The future of the Eurozone

An economic discussion document commissioned by

MATT CARTHY MEP

European United Left • Nordic Green Left
EUROPEAN PARLIAMENTARY GROUP
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List of abbreviations

BRRD – Bank Recovery and Resolution Directive
CAP – Common Agricultural Policy
CDO – Collateralised Debt Obligation
CDS – Credit Default Swap
CSO – Central Statistics Office (Ireland)
CMU – Capital Markets Union
EBA – European Banking Authority
ECB – European Central Bank
ECSC – European Coal and Steel Community
EDIS – European Deposit Insurance Scheme
EFSF – European Financial Stability Fund
EFSM – European Financial Stability Mechanism
EFSI – European fund for Strategic Investment
EFTA – European Free Trade Area
EMU – Economic and Monetary Union
EMF – European Monetary Fund (proposed)
EMS – European Monetary System
ERM – Exchange Rate Mechanism
ESM – European Stability Mechanism
ESRB – European Systemic Risk Board
EU – European Union
FSB – Financial Stability Board
GDP – Gross Domestic Product
GNI – Gross National Income
GNI* – Gross National Income (modified)
G-SIB – Global Systemically Important Bank
IMF – International Monetary Fund
LTRO – Long Term Refinancing Operation
NPL – Non-Performing Loan
OMT – Outright Monetary Transaction
QE – Quantitative Easing
TLTRO – Targeted Long Term Refinancing Operation
SSM – Single Supervisory Mechanism
SRB – Single Resolution Board
SRF – Single Resolution Fund

Foreword by Matt Carthy

October 2017

AS ECONOMIC stagnation largely continues in the Eurozone a full decade after the onset of the global financial crisis, there is widespread agreement that the underlying structural problems in the design of the common currency need to be addressed. And while the Irish state is portrayed as the poster child for the EU's austerity programmes, it is very clear that the recovery is limited. The figures are massively distorted by accountancy tricks by multinational corporations booking their profits in the Irish state to avoid paying their fair share of tax. More importantly, the Eurozone's permanent austerity and the structural flaws in the design of the common currency mean the Irish state remains very exposed to future financial, debt and economic crises.

Since the crisis there has been a push to implant the failed and ideologically-driven deficit fetishism ever more firmly in the structure of the Eurozone – by creating new mechanisms to surveil and structurally reform the economies of member states, and to surveil and control their spending, taxation and borrowing through budgetary control.

The political crisis is deepening, and the structural economic flaws in the Eurozone that caused the financial crisis to manifest in a double-dip recession and decade-long slump in Europe remain firmly in place. The ECB's monetary policies, which have masked these underlying problems to a certain degree over the past five years, are running out of steam, and a new debt crisis in the peripheral economies is a distinct possibility.

In the past two years there has been a flurry of publications, reflection papers, and strategy papers regarding the future of Europe being pumped out of the EU institutions, particularly the European Commission.

I commissioned this paper in order to contribute to this discussion from a progressive perspective – and to challenge the European elite's prescription for permanent austerity and the further surrendering of democratic rights to unelected supranational bodies. It is not a Sinn Féin policy document, but rather a discussion document that aims to move beyond the critique of the impact of austerity in the countries that suffered under Troika programmes. It aims to examine the structural problems inherent in the Eurozone that have worsened and prolonged the crisis within the currency union, including their impact on the Irish economy, in order to contribute to the debate among the Irish and European left on how to relate to the EU during this period of political crisis, and how to change the rules governing the Eurozone to the benefit of ordinary people.

I want to thank Emma Clancy for her work on this paper, assured as I am that it has the potential to insert an important alternative vision into a conversation which is sorely needed.

Introduction

MANY THOUSANDS of words have been written about the Eurozone crisis and European governments' response to it. On the political left, much of the discussion and analysis has focused on the conditions imposed by the Troika on the so-called peripheral economies that experienced a sharp and sudden stop of credit during the sovereign debt crisis of 2010. A serious critique of the Troika programmes – from the left, from communities campaigning against cuts to public services, and from Keynesian social-democrats – was, and remains, crucial in bolstering popular movements against austerity.

As the economic slump in the Eurozone stretches towards a full decade while other countries and regions returned to growth several years ago, however, we need to develop a serious analysis of the structural flaws in the Eurozone that have worsened and prolonged the downturn here, and to understand their implications for the future of the Eurozone and for the European Union (EU). And while leaders of EU institutions laud the feeble and uneven signs of economic recovery that have appeared this year, the political crisis across the continent gets deeper. Shook up by the Brexit vote in Britain last year, the EU establishment then breathed a sigh of relief following the French presidential election in May, hailing the election of Emmanuel Macron as a turning point in the march of the far right across the continent. The fact that EU political leaders welcomed the fact that "only" 11 million French voters voted for far-right candidate Marine Le Pen is an illustration of both the depth of the political crisis, and the refusal of European leaders to face reality.

There are many major problems with the European Union that need to be addressed, including its drive towards militarisation, its increasingly hostile treatment of asylum seekers, and its extreme democratic deficit. This paper aims to focus on just one area, but a significant one – the common currency, and the ways in which the Eurozone's architecture, policies and ideological basis have attacked the rights and conditions of ordinary people across the monetary union.

While the concerns of disintegration that dominated in 2012 have receded, the stagnation that has contributed in a major way to the political crisis continues. The Eurozone continues to lack the institutions that could effectively reduce divergence across the area's economies; the architecture that facilitates trade imbalances, capital flight and debt crises remains firmly in place. It appears to be unable to generate enough growth and inflation to restore full employment and production, or to place massive levels of public and private debt on a credible path of reduction. ECB policies have bought some time but they too are increasing both inequality and volatility.

This paper aims to examine the underlying causes of the ongoing stagnation in the Eurozone by examining the ideology that underpins it and the political forces that created it. It places the development of the euro in the context of major global geopolitical changes in the 20th century. It looks at the ways in which both policy and design flaws caused the sovereign debt crisis and worsened the economic and financial crises. The discussion then turns to the nature of monetary unions and what requirements must be in place to ensure they work smoothly, before critiquing the Eurozone's path of attempting to reduce trade imbalances by a process of internal devaluation. Finally, it examines the limitations of the ECB's mandate and policy, before making a number of observations regarding the short, medium and long term changes that are required in the structure of the Eurozone in order to end its tendency towards crisis and stagnation.

CHAPTER ONE

Eurozone's permanent austerity based on failed ideology

BACK IN 1929 when the Wall Street crash hit, the response of then-US President Herbert Hoover was to restrict government spending – an action now almost universally acknowledged as having turned the stock market crash into the Great Depression.

The free-market ideology underpinning Hoover's austerity policies held that an economy with high unemployment could return to full employment through market forces alone. Instead of boosting public spending, the government should do the reverse. By cutting government spending and increasing taxes, the government deficit would be reduced, which would restore market "confidence". This restoration of confidence would lead to increased private investment, and the market would adjust itself to return to full employment.

The confidence fairy

The confidence theory was demonstrated back in 1929 to be incredibly damaging and to achieve precisely the opposite effect of what it aimed to achieve. The actual effect of implementing austerity in a period of economic downturn was to cause a contraction in the economy, thus weakening the economy further, causing tax revenues and national income to fall, and the deficit to increase. The contractionary impact of austerity policies during a downturn was explained by John Maynard Keynes during the 1930s, and Keynesian models have proved to be a reliable predictor of growth (or lack thereof) in the wake of the 2007-2008 crisis.

Countless books, academic studies and articles have outlined how the programmes imposed by the Troika – the European Commission, the European Central Bank (ECB) and the International Monetary Fund (IMF) – on the Eurozone's "peripheral" economies since 2008 have exacerbated the crisis. In the decades before the global financial crisis, these same policies had caused the exact same devastating contractionary effects when imposed under the guise of "structural adjustment programs" by the IMF across Africa, Asia and Latin America.

But while Keynesianism was experiencing an academic and policy revival internationally following the global financial crisis, Europeans somehow managed to cling to the confidence theory, which persisted in the decades beyond the Great Depression to this day. It is the dominant theory that has shaped both the structure of the Eurozone and European Union (EU), and the EU response to the global financial crisis of 2008.

In 2011 at the height of the Eurozone crisis, Nobel Prize-winning economist Paul Krugman memorably dismissed this theory as the "confidence fairy"[1]. Two years later, commenting on the theory's persistence in the face of overwhelming evidence to the contrary, he added: "European leaders seem determined to learn nothing, which makes this more than a tragedy; it's an outrage."[2] Fellow Nobel Prize-winning economist Joseph Stiglitz has dubbed the free-market fundamentalists' obsession with reducing deficits as "deficit fetishism", pointing out that "no serious macroeconomic model, not even those employed by the most neoliberal central banks, embraces this theory in the models they use to predict GDP"[3].

Europe's lost decade

It is common for scholars to refer to the results of the IMF structural adjustment programmes from the 1970s-1990s in Latin America, Asia and Africa as having caused these continents "a lost decade" or "lost decades". Europe has lost a decade but there is a danger that it may lose several more – not only because of the policy responses to the crisis but because of the actual structure of the Eurozone. The results of the European response to the crisis are damning. Three patterns are obvious: the Eurozone countries have in general fared far worse in terms in terms of recovery than countries outside of the common currency; the recovery within the Eurozone has been sharply asymmetrical,

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[1]Krugman, Paul. 'The Death of the Confidence Fairy', *The New York Times*, September 13, 2011. https://krugman.blogs.nytimes.com/2011/09/13/the-death-of-the-confidence-fairy/

[2] Krugman, Paul. 'Disastrous Predictions and Predictable Disasters', *The New York Times*, March 1, 2013. https://krugman.blogs.nytimes.com/2013/03/01/disastrous-predictions-and-predictable-disasters/

[3] Stiglitz, Joseph. 2016. *The Euro: And its Threat to the Future of Europe,* Allen Lane, USA. (Ebook). p159

with divergence between strong and weak countries increasing; and there has been a significant rise in inequality across Europe.

Growth in the US and Britain has been weak since the crisis but it has far outpaced the Eurozone recovery. It is difficult to even use the word "recovery" to describe the Eurozone experience – only last year did Eurozone GDP reach its pre-crisis level. In June 2016, the Eurozone unemployment rate was still in the double figures at 10.1 per cent; while the EU-28 had unemployment of 7.7 per cent. But the unemployment figures in several of the crisis countries remains double the Eurozone average – in Greece by 2017 the unemployment rate was 21.7 per cent while at the same time in Spain the jobless rate was 17.8 per cent. The figures are masked by the huge levels of emigration that the crisis countries experienced as well as the fact that number of hours worked per worker has declined across the Eurozone.

Stiglitz notes that youth unemployment persists at twice the level of overall unemployment. "The persistence of high unemployment among youth will have long-lasting effects – these young people will never achieve the incomes they would have if job prospects had been better upon graduation from school."[4]

While the Eurozone stagnated for a full decade following 2007, countries within the EU but outside the Eurozone had a GDP 8.1 per cent higher than in 2007 by 2015. The United States had a GDP almost 10 per cent higher in 2015 than in 2007. Over the same period, the Eurozone's GDP grew by just 0.6 per cent.

When measuring living standards it is more accurate to examine GDP per capita than GDP overall, and while in the US GDP per capita increased by more than 3 per cent from 2007-2015, while over the same period in the Eurozone it actually declined by 1.8 per cent. As living standards have declined – devastatingly in crisis countries, and especially in Greece – income inequality has also risen drastically. In its Economic Forecast last autumn, the European Commission warned of a potential "vicious circle" as expectations of long-term low growth affect investment decisions, and that "the

[4] Ibid, p126

projected pace of GDP growth may not be sufficient to prevent the cyclical impact of the crisis from becoming permanent”[5].

The declining level of growth in the British economy since the Brexit vote means a “strong downward revision of euro area foreign demand”[6], while the “sizeable depreciation of sterling vis-à-vis the euro is expected to have an adverse direct impact on euro area exports to the UK”[7]. Eurozone exports were forecast to decrease slightly this year and stagnate in 2018, while possible financial crashes in China or the US and the ongoing non-performing loan banking crisis in the Eurozone pose serious risks.

Despite these sober warnings, European leaders and the financial press have raucously celebrated the anemic growth in the Eurozone’s GDP in the first two quarters of this year, of 0.5 per cent and 0.6 per cent respectively – crucially, driven by a slow increase in domestic demand as opposed to export-led growth. But this celebration ignores the fact that in normal circumstances, these figures would be viewed as abysmal, and that global economic forces pose serious threats to this fragile recovery.

Fairies and leprechauns

Predictably, these feeble shoots of growth are described as being the result of austerity policies by those who have claimed for the past 10 years that austerity will start to work any day now. A slightly recalibrated confidence theory has been proposed by a small number of economists associated with the neoliberal school of thought since the 2008 crisis – that of an “expansionary fiscal contraction”, with Harvard’s Alberto Alesina and Goldman Sachs’s Silvia Ardagna leading the charge with their joint paper in 2009. What they are actually recommending largely amounts to recovery through beggar-thy-neighbour competitive devaluations (or in the common currency, internal devaluation).

Stiglitz points out that these instances of economic recovery are actually cases where certain countries had “extraordinarily good luck” in that “just as they cut back on

[5] European Commission, 2016. *Autumn Economic Forecast 2016*, https://ec.europa.eu/info/business-economy-euro/economic-performance-and-forecasts/economic-forecasts/autumn-2016-economic-forecast_en

[6] Ibid

[7] Ibid

government spending, their neighbours started going through a boom, so increased exports to their neighbours more than filled the vacuum left by reduced government spending"[8]. Several papers from the IMF itself have backed up this analysis.

