The Euro Crisis and contradictions of Neoliberalism in Europe

Engelbert Stockhammer

7 January 2014

PKSG

Post Keynesian Economics Study Group

Working Paper 1401

The Euro Crisis and contradictions of Neoliberalism in Europe

Abstract: Neoliberalism has not given rise to a sustained profit-led growth process, but to a finance-dominated accumulation regime in which growth relies either on financial bubbles and rising household debt ('debt-driven growth') or on net exports ('export-driven growth'). The financial crisis that began in the market for derivatives on the US subprime mortgage market has translated into the worst recession since the 1930s. In Europe the crisis has been amplified by an economic policy architecture (the Stability and Growth Pact) that aimed at restricting the role of fiscal policy and insulating monetary policy and central banks from national governments. The crisis has thus led to a sharp economic divergence between core and peripheral countries. Contrary to the situation in the (export-driven) Germanic core of Europe, the crisis is escalating in the (debt-driven) southern countries of Europe. The paper interprets the policy regime as the outcome of national elites' attempt to use European integration as a means to constrain nation states. The result is a policy regime that has fatally weakened nation states as regards their fiscal and monetary capacities without creating a European state.

Keywords: Euro crisis, neoliberalism, European economic policy, European integration, financial crisis, sovereign debt crisis

JEL classifications: E02, E12, E5, E6, F5, P16

Acknowledgements. The paper was presented at the SPERI conference 2013, Sheffield, and EISA conference 2013, Warsaw. The author is grateful for discussions there and to Cedric Durand, Gilles Christoph, Karsten Köhler and Paul Auerbach for helpful comments. The usual disclaimers apply.

Engelbert Stockhammer
Kingston University
Engelbert Stockhammer, Kingston University, School of Economics, History and Politics, Penrhyn Road, Kingston upon Thames, KT1 2EE, UK
Email: e.stockhammer@kingston.ac.uk

Introduction

The financial crisis began in the market for derivatives of US subprime mortgages and translated into the worst recession since the 1930s in all advanced economies. However, five years after the crisis began the experience differs dramatically across countries. Only in Europe has the crisis mutated into a sovereign debt crisis. This paper offers an analysis that puts Neoliberalism at the very heart of the crisis in Europe – both as a cause of the imbalances at the root of the crisis and, specific to the EMU (Economic and Monetary Union), as an economic policy regime that has turned the financial crisis into a sovereign debt crisis.

Neoliberalism has given rise to an unstable finance-dominated accumulation regime. It has not led to a sustained profit-led growth process, but to two complementary growth models that rely either on financial bubbles and rising household debt ('debt-driven growth') or on rising export surpluses ('export-driven growth'). These two growth regimes can be observed across the world, but in Europe, their emergence is closely linked to the process of European integration along neoliberal lines. European Neoliberalism had, on the one hand, fostered financial deregulation and, as a consequence, financial flows that fuelled the housing bubbles in Spain and Ireland. On the other hand it has fixed exchange rates and created an economic policy regime that has allowed the German ruling classes to pursue an aggressive neo-mercantilist strategy by suppressing wage growth in the wake of German unification. Trade imbalances as well as the build-up of debt are closely related to neoliberal strategies.

European Neoliberalism is also at the root of the uniquely dysfunctional economic policy reaction to the crisis. The EMU came with an economic policy package that has downward flexible wages (or 'internal devaluation') as the preferred adjustment mechanism, which creates a deflationary bias and puts the adjustment burden on the deficit countries. It also has constrained national fiscal policies from counteracting the recession and, by trying not to play the lender of last resort (LOLR) for governments, but only for private banks, it has paved the way for sovereign debt crises.

We will argue that this policy package is in part due to the strategy of (national) European capitalist classes which have aimed at curtailing the relatively corporatist nation states by imposing fiscal and monetary policy constraints. These constraints have become binding in the crisis, putting welfare state arrangements in question and proving counterproductive as they impose pro-cyclical austerity policies on the countries in crisis. By separating money (and central banks) from governments they have created a highly unstable situation that undermines nation states' ability to underwrite social compromises. The crisis thus threatens to turn into a political crisis of either the Euro system or its nation states.

The paper is structured as follows. Section 2 discusses Neoliberalism and the EMU's economic policy regime. Section 3 analyses the export-driven and debt-driven growth models in Europe. Section 4 highlights how the neoliberal European economic policy regime has amplified the crisis and discusses the dialectics of public and private debt. Section 5 concludes by outlining a Keynesian alternative.

European Neoliberalism

There is an extensive debate on the nature of Neoliberalism (Foucault 2007, Harvey 2005, Brenner et al 2010, Duménil and Lévy 2004, Glyn 2006). Foucault (2007) points out a defining feature of neoliberal thought - while markets are regarded as a desirable and ubiquitous form of social organisation, they are not seen as natural and entirely self-regulating; rather they have to be created and maintained. Institutions and competition policy now play a critical role. This is different from classical liberalism in which markets spontaneously spring into existence. Neo-liberalism is thus interventionist, while simultaneously positing the superiority of market relations. One of the achievements of Neoliberalism is that it has extended the sphere of economic analysis to non-economic and non-market activities – in particular, the public sector sphere is subjected to a regime that tries to emulate competitive relations where they do not exist and are not stable.

