-crisis reform are. From a *context* perspective, the European debt crisis has pointed out that a clear political power structure needs to be in place in order to weather potential debt crisis storms. While European member states ceded control over the monetary policy when forming the EMU, they never formalized a true fiscal and political union, a lack of which now hampers the decision-making that is needed to decisively put an end to the crisis. In the US, contextual factors contributing to the emergence of the crisis in the first place had more to do with the market fundamentalism ideology of neo-liberalism that has dictated US economic policy for decades. A paradigm-shift from Keynesian economics during the Great Moderation towards neo-liberalism in the Reagan years and thereafter have had significant impact on the contemporary US federal budget discussions. Tax cuts, small government, and in particular large-scale deregulation of financial markets have created the ideal environment for financial crises in which to take place. In short, from a *context* perspective, the two major recommendations that should be taken into account in debt crisis reform are political union and ample regulation of financial markets.

Characteristic	*Europe*	*United States*
Context	Establishing a strong political union, which is needed to enforce fiscal policies.	Increased regulation of financial markets in order to avoid out-of-control finance; Responsible tax policies.

On the *content* side, we have established a number of striking similarities between both case studies. The content of reform has much to do with the technical components of the reform package, and its objective. For both Europe and the US, it seems as if the political leaders involved have had only a short-term objective in mind while constructing the reform packages. In both cases, the creation of a safety net (Europe) or raising the debt ceiling (US) does not provide a solution for long-term sustainable fiscal budgeting. On top of this, the creation of the European bailout mechanisms (EFSF/EFSM) has limited legal foundation due to political constraints, as fiscal policy is still a responsibility of individual member states. Luckily, European leaders seemed to have embraced delegating power to the to-be created ESM, the institution that will include more stringent rules on fiscal coordination and surveillance. In the US, there has never been any debate regarding whether or not to raise the debt ceiling, the discussion was centred around the conditions under which the debt ceiling would be raised. The fact that it is deemed normal to keep raising the debt ceiling to account for structural budget deficits raises morality issues, and while the raising of the debt ceiling has always been a mere formality, 2011 budget discussions were, for the first time, focused on putting the fiscal house back in order on the long term. However, in both Europe and the US, the actual content of the reform packages, whilst being sufficient to reach the short-term goals of averting sovereign default, are by no means sufficient to reach the long-term goals of sustainable budgeting. Political differences and a lack of awareness have proven to be a gap too big to close, resulting in the following major recommendations from a *content* perspective:

Characteristic	*Europe*	*United States*
Content	Ensuring legal foundation for reform mechanisms; Address long-term issues such as productivity differences between member states.	Address long-term sustainable finance issues, party-political ideas should be made subordinate to sound fiscal budgeting.

Regarding the *process* in which both reforms took place, both case studies share some significant similarities and differences. Similarities include the role of elite-decision making, the heavy debates which were strongly influenced by political agendas, and the general opinion that the end-results of both reform packages is by no means sufficient for long-term sustainable budgeting. In Europe, the process has been described as being arduous and incremental, mainly due to the fact that not being a true OCA hampers Europe's ability to swiftly put effective measure into place. The main obstacle in Europe has been the political situation, which was one of differences between various European leaders, a slumbering north-south divide and a lack of central power of authority. Europe needs to be able to provide a clear power structure in which all needs and wants of the various member states are taken into account, and which is sufficiently legitimized to avoid anti-European sentiments from sabotaging increased European integration. In the US, the process has also been drenched heavily in bipartisan political differences between Democrats and Republicans. The problem in the US is similar to Europe, whereas politicians seem to be more concerned with the next elections than worrying about what is best for the country. The major recommendations regarding *process* are therefore:

Characteristic	*Europe*	*United States*
Process	Address national political issues that loom in the dark, but focus on the long-term benefit for all.	Party-political differences need to be subordinate to long-term economical sustainability.

