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Prospects for the eurozone

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> The Euro, probably more than any other currency, represents the mutual confidence at the heart of our community. It is the first currency that has not only severed its link to gold, but also its link to the nation state. (Wim Duisenberg, President of the ECB in 2001, quoted in Marsh, 2009, p. 1)

> Europe's integration could not succeed if it promised to make the strong regions stronger and the weak ones weaker. (Magnifico, 1973, p. 8)

For Wim Duisenberg, the euro's perceived independence from the nation state was a path-breaking achievement, to be proud of and to cherish. Little more than a decade later—and three years into the deepest economic crisis Europe has known since the Great Depression—Duisenberg's elation rings strangely anachronistic, since what the 'nationless' euro seems to have achieved, above all, is to undermine whatever 'mutual confidence at the heart of our community' there may have been at the start.

This Special Issue takes stock of the euro crisis so far. It is concerned with the in-depth analysis of its main causes, policy proposals for a recovery from the crisis and reform strategies for the reconstruction of a more viable and egalitarian eurozone in the future. This Introduction provides an overview of both core features of the euro crisis and related debates, as well as individual contributions to this Special Issue. Section 1 examines the origins of the euro crisis; Section 2 reviews key policy developments in the evolution of the crisis, from its onset in May 2010 to the adoption of outright monetary transactions (OMTs) by the European Central Bank (ECB) in September 2012; and Section 3 provides an overview of the contributions to the Special Issue.

1. Origins of the crisis

The construction of the European Union (EU)—and its development since the introduction of a common currency in 2001—had both political and economic objectives. This section focuses on the latter, but necessarily takes into account the former.

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From the point of view of mainstream economic theory, there is little doubt that European economic integration should benefit member states. Joining a customs union—and, subsequently, also a currency and monetary union in the case of some member states—restricts national policy autonomy and the ability to correct macroeconomic imbalances *vis-à-vis* other member states and the rest of the world: without substantial policy control over trade, exchange rate or monetary policies, such imbalances can be managed only through real wage and price adjustments. However, from the point of view of mainstream economic theory, this is of minor concern, so long as it can be presumed that markets for core production factors are flexible across nations within the customs (and monetary) union and that adjustment costs in the process of specialisation and integration are minor. The distribution of overall gains from trade and monetary integration may be unequal, but overall gains there would be.

This vision, based on a politically and ideologically motivated belief in the superiority of 'free markets' has not stood the test of time in the case of European economic and monetary integration.

The prevailing view in the core[1]—which dominates economic policy making—is that the crisis is *fiscal* in nature, resulting from financial profligacy of governments of deficit countries in the periphery.[2] Consequently, as it is their irresponsibility that has created the problems, it is only by their acceptance of the burden of adjustment that it will be resolved. Further, because fiscal overstimulation is held responsible for inflationary pressures and the rising deficit-fuelled indebtedness that are unsettling financial markets, fiscal austerity is prescribed despite the deepening recession. The paramount requirement is seen to be balancing budgets and cutting sovereign debts so as to reduce the risk of default.

The alternative view is that the crisis is one of *balance-of-payments* surpluses in the core and deficits in the periphery. From this perspective, far from remedying the crisis, fiscal austerity, by addressing the symptom (fiscal imbalance) rather than the cause (balance-of-payments imbalance), can only make matters worse by impeding economic recovery and lowering prospects for growth. Rapidly deepening and generalised austerity is seen to be exacerbating the problem of escalating budget deficits and sovereign debt by pushing the eurozone further into recession, which is reducing effective demand, shrinking the tax base by reducing incomes and increasing social welfare and other recession-related expenditure.

The European Commission and the ECB appear to be interpreting the growing budget deficits and ever-increasing government debts as evidence of insufficient fiscal retrenchment; and they continue to cling to the orthodox belief that more austerity is needed to restore financial markets' confidence, so as to secure their willingness to invest in sovereign bonds in exchange for reasonable rates of interest. Thus, the evidence that austerity has not had its predicted effects has done little to weaken its proponents' belief in the efficacy of this approach, or their faith in its ultimate success. In an interview with the *Wall Street Journal*, ECB President Mario Draghi recently maintained:

> There was no alternative to fiscal consolidation, and we should not deny that this is contractionary in the short term. In the future there will be the so-called confidence channel, which will reactivate growth; but it's not something that happens immediately, and that's why structural

[1] The core eurozone countries include Austria, Belgium, Finland, France, Germany, Luxembourg and the Netherlands.

[2] The peripheral eurozone countries include Greece, Ireland, Italy, Portugal and Spain.

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reforms are so important, because the short-term contraction will be succeeded by long-term sustainable growth only if these reforms are in place. (Blackstone *et al.*, 2012)

He went on to contend that 'a "good" consolidation is one where taxes are lower and the lower government expenditure is on infrastructures and other investments … the bad consolidation is … raising taxes and cutting capital expenditure … [because] it depresses potential growth' (Blackstone *et al.*, 2012).

