

Is High Employment in the Eurozone Possible? Some Reflections on the Institutional Structure of the Eurozone and its Crisis

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Abstract: The paper looks at some well-known explanations of the Eurozone crisis and seeks to provide an answer to the question of whether expansionary fiscal policy is feasible within the restrictive confines of the existing structure of the Eurozone. The paper addresses this question by focusing on a very precise historical period immediately following the global financial crisis and the ensuing Great Recession, the 2008-2009 period, to understand what happened to permit such a sharp rise in government spending throughout the Eurozone without triggering a sovereign debt crisis until early 2010.

Keywords: Eurozone crisis, fiscal policy, institutional adaptation

JEL codes: E52, E58, E62, E63.

Many economists have written about the Eurozone crisis and the broad consensus has been that it began sometime in early 2010 when the Greek drama began to unfold (Baldwin and Giavazzi 2015). This crisis remains virtually unprecedented in the economic history of Western Europe over the last seven decades since the end of World War II, because it brought widespread deflation as well as levels of mass unemployment in some European countries not witnessed perhaps since the Great Depression. Although the global financial crisis of 2007-2008 (starting with the US subprime crisis), had preceded the Eurozone crisis by at least two years, I wish to argue in this paper that the worldwide financial crisis was neither the proximate cause, nor perhaps even the triggering mechanism of the Eurozone regional crisis. Since 2010, the European continent embarked on a roller-coaster ride that for a while seemed to be heading out of control by bringing economic and social devastation as well as political turmoil along its path. While these instabilities have somewhat diminished in recent years, this has not happened because of the initial lending provisions and bailout conditions enforced by the so-called troika (the European Commission, the European Central Bank (ECB), and the International Monetary Fund (IMF)). Some of these provisions were almost in the nature of Ponzi financing schemes imposed on some of the recipient member states of the European Economic and Monetary Union (EMU), such as Greece. The easing of the initial instabilities was primarily the result of other important actions by the ECB in redefining somewhat its own role. Indeed, these latter central bank actions, which some have argued have made the ECB itself a sort of fiscal arbiter of last resort (Auerback 2010-11), have provided indirectly more latitude for fiscal policy movement, particularly through its recent activities of quantitative easing (QE) with its large-scale purchases of European government securities in the secondary sovereign bond market.

The purpose of this paper is to provide an answer to a simple question: If European policymakers wanted to achieve a high level of employment, would it be possible to reach this goal through concerted fiscal policy action that is feasible under the existing restrictive Eurozone monetary architecture? Despite the terrible consequences of the crisis on European society, this is a structure that has remained largely intact in terms of the lack of institutional integration between money and the state. The implications of that fundamental institutional separation has meant the *de facto* tying of the hands of national fiscal authorities to the discipline required of the domestic and international financial markets, by imposing a perverse macroeconomic policy of pro-cyclical budgetary net spending in times of crisis. Many commentators and critics of the existing architecture of the Eurozone now broadly understand this “structural design flaw” of the EMU (see, for example, Stiglitz 2014, 2016). Indeed, some authors have argued that this deflationary bias was actually not so much a “flaw” as it is an institutional reflection of the original intent and purpose of the peculiar design of the EMU (see Parguez, Seccareccia and Gnos 2003; and Parguez 2016).

To pose the previous question somewhat differently: has this perverse macro-fiscal policy response that characterized the immediate post-2010 era been true generally throughout the short life of the EMU or have there appeared exceptions to the way the financial markets have behaved in disciplining countries that seek to pursue expansionary fiscal policies? To answer the question, I have engaged in a certain *pointilisme* by inspecting closely, almost as one would with a magnifying glass, a particular historical episode going from the third quarter of 2008 to the end of 2009. The purpose is to observe to what extent the existing EMU structure actually prevented Eurozone countries from pursuing a substantial fiscal expansion, as they became committed to some hybrid fiscal policy of functional finance. Given the international desire to combat recession through fiscal stimulus, the 2008-2009 period --- the so-called “Keynes moment” (after the “Minsky moment” of 2007-2008) --- offers a unique historical

litmus test. My conclusion is that, when there was a political will to do so collectively, national governments were able to increase public debt largely in lock step with much of the rest of world to combat the Great Recession of 2008-2009 and, at the time, also to bail out the banking sector that had derailed in many countries. This was so probably for the self-interest reasons of the financial sector. Moreover, the general acceptance (principally by the G-20 leaders at the time) of the policy perspective of the “new fiscalism” that had hurriedly been adopted in most industrialized countries immediately after the international financial crisis of 2008 (see Seccareccia 2012) contributed to avoid any significant negative reactions from the financial markets. Only in 2010 was there a reversal of attitude, after the banking sector had been bailed out by national governments (both inside and outside the Eurozone) and after the spooking of financial markets because of the disclosure of apparently hidden and unsustainable Greek government debt levels. Starting in 2010, national governments, mainly of the so-called GIIPS countries (Greece, Ireland, Italy, Portugal, and Spain), began to accumulate explosive debts not so much because of any excessive primary deficits but because of rising interest rates resulting from the downgrading of their government bonds in the financial markets. In fact, these countries struggled throughout this period to achieve target primary public sector surpluses through severe fiscal austerity measures imposed at terrible cost to the entire social fabric of those regions of Europe. As we shall see, the perception and herd behavior of the financial markets (regardless of reality, known to many financial actors even before 2008) actually exacerbated the crisis for the weakest links, especially Greece.

An important objective of this paper is not to defend the view that the Eurozone institutional structure could and should be salvaged without some profound structural changes. I have argued over the years against the existing Euro architectural design (see Parguez, Seccareccia and Gnos 2003, Seccareccia and Lequain 2006, and Seccareccia and Correa 2015). The point that I wish to make is that the veritable obstacle to high employment in Europe is the lack of political will on the part of the European political elites themselves whose behavior after 2010 was instrumental in conditioning the financial markets to react throughout the Eurozone crisis in such punitive ways, particularly during the Greek saga.

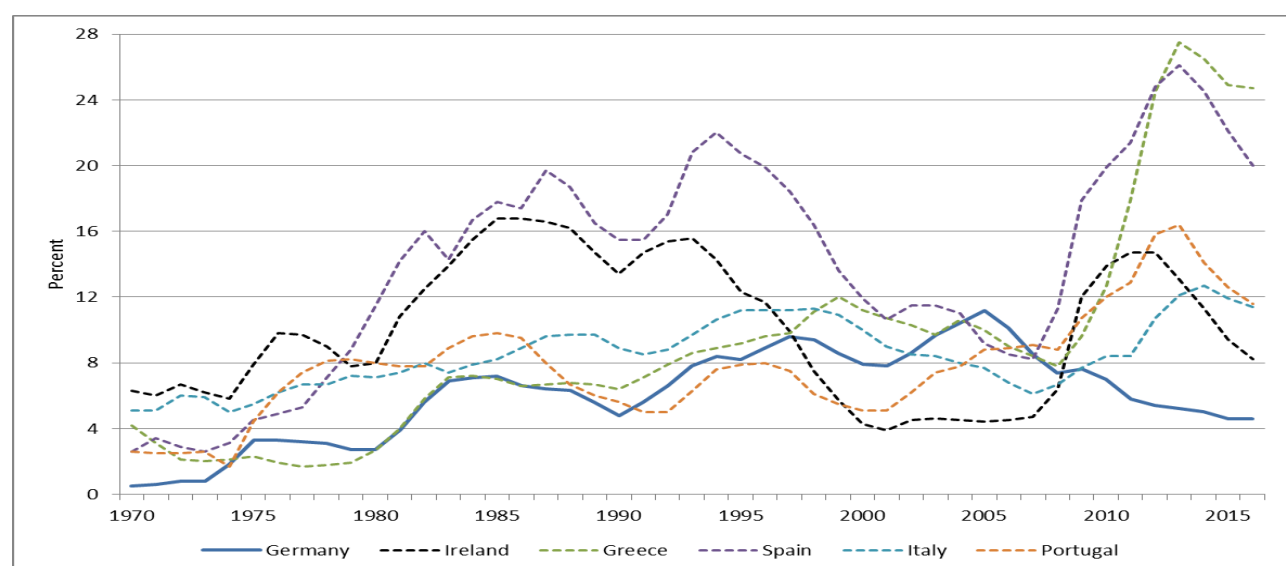
The Eurozone Unemployment Disaster and Its Causes

