Explaining the Euro Crisis: Current Account Imbalances, Credit Booms and Economic Policy in Different Economic Paradigms

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Abstract: The paper proposes a post-Keynesian analysis of the Eurozone crisis and contrasts interpretations inspired by New Keynesian, New Classical, and Marxist theories. The origin of the crisis is the emergence of a debt-driven and an export-driven growth model, which resulted in a rapid increase in private debt ratios and current account imbalances. The reason the crisis escalated in southern Europe, but not in other parts of the world, lies in the unique dysfunctional economic policy regime of the Euro area. European fiscal rules and the Troika impose fiscal austerity on countries in crisis and the separation of fiscal and monetary spaces has made countries vulnerable to sovereign debt crises and forced them to comply. We analyse the role different paradigms attribute to current account imbalances, fiscal policy and monetary policy. Remarkably, opposing views on the relative importance of cost and demand developments in explaining current account imbalances can be found in both heterodox and orthodox economics. Regarding the assessment of fiscal and monetary policy there is a clearer polarisation, with heterodox analysis regarding austerity as unhelpful and large parts of orthodox economics endorsing it. We conclude that there is a weak mapping between post-Keynesian, New Classical, New Keynesian and Marxist theories and different economic policy strategies for the Euro area, which we label Keynesian New Deal, European Orthodoxy, Moderate Reform and Progressive Exit respectively.

Keywords: Euro crisis, European economic policy, sovereign debt crisis, current account balance, fiscal policy, quantitative easing

JEL classifications: B00, E00, E5, E63, F53, G01

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1 Introduction

The global financial crisis (GFC) began 2007 in the US market for financial derivatives on subprime mortgages. By 2008/09 literally all advanced economies were in a severe recession. In most countries the ensuing recovery was weak; only in the southern European Euro member states did the crisis turn into something akin to the Great Depression and only in these countries did the crisis morph into a sovereign debt crisis. These developments pose challenges to economic theories and offer a unique occasion to assess the explanatory power of different economic paradigms. This paper advocates a post-Keynesian (PK) explanation of the Euro crisis and systematically contrasts it with New Classical mainstream (NCM), New Keynesian mainstream (NKM), and Marxist Political Economy (MPE) approaches. In particular we review what various authors have argued with respect to the role of monetary union and current account imbalances and the role of fiscal policy. The paper thus asks questions like: What are the effects of a monetary union: is it essentially a fixed exchange rate arrangement or does the divorce of fiscal and monetary space pose deeper problems? Are current account imbalances due to divergence cost developments or a side effect of financial bubbles in some countries? Is financial discipline inevitable in a monetary union or has austerity exacerbated the crisis? It is difficult to assess the different approaches and we should be explicit that we endorse a PK view. The aim of the paper is to pinpoint differences and similarities in explanation rather than rigorously evaluate them. This exercise is useful as at present no comparison of paradigms regarding the Euro exists and this crisis poses interesting and revealing challenges for all paradigms.

In our PK interpretation the origin of the crisis is the emergence of a debt-driven and an export-driven growth model, which resulted in a rapid increase in private debt ratios and current account imbalances. The reason the crisis escalated in southern Europe but not in other parts of the world lies in the unique dysfunctional economic policy regime of the Euro area. European fiscal rules have been designed to impose fiscal discipline and imply pro-cyclical austerity. But it was the separation of fiscal and monetary spaces that has made countries vulnerable to sovereign debt crises and forced them to comply with the regime. The Troika then imposed harsh austerity on countries in recession. Thus while the origins of the crisis lie in unstable neoliberal growth models, in particular real estate bubbles and a debt-driven growth model, the escalation of the crisis into a sovereign debt crisis and a depression in southern Europe is to a large extent the result of the EU's economic policy regime. The main effect of a currency union, in this view, is not in terms of a fixed exchange rate regime, but that the divorce of fiscal and monetary spaces undermines the ability of nation states to combat recession.

We identify four economic policy strategies for the Euro area and argue that these are linked with different economic paradigms, but any mapping of positions is a messy one: the crisis has led to debates between and within paradigms and new battle lines are drawn, in particular within the mainstream. Post-Keynesians regard the Euro crisis as the outcome of the neoliberal economic policy regimes of the Euro area. This lends itself to a *Social Europe* or *European New Deal* approach that seeks to overhaul the economic policy regime, giving a prominent role to European fiscal policy, which would be supported by central bank purchases of government bonds and a shift to a coordinated and egalitarian wage policy (Hein 2013, Stockhammer 2016). Ultimately this aims at institutionalising an anti-cyclical fiscal policy at the European level and a wage-led growth strategy. This is in sharp contrast to the strategy that we will refer to as *European Orthodoxy*, which argues that the imbalances prior to the crisis were due to fiscal profligacy in southern European countries, paired with excessive wage growth (e.g. Feld et al 2015). Thus austerity and labour market deregulation are essential to restoring order. Fiscal union is detrimental because it can create moral hazard problems for fiscal policy. While this is the line taken by the German finance ministry and, effectively, the European Commission, and is broadly consistent with New Classical economics, the crisis has shown new fault lines with the mainstream. There is also a *Moderate Reform* position that is connected to the NKM paradigm. It highlights the rapid growth of private debt and financial bubbles as important factors for the crisis and argues that in the short run austerity is harmful and indeed, that excessive ('frontloaded') austerity is regarded as having exacerbated the crisis (Baldwin et al 2015). Labour market reform is desirable, but is not helpful during a recession. The Marxist view on the Euro crisis is less fully developed, but many Marxist writers regard the Euro area's policy arrangements as serving Germany's needs. Monetary union enabled German capital to improve its competitiveness at the expense of other EU countries (Lapavitsas 2015a, 2015b). At the core of Marxist analyses is the development of profitability, and fiscal and monetary policy gets comparatively less attention. This approach lends itself to a *Progressive Exit* strategy that regards the European institutions as unreformable (from a pro-labour perspective).

The paper is structured as follows. Section 2 presents the basic economic paradigms regarding the role of demand, income distribution and nature of money. Section 3 covers debates on the cause and the significance of current account imbalances. Section 4 discusses different perspectives on austerity and fiscal policy. Section 5 summarises the debates on credit booms and monetary policy. The different positions are brought together in section 6, where we analyse the relation between paradigms and policy strategies.

2 Post-Keynesian, New Classical, New Keynesian and Marxist paradigms

This section briefly reviews the main economic paradigms to see how their analytical framework shapes their analysis of the Euro crisis. In PKE the economy is demand-led in the short- as well as in the long-run (Lavoie 2014, King 2002). Excess capacity and involuntary unemployment are regarded as normal in capitalist economies and supply adjusts via induced technological progress. Path dependency and hysteresis are pervasive features, and economic policy interventions can have short- as well as long-run effects (Lavoie 2009, Setterfield 2011, Stockhammer 2011). Among the demand determinants in PKE two stand out for our context: First, PKE has offered an extensive analysis of financialisation and financial instability (see below). Second, income distribution plays a central role in PKE. Following Bhaduri and Marglin (1990) a rich analysis of demand regimes has been developed. A rise in the wage share due to workers' increased bargaining power has a negative effect on investment (higher profits 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 wages imply a loss of competitiveness). The net effect will depend on the relative size of the partial effects and may differ by country and time period. If the net effect of a rise in the wage share is positive, i.e. if the consumption effect outweighs the investment (and net export effect), the demand regime is called wage led, if it is negative it is called profit led (Lavoie and Stockhammer 2013). Neoliberalism is analysed as a group of growth models where pro-capital distributional changes in a wage-led demand regime lead to potential stagnation, but external demand stimulates growth in an unstable fashion, giving rise to debt-driven and export-driven growth models. These are unstable because they rely either on increasing debt-to-income ratios or growing trade imbalances.