This is largely what happened in the Irish economic recovery, which has become the EU's poster child for austerity policies. The narrative goes that the Irish state followed the German model – it followed all of the EU rules and implemented the Troika's structural reforms, slashed government spending to reduce the deficit, cut wages to increase competitiveness, and as a result restored market confidence, depressed domestic consumption and experienced a corresponding rise in exports.

The reality is more complex, and is based on a combination of growth in jobs in the indigenous sector, including the services sector, arising from favourable exchange rates for the Irish state; and on the illusory "growth" of GDP caused by the industrial-scale corporate tax avoidance strategies undertaken by US multinationals in the technology, pharmaceutical and aircraft-leasing sectors.

There has also been a certain level of export-led growth since 2009 but it has been hugely exaggerated and difficult to reliably quantify. But this export-led growth did not in any way fit into the German model and "expansionary austerity" narrative of an internal devaluation based on lowering wages and domestic demand. Rather than being based on manufactured exports with a competitive edge because of wage cuts, export growth took place among firms in high-wage service sectors such as technology and finance during a period in which wages in these sectors were going up[9].

Of course, last year's ludicrous announcement that Irish GDP had grown by more than 26 per cent in 2015 raised an enormous red flag that all may not be what it seems in Ireland's economic recovery. Krugman, coiner of the "confidence fairy" term, found another apt folkloric description for the occasion: "leprechaun economics"[10].

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[8] Stiglitz, 2016 (above note 1). p159

[9] See Regan, Aidan and Brazys, Samuel. 'Celtic phoenix or leprechaun economics? The politics of an FDI-led led growth model in Europe'. January 12, 2017, UCD Geary Institute for Public Policy Discussion Paper Series. www.ucd.ie/geary/static/publications/workingpapers/gearywp201701.pdf

[10] Krugman, Paul. Tweet on July 12, 2016, @paulkrugman.

These figures were so detached from reality that they were cause for serious alarm but, incredibly, the Irish government welcomed them. According to the figures, per capita income apparently rose to 130,000 in 2015, and the state's industrial base doubled in just one year. But the Net National Income grew by 6.5 per cent in 2015 while consumer spending rose by 4.5 per cent. These income and consumption figures are a far more accurate reflection of real economic activity and growth. Official GDP figures have a major and serious role to play in fiscal planning, spending and borrowing. They need to be credible and a measurement of real economic activity.

Most alarmingly, the figures reveal a glimpse at the level of dubious accountancy tricks being played by multinationals in Ireland during a period in which the Irish government claimed it was committed to playing its part in the global crackdown on tax avoidance. The Irish Central Statistics Office (CSO) identified relocations and inversions by multinational enterprises as the major contributing factors to the so-called growth. It seems as though there was a rush by multinationals to 'turn Irish' in 2015 in the context of global action on tax avoidance and tax havens, through inversions – where a multinational corporation changes tax domicile after it buys up a smaller Irish-registered company. The transfer of financial assets and intellectual property patents into Ireland does nothing to actually create jobs or contribute to growth in the real economy.

In response to the fantasy figures for 2015, the Central Bank of Ireland published a study stating that to measure growth or activity without the reality being skewed by the activities of multinationals, GNI* (Gross National Income, modified) should be used instead. GDP and Gross National Income differ as a result of the "net factor income from abroad" (eg, repatriated profits and dividends of multinationals). While GDP is a measurement of the income generated by the economy, GNI measures the income actually available to its residents. Irish GDP is more than 20 per cent greater than GNI, one of the largest differences among all economies globally (the two figures can usually be used interchangeably).

But even using GNI is not sufficient to get an accurate picture of real economic activity according to the CSO, which developed a measure of "modified gross national income" or GNI*. GNI* is Gross National Income "adjusted for retained earnings of redomiciled firms and depreciation on foreign-owned domestic capital assets"[11] – ie, modified to account for depreciation on intellectual property owned by technology and pharmaceutical firms. When GNI* is used to measure the Irish economic recovery, the picture is not so rosy. "The Irish economy is about a third smaller than expected. The country's current account surplus is actually a deficit. And its debt level is at least a quarter higher than taxpayers have been led to believe,"[12] the *Financial Times* reported on the first set of "de-globalised" data on the Irish economy in July this year.

For 2016, the value of the Irish economy according to its GDP was €275 billion, but according to its GNI* its value was €190 billion – a huge difference that indicates that not only is the Irish economy not nearly as strong as the official narrative portrays, but also that the Irish state may have facilitated multinationals in avoiding up to €85 billion in tax in one year alone. The CSO reported that in 2015, government debt was 79 per cent of GDP but 100 per cent of GNI*; and that while the state's fiscal deficit was 1.9 per cent of GDP, it was 3.4 per cent of GNI*, well above the 3 per cent limit imposed by the EU's fiscal rules.

There has also been growth in employment over the past three years in the Irish indigenous sector. For example, job growth took place in the agriculture and food sectors, and in accommodation and tourism. This growth was based on two related factors. The first was the depreciation of the euro against the dollar and sterling as a result of the crisis, and the second was the relatively higher economic growth in Britain and the US, the Irish state's two largest trading partners. The (temporary) lower value of the euro was critical to the recovery experienced in the Irish indigenous sector. The relative growth in the US and Britain was also influenced by the fact that these two states are not constrained by the Fiscal Compact rules – borrowing in the US and Britain did not fall below 3 per cent since 2008.

But the specific circumstances of the Irish state's trading patterns mean that this "recovery" cannot be transposed or replicated in other member states of the EU. It also poses significant risks, especially the risk of a significant fall in the value of sterling as a consequence of Brexit. A sharp depreciation of sterling against the euro – something we

[11] Central Statistics Office, 'A Modified Current Account Balance for Ireland 1998-2016'. http://www.cso.ie/en/releasesandpublications/in/acabi/amodifiedcurrentaccountbalanceforireland1998-2016/

[12] Boland, Vincent. Ireland's 'de-globalised' data calculate a smaller economy, *Financial Times,* July 18, 2017. https://www.ft.com/content/dd3a6f1c-6aea-11e7-bfeb-33fe0c5b7eaa

are already beginning to see – would likely jettison this recovery. Worrying signs of a technology bubble, a new Irish housing bubble and a massive shadow banking sector are all factors that may also influence this recovery. Crucially, the structure of the Eurozone itself, and the austerity ideology it has enshrined, make another economic slump inevitable.

The evidence shows that the Irish recovery happened in spite of, not because of, the EU austerity recipe – and it would have happened sooner, and with far less pain to the Irish people, had ideologically driven deficit fetishism been rejected.

A fiscal straitjacket

In 1992 the member states of the European Economic Community (EEC) signed up to the Maastricht Treaty, which laid the foundation for the common currency. The Maastricht Treaty enshrined the so-called convergence criteria – a set of rules members and potential members of the common currency were obliged to follow. To join the Economic and Monetary Union (EMU), states had to pledge to control inflation, and government debt and deficits, and commit to exchange rate stability and the convergence of interest rates. The blanket, one-size-fits-all fiscal rules in the criteria – that member states must keep public debt limited to 60 per cent of GDP and annual deficits to below 3 per cent of GDP – were proposed by Germany, based on its national Stability and Growth Pact.

The convergence criteria, as the term suggests, were aimed at achieving convergence among the diverse economies that were to form the Eurozone. The founders of the euro acknowledged the tendency for economic shocks to hit diverse economies asymmetrically in a monetary union. Without convergence, a common currency won't work – for example, with diverse economies the interest rate set by the ECB for the entire Eurozone may impact positively on one country but negatively on another country with different economic characteristics. Without convergence, it would be difficult if not impossible to ensure full employment and current account (external) balance among different economies at the same time.

There are many spillover effects that one economy can have on another in a monetary union – for example trade imbalances and internal devaluations – but the only one that the Maastricht Treaty focused on was members' fiscal policy. "Somehow they seemed to believe that, in the absence of excessive government deficits and debts, these disparities would miraculously not arise and there would be growth and stability throughout the Eurozone; somehow they believed that trade imbalances would not be a problem so long as there were not government imbalances,"[13] Stiglitz comments.

Governments facing an economic downturn have three main ways they can aim to restore the economy to full employment: to stimulate exports by devaluing their currency; to stimulate private investment and consumption by lowering interest rates; or to use tax-and-spending policies – increase spending or lower taxes. Membership of the Eurozone automatically rules out using the first two mechanisms, and the fiscal rules largely remove the third option from governments.

(The confidence fairy is almost always accompanied by a fervent belief in "monetarism" among neoliberals – ie, that only monetary policy by an independent central bank should play any role in economic adjustment, and anything else would amount to dreaded government intervention in the economy.)

When a Eurozone member state experienced a downturn, its deficit would inevitably rise as a result of lower tax revenue and higher expenditure on social security. But when the convergence criteria kicked in, causing governments to cut spending or raise taxes, it would invariably worsen the downturn by dampening demand. Moreover, debt and deficits did not, and do not, cause economic crises. Ireland and Spain were running surpluses when they experienced a crisis, and both had low public debt.

The convergence criteria are purely ideological and economically unsound. But as the European Central Bank (ECB) was preparing to begin operating to control inflation and interest rates, Germany pushed for the adoption of an EU-wide Stability and Growth Pact in 1997, including non-Eurozone members, to enshrine the fiscal control aspects of Maastricht, and more generally to increase EU surveillance and control over member states' national budgets.

The Stability and Growth Pact has been called a lot of names in its day – the "Stupidity Pact", a "Suicide Pact", the "Instability Pact", and more. And it is deserving of each

[13] Stiglitz, 2016. pp103-104

one. In 2002, then-President of the European Commission Romano Prodi told reporters the pact was “stupid”, while French Commissioner Pascal Lamy called it “crude and medieval”. In practice, the Stability and Growth Pact has proved to achieve the opposite effects it claims to aim for. Cuts to government spending have a contractionary effect and cause the economy to shrink; when the national income shrinks, spending on unemployment benefits have to rise, and the situation gets worse. This is exactly what happened in the aftermath of the recessions in Ireland, Spain, Greece and Portugal.

Early in the 2000s, both Germany and France repeatedly breached the fiscal rules. But they were not penalised, and were always provided with an extension to try to meet the targets. Almost all EU member states have breached the rules at some point – during the recession only Luxembourg did not go over the 3 per cent deficit target. Fiscal contraction will exacerbate unemployment, but it may eventually restore a current external account balance – when demand for imports becomes so low as a result of the recession that exports catch up.

University of London Professor George Irvin has described German Chancellor Angela Merkel’s insistence that government profligacy is at the root of the Eurozone crisis as betraying “near-total ignorance of how economies work”[14]. “Budget balance for a national economy is fundamentally different from that of the household or the firm. Why? Because budgetary (or fiscal) balance is one of three interconnected savings balances for the national economy. The other two fundamental economic balances are the current external account balance… and the private sector savings-investment balance. If any one account is out of balance, an equal and opposite imbalance must exist for one or both of the remaining accounts,”[15] he wrote.

But despite the vast evidence that the Stability and Growth Pact was counterproductive and unenforceable, Germany pushed for the fiscal rules to be tightened yet again in 2012 through the Fiscal Compact Treaty, which created the obligation for the convergence criteria targets to be inserted into the national law of the ratifying states.

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[14] Irvin, George. ‘Why Europe's fiscal compact is bound to fail’, *The Guardian*, May 11, 2012. https://www.theguardian.com/commentisfree/2012/may/11/europe-fiscal-compact-fail

[15] Ibid.

The Fiscal Compact

In 2010, Germany proposed the reform of the Stability and Growth Pact to make it stricter, and "in return" pledged to support the creation of a Eurozone bailout fund that member states could draw upon if they were in dire straits – with strict fiscal conditions attached, of course. The reforms aimed at enforcing compliance of the Stability and Growth Pact known as the "Six-Pack" and "Two-Pack" of additional regulations and directives were adopted at EU level.

In 2012, an intergovernmental treaty – the Treaty on Stability, Coordination and Growth – was signed by all EU Member States with the exception of Britain and the Czech Republic. (When Croatia joined the EU in 2013, it declined to sign.) The Treaty, known as the Fiscal Compact, incorporated the Stability and Growth Pact, the Six-Pack and Two-Pack requirements, and more. Its central principle is that member states' budgets must be in balance or in surplus, which the Treaty defines as not exceeding 3 per cent of GDP.

Critics of the Stability and Growth Pact had called on the EU to focus not on the general deficit but rather the structural deficit – what the deficit would be if the economy were at full employment. But instead of dropping the general deficit limit, the Fiscal Compact has adopted rules on both the general deficit and the structural deficit. The structural deficit limits are set by the Commission on a country-by-country basis and must not exceed 0.5 per cent of GDP for states with debt-to-GDP ratios of more than the 60 per cent limit, and must not exceed one per cent of GDP for states within the debt levels.

The "debt-brake" rule is the convergence criteria rule that government debt cannot exceed 60 per cent of GDP. The Fiscal Compact enshrines the rule that members in excess of this limit are obliged to reduce their debt level above 60 per cent at an average of at least 5 per cent per year. The structural deficit rule – called the "balanced budget rule" – must be incorporated into the national law of signatory states under the Fiscal Compact. An "automatic correction mechanism", which is to be established at member state level and kicks in when "significant deviation" from the balanced budget rule is observed, must also be incorporated into national law.