Rates of unemployment in Europe reached levels since the Eurozone crisis that even surpassed the earlier postwar peaks of the 1980s and 1990s, with unemployment nowadays still probably afflicting close to a majority of the youth labor force in countries such as Greece and Spain. International forces did initially affect the GIIPS countries, whose exports were most sensitive to U.S. growth rates starting in 2008. However, the continued rise in unemployment and the persistence of this unemployment disaster was primarily the result of deep budget cuts and austerity policies adopted since 2010, after the banking bailouts and the initial stimulus packages were implemented during the 2008-2009 period by most countries in the Eurozone and internationally. Since then, many of these economies, primarily of the GIIPS countries, witnessed a terrible contraction in real GDP, as much as a drop of over 20 percent for the immediate half-decade after the Eurozone crisis began, as in the case of Greece. Tragically, this decline also stands out and compares in the historical annals with the scale of severe contractions in output in the Western world not witnessed internationally since the Great Depression.

This mass unemployment was not new in the European context, with the origins of double-digit unemployment rates beginning in the 1980s after the creation of the European Monetary System (EMS). At the time, mainstream economists often mistakenly attributed the high unemployment to supply-side

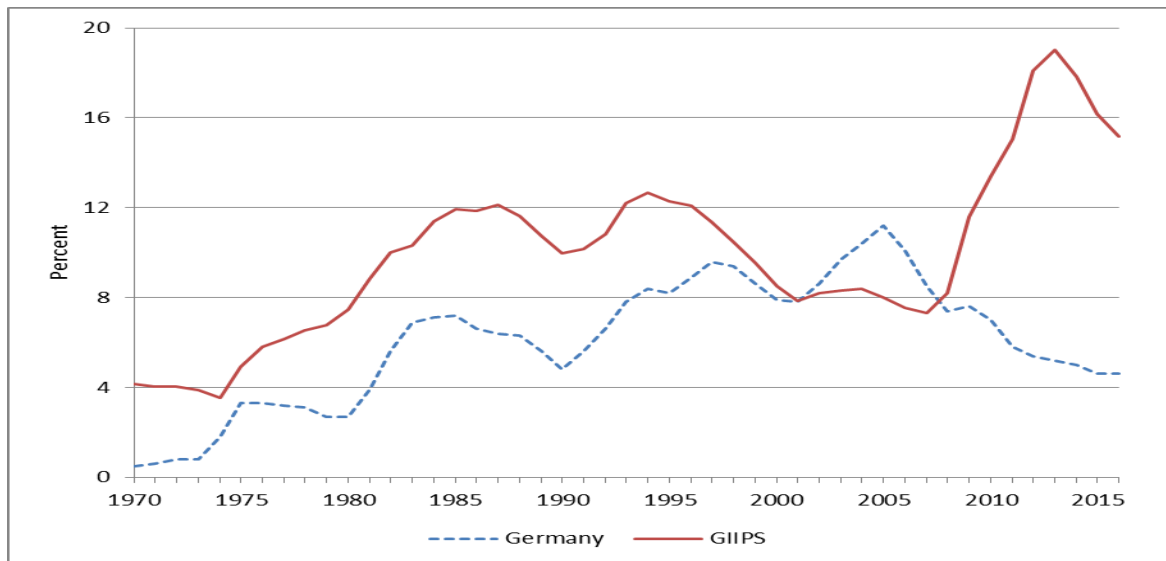
labor-market factors, which was a view, the so-called “euro-sclerosis” argument that, at the time, had been promoted by OECD economists (for a discussion and criticism, see Seccareccia and Lequain 2006). From a longer-term perspective, one can easily corroborate that the severity and sharp rise in unemployment rates over the five years following the global financial crisis was unprecedented for the post-WWII period (see Figures 1 and 2 below for the post-1970 period). The unemployment rate, however, had been steadily declining in the GIIPS countries since the mid-1990s after the crisis of the European Exchange Rate Mechanism (ERM) preceding the adoption of the euro, with the differences in unemployment rates, especially vis-à-vis Germany decreasing before the international financial crisis. As it can best be observed from Figure 2, Germany and the GIIPS countries bifurcated both *before*, as Germany became the “sick man of Europe” (partly as a consequence of German unification a decade earlier), and *after*, as German neo-mercantilist policy triumphed at the expense of its southern neighbors. One can best see this when regrouping these GIIPS countries by simply averaging their unemployment rates and comparing them to those of Germany (as in Figure 2 below).

Figure 1: Evolution of Unemployment Rates in Europe over the Last Four Decades, 1970-2016



Source: AMECO - http://ec.europa.eu/economy_finance/ameco/user/serie/SelectSerie.cfm, Series Code: ZUTN

Figure 2: Evolution of Unemployment Rates in Europe: Germany and Average of GIIPS countries, 1970-2016



Source: AMECO - http://ec.europa.eu/economy_finance/ameco/user/serie/SelectSerie.cfm, Series Code: ZUTN

What is clearly observable in Figure 2 is that, until a bit before the financial crisis, the evolution of the gaps in European unemployment rates did not presage the sharp reversal that took place primarily after the global financial crisis. There was, indeed, a short prelude beginning a few years before the dramatic bifurcation of the series actually took shape, but this was so largely because of a more rapid decline of Germany's unemployment rate when compared to the milder trend *decline* of the GIIPS countries after 2005. It is during and after the financial crisis that the disastrous reversal occurred and continues to persist, despite the significant turnaround in more recent years.

Traditional Explanations of the Eurozone Crisis

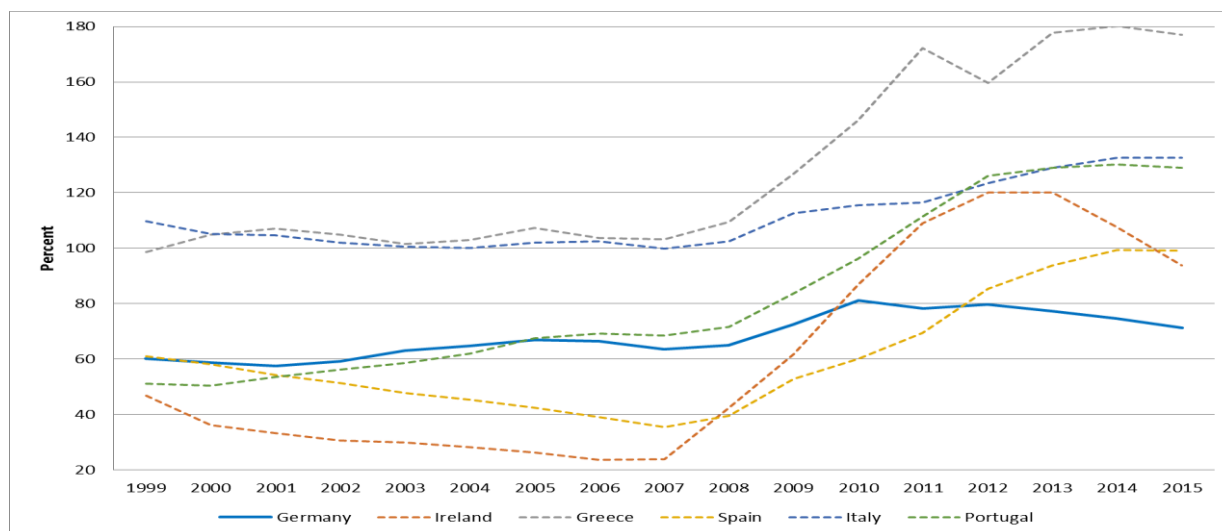
(1) Fiscal Profligacy

The most divisive of the explanations for the existence and persistence of the Eurozone crisis, one that still prevails, especially among certain European policymakers, is the view that the problem is due to a lack of fiscal discipline. The latter behavior would be a cultural trait of the GIIPS countries, when compared to the austere German attribute. This explanation, which was originally given much credence by the media and political leaders in Europe, has two sides to the argument. The first aspect of the profligacy story, stated usually in the form of an untestable truism, is simply the affirmation that it was the indiscipline of policymakers, which resulted in reckless overspending and created the sovereign debt crisis for the GIIPS countries, as the latter governments raised public debt ratios to unsustainable levels. Hence, feeding into the usual stereotyping, corrupt GIIPS leaders were the cause as the latter succumbed to myopic political pressures from interest groups who benefitted from the excessive net spending. The second aspect of the fiscal profligacy argument is less blatant and based on a more complex Mundell-type reasoning. It is often reduced to a simple moral hazard problem arising from the behavior of one country in the context of a multi-country monetary union. This arises when the government of a member state acts myopically to maximize the short-run gains in the form of higher incomes for its own citizens by choosing to run excessive deficits while externalizing some of the increased costs to the whole monetary