Yet, it is difficult to maintain, in the face of empirical evidence, that the euro crisis is primarily a crisis of public profligacy in the periphery. What those member states that today find themselves in difficulties had in common prior to the onset of the euro crisis, is that they all—Greece, Spain, Italy, Portugal and Ireland—ran growing *trade* deficits (see, e.g., Wolf, 2011).

What they did *not* have in common were large *public* sector deficits *prior* to the onset of the global financial crisis (GFC) (see, e.g., *Cambridge Journal of Economics*, 2009, *Special Issue: The Global Financial Crisis*, vol. 33, no. 4) and the euro crisis: although Spain and Ireland both had large *private* sector deficits, they had public sector budget surpluses. Portugal and Greece financed their trade deficits through both private and public sector deficits, with Portugal's net public sector debt being lower than that of Germany's as a percentage of its gross domestic product (GDP), up until 2007. Only Italy had high net public sector debt (as a percentage of its GDP) throughout the 2000s until 2009, financed exclusively by capital inflows (current account deficits), while its private sector remained in surplus (see, e.g., Hein *et al.*, 2011). The current large public deficits in all of these economies were the consequence of the GFC when (with the exception of Italy) much of the private debt that had gone 'bad' was nationalised in one form or another.

The trade imbalances that emerged in the 2000s between Germany (as well as Austria, Belgium and the Netherlands), on the one hand, and Greece, Italy, Spain, Portugal and Ireland, on the other, were symptomatic of structural imbalances and growing difficulties in the periphery countries to maintain viable routes to international competitiveness. This has been particularly the case in the wake of growing manufacturing competition from emerging markets. However, a driving factor exacerbating this loss of international competitiveness was Germany's strategy of 'wageless productivity growth' within the eurozone. Strong 'wage-restraint' policies in Germany drove down its unit labour costs. In combination with Germany's long-standing strength in maintaining its high-technology infrastructure, this served to undermine an already weak lower-wage competitive advantage in its Southern European trading partners (see, e.g., Flassbeck and Spiecker, 2011). Put another way, Germany reinforced its traditional high-productivity advantage by competing, in part, on the basis of low and falling unit labour costs, rather than using its high productivity to promote higher (collective) living standards at home and—through higher imports and foreign direct investment—in Southern Europe.

Yet, if Germany's wageless-productivity-cum-export-led growth strategy took little note of the various structural predicaments of its (mainly) Southern European EMU neighbours, the current financial and--ultimately--political crisis of the eurozone goes back to the deeply flawed architecture of European monetary and financial integration. This was laid down in the Maastricht Treaty of 1992 and the Lisbon Treaty of 2007. As almost all of the contributors to the Special Issue point out, this architecture combined unfettered private sector financial integration with both the abolition of

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monetary sovereignty in EMU member states and a very loose (or 'soft') supranational fiscal policy framework that promoted restrictive fiscal policies at the national level. However, it failed to establish a clear institutional path to supranational fiscal policy making. Essentially, this has created—in what is, after all, the second largest economy of the world (the EMU)—a supranational monetary system that explicitly prioritises the interests of private bondholders (creditors) over those of states. In the EMU, the formal 'rules of the game' of monetary and financial integration are more heavily stacked against state intervention and in favour of private sector dominance than in any other advanced economy. Following the GFC this has not only led to a destructive 'tug of war' between private financial markets, driving up the borrowing costs of national governments in the EMU, on the one hand, and what central EMU 'rump authority' there is to try and keep these down, on the other. It has also put enormous pressure on political relations, both between the nation states that integrate the EMU and within them, as witnessed in the outcome of the Italian national elections in February 2013.

The deeply flawed institutional and governance structure of the EMU placed it in a difficult position from which to effectively address the widening trade and macroeconomic imbalances within it, much less their escalation under the impact of the GFC. Yet, despite its exalted position in the creation of the EMU—as well as in the debates about its survival since the onset of the euro crisis—mainstream economic theory offers no coherent explanation for these regional imbalances. It is therefore a poor guide for policy.

In contrast, cumulative causation theory—in particular as conceptualised by Gunnar Myrdal on the basis of his extensive research on inequality (both between individuals and regions)—offers a useful framework for understanding the root cause of regional inequalities and the cumulative processes at work. It is therefore a much better tool than economic orthodoxy for identifying the appropriate direction of policy. According to Myrdal (1957), orthodox economic theories were 'never developed to comprehend the reality of great and growing economic inequalities and of the dynamic processes of underdevelopment and development' (p. 51). They are therefore unable to explain the existence—and persistence, if not widening—of inequality within and among nations. From Myrdal's perspective, such inequality is a consequence of the 'circular and cumulative' effects generated by the economic process itself. Further, within market systems, the endogenous and self-reinforcing nature of economic change is such that 'the play of forces within the market tends to increase rather than decrease the inequalities' (Myrdal, 1958, p. 26).