While Neoliberalism is often associated with free market rhetoric even at the macro level, it is not necessarily opposed to government intervention on *economic* grounds. It is the political (and ultimately democratic) nature of the interventions that worries neoliberals. Government intervention is then pursued on rule-based and technocratic form (to counteract populist and opportunistic impulses of politicians and the electorate). To illustrate, modern economic theory[1] in the form of the so-called New Consensus Model or the ‘New Keynesian Dynamic Stochastic General Equilibrium’ models need central bank policy as an essential ingredient to obtain stability of the economic system. Monetary policy setting the interest rate should follow a Taylor rule or, more narrowly, an inflation target. These models are now the main ones used by central banks in which, according to them, economies would not reach equilibrium without government intervention.

In this paper we take a regulationist approach[2] and from this perspective neoliberalism has been very effective in reconfiguring the mode of regulation. Neoliberalism has to be understood in the context of a tension between a political project and a theoretical project, but we are ultimately referring to a political project that is reconfiguring the institutional space of capitalism and, consequently, its economic logic. By identifying Neoliberalism as a political project, we are giving up the well-defined utopian or theoretical template to which neo-liberalism is aspiring to and opening it up for an analysis of the specific interests that shape neoliberal interventions (see also Fourcade-Gourinchas and Babb 2002). In particular we will argue that neoliberalism can mean very different things in different places and give rise to dysfunctionalities even by the standards of its proponents. For the macroeconomic purposes of this paper the key characteristics of the ‘neoliberal mode of regulation’[3] are the weakening of labour, internal and external financial deregulation and the EMU economic policy regime (Stockhammer 2008).

In the Anglo-Saxon countries neoliberalism came with an outright attack on organized labour. The miners’ strike in Great Britain and the air traffic controller strike in the USA marked bitter defeats for labour. In continental Europe the organisational strength of labour was eroded by two decades of high unemployment, welfare state retrenchment and

---

[1] It is quite difficult to pin down what ‘mainstream economics’ is and to what extent it is ‘neo-liberal’. The NCM and NK-DSGE models are mainstream in economic policy (e.g. the IMF or the Central Banks use them). However, the mainstream in academic research is more in line with New Classical economics, i.e. stronger in the tradition of General Equilibrium models. These models are quite different from neo-liberalism of the Hayekian mode. Stockhammer and Ramskogler (2009) discuss recent developments in mainstream economics and use the term ‘*enlightened neo-liberalism*’ to refer to the turn in mainstream economics that puts institutions at the central place of the analysis (which is in sharp contrast to traditional General Equilibrium theory).
[2] The term regulationist ‘framework’ or ‘approach’ rather than regulationist ‘theory’ is used as the Regulation School, is an ‘intermediate theory’ that offers a platform to analyze historically specific eras by encompassing socio-institutional as well as economic aspects and potentially allows for the (historically specific) integration of (among others) Keynesian and Marxian arguments, as attempted in this paper.
[3] It is the outcome and institutionalization of various compromises and (in their intention often provisional) arrangements that acquire a certain degree of coherence.

globalization. The effects of these events on income distribution have been profound (see Atkinson et al. 2012 on top incomes and Stockhammer 2013b on wage shares).

Financial deregulation has two dimensions: liberalization of international capital flows and the deregulation of domestic financial systems. This has led to fundamental changes in the financial landscape. At the international level, capital flows have been liberalized; domestically, changes in the financial framework have given rise to a rapid pace of financial innovation, eventually increasing the scope for speculation. Both developments have strengthened the influence of the financial sector. Real interest rates rose well above the growth rates of real GDP. Financial ratios such as stock market capitalization, derivatives turnover or cross-border lending have soared. Overall the income shares of financial capital have increased considerably (Duménil and Lévy 2001, Power et al. 2003). Moreover, the influence of financial investors on non-financial businesses has increased substantially under the so-called shareholder value revolution (Lazonick and O'Sullivan 2000). These structural changes have been summarily called financialization and will play a key role in our analysis of the structure of accumulation (Stockhammer 2013a, Hein 2012).

In continental Europe neoliberalism came, at least as far as economic policy is concerned, often in the guise of European integration and EU policies. In particular the free trade agreements of the Single European Act, competition policy, and, later, the services directive reflect the liberal creed. The Maastricht Treaty and the Stability and Growth Pact combined an anti-inflation priority with a restriction on fiscal policy without offering adjustment mechanisms for the imbalances that it gave rise to.

The economic policy regime in the Euro area is enshrined in the Maastricht Treaty, the Stability and Growth Pact, and the Lisbon Treaty. Recent changes due to the Treaty for Stability, Coordination and Governance in the Economic and Monetary Union will be discussed in Section 3. The basic structure can be summarized as follows: First, fiscal policy is essentially national policy. The EU budget, restricted to 2% of GDP, is too small and too inflexible to serve a macroeconomic function. It is simply not designed to provide a counter-cyclical stimulus in case of crisis. Second, national fiscal policies are restricted in the short term as the budget deficit must not exceed 3% of GDP (except in severe recessions) and they must aim at a balanced budget in the medium term. Third, monetary policy is centralized at the EU level and it is effectively inflation targeting, with the independent ECB having set the inflation target close to or below 2%. Fourth, financial markets are liberalized, internally as well externally. Thus the EU foregoes instruments of controlling credit growth or allocating credit. Fifth, there was a no bail-out clause, stating that neither other national governments nor the ECB will support individual countries which are facing problems in financing themselves (this is the only area where we will see fundamental changes in the policy setup). Sixth, labour markets are supposed to be flexible. The European Commission (EC) and the ECB regard wage flexibility as the cure to economic imbalances. By this they mean *downward* wage flexibility (they have not called for higher wages in Germany). But this anti-labour bias should not hide the fact that within the economic policy regime of EMU there is an economic logic to the argument: with fiscal policy restrained, exchange rate policy abolished and monetary policy centralized, the standard economic policy tools are all paralyzed. The burden of adjustment has thus to be carried by the labour market and wage policy.