union. According to this explanation, deficit spending in one country (say, Italy) generates benefits through the usual multiplier effect for a country in terms of higher incomes domestically, but this excessive spending in one country can potentially harm one's neighbor (say, France). Accordingly, as long as it brings only a slight upward pressure on interest rates of the overall monetary union because of common monetary policy and high capital mobility, the traditional neoclassical crowding-out effect that normally afflicts the domestic economy would instead be shared by the economies of the entire monetary union. This would be in the form of both marginally lower interest-sensitive private spending across the monetary union and some export-crowding out because of the incremental upward pressure that the slightly higher interest rates would also bring to the exchange rate of the common currency. Various complex forms of this externality effect, whereby benefits to one country in the form of higher domestic incomes become a loss shared by members of the monetary union as a whole, can be found, for example, in Carlberg (1999, 2001, and 2006). Some of this reasoning is highly questionable theoretically because of its neoclassical foundations. However, in the political sphere in Europe, especially with the adherence since 2012 to the "reinforced" Stability and Growth Pact (the so-called "fiscal compact"), with its reaffirmation of the mandatory balanced budget rule (for a discussion, see Asensio 2013), it remains the focus of policy discussion and serves as an important ideological underpinning for the continued implementing of austerity measures in the GIIPS countries.

If we are to believe this story of excessive public spending, where is the evidence of this fiscal profligacy precipitating the Eurozone crisis? Figure 3 below displays some series of debt/GDP ratios for a selected group of countries within the Eurozone. While it is well known that some countries began with high overhanging public debt ratios, namely Greece and Italy, what is most remarkable is the relative stability of these public debt ratios, with some GIIPS countries, specifically Ireland and Spain, even running budget surpluses until 2007. Ironically, it was primarily the core countries, Germany and France that had been running deficits until 2005-2006, as can be seen in the chart below for Germany where the public debt-to-GDP ratio had been rising for much of the period and actually only declined significantly again after 2012.

Figure 3: General Government Consolidated Gross Debt as a Percentage of GDP, Selected Countries of the Eurozone, 1999-2015

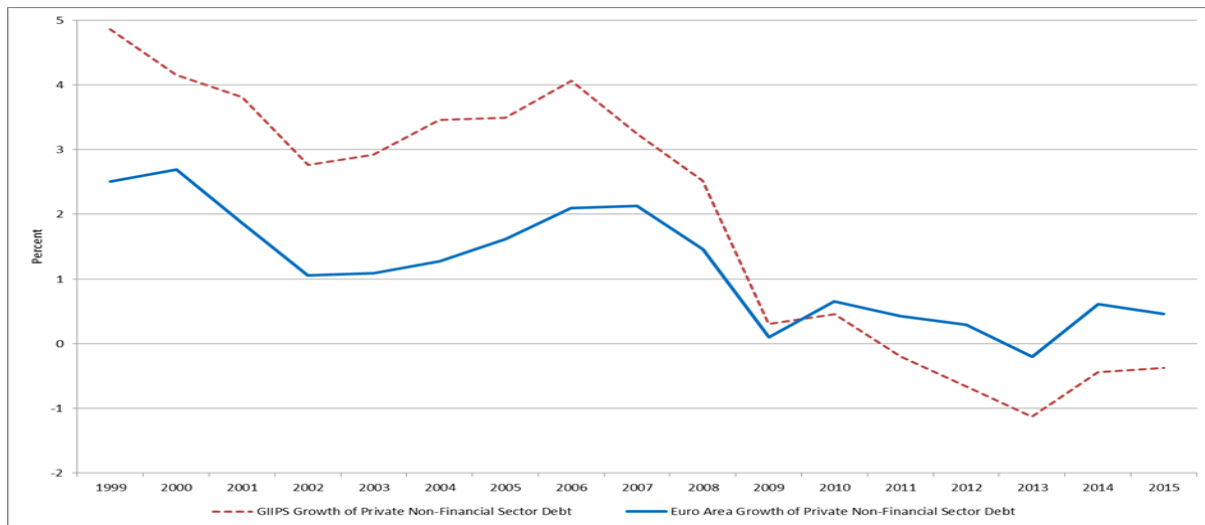


Source: AMECO - http://ec.europa.eu/economy_finance/ameco/user/serie/SelectSerie.cfm, Series Code: UDGG

Despite the persistence and relative stability of a specific structure of public debt ratios, interest rates in the Eurozone converged throughout that era before the global financial crisis, as it will be analyzed separately and discussed below. As these countries had adopted a single currency, the financial markets behaved as if, having now eliminated exchange rate risk that had generated recurrent problems plaguing the previous fixed-exchange rate system (the EMS) from 1979 to 1998, there was no other risk factor to be concerned about under a single currency. Few imagined at the time that, under the EMU structure, exchange rate risk would merely undergo a metamorphosis and become a problem of sovereign debt risk, since everyone believed that financial market pressures on sovereign states would suffice to ensure compliance of budgetary rules. However, in practice, this is not altogether what happened.

Figure 3 also shows that something dramatic did happen in 2008-2009 to push virtually every country into public-sector deficits, with public debt ratios rising sharply in these countries and with each following very similar trajectories until the post-2010 Eurozone crisis (even in Germany and Italy where the rise was somewhat milder). There are essentially three reasons for the jump in those debt ratios during the short interval between the global financial crisis of 2008 and the Eurozone crisis that began in 2010. First, as the world economy went into a “Great Recession” in 2008-2009 with growth rates collapsing and unemployment rates increasing concomitantly, this prompted automatic stabilizers in these countries to generate significant public sector deficits. For a highly integrated world economy in trade and financial flows, this was simply the outcome of a worldwide shock resulting in negative growth. Using as indicator the growth rate of private-sector debt, Figure 4 displays how this indicator for the Eurozone collapsed in 2008-2009, falling to near zero or even negative values. This brought about increased upward pressure on public sector spending, especially in the GIIPS countries that faced a steeper decline at the time. Hence, declining private debt spurred on growing public debt.