Dynamic elements of trade between countries trigger what Myrdal identified as *backwash* and *spread* effects—and, hence, the possibility of uneven economic development. Backwash and spread are, respectively, the adverse and beneficial effects generated outside of an area of economic expansion as a consequence of differences in economic opportunity. Backwash effects include such things as outmigration of skilled labour from a lower-wage region (i.e. 'brain drain'), capital flight and difficulties attracting capital, unequal exchange in trade and deindustrialisation; transfer of higher value-added production to the more prosperous region and concentration of lower value-added production in the less prosperous region; and deterioration in social relations and other non-economic factors. They are circular, cumulative and self-reinforcing, and they tend to dominate under a situation of *laissez-faire*.

Against the backwash effects of economic expansion are certain centrifugal effects of expansionary momentum that spread to other regions. Spread effects operate 'through

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increased demands for their products and in many other ways weave themselves into the cumulating social process by circular causation' (Myrdal, 1957, p. 31). The resulting increase in prices (including wages and other factor prices) provides opportunities for other regions to compete on the basis of lower production costs, setting off a virtuous cycle of expansionary possibility. Working in opposition to backwash effects, when strong enough, spread effects have the potential to generate an expansionary momentum that serves as a countervailing force against the backwash effects. However, Myrdal noted that national boundaries can serve as powerful barriers to spread effects:

> Differences in legislation, administration and mores, generally, in language, in basic valuations and beliefs, in levels of living, production capacities and facilities, make national boundaries much more effective barriers to the spread of expansionary momentum than any demarcation lines within one country can be … Basically, the weak spread effects as between countries are … a reflection of the weak spread effects within the under-developed countries themselves, caused by their low level of development attained. In these circumstances, market forces will tend cumulatively to accentuate international inequalities. (Myrdal, 1957, pp. 54–5)

In developing the concepts of backwash and spread effects, Myrdal emphasised the roles played by both economic and non-economic factors—of which social, political and distributional effects are important. For Myrdal (1957), non-economic factors 'are among the main vehicles for the circular causation in the cumulative processes of economic change' (p. 30) and they react 'in a disequilibrium way' (p. 10). He also called attention to the dynamic, non-equilibrium nature of economic change.

Until the arrival of the GFC, the core eurozone countries clearly benefitted from the single currency. Their exports became more competitive in world markets, since the value of the euro against non-euro currencies was lower than the value of the national currencies it replaced. As a percentage of GDP, the average current account surplus for core members increased from 3.7% in 2000 to 4.7% in 2007 (Eurostat, 2013). In contrast, those of the periphery became less (price) competitive and their average current account deficit rose steadily from 4.6% in 2000 to 8.5% in 2007 (Eurostat, 2013).[3]

In the core, trade competitiveness—both internationally and within Europe—had self-reinforcing positive effects on manufacturing output, employment and income levels, investment and technical change, productivity levels and exports. Germany, in particular, benefitted. Its subcontracting links with countries to the east were strengthened. This served to lower their production costs (Simonazzi, 2013), which were also kept down by labour market deregulation in Germany, which exerted downward pressure on money wages, especially those of the lowest paid. The effect of this on real living standards was ameliorated by the inflow of low-cost consumer products, mainly from China. Consumption in Germany thus grew slowly relative to production capability and the transfer of this surplus abroad made Germany the world's leading exporter. Spread effects included closer integration of eastern EU members' production capability into the German productive system, whilst backwash effects were the cumulative loss of industrial competitiveness of countries in the eurozone's periphery.

However, despite their growing competitive disadvantage in international trade, many of the peripheral eurozone members appeared to benefit from the availability

[3] Countries that have joined since the 2007/08 financial crisis began (Cyprus, Estonia, Malta, Slovenia and Slovakia) are not included in this analysis.

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of abundant, easy credit—at rates approaching those of the core. Since the eurozone promised stability and growth as well as rising incomes and economic performance approaching the levels enjoyed in the core, private capital inflows combined with high levels of confidence to fuel domestic consumption booms in the periphery. Liberalised financial markets supported demand-driven growth and asset bubbles inflated as property markets soared—especially in Spain and Ireland. Strong demand was accompanied by rising prices and costs, which further eroded trade competitiveness. But booming consumer, financial and property markets—and the strong rates of growth that accompanied them—gave the appearance of prosperity. Governments were also able to borrow at relatively low cost to finance increasing public expenditures whilst growing tax revenues generated by strong economic growth translated into improving fiscal positions. The resulting strong domestic demand-driven growth thus gave the appearance of macroeconomic and fiscal strength in many of the peripheral eurozone countries whilst the northern eurozone countries benefitted further from the cumulative loss of trade competitiveness in the periphery.

The GFC halted the cross-border flow of private finance, causing property bubbles and other private sector activities to collapse and fiscal deficits to grow. At this point, the excessive risks that had been taken by financial institutions (and the failure of governments to regulate them), the excessive debt-fuelled spending by households and the gaps in competitiveness were ruthlessly exposed—as were the financial backwash effects of the flow of capital into the financial markets of the periphery.