Effective demand in PKE is monetary demand. Money is a liquid asset that is held, in part, to allow flexibility in a world with an uncertain future. Money is thus, in particular in times of crises, held as an asset and not as a means for real transactions. The reason why in today's world bank deposits play the role of money is that they are backed by the state, both in the sense that states guarantee deposits (usually up to a certain amount) and banks have access to central bank (i.e. non-market) lending. Deposits are created endogenously as a side effect of commercial bank lending. In the PK view credit creates deposits, not vice versa as in most standard economics textbooks. Money is neither a commodity (as in Marxian and classical economics) nor is it fully under the control central banks (as in Monetarist theory). While money in the modern economy is largely created by private banks, its origins lie with the state and sovereign authority. The state is not only the largest borrower, but it also uses legal and coercive powers to establish its currency. State authority is at the foundation of the hierarchy of monies.[1] Money is based on sovereign power but is created by profit-seeking private institutions. The lending decisions of banks become a key variable. Keynes (1936) and Minsky (1986) highlight the role of financial factors, credit and leverage cycles are an important explanation of business cycles and economic crises, as private lending decisions tend to be highly pro-cyclical, amplifying booms and trapping the economy in liquidity and debt-overhang crises.

The labour market plays a passive role in PKE. In the short run the level of demand determines the employment level. Moreover, the adjustment mechanisms on the labour market may well lead to perverse goods market adjustments: falling wages may cause a decline in effective demand and a further decline in employment if demand is wage led. But

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[1] This analysis of money has great similarity with that of economic sociologists like Ingham (2004), anthropologists like Graeber (2011) and the Legal Theory of Finance (Pistor 2013).

PKE argue that even over longer periods the labour market will be dominated by the goods market due to a range of hysteresis or path dependency mechanisms (Stockhammer 2008, 2011), [2] in particular endogenous technological progress (Kaldor and Mirrlees 1962, Setterfield 2010), endogenous normal capacity utilisation and endogenous wage norms (Skott 2005, Stockhammer 2008, Stockhammer and Klär 2011)

In mainstream economics the economy is anchored in a deep (and stable) equilibrium determined by supply side factors such as technology and preferences, at least in the long run. Whereas in the NCM version the economy is always regarded as being driven by supply factors, the NKM version allows for short run dynamics that are driven by demand shocks. These models still are rooted in a labour market equilibrium, a NAIRU, in the longer term (Nickell 1998, Stockhammer 2008). If adjustment is slow because of wage and price rigidities, there may be a positive role for government intervention. Before the crisis the NKM has given priority to monetary policy for this. Since the crisis, it has been recognised that situations like a low inflation environment may arise where monetary policy ceases to be effective because of the zero lower bound (De Long and Summers 2012, Eggertson and Krugman 2012). In addition, there is an empirical recognition that fiscal multipliers may be higher in recession than during periods of high growth (Blanchard and Leigh 2013, Auerbach and Gorodnichenko 2012). The NKM has also given rise to a literature of bubbles in the form of noise trader models (Shleifer and Summers 1990). While these arguments potentially have great importance here, they are rarely tied in a systematic analysis of the Euro crisis.

[2] While the use of the term hysteresis in economic research is often associated with neo-classically inspired authors (Blanchard and Summers), PKE clearly contains a longer and more general tradition of emphasising path-dependency which goes beyond the sense of the term used in conventional research.

In the context of this paper, two central features of mainstream treatments of money and finance should be highlighted. The first is its focus on the 'medium of exchange' function of money rooted in the historical neoclassical view of money as a commodity (Ingham, 2004). This becomes evident in the analysis of optimum currency areas (OCA) (e.g. Ricci, 1997) which focuses on transaction cost reductions in evaluating the benefits of currency unions and does not discuss the historical connection between monetary and fiscal spaces (Goodhart, 1998). The second central point is the continued use of the loanable funds model of credit in which the interest rate is determined by the supply and demand for savings, despite some objections from within the mainstream (Jakab and Kumhof, 2015). In the context of the Eurozone crisis, this approach is especially associated with Sinn (2010, 2011, 2012) who argues that prior to the crisis, German savings were 'exported' to the south and hence unavailable to finance investment in Germany. Many of the NK-leaning contributions in Baldwin and Giavazzi (2015) similarly make use of loanable funds concepts such as the natural rate of interest. Since the loanable funds model and the natural rate of interest are non-monetary concepts, their use underlines the continued attachment of the mainstream to a separability of monetary and real analysis in which money is neutral at least in the long run.

MPE is critical of the capitalist mode of production but shares a supply-side focus in its analysis of capitalist dynamics. However, the supply side is associated with class struggle and the degree of exploitation rather than with preferences and technology. MPE is based on a classical surplus model where investment is financed out of profits (Goodwin 1967). Business cycles emerge when unemployment declines during a boom, which increases the bargaining power of workers, which in turn depresses profits and thus investment spending. Traditional macroeconomic topics of fiscal and monetary policy, however, have not featured prominently in MPE.

MPE has traditionally been based on a commodity theory of money (Marx 1976, dos Santos 2012), but recently there have been attempts to go beyond that (Graziani 1997, Bellofiore 2005). Credit and the banking system are regarded as a source of instability, because they allow for temporary expansions of economic activity (e.g. Hilferding 1910). However, Marxists tend to highlight deeper structural factors for the explanation of crises and treat financial factors as amplifying. Additionally, even if finance is accorded more prominence, money and credit are regarded as private relation and there is no active role for the state in the formation of money.

PKE differs from mainstream economics and MPE on several grounds. First, it has a strong focus on demand formation, whereas NCM and MPE tend to favour supply-side factors. PKE offers an analysis of demand regimes that allows for wage-led as well as profit-led growth. There is no a priori assumption that profits get reinvested, and higher wage growth can result in higher aggregate demand. MPE economics routinely assumes that wage moderation has positive growth and employment effects; in other words, they assume a profit-led demand regime.[3] Marxist theory usually has a secondary, short-run role for demand, but it tends to assume that growth is profit-led in the long run (e.g. Dumenil and Levy 1999, Foley and Michl 1999). Crises originate from the (lack of) production of surplus value or from a rising organic composition of capital, not from lack of demand. Indeed, in Marxist theory crises are often regarded as rooted in overaccumulation, i.e. excessive investment due to competitive

[3] A similar argument can be made for mainstream economics. New Keynesian economics has a short-run role for aggregate demand, but asserts the dominance of supply-side factors in the long run, and it is usually silent on the possibility of wage-led growth. Indeed, a downward-sloping labour demand function, i.e. a profit-led demand regime, is routinely assumed.

pressures (e.g. Brenner 1998).[4] PKE regards money as mostly created by commercial banks, whose lending decisions are likely to be pro-cyclical. Consequently, it regards liberalised financial systems as a major source of instability. From this perspective European monetary integration, which led to more capital flows but was not accompanied by stronger financial regulation, appears as a destabilising force. Additionally, since money is not a purely private institution but is backed by government authority, the separation of monetary and fiscal spaces which resulted from EMU threatens to undermine the ability of governments to respond through fiscal policy in times of crises. This analysis is distinct from NCM and MPE analyses, which tend to look to real supply-side factors as explanations for crises, and from the NKM, which recognises financial instability, but regards monetary policy as sufficient for stabilisation except for cases when inflation hits the zero lower bound.

3. Current Account Imbalances, Cost-Competitiveness and Demand Booms

In 1999 current accounts for most European countries were close to balance. However, post 2000, when the EMU was completed, substantial divergences in current account positions among Euro member states became evident. A Eurozone periphery emerged (mainly Spain, Greece, Portugal and Italy) with large and persistent current account deficits, while the Eurozone core (chiefly Germany) registered large surpluses. Germany's external position only turned positive in the 2000-03 period and its external surpluses were as high as 5% of GDP prior to the crisis. However, in the post crisis period, there was substantial adjustment in peripheral countries' external imbalances. On average, external balances improved in the periphery and even reached surpluses for Spain, Portugal and Italy. But this rebalancing was

[4] MPE has theorised constellations that PK would characterise as wage-led demand regimes under the heading of underconsumption crises. However, these constellations create a tension to the Marxist theory of exploitation, because they allow for increased wages to have a positive effect on profitability. The link between exploitation and profitability thus gets broken.

mainly due to demand contraction rather than a catching up effect and German surpluses remained large.

The role of price competitiveness, in particular unit labour costs, in determining these intra-Eurozone imbalances has been a subject of major controversy, especially in PKE. But there is some agreement across the heterodox/orthodox divides on the role of demand developments and financial bubbles in determining trade imbalances, though heterodox and mainstream scholars often arrive at very different policy conclusions. Importantly, there is also disagreement across different schools of thought regarding the significance of current account imbalances for the Eurozone crisis.