Figure 4: Percentage Growth of Private Sector Debt: Euro Area and GIIPS Average

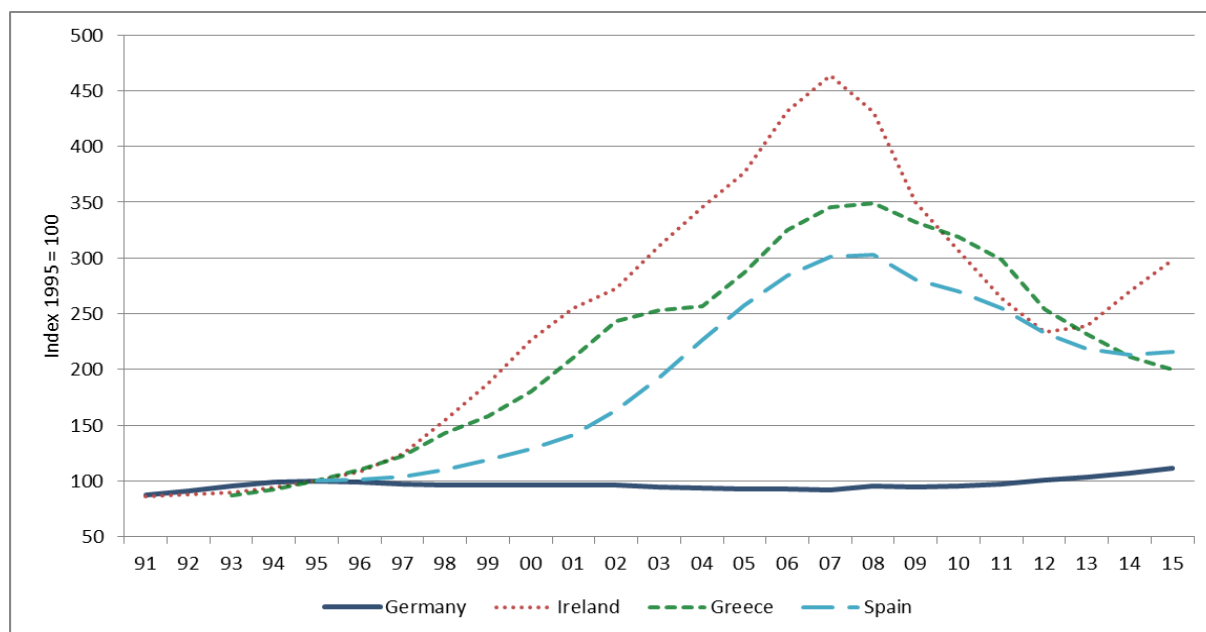


Source: BIS Total Credit Statistics, <http://www.bis.org/statistics/totcredit.htm>

Secondly, and just as important, following the G20 meeting in mid-November of 2008 in Washington, there was an international coordinated effort to undertake discretionary net spending in the form of fiscal stimulus packages worldwide. Much as in the rest of the world, at the time, this policy action also reverberated in the Eurozone. These reactions hardly represent the misbehavior of any one group of countries engaged in some form of fiscal extravagance, but rather they seem to appear more as part of a coordinated effort to combat the severe recession resulting from the global financial crisis.

There was, however, a third reason that one may describe as being more “home-grown” in the GIIPS countries. Not only was there higher growth in overall private sector debt in these countries before the global financial crisis, but, moreover, many of these GIIPS countries had experienced a housing bubble from which Germany had been completely shut out during the decade prior to the global financial crisis. The convergence of interest rates among the Eurozone countries (towards the lower German interest rates) together with the rising growth rates in the GIIPS countries, were accompanied by a rising trade imbalance in favor of Germany, which even attracted progressively more speculative German savings and thereby further supporting the booming domestic real estate markets of Ireland and southern Europe (see Koo 2014.) A look at the evolution of residential property values in Ireland, Greece and Spain, as compared to Germany (in Figure 5), would substantiate this discrepancy between Germany and the GIIPS countries, as the latter’s banking sectors succumbed to the collapse of their respective housing markets. One witnesses the transformation of private debt into sovereign debt as their domestic banks necessitated bailouts in 2008-2009.

Figure 5: Evolution of Residential Property Prices in Germany versus Ireland, Greece, and Spain, 1991-2015



Source: BIS Residential Property Price database, <http://www.bis.org/statistics/pp.htm>

Hence, the relative stability of public debt ratios of Eurozone countries throughout the period prior to the international financial crisis and the proportionate rise of their public debt ratios during the Great Recession would mean that something actually happened only after 2009 to trigger the Euro crisis that was hardly the result of fiscal profligacy.

(2) Neo-Mercantilist Trade Imbalances and Balance of Payments Problem

There has been much discussion over the issue of trade imbalances even among heterodox economists, with most of the criticism on the part of the latter being focused on the neo-mercantilist role of Germany in the context of the Eurozone. At least two versions of the competitiveness argument have appeared in the literature.

First, the mainstream narrative of this trade imbalance problem starts from the founding of the Eurozone itself in 1999 as a non-optimal currency area (OCA). Based on OCA reasoning, it starts from the principle that asymmetric shocks, especially because of the global financial crisis, affected Eurozone countries differently and these eventually triggered some form of twin deficits. However, these imbalances were believed to be simply part of the restructuring process until, in the long run, the underlying industrial asymmetries within the Eurozone would disappear, often appealing to reasoning originally defended by Frankel and Rose (1998) on the endogeneity of the OCA adjustment process (Brodzicki 2012). However, the structure of causality now went from trade imbalances to budgetary imbalances and sovereign debt problems and not so much the other way around, as in the fiscal profligacy storyline. Other mainstream writers, such as Calmfors, et al. (2012) and Sinn (2014), tend to play down the OCA argument and point to a neo-Hayekian problem of resource misallocation. For instance, Calmfors et al. (2012) write:

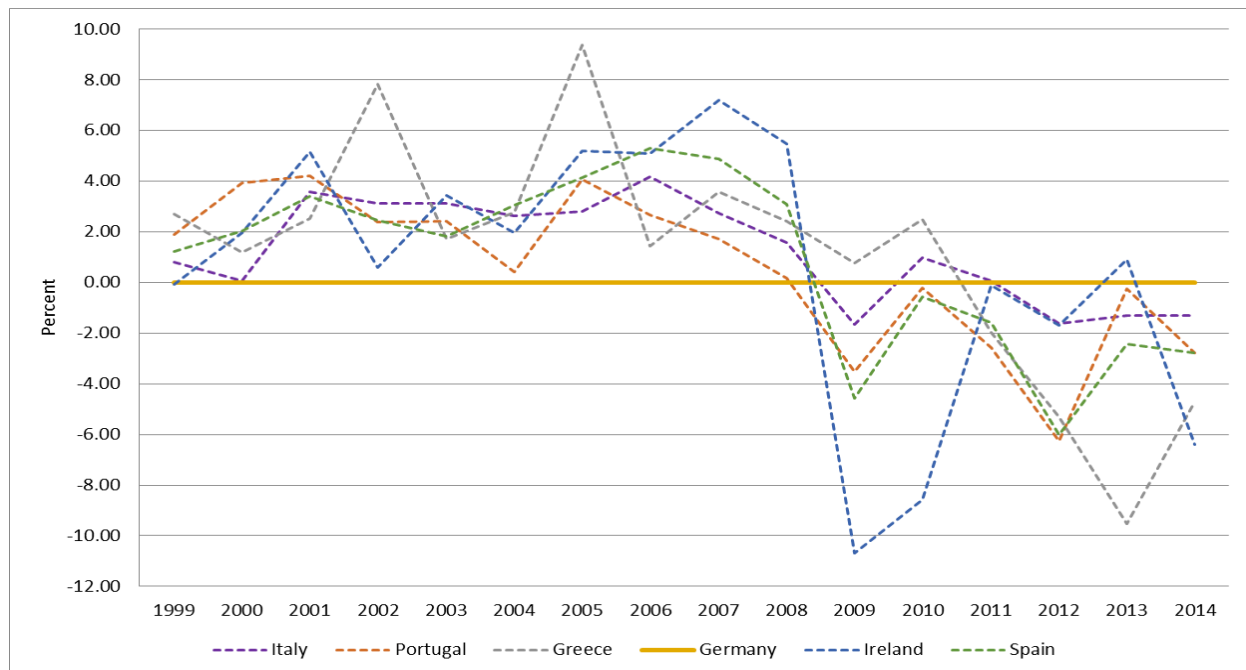
“The announcement and introduction of the euro (in a period of global undervaluation of risk) constituted a unique and strong shock to Western Europe’s economy that led to extreme and unusual cross-border capital

movements. In those countries subject to capital inflows, the economy underwent a growth process with sustained increases in prices and rising current account deficits. In Germany, which suffered from a capital outflow, the real economy and prices stagnated, turning its current account deficit into a surplus, as the competitiveness of exporting industries increased and imports were held back by stagnating incomes.” (Calmfors, et al. 2012: 63).