Of all the member states who signed the intergovernmental treaty, only the Irish state put the Fiscal Compact to a referendum. The Fiscal Compact Treaty was adopted by just over 60 per cent of the voting electorate, with around 50 per cent turnout. The Fine Gael/Labour government's decision to hold a referendum was not based on a belief in the right of the Irish people to have their say on their economic future, but rather their desire to go one step beyond simply incorporating the permanent austerity rules into legislation, and to insert them into the Constitution – despite the fact that the government's Fiscal Advisory Council recommended the legislation option. Fine Gael, Fianna Fáil and Labour representatives urged the people to vote yes, dangling the carrot of access to the new bailout fund. The vote in favour was hailed by the government as an endorsement of its austerity policies.

The reality is that the Irish electorate was blackmailed into voting in favour of a proposal that endorsed a damaging austerity framework based on free-market fundamentalism as a result of the threat of crisis funds being withheld in future, and by the promise of the debt burden being relieved through the direct recapitalisation of the failed Irish banks by the future European Stability Mechanism. And after the approval of the Fiscal Compact Treaty and the constitutionalisation of austerity in Ireland, the Fine Gael-led government quietly dropped its call for the EU to recapitalise the Irish banks. Unbelievably, by 2015, the same Irish government representatives who had urged voters to approve the Fiscal Compact Treaty were pleading with EU authorities for more flexibility for Ireland's implementation of the rules.

Irvin points out that Germany's debt-brake cannot be good for other Eurozone countries, or even possible, for three reasons – that Germany's exports to the Eurozone are by definition another member state's imports; that there is insufficient global demand to sustain all Eurozone economies becoming net exporters like Germany; and that the public debt-brake completely ignores the problem of private debt, especially in the over-leveraged banking sector[16].

In a scathing critique of the Fiscal Compact, Francesco Saraceno and Gustavo Piga highlight that "no other country in the world has ever considered [such a rule], and with good reason" and say that the adoption of the Fiscal Compact has been "untimely, unfortunate and unequivocally wrong". "Its uniquely negative effects, as the experience

[16] Ibid.

of Italy clearly shows, lie in the perverse features whereby, even if a government is allowed to renege year after year on the promised path toward a balanced budget, it is still required, every year, to recommit to a medium term (3-4 years) adjustment toward that balance. In so doing, business expectations are negatively affected, private investment plans are postponed, and stagnation becomes a permanent feature of the economy,"[17] they write.

Return fiscal powers to member states

There have been repeated efforts, led by Germany, to exercise control over the budgets of member states. For several decades now, France's demand for a European monetary union was always met with the German response that it must be accompanied by fiscal union, or German-led surveillance and control over national budgets. The same argument continues today, based on the same flawed ideology.

There have been several important proposals to reform the Fiscal Compact – for example, to focus only on the structural deficit; or to exclude capital investment from the rules. But while these proposals may loosen the straitjacket a little, it would be better to just take it off. As part of the Fiscal Compact treaty, the Council is required to adopt a formal decision on the Fiscal Compact by 1 January 2018 on whether or not to insert it into the EU Treaty. Saraceno and Piga argue: "If a number of important countries were to veto that move, this could set in motion a profound rethink of the appropriate fiscal policy infrastructure supporting the euro zone in future, one consistent with recent developments in macroeconomics."[18]

The Fiscal Compact has already been proven to be unworkable. The European Council voted last year to adopt the Commission's recommendation to impose no fines for excessive deficits on Spain and Portugal in a clearly politically motivated decision. The austerity lie is losing its power, with even the IMF and the Commission questioning its benefits after a decade of stagnation. Barry Eichengreen and Charles Wyplosz argue that the attempt to centralise fiscal policy at the EU level is "doomed" and should be abandoned. In a paper on minimum conditions for the survival of the Eurozone, they

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[17] Saraceno, Francesco and Piga, Gustavo. 'European Leaders Should Ditch The Fiscal Compact', Social Europe, February 3, 2017. https://www.socialeurope.eu/european-leaders-should-ditch-the-fiscal-compact

[18] Ibid.

write: “The fiction that fiscal policy can be centralised should be abandoned, and the Eurozone should acknowledge that, having forsaken national monetary policies, national control of fiscal policy is all the more important for stabilisation.”[19]

[19] Eichengreen, Barry and Wyplosz, Charles. ‘Minimal conditions for the survival of the euro’, *How to fix Europe’s monetary union: Views of leading economists*. VoxEU Ebook. February 12, 2016.

CHAPTER TWO

From Bretton-Woods to Maastricht: the creation of the Eurozone

WHEN AN economic downturn affects a country, for whatever reason, a government usually has three key tools to stimulate the economy and restore full employment – lowering interest rates, devaluing the country's currency (or allowing it to depreciate), or using macroeconomic policy (eg, lowering taxes and boosting public spending). In a currency union, the first two options are dependent on the policy choices imposed by the union's supranational institutions instead of national bodies.

If all of the economies within the currency union are sufficiently similar in nature, this should theoretically not be a problem. But the economies of the 19 member states of the Eurozone vary widely in their characteristics. At any given moment, the value of the euro vis-à-vis other currencies may be beneficial for some states' economies but damaging for others. Likewise, the Eurozone-wide interest rates set by the ECB may boost some economies but depress others.

An economic crisis that affects a monetary union comprised of diverse economies will affect different countries in different ways. The designers of the Eurozone were aware of this possibility of "asymmetric shocks" having a different impact on different member states, motivating their development of the so-called convergence criteria. However, for ideological reasons, they chose to focus only on the issue of budgetary divergence, controlling member states' national debt and deficits. This singular focus on controlling fiscal policy – despite overwhelming evidence that public spending cuts have a contractionary impact during downturns, and with no corresponding focus on the external current account (trade) balance of member states – has caused an increase in inequality and contributed to divergence instead of convergence among the Eurozone's economies since the introduction of the currency peg.

While left-wing political movements and parties in Europe have focused on campaigning against the policy choices enacted by the EU institutions since the crisis, particularly the imposition of fiscal austerity, there is an urgent need to also examine –

and explain – how the very structure of the Eurozone has contributed to inequality and divergence, prolonged and deepened the financial crisis and sovereign debt crisis, and makes future sovereign debt crises inevitable.

The gold standard currency peg

The euro is a currency peg system, which lacks the institutions that have allowed a common currency to work in other parts of the world – ie, in federal states such as the United States, Canada and Australia. Under a peg system, a currency's value is fixed relative to a commodity, or to another currency.

Before the 20th century the global monetary system was characterised by the gold standard, where the value of different countries' currencies were pegged to the value of gold, and to each other. The reason there was widespread support for fixing a state's currency relative to gold was so that governments would not be able to print more money in response to economic conditions to their short-term political benefit. It was intended to deliver price stability. If there was more money pumped into the economy, it would cause prices to rise – causing inflation, reducing the purchasing power of working people, and making it harder for businesses to export their goods. Governments fixed their currencies at a set exchange rate, fixed the rate for exchange of these currencies with gold, and fixed the amount of money they could print with the small and reliable amount of gold entering the economy each year due to new discoveries of the precious metal.

For many decades during the 18th and 19th centuries, the US used a fixed gold standard and at other times relied on fiat money (money backed by a government guarantee instead of being backed by gold) – at times floating, and at times fixed to gold. The scarcity of gold in the late 19th century led to falling prices, deflation and depression in the US; debt became more difficult to repay. During the First World War the Gold Exchange Standard was temporarily suspended. But in spite of these problems and temporary suspensions, the Gold Exchange Standard was still being used by the capitalist countries when the Wall Street stock market crashed in 1929.

This currency peg worsened the Great Depression for the countries that clung to it because it prevented their governments from printing more money to stop banks and businesses failing, and generally to stop a deflationary spiral developing; those who exited the currency peg earlier recovered quicker. The two central lessons of 1929 and governments' response to it, almost universally accepted by economists today, are that both inflexible exchange rates and austerity measures in response to a sharp downturn will deepen and prolong the crisis.

When a state's money is flexible it works as a form of shock absorber, but fixed exchange rates remove a key way that economies can adjust to shocks or trade imbalances. Instead of abandoning the gold standard in response to the Great Depression, US President Hoover raised trade tariffs, contributing to a rise in protectionism and a decline in global trade. Some countries who had walked away from the gold standard retaliated by engaging in competitive devaluations of their currencies, in an example of 'beggar-thy-neighbour' economic policies. These 'currency wars', as they were known, saw countries cause the exchange rate of their currency to fall in relation to other currencies in order to gain a trade advantage – i.e., in order to boost their exports at the expense of other economies. When Franklin Delano Roosevelt won the US presidential elections in 1932, he promptly took the US out of the gold standard, largely ending the common currency system of the era. But the damage had been done, and the slump in the global economy continued until the massive public investment into the "industrial scale carnage"[20] brought about by the Second World War.

The golden era of Bretton-Woods, 1944-1967

The decision to create the euro in 1992 was based on different motivations among its proponents in different countries. But one of the key goals shared by all of the participants was to create a replacement for the Bretton-Woods system that had underpinned the global economy since the end of the Second World War. Bretton-Woods disintegrated in August 1971 with the 'Nixon Shock', the announcement by then-US President Richard Nixon that the US was abandoning its commitment to propping up the global economy with the dollar.

The post-war global financial and monetary system was devised and agreed at a three-week conference attended by representatives of 44 Allied countries in the town of Bretton-Woods, New Hampshire, in the US in July 1944 as the Second World War

[20] Varoufakis, Yanis. 2016. *And the Weak Suffer What They Must?* Vintage, London

neared its end. It aimed to bring an end to the inter-war global financial volatility that had led to the Great Depression and the collapse of the gold standard, as well as the post-Depression rise of protectionism and competitive currency devaluations.

The leading figures formulating the agreement were John Maynard Keynes on behalf of the British Treasury, and his more powerful counterpart from the US, Harry Dexter White, representing President Roosevelt. In addition to creating the International Monetary Fund and the International Bank for Reconstruction and Development (which later became known as the World Bank), the agreement also included a commitment to a global fixed-exchange rate system, underpinned by the American dollar, in turn backed by gold. Restrictions were placed on international capital flows in order to prevent currency speculation. The IBRD was to act as an international investment bank with the goal of promoting economic recovery from the war.

As part of the agreement, the US committed to guaranteeing this fixed exchange rate and the convertibility between the dollar and the gold it held, at the price of $35 per ounce of gold. There was a limited option for a country's exchange rate to be renegotiated if it was clearly impossible to maintain. Within the fixed exchange rate, governments would be required to keep fluctuations within a band of plus or minus one per cent, by buying or selling their own dollar reserves.

The main reason the pre-war gold standard had collapsed was that it was unsustainable for countries to continue to keep such a high value for their currencies when their current account, or trade account, was in a deep deficit. Then, as now, there are balance-of-payment creditor economies with a trade surplus, meaning they export more than they import, and debtor economies with a trade deficit, meaning they import more than they export. A surplus in one country must equal a deficit in another, and every deficit must be financed, usually by borrowing. Economies with a trade surplus find themselves holding large quantities of money in their banks, who lend it to the deficit countries which need to finance their imports. As money is scarce in deficit countries, the interest rate will be higher, meaning it is more profitable for banks to lend to borrowers in these debtor nations. This lending by banks recycles the surpluses – but during a downturn such lending dries up[21].

[21] Ibid.

The role of the IMF, according to the Bretton-Woods agreement, was to (partially) address this problem for debtor countries by acting as a lender of last resort. White, representing the world's largest creditor country, scuttled Keynes's proposals for measures to be taken to adjust trade imbalances on the part of creditor nations, and for a new global currency, the *bancor*, to be created to underpin an international balance-of-payments clearing mechanism.

However, White and Roosevelt did understand that such a global fixed exchange rate would remove a shock absorber for the global economy and would have the potential to turn a future downturn in the value of the dollar into a global recession. They aimed to establish a mechanism to avoid this. They believed strong regional currencies, backed by heavy industry, needed to be developed in both Europe and Asia[22]. Very quickly after the war was over the US turned to its former foes to act as these strong regional currencies to support the dollar. In March 1947 then-President Harry Truman made a speech calling on the US Congress to intervene in Greece's civil war by plugging the gap left by the British in providing financial support to pro-monarchist forces fighting Greek communists. The speech marked the arrival of the Truman Doctrine, opening the Cold War era, and it also marked the beginning of a US-backed industrial revival in its former enemies-turned-protégés, West Germany and Japan.

The Marshall Plan, officially known as the European Recovery Program, was launched shortly after the Truman Doctrine was announced and saw the US pump in more than 2 per cent of its national income in aid to western European economies to assist in recovering from the war, but also to ensure their dollarisation. The final factor that ensured Germany's revival was the role of the US at the London Debt conference of 1953, in which it pressured other European countries to write down, or even write off, Germany's pre-war debts.

In his book on the changing role of the US in the global economy throughout the 20th century, former Greek finance minister Yanis Varoufakis writes that Keynes's proposal for an International Currency Union was overruled by Roosevelt's New Dealers because they had an alternative plan: "The dollar would effectively become the world currency and the US would export goods *and* capital to Europe and Japan in return for direct

[22] Ibid.

investment and political patronage"[23]. The US would run a massive trade surplus with the rest of the world, but it would also use this surplus to directly finance its protégés through aid and investment – meaning that demand for US products would be sustained in these countries. It would also support its key regional currency partners, West Germany and Japan, in their development of trade surpluses with their neighbours at a regional level.