3.1 A Post-Keynesian View on Current Account Imbalances and the Euro Crisis

PKE have offered quite divergent accounts of causes of European current account imbalances. German PKs well before the crisis highlighted that Germany has pursued a strategy of real depreciation both through exchange rate policy (e.g. Thomasberger 1995) and later through wage policy (Priewe 2011). They then typically conclude with calls for wage coordination across countries and emphasise that this requires a redirection of fiscal and monetary policy (Hein and Truger 2005). In particular, they argue for higher wage growth and fiscal expansion in the surplus countries. Mazier and Petit (2013) and Cesaratto (2015) maintain that cost divergences are the prime cause of the Eurozone imbalances and that this is due to the lack of exchange rate adjustment imposed by the currency union.

At the other extreme, Storm and Naastepad (2015a, 2015b, 2014) argue that demand factors and not costs are the key drivers of current account imbalances, rather, they are due to differences in credit growth and private debt.[5] Samarina et al (2015), though less polemical against the cost argument, provide econometric evidence for the role of credit in determining current account imbalances. Other post-Keynesians like Stockhammer and Sotiropoulos (2014) take a more balanced view and argue that both costs and demand factors are driving the external imbalances. Though there are disagreements on the determinants of the intra-Eurozone imbalances within PKE, post-Keynesians do find consensus on the policy front. They call for wage coordination with an emphasis of wage inflation in centre countries (Stockhammer, Constantine and Reissl (Forthcoming)).

Though the competitiveness-imbalances debate is of interest in itself, the imbalances are in our view not the key explanatory factor for the Euro crisis. Both the UK and USA have large current account deficits, financial crises and a debt-fuelled boom; yet, these did not lead to sovereign debt crises. The EMU policy architecture is what differentiates the Eurozone from these economies. In particular, the rules on fiscal policy effectively makes them pro-cyclical, which can turn recessions into depressions and the lack of a de facto lender of last resort can turn financial crises into sovereign debt crises. Even if Eurozone member states had balanced external accounts, the separation of monetary and fiscal policy and their pro-cyclical rules would severely hamper responses to banking crises (for instance) and this delayed response alone can lead to further crises.

[5] There is an empirical debate regarding the size and significance of cost and income elasticities of demand for exports and imports. Storm and Naastepad (2015a) estimate import and export equations for selected Eurozone countries and find that unit labour costs are numerically small and statistically insignificant. But these findings are difficult to reconcile with other studies. For instance, Carlin, Glyn and Reenen (2001) investigate the relationship between export market shares and RULC using a panel of twelve manufacturing industries for fourteen OECD countries. They conclude that RULC are important determinants even if they cannot fully explain changing export positions. Using a fixed effect model for a panel of Euro members from 1999 to 2011, Stockhammer and Sotiropoulos (2014) find that unit labour costs have statistically as well as economically significant effects.

3.2 The Mainstream on Current Account Imbalances and the Euro Crisis

Within the mainstream there exist various positions on the reasons for and the significance of intra-Euro current account imbalances, but it is difficult to tie them directly to New Classical or New Keynesian traditions. However, there emerge distinct lines in terms of economic policy recommendations. Wyplosz (2013) argues that fiscal deficits in the periphery caused demand booms, which induced trade deficits. Thus fiscal indiscipline, not cost divergence has caused external imbalances. It follows that fiscal austerity is needed to curb demand booms and chronic trade imbalances.

The European Commission (2010) argues that the current account imbalances are due to different demand developments rather than cost divergences, and that credit booms and property bubbles played an important role in determining demand in member states. However, the main policy conclusion it derives centres on labour market deregulation in the deficit countries: "Member States which have accumulated large current account deficits and large competitiveness losses […] need to undertake the necessary relative wage and price adjustments and facilitate the reallocation of resources from the non-tradable to the export sector. In countries with fiscal imbalances, this adjustment should go hand-in-hand with sizeable fiscal consolidation" (European Commission 2010, 37). While the wage divergence was not at the root of the problem, wage cuts and fiscal austerity are the solution. The European Commission (2011, 14) boldly states, "Labour market reforms will spur job creation and increase wage flexibility".

Benassy-Quere (2015) states that the Euro itself is not the source of the crisis. He argues that a key flaw of the Maastricht Treaty is its deflationary bias: fiscal deficits are capped but this is not so for fiscal surpluses. He calls for a Eurozone budget for stabilisation purposes, debt restructuring and shared sovereignty, meaning that surplus countries need to reduce the gap between demand and supply, in other words, the burden of adjustment must be symmetrical. This is in line with PKE in that current account imbalances are not the cause of the crisis and that the roots of the crisis lie in the EMU policy regime. Similarly, De Grauwe (2015) argues that the crisis is related to the design flaws of the Eurozone and that the external imbalances are related to booms and busts rather than costs divergences. He contends that the absence of a lender of last resort is the key reason for the crisis – as a general solution, he recommends further political integration to ensure that political will is present to address the current and future crises.

3.3 Marxists on Current Account Imbalances and the Euro Crisis

Lapavitsas et al (2012) argue that the Euro crisis is closely tied to the Eurozone's external imbalances, with the latter being primarily determined by cost divergences. Much blame is placed on mercantilist Germany and its wage suppression strategy. Flassbeck[6] and Lapavitsas (2013) argue that in a common currency, wages across member states must grow in line with the union's inflation target, any deviation leads to imbalances and crises, although the mechanism which actually triggers the crisis is left rather vague. Southern economies substantially overshot the defined wage target at the same time as core economies (especially Germany) undershot it before the crisis, meaning that both must adjust. Given their analysis, Lapavitsas (2015a, b) calls for deficit countries to exit the Euro. Though this view is similar to post-Keynesians like Priewe (2011) and Mazier and Petit (2013), it is in contrast to the majority view in PKE. Unlike PKE, Marxist explanations appear to implicitly assume a

[6] Heiner Flassbeck, who has been a very vocal commentator on the Eurozone crisis, can be characterised as an (old-) Keynesian economist, rather than a Marxist. His work has frequently emphasised the shortcomings of the EMU fiscal framework (e.g. Flassbeck, 2012), but his work with Lapavitsas in particular is more in line with Marxist views in that it has strongly highlighted the role of current account imbalances and divergences in cost-competitiveness and is sceptical about the possibility of a reform of the EMU policy framework along the lines advocated by PKs.

profit-led demand regime: stagnant wages in Germany produces profit-led growth dynamics, in particular, export surpluses. A problem with this story is that even if one accepts the alleged primacy of relative ULC in determining trade balances, the theory lacks an explanation of why economic growth in the deficit countries consistently *exceeded* that of the surplus countries.

Lapavitsas (2015a, b) argues that the main purpose of the Euro project is to serve the European hegemon – Germany. Varoufakis (2016) extends this argument and notes that the USA pushed for European integration to expand the market for German exports. He explains that this was part of US foreign policy after they were no longer a surplus country. If Germany is able to build up its external surpluses, it provides a pool of savings that can be recycled into the US economy. Given this line of reasoning, there is a hegemonic power dynamic to the Euro crisis and, following Lapavitsas (2015a, b), a Euro exit might reclaim some power, in particular, monetary control. Overall the Marxist approach focuses on the role of cost divergences and downplays the role of capital flows and real estate booms as factors that lead to demand booms, which can induce trade deficits. It understands the Euro crisis as a balance of payment crisis due to the fixed exchange rate system rather than the outcome of a flawed EMU policy framework.

The central finding of this section is that there is no consensus on the causes of the Eurozone imbalances and the role they played in the Eurozone crisis. Table 1 groups the literature in terms of what they regard as the main cause of the imbalances and what their policy suggestions are.[7] Interestingly most mainstream contributions identify different demand

[7] It should be noted for this as well as for subsequent tables that in many cases, any individual listed contribution does not exhibit all the positions attributed to the cell in which it is placed. However, we believe that the sets of

developments as the main cause of imbalances. These are often linked to financial factors. However, in some cases their policy recommendation is internal devaluation, i.e. wage cuts, and fiscal austerity in the deficit countries (European Commission (2010)). Other mainstream economists draw different conclusions from the strong role of financial factors. Baldwin et al (2015) also identify private debt booms as the core cause of the crisis. They warn against excessive austerity and do not discuss labour market reforms. Wyplosz (2013) is one of the few mainstream contributions that highlight fiscal profligacy as the cause for imbalances. Marxists along with some post-Keynesians have highlighted cost divergences as the major factor for the imbalances. As a consequence, Lapavitsas (2015a, b) advocates Euro-exit. However, the majority of PKE and some New Keynesians see the root cause of the crisis in the flawed design of the EMU policy regime.

contributions in each cell taken together do represent the respective opinions on causes of and solutions for the Eurozone crisis in a fairly coherent fashion.