Hence, the adoption of the Euro brought optimistic expectations about the prospects of high growth in the peripheral countries, initially by attracting savings from the core countries, which, with the elimination of exchange rate risk, brought about in the GIIPS countries both artificially low interest rates and, and on the basis of the usual neoclassical causality, an investment boom. The high growth in the GIIPS countries eventually pushed up wages and prices in relation to those of the core countries. This inflation eroded their competitiveness and generated current account imbalances across the Eurozone and, accompanying it, budgetary imbalances. Within this logic, the solution, of course, is deflation in the GIIPS countries through the implementation of austerity policies.

The second version of this trade imbalance argument is the non-mainstream account that frames the analysis in terms of German “monetary mercantilism” of beggaring its own workers so as to achieve a persistent trade surplus (see, for instance, Cesaratto and Stirati, 2010-11, Simonazzi, Ginzburg, and Nocella 2013, Cesaratto 2015). Following German unification, by the 1990s German firms found themselves in a favorable position by being able to access a vast pool of labor reserves both within the now united Germany and from Eastern Europe. This brought down wage growth in Germany and the Germany economy was for a long time “living below its means” by pursuing a neo-mercantilist strategy of “implicitly undervalued” commodity exports (Flassbeck and Lapavitsas 2013: 12, 17). The implications for Europe were that that this German neo-mercantilist strategy caused persistent trade imbalances that ended with a balance-of-payments crisis by 2010.

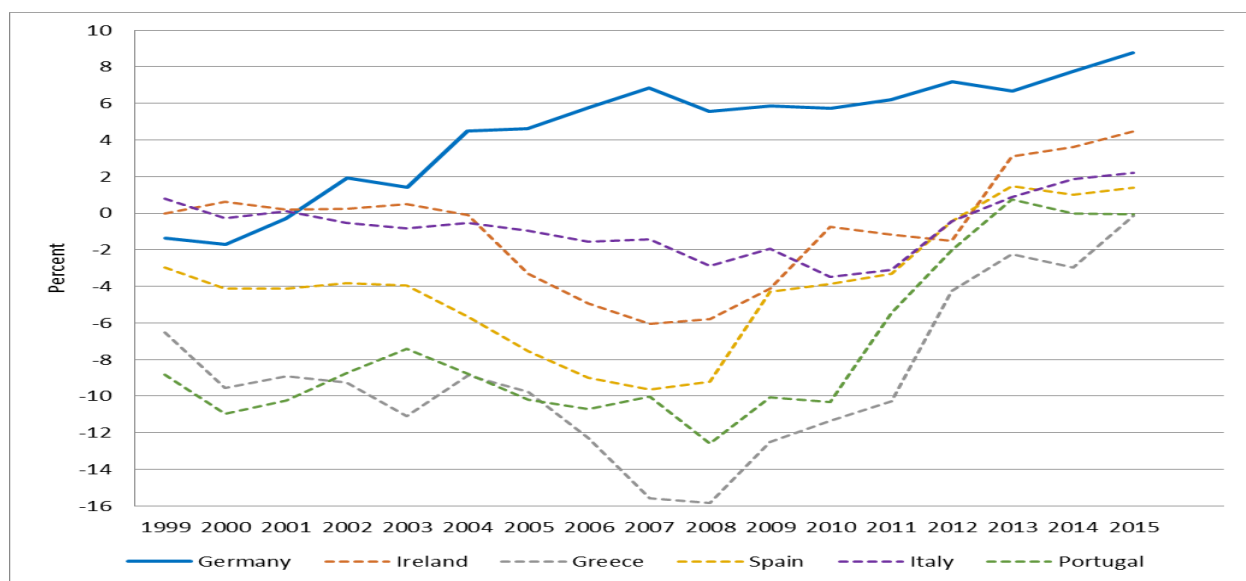
Figure 6: Growth Rate Spread in Unit Labor Costs (with Germany as Reference), 1999-2014



Source: OECD - <https://data.oecd.org/lprdt/unit-labour-costs.htm>

The solution proposed by heterodox economists becomes the mirror opposite of the austerity solution advocated by the mainstream. Much as Keynes had argued in the 1940s (in the debates over an International Clearing Union), rather than deficit countries pursuing policies of austerity and deflation, the proposed solution is that surplus countries ought to inflate. This would entail not only a high-growth spending strategy pursued by the core countries, primarily Germany, that were on the positive side of the twin balances, but also the setting up of a Eurozone “wage solidarity” incomes policy, for instance, referred to by Brancaccio (2012) as a “European Wage Standard”. In focusing their proposal on Germany with its much lower growth of wages and prices, Flassbeck and Lapavistas (2013: 17) argue that: “This is why the adjustment process has to be symmetric at least. This means that the country that is implicitly undervalued has to undertake as strong an effort towards upward adjustment, and that means faster wage increases, as the other countries undertake in terms of downward adjustment.” However, just as it took a long time to create the economic disarticulations and imbalances that began even before the adoption of the Euro, they also note that such a strategy in dealing with the competitiveness problem may well take a long time to unwind.

Figure 7: Current Account Balances, Selected Countries of the Eurozone, 1999-2015



Source: AMECO - http://ec.europa.eu/economy_finance/ameco/user/serie/SelectSerie.cfm Series Code: UBCA

There is much to be said about the latter diagnosis of the problem, since it also fits very well the view emanating from certain circles of the International Labor Organization in favor of a wage-led growth strategy. However, if the problem is one of competitiveness, it would ensue that a reversal of the cumulative mechanism that caused the problem would require high wage growth for, say, Germany, but some form of continued wage stagnation for the workers of the GIIPS countries who have already taken such a hard beating since the global financial crisis. In some ways, it may be said that the difference between the neoclassical solution and the heterodox proposal is not one of substance but merely one of degree and intensity of adjustment of relative unit labor costs (ULC). In fact, as shown in Figure 6 describing the gap in ULC growth rates for the period prior to and following the global financial crisis, the

growth of ULCs in the GIIPS countries did exceed continually that of Germany (our reference line) and then witnessed a sharp reversal after 2008. On the other hand, as can be seen from the evolution of the current account balances in Figure 7, there was a significant improvement in the current account balances of the GIIPS countries, even though most continued to remain in the red. On the other hand, Germany's current account position steadily improved, thanks perhaps mostly to the higher growth in demand from the rest of the world, despite the broadly negative labor cost growth turning in favor of the GIIPS countries. Hence, what seems evident from this is that, if wage deflation in some of the GIIPS countries, such as Greece, does not fully turn around the current account balance, the outcome would probably be no more likely as an effective policy if wages were merely to rise more quickly in Germany while stagnating in the periphery. *Prima facie* it would seem from the recent experience of the GIIPS countries that there would be needed more than this sort of incomes policy to solve the Eurozone crisis.

Indeed, as emphasized by Storm and Naastepad (2016), the argument that adjustment in relative ULCs as a solution to the competitiveness problem via wage changes is somewhat crude and problematic because it narrowly looks only at wage costs. There is also productivity and non-price technological competitiveness that matters. The neoclassical solution of austerity would hardly get firms to invest in more productive and technologically more sophisticated activities in an environment in which overall demand is collapsing as happened in the GIIPS countries in accordance with Verdoorn's law. What one would need are massive investments in the GIIPS countries but that would not happen in an environment of stagnant economic growth. Conversely, high wage growth may well stimulate greater productivity growth in Germany that would be able to offset better the growth in wages. Hence, a policy of both expanding demand and wage growth in the core countries could probably further reinforce the cleavage in non-price competition that exists between the latter countries and the periphery.