The eurozone's private sector debt problem quickly morphed into a sovereign debt crisis as governments attempted to rescue their banking systems by loans, guarantees and nationalisation. The resulting high levels of public debt and the inability of eurozone countries, individually, to expand their money supply meant that the risk of default was a credible one. Capital flight from the sovereign debt of countries most at risk dramatically raised their cost of refinancing—starting with Greece but quickly followed by Portugal, Italy, Ireland and Spain. This perceived need for a European rescue plan based on austerity translated into further fiscal deflation, a worsening economic crisis and financial instability as the vicious cycle continued to play itself out. In the process, regional imbalances within the eurozone have been revealed and have substantially widened as the crisis has deepened.

Austerity programmes are reinforcing the vicious cycle of cumulative decline, extending from the economic to the social and political. In turn, non-economic factors are having circular and cumulative economic effects as growing social unrest creates political instability. In the process, inequality continues to rise, not only across eurozone countries, but also within their most deprived regions. All of this raises fundamental questions about the theories and institutional structure underpinning the eurozone, which itself is rooted in a belief in the ability of markets to produce a stable equilibrium with beneficial and equitable outcomes for its disparate members.

2. The euro crisis unfolding: monetary and fiscal policy responses so far

On 10 October 2008, in the midst of the unfolding GFC, *Financial Times* journalist Gillian Tett warned of trouble ahead for the eurozone, taking a widening spread in the costs of insuring European sovereign debt as her clue:

> What the CDS market suggests is that investors are becoming more worried about the fiscal implications of bank bail-outs and financial stress. Moreover, these concerns are also threatening

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> to undermine the single currency ideal that eurozone countries move as a pack … After all, what this crisis [the GFC] has shown is that, when it comes to the crunch, European governments are truly hopeless at co-ordinating themselves. So, if you take that trend to its logical extremes and imagine a brutal recession—or perhaps additional financial stress—it is not hard to imagine that economic nationalism will rise. After all, we are already seeing hints of this in the fight between the UK and Iceland about retail deposits. If that tussle was ever repeated inside the eurozone, currency union could come under strain. (Tett, 2008)

Despite her caution at the time—'this is not a scenario I am forecasting with high probability. But nor should it be completely ignored' (Tett, 2008)—Tett was spot on. Even so, what is now known as 'the euro crisis' did not officially set in until April/May 2010, when Greek sovereign debt came up for negotiation with the Troika. As mentioned, what ensued over the next two years and four months was a destabilising and counterproductive 'tug of war' between private financial markets, driving up the costs of refinancing sovereign debt in crisis-ridden EMU member states, on the one hand, and the Troika, trying to keep these costs down, on the other. A truce was finally called on 6 September 2012, when Mario Draghi, President of the ECB, announced the introduction of OMTs, thereby effectively recognising the ECB's role as lender of last resort to the EMU.

Prior to 6 September 2012, the Troika's approach to the widening euro crisis had been dominated by its insistence on a 'market-friendly' solution that strove to combine private sector participation in the renegotiation of the sovereign debt of EMU member states with limiting the role played by the ECB to indirect interventions. In the face of a growing threat to the eurozone's entire banking system and a deepening EMU-wide economic crisis, this resulted in a series of *ad hoc* policy and institutional innovations, beginning with the European Financial Stability Facility (EFSF), created in May 2010 in response to the escalating Greek sovereign debt crisis.

The EFSF's rescue mechanism consisted essentially of extending large and still relatively expensive loan packages to all but bankrupt states, using the proceeds obtained from issuing bonds and other more complex debt instruments on the capital markets. A core feature of the EFSF loan packages for Greece, Portugal and Ireland are the stringent austerity conditionalities attached to these. From the start, the EFSF was authorised to intervene in primary and secondary bond markets, enforce conditionalities and also to extend its lending facilities to EMU governments not already party to any of its programmes, such as Spain, for the purpose of recapitalising banks and financial institutions at risk of insolvency. In October 2010, barely five months into its existence as a temporary rescue facility, the European authorities declared their intention to transform the EFSF into a permanent institution, the European Stability Mechanism (ESM), which eventually entered into force on 8 October 2012. Over the two and a half years since its creation, the EFSF/ESM largely failed to restore financial market confidence in the ability of European authorities (and the IMF) to gain control of the spiralling euro crisis, prompting instead recurrent speculative attacks on sovereign debt in crisis-ridden EMU member states. A prime example of this 'tug of war' between the Troika and financial investors is the so-called 'Accord of 27 October 2011' on Greek sovereign debt. The deal achieved only a very brief stabilisation of European stock markets, mainly because it relied on uncertain cooperation by private creditors and on heroic assumptions about a positive long-term impact of the harshest austerity programme in modern history on the Greek debt-to-GDP ratio.

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In May 2011, the ECB began to engage in massive purchases of government bonds from crisis-ridden EMU member states in the secondary bond markets and to lend to these governments indirectly, through loans to commercial banks that had been financing government debt. In December 2011, so-called long-term refinancing operations (LTROs) were officially adopted. Through these, the ECB offered to lend to euro banks at an interest charge of around 1% over three years and on fairly lax repayment conditions. This was in the hope that it would bring further relief to GIPS (Greece, Ireland, Portugal and Spain) governments, whose bonds were trading at 6% and above. Again, the results were disappointing—euro banks preferred to cash in on cheap ECB loans for almost any purpose other than buying GIPS government bonds. The 'market verdict' was unambiguous: unless the EMU were to show its hand as a quasi-nation state with a central bank capable of acting as a lender of last resort to the eurozone, neither primary nor secondary markets for EMU government debt would stabilise. The widely recognised failure of LTROs signalled the end of 'market-friendly' solutions to the euro crisis, with the ECB fast running out of policy options within this remit.