Table 1. The determinants of current account imbalances and policy recommendations

	Euro-exit for deficit countries or a dissolution of the Euro	Internal devaluation and fiscal austerity in deficit countries	Fiscal discipline at member state level, & Automatic stabilizers at Union level	Inflationary fiscal and wage adjustment in Centre countries
Fiscal indiscipline as cause of current account imbalances		Wyplosz (2013)		
Cost divergence as cause of current account imbalances	Flassbeck and Lapavitsas (2013), Lapavitsas (2015a, b)			Cesaratto (2015), Priewe (2011) Stockhammer and Onaran (2012),
Capital flows and credit booms as cause of current account imbalances		European Commission (2010)	Benassy-Quere (2015), De Grauwe (2015)	Stockhammer (2016), Storm and Naastepad (2015a,b, 2014)

4. The effects of austerity and fiscal policy strategies

Beyond examining the causes and effects of European current account imbalances, most analyses of the Eurozone crisis also discuss the roles of fiscal and/or monetary policies both during the build-up of the crisis, and to explain subsequent developments and suggest solutions. This section examines the role of fiscal policy while the next looks at monetary policy.

Prior to the eruption of the crisis, fiscal situations within the Eurozone were fairly diverse, with some governments (including soon-to-be crisis countries such as Spain or Ireland) running budget surpluses and decreasing government debt to GDP ratios, and others (including core countries such as Germany and France but also soon-to-be crisis countries such as Greece) running more or less sustained deficits and accumulating debt. When the US financial crisis began to spread over to Europe, European governments initially allowed budgets to move into large deficits (exceeding, sometimes by far, 10% of GDP in those countries which would subsequently be hit by the sovereign debt crisis) produced both by expansionary fiscal policy and rescue measures in the banking sector. These measures, coupled with decreases in GDP led to (in some cases very sharp) increases in debt-ratios. The phase of expansionary policy soon came to an end as initial stimulatory measures appeared to have paved the way for recovery, economic policy-makers (and parts of the economics profession) began to view government debt as a potential obstacle for a sustained recovery, and as financial markets began to question the solvency of certain Eurozone economies.

Since then, a period of fiscal tightening aimed at decreasing budget deficits and debt-ratios has followed, which was relatively more severe in the Eurozone than in the Anglo-Saxon economies and, within the Eurozone, far more severe in the peripheral countries caught in the sovereign debt crisis due to the conditions imposed on these countries by the creditor countries within the EMU's fiscal policy framework (see Stockhammer et al., 2016).

4.1 A Post-Keynesian view on fiscal policy and the Eurozone crisis

PK economists have been consistent in arguing that the EMU fiscal policy regime is flawed both before and after the introduction of the common currency (e.g. Godley, 1992, 1997; Arestis et al., 2001). The separation of monetary and fiscal sovereignty and the consequent restrictions placed on fiscal policy both through formal rules (the Maastricht criteria) and the potential absence of a monetary policy supporting any individual country's fiscal stance have been viewed as major shortcomings of EMU. This view is based on the PK understanding of money as a creation of state-authority which implies that the fiscal constraints faced by governments spending in a currency which they do not issue is fundamentally different from those faced by others. Thus PKs argued long before the Eurozone crisis that the currency union was ill-prepared to combat serious downturns since the constraints placed on fiscal policy would prevent an adequate policy response and more generally exert a deflationary bias on the Eurozone economies (Hein and Truger, 2002). Out of all the approaches we survey, this aspect has been the most central to PK analyses as there exists a consensus within that paradigm that fiscal policy is an essential stabilisation tool. The emphasis on fiscal policy measures to stabilise output in PKE arises both from a relative scepticism of the efficacy of monetary policy in attenuating economic fluctuations, and from its analytical framework which holds that capitalist economies are not self-adjusting toward full employment. While in mainstream models fiscal policy (and thus also austerity) typically only has short-run impacts, PKE strongly emphasises the hysteresis effects of both booms and recessions (e.g. Stockhammer, 2008). This, in conjunction with a rejection of the premises of expansionary austerity (Botta, 2015) also means that PKs advocate *discretionary* fiscal stimulus.

PKE views fiscal stances as a key reason for the prolonged depression in the Eurozone periphery and conversely, that these depressions can only be brought to a conclusive end through sustained expansionary fiscal policy. Based on recent estimates of regime-dependent multipliers Stockhammer et al. (2016) show that a large share of the divergent performances of Anglo-Saxon and European core economies on the one hand, and peripheral economies on the other hand can be explained through their differing fiscal stances. The conditions imposed on those countries caught in sovereign debt crises are viewed as counterproductive, both in terms of reducing debt-levels and, more importantly, in producing a recovery. PKE also rejects the claim that excessive government deficits prior to the GFC are to blame for the Eurozone crisis and rather highlights the role of private sector debt and inequality in driving credit-led booms (and producing current account imbalances) both within and outside Europe which eventually unravelled in 2007-2008 (Stockhammer, 2015), causing deep recessions in most of the developed world, including the US and the UK, but only leading to a sovereign debt crisis in the European periphery due to the EMU's fiscal and monetary policy framework.

While PKE agree in their criticism of current fiscal policy within the Eurozone as well as with the fiscal policy regime of the EMU in general, there is some disagreement regarding the relative importance of these aspects in explaining the Eurozone crisis. Some PKs, in particular those close to Modern Monetary Theory, have well before the crisis highlighted that the EMU's institutional set-up would at some point lead to sovereign debt crises and force governments into austerity (Parguez 1999, Bell 2003; see also Lavoie, 2013). These authors generally place less emphasis on the role of intra-Eurozone current account imbalances as a cause of the crisis since these are viewed as a less important explanatory factor in light of the existing TARGET2 system, and rather argue that the Eurozone's institutional set-up has increased the risk of financial instability in general at the same time as restricting the possibility of responding to financial crises. Other PKs stress current account imbalances and interpret the Eurozone crisis as a balance-of-payments crisis (Cesaratto, 2015), arguing that excessive current-account imbalances eventually led to a sudden stop in capital flows akin to those observed in classic examples of balance-of-payments crises, which subsequently led to deep recessions (see Febrero et al., 2016 for a summary of this debate). Nevertheless, there is consensus within PKE that the existing institutional set-up of the EMU with regard to fiscal policy is seriously flawed, that austerity has seriously exacerbated the crisis, and also that the Eurozone crisis could have been avoided under a different regime, a view which is shared even by advocates of the balance of payments view (ibid.). The separation of monetary and fiscal policy spaces within the EMU can explain why the financial crisis turned into a sovereign debt crisis only in the Eurozone. With monetary policy being delegated to a supra-national authority, member states surrendered the sustainability of their public finances to the sentiments of private bond markets and were forced into austerity when these markets lost confidence and the monetary authority did not provide sufficient support due both to its statute and to existing conventions regarding the support of fiscal policy through central bank actions (see Lavoie, 2015). For this reason, PKs advocate a fundamental reform of the EMU which enables the implementation of countercyclical and *discretionary* fiscal policy actions at the European and/or the national levels (Hein, 2013; Stockhammer, 2016).

4.2 Mainstream views on fiscal policy: from the New Consensus to New Classicals versus New Keynesians

Whereas PK opinions of fiscal policy have been highly uniform, the dominant view on fiscal policy within the broadly-defined neoclassically inspired mainstream of economics has varied over time. Before the Eurozone crisis, much of the academic literature was focused on investigating how fiscal policy could best be constrained (Fatàs and Mihov, 2003). As Mongelli (2002) notes, the costs of currency unions in terms of losses of policy autonomy were increasingly de-emphasised in the OCA literature. The main problem, in the Eurozone and elsewhere, was widely held to rather be fiscal indiscipline (Afonso, 2005). Additionally, fiscal stimulus was increasingly viewed as being ineffective based on empirical research (Hemming et al, 2002), and the idea of expansionary fiscal consolidations (Giavazzi and Pagano, 1990) was gaining traction. Overall, these research programmes contributed to a convergence between the NC and NK strands of mainstream economics, leading to the emergence of the 'New Consensus' model in which macroeconomic stabilisation was envisioned to be fully undertaken by monetary policy conducted through an independent, inflation-targeting central bank. The EMU’s focus on fiscal discipline and the high degree of independence granted to the ECB thus very much reflected the mood of the time.