6.4 Limitations

Even though this research has been carried out with care and consideration, it is not without limitations. By conducting a qualitative, comparative case study, comes with obvious limitations. For example, the small sample size in the amount of cases makes the external validity relatively low, as generalizability of the results from this particular research is limited. Also, the very nature of data collection to some extent decreases the reliability of the research, as the researcher is prone to subjectivity. A quantitative research with a larger sample would make for an excellent follow-up in order to generate more generalizable results. Secondly, even though we have argues that both case studies share substantial commonalities, one may also argue that the differences between Europe and the US are even more significant, adding to the the issue of generalizability of the results. In future research, it may be worthwhile to compare post-crisis reform within the same country or region throughout history in order to be able to draw stronger conclusions. Third and lastly, crisis economics as a field of research is still relatively uncharted terrain, making it hard to create a proper research model that encompasses every significant criterion of successful post-crisis reform.

6.5 Discussion

During the global financial crisis in the late 2000s, the world looked into the abyss and became painstakingly aware of the risks that come from irresponsible fiscal policy and limited regulation of financial markets. Subsequently, the series of crises of which the European sovereign debt crisis and the US debt ceiling crisis are two examples have opened the eyes of the western world, which has come to realize that crises are no longer a concept known to only developing and emerging markets. Roubini & Mihm (2010) state that “while the global economy has started to rebound, its risks and vulnerabilities may lead to renewed crises in the coming years” (p. 276). Angela Merkel, chancellor of Germany, also paints a gloomy picture stating that it will surely take a decade until the situation (i.e. the European debt crisis) improves again.

The last few decades have seen an enormous boost in globalization, making trade in goods and services, the migration of workers and the diffusion of information increasingly international in scope. Simultaneously, technological advancement has exploded and walked hand in hand with globalization, each reinforcing the other. Consequently, globalization and innovation have brought unprecedented economic growth and increased the standard of living of hundreds of millions of people around the world. However, globalization and innovation are not without risks, as we have learned the hard way during the last couple of years. For example, the rise of emerging markets in the global economy account for some of today’s economical stress points such as current account imbalances and the subsequent financial crises as integrating these huge markets (such as China and India) is a complex endeavour (Roubini & Mihm, 2010). Moreover, globalization has been associated with growing inequalities in income and wealth distribution, causing growing concerns about the concept of globalization and free trade. Globalization may also lead to more frequent and stronger crises, as the world has become integrated to the point where financial capital can be moved around the world with one press of a button. After all, while financial markets have gone global, its regulation is still an affair of national politics, increasing the likelihood of future financial crises.

In the background of this all lies a more fundamental discussion regarding morality. Leveraging and acquiring debt has become common practice with companies and civilians alike, in a way one could argue that we have become addicted to borrowing. The problem of addiction is never solved by a gentle approach; in order to be able to turn this problem around we need hard measures, strong governance structures, heavy regulation and perhaps even penalties against acquiring (e.g. increasing the cost of debt for consumers). If we are not able to achieve this turnaround, we run the risk of discarding the advantages of debt. After all, debt does not only destroy, it also creates.

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Appendix I – Government Defaults and Restructurings 1820-2004

	1824-1834	*1867-1882*	*1890-1900*	*1911-1921*	*1931-1940*	*1976-1989*	*1998-2004*
Europe							
Austria		1868		1914	1932		
Bulgaria				1915	1932		
Greece	1824		1893	`			
Germany					1932		
Hungary					1931		
Italy					1940		
Moldova							2002
Poland					1936	1981	
Portugal	1834		1892				
Romania				1915	1933	1981	
Russia				1917			1998
Serbia	1831		1895		1933	1983	
Spain		1867, 1882					
Turkey		1876		1915	1940	1978	
Ukraine							1998, 2000
Latin America							
Argentina	1830		1890	1915	1930	1982	2001
Bolivia		1874			1931	1980	
Brazil	1826		1898	1914	1931	1983	
Chile	1826	1880			1931	1983	
Colombia	1826	1879	1900		1932		
Costa Rica	1827	1874	1895		1937	1983	
Cuba					1933	1982	
Dominica							2003
Dominican Rep.		1869	1899		1931	1982	
Ecuador	1832			1911, 1914	1931	1982	1999
El Salvador	1827	1868		1921	1931		
Grenada							2004
Guatemala	1828	1876	1894		1933		
Honduras	1827	1873		1914		1981	
Mexico	1827	1867		1914		1982	
Nicaragua	1828		1894	1911	1932	1980	
Panama					1932	1982	
Paraguay	1827	1874	1892	1920	1932	1986	2003
Peru	1826	1876			1931	1978, 1983	
Uruguay		1876	1891	1915	1933	1983	2003