Finally, the wage policy argument may well be a solution in search of a problem. The problem in the Eurozone since 2010 is one of financial imbalances generating problems of sovereign risk. Why should trade imbalances necessarily trigger financial imbalances? In a monetary union such as Canada and the United States, there will always be private sector trade imbalances across regions. Hence, if a region such as Québec runs a trade deficit with a region like Alberta in Canada, all that would happen would be that Québécois assets would slowly be transferred financially to Albertans. As pointed out by Lavoie (2015b), this would not create a "balance of payments" problem because there would be redistribution of assets denominated in that single currency, and it would not even necessarily lead to changing interest spreads between the two regions in a union. A balance-of-payments problem would only arise in a world of fixed or pegged exchange rates. For this reason, German mercantilism, no more than the simple fiscal profligacy argument, can properly explain the Eurozone crisis.

What then is the Eurozone Crisis Really All About?

As someone who believes that institutions matter a great deal, I wish to argue that I side strongly with those who have put forth the view that the problem with the EMU is one of "faulty design" with an inherent deflationary bias. The precise structure was intentionally shaped from its inception to suppress within the whole Eurozone significant wage growth and prevent strong public spending for macroeconomic stabilization (Parguez 2016). In that sense, the multitude of rules stipulated in the various Eurozone treaties, since Maastricht in 1992, are there not because those are indispensable to the proper functioning of some ideal monetary union, but because they were designed to control the behavior of

various economic agents in order to prevent “excessive” wage growth and public spending. In opposition to the upside-down world of neoclassical economics, most heterodox economists nowadays would argue that such solid wage growth and higher public spending are not in themselves the source of the problem but actually may be needed in the current context, especially in the core countries, for an effective overall resolution of the crisis.

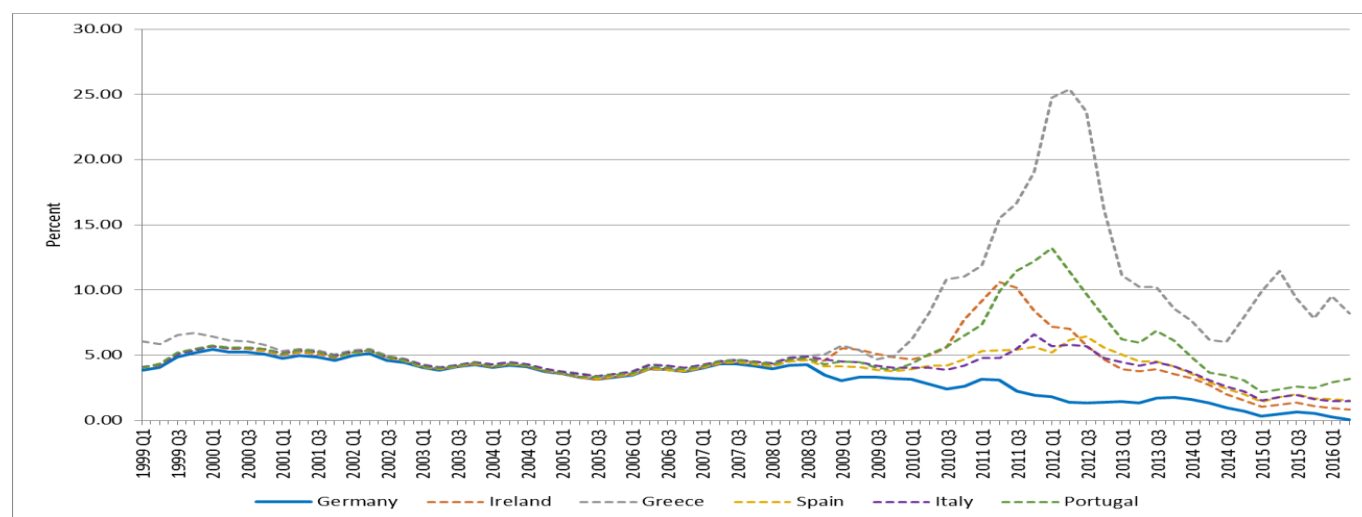
It is well understood among heterodox circles that the Euro was designed as a stateless money, whereby national governments cannot rely on the supranational monetary authorities to eliminate problems of sovereign risk that come from building-up public debt denominated in a currency that is not under national control (see, for instance, Parguez 1999, Kelton and Wray 2009, Lucarelli 2015, and Seccareccia and Correa 2015). However, these institutions matter a great deal in the sense originally described by institutionalist economists going back to Thorstein Veblen (1899). As the social creation of what are generally accepted habits of thought, the actions of individuals behind these institutions, who abide by the rules of behavior that are specific to these institutional structures and that are constrained by economic agents’ own cognitive limits, matter even more. This is because institutions, as social constructs, cannot be conceived as one would, for instance, a physical structure that exists independently of human action or conduct. To appreciate the importance of this in understanding what really happened in triggering the Eurozone crisis, I would like to bring to the attention of the reader a short but important episode in the history of the Eurozone. During that historical episode, procedural rationality and herd behavior were all that mattered and that eventually led to a certain institutional adaptation which mainstream writers seem to be incapable of understanding well. The experience of the Eurozone during that short interval coinciding with the global financial crisis from the end of 2008 to the beginning of 2010 advises that perhaps it is possible to avoid crises as long as countries conduct expansionary Keynesian macroeconomic policy in tandem and not in some desynchronized way. In short, bandwagon behavior without outliers is self-reinforcing, while perceived outliers generate fears and centrifugal processes.

As we have previously discussed and following O’Connell (2015) in terms of center-periphery relations, let us continue to consider the Eurozone as comprising two broad regions. There is a core region made up of more industrialized and financially more developed countries that include Germany, France and the satellite countries of the North; while there is the periphery, which includes the less industrialized and less financially developed economies, primarily of Southern Europe, including Ireland (the GIIPS). After the integration of East and West Germany, unified Germany came into the Eurozone as a country of low inflation, low wage growth and low growth especially in household spending. This can be easily substantiated in Figure 5 above, for instance, by a very flat housing market, when compared to some countries at the periphery that were experiencing much higher growth (see Figure 4). This is because all the GIIPS countries, which had been used to very high interest rates prior to the adoption of the Euro under the EMS, quickly experienced a downward convergence of those interest rates, thanks to the currency union. Indeed, much as it had occurred in the U.S. housing bubble, overwhelmingly local domestic banks, as well as perhaps even some German and French banks, which were better positioned to adopt the newly emerging pre-financial crisis business model of banking, financed extravagantly and encouraged speculative excesses and overinvestment in the real estate market of these peripheral countries. Not all the GIIPS countries experienced the same private sector growth, but noticeably all the GIIPS countries moved in a rather different direction to that of Germany. Even though there was strong growth in private spending in these countries, which, to a prudent financial institution, would signal higher risk for the national governments that might be stuck with the bailout of financial institutions, interest

rates converged in the downward direction throughout the Eurozone until 2007. Consequently, despite the somewhat divergent evolution between Germany and the GIIPS countries, this did not disturb the financial markets and no one from the European political elite even seriously took notice that there was a potential problem resulting from the nature of the perilous institutional structure constituting the Eurozone.