In other words, the US was committed to ensuring it benefited from its position of a strong trade surplus, but made a simultaneous commitment to recycle a large part of its own surplus – in order to bolster other capitalist countries during the Cold War, and to ensure the stability of the new monetary system. The Bretton Woods structure "plainly recognized the asymmetry of the world as it was"[24], according to US economist and former Federal Reserve chair Paul Volcker, speaking in 1978. "The US, in effect, held an umbrella over the system."[25]

Nixon Shock: 'It's our currency but it's your problem'

The Bretton Woods era saw two decades of post-war growth and relative stability. But the US had designed this global architecture in the mistaken belief that it would always be in the position of being a trade surplus country. The growth in the industrial capacity of West Germany and Japan in the following decades, combined with a massive rise in US government debt as a result of the costs to the US Treasury of the Vietnam War, started to shake the system by the mid-to-late 1960s. The global trade balance experienced an inversion and the US entered a deficit. Only the US was allowed to print more dollars under the Bretton Woods system, but the fixed exchange rate meant that other currencies pegged to the dollar started to suffer the consequences of US monetary policies. The rising amount of dollars was causing inflation in Europe and elsewhere, and in order to keep the fixed exchange rate in place, European governments had to increase the volume of their own currencies. Currency speculators predicted that the price of gold could not be maintained at $35, and frenetically purchased stocks of gold, worsening the situation.

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[23] Varoufakis, Yanis. 2011.*The Global Minotaur,* Zed Books, London, p67

[24] Volcker, Paul. 1978. 'The Political Economy of the Dollar'. Fred Hirsch Speech at Warwick University, https://www.newyorkfed.org/medialibrary/media/research/.../1978v3/v3n4article1.pdf

[25] Ibid.

Germany, France and Britain in particular began to signal their displeasure at the rising quantity of dollars in global markets. From the early 1960s, the Bundesbank resisted printing more Deutschmarks to defend the currency peg. In 1967, the British government under Labour Prime Minister Harold Wilson made an extreme deviation from the one-per-cent fluctuation limit set by Bretton Woods and devalued the pound sterling by 14 per cent. And most dramatically of all, France sent a warship filled with US dollars to New York harbour in early August 1971 with instructions to claim its gold held in the US Federal Reserve and Fort Knox. Britain immediately followed suit – minus the warship – and requested that $3 billion it held in US dollars be redeemed for gold.

Within days, US President Richard Nixon announced the end of gold convertibility on 15 August 1971, in a move that became known as the Nixon Shock and which marked an abrupt collapse of the Bretton Woods system. The US was cutting the rest of the world loose from the dollar zone. The regions that had benefited most from the system, Europe and Japan, would suffer the most from this unceremonious ejection. The US Treasury Secretary, John Connally, famously told a group of European finance ministers that the dollar "is our currency, but it's your problem".

The idea of suspending gold convertibility was proposed to Nixon by Paul Volcker as a kind of 'Plan B' in May 1971; Nixon had appointed him as undersecretary of treasury in 1970. At a speech Volcker made in 1978, he reflected: "In the end, the inherent contradictions in the system were too great. With the benefit of hindsight, it would seem that an erosion of the US competitive position was implicit in the post-war arrangements. Europe and later Japan brought its industrial capacity close to US. It took some twenty years, but eventually the US payments position was irreparably undermined."[26] In the same speech he also said that US policymakers in 1971 believed that "controlled disintegration" of the global economy was a "legitimate goal"[27]. The price of gold and commodities rose drastically and the 1970s were marked by a period of so-called 'stagflation' where high unemployment combined with high levels of inflation.

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[26] Ibid.

[27] Ibid.

Varoufakis offers a convincing analysis and description of the reversal in global capital flows that followed the Nixon Shock. The US now had both a government deficit and a trade deficit, which policymakers resolved to find ways of making the rest of the world finance. The surpluses generated by the former US beneficiaries, Germany and Japan, needed to be redistributed towards the US somehow. Varoufakis argues that there were "two prerequisites for the reversal of global capital flows, which would see the world's capital stream into Wall Street for the purpose of financing the expanding US twin deficits"[28] – a rise in the competitiveness of US firms against their competitors in Europe and Japan, and a steep rise in interest rates in the US that would attract capital flows to the US by increasing profitability, but damage other countries' economies and its own population.

This motivation underpinned the tight constraint of average real wages in the US since the 1970s – which to this day have not regained the real purchasing power they had in 1973 – and unleashed the wave of financial deregulation that was then implemented with enthusiasm by President Ronald Reagan. Capital gravitated towards the dollar in the aftermath of the Nixon Shock, purchasing US Treasury bills and investing in Wall Street. As net capital flows reversed – flowing into the US rather than out of it – the surplus capital of other countries was recycled as the US government and consumers then bought the exports of these same countries. The US played the complete reverse role it had during Bretton Woods but its leading role in recycling trade surpluses in order to maintain a semblance of balance continued. An expansion in the access to credit as a result of capital flows into Wall Street meant working people in the US increasingly went into debt to compensate for their stagnating wages, a pattern that was soon to be replicated in Europe.

The Union is born – as a price-fixing cartel

Understanding the Bretton Woods system, and the reversal in global capital flows that followed its collapse, is crucial to understanding the structures and beliefs underpinning the Eurozone – because the creation of the Eurozone was largely an attempt to recreate the Bretton Woods system.

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[28] Varoufakis, 2011 (above note 17). p98

The European Coal and Steel Community (ECSC), created in 1951, was the first step towards a European Union (EU). In 1950, French foreign minister Robert Schuman proposed that “Franco-German production of coal and steel as a whole be placed under a common High Authority, within the framework of an organisation open to the participation of the other countries of Europe”, which later became the ECSC with the Treaty of Paris in 1951, signed by West Germany, France, Italy, Belgium, the Netherlands and Luxembourg. This “High Authority” of 1951 became known as the European Commission.

Although the leaders of the ECSC participant countries of 1951, and the EU leaders of today, would express horror at such a characterisation, the reality is that the EU began life as a US-devised price-fixing cartel, which “openly and legally controlled prices and output by means of a multinational bureaucracy vested with legal and political powers superseding national parliaments and democratic processes”[29], according to Varoufakis in his book on the history of the Eurozone and the crisis. France and other countries also aimed to ensure the post-war scarcity of coal and steel did not work to Germany’s advantage. The ECSC fixed the price of coal and steel, and later moved to remove tariffs on coal and steel between members, and then on all goods.

The Treaty of Rome created the European Economic Community (EEC) in 1957. The objections of farmers, particularly in France, to the lowering or elimination of tariffs led to the creation of the Common Agricultural Policy from 1962 onwards, where part of the profits made by the heavy industry cartel were distributed to farmers as subsidies in order to gain their compliance with further economic integration and a customs union. A monetary union was first raised in the Marjolin Memorandum in 1962, authored by the European Commission. This memorandum initiated the first discussion on monetary integration in the EEC and proposed that the customs union should lead to fixed exchange rates between the currencies of its members. But as the Bretton Woods system was working reasonably well at the time to ensure exchange rate stability, there was little follow-up on the proposal in the short term. The first call for a common currency from a political leader came in 1964 – from then-French finance minister (and later President) Valéry Giscard d’Estaing.

[29] Varoufakis, Yanis. 2016. *And the Weak Suffer What They Must?* Vintage, London

A defining moment in the development of a common currency was the publication in 1970 of the Werner Report (to the Council and Commission of the European Communities) "on the realization by stages of economic and monetary union in the Community"[30]. This report, produced against the backdrop of an increasingly strained, and soon to be destroyed, Bretton Woods system, proposed the main elements necessary for monetary union: full and irreversible convertibility of the currencies of the union; elimination of fluctuations in exchange rates; complete freedom of movement of capital; and the centralisation of monetary policy. National currencies could be maintained under the system, the report stated, or a single Community currency could be created, "but psychological and political factors weigh the scale in favour of adopting a single currency that would *demonstrate the irreversible nature of the undertaking*"[31] (my emphasis).

A snake in a tunnel

The first practical attempt at creating a European currency peg, known as the 'snake in the tunnel', began in 1972. The metaphor was grim but apt – the snake was a currency's exchange rate, and the tunnel was the narrow band in which the rate could fluctuate. Several members of the EEC, plus Britain, Ireland, Denmark and Norway, agreed to limit the margin of fluctuation between their currencies to a difference of no more than 2.25 per cent. It was a clear and open attempt to replicate the Bretton Woods fixed exchange rate regime in order to regain price stability between the European currencies after the collapse of the dollar-backed system the year before.

The Nixon Shock had caused the value of the dollar to fall but the Deutschmark to rise significantly, meaning the price of West Germany's exports were becoming increasingly expensive. The Deutschmark's soaring value strained the attempts to manage (or fix) the prices of Europe's heavy industry and agricultural sectors, the *raison dêtre* of the EEC. The oil shock – a huge and sudden rise in energy costs – of 1973 forced the deficit countries to emerge from the tunnel. France, Italy, Britain and Ireland could not maintain these fixed exchange rates with the Deutschmark. The only way these deficit countries could maintain such an exchange rate was to increase their interest rates to attract foreign capital and to cut public spending to increase 'confidence' that

[30] Werner Report, 1970. Available at aei.pitt.edu/1002/1/monetary_werner_final.pdf

[31] Ibid.

government debt could be repaid, both of which would have significant negative effects on their own populations. By the late 1970s, only the Deutschmark, the Danish Krona and the Benelux countries' currencies – Belgium, Luxembourg and the Netherlands – were still members of the snake in the tunnel system.

The road to Maastricht

As is the case with all major developments in the history of the EU, the creation of the European Monetary System (EMS) enacted in 1979 was the product of a political compromise between Germany and France. The German and French leaders had announced the creation of the EMS in September 1978. The EMS set a European Currency Unit (ECU) as a "basket" of currencies, and it established an Exchange Rate Mechanism (ERM), which was based on fixed exchange rate margins – but with a degree of variation possible within those margins. There was no official "anchor" currency of the EMS, which lasted for two decades until 1999. But indisputably the Deutschmark was the anchor, and the policies and approach of the system were heavily influenced by the Bundesbank's phobia of inflation.

There were four key phases of the EMS according to an expert report carried out for the European Commission[32]. The first phase, 1979-1985, included the retention of capital controls by several member countries. The inflation differentials, combined with fixed nominal exchange rates, required "frequent adjustment of the official parities"[33]. The Irish state joined the EMS in 1979, and was required to break the punt's parity with sterling in order to do so, as sterling – not in the ERM – was appreciating against the ERM currencies. Parity with sterling would have taken the punt outside of the agreed band, so it had to be broken as a condition for Irish entry into the ERM.

During the second phase, 1986-1992, the EMS was referred to by many as the "Deutschmark Area" because members of the system were forced to give up their own monetary policies in order to implement the anti-inflation policies of the Bundesbank and reduce their inflation levels to "German" levels. The so-called Mundell–Fleming trilemma (developed by Robert Mundell and Marcus Fleming, also referred to as the

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32 Mongell, Francesco Paolo. 'European economic and monetary integration and the optimum currency area theory'. Report for European Commission, February 2008.

33 Ibid.

“impossible trinity”) holds that it is impossible for an economy to simultaneously maintain a fixed exchange rate, free movement of capital, and an independent monetary policy. The Commission report agrees: “Owing to the impossible trinity all central banks participating in the ERM had de facto renounced an independent monetary policy”[34].

During this second phase, the Single European Act was passed in 1986, moving towards a single market in the EEC. The then-Commission President, Jacques Delors, established a committee to examine a possible future monetary union, which produced the ‘Delors Report’ in 1989 – the document that led to the Maastricht Treaty of 1992 (endorsed by EEC governments in 1991 but ratified in referenda in Denmark and France in 1992). The Delors Report promoted the view that there was a need for national budget deficit rules, which became the Maastricht convergence criteria, and proposed a new institution, independent of member states, with responsibility for monetary policy – the European Central Bank. In 1990, following the Delors Report’s roadmap, capital controls among members of the EMS were abolished. These developments occurred against the backdrop of the disintegration of the Soviet Union and of German reunification.

From September 1992 until March 1993 the EMS experienced a severe crisis. Some of the members of the EMS were experiencing rising inflation which they were unable to reduce. Currency speculators targeted the over-valued currencies. Fears that voters would reject the Maastricht Treaty on a monetary union, proposed in 1991, contributed to the speculative currency attacks. In June 1992 the Treaty was rejected by 50.7 per cent of Danish voters in a referendum. A similar referendum was held in France, which narrowly endorsed the Maastricht Treaty in September 1992, with 51 per cent of voters supporting it. But massive speculative pressure in the lead-up to the French referendum contributed to the worst crisis in the history of the EMS, which led to the forced ejection of the pound sterling and Italian lira from the ERM, the devaluation of Spain’s peseta, and threats of forced devaluation of other currencies. The fluctuation margin of the EMS was widened to an enormous plus or minus 15 per cent in 1993 in a bid to stop other currencies, particularly the franc, from having to exit. Italy later rejoined the ERM in 1996.

[34] Ibid.