The EU policy package is a form of neoliberalism. It is characterized by a strong belief in the efficiency of the market system, a distrust of state activity and an anti-labour bias. However, it is surprisingly difficult to pin down a theoretical case for monetary union. For example, while the design of EMU is often considered Monetarist, Monetarists have long defended flexible exchange rates. But Huerta de Soto (2012) offers a neo-Austrian defence of the Euro arguing that it constrains government intervention. Furthermore, the discussion of the EU in terms of the (mainstream) theory of optimal currency areas mostly concluded that the Euro area was *not* an optimal currency area.[4]

The policy package was criticized sharply by Keynesian economists (Arestis et al 2001; Euromemo 2011; Hein and Truger 2005; Huffschmid 2005; Stockhammer 2011): first, they predicted, reliance on labour market flexibility in the adjustment will not generate full employment. Keynes (1937, chapter 19) had argued in the *General Theory* that wage flexibility in a crisis is likely to make things worse: wage cuts will lead to shrinking consumption demand and to deflation, which may depress demand further in a debt-burdened

[4] Optimal currency areas are defined as regions that are structurally similar, have high labour and capital mobility and/or fiscal redistribution. Southern and Northern European countries don’t fit that bill. The theory was pioneered by Mundell, a member of the (neoliberal) Mont Pèlerin Society. As Goodhart (1998) points out, optimal currency theory is built on the ‘metallist’ theory of money that interprets money as originating from private transactions, whereas Chartalist theories of money argue that money originates from the state and its ability to tax (and impose order). The Chartalist approach lends itself to a sceptical view of the Euro project, because it regards a money without state as not viable.

economy as the real (inflation-adjusted) value of debt increases. Second, the EU policy system would create a deflationary bias. In the case of imbalances within the EU, with some countries running trade deficits and others running trade surpluses, the burden of adjustment would effectively fall on the country with trade deficits. This creates a deflationary bias. The adjustment of the surplus countries would be inflationary and growth-oriented, whereas the adjustment of the deficit countries is deflationary. They have to dampen demand (to decrease imports) and lower their prices and wages (to restore competitiveness). The exclusive reliance on wages as the adjusting variable will create a downward pressure on wages and result in prolonged unemployment without solving the EU's problems.

We will argue that the form of the crisis in Europe is due to the specific neoliberal policy regime that the Euro area has established. The policy regime is, to a significant extent, the outcome of the peculiar neoliberal strategy in Europe whereby the elites of various countries sought to implement neoliberal policies at the European level for which they could not gain popular acceptance at the national level. This transnational class strategy has interacted in complex ways with different national interests and strategies. Much of what the EU has done has been about imposing constraints on the scope of economic activity of nation states. The aim here was not to abolish the nation state, but to change it. In the process nation states were critically weakened. The fiscal rules have restricted their abilities to react in the face of a crisis. And the loss of monetary sovereignty has meant that national governments have lost national lenders of last resort. In times of sovereign debt crisis this can lead to a fundamental weakening of the state. Together these two measure undermine the ability of nation states to stabilise economic activity and, indeed, to survive. They thereby also lose the ability to forge social compromise and to create stability. Of course, this was partly intended. The SGP and the ECB charter were meant to circumscribe the abilities of nation states. However, this policy regime also proves profoundly dysfunctional as it effectively worsens the economic crisis.

Imbalances in Europe: German neo-mercantilism and debt-driven growth in the periphery

Neoliberalism has given rise to a polarisation of income distribution expressed in rising profits and top incomes, but that has nowhere translated into an investment boom. One might think that capitalists invest their profits (indeed in Marx's *Capital* they are forced to do so by competitive pressures). Keynesians have long questioned this. In their view the investment decisions of capitalists are a category sui generis (often interpreted as driven by animal spirits). Rather than generating profit-led growth regime, Neoliberalism has had to rely on other means of stimulating demand. It has resulted in two distinct growth models, which are both unstable: debt-driven growth and export-driven growth. It is the interaction of these processes that gave rise to the imbalances that erupted in the crisis. The crisis is thus a crisis of neoliberalism in the sense that neoliberalism is at the very root of the crisis.

We will use a Post Keynesian macro economic framework to clarify these arguments (Lavoie and Stockhammer 2012, Stockhammer 2011). This model goes back to Bhaduri and Marglin (1990) and allows for wage-led growth as well as profit-led growth. Simply put, in a wage-led economy higher wages will have expansionary effects as workers have a higher consumption propensity than capitalists. In a profit-led economy, profits get re-invested and thus drive the growth process. More technically, a rise in the wage share has negative effect on investment (higher profits do lead to higher investment), a positive effect on consumption (because capitalists save more than workers) and a negative effect on net exports (because the higher wage share implies a loss of competitiveness). The net effect, i.e. whether an actual economy is wage-led or profit-led will depend on the relative size of the partial effects and may differ by country and time period.