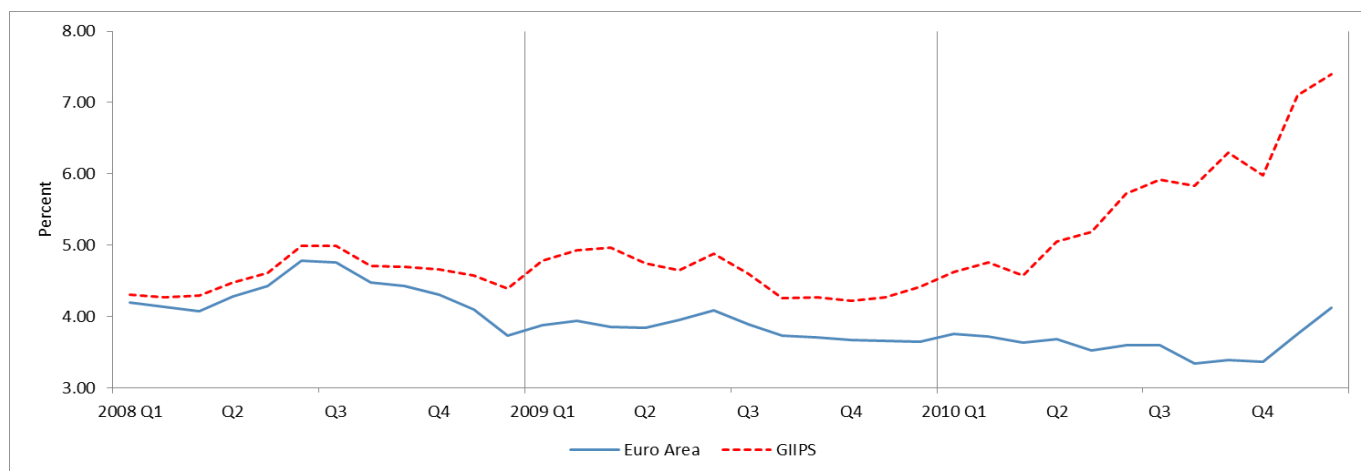
Despite some ominous signs, this period of financial tranquility continued throughout the worst turmoil of the financial crisis from 2008 until early 2010, when most of the Eurozone countries implemented important fiscal stimulus packages, just like many other countries of the world. As discussed earlier, both because of existing automatic stabilizers in place domestically and because of the discretionary fiscal stimulus packages, and also because of bank bailouts in a number of countries, one witnesses tremendous spikes in deficit spending with public debt ratios rising dramatically in all of these countries. Notwithstanding the fact that during this short period, from the third quarter of 2008 to the end of 2009, one observed the highest rise in the public debt ratios by all these countries in the history of the Eurozone (as displayed in Figure 3 for both Germany and the GIIPS countries), very little happened in the financial markets, when measured by changes in interest rate spreads for long-term government bonds, which turned out to be only very mildly disturbed. As one focuses carefully on that short period (see Figures 8b and 8c for the GIIPS and Greece vis-à-vis the Euro area), it took the financial markets at least a year during 2009 and even in 2010 to start to recognize the huge spike in the debt ratios that were supposedly to warn and foreshadow impending financial trouble. Indeed, as we can confirm from Figure 3, the public debt ratios had risen greatly and had eventually plateaued by 2011.

Figure 8a: EMU Convergence Criterion Bond Yields, Defined as Central Government Bond Yields on the Secondary Market with around 10 Years' Residual Maturity, 1999-2016 (Quarterly Observations)



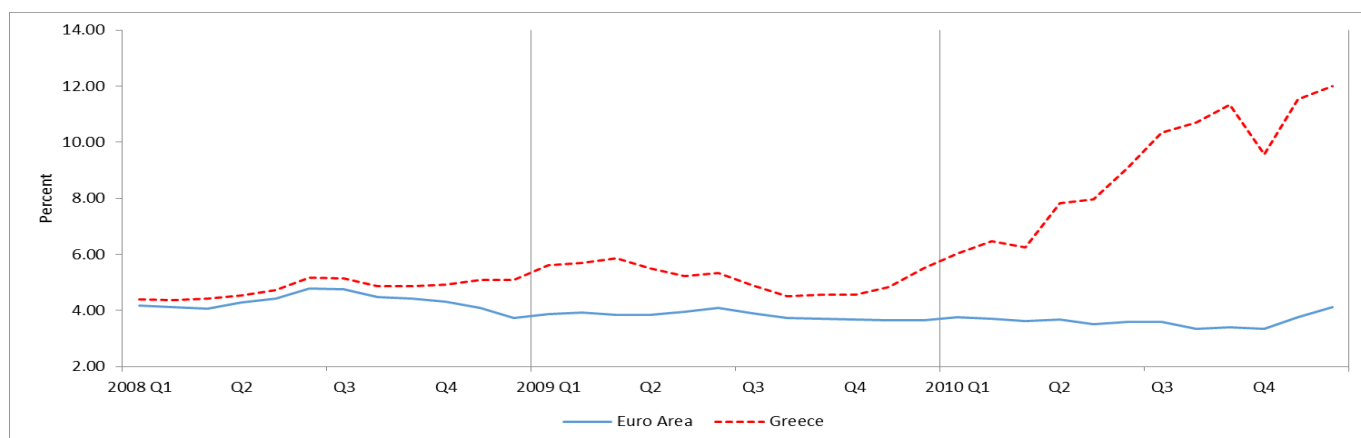
Source: Eurostat: EMU convergence criterion series - quarterly data [irt_lt_mcby_q], http://ec.europa.eu/eurostat/web/products-datasets/-/irt_lt_mcby_q

Figure 8b: Focus on the Financial Crisis Period: Interest Rates Evolution of GIIPS Countries vis-à-vis Euro Area (Monthly Observations from January 2008 to December 2010)



Source: Eurostat: EMU convergence criterion series - monthly data [irt_lt_mcby_m], http://ec.europa.eu/eurostat/web/products-datasets/-/irt_lt_mcby_m

Figure 8c: Focus on the Financial Crisis Period: Interest Rates Evolution of Greece vis-à-vis Euro Area (Monthly Observations from January 2008 to December 2010)



Source: Eurostat: EMU convergence criterion series - monthly data [irt_lt_mcby_m], http://ec.europa.eu/eurostat/web/products-datasets/-/irt_lt_mcby_m

Some would see this as an example of a “market failure” in terms of financial markets misconstruing risk. Though no one could have easily predicted how the global financial shock in 2008 (emanating from the U.S. epicenter of the financial crisis) would have affected the Eurozone, many major banking and financial institutions in Europe would have known how indebted the GIIPS countries were. Many would also have known how much sovereign debt liability GIIPS governments would eventually be absorbing because of the bailouts of these same banking institutions. After all, the latter knew how quickly the private sector had been building up unsustainable private debt during the previous era, since these financial institutions themselves had been their major lenders (for instance, in the housing bubble in the GIIPS countries), which then required massive bailouts from national governments that quickly transformed the accumulated private debt into a public one. This was surely, according to the popular French expression, an open secret of Polichinelle. It should certainly not have taken another year (or even more) for the financial sector to recognize and then become frightened of the huge build-up of public

debt that led eventually to the sharp rise in the interest spreads during 2010. This could hardly be considered an error of judgement or “market failure” for the financial markets to start reacting massively only in early 2010 once the revelations of the so-called hidden debt of Greece appeared in the international media. Indeed, this hidden debt supposedly had been “concealed” with the help of some of the same major financial players connected with such established multinational financial conglomerates as Goldman Sachs. Yet, it was already a year after the global financial crisis that the financial markets began eventually to start to downgrade extensively Greek sovereign debt, that is, after the election in Greece of a center-left PASOK government and the discovery of “severe irregularities” in the previous accounting of the Greek public debt.

There are two possible explanations for this puzzling episode between 2008 and 2010 before the Eurozone crisis, when the financial markets had accommodated the huge growth in public debt by underestimating the risk associated with sovereign debt in Europe. After all, the main financial actors surely were aware that there existed a precise institutional structure delineated by the Maastricht Treaty of 1992 and the Stability and Growth Pact of 1997, with the political elites of Europe preaching fiscal responsibility by placing national governments on a legal and financial leash. This institutional structure was precisely to prevent this “excessive” build-up of public debt that actually occurred on such a wide scale. Why then did the financial sector so easily finance this accumulation of debt that backfired only with the scandal surrounding the Greek debt in 2010?

The first of these explanations has to do with the Minskian element of perceived risk during a period that followed a long episode of financial stability. As previously stated, it was certainly conceivable at the time to imagine that this huge private sector debt in the periphery would be transformed into high-risk sovereign debt (Costâncio 2013). In the context of the “new fiscalism” and policy coordination of the period, most industrialized countries were also engaging in some form of fiscal pump-priming to combat the Great Recession in 2009 and to support the banking and financial sector. The herd effect of this policy emulation internationally made it certainly plausible that the growth that this would induce could spread within all of the countries of the Eurozone. Indeed, this would be more so than if only one single country engaged in deficit spending within the monetary union. Hence, the fears of pursuing “Keynesianism in one country” did not really exist since one could expect that some, if not all, of this public spending could in due course come back in the form of increased revenues. These revenues would be forthcoming from increased overall growth, as long as others were pursuing in tandem similar policies to move the economy out of the recession and as long as this was seen as a “temporary” measure to combat the recession. This may well be an important reason why the spreads widened only slightly throughout 2009.