The final phase of the EMS lasted from 1993 until 1999 when the Eurozone was launched by its original 11 member states – Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal and Spain. Greece joined the Eurozone in 2001, Slovenia in 2007, Cyprus and Malta in 2008, Slovakia in 2009, Estonia in 2011, Latvia in 2014, and finally Lithuania in 2015. An ERM II is in place, supposedly to draw non-Eurozone members of the EU into an alignment of exchange rates, but only the Danish Krona is a member currently. The single market was completed in 1993, allowing the free movement of capital, labour, goods and services, becoming formalised in 1994 by the European Economic Area (EEA) agreement.

TIMETABLE OF MONETARY INTEGRATION[35]

1958 Establishment of the Monetary Committee

1962 A proposal for economic and monetary union among the members of the European Economic Community (EEC) is first floated in the Marjolin Memorandum.

1964 A Committee of Governors of the central banks of the Member States of the EEC is formed to institutionalise the cooperation among EEC central banks.

1970 The Werner Report sets out a plan to realise an economic and monetary union in the Community by 1980.

1972 A system (the "snake") for the progressive narrowing of the margins of fluctuation between the currencies of the Member States of the EEC is established.

1974 The ECOFIN Council adopted a Decision to foster the convergence of economic policies and a Directive on stability, growth and full employment.

1979 The European Monetary System (EMS) is created.

1987 Strengthening of the EMS through the Basle-Nyborg Agreement.

1988 The European Council mandates a committee of experts under the chairmanship of Jacques Delors (the "Delors Committee") to make proposals for the realisation of EMU.

1989 The "Delors Report" is submitted to the European Council.

1989 The European Council agrees on the realisation of EMU in three stages.

1990 Completion of "One Money, One Market" evaluation that had been commissioned in 1988 as an input for the Delors Report.

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[35] Reprinted from [35] Mongell, Francesco Paolo, 2008 (above note 25).

1990 Stage One of EMU begins in July. An Intergovernmental Conference to prepare for Stages Two and Three of EMU is launched.

1992 The Treaty on European Union (the "Maastricht Treaty") is signed in February.

1993 The Treaty on European Union enters into force.

1994 Stage Two of EMU begins and the EMI is established.

1997 The European Council in June agrees on the Stability and Growth Pact.

1998 In May Belgium, Germany, Spain, France, Ireland, Italy, Luxembourg, the Netherlands, Austria, Portugal and Finland are considered to fulfil the necessary conditions for the adoption of the euro as their single currency; the Members of the Executive Board of the ECB are appointed.

1998 The ECB and the ESCB are established in June.

1999 In January Stage Three of EMU begins; the euro is launched; conversion rates are fixed irrevocably; a single monetary policy is established for the euro area.

2001 Greece joins the euro area.

2002 The euro cash changeover: euro banknotes and coins are introduced and become sole legal tender in the euro area by the end of February 2002.

2004 In May the national central banks of the ten new EU Member States join the ESCB.

2007 Slovenia joins the euro area.

2008 Cyprus and Malta join the euro area, and Bulgaria and Romania join the EU and ESCB.

CHAPTER THREE

Some euros are more equal than others: trade imbalances and debt crises

WHY WERE leaders of European Union countries so determined to establish a monetary union among member states despite the setbacks and shocks experienced in the first decades of such an attempt at creating a common currency? In part it was a response to the collapse of Bretton Woods, and in part it was viewed by committed European federalists as a way to push the pace of political integration. There was a widespread belief stretching back to the Gold Exchange Standard that a common currency would ensure price stability and predictability, eliminate the risk of changes in exchange rates and therefore boost trade. For the European deficit states, the susceptibility of their currencies to repeated devaluations against the Deutschmark was viewed as an economic and political vulnerability, which caused inflation that reduced the purchasing power of both rich and poor. Meanwhile, from the mid-1980s the expanding US deficit had allowed both Germany and the EEC as a whole to generate a trade surplus. For the technocrats that had already set up shop in the limited European community administrative bodies, the creation of the euro would speed up the process of political integration and movement towards a European federation.

A shared currency with different motivations

Successive French governments had repeated the call for a European monetary union since Giscard d'Estaing first proposed it in 1964, with a view to reining in German power – and to make it easier to impose wage restraint on French workers, by comparing their wages with those of German workers. French national expertise in constructing political institutions would also be able to shine in a European administration. Germany had dragged its heels on such a union for decades, largely because of a fear that a fixed exchange rate between the franc and the Deutschmark would require the Bundesbank to print more money to prop up the franc, causing inflation that had been regarded with profound dread by Germans since their experience of the hyper-inflation of the 1920s, a dread that continues to define German monetary policy today.

The typical explanation regarding the creation of the Economic and Monetary Union (EMU) found in history books is that Germany finally agreed to the long-standing French call for a monetary union after the fall of the Berlin Wall in exchange for French acceptance of Germany's reunification. But it was also created to accommodate Germany's export-led economic strategy. The Deutschmark's sky-high value in the wake of the collapse of Bretton Woods was a reminder to Germany that if the Deutschmark's exchange rate was to float freely its value could rise indefinitely, making its exports too expensive and destroying its trade surplus strategy. Competitive currency devaluations were successfully reducing Germany's trade surpluses with the countries that used them during the 1980s. Germany needed some way of locking its exchange rate to other currencies after the demise of the dollar zone. The ERM was viewed as a partial solution to these problems by German political leaders and the Bundesbank. But the speculative attacks on the currency fluctuations possible within the ERM that caused its collapse in 1992 led Germany to finally accept the creation of a common currency – on the condition that the deflationary debt and deficit rules of the Maastricht convergence criteria were accepted by its neighbours, of course.

Germany's biggest export – stagnation

The question of how to deal with chronic, persistent trade imbalances within a common currency area was resolved to a large degree under the Bretton Woods system by the American commitment to spend its surplus internationally – its direct injection of capital into the economies of its capitalist allies during the duration of the system through aid and then investment. In this way, the US exported its goods but it also exported demand. The German model, on the contrary, aims to export its goods and import demand from other countries. In this way, the biggest German export can said to be stagnation. Instead of playing a role of recycling surplus profits, generating growth and stabilising the international economic system, the persistent German surplus plays a destabilising and deflationary role in the monetary union.

China has faced much criticism internationally in recent years for consistently running a large trade (or current account) surplus, but Germany's trade surpluses have been almost twice as high as China's in recent years as a percentage of GDP. China has made a conscious effort to reduce its economic dependence on exports, while Germany recorded a record surplus in the first half of 2017. Large and persistent trade surpluses are a problem because the sum of all surpluses has to equal the sum of all deficits. As discussed above, in stable economic periods, the banks in surplus countries can lend to borrowers in deficit countries, maintaining a semblance of balance, but in a crisis this surplus recycling measure comes to a sudden stop. But chronic surpluses also cause an overall decline in demand. The surplus countries are exporting goods but they are spending less than they are making in income.

Keynes called this the paradox of thrift – the phenomenon where when a country's population saves their money during a downturn this actually causes a fall in aggregate demand, while total savings are not actually increased. Savings must equal investment, so if the level of investment remains the same, the level of savings must also remain the same. People might save a higher proportion of their income, but the only way the level of savings can change is if there is a reduction in the level of income. Stiglitz argues that the global economy today "is in this precise position, with a deficiency of aggregate demand leading to slow growth and 200 million unemployed. This deficiency of demand is the cause of what many call global secular stagnation"[36] (secular meaning long-term stagnation as opposed to cyclical stagnation).

Trade imbalances cause debt crises

Trade imbalances do not only contribute to stagnation. Countries who run deficits must borrow the gap between what they export and what they import, meaning they have to take on more debt and become exposed to the risk of a debt crisis. If the country's exchange rate can be devalued, then the external imbalance can be gradually reduced as the deficit country's exports become more competitive on the global market. But inside a currency union, the option of exchange rate adjustment disappears. The main alternative way for a deficit country inside a currency union to regain trade balance is by an 'internal devaluation'. This is when the nominal exchange rate remains fixed, but the *real* exchange rate falls as local prices in the deficit country drop, which makes its exports more competitive. (The nominal exchange rate sets the amount of foreign currency that can exchanged for a unit of the domestic currency, while the real exchange rate takes into account local prices and indicates how much goods in the domestic economy can be exchanged for goods in a foreign country.)

[36] Stiglitz, 2016, p137.

In a currency peg system, participating countries are not only prone to experiencing high or long-term unemployment, as they lack the ability to change their exchange rates and interest rates after a shock; they are also very susceptible to debt crises. In the absence of successful internal devaluation, deficit countries with a misaligned exchange rate seeking to finance the gap between their imports and exports rely on capital inflows. If foreign direct investment is not forthcoming then the only option is debt. But if the misalignment in the exchange rate is persistent, then the debt mountain grows until creditors fear it will not be repaid, usually resulting in a sudden stop of credit.

The Irish economy, Spain, Greece and others received huge capital flows after the creation of the euro in 1999, as a result of the elimination of exchange-rate risk. These countries were able to run deficits but also maintain employment and experience growth as a result of the low interest rates they were allowed to borrow at, and the small risk premium on government bonds (the extra amount that was added to the government bonds to compensate for the perceived extra risk associated with lending to that country). Both Ireland and Spain experienced massive housing bubbles based on speculative inflows of capital throughout the 2000s, while neither country imposed any effective measures to cool the heat.

Economist and writer Martin Wolf comments in his book on the financial crisis, *The Shifts and the Shocks*[37], that the belief among the Eurozone's founders was that the problem of trade imbalances would no longer matter in a currency union, "as exchange-rate risks would vanish and payment disequilibria within the area would be smoothly offset by private capital flows". But "these expectations proved delusional; the sovereign debt crisis in the Eurozone in 2010-12 started as a fully-fledged balance-of-payments crisis… prompted by the accumulation of large payment imbalances between its members and reflecting persistent underlying divergences in prices and costs". These countries that were running trade deficits based on private and government debt due to the misalignment of their exchange rates then experienced the sudden stop of credit brought about by the global financial crisis, causing creditors to doubt their debts would be repaid. The common currency meant that these countries were forced to turn to the so-called Troika of the European Commission, the ECB and the IMF to be bailed out.

[37] Wolf, Martin. 2014. *The Shifts and the Shocks: What We've Learned – And Have Still to Learn – From the Financial Crisis.* Allen Lane, London, p189

The euro, in this way, is somehow both a domestic and a foreign currency for its members. It is less risky for people, firms and governments to borrow in local currency markets than to borrow in foreign currency. To prevent a debt crisis developing, the government can print more of the local currency to repay creditors. But for Eurozone members, they were borrowing in a supposedly "local" currency that they could not then control. The nature of the Eurozone changed as soon as some members of the monetary union owed other members, Stiglitz argues. "Rather than a partnership of equals striving to adopt policies that benefit each other, the ECB and Eurozone authorities have become credit collection agencies for the lender nations, with Germany particularly influential"[38]. The deficit countries dependent on creditor countries and the ECB are then vulnerable to any and all political and economic demands made by the creditors.

In their study of financial crises over eight centuries, Carmen Reinhart and Kenneth Rogoff identify several key features as having strong correlations with banking crises, all of which applied in the Eurozone. They note that in an analysis of banking crises after 1970, in 18 out of 26 of those studied the financial sector had been liberalised within the previous five years. They also identify a major correlation between removing restrictions on capital mobility and the incidence of banking crises over centuries. "Periods of high international capital mobility have repeatedly produced international banking crises, not only famously as they did in the 1990s, but historically"[39].

A further common feature they identify is that in the lead-up to banking crises there is often what they call a "capital flow bonanza" – a surge of capital inflows of roughly a few per cent of GDP on a multiyear basis, and the tendency to run a large current account deficit. While the liberalisation of the financial sector is by no means limited to the Eurozone, the free movement of capital and persistent trade imbalance problems inherent in the Eurozone, due to its design, make the common currency area prone to crises.

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[38] Stiglitz, 2011. p134

[39] [39] Reinhart, Carmen and Rogoff, Kenneth, 2009. *This Time Is Different: Eight Centuries of Financial Folly,* Princeton University Press, USA

Capital defies gravity

After the signing of the Maastricht Treaty in 1992, the interest rates across the euro area converged towards the low level predominant in Germany. At the same time, in taking steps to lower inflation to the 3 per cent limit required for entry into the common currency, governments implemented deflationary measures that compressed wages. These low interest rates, lower real wages and the removal of all restrictions on capital flows as well as financial deregulation in the euro area combined to cause massive influxes of capital into the peripheral economies, and a massive expansion of both private and government debt in these countries. These trends reached new heights in the years leading up to the crisis, causing worsening trade imbalances and divergence.

From 2003 to 2007, net capital outflows from Germany were on average 45 per cent of its GDP. By comparison, the net capital inflows into Greece over the same period was 37.5 per cent of GDP; in Portugal the net inflow was 36.6 per cent of GDP and in Spain it was 29.1 per cent. A large majority of these inflows came in the form of credit. In the Irish state, house prices doubled in real terms between 1995 and 2005, and then continued to rise. From 2003 until 2007 lending to households in the Irish state expanded at one of the highest rates in the Eurozone, with the exposure by German banks reaching more than US$200 billion.