This model has given rise to a substantial empirical literature (Bowles and Boyer 1995, Stockhammer and Onaran 2004, Naastepad and Storm 2006-07, Barboso-Filho and Taylor 2008, Hein and Vogel 2008, Stockhammer and Stehrer 2011, Onaran and Galanis 2012). The majority of empirical studies find that private domestic demand is wage-led. The size of the export effects will critically depend on the geographical unit that is analysed: for individual countries, in particular for small open economies, they will be substantial, whereas for the world economy overall they play no role. This is important for our context because while individual European countries may well be profit-led because of exports, the Euro area overall is a relatively closed economy and empirical evidence suggests that demand is wage-led (Stockhammer et al 2009, Onaran and Galanis 2012).

So if the world economy is in a wage-led demand regime, how have economies grown at all? It's important to realise that in the neoliberal era growth has nowhere been driven by business investment. Growth has not been the result of a profit-led growth regime. Rather, two different growth models have emerged: the Anglo-Saxon countries developed a debt-driven growth model, which was driven by increasing household debt, strong consumption demand and, in some cases, a residential investment boom (Crouch 2009 refers to this as 'privatised Keynesianism'). Other countries, namely Germany, China and Japan adopted an export-driven growth model, where domestic demand is weak and growth relies on export surpluses. Germany pursued this strategy particularly aggressively with average real wages stagnating in the decade prior to the crisis and the sharpest increase in wage inequality among advanced economies (OECD 2008).[5]

The peripheral European countries also followed a debt-driven growth model. While the level of household debt has been traditionally low, the increase in household debt, which is the variable relevant for consumption expenditures, has grown rapidly. Indeed, Table 1 shows that the increase in household debt in the southern European countries was not only above the increase in the northern European countries (with the exception of the Netherlands), but it also exceeded that of the USA and the UK. The rapid expansion of credit was made possible to a significant extent through European financial integration. The EC's policy (namely the Financial Services Action Plan) aimed at creating a single financial market for Europe (Grahl 2009). In theory this means uniform interest rates across Europe and in practise it meant massive capital flows from Germany, France and the UK to the peripheral European countries. While this initially fostered manufacturing investment (as in the case of Spain and Ireland), it soon fuelled an unsustainable property boom.

Table 1. Increase in household debt (in % GDP), 2000-08

Northern European Countries		**Anglo-Saxon Countries**	
Germany	-11.3	USA	26
Netherlands	32.8	United Kingdom	28.1
Austria	7.9	**Southern European Countries**	
France	15.8	Ireland	62.7
		Greece	35.5
		Spain	33.8
		Portugal	27.4
Source: Eurostat, except USA: FoF			

[5] Hein and Mundt (2012) offer a more in detailed classification the growth models of G20 countries.

At the same time the southern European countries experienced substantially higher price and wage inflation. As a consequence the south lost competitiveness. This is illustrated in Table 2 which gives the growth in unit labour costs (ULC), a standard measure of cost competitiveness, from 2000-08. The southern European countries all had a growth of more than 24%, compared to a Euro area average of 16% and Germany at 3%. Together with fast growth in many southern countries, this resulted in substantial current account deficits, which were mirrored by export surpluses in the north. These surpluses were recycled as private credit flows back to the southern European countries, where they financed property bubbles and rising household debt.[6] In fact the situation differed by country, but a massive increase in *private* household debt (in southern European countries) is the hallmark of this growth. With the exception of Greece, public debt was declining (see also de Grauwe 2010).

Table 2. Increase in unit labour costs (ULC), 2000-08

Northern European Countries		**Southern European Countries**	
Germany	3%	Ireland	33%
Netherlands	19%	Greece	26%
Austria	9%	Spain	30%
		Italy	27%
Euro Area (12)	16%	Portugal	24%

Source: AMECO

The crisis, the EU policy regime and the nature of money

The Global Financial Crisis began in the US subprime sector. The underlying factors of the crisis include financial deregulation, the rise in inequality and the international imbalances that had built up. These are directly tied to Neoliberalism and the two growth models in the finance-dominated accumulation regime. Initially the crisis hit debt-driven and export-driven economies equally hard. However the export-driven economies were quicker to recover as they were not suffering from a debt overhang. In the USA the crisis was countered by

[6] Two qualifications are in place. First, actual trade relations are more complex relations. For example, Germany's largest export surpluses are with Austria and with France. Austria has had export surpluses itself. France's export position was rather balanced in the first half of the 2000s and deteriorated thereafter. Both countries had surpluses with southern European countries. Second, financial flows are quite independent of trade imbalances. In particular French and British banks have had strong exposure to southern European banks, reflecting their positions as financial centres.

moderate counter-cyclical fiscal policy[7] and by aggressive monetary policy in the form of QE.[8] In the USA the crisis turned into a weak recovery. Economic policy in Europe was less anti-cyclical. While countries adopted stimulus packages in the first year of the crisis, fiscal policy turned to austerity more quickly and, worse, it became more restrictive in those countries hit hardest by the crisis after 2010. Monetary policy in the EU tried to avoid what is now known as unconventional monetary policy or quantitative easing (QE) as long as it could, but as the Euro crisis deepened, the ECB did expand its balance sheet. Given the different growth models and differences in economic policy, the crisis led to sharply different performances across Europe: a fragile recovery in the north and a depression in the southern European countries.