With the outbreak of the GFC, however, a divergence within the mainstream has emerged. With regard to the Eurozone crisis in particular, two broad views can be distinguished. Some mainstream analysts, whom we characterize as New Classicals, regard the Eurozone crisis as arising from insufficient fiscal discipline. For instance, Wyplosz (2013) seeks to show empirically that European current account imbalances were largely caused by public deficits and argues that austerity is necessary to curb these imbalances. Feld et al. (2015) argue that a lack of fiscal discipline, which in their view also contributed to private debt build-ups, lies at the root of the crisis. While Sinn (2015) does not believe that the Eurozone crisis has fiscal roots, he nevertheless argues that austerity is now inevitable to restore competitiveness, provide incentives for ‘structural reforms’ and ensure fiscal sustainability. The possibility of fiscal expansions financed at the European level (e.g. through the issuance of Eurobonds or similar measures) would in this view create moral hazard and should be avoided, a view that is particularly widespread among German economists (Merz et al., 2011). While it cannot be said that this ‘New Classical’ view represents a clearly strand in mainstream economics, it has been dominant, whether for economic or political reasons, in the policy response to the Eurozone crisis which has primarily focussed on attempts to reduce levels of sovereign debt through austerity.

A second view, which may be termed New Keynesian, argues that solvency issues of EMU member states are merely a symptom of the crisis. This strand generally regards austerity as damaging in the short run, but sees fiscal consolidation as necessary in the medium to long run, with the degrees of emphasis differing between authors. Many contributions in Baldwin and Giavazzi (2015) lament a lack of fiscal discipline prior to the crisis but none of them view the crisis itself as having fiscal roots. Tabellini (2015), whose research before the crisis highlighted reasons for fiscal indiscipline (e.g. Alesina and Tabellini, 1990), now takes a position on the shortcomings of the EMU fiscal policy regime similar to arguments put forward by PKs, but remains more cautious regarding reform of the policy framework (Tabellini, 2016). Similar views have been expressed by De Grauwe (2015). De Grauwe and Ji (2013) seek to show that Eurozone austerity has been highly damaging and unhelpful in the short run. De Grauwe (2011) has, out of all New Keynesian writers, probably come closest to the analyses advocated by PKE, arguing that the EMU's fiscal policy regime, and particularly the fact that the ECB has, other than the Fed or the BoE, not acted as a de facto lender of last resort for governments are the key factors in explaining and providing solutions for the Eurozone crisis. Shambaugh (2012) recognises the fundamental connection between banking crises, sovereign debt crises, austerity and stagnation and advocates a holistic solution which tackles all aspects of the crisis, including a reform of the fiscal and monetary framework to prevent sovereign debt crises. Thus, while differences of analytical frameworks persist, there has been a convergence between the policy proposals advocated by PKE and certain parts of neo-classical economics. At the same time however, the NK literature contains surprisingly little application of recent research results on fiscal multipliers (which itself in large parts emanated from a New Keynesian perspective) to discussions of the Eurozone crisis. Frankel (2015) emphasises the effect the underestimation of fiscal multipliers documented by Blanchard and Leigh (2013) has had in the context of Eurozone austerity. However, the literature contains no systematic connection between New Keynesian research on non-linear and regime-dependent effects of fiscal policy (Gechert et al., 2015; DeLong and Summers, 2012) and practical policy recommendations for the Eurozone as there has been for the US

(Ball et al., 2014). Thus, for instance, while PKs stress the need for discretionary fiscal policy actions to combat recessions, the New Keynesian mainstream largely concurs with the Five Presidents' Report according to which automatic stabilisers at the European level would be sufficient (cf. Reissl and Stockhammer, 2016) and should be combined with enhanced fiscal discipline at the national level (e.g. Pisani-Ferry, 2016; Tabellini, 2016). More broadly, most neo-classically inspired economists share the view that any adverse effects of austerity will be contained to the short run and that fiscal consolidation will be beneficial at least in the long run, in line with a view of the economy as supply-determined over longer time-horizons.

4.3 Marxist views on fiscal policy

It is difficult to identify a uniform Marxist view on fiscal policy in general and in the context of the EMU in particular. Many Marxist-inspired analyses broadly agree with the PK case for fiscal policy effectiveness and stress the adverse effects of austerity (Bellofiore, 2013; Bellofiore et al., 2015).[8] However, some Marxist authors doubt the general effectiveness of fiscal policy. For instance, Roberts (2012, 2016) argues that Keynesian multipliers ignore the effects of different types of government activity and induced expenditures on the rate of profit. He contends that Keynesian multipliers should be replaced with Marxian ones, which take into account the effects of public spending programmes on the rate of profit, which itself to the conclusion that fiscal stimulus is ineffective (see Carchedi, 2012). Ivanova (2012) argues that the GFC is merely a symptom of a deeper structural crisis of accumulation manifested in global imbalances, which are outcomes of the processes of globalisation and financialisation. Fiscal policy interventions, while perhaps providing a temporary relief, cannot address these fundamental imbalances such as a global over-accumulation of capital,

[8] Riccardo Bellofiore is quoted here as a Marxist, but he regards himself as both a post-Keynesian and Marxist. Theoretically he tries to square a Marxist labour theory of value and a PK theory of endogenous money and financial instability.

and thus do not provide a lasting solution. Regarding the Eurozone crisis in particular, Marxian analyses emphasise current account imbalances and divergences in competitiveness (see previous section), linking them to power relations between core and peripheral economies, while detailed discussions of the effects of fiscal policy do not feature as prominently (e.g. Lapavitsas 2015a; Flassbeck and Lapavitsas, 2013). As we shall see, a similar conclusion can be reached regarding Marxist analyses of monetary policy.

Table 2 summarises the views outlined above with regard to fiscal policy. PKs have consistently been highly critical of austerity and the abandonment of fiscal stabilisation policy in mainstream economics prior to the crisis. They argue that a fundamental reform of the EMU's fiscal policy regime is necessary to enable expansionary policies to combat the crisis. The views among those economists inspired by the neoclassical paradigm meanwhile, are today less uniform than they were before the Eurozone crisis and two broad views can be discerned.[9] One views austerity as necessary to overcome the crisis while the other, to varying degrees, is in favour of some form of expansionary policy. Marxists reject the view that the Eurozone crisis was caused by fiscal indiscipline but are divided on whether a reform of the EMU's fiscal framework and fiscal expansion can provide a remedy.

Table 2. A summary of arguments on fiscal policy and the effects of austerity

	Fiscal Policy cannot conclusively solve the Eurozone crisis	Austerity to curb excessive demand and/or lack of competitiveness in periphery	Enhanced discipline at member state level & some degree of fiscal policy at European level	Fundamental reform of EMU fiscal policy regime enabling discretionary fiscal policy

[9] While there obviously exists some heterogeneity even within these two groups, we do think that the similarities are sufficient to justify our categorisation.

<table>
<tr><td>Fiscal indiscipline as cause of Eurozone crisis</td><td></td><td>Wyplosz (2013), Feld et al. (2015)</td><td></td><td></td></tr>
<tr><td>Eurozone crisis is not due to fiscal factors</td><td rowspan="2">Lapavitsas (2015a), Flassbeck and Lapavitsas (2013)</td><td>Sinn (2015)</td><td rowspan="2">Tabellini (2016), Pisani-Ferry (2016), De Grauwe (2015)</td><td rowspan="2">Hein (2013), Stockhammer (2016), Bellofiore et al. (2015)</td></tr>
<tr><td>Austerity has exacerbated crisis in Europe</td><td></td></tr>
</table>

5. Financialisation, credit booms and monetary policy

The period prior to the GFC and the subsequent Eurozone crisis was characterised by an increase in the perceived importance of monetary policy in macroeconomic stabilisation and major central banks used interest rate policies in order to target the rate of inflation through attempting to influence output gaps and unemployment. The ECB was no exception, although it has been regarded as having a superior degree of independence and a stronger focus on price stability than other major central banks (Bibow, 2010). European monetary integration meant that a uniform monetary policy was applied to all Eurozone economies, with the ECB targeting inflation for the entire currency union. In addition, integration also lead to a convergence of interest rates across the Eurozone, with rates in peripheral countries converging toward the lower ones in core economies.