The once-popular view outlined by Wolf above and expounded by free-market fundamentalists – that trade imbalances would be offset and rectified by private capital flows – proved to be completely false. Instead of playing a balancing and stabilising role in the Eurozone economy, the completely free movement of capital generated massive speculative bubbles, and the abrupt reversal of capital flows from 2008 shows that these capital flows have operated in a pro-cyclical instead of counter-cyclical way. (Pro-cyclical policies exacerbate economic and financial fluctuations, while counter-cyclical policies aim to decrease fluctuations.) If the free movement of capital operated in a counter-cyclical way, as was claimed, then it would flow to weak countries when they were in trouble, instead of doing precisely the opposite.

While there is a single interest rate across the Eurozone, set by the ECB, the risk premium on government bonds and bank debt in different countries means the actual interest rate differs significantly across the common currency area. The perceived risk in lending to a weaker country is reflected in the spread of interest rates. Where economies are viewed as strong (and governments viewed as being capable of bailing out their banks), their banks will benefit from lower interest rates. Weaker countries and their companies have to pay a higher interest rate. During a crisis, capital flees to the 'safe' countries' banks. Since 2008 capital has flowed dramatically from the poorer countries to the rich – not only in the Eurozone but across the global economy – with a large proportion of global capital fleeing to the US as a result of the US government's perceived ability (and political commitment) to bail out the banks. Inside the Eurozone, the trend has been for capital flight from banks in the periphery to the core, particularly Germany. Stiglitz notes: "Standard economics is based on the gravity principle: money moves from capital-rich countries with low returns to countries with capital shortage. But in Europe under the Euro, capital and labor defy gravity. Money flowed upward".

The proposed European Deposit Insurance Scheme, the so-called third pillar of the EU's Banking Union following a single rulebook and single supervision, was dreamt up as a way to reduce this tendency. It is one of the few proposals emanating from the Commission and the leaders of the EU that would could actually effectively reduce divergence in the Eurozone, and reduce the incentive for capital flight from the weak to the strong countries. It could work as a form of institutionalised surplus recycling during a downturn or a period of crisis for the periphery – and for that reason it is being resisted by Germany and has been put on the legislative back-burner. The lack of a common deposit insurance scheme makes the Eurozone "structurally vulnerable"[40] to bank runs according to Wolf.

Betting on default

The so-called sovereign debt crisis saw the global financial crisis shift to inside the euro area, where it still remains, due to the structural flaws in the architecture of the Eurozone. The 'foreign currency' nature of the euro – the fact that countries couldn't create the money they were borrowing in – meant that the belief by investors in the years following the creation of the common currency that all Eurozone government bonds were equal was short-lived. From 2007-2009 the spreads between government bonds in Greece and government bonds in Germany ('bunds') increased tenfold up to 2.8 percentage points, with the market giving its 'verdict' on the creditworthiness of the

[40] Wolf. 2014. p50

Eurozone's deficit countries. This increased again to a differential of almost 4 percentage points by April 2010, when the Greek government found itself unable to keep funding itself from international money markets. After the Greek default, the markets turned to train their sights on Ireland.

Varoufakis describes this 'market verdict' of risk strikingly: "Suddenly [in 2009-2010] hedge funds and banks alike had an epiphany. Why not use some of the public money they had been given [in the mass bank bailouts] to bet that, sooner or later, the strain on public finances (caused by the recession on one hand, which depressed the governments' tax take, and the huge increase in public debt on the other, for which the banks were themselves responsible) would cause one or more of the Eurozone's states to default?"[41] The most common way to place these bets was through credit default swaps, which are basically insurance policies that pay out in the case of a default by a third party. As the CDS casino on sovereign debt in the Eurozone grew – instead of this capital being directed towards productive investment or economic recovery – the rising value of CDSs in Greece, Ireland and the other peripheral economies caused the interest rates these countries were forced to pay to rise, pushing them towards the cliff.

Ireland defaulted in December 2010, followed by Portugal and Cyprus. Portugal hadn't gone through a bubble bursting like Ireland but had experienced a long period of stagnation as a consequence of joining the euro at a very uncompetitive exchange rate that it was then locked into. Cyprus imposed capital controls on euros leaving the country between 2013 and 2015 in fear its partial 'bail-in' of deposits would prompt massive capital flight. Iceland had done the same in 2008 but this was the first time capital controls had ever been used in the Eurozone. The Treaty on the Functioning of the EU states that capital controls can only be "justified on grounds of public policy or public security" and that such measures should "not constitute a means of arbitrary discrimination or a disguised restriction on the free movement of capital and payments" (Articles 63 and 65), prompting threats of legal action.

The existential crisis of the Eurozone began in 2011 when the CDS bets on Spain and Italy defaulting caused the spreads in the government bonds of these two countries to diverge from bunds by between three and six percentage points, yield rates that had pushed Greece, Ireland and Portugal over the edge. Spain received a recapitalisation

[41] Varoufakis, 2011. p204

package for its banks but it was not a fully-fledged bailout. Italy's public debt was around four times the amount of the Eurozone rescue fund.

The European Financial Stability Fund (EFSF) was created in 2010 as a temporary vehicle to finance bailouts, and was made permanent in 2013, becoming the European Financial Stability Mechanism (EFSM). The EFSF and EFSM were created to bail out banks, not states. Varoufakis likens the Eurobonds issued by the EFSF to the toxic collateralised debt obligations (CDOs) peddled by Wall Street in the lead-up to the crisis. CDOs were instruments that included 'slices' of different bank loans, each with a different level of risk and a different interest rate. The rationale behind CDOs was that by pooling together risky loans with less risky assets, the overall risk profile would be lowered – the CDO would be able to gain a higher credit rating – and they would be more profitable for investors. The "mix was toxic because if one slice within a CDO went bad, that increased the risk of a default by the next slice"[42]. Unbelievably, the same structure and rationale that underpinned the disastrous CDO was used by the EFSF when issuing Eurobonds for lending to the Irish state, and later other countries subject to Troika intervention. Each Eurozone state was required to make a guarantee according to the size of their GDP, and these guarantee from states with wildly diverse credit ratings were then bundled together as bonds. Weaker countries were charged higher interest rates, increasing the pressure on the next weakest state to fall. The EFSM is now a permanent body called the European Stability Mechanism (ESM).

[42] Ibid, p175

CHAPTER FOUR

What conditions are required for a monetary union to work?

SO WHAT are the necessary requirements for a common currency to actually work effectively to the benefit of all its members? Why do the dollar-zones in the US, Canada and Australia not experience the same level of crisis, divergence and stagnation as the Eurozone has been plagued with? Simply put, the institutions in place in federal states such as these allow for the smooth, timely and effective recycling of excess profits from surplus states to those experiencing deficits. They also have central banks that have a mandate to ensure full employment, as well as price stability. In comparison, following the Bundesbank model, the ECB's mandate is solely to maintain price stability and it is not to concern itself with employment.

When a downturn or crisis hits a common currency area, it will cause an asymmetric shock unless there has been sufficient convergence in the economies of the union. Divergent economies would be affected differently by different external and internal developments. This danger was understood by the architects of the euro, but for ideological reasons they focused only on attempting to achieve convergence in government debt and deficit levels at Maastricht and ever since, instead of looking at the more important role of divergence in balance of payments between members.

In 1961, economist Robert Mundell articulated his 'optimum currency area' theory on how currency unions could work to overcome asymmetrical shocks. The adjustment mechanisms identified through this theory include price and wage flexibility; mobility of labour and other factors of production; financial market integration; a high degree of economic openness; the diversification of production and consumption; similar inflation rates; fiscal integration; and finally, political integration. Some of these mechanisms can be seen to work effectively in the US. The three most important factors in place in the US economy identified by Stiglitz and others are: (1) the ease of migration across states, (2) federal spending on national programmes, and (3) the fact that the US banking system is a federal and not state-based system.

If one state in the US experiences a shock, workers can easily migrate to another state in a better economic condition in order to look for work. Technically there is freedom of movement of labour in the EU, but in practice migration within the US is far easier due to the fact states share a common language, a common culture and national identity, and the same access to federal welfare programmes. National government programmes such as social security and Medicare are available across all states, which means that if one state is experiencing a downturn, the federal government will automatically recycle surpluses towards the state in trouble in the form of, for example, increased unemployment benefits. Around one-fifth of GDP is spent at the federal level in the US. The federal government can also choose to boost investment or spending in certain federal projects at the state level in order to aid economic recovery. By comparison, in the Eurozone there is very little fiscal capacity to redirect funds towards depressed states because the European budget is around one per cent of member states' GDP. Almost all spending occurs at the member state level. US banks are also guaranteed at the federal level by the Federal Deposit Insurance Corporation, preventing capital flight from one state to another in times of crisis.

Clearly the EU lacks similar institutions. But with the exception of a common deposit insurance scheme, the creation of such adjustment mechanisms in the Eurozone is either impossible in the short-to-medium term, or completely undesirable from a left standpoint by virtue of the fact that increased economic, fiscal and political integration require unacceptable trade-offs in the ability of people to participate in the decision-making process democratically at the local and national level.

Eurozone's architects opt for internal devaluation

Of the various adjustment mechanisms identified by optimum currency area theorists, the Eurozone's founders have clearly focused single-mindedly on attempting to achieve 'flexibility' of wages. Countries inside a common currency area cannot engage in competitive devaluations by devaluing their currency to make their exports more competitive. But they can implement policies domestically to bring about an 'internal devaluation' – lowering their real exchange rate vis-à-vis their neighbours. The main way this takes place is by compressing or reducing wages, which causes prices to fall. Germany has consciously implemented this policy for several decades, at the expense of German workers, millions of whom are working but living in poverty. This long-term strategy was intensified in 2003 under the then social-democrat/Green coalition government, which carried out a radical and vicious reform of the labour and welfare systems entitled Agenda 2010.

The competitiveness of prices largely determines the performance of a country's exports, and the key factor determining prices is the nominal unit labour cost (the nominal unit labour cost is the ratio of labour cost per employee to productivity – the value added per worker). Unit labour costs in Germany stopped growing in the mid-1990s. Between 1998 and 2007, the rise in unit labour costs in Germany was zero. But in the rest of the Eurozone over the same period, average wage costs mainly increased with inflation, of around 2 per cent per year. This difference greatly increased the competitiveness of German exports and reduced it for the exports of other Eurozone members. So the success of Germany's economic model is at the expense of the rights and living standards of its workers. The Agenda 2010 strategy has been deepened under successive governments and by 2015, more than 12.5 million Germans, out of a population of 80 million, were living in poverty in Europe's "economic powerhouse".

The EU's focus on structural reform, particularly labour market reform, with a view to achieving increased "flexibility" has been a constant feature of its agenda since Maastricht. This was a major element of the Jobs Strategy of 1994, and the Lisbon 2010 Agenda adopted in 2000. The Lisbon Agenda originally set out to make the EU "the most competitive and dynamic knowledge-based economy in the world" by 2010. It included an economic pillar, a social pillar and an environmental pillar. In 2005, the Lisbon Agenda was revised by the European Council and Commission. Their verdict was that the agenda was failing to achieve its goal, and so they decided to drop the social and environmental pillars and focus on the economic pillar. In 2010 the Lisbon Agenda was relaunched as a new 10-year plan, the Europe 2020 strategy – "an agenda for new skills and jobs: to modernise labour markets by facilitating labour mobility and the development of skills throughout the lifecycle with a view to increasing labour participation and better matching labour supply and demand"[43].

The "progress" of member states in implementing structural reforms that will facilitate downward movement on wages is monitored through the European Semester process, a

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[43] European Commission, 2010. 'Europe 2020 Strategy', https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/eu-economic-governance-monitoring-prevention-correction/european-semester/framework/europe-2020-strategy_en

yearly cycle of policy "coordination" between member states and the Commission. In spring each year, Member States submit their plans for managing public finances – including keeping debt and deficits within the Stability and Growth Pact limits – and their National Reform Programmes to achieve "smart, sustainable and inclusive growth". These plans are then assessed by the Commission, which proposes country-specific recommendations to member states, which are discussed and adopted by the Council. Then each autumn member state governments are graciously permitted to present their draft national budgets to their respective parliaments. The Five Presidents' Report of EU leaders of 2015 proposed the creation of National Competitiveness Authorities to advance this agenda further.

The Eurozone elites believe (or claim to believe) that if only "wage rigidities" in the member states were overcome, both unemployment and trade imbalances would disappear. If only a country's population could be forced to work for poverty wages, there would be a job for everyone; and the resulting stagnation in domestic demand would mean prices would fall and this country's real exchange rate, which had become misaligned and risen too high, could regain its balance. This view underpins the repeated attacks on the rights and wages of French workers, set to intensify fiercely under President Macron, as well as underpinning the EU's overall agenda and forcing structural reforms in the member states in order to increase productivity and competitiveness – and profit, of course. The austerity imposed by the Troika was not only designed to regain market "confidence" in peripheral governments, but also to facilitate internal devaluations in member states by a form of shock therapy. Of course, this adjustment facilitates not only the reduction of trade imbalances but also a sharp increase in the amount of wealth transferred from labour to capital.

There has certainly been an internal devaluation process in the Eurozone countries, affecting primarily the peripheral economies. But as Stiglitz points out, "this has not worked – or at least not fast enough to restore the economies to full employment. In some countries such as Finland, low inflation not been enough to even restore exports of goods and services to the levels before the crisis"[44]. An increase in exports in these countries should have boosted growth and employment. But with the exception of the hugely distorted "globalised" data from the Irish economy, this has not been the case. The restoration of trade balance that the Eurozone has experienced since the crisis has

[44] Stiglitz, 2016. p115

largely been due to the fact that imports fall when demand stagnates – “one can achieve a current account balance by strangulating the economy”[45]. For the crisis countries, the reduction in their trade deficits post-crisis largely resulted from a reduction in imports and not an increase in exports.