While recent developments have vindicated Keynesian criticisms, the EU's policy package has not changed direction, but become, as of today, more rigid and doctrinaire. The Treaty for Stability, Coordination and Governance in the Economic and Monetary Union (TSCG) has tightened the grip on fiscal policy (Grahl 2012). Constitutional debt breaks are to be introduced in the Euro member states; there will be an automatic obligation to austerity if public debt exceeds the 60% target (the 1/20 rule) and the European Commission will be involved in the national budget process (the European Semester). The one area where there has been a change in direction is with respect to the no bail-out clause. The EU has, belatedly, set up a collective fund for member states that have lost access to market finance (EFSF, EMF). This fund gives loans to the countries that are misleadingly referred to as 'rescue packages' and imposes conditionality that is similar in spirit (if not as far reaching) as IMF adjustment programmess.[9]

Why was such a policy package adopted? The reasons are complex. First, and this is the factor we want to highlight, it was the political strategy of many national capitalist classes to

---

[7] Fiscal policy was moderate in the sense that given the extent of the recession it was by far insufficient to ensure full employment. However, by historical standards it was indeed substantial. The budget deficit (in the USA) peaked at 10% of GDP and stayed above 7% for four years.
[8] The increase in the balance sheet of the Fed corresponds to some 15% of GDP since 2008.
[9] The 'rescue packages' have in no case led to a decline in public debt. For example in the case of Greece public debt has increased from 113% 2008 to 160.6% 2012, in Ireland from 44.2% to 116.2% (according to the EC's 2012 spring forecast). Greece has not received financial aid, but rather public loans at rates well above the market rates of Germany. These loans are used to repay private lenders. Essentially the 'rescue packages' have been gigantic machineries to transform private debt into public debt. Credit Suisse estimates that the second Greek rescue package reduced the private sector share in the holding of Greek government debt from 62% to 30% (Credit Suisse Economics Research 2012).

pursue European integration as a means to curtail corporatist national states that proved resilient domestically (see Bonefeld 2002 for a similar argument)[10]. Second, the historical situation in the aftermath of the 1992/3 EMS crisis had made clear that the previous monetary regime was unsustainable. Monetary integration, or so it was widely perceived, either had to go all the way or national currencies had to be re-established. It was the southern European countries that wanted monetary integration, not Germany, as the high inflation countries had been burnt by the experience of the 1980s when they had to follow German interest rates without having a say in the determination of these rates. However, it was Germany (or the Bundesbank) who wrote the rules for the new currency. Third, for important actors, most especially the Bundesbank, monetarist ideology played a major role. The conservative nature of central banks in many corporatist countries requires further research as it does not necessarily reflect financial interests that are arguably less developed than in the Anglo-Saxon countries. Fourth, on the part of some actors (namely Jacques Delors) there was an attempt to instrumentalise monetary integration for the project of European political integration. A common currency was regarded as a first step towards political integration (Delors 1994, pp. 237-43; Spolaore 2013).

The crisis has illustrated the strong interdependence of the government sector and the financial system. More theoretically put, the crisis has highlighted the tension between the public and private nature of money. The crisis thus raises interesting questions about the nature of money and the state.

To begin, note that the four arguments regarding EMU listed above imply very different views of the relation between the state and monetary sovereignty. The first argument (class strategy) *wants to separate* the state and money in order to shift the policy goals. The second argument (high inflation countries in favour of integration to have a say in interest rates) implies that countries *have already* lost monetary sovereignty (implicitly the ability to set interest rates, in fact in normal times a key feature, is conflated with monetary sovereignty). The third (monetarist) view argues that money and the state *can* be separated due to the

[10] Bonefeld (2002) makes a more general argument about the history of European integration. While this is consistent with our argument, our claim only refers to the neo-liberal period after 1980.

private nature of money.[11] The fourth argument implies that monetary sovereignty and the state *cannot* be separated and thus monetary integration must necessarily be followed by political integration.

Economic theory is divided on the theory of money. Mainstream economics (and indeed parts of Marxian theory) regard money as emerging from private transactions. In classical economics (and Marx) gold can become money because it has value as a commodity. By contrast, Post-Keynesian theory and other heterodox traditions stress that debt relations and in particular government debt and the ability of governments to collect taxes in their own currency are the foundation of money (Goodhart 1998; see also Graeber 2011 chapters 2 and 3). Ingham (2004) stresses the state origin of money, but highlights that the social mode of production of credit money is through private banks. Money thus is a contested field that has sovereign power as a constituent element, but private institutions are critically involved. This is also reflected in central banks. Most central banks were originally founded in order to strengthen state finances and later acquired bank supervision functions. Central banks were first LOLR for the state and only later became LOLR for private banks. Most countries' central banks are public-private hybrids, often with commercial bank representation on the crucial decision-making bodies. However, in the process of EMU, central bank independence was strengthened and the ECB was forbidden to fund governments directly. That is by design it was meant to be a LOLR for the private sector only. Money and monetary policy was to be insulated from the political process.