Venezuela	1832	1878	1892, 1898			1982	
Africa							
Angola						1988	
Cameroon						1989	
Congo						1986	
Cote d’Ivoire						1984	2001
Egypt		1876				1984	
Gabon						1986	1991, 2002
Gambia						1986	
Liberia		1874		1912		1980	
Madagascar						1981	
Malawi						1982	
Morocco						1983	
Mozambique						1984	
Niger						1983	
Nigeria						1983	
Senegal						1981	
Seychelles							2002
Sierra Leone						1977	
South Africa						1985	
Sudan						1979	
Tanzania						1984	
Togo						1979	
Uganda						1981	
Zaire						1976	
Zambia						1983	
Asia & ME							
Indonesia							1999
Jordan						1989	
Philippines						1983	
Pakistan						1981	1999
Vietnam						1985	

Sources: Sturzenegger & Zettelmeyer (2006, pp. 7-9)

Appendix II – The Washington Consensus

Policy Recommendation	*Description*
Fiscal Discipline	Budget deficits, properly measured to include those of provincial governments, state enterprises, and the central bank, should be small enough to be financed without recourse to the inflation tax. This typically implies a primary surplus (i.e., before adding debt service to expenditure) of several percent of GDP, and an operational deficit (i.e., disregarding that part of the interest bill that simply compensates for inflation) of no more than about 2 percent of GDP.
Public Expenditure Priorities	Policy reform consists in redirecting expenditure from politically sensitive areas, which typically receive more resource than their economic return can justify, such as administration, defense, indiscriminate subsidies, and white elephants, toward neglected fields with high economic returns and the potential to improve income distribution, such as primary health and education, and infrastructure.
Tax Reform	Tax reform involves broadening the tax base and cutting marginal tax rates. The aim is to sharpen incentives and improve horizontal equity without lowering realized progressivity. Improved tax administration (including subjecting interest income on assets held abroad – flight capital – to taxation) is an important aspect of broadening the base in the Latin context.
Financial Liberalization	The ultimate objective of financial liberalization is market-determined interest rates, but experience has shown that, under conditions of a chronic lack of confidence, market-determined rates can be so high as to threaten the financial solvency of productive enterprises and government. Under that circumstance a sensible interim objective is the abolition of preferential interest rates for privileged borrowers and achievement of a moderately positive real interest rate.
Exchange Rates	Countries need a unified (at least for trade transactions) exchange rate set at a level sufficiently competitive to induce a rapid growth in non-traditional exports, and managed so as to assure exporters that this competitiveness will be maintained in the future.
Trade Liberalization	Quantitative trade restrictions should be rapidly replaced by tariffs, and these should be progressively reduced until a uniform low tariff in the range of 10 percent (or at most around 20 percent) is achieved. There is, however, some disagreement about the speed with which tariffs should be reduced (with recommendations falling in a band between 3 and 10 years), and about whether it is advisable to slow down the process of liberalization when macroeconomic conditions are adverse (recession and payments deficit).

Foreign Direct Investment	Barriers impeding the entry of foreign firms should be abolished; foreign and domestic firms should be allowed to compete on equal terms.
Privatization	State enterprises should be privatized.
Deregulation	Governments should abolish regulations that impede the entry of new firms or restrict competition, and ensure that all regulations are justified by such criteria as safety, environmental protection, or prudential supervision of financial institutions.
Property Rights	The legal system should provide secure property rights without excessive costs, and make these available to the informal sector.

Source: Williamson, J. (1994, p 26-28)