As can be observed from the above charts, it was only at the end of 2009 and during early 2010 that distrust began to prevail about the “oversized” Greek debt. Once discordant behavior among policy makers took hold with their overt fears of default looming over most of the GIIPS countries, this quickly led to the unravelling of the fiscalist consensus that existed during late 2008 and throughout most of 2009. Only when the fiscal authorities began to move in reverse gear, interest spreads exploded and the financial markets began to punish the weakest links, thereby resulting in a significant widening of interest spreads for the post-2009 period. By early 2010, there was a general awakening of the financial markets to the fact that, unlike countries such as the United States and Japan, which have their own sovereign currencies, countries of the Eurozone were merely “eurorized” regimes, caught in a financial lobster trap as mere users of a currency.

A second, and possibly more murky, reason that could also partly explain this particular phenomenon at the time of the global financial crisis of 2008-2009 might well pertain to the self-interest behavior of the banking and financial sector itself. The banks would have had hardly any desire or interest in generating panic in the bonds markets about sovereign debt that would have meant raising the interest spreads to such high levels, as they were eventually to do so after 2009-2010. Given the pressures for a banking bailout in countries such as Ireland and Spain (because of the collapse of their housing markets), the banks needed the national governments' financial support to pull them out of potential bankruptcy, since the banks themselves did not know the precise extent of their own vulnerability during the thick of the financial crisis. Why would the banks want to put political pressure on policy makers in the GIIPS countries *not* to go into debt (that is, by signaling higher risk that could result in the downgrading of government debt) when this could abort the possibility of their own bailout? Surely, they had every interest to wait until the national governments would have socialized their losses and saved the banks from insolvency. While this shadowy behavior can certainly not be excluded, what is evident is that the expected link between those interest spreads and growing public-sector indebtedness in the Eurozone did not materialize until after a very significant and somewhat bewildering time lag of as much as a year.

While it would be difficult to brush off this second explanation for the behavior of the spreads during 2008-2009, one would like to think that it was most likely a mixture of the first and second explanations that can probably explain what had actually happened at the time. To the extent that the first explanation holds more sway, the experience during the worldwide financial crisis would advise that, as long as all countries seek to implement a fiscal policy expansion simultaneously, it was possible to implement a Keynesian expansion with little effect on (or threats from) the financial markets, even under the institutional structure of the Eurozone. This experience may well have been unique historically and may not actually be repeated, but the mere fact that it happened lends weight to the importance of how economic actors move collectively in conditioning their behavior within any given institutional structure of the type set out in the EMU architectural landscape.

In addition, it was not the recognition of large amounts of private toxic assets (once the bubble burst in 2008) in such countries as Ireland and Spain, but the fact that this had to be absorbed by their national governments as unproductive public debt that sustained the crisis. To use a Parguezian expression, it was not the "good deficits" of the fiscal stimulus of 2008-2009, which triggered negative reaction from the financial markets, but the "bad deficits", as governments absorbed private toxic assets held in the banks' balance sheets (Parguez, 2013). Hence, it was not the public spending on, say, public investments to stimulate growth but the recognition or perception that the emperor had no clothes once these countries' public debt ratios rose with governments finding themselves in an untenable situation of holding "bad" debt. These bad debts then tended to rise dramatically once interest rates rose quickly, as in a Domar-type scenario with the compounding effect of real interest rates rising and real GDP growth plummeting.

This perception of bad debt became so widespread in 2010-2011 that, when the former governor of the ECB, Jean-Claude Trichet, responded with the initial round of purchases through its Securities Market Program of these government bonds in the secondary markets that were being rapidly downgraded by the rating agencies in the financial markets, the reaction of the ECB was inadequate at the time to counteract the widely-held perception. In 2010-2011, the political support for a stronger commitment by the ECB for a quasi-permanent change in its role was not there. As will be discussed below, the most significant turning point in the spreads came in 2012 when the current governor, Mario

Draghi, made it very clear to the financial markets that the ECB was *de facto* acquiring a new institutional role in the holding and managing of government sovereign debt, which until then had neither been understood by the ECB authorities nor sufficiently asserted and communicated to the principal protagonists in the financial markets.

Institutional Adaptation in Recent Times: Learning from this Historical Experience

Fiscal austerity since 2010 has led to a reversal of the GIIPS competitiveness position and an improvement in their current account balances (as displayed in Figures 6 and 7 above). However, interest rates did not begin to plateau until the ECB vowed to intervene systematically and massively in buying sovereign debt in the secondary bond market. Indeed, the remedy to backstop and prevent the financial fallout and default of some of the GIIPS countries required ultimately that the ECB declare itself in July 2012 to stand ready to purchase government securities, with full financial market sterilization, *as needed* through Outright Monetary Transactions (OMT). Yet, to replace the ECB original bond purchases program (via its Securities Market Program (SMP)) after 2012, the support took many other forms as well. For instance, this took the form of direct rescue loans such as the European Financial Stability Facility (EFSF), the European Financial Stability Mechanism (EFSM), the European Stability Mechanism (ESM) by 2013, and even the IMF support. However, these were all Band-Aid solutions of a largely contradictory nature. These funding agencies would provide the various loans and financial support only if national governments agreed to further austerity, which at the end merely made it perhaps even more difficult for some of the most vulnerable members of the GIIPS countries, especially Greece, to generate the domestic growth needed to meet their debt service requirements.

Since the beginning of 2015, the ECB took further steps to implement a policy of quantitative easing (QE) in the form of unsterilized asset purchases in the secondary bond market. Much has been written about the effects of QE in countries such as the U.S. and Japan and, as shown in some previous work (see Lavoie and Seccareccia 2012; and Seccareccia 2017), QE cannot generate spending growth except, at best indirectly, through its effects on the level of central bank interest rates and on the shape of the yield curve. It cannot directly stimulate private spending along traditional quantity theory reasoning. However, one other important positive effect of QE in the Eurozone is that, by sustaining bond prices and very low yields on government securities, the ECB has enabled more fiscal space to Eurozone governments even without direct purchases of government securities on the primary market, that is, without contravening Eurozone treaties. In a clumsy and byzantine way, the ECB is now taking on an institutional role behind the scene as a sort of “fiscal complement” of last resort that no previous treaties had ever considered or approved. By fiscal complement, it is meant that, *de facto* (but not *de jure*), the ECB no longer acts as if it is completely removed of national government financing of deficits and debt. It will systematically respond to crisis needs via financial intervention through its actions in the secondary bond markets, as it has been doing, since the beginning of the Eurozone crisis. However, it is doing so only with the extremely limited tools that are available to a central bank and without the legitimacy that a central fiscal authority would command in gaining access to central bank financing, as in most non-dollarized countries, where national central banks have the legal authority and, in some sense, even the obligation to intervene in the primary market for government securities.

An obvious lesson from all this is that a modern monetary market economy founded on the fundamental separation between money and the state is dysfunctional and cries out for a fiscal authority

that can implement macroeconomic stabilization policies, which even the current governor of the ECB implicitly recognized in his famous Jackson Hole speech in August 2014 (Draghi, 2014). In the short history of the Eurozone, we have seen that, whenever the EMU is confronted with serious shocks to the system, as during 2008-2009, it was able temporarily to behave as if this constraint does not exist, just to be faced in 2010 with the challenge of a still greater and deeper crisis of the Eurozone. The monetary authorities have been tinkering a great deal with the way in which they conduct monetary policy since 2012. These authorities are now offering greater fiscal *souplesse*, but without changing the essentially dysfunctional nature of the Eurozone structure. Other options are certainly available with or without the Euro (see, for instance, Ehnts, 2017: 193-201).

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