The introduction of OMTs from 6 September 2012 finally saw the ECB assuming a role as the 'banker of government(s)', contrary to its legal and long-standing political commitments to resist this role. Essential for the effectiveness of OMTs in stabilising bond markets and averting a surge in capital flight are two features of the programme. First, there is no quantitative or temporary limit on purchases of sovereign bonds of one- to three-year maturity and, second, the ECB gave up its senior credit status. To qualify for ECB bond purchases, countries either have to subscribe to a full and long-term austerity programme (such as the EFSF programmes for Greece, Portugal and Ireland) or to enter into a less stringent 'precautionary programme' designed to provide them with a line of credit for the duration of what are considered short-term temporary shocks to their otherwise 'sound' economies (such as the ESM programmes for Spain and Italy).

So far, OMTs appear to be reasonably successful in stabilising the European bond markets, essentially by assuaging investor uncertainty about the potential exit of some of its weaker economies. Paradoxically, the transformation of the ECB from a handmaiden to private bondholder interests into a (potentially) full-blown banker of governments has at least partly been driven by the very rentier interests that the architects of the Maastricht Treaty and EU Stability and Growth Pact intended to protect from 'excessive' state intervention. Yet, the unintended consequence of a largely finance-led process of economic integration has been to empower not only private bondholders but also, indirectly, indebted governments. Just as private bondholders have engaged in a 'tug of war' over the costs of government debt with the European Central Banking System (ECBS) to obtain a *de facto* 'Europeanisation' of this debt, so indebted governments can use the threat of default and exit to obtain the same result. Given very high levels of financial integration, this threat is tantamount to a European banking crisis and, possibly, to the break-up of the eurozone, leaving the ECBS with little credible choice but to refinance government debts, one way or another.

It is, however, far less clear that the emergence of a 'lender of last resort' will suffice to safeguard the EMU from further economic turmoil and political destabilisation. Obviously, the long and torturous stand-off between financial markets and the Troika that preceded this outcome, has already imposed huge economic, social and political costs on the wider process of European integration. These have to be added to the deep

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macroeconomic imbalances that had evolved between core and periphery economies in the EMU prior to the onset of the euro crisis. In the predominant policy perspective of the Troika, the greater good of saving the EMU from another major banking crisis may justify the smaller evil of allowing the ECB to take on its role as 'lender of last resort' in all but formal language. But this compromise only reinforces the need to safeguard the wider economic founding principles of the EMU, namely its iron commitment to private sector-led economic development and to monetary stability, to be achieved through low inflation and low government borrowing. With the process of immediate 'firefighting' apparently out of the way, the debate has moved on to strategies for economic recovery and growth, in particular, but not exclusively, in the debt-ridden periphery countries. For the advocates of the monetarist and neoliberal founding principles of the EMU—or as heterodox opponents to this approach would have it, the founding flaws of the EMU—the only viable strategy remains austerity. In fact, austerity is the price to be extracted from governments that are being bailed out and from their ordinary citizens—not from private bond-holders.

Beyond the highly controversial austerity and 'precautionary' programmes imposed on individual EMU member states by the EFSF/EMS (see, e.g., *Cambridge Journal of Economics*, 2012, *Special Issue: Austerity: Making the Same Mistakes Again—Or is This Time Different?* vol. 36, no. 1), austerity is currently being written into stone for EU member states through the so-called 'European fiscal compact', which came into force on 1 January 2013 for (so far) 12 signatory governments. At its heart is the 'golden rule' of public finance. This stipulates that once signatory governments approach a debt threshold of 60% of their GDP, they should run an annual budget surplus or maintain a balanced annual budget, such that their annual structural deficit does not exceed 0.5% of nominal GDP. Thus, beyond a historically low debt-to-GDP ratio for most countries, EU governments shall not borrow. If the EMU, or any of the signatories to the fiscal compact, were to be hit by mass unemployment, an ecological crisis of major dimensions, a war or an invasion by aliens, its governments will have to stand by and let the private sector sort out the problem.

Just as the infamous EMU membership requirements, laid down in the predecessor to the 'fiscal compact', the EU Stability and Growth Pact of 1997, were eventually relaxed in 2005 and again in 2011, there does, of course, remain a question mark over the long-term staying power of ideological doctrine *vis-à-vis* the need for political and economic pragmatism. For now, however, there can be little doubt that ideology rules the roost. If confirmation were needed, it suffices to recall the recent negotiations about the next long-term EU budget for 2014–20 that took place on 7–8 February 2013 in Brussels. These resulted in a cut of €34 billion to planned 'real' expenditures (as opposed to so-called 'commitments' to allocate funds to specific projects). Even if 'only' around 1% of the EU's combined gross national income was at stake, the fight over what, in the larger picture of European integration and the future of the EMU, are economically insignificant decisions was ferocious and the triumphalism of austerity hawks unalloyed.

