Eurozone crisis spreads: Portugal, Italy, Belgium hit by fallout from Irish bailout

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In the wake of last weekend's bailout of Ireland, the Eurozone financial crisis has rocked Portugal and begun to affect the day-to-day financing of Italy, Belgium, and Spain.

All four countries were compelled to offer record yields on 10-year state bonds Tuesday, as lenders demanded the highest returns since the introduction of the euro in 1999. Even French and German bonds were caught in the downdraft, as speculators demanded a full half-point higher interest rates compared to last summer.

Portugal narrowly escaped disaster on Wednesday morning, as it successfully floated €500m of 12-month bonds, but it was compelled to pay a much higher rate of interest, 5.281 percent, up from 4.813 percent at a similar auction two weeks ago. The auction was held just hours after the American bond-rating service Standard & Poor's threatened to cut the country's credit rating.

An S&P analysis noted that the savage budget cuts already adopted by the Portuguese government would likely throw the country's economy into recession. "We see the government as having made little progress on any growth-enhancing reforms to offset the fiscal drag from these scheduled 2011 budgetary cuts," S&P warned. "As a consequence of the Portuguese economy's structural rigidities and the volatile external conditions, we project that the economy will contract by at least 2 percent in 2011 in real terms."

In a report issued Tuesday, the Portuguese Central Bank warned that it was suffering a crisis of liquidity and was only being kept afloat by loans from the European Central Bank. For the first time a leading Portuguese politician, opposition leader Pedro Passos Coelho of the Social Democrats, conceded that the country may have to accept an EU-IMF bailout. This would make Portugal the third Eurozone country to receive such a loan, following Greece and Ireland.

In Italy Prime Minister Silvio Berlusconi warned his cabinet colleagues of the potential repercussions of the record yields being charged for Italian state bonds. His cabinet colleague Gianni Letta drew a comparison between the latest moves on the money markets with AIDS. Letta told the press he feared that "euro market shocks may contaminate other more solid countries like Spain, Portugal and Italy" and that "market turbulences are more infectious than AIDS, and a vaccine is needed."

The continuing crisis also led to a sharp drop in the value of the euro, which at one point this week fell below $1.30 for the first time since September. The continuing decline of the euro comes despite a concerted trade war campaign by the US administration to drive down the value of the dollar on international markets.

The governing council of the European Central Bank is meeting Thursday, amid mounting pressure for the ECB to step up bond purchases of the weaker countries in order to prop up the financial markets.

Over the course of the past two weeks leading European powers, together with the European Commission and the ECB, have taken a series of extraordinary measures in order to appease the blood lust of the major banks and financial players. In a major move to assuage the banks, European finance ministers hurriedly agreed to a proposal put forward by Germany and supported by France at the weekend for an extension of the existing European emergency bail out fund, through the creation of a European Stability Mechanism (ESM).

The main element of the new agreement is the setting up of a fund to replace the existing €440bn ($583bn) rescue fund established by European governments in the wake of the Greek debt crisis in May of this year. This fund, known as the European Financial Stability Facility, was due to expire in 2013. The new fund (ESM) will come into affect in 2013 and introduces a series of measures enabling the most powerful European countries to impose "shock therapy" type punitive sanctions on weaker countries confronting bankruptcy. For the first time the new mechanism includes the possibility of countries defaulting on their loans.

The extension of the current European emergency fund has been a principal demand by the banks and money markets for some time. The necessity for a further mechanism to protect the interests of the banks was exposed at the start of this week when the EU Commission announced that the first candidate for a massive European loan, Greece, will be unable to pay its debts on time. The EU Commission is now proposing to extend the repayment period for Greek loans for an additional three years, to 2017.

In a further concession to the banks the ESM agreement dropped the demand, first raised by German Chancellor Angela Merkel, that private creditors be automatically called upon to accept losses in the event of future bailouts. The dropping of this demand came mainly as a result of pressure from France.

The real implications of the ESM, which is supported by the International Monetary Fund, were revealed in a comment by one of the experts who worked on developing it. Andre Sapir, a leading member of a Brussels think-tank, declared: "If you had asked me a year ago, I would have said such an idea was impossible…One is now accepting an idea which itself is an incredible leap—that a euro area country's debt may be restructured. That was unthinkable, it was something just for emerging countries. In that sense, this is a real revolution."

The "revolution" Sapir is referring to is the power of the European Union to deploy the type of "shock therapy" policies implemented by the IMF in a series of countries in the past. Following an intervention by the IMF in Argentina in the 1990s, the country's economy shrunk by 27 percent and over half of the population was plunged into poverty.

Despite the attempt by Germany and France to acquire the sorts of political clout traditionally associated with the IMF, aimed at enforcing social devastation at the behest of the banks, the money markets gave the new plan the thumbs down. Too many details remained unclear regarding the function and funding of the mechanism, which would come into effect far too late to provide banks with the money they were demanding. Just a day after the publication of the plan, financial speculators began a new onslaught on exposed economies.

The latest stage of the crisis, which some commentaries compare with the banking crash of 1931, has forced leading European politicians and bankers to even more extreme measures. The president of the ECB, Jean-Claude Trichet, is under pressure to massively expand credit.

Commenting on the role of the ECB, the chief economist at Citigroup, Willem Buiter declared: "The involvement of the ECB is likely to rise, despite its statements—and probably wishes—to the contrary."

He described Ireland as "insolvent," Portugal as "quietly insolvent," Greece as "de facto insolvent" and Spain in need of large-scale restructuring of the debt of its banks. Buiter added that the Eurozone crisis was only an "opening act" for a broader financial calamity involving Japan and the United States as well.

The stakes for American capitalism in the mounting crisis in Europe were underscored by the dispatch of a special envoy, Lael Brainard, the undersecretary for international affairs, who is visiting Madrid, Berlin and Paris for talks on "economic developments in Europe."