While these debates on the nature of money may appear academic, closely related issues surface in the present crisis in how public and private debt are related. Public debt is a private asset. Most government bonds are held by private banks and pension funds. Public debt is essential for the working of the private financial sector. It forms the most important collateral used on money markets and repo markets (Gabor 2013, Mehrling 2011). The credibility of public debt is thus essential for the functioning of private debt markets. A sovereign debt crisis also poses a mortal threat to the respective country's banks, as they usually lose access to the private financial markets. In the Euro area this is amplified by contagion effects as the credibility of one country's sovereign debt calls into question the quality of another country's

---

[11] In the Monetarist view, the central bank should be a public institution, but rule-bound and independent of governments. The origin of money is found in economising private market transactions (Goodhart 1998). The separation of the nation-state and money is thus regarded as unproblematic.

assets. But this dialectic between private and public debt goes further. The credibility of public debt depends, in many cases, on the assessment of private financial institutions. In the case of Spain and Italy, debt levels were clearly sustainable at the interest levels prior to the crisis. After the financial crisis, interest spreads on southern European countries increased sharply; essentially the banks started speculating against the governments that had rescued them (Weeks 2013). There clearly will be some interest rate (and the 7% rate that is frequently used as a benchmark seems plausible) where debt levels are unsustainable (in the sense of unserviceable).

From the autumn of 2008 central banks in the USA, the UK and the Euro area embarked on QE, i.e. aggressively expanding their balance sheets. The orders of magnitude are substantial: central bank balance sheets tripled in size, expanding from some 6% of GDP to more than 20%. Central banks initially focused on buying private assets, but from spring 2009 the Fed and the BoE increasingly bought government bonds, i.e. they supported government spending. The ECB was, in the early phase of the financial crisis, much more hesitant. It started quantitative easing later, expanded its balance sheet less, and has hardly bought government bonds. At the same time (like its American and British counterparts), it has expanded the range of credit to private financial institutions (Pisani-Ferry and Wolff 2012). In short, the ECB is playing the role of lender of last resort for the financial sector, but – different from the Fed and the BoE –not for the government sector. Only in August 2012, when the Greek sovereign debt crisis threatened to engulf the other Euro member states, did the ECB commit to buying government bonds (under the condition that those countries submitted to the conditionality of the bailout packages – the so-called Outright Monetary Transactions, OMT, programme). For several European countries the situation is now similar to that of developing countries which have debts in a foreign currency.

The crisis is, in our view, due to the fact that political forces in Europe have built half a European state, while they have seriously damaged the ability of nation states to counter an economic crisis (and by implication) to underwrite social compromises. This is not an accident. In our analysis, this particular form of European integration is the outcome of a strategy of European national capital classes that have used European integration to undermine the, in their view, excessively corporatist and Keynesian (national) states. The incapacitation of nation states has several dimensions. The restrictions on fiscal policy directly impede governments on the expenditure side. In particular it has forced those countries most desperately in need of expansionary fiscal policies to pursue austerity.[12] The loss of monetary sovereignty means that countries cannot set interest rates and, more importantly in times of sovereign debt crisis, they don't have the lender of last resort facility to support the government. This effectively turns what would have been (under the EMS regime) an exchange rate crisis into a sovereign debt crisis, with a great deal of similarity to debt in a foreign currency. Third, the set of rules effectively leaves few policy variables at the states' availability and encourages a wage policy that aims at competitive devaluation.

So, how have the national bourgeoisies fared? In the south, they got many of the reforms they wanted (in particular with respect to the labour market and the welfare state), but under conditions that they didn't want. By this we mean the recession, but also the increasing influence of the German government as well as of German capital. In the north, capital could push further desired changes in policy regimes, but they are in danger of paying for substantial parts of the costs either in the form of inter-country transfers or in the form of debt restructuring in which their countries would have to shoulder (some of) the costs of the crisis. Meanwhile, European labour is divided not only along national lines, with their experience of the crisis differing sharply between themselves: Germany having a lower unemployment than before the crisis and the southern countries having the unemployment rates of the Great Depression.

There is an alternative

This paper tells a rather gloomy story, but it also highlights that European Neoliberalism, while so far successful politically, has created a mess economically. Europe now faces several challenges. It has to re-balance its trade flows and cost and price levels. And it has to deal with high private and public debt. In principle the cost imbalances can be dealt with by inflationary adjustment (that is adjustment in the surplus countries to increase prices and output) or by deflationary adjustment in the deficit countries.[13] The latter is presently being pursued under the name of 'internal devaluation'. The high levels of debt, when considered

---

[12] It is difficult to assess the relative impact of this historically. After the EMS crisis the deficit countries also pursued austerity policies, but the effects of the latter were alleviated by simultaneous devaluation.
[13] Stockhammer and Sotiropoulos (2012) find that the internal devaluation strategy presently pursued would require a reduction of 23-47% of GDP in the southern European countries in order to balance the current account imbalances.

unsustainable can be dealt with by letting economic units go bankrupt, by debt restructuring or by bail-outs.

A Keynesian economic strategy aims for an inflationary adjustment strategy (simply put: higher wage growth in Germany and expansionary fiscal policy across Europe). For short-term crisis management, European Central Bank intervention on public debt markets is essential, but Europe needs a complete overhaul of its economic policy mix, one that thoroughly breaks with Neoliberalism.

First, there needs to be a rethink of wage policy. The present policy regime preaches wage flexibility and has led to declining wage shares across Europe. Instead, Europe needs a system of transnationally coordinated wage bargaining that takes into consideration issues of equity and trade balances. This would imply a strengthening of collective bargaining structures and ought to be complemented by a European system of national minimum wages (as many countries, including now Germany, have substantial segments of workers that are not covered by collective bargaining agreements; Schulten and Watt 2007). The macroeconomic aim of European wage coordination ought to be higher wage growth in the trade surplus countries, which would help prevent imbalances. Simply put, southern European countries need much higher wage growth in Germany – or else they have to go into deflation.