The period prior to the crisis was also characterised by rising levels of private sector debt throughout Europe, as well as asset price booms, particularly in housing, in many countries (Stockhammer, 2016). These phenomena coincided with what has been described as an "increasing importance of financial markets, financial motives, financial institutions, and financial elites in the operation of the economy and its governing institutions, both at the national and international levels" (Epstein, 2005, p. 3), summarily termed financialisation (see e.g. Stockhammer, 2012).

When asset price booms came to an end and the GFC began to feed back on the real economy, Central banks reacted through cutting interest rates,[10] but as rates were approaching their lower bounds, more wide-ranging measures were believed to be necessary (Joyce et al., 2012). Large scale asset purchase programmes, often referred to as quantitative easing (QE) were instituted by the Federal Reserve and the Bank of England. The ECB was overall more hesitant (De Grauwe, 2011). A full-blown QE programme comparable to those of the US and the UK was not implemented until early 2015 and prior to this, the ECB focussed on purchasing private sector assets rather than government debt (Cukierman, 2013; Tabellini, 2015; Micossi, 2015) and on lending to the financial sector on a large scale through the LTRO programme. The QE programmes in the Anglo-Saxon countries were enormous in size, quadrupling the size of central bank balance sheets (Fawley and Neeley 2013) and monetary policy has remained strongly expansionary up to the time of writing with only the Fed slowly beginning the process of tightening.

5.1 Financialisation, credit booms, and the role of the ECB – a post-Keynesian view

PKs have been highly critical of the role of monetary policy in the mainstream 'New Consensus' model (Fontana, 2009, Bibow, 2010), and have questioned mainstream accounts of the monetary policy transmission mechanism (e.g. Rochon and Rossi, 2006; Hannsgen, 2006; Forder, 2006) which formed the theoretical basis of the conduct of monetary policy prior to the crisis. Overall, PKs doubt that inflation-targeting monetary policy is an

[10] The ECB's response was notably more tardy than those of other central banks since it kept rates at levels more appropriate to conditions in core economies and even raised them twice in 2011, whilst the periphery was suffering a severe recession.

appropriate tool to dampen macroeconomic fluctuations. PKs have also noted that mainstream accounts do not sufficiently discuss the role of monetary policy in managing financial instability (Morgan, 2009; Tymoigne, 2009). Accounts of the build-ups of financial fragilities in the global economy and within Europe in the context of an increasing financialisation of advanced economies, often linked to increasing degrees of income inequality, have been central to PK explanations of the GFC and its aftermath in the Eurozone (Palley, 2013; Stockhammer, 2014; Samarina et al., 2015). Since financial instability and credit bubbles play a central role in PK theories of crises and explanations of the Eurozone crisis (Stockhammer, 2016), whilst PKs are more doubtful about the ability of monetary policy to dampen output fluctuations, the PK perspective argues that financial stability should become a primary goal of central bank policy, a view which was perhaps more controversial before the crisis than it is now (see IMF, 2013). Financial stability could be achieved through targeted interventions in markets exhibiting bubble-dynamics (Palley, 2004).[11] In PKE, the origin of financial bubbles is viewed firmly in private markets rather than in government interventions.

PKs also argue that unconventional monetary policies such as quantitative easing by themselves are suboptimal tools for curing recessions (Fullwiler, 2013). While it is accepted that asset purchase programmes have been successful in depressing long-term interest rates, PKE has long argued that low rates during a depression are unlikely to lead to an increase in borrowing and expenditure (Sawyer, 2009). In an empirical study of the UK case, Lyonnet and Werner (2012) do not find significant effects of QE on real economic activity. While PKs

[11] There is an emerging literature on the potential interactions of and conflicts between conventional, inflation-targeting monetary policy and macro-prudential policy aimed at increasing financial stability (see e.g. IMF, 2013, De Grauwe and Gros, 2009). Much work remains to be done in this area, and there have not to our knowledge been PK contributions on the potential for conflict in particular. However, PKs have discussed models in which the central bank does not undertake to control inflation at all, with that objective being for instance taken over by distributional policy (Hein and Stockhammer, 2009).

argue that conventional or unconventional monetary policy is an imperfect substitute for fiscal policy in reviving economic activity, they emphasise that such programmes can provide manoeuvring space for Eurozone countries through depressing rates on government bonds (Lavoie, 2015; Stockhammer, 2016). The ECB did not, either directly or indirectly, act as a lender of last resort to those peripheral governments facing solvency problems. By contrast, the Fed and the BoE, through their large-scale asset purchase programmes, did act as *de facto* lenders of last resort to their governments. In the PK view, the ECB has been a lender of last resort only to the private sector, both through extensive lending programmes and asset purchases and it has arguably been successful in effectively bailing out the private sector. Only in early 2015 did it begin to purchase public sector securities on a broader basis (Claeys et al., 2015). Since the ECB, due to existing statutes, conventions, and the prevailing political environment did not credibly ensure the solvency of all Eurozone national governments, a sovereign debt crisis (and the consequent large-scale austerity measures) could emerge, providing a rationale for the large austerity programmes which followed, whereas there was never a danger of sovereign debt crisis for the US or the United Kingdom. The tight connection between monetary and fiscal spaces set out above in this way becomes key to PK explanations of the Eurozone crisis. A reform of European fiscal policy along post-Keynesian lines would thus also entail a reorientation of monetary policy and the ECB's mandate which allows the ECB to support national and/or supranational fiscal policies during times in which fiscal expansions are necessary and which makes financial stability a primary objective of its policy.

5.2 Mainstream: from EMH to undertheorised QE

Before the GFC, the mainstream held that monetary policy can affect the real economy in the short run (Woodford, 2009); that it should be the primary or only stabilisation tool, and that it should be used to target inflation (IMF, 2013). Importantly, the main task of monetary policy was to target variables in the real economy rather than stability in financial markets. Following the move toward unconventional monetary policy in the wake of the GFC, the Fed's QE programme was initially justified by its Chairman Ben Bernanke using the money multiplier model (Bernanke, 2009), but over time, justifications for such programmes became more sophisticated, with attempts to take into account the complex effects QE might have on financial markets (Ricketts, 2011). There remains, however, some disagreement among neoclassically-inspired economists about the efficacy, particularly in terms of stimulating real economic activity, of QE (cf. e.g. Joyce et al., 2011, Martin and Milas, 2012, Hausken and Ncube, 2013)

Analyses of QE or, more broadly, of the proper tools and goals of monetary policy during and after financial crises raise several thorny issues for which neoclassically-inspired approaches are ill-equipped. In this field policy has proceeded ahead of conventional economic theory. Such analyses require both a theory of money creation and a theory of the functioning and stability of financial markets. Both have become subject of debates within the mainstream. Before the GFC the view that financial markets are, by and large, efficient and stable was dominant especially in macroeconomics, justifying a relative neglect of the role of financial markets in that field. However, there has since been a substantial amount of research that demonstrates the link between build-ups of private debt, often associated with real estate bubbles, and economic crisis (e.g. Schularick and Taylor 2012, Drehmann et al 2012). This research, while done by mainstream institutions, is typically empirically driven rather than theory-guided and has a broad historical sweep which is not focused on the Euro crisis. Thus, while Baldwin et al. (2015) argue that the private debt and in particular private cross-border lending is an important factor in explaining the Euro crisis, the theoretical aspects of such arguments in conventional economics remain underdeveloped. A debate has also emerged regarding theories of money creation and their importance in macroeconomic arguments. Before the crisis, the New Consensus model implicitly acknowledged the endogeneity of the money supply but portrayed it as a policy choice of the central bank and did not accord much importance to this issue. At the same time, arguments based on exogenous money continued to be used, for instance, as mentioned above, in initially justifying QE. Since the crisis, various publications have come closer to the theory of endogenous money as long advocated by PKE but there continue to be debates regarding the mode of money creation and the importance of this issue (McLeay et al., 2014, Krugman, 2014).