This ideological stance, if it lasts in acts as well as in words, is bound to undermine the little stability that may have been achieved by way of the ECB finally, though half-heartedly, assuming its role as lender of last resort. Important as this is, no 'banker of EMU governments' alone can resolve the vast institutional and growing structural problems that caused the euro crisis. As virtually all contributors to this Special Issue argue, the underlying structural, institutional and policy issues that led to widening

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trade and macroeconomic imbalances between core and periphery economies require profound institutional and policy reforms. Institutionally, the eurozone's central bank requires a government and, in particular, a federal treasury (or equivalent). Yet, fiscal federalism will be useful only to the extent that it promotes policies that prioritise long-term and balanced regional economic growth over short-term financial interests and ideological grand-standing. This is a tall order, since, in the detail, any such growth strategy will have to build on the intranational as well as supranational coordination of a range of policy areas. These include the promotion of (inter)national competitiveness by alternative means to low-wage competition alone; wider industrial and technology policies; social and income policies; and environmental policies. It is far from clear whether conflicting national as well as class and sectoral interests can be reconciled, if only to the extent required to create a functional institutionalisation of differentiated, yet centrally coordinated, fiscal and growth-enhancing policy making at the EU level. What is clear, however, is that the current obsession with austerity amongst the most powerful EU leaders is entirely counterproductive to this objective. Obliging all governments to run fiscal surpluses (beyond a minimal debt-to-GDP ratio) is tantamount to deepening the ongoing economic and debt crisis in the eurozone, as well as its internal macroeconomic imbalances. By simple national accounting logic, such fiscal surpluses must be more than offset by trade surpluses and/or private sector surpluses for GDP to rise. With private sector investment already falling, and the route to trade surpluses barred to all but a handful of high-productivity economies in the eurozone, austerity can achieve only one thing: to further undermine whatever 'mutual confidence' there may have been 'at the heart of our community' when the euro was introduced.

3. The contributions to this Special Issue

All contributions to this Special Issue are concerned with an explanation of the causes of the euro crisis and, in most cases, a discussion of policy proposals and reform strategies to stabilise the eurozone and to promote future economic growth in the region. Unsurprisingly, the two common themes that dominate the causal analysis of the euro crisis are flaws in the architecture of European economic policy making and the emergence of persistent macroeconomic regional imbalances within the EMU. Taken together, the contributions provide a systematic overview of both these themes that is clear in its basic critique of central flaws in European and EMU economic governance, very rich in detail and conducted from a range of different analytical, historical and policy perspectives. There is a clear consensus that the current institutional setting of the EMU/EU is not only inconsistent but also fundamentally unsustainable.

Naturally, the discussion of policy strategies aimed at facilitating a more egalitarian and sustainable European growth regime is more tentative. However, the consensus that emerges is clear: austerity is doomed to fail in achieving any narrow objective of debt reduction in periphery EMU economies. Further, and more importantly, it is bound to aggravate economic, political and social tensions within the EMU and the EU, with the attendant risk of contributing to the implosion of European integration. On the constructive side, the view that prevails is that if the EMU and progressive European economic integration is to survive, institutional reform at the EMU level will need to move towards a fiscal union, in some form. Yet there is no shortage of warnings to the effect that institutional reform towards a centralisation process that balances monetary and fiscal policy instruments more equitably is heavily reliant on

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growth-enhancing *policies* being adopted. The contributors are also well aware of the profound challenges to a growth-enhancing and reformed process of economic integration in Europe that are posed by complex conflicts between national, class and sectoral interests. Taken together, the contributions provide a constructive basis for further debate on forward-looking policy across a range of areas.

Fitoussi and Saraceno (2013) argue that the EU has gone further than any other advanced economy in adopting the neoliberal policy agenda of the Washington Consensus, by embracing this as a matter of quasi-constitutional principles. In their view, the 'Berlin–Washington Consensus' is largely responsible for the European 'growth deficit' (p. 481) during the two decades preceding the euro crisis; and it has made a fast recovery from this crisis all but impossible. Fitoussi and Saraceno (2013) provide a critical analysis of the core theoretical and empirical shortcomings of the 'Berlin–Washington Consensus', arguing, in particular, that it fails to take into account important dynamic links between current and future economic growth. Using a simple macroeconomic model, they show how the EU/EMU's singular focus on structural reform aimed at increasing competition and openness is bound to produce a negative trade-off with short-term stabilisation policies. Based on a detailed discussion of the main limitations of European monetary and fiscal governance—and of what they consider to be an 'inconsistent institutional setting' at the heart of European policy making—Fitoussi and Saraceno conclude that unless the 'Berlin–Washington Consensus' can be overturned, there is little hope both for a successful recovery from the euro crisis and for the euro's long-term survival.