Second, there need to be a rethink on how to treat finance. Debt-driven growth in consumption is unsustainable. Bankruptcy is economically disruptive. Debt restructuring will in some cases be necessary to make debt manageable, but in general the Keynesian strategy aims at raising income rather than deleting debt. An inflationary environment would greatly facilitate reducing the debt level. To counteract the regressive distributional effects of bank rescues, a substantial wealth tax would have to be introduced. At the same time the bail-out of financial institutions would have to come with proper socialisation to ensure change in management practises. A financial sector dominated by not-for-profit institutions would be desirable. Speed bumps on national as well as international financial transactions would have to be implemented in the form of macroprudential policy (that aims at controlling the growth of credit) and/or by a Financial Transactions Tax and asset-based reserve requirements that counteract the self-reinforcing loop between asset prices and credit.

Third, there needs to be a robust mechanism of redistribution across regions that does not rely on generosity and bail-outs. There is a simple solution to this: a European social security system. A European tax on profits that finances social expenditures, say unemployment benefits, would redistribute income from prosperous to depressed regions without increasing debt levels. This would build what Europe needs: a system of funding financial flows to deficit units that does not create rising liabilities for either the private or the public sector. It will no doubt be difficult to institute this mechanism and there are good reasons why various institutions of the labour movement have so far been opposed to transferring social policy competences to the European level: the European level has typically been more prone to pro-capital lobbying than national institutions. A European social security system would thus have to come with institution-building that guaranteed a role for labour organisations (or more broadly labour and capital) in the administration and funding decisions of the institution.

Effectively, these measures would amount to the creation of a European welfare state. This could give a new life to the project of European integration. And it would make economic sense.

References

Arestis, P, McCauley, C. and M. Sawyer 2001. An alternative stability pact for the European Union. *Cambridge Journal of Economics* 25: 113-130

Arestis, P. and M. Sawyer, 2004. On the Main Ingredients of the European Economic and Monetary Union. *International Journal of Political Economy*, 34: 5-18

Barbosa-Filho, N. and Taylor, L. (2006). "Distributive and demand cycles in the US economy – a structuralist Goodwin model", *Metroeconomica* 57, 3, 389-411

Bhaduri, A., and S. Marglin 1990. Unemployment and the real wage: the economic basis for contesting political ideologies. *Cambridge Journal of Economics*, 14: 375-93

Bibow, J 2007. How the Maastricht regime fosters divergence as well as instability. in: P. Arestis, E. Hein and E. Le Heron (eds) Monetary Policies: Modern Approaches, Palgrave, pp. 197-222

Bonefeld, Werner, 2002. European integration: the market, the political and class. Capital and Class 77, 117-42

Bowles, S., and R. Boyer, 1995. Wages, aggregate demand, and employment in an open economy: an empirical investigation. In *Macroeconomic policy after the conservative era. Studies in investment, saving and finance*. Ed. G Epstein and H Gintis . Cambridge: University Press

Brenner, N, Peck, J, Theodore, N, 2010. Variegated neoliberalization: geographies, modalities, pathways. Gloal Networks, 10, 2: 182-222

Credit Suisse Economics Research, 2012, European Economics. Assessing debt sustainability and financing needs in Greece ahead of the PSI. https://doc.research-and-analytics.csfb.com/docView?language=ENG&source=ulg&format=PDF&document_id=948097251&serialid=IjiUHEvdB6unRmTlYr3p6Dv6YM8Upex%2FTeRbVrcgI6U%3D accessed 6/9/2013

Crouch, C. (2009). Privatised Keynesianism: An unacknowledged policy regime. British Journal of Politics and International Relations 11, 382-99

Delors, Jacques, 1994. L'unité d'un homme: entretiens avec Dominique Wolton, Paris: Odile Jacob

De Grauwe, P. (2010) The Financial Crisis and the Future of the Eurozone, *Bruges European Economic Policy Briefings*, 21.

Duménil, G, Lévy, D. (2001). Costs and benefits of Neoliberalism: a class analysis. *Review of International Political Economy* 8 (4), 578-607

Duménil, G., Lévy, D. (2004) *Capital Resurgent. Roots of the Neoliberal Revolution*. Cambridge, MA: Harvard University Press

European Commission 2012 European Economic Forecast, Spring 2012. European Economy 1/212 http://ec.europa.eu/economy_finance/publications/european_economy/2012/pdf/ee-2012-1_en.pdf accessed 6/9/2013

Flassbeck, H. & Spiecker, F. (2005). Die deutsche Lohnpolitik sprengt die Europäische Währungsunion. *WSI Mitteilungen* 12/2005, pp. 707-13

Foucault, M. (2008) *The Birth of Biopolitics: Lectures at the College de France, 1978—1979*. Houndsmills: Palgrave MacMillan

Fourcade-Gourinchas, M, Babb, S, 2002. The rebirth of the liberal creed: paths to Neoliberalism in four countries. American Journal of Sociology 108, 3: 533-79

Gabor, D, (2013) Learning from Japan: The European Central Bank and the European sovereign debt crisis. Review of Political Economy forthcoming

Glyn, A. (2006) *Capitalism unleashed: Finance, Globalization and Welfare*. Oxford University Press.