Crucially, internal devaluations also increase the level of debt of households, firms and governments who have borrowed in euros – as the value of their income is depressed, they owe a higher proportion of their income. High levels of debt were a major factor in causing the recession, because those in debt cut back on spending on both imports and domestic goods, causing a decline in GDP. It has also contributed greatly to the lingering problem of non-performing loans burdening Eurozone banks, particularly in the crisis countries.

[45] Ibid.

CHAPTER FIVE

The ECB – Europe's unelected government

MONETARY POLICY is a key tool for governments to use to benefit citizens, societies and economies. Central banks are empowered to determine interest rates, and to influence the exchange rate of their currency (and others') by buying and selling reserves of foreign currencies. If a central bank sets a higher interest rate, this makes the return on this currency higher, leading to a higher demand for the currency and a resulting higher exchange rate. By lowering interest rates central banks can stimulate growth by expanding credit. With the creation of the ECB in 1998, members of the common currency transferred their power to set interest rates and other monetary policy powers to the ECB, which would set a centralised monetary policy across the Eurozone. The ECB and national central banks form the European System of Central Banks (ESCB), and the ECB can "exceptionally" provide emergency liquidity assistance (ELA) as a last resort for struggling Eurozone banks. The ECB differs from most of the other major central banks around the world in that it has a more limited mandate, and in its governance structure.

A narrow mandate

The neoliberal ideas, and the German economic ideology of 'Ordoliberalismus', that shaped the construction of the Eurozone can also be seen starkly in the nature of the ECB. This ideology has been dominant in Germany since the Second World War and combines a belief in a welfare safety net with the view that one of the government's key roles is to promote market competition, stressing the importance of constitutional rules, as opposed to the use of discretionary policy[46]. This ideology shaped the nature of the Bundesbank, which was dedicated to tightly controlling the money supply to maintain price stability. The ECB was constructed on this model, with a mandate to focus on price stability – controlling inflation. Despite the total discrediting of this ideology in the wake of the financial crisis, Berlin's belief that if the government ensures inflation is

[46] Wolf, 2014. p54

kept low and stable, then markets will ensure growth and employment of their own accord, persists.

The ECB's mandate is in contrast to many other major central banks, like the Federal Reserve in the US, which are tasked with the broader role of maintaining full employment and promoting growth, in addition to maintaining price stability. As a result of its narrow mandate the ECB only focuses on controlling inflation, regardless of how high the unemployment rate is. If there is low and stable inflation in the Eurozone as a whole – and in Germany in particular – then the ECB will ignore the growth needs of states experiencing high employment. In the midst of the recession and the sovereign debt crisis in 2011, the ECB actually *raised* interest rates twice, in April and July, contributing to the cause of the Eurozone's double-dip recession. This caused major hardship in the crisis countries, particularly for mortgage-holders who were pushed further into arrears.

The other key difference between the ECB and other major central banks is its level of democratic accountability: for example, while the Fed is often described as "independent", it is ultimately accountable to Congress. The ECB is unaccountable to any elected government or parliament. This feature reflects the drive by elites to "depoliticise" economic policy by outsourcing it to supposedly independent technocrats in order to weaken resistance to highly political decisions that have profound redistributive consequences for society. Bill Mitchell and Thomas Fazi write: "[T]he creation of self-imposed 'external constraints' allowed national politicians to reduce the political costs of the neoliberal transition – which clearly involved unpopular policies – by 'scapegoating' institutionalised rules and 'independent' or international institutions, which in turn were presented as an inevitable outcome of the new, harsh realities of globalisation, thus insulating macroeconomic policies from popular contestation"[47].

The decisions that the ECB has taken in response to the crisis have been extremely political, such as its decision to raise interest rates in 2008 and 2011, when the real danger to the majority of Eurozone members was deflation. The two most strikingly political acts during the crisis were the ECB's threat to cut off emergency liquidity assistance to the Irish state unless it agreed to request a bailout, and its decision to cut

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[47] Mitchell, Bill and Fazi, Thomas. 'Everything You Know About Neoliberalism Is Wrong', Social Europe, October 20, 2017, https://www.socialeurope.eu/everything-know-neoliberalism-wrong

off emergency liquidity to Greek banks in the middle of 2015 in a threat to Syriza that Greece would be forced out of the Eurozone if it did not submit to the conditions of the Troika that were resoundingly rejected by Greek voters in a referendum. The ability to withhold credit to elected governments gives the unaccountable ECB an enormous degree of power to impose its own policy on countries in need of assistance.

The ECB's financing operations

In 2011 the ECB began the first of several financing operations in order to assist the economic recovery in the Eurozone. In December 2011 it announced its long-term refinancing operation (LTRO), which provided one trillion euro in credit in secured funding to troubled banks at a rate of one per cent interest. The banks often invested it into government bonds at higher rates, which helped the banks' balance sheets but cost government budgets in debt servicing payments, and tied the banks and sovereigns even closer together.

As the Eurozone teetered on the brink of fragmenting in July 2012, ECB President Mario Draghi made his famed speech that is widely believed to have "saved" the common currency, which included the statement that, "Within our mandate, the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough".[48] The speech preceded a new financing operation called Outright Monetary Transactions (OMT) in which the ECB offered to purchase sovereign bonds of the most indebted states. In 2014 Paul Krugman described the OMT programme as a "bluff" because "nobody knows what would happen if OMT were actually required"[49]. The OMT programme has not in fact ever been used, because no member state has met all of the requirements needed to activate it. Martin Wolf and others have observed that the bluff was so successful not only due to its announcement, but also due to the tacit acceptance of the announcement by all member states including Germany, as this was perceived by markets as a signal that the risk of the Eurozone disintegrating was eliminated. But he adds that while the spreads between government bonds in crisis and core countries fell

[48] ECB, 'Verbatim of the remarks made by Mario Draghi', July 26, 2012. https://www.ecb.europa.eu/press/key/date/2012/html/sp120726.en.html

[49] Krugman, Paul. 'Even More on Scotland', *The New York Times,* September 10, 2014. https://krugman.blogs.nytimes.com/2014/09/10/even-more-on-scotland/

sharply in response to the OMT announcement, they remain significant. “For countries caught in a deflationary trap, these spreads might yet prove unmanageable.”[50]

In a telling side note, it was revealed in October 2017 that the Eurosystem had made super-profits of €6.2 billion between 2012 and 2016 from Greek bonds the ECB had purchased at knock-down prices in 2012. While the Greek government and its creditors in 2012 had agreed to “haircut” Greek bonds, those purchased by the Eurosystem were conveniently excluded[51].

Neither the LTRO nor the OMT programmes did much to actually improve the supply of credit to the productive economy. The next financing operation was announced in 2014 – targeted longer-term refinancing operations (TLTRO) – and it was aimed at providing banks with funds on the condition that they would be used to supply credit to small and medium enterprises as opposed to being directed towards speculation. But the lack of demand in the economy has meant that the TLTRO offer was not widely taken up by firms. Despite the ultra-low and at times negative interest rates, and the billions of euros handed over to banks through its financing operations, the ECB was not able to generate recovery in the real economy and restore growth, and it has persistently missed its target of 2 per cent inflation.

In March 2015, the ECB announced a quantitative easing (QE) programme in which it would create €60 billion each month and use it to purchase corporate sector assets and government bonds. It was originally intended to last for one year but has been extended and remains in place, though economists expect the announcement of “tapering” in the near future, the phased winding-down of the programme. The Corporate Securities Purchasing Programme (CSPP), introduced in March 2016 and now valued at around €125 billion, has been widely criticised by NGOs and MEPs for the lack of transparency on how the bonds are selected, and the fact that the funds are being directed towards multinational corporations and the fossil fuel industry. Corporate Europe Observatory has examined the limited publicly available data on the bonds favoured by the CSPP

[50] Wolf, 2014. p58

[51] GUE/NGL, ‘The ECB as vulture fund: how central banks speculated against Greece and won big’, October 16, 2017. (Press release in response to reply from ECB to written question from Popular Unity MEP Nikolaos Chountis). http://www.guengl.eu/news/article/the-ecb-as-vulture-fund-how-central-banks-speculated-against-greece-and-won

and found a marked preference for climate-damaging corporations[52]. Another report by Corporate Europe Observatory published in October 2017 found that 98 per cent of all advisors in the ECB's advisory groups have been assigned to representatives of the finance industry. Just three financial institutions, Deutsche Bank, BNP Paribas and Citigroup, occupied 208 out of 517 total advisory seats[53].

The QE for People and Positive Money campaigns have developed a detailed critique of the limited impact on real economic recovery of the ECB's "trickle-down" QE programme and have developed excellent policy alternatives. This campaign is supported by dozens of leading economists. Two examples of alternative monetary policies they propose are for the ECB to transfer newly created money to Eurozone governments directly, who can use it to increase public spending on green infrastructure and services; or for the ECB to create money that can be directly distributed to citizens of the Eurozone, which would increase their purchasing power and directly enter the real economy[54]. The current QE programme is not only unfair and ineffective – it is also increasing financial volatility and encouraging the inflation of new speculative bubbles.

A new banking crisis?

Despite the fact that the European banking sector has received more than €1.6 trillion through taxpayer-funded bailouts since 2008 – and despite the fact that the ECB has pumped in €60-€80 billion each month through its financing operations since March 2015 amounting to an additional €2 trillion in support – another crisis is unfolding in the European banking sector.

Banks in the EU, and particularly in the Eurozone, have been experiencing a chronically low level of profitability since the global financial crisis. While profitability of US and

[52] See Corporate Europe Observatory, 'European Central Bank has bought more climate-trashing bonds', June 23, 2017 https://corporateeurope.org/economy-finance/2017/06/european-central-bank-has-bought-more-climate-trashing-bonds

[53] Corporate Europe Observatory, 'Corporate capture at its most extreme', October 3, 2017. https://corporateeurope.org/pressreleases/2017/10/corporate-capture-its-most-extreme-98-ecb-advisors-represent-industry

[54] See for example Positive Money's proposal, 'Recovery in the Eurozone, Using Money Creation to Stimulate the Real Economy', http://positivemoney.org/publications/recovery-in-the-eurozone-using-money-creation-to-stimulate-the-real-economy/ Positive Money

British banks has improved somewhat post-crisis, many Eurozone banks are struggling to keep their heads above water.

ECB Vice President Vítor Constâncio noted in a speech in Brussels in February that the key measure of profitability – return on equity – for euro-area banks "has hovered at around 5 per cent", a rate which, he pointed out, "does not cover the estimated cost of equity"[55]. By contrast, the return on equity in the US has recovered to above 9 per cent (around the current cost of equity in the euro area banks), and the industry generally considers 10 per cent to be a good rate of return. European banks' income from interest, which was on average 19 per cent of their equity in June 2016, is less than their operating expenses of 20.9 per cent, according to the European Banking Authority (EBA).

The crisis has been demonstrated in the failure (or near-failure) of several banks across the Eurozone this year – including Italy's Monte dei Paschi di Siena (MPS), Veneto Banca and Banca Popolare di Vicenza, and Spain's Banco Popular – as well as the serious ill-health of German giant Deutsche Bank. Other banks that have caused concern, largely due to the results of the 2016 banking stress tests carried out on 51 major EU banks under the authority of the EBA, include RBS, which was bailed out by the British government in 2008 in the world's largest ever bailout, and has since posted nine straight years of losses. Irish banks Allied Irish Bank and Bank of Ireland, British bank Barclays, Switzerland's Credit Suisse and Austrian bank Raiffeisen are all also subject to concerns about their health and viability.

In an illustration of the seriousness of the systemic risk posed by the profitability crisis, EBA chairperson Andrea Enria said last October: "The problem is European in scale: we have more than €1 trillion of gross non-performing loans in the system; even considering provisions [money set aside to cover losses], the stock of uncovered non-performing loans is at almost €600 billion — more than all the capital banks raised since 2011, more than six times the annual profits of the EU banking sector, more than twice the flow of new loans.

[55] ECB, 'Resolving Europe's NPL burden: challenges and benefits'. Speech by Vítor Constâncio, to Bruegel conference, February 3, 2017. https://www.ecb.europa.eu/press/key/date/2017/html/sp170203.en.html

“For supervisors, *this casts serious doubts on the long term viability of significant segments of the banking system* [my emphasis]. The same concern is shared by investors and is reflected in the low valuations registered in stock markets.”[56]

Most experts and financial commentators point to four key contributing factors to this lack of profitability – the high volume of non-performing loans on the banks’ books (loans that are in default after 90 days of non-repayment); the very low interest rate environment arising from the ECB’s recent monetary policy; the fines for misconduct banks have been required to pay since the crisis; and over-capacity in the sector, including increasing competition from FinTech.

Between 2010 and 2014, EU banks paid out around €50 billion in settlements and fines imposed by regulators for misconduct, largely due to mis-selling the risky financial products that contributed to the global crash. The EU’s largest banks, those classified as global systemically important banks (G-SIBs), were the worst culprits and paid the vast majority of the €50 billion figure. A report by the European Systemic Risk Board in 2015 found that past and looming fines would wipe out erase basically all of the new capital that had been raised by European G-SIBs over the past five years.