Regarding the role of credit booms and monetary policy in the Eurozone crisis one can once more discern a rift among neoclassically-inspired authors. A New Classical camp argues against the measures which the ECB has taken to date. As became apparent in our analysis of different views on current account imbalances, this New Classical view also comprises both writers who believe that (public or private) credit-led booms are important in explaining the crisis and writers who stress 'real' factors, chiefly divergences in competitiveness as causal factors (e.g. Feld et al., 2015; Sinn, 2015; Wyplosz, 2013). Their criticisms of unconventional monetary policy have mostly focused on warnings about a conflation of fiscal and monetary policy which is perceived as a threat to central bank independence. Issing (2012) contends that unconventional monetary policies could compromise central banks' focus on price stability. Sinn (2010) argues that Eurozone QE creates moral hazard and might endanger reforms and austerity, which he views as necessary. Drudi et al. (2012) concur, arguing that Eurozone QE should be tied to strict conditionalities.

Similarly to the debate about fiscal policy, however, there is here also a NK camp which argues that the extensive unconventional monetary policy measures by the ECB are necessary to promote recovery (Levy, 2014; Giavazzi and Tabellini, 2015), and that these can be designed so as to avoid moral hazard (De Grauwe and Ji, 2015). Additionally some exponents of New Keynesian views have begun to stress the implications of the ECB's monetary policy for national fiscal policies which are also highlighted by PKs (De Grauwe, 2011). NK contributions also frequently stress the role of credit bubbles in explaining the Eurozone crisis and some have come close to PK positions in arguing that financial instability is a basic feature of capitalist economies (Baldwin and Giavazzi, 2015, p. 54) and that the Eurozone crisis is at its root a crisis of private finance (Shambaugh, 2012). However, they stop short of calling for a comprehensive reorientation of monetary policy in light of these arguments.

Despite an increase in discussions of the role and stability of financial markets within conventional economics and despite contributions particularly within the New Keynesian paradigm which highlight the important role of inherent financial instability in causing economic crises, there has been little academic discussion of the potential effects of the move toward a European Capital Markets Union (CMU) which has been promoted by the European institutions as a reform leading to growth and employment creation as well as greater financial stability. While from a PK perspective, the CMU, particularly in its current form,[12] reinforces the potential for financial instability and certainly will not function as a countercyclical 'buffer' against recessions (Reissl and Stockhammer, 2016), the few discussions of CMU which exist from a neoclassically-inspired perspective have largely concurred with the European institutions that CMU will enhance the functioning of the

[12] It remains to be seen to what extent the Brexit vote and the subsequent resignation of Jonathan Hill, who was a driving force behind the current plans for the CMU's regulatory framework will bring about a change of course.

common currency and reduce financial instability (Valiante, 2016; Martinez and Philippon, 2014). However, one can discern an increased concern with the potential effects of CMU on financial stability in some contributions, even though they remain in favour overall (Véron and Wolff, 2015).

5.3 Monetary policy and financial crises in Marxist analysis

The general lack of coherence regarding Marxist theories of money and finance make it difficult to identify a uniform Marxist position on monetary policy. Indeed, there are few publications which explicitly discuss this topic in the first place. One exception is Roberts (2016) who, in discussing responses to the GFC, invokes Keynesian arguments to claim that monetary policy is likely to have little effect in promoting a recovery from deep recessions. Roberts (2015) maintains that "in a slump or crash, capitalists try to hoard and avoid investment. If profitability stays low, then even a low rate of interest or mountains of 'liquidity' will not release that hoard". Thus, once more, the rate of profit becomes the crucial variable in judging the effectiveness of stimulatory measures. Ivanova (2012) holds similar views about monetary policy and emphasises that financial crises are merely reflections of deeper, structural imbalances and thus that financial explanations of the GFC are inadequate. Lombardi (2014) warns about potential inflationary effects of QE thus adopting a conclusion rather akin to what a monetarist might argue. There do not appear to be any Marxist-inspired contributions about monetary policy in the context of the Eurozone crisis in particular. And although some Marxist authors have written extensively on financialisation (e.g. Lapavitsas, 2011), there also does not appear to be any systematic Marxist treatment of financial instability and credit bubbles in the context of the Eurozone crisis. The work of Flassbeck and Lapavitsas (Flassbeck and Lapavitsas, 2013) is a partial exception in that it contains an extensive discussion of private credit bubbles in the Eurozone periphery. Nevertheless, the focus remains squarely on ‘real’ factors, especially divergences in unit labour costs which are viewed as the fundamental cause of the crisis (cf. also Lapavitsas, 2015a, b). Bellofiore et al. (2015), however, agree with the point, most prominently associated with PKE, that the design flaws of the EMU, with the separation of fiscal and monetary spaces and the lack of an effective de facto lender of last resort for governments must play an important role in explanations of the Eurozone crisis.

Table 3 provides a brief overview of the different opinions on monetary policy, quantitative easing, and the role of credit bubbles and financial instability. PKs view monetary and fiscal policy as closely connected in that monetary policy regimes and practical policy decisions can exert strong influences on fiscal policy space. Since PKs believe that fiscal policy measures are necessary to combat the Eurozone crisis, they argue that these must be supported by ECB action. Furthermore, they question the primacy of monetary policy in stabilising output fluctuations and argue that monetary policy should be used to prevent private credit bubbles, which for PKs represent a major source of economic instability. Consequently, a European CMU is not seen as helpful in promoting financial and economic stability. The opinions expressed by neo-classically inspired authors are varied, with differing views on the importance and causes of financial instability in explaining the Eurozone crisis. A clearer division emerges with respect to the desirability of QE, with many analysts opposing it on the grounds of moral hazard and others supporting it. The Marxist position, if any can be discerned, seems to be that financial instability and credit bubbles in the Eurozone are less important than ‘real’ factors in explaining the Eurozone crisis and that monetary policy can do little to solve the crisis.

Table 3. Credit booms and monetary policy positions

	Monetary policy reform will not solve the Eurozone crisis	ECB policy produces moral hazard	ECB policy action necessary for recovery	QE & reform of ECB necessary to support fiscal policy
Financial bubbles a major factor for the Euro crisis		Feld et al., 2015	Giavazzi and Tabellini, 2015 De Grauwe and Ji, 2015	Lavoie, 2015 Stockhammer, 2016
Euro crisis caused by 'real factors'	Flassbeck and Lapavitsas, 2013	Sinn, 2010 Drudi et al., 2012		

We view PK explanations of the Eurozone crisis and consequent proposals for its resolution as the most coherent. The policies advocated by those analysts whom we have summarised under the heading of New Classical economics have been successfully applied throughout the periphery for years without apparent success. The New Keynesian strand of mainstream economics questions some of these views, but does not present a comprehensive challenge to them as it often stops short of drawing conclusions which fundamentally undermines these views. Meanwhile, Marxists have primarily been advocating exits from or a dissolution of the Eurozone. As Realfonzo and Viscione (2015) point out such proposals must however be coupled with comprehensive policy recommendations on what to do following such a step, going beyond the hope for stimulatory effects from nominal depreciations. Furthermore, it appears that no Eurozone government (or indeed the population of any Eurozone country) is willing to leave the common currency, justifying the focus of most PKE authors on ways to reform the EMU. The next section provides a more comprehensive discussion of the issues presented thus far.

6. Economic paradigms and economic policy strategies for the Euro area

This paper has surveyed a large number of different views, both theoretical and empirical, on the Eurozone crisis. Contrary to what the title of Baldwin and Giavazzi (2015) suggests, there is no consensus view on the causes of or remedies for the crisis. Table 4 summarises the different policy conclusions which have emerged from this survey. We identify four policy strategies and will evaluate to what extent they can be mapped to the four theoretical paradigms.