Goodhart, Charles, 1998. The two concepts of money: implications for the analysis of optimal currency areas, European Journal of Political Economy, 14, (3), pp. 407-432

Graeber, David. *Debt. The first 5000 years*. New York: Melville House

Grahl, J. (2009) *Global Finance and Social Europe* (Aldershot: Edward Elgar).

Grahl, J (2012) The First European Semester: an incoherent strategy. Paper presented at the PERG workshop Europe in Crisis, April 2012, Kingston University

Harvey, D. (2005) *A short history of neoliberalism*. Oxford: Oxford University Press

Hein, E. (2012) The Macroeconomics Of Finance-Dominated Capitalism – And Its Crisis. Cheltenham: Edward Elgar

Hein, E. & Truger, A. (2005) European Monetary Union: nominal convergence, real divergence and slow growth?, *Structural Change and Economic Dynamics*, 16(1), pp. 7-33.

Hein, E. Mundt, M. (2012). Financialisation and the requirements and potentials for wage-led recovery – a review focussing on the G20. ILO Working Papers, Conditions of Work and Employment Series No. 37, Geneva.

Hein, E., Vogel, L. 2008. Distribution and growth reconsidered – empirical results for Austria, France, Germany, the Netherlands, the UK and the USA. *Cambridge Journal of Economics*, 32 (3): 479-511.

Huerta de Soto, J. (2012). An Austrian Defense of the Euro. Mises Daily 22 June 2012. http://mises.org/daily/6069/ (accessed 18/11/2013)

Huffschmid, J 2005. *Economic policy for a social Europe: a critique of neo-liberalism and proposals for alternatives*. Basingstoke: Palgrave Macmillan

Ingham, Geoffrey, 2004. *The nature of money*. Cambridge: Polity Press

Marsh, David, 2009. *The Euro. The battle for the new global currency*. New Haven: Yale University Press

Martin, Felix, 2013. *Money. The unauthorised biography*. London: Random House

Mehrling, Perry. 2011. The New Lombard Street, How the Fed Became the Dealer of Last Resort. Princeton, NJ: Princeton University Press

Mirowksi, P, Plehwe, D. 2009. *The road from Mont Pelerin*. Cambridge, MA: Harvard University Press

Naastepad, C.W.M., and S. Storm 2006/7. OECD demand regimes (1960-2000*). Journal of Post-Keynesian Economics*, 29: 213-248.

OECD, 2008. *Growing unequal? Income distribution and poverty in OECD countries*. Paris: OECD

Onaran, O. and Galanis, G. (2012). Is aggregate demand wage-led or profit-led? National and global effects, ILO Working Papers, Conditions of Work and Employment Series No. 40, Geneva.

Pisani-Ferry J. and Wolff G., (2012) Is LTRO QE in disguise? http://www.voxeu.org/index.php?q=node/7923 (accessed 20/11/2013)

Schulten, T, and Watt, A,2007. European minimum wage policy –a concrete project for a social Europe. ETUI European Economic and Employment Policy Brief No 2-

Spolaore, Enrico 2013. What is European integration really about? A political guide for economists. Journal of Economic Perspectives 27, 3,125–144

Stockhammer, Engelbert, 2008. Some Stylized Facts on the Finance-Dominated Accumulation Regime. *Competition and Change* 12, 2: 189-207

Stockhammer, E, 2011a. Peripheral Europe's debt and German wages. *International Journal for Public Policy* vol. 7, no. 1-3, 83-96

Stockhammer, E 2011b. Wage-led growth. An introduction. *International Journal of Labour Research* vol. 3, no. 2, 167-188

Stockhammer, E. 2012a. Euro-Keynesianism? The financial crisis in Europe. *Radical Philosophy* 175 (Sept/Oct 2012), 2-10

Stockhammer, E, 2012b. Financialization, income distribution and the crisis. *Investigación Económica,* vol. 71, no. 279: 39-70

Stockhammer, E. 2012c. The Euro crisis, European Neoliberalism and the need for a European welfare state. *Soundings* 50, 121-130

Stockhammer, E. 2013a. Financialization and the global economy. In: G. Epstein and M. Wolfson (eds) *The Handbook of the Political Economy of Financial Crises.* Oxford University Press

Stockhammer, E. 2013b. Why have wage shares fallen? A panel analysis of the determinants of functional income distribution. ILO Working Paper, Conditions of Work and Employment Series No. 35

Stockhammer, E, Ramskogler, P, 2009. Post Keynesian economics - how to move forward. *Intervention* 5 (2): 227-46

Stockhammer, E. Sotiropoulos, D., 2012. The costs of internal devaluation PKSG Working Paper 1206

Stockhammer, E, and Stehrer, R, 2011.Goodwin or Kalecki in demand? Functional income distribution and aggregate demand in the short run. *Review of Radical Political Economics* vol. 43, no. 4, 506–522

Stockhammer, E, Onaran, Ö and Ederer, S. 2009. Functional income distribution and aggregate demand in the Euro area. *Cambridge Journal of Economics* vol. 33, no. 1, 139-159

Stockhammer, E., and Ö. Onaran 2004. Accumulation, distribution and employment: a structural VAR approach to a Kaleckian macro-model. *Structural Change and Economic Dynamics* (15): 421-47.

Weeks, J. (2013), Euro crises and euro scams: Trade not debt and deficits tell the tale. Review of Political Economy forthcoming

Worldbank (2002) *Building Institutions for Markets. World Development Report 2002*. Washington, DC: Worldbank