Bellofiore (2013), too, places the euro crisis within a wider analysis of the defining features, as he sees them, of global capitalism during the past three decades. This was characterised by a finance-led 'privatised Keynesianism' (p. 498)—i.e. by the combination of the primacy of finance with credit- and debt-fuelled consumption booms. Bellofiore then turns to European economic and political history, tracing Western European 'neomercantilism' back to the late 1940s and to changing German–French–Italian policy relations throughout the 1960s, 70s and early 80s. In his view, the euro, far from representing the logical outcome of the history of European integration and the end of the Cold War, was more prosaically a French-driven project to contain the political and economic implications of German reunification during the 1990s. From this perspective, the euro crisis was an exogenous shock to a single currency that initially worked well, despite its almost *ad hoc* construction, but whose fundamental flaws quickly became apparent in the course of this crisis. Bellofiore maintains that the only sustainable solution to the euro crisis is a class-based new Keynesian deal that goes beyond fiscal expansionism *per se*, to involve a radical 'socialisation of investment' and a shift towards collective (rather than privatised) demand as the engine of growth.

Mazier and Petit (2013) begin with a detailed empirical investigation of intra-EMU macroeconomic imbalances, based on an estimate of existing underlying real exchange rate misalignments and of the costs and benefits of required real adjustment (of prices and wages) in EMU member states. The extent of structural diversity throughout the eurozone (and of the underlying overvaluation of the euro for a large number of its member economies) suggests to the authors that 'financial federalism' (p. 520) or the 'Europeanisation' of debt, in one form or another, does not provide a sustainable solution to the euro crisis. This is particularly the case in the context of the prevailing dominance of deregulated global financial markets. They then discuss a range of

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alternative, more sustainable paths out of the euro crisis, including various approaches to budgetary federalism, all of which require strong political commitments to a unified Europe. The authors argue that since this imposes a strong political constraint on economic solutions to the euro crisis that envisage a full-blown fiscal union, a 'multispeed Europe' could provide an alternative solution. This essentially provides for a flexible approach to national structural and social policy regimes across EMU member states through a lower degree of fiscal centralisation and the introduction of a two-tier Eurosystem, in which a single 'external' euro coexists with fixed parities between national 'internal' euros. However, the authors also note that this would require the introduction of capital controls.

Boyer (2013) proposes a multicausal analysis of the trajectory of the euro, from initial success to a systemic crisis, not least with a view to 'overcome th[e] rather simplistic dichotomy of "full federalism versus the death of the euro"' (p. 534). Specifically, he identifies two processes along this trajectory whose interaction explains the complexity and depth of the euro crisis. The first pertains to the role of economic theorising in the formation of dominant beliefs about the invulnerability of market economies. According to Boyer, the rise of the new classical macroeconomics successfully sidelined substantial concerns, derived from mainstream as well as heterodox economic theory, about the ability of the euro to cope with heterogeneous capitalisms and modes of regulation within the eurozone. Second, with the creation of the euro, a perverse political process set in that strengthened the ability of national governments to defend national liberalisation agendas against contestation at home, by pointing to external constraints from Brussels while also undermining actual enforcement powers by European authorities as well as their wider legitimacy in the longer term. Both processes help to explain the inability of the European authorities to respond decisively to the euro crisis, in a way that could halt contagion and restore the euro's creditability. In Boyer's view, the future of the euro remains open for now, with both a political implosion of the eurozone and a more democratic reconfiguration of national and central policy processes within the EMU still on the cards.

Toporowski (2013) analyses the prospects of the EMU from the perspective of theoretical approaches to the explanation of how monetary unions operate. In line with other contributors, he maintains that the euro crisis is the result not simply of a bad policy mix, but of systematic institutional flaws in the construction of the eurozone. In his view, at the heart of major deficiencies in the architecture of economic policy making in the EMU, before and after the crisis, is the prevailing dominance of the theory of optimal currency areas. This is based on an outdated Ricardian conceptualisation of money as a commodity or a *fiat* currency. According to this analysis, the exchange rate and wages are substitutes for achieving international competitiveness; and the current difficulties of the EMU can be reduced to relative wage differentials across its member states. Toporowski develops a detailed critique of this approach, based on his alternative conceptualisation of a 'pure credit international economy' (p. 576), characterised by credit money that is backed by debt. In this alternative view, trade imbalances are not accommodated by the accumulation of commodity or fiat money, but are, instead, absorbed into the balance sheets of banking systems. Toporowski then explores a number of theoretical and policy implications that follow from his analysis. In the context of advanced financial integration in Europe, a core implication for the debate on the euro crisis is that exit from the eurozone is not a viable option for indebted economies: exchange rates and wages are not to be regarded as simple substitutes for

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macroeconomic adjustment; the import intensity of exports—and therefore the need for additional austerity—must also be taken into account. More importantly, exchange rate depreciations in any exit economy would put at risk the entire European banking system, due to the vulnerability of bank balance sheets to such depreciations in a 'pure credit international economy'.