Table 4. Policy strategies for the Euro area

	Progressive Exit	European Orthodoxy	Moderate Reform	Keynesian New Deal/Social Europe
Current account imbalances	Euro-exit for deficit countries or a dissolution of the Euro.	Internal devaluation and fiscal austerity in deficit countries to restore competitiveness.	Restoration of competitiveness is necessary but should not be accompanied by austerity.	Inflationary adjustment in Centre countries: higher wages and fiscal expansion.
Fiscal Policy	Either siding with PKE or holding fiscal policy to be ineffective in solving crisis viewed as structural.	Austerity and enhanced fiscal discipline at national level. European fiscal policy produces moral hazard.	Fiscal discipline at national level but introduce automatic stabilisers at European level.	Refom EMU policy framework to allow discretionary fiscal policy at national and/or European level.
Monetary Policy & Financial Markets	As above.	Unconventional monetary policy action must be tied to conditionalities (moral hazard).	QE to stimulate economic activity.	QE important to support fiscal policy. Reform of ECB mandate. Monetary policy to promote financial stability.
Labour market policies		High priority for labour market reform	Labour market flexibilisation desirable, but may have negative short term effects	Opposed to LM flexibilisation; Wage-led growth strategy

The *Keynesian New Deal/Social Europe* policy package calls for a thorough reform of the EMU's fiscal and monetary policy framework. Firstly, the ECB must, in future crises, reliably act as a *de facto* lender of last resort to Eurozone governments to ensure sufficient liquidity provision to governments who need to undertake expansionary policies. This would necessitate changes to the legal framework (Bonizzi et al., 2015) and would constitute a substantial change in the conventions which have hitherto framed the acceptable range of monetary policy actions for the ECB (Lavoie, 2015). Secondly, it would involve orienting fiscal policy towards full employment and requires coordination of fiscal policies (to ensure inflationary adjustment in the surplus countries) as well as a substantial fiscal capacity at the European level. Again this would require treaty changes. Proposals to this effect abound (e.g. Palley, 2016, Watt, 2015, Varoufakis et al., 2013), ranging from overt monetary financing of the European Investment Bank to the establishment of a European Finance Ministry, but they all have in common some mechanism whereby appropriate fiscal stances are at least partly decided at the European level. Such a fiscal policy strategy would no longer have fiscal discipline as commonly defined as its main goal and would not target any specific level of government debt or public deficits. Third, in terms of financial market regulation it would lean against the wind, both in terms of macroprudential regulation, but also involving controls of credit growth.[13] Fourth, to the extent that current account imbalances reflect divergences in productive structures or in cost competitiveness, they should be combated through large scale public investment programmes in the periphery, financed through the channels outlined above, and industrial policies. Fifth, a European wage policy should aim at a stable wage growth, recognizing the key role of wages for consumption expenditures and reduce inequality. This has also been referred to as a wage-led growth strategy (Lavoie and

[13] If there is to be a European Capital Markets Union, its main goal should be too provide a strong, unified European framework of financial regulation (e.g. Tonveronachi, 2016), rather than serving as a vehicle for deregulation as it currently does.

Stockhammer, 2013). Demand management rather than supply-side policies are the main tool to achieve the employment target. Hein and Truger (2011) and Stockhammer (2016) outline full policy package.

European Orthodoxy pursues a strategy that combines austerity with labour market reforms in order to achieve internal devaluation. Adjustments are to happen in the deficit countries. Any support on the fiscal side (via the Troika) or by the ECB has to be tied to strict conditionality. That is the policy package of the European Commission and the German Finance Ministry. Theoretically, it roughly corresponds to the views of New Classical economics, which strongly emphasises moral hazard problems in monetary and fiscal policy, and regards any negative effects of austerity as short lived. Academic voices which closely correspond to this policy paradigm include Sinn (2010) and Feld et al. (2015). The *Moderate Reform* strategy argues for expansionary fiscal policy and typically via a European fiscal facility (e.g. Euro bonds). It regards labour market reforms as desirable, but they can have negative demand effects and thus need to be combined with expansionary policies. This can most closely be mapped to what we have summarised as New Keynesian views. Comprehensive statements of the Moderate Reform view on causes of and resolutions for the crisis can be found in Baldwin et al. (2015) and also among the contributions in Baldwin and Giavazzi (2015).

The *Progressive Exit* holds that a reform of the Eurozone's economic policy regime is not possible, because either neoliberalism or German hegemony are too deeply ingrained in European institutions. In order to gain room for domestic economic policy and to improve competitiveness, countries in crisis should exit the Euro. Costas Lapavitsas, a renowned Marxist economist, is a well known proponent of this argument (Lapavitsas et al 2012, Flassbeck and Lapavitsas 2015). It is thus tempting to associate this strategy with the Marxist approach. However, it is difficult to distil Marxist contributions to a particular policy paradigm. In fact, there are few Marxist works that discuss the Eurozone crisis in great detail, particularly with regard to fiscal or monetary policy. One reason for this, exemplified in Mavroudeas (2015), is that Marxist crisis theory tends to focus on 'deep structural' causes, including falling profit rates and competitiveness divergences based on neo-mercantilist growth models in the core economies.

Three questions arise: How clear are the dividing lines between the different strategies? How close is the mapping between policy strategies and economic theories? And, how coherent are the different paradigms?

The main dividing line between the European Orthodoxy and Moderate Reform is the issue of austerity. This closely corresponds to the theoretical and empirical positions of NCM and NKM about the effectiveness of fiscal policy. This is an important development within mainstream economics, where before the crisis we do not find such a clear split between NCM and NKM positions.[14] The dividing line between Moderate Reform and Keynesian New Deal is on the one hand the issue of labour market reform and the other hand the role of the ECB in supporting fiscal policy. Labour market reforms has not played a prominent role in NK analyses of the Euro crisis, but NKs tend to view flexibilisation of labour markets as desirable (at least in the long run), whereas PKs regards strong labour market institutions as desirable and wage flexibility as destabilising. Things are less clear cut as regards ECB policy. While PKs have made a more principled case for central banks taking on the role of

[14] Arguably the split is even more pronounced in American academia, where several NKM have more sharply and more systematically criticised the NCM positions (De Long and Summers 2012, Romer 2016).

lender of last resorts for governments, NKs have called for central bank interventions in government debt markets. The dividing line of the Progressive Exit is that national rather than European solutions are sought.

For the European Orthodoxy, Moderate Reform and Keynesian New Deal we thus find a relatively close mapping to the core arguments of NCM, NKM and PKE, however less so for the Progressive Exit and MPE. Ultimately the Progressive Exit seems to be based on the political assessment that a Keynesian reform of the EU is impossible, rather than on Marxist theory itself, even if Marxists are more likely to reach that conclusion.

How neat is the mapping and how homogenous are the paradigms? Several academic contributions cannot be mapped one-to-one to our stylised policy paradigms. For instance, some of the contributors to Baldwin et al. (2015) such as Corsetti (e.g. Corsetti and Müller, 2012) have at times put great emphasis on the need for and potential benefits of fiscal consolidations, bringing them rather close to NCM positions. On the other hand, De Grauwe (2010, 2011, 2013) while adopting a NKM analytical framework, puts forward arguments and policy conclusion that come very close to the Keynesian New Deal/Social Europe. He has argued that the ECB needs to act as a lender of last resort on government bond markets and that overall design of the Euro area is deeply flawed and has amplified endogenous market-based boom bust cycles. Among the Marxist-inspired contributions Bellofiore (2013) is closer to Keynesian New Deal/Social Europe proposals than to the Progressive Exit.

While this survey has been partisan in endorsing a PK interpretation of the Euro crisis, we should be clear that some weaknesses in the PK literature on the Eurozone crisis exist. Chief among these is the continued disagreement within PKE on the causes and consequences of intra-European current account imbalances. Some PKs have interpreted the Eurozone crisis as a balance of payments crisis, others regard financial bubbles as the main driver. We see a role for both, but with more emphasis on the latter. However, while current account imbalances and intra-European capital flows are important aspects for explaining how financial fragilities built up within Europe, the fiscal and monetary policy framework is the more crucial element in understanding the crisis (cf. Bibow, 2016). Only the separation of monetary and fiscal spaces allows us to understand how imbalances transformed into a sovereign debt crisis. The roots of the crisis lie in credit bubbles in the periphery which eventually collapsed, leading to recessions which then escalated into the sovereign debt crisis. However, within the current EMU policy framework, any serious financial crisis, regardless of whether or not it is preceded by current account imbalances, could lead to a deep depression. Conversely, if the constraints on stabilising policy did not exist, it is not clear why current account imbalances should ever necessarily lead to a crisis.

Despite these disagreements, this paper demonstrates that there exists a powerful policy response to the Eurozone crisis which PKEs at large agree on. This response would not only provide a conclusive resolution of the single currency’s ongoing troubles but also put it on a sustainable footing in the long run.

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