Panico and Purificato (2013) provide a detailed account of the unfolding of the euro crisis since May 2010, using this to highlight core difficulties and shortcomings in the process of policy coordination at the European level. In their analysis, this process is characterised by a high level of uncertainty about the actual behaviour of national actors and central authorities. This has two main consequences. First, it means that non-cooperation and a defensive or minimalist approach to policy coordination persistently undermine the search for, and enforcement of, credible policy solutions for the EMU as a whole—and, therefore, its overall economic performance. Second, these constraints manifest themselves in the interaction between national and central players and institutions. Importantly, they have been 'internalised' by the ECB, thus hampering its internal decision-making process and policy effectiveness. In the authors' view, despite the eventual introduction of OMTs in September 2012, these internal conflicts will impede a resolute assumption of the ECB's role as lender of last resort in the future. The authors conclude that, seen in conjunction with the prevailing doctrine of austerity in the fiscal policy domain, continued uncertainty in the process of policy coordination—within the ECB and between national and central players—does not bode well for the chances of substantial institutional and economic reform in the eurozone.

The remaining contributions focus on specific aspects of the euro crisis and on areas for policy reform. Bibow (2013) examines the influence of German intellectual and historical traditions on the Eurosystem and, in particular, on the ECB. Through a comparative analysis of the peculiarities of German intellectual thought on the role of central banks in the economy, on the one hand, and Keynes's chartist conceptualisation of money and central banks, on the other, Bibow shows how a supposedly 'super-strong'—yet in practice often much weaker than perceived—ECB came to dominate policy making in the eurozone. Core to Bibow's argument is the insight that the dominance of monetarist central banking over fiscal policy making and institutions in Germany (and eventually the EMU) derives not primarily from theoretical debate, but from the political history of modern Germany and from deeply rooted 'mythologies' about this history. Whereas Keynes considered the central bank to be an integral part of the state, in Germany it evolved into a guardian of private business interests *vis-à-vis* a state that was perceived to have been captured by labour interests and to use fiscal policy to dominate the economy. Bibow then explores the implications of this particularly German heritage for the eurozone, both with regard to its original policy design and the implications of this policy design for a viable resolution to the euro crisis.

Capraro and Perrotini (2013) explore the Latin American political and economic experience with debt crises to identify lessons that might be learnt for the eurozone. The authors extend the Harrod–Pasinetti model of the role of public debt in a closed economy to emerging-market open economies with demand-constrained output growth. From this, they argue that expansionary fiscal policy is the most efficient policy strategy to reduce excessive debt burdens on the macroeconomy and to return the economy to a growth-compatible level of debt. This theoretical analysis

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of the relationship between public debt and economic growth in open economies is accompanied by a discussion of Latin American experiences with austerity measures in response to debt crises that resulted in the so-called 'lost decade' of Latin American economic development. Notwithstanding obvious differences between the political economies of Latin American and European countries, as well as their differing roles in the international economy, Capraro and Perrotini warn that the core lesson to be learnt from Latin American experiences for Europe is that more debt is the solution to debt-induced economic downturns. Unless this lesson is learnt soon, Europe is headed towards long-term economic stagnation, such as that experienced by Latin America during the 1980s.

Simonazzi *et al.* (2013) return to the theme of the dominant role of the German economy in the eurozone, from the perspective of trade relations and balance-of-payment imbalances between EMU member states. They explore alternative explanations of the German current account surplus—as the result of virtuous savings behaviour and/or of stagnant domestic demand—and argue that an expansion of domestic demand in Germany will alone be insufficient to address current trade imbalances in the EMU, the persistence of which is reflective of a complex pattern and uneven pace of trade specialisation, diversification and quality composition in Germany, relative to its southern periphery neighbours. The cumulative effects of these specialisation patterns on productive structures in Germany and the southern periphery therefore require more sophisticated policy responses to regional imbalances than expansive income and fiscal policies in Germany. In particular, they highlight the need for coordinated trade and industrial policies aimed at improving the long-term international competitiveness of current deficit economies, including an expansion of trade relations between these.

Grahl and Teague (2013) discuss the role of social policy in restoring credibility to a post-crisis EMU. Their detailed survey of the origins and past evolution of EU social policy highlights the persistent ambiguities that have characterised social policy making at the EU level over the years, mostly as a consequence of the lack of convergence of national labour markets and their institutions. With the euro crisis and austerity having undermined what little consistency EU social policy achieved in the past, they argue that a fresh and ambitious approach to social policy is essential for a successful resolution of the crisis, both in socio-economic as well as political terms. On grounds of realism, they assume that neither a fully fledged fiscal union nor strongly centralised and harmonised social policies are likely to emerge soon. However, they conclude that the survival of the eurozone will require a major transfer of sovereignty to a central government with the capacity to design and implement differentiated fiscal policies across member states, and to which the ECB is subordinated. In this context, social policy would also have to remain differentiated, but would fulfil two core roles in the reconstruction of the eurozone: economically, a differentiated, yet highly active social policy would initially focus on public sector-led employment recovery. Politically, a strongly solidaric, yet differentiated social policy would provide federal institutions with much needed legitimacy.

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