While misconduct fines and over-capacity dampen profits, the two most important of the four factors listed above are the NPL problem and the interest rate environment. But a key pressure on profitability that the ECB, EBA and the other EU institutions routinely fail to acknowledge is on the demand side – ie, the general economic stagnation in the Eurozone that has caused the demand for credit to fall and remain low. This stagnation has also contributed to and worsened the NPL problem. Euro-area banks held just over €1 trillion in NPLs last year, the equivalent of around 9 per cent of the Eurozone’s GDP, and amounting to around 6.4 per cent of total loans in the Eurozone. The level of NPLs differs dramatically across the euro area, with almost half bank loans in Greece and Cyprus now classified as NPLs, and Italy, Ireland, Portugal and Slovenia all holding NPLs at rates of 10-20 per cent.

There is a clear overlap between the high level of NPLs and the impact of the financial crisis on the so-called peripheral economies in the Eurozone, and a clear interaction

[56] EBA, ‘Andrea Enria's speech at the 7th FMA Supervisory Conference 051016’, October 5, 2016. https://www.eba.europa.eu/.../Andrea+Enria%27s+speech+at+the+7th+FMA+Supervis.

between the austerity measures prescribed for these economies by the Troika and their inability to significantly reduce their NPL ratios. The collapse of the industrial sector in Greece and Italy in particular has been a major contributing factor to the rise of distressed loans as businesses of all sizes failed and their owners were unable to repay loans. The austerity policies enforced by the Troika in the crisis countries in return for bailout funds inevitably exacerbated the NPL problem.

Publicly funded bank bailouts are back with a vengeance

"EU forges bank bailout deal to protect taxpayers"[57] – that was the Associated Press headline in June 2013, describing the agreement reached in Brussels on the EU Banking Union. The Banking Union is an initiative to further integrate the banking and financial sectors in the Eurozone countries, which was promoted as a response to the global financial crisis and subsequent sovereign debt crisis. It is envisioned as having three pillars based on a "single rulebook" – a system of harmonised supervision under the Single Supervisory Mechanism; a single resolution mechanism and associated fund implemented by the Bank Recovery and Resolution Directive (BRRD) at the beginning of 2016; and an as-yet to be developed third pillar of a European Deposit Insurance Scheme.

The Banking Union, European lawmakers assured the public, would call time on the "too-big-to-fail" problem and ensure taxpayer-funded bailouts – which had cost EU governments more than €1.5 trillion since 2008, including €64 billion in the Irish state – were a thing of the past. The BRRD was supposed to make sure that in case of a bank failure, the institution would be wound down in an orderly way by an early intervention by regulators, and that senior bondholders and depositors with more than €100,000 in the bank would be "bailed in". Creditors would have to incur losses of at least 8 per cent of their liabilities before a bank would be able to receive government aid. Speaking to reporters at the summit where the deal was reached between EU Finance Ministers that day in 2013, then-Irish Finance Minister Michael Noonan said: "Bail-in is now the rule… This is a revolutionary change in the way banks are treated."[58] But there was an

[57] AP, 'EU forges bank bailout deal to protect taxpayers', reprinted in *The Guardian*, June 7, 2013. https://www.theguardian.com/business/2013/jun/27/eu-deal-bank-bailout-taxpayers

[58] Kanter, James. 'Europe agrees on new banking rules', *The New York Times,* June 26, 2013. http://www.nytimes.com/2013/06/27/business/global/europe-agrees-on-new-banking-rules.html

exception clause, as there usually is in EU legislation, and its name was "precautionary recapitalisation".

Resolution Directive fails miserably in its first test

The Italian banking crisis that deepened throughout 2016 culminated in the December announcement by the Italian government of a €20 billion taxpayer-funded rescue package for the ailing MPS and other Italian banks, indicating its intention to activate the precautionary recapitalisation clause of the BRRD. The clause allows for the bail-in of creditors to be sidestepped if certain conditions are met – namely that the bank is still solvent, and its resolution would threaten financial stability. This exceptional clause is complemented by a similar "safeguard" clause in the EU's state aid legislation on burden-sharing.

After months of negotiations between the European Central Bank (ECB) and the Commission, about both the extent of the capital shortfall and the terms of the deal, Competition Commissioner Margrethe Vestager reached an agreement in principle with the Italian Finance Minister on June 1, 2017. The Commission, and the ECB in its supervisory role, gave the green light to the precautionary recapitalisation. "State aid in this context can only be granted as a precaution (to prepare for possible capital needs of a bank that would materialise if economic conditions were to worsen) and does not trigger resolution of the bank,"[59] Vestager said in a statement.

Conditions of a precautionary recapitalisation include that broader financial stability must be threatened by the bank's failure; the state support cannot be used to cover previous or near-term expected losses; and the need for state support must be only temporary. But MPS already received two state-funded bailouts in 2009 and 2012, casting significant doubt on whether it meets these two latter criteria.

Back in December when the Italian government made its rescue package announcement, the ECB suddenly began to say that MPS's capital shortfall was not €5 billion as previously estimated but actually €8.8 billion. The ECB didn't bother to explain publicly how it arrived at this figure, but its retroactive and opaque revision of

59 European Commission, 'Statement on Agreement in principle between Commissioner Vestager and Italian authorities on Monte dei Paschi di Siena (MPS)', June 1, 2017. http://europa.eu/rapid/press-release_STATEMENT-17-1502_en.htm

the figures raised serious concerns and questions about the health of MPS. Was the bank actually solvent when it applied for a precautionary recapitalisation? If not, it would not qualify for public assistance. The details of the Commission's agreement in principle have not yet been made public.

There are many criticisms that can be made of the resolution aspects of the Banking Union legislation. The bail-in of creditors of only 8 per cent is, in many cases, going to raise a totally insufficient proportion of the costs of a resolution. In ordinary insolvency procedures investors would usually lose far more than 8 per cent. Bail-in also poses additional risks to ordinary taxpayers in a number of ways including through increased premiums in pensions and health insurance, and through the mis-selling of risky and inappropriate financial products that are eligible for bail-in to small retail investors.

The precautionary recapitalisation clause, however, is the glaring loophole that makes a joke out of the Banking Union's promise to end taxpayer-funded bailouts of banks and to resolve the 'too-big-to-fail' problem. Under the Bank Recovery and Resolution Directive, a review of the precautionary recapitalisation clause was supposed to have taken place by now. The Commission was required to review whether "there is a continuing need for allowing the support measures" in the clause by December 2015 and report on this to the European Parliament and Council, which it has failed to do.

Now, the European Banking Authority (EBA), supported by many within the European Central Bank (ECB), is making a concerted push for the precautionary recapitalisation loophole to be invoked in order to use public funds to bail out the big bank across the EU more generally, by calling for state funds to be used to reduce the high level of non-performing loans in European banks and to restore them to profitability.

A crisis of abundance

Writing in response to the Great Depression, Keynes said, "This is not a crisis of poverty, but a crisis of abundance,"[60] a description that is perfectly fitting for the current economic crisis. The ongoing tendency towards stagnation in the Eurozone and in the broader economy is not primarily the result of trade imbalances, which in any case,

[60] Keynes, John Maynard. 1932. 'The World's Economic Outlook', reprinted in *The Atlantic*, https://www.theatlantic.com/ideastour/markets-morals/keynes-full.html

have been reduced as a result of the fall in aggregate demand. There is an unprecedented mass of money not being used in the economy, which has built up over decades of a declining labour share of income and record-high corporate profits. There is at least US$5 trillion in "idle money", much of it resting in tax havens. Varoufakis writes: "Try to imagine the mountain of cash on which corporations in the United States and Europe are sitting, too terrorized by the prospect of insufficient consumer demand to invest in the production of things that society needs."[61] He notes that every crisis generates two mountains: "one of debts and losses, another of idle, fearful savings" – the only difference being the scale of this crisis.

Investment continues to stall across the Eurozone, and the Juncker Investment Plan, and its key instrument, the European Fund for Strategic Investment (EFSI), has been a dismal failure. It was announced in late 2014 as an initiative from the Commission in partnership with the European Investment Bank (EIB) in order to address the 'investment gap' that the Commission estimates to be 200-300 billion euros per year in the EU. The stated goal of the Juncker Plan was to "mobilise" more than €300 billion in private capital investments – by creating an initial fund of just €21 billion to secure loans for infrastructure projects. The European Trade Union Confederation immediately responded to the Juncker Plan by saying the Commission was "relying on a financial miracle like the loaves and fishes"[62].

There was no new money forming the EFSI – the seed capital was cut from other existing EU budgetary programmes, including the research plan Horizon 2020 and the Connecting Europe transport infrastructure programme. This €21 billion in initial capital was to be used to guarantee €60 billion of EIB borrowing to fund riskier projects than the EIB usually funds. The entire rationale of the Juncker Plan was to ensure that private investment that would otherwise not have happened took place. The investment plan stipulates that the funds must be disbursed across all EU economies according to the size of their GDP levels, meaning most of the projects that have been approved have benefited Germany and Britain instead of the smaller peripheral economies who are in greater need due to the fact that investment has largely ground to a halt. It has largely

[61] Varoufakis,Yanis. 'Vicious Disequilibrium, Los Angeles Review of Books, April 3, 2014. https://lareviewofbooks.org/article/vicious-disequilibrium/#!

[62] ETUC. 'Investment: Commission relying on a financial miracle'. Press release, November 26, 2014. https://www.etuc.org/press/investment-commission-relying-financial-miracle#.WfLWoIZx1E4

focused on public-private partnerships, which are being used across the EU to promote privatisation of public goods and services.

The Bruegel think-tank undertook a study of the first 55 EFSI-funded projects that were approved in the first year, and found that 42 would in all likelihood have proceeded anyway in the absence of the Juncker Plan. The only difference is that public money is now being used as a guarantee for private ventures.

The European Parliament admits the results of the Juncker Plan have been disappointing and that it has failed to unleash any discernible surge in investment. The most critical group, the European United Left (GUE/NGL) points out that most of the investments made under the plan would have proceeded regardless, without the EU guarantee, but now private investors can shift the risk of their investments to taxpayers. The group argues, “The EFSI induces rent seeking and asset stripping by private investors at the expense of the Union budget, via public private partnerships, the privatization of profits and the socialization of losses, while only sparely contributing to additional investment”.

CONCLUSION

The way forward: changing the rules

THE KEY problems identified in this paper relate to both the policies and the architecture of the Eurozone, and most importantly to the ideology that underpins them. It aims to help encourage and inform public debate, and debate among progressive forces in particular, about the nature of these problems and the potential solutions to them. Rather that focus on the question of whether the Eurozone is a viable arrangement in the long term, this paper aims to discuss solutions to pressing problems in the short and medium term during a period of political crisis in Europe. There are also many excellent, detailed policy proposals being made by progressive political forces, NGOs and trade union across the Eurozone, several of which have been referred to above.

The (grim) state of the Union

The Commission has floated several proposals regarding the deepening of the Economic and Monetary Union in recent years. Most recently, some of these were repeated by Commission President Jean-Claude Juncker in his annual State of the Union address in September, in which he outlined the Commission's analysis of the political and economic situation, and its priorities for the coming year and the future more generally. The most significant proposals outlined by Juncker regarding the economic future of the EU were to introduce a euro-area budget line within the EU budget, and to create a European Monetary Fund (EMF) and a European Finance Minister to take over responsibility for administering the EU's debt and deficit criteria – the austerity agenda currently administered by the Commission.

There are two main goals evident in the Commission's proposal. The first is to ensure that the current informal economic governance structure that exists in the Eurozone – outside of the Treaties and beyond democratic oversight – is extended across the EU as a whole in order to pressure the non-euro member states to join the common currency as soon as possible, and to give the Eurogroup the veneer of legitimacy. (The Eurogroup – the Eurozone finance ministers – exists informally and operates outside of the Treaty and beyond any public scrutiny or accountability.)

The second goal is to implant Germany's failed and ideologically-driven deficit fetishism ever more firmly in the structure of the EU by creating a Ministry to surveil and structurally reform the economies of Member States, and to surveil and control their spending, taxation and borrowing through budgetary control.

After the election of President Macron in France this year, Germany and France set up a working group to discuss the creation of a European Monetary Fund, or EMF, to replace the ESM and deal with future crises. The states who may require the aid of an EMF are those of us in the periphery of the EU – the Irish state, Greece, Spain, Portugal and Italy – who are suffering debt crises largely as a result of Germany's massive and damaging current account surplus.

Shortly before Juncker's State of the Union address, it was reported that Germany is proposing that a German-dominated European Monetary Fund take fiscal oversight away from the Commission – but that it is attempting to win the support of France and Italy for the move by including the promise that Germany, France, and Italy can each have a veto over its decisions. This proposal will essentially give Germany strict control over the oversight of budgets of all the Eurozone states who require the assistance of the fund, with only France and Italy having the right to reject the EMF's conditions.

The French side has been pushing for the EMF to also require more risk-sharing and debt-sharing, which would benefit the peripheral states more. The Commission's final proposal regarding turning the current crisis fund, the European Stability Mechanism, into an EMF, will be published in December. It is unclear from Juncker's speech and its accompanying documents which aspects of the German and French proposals will form the basis of the detail of the EMF proposal – but if Juncker's other proposals are an indication of the general balance of power, it's safe to bet on the German proposal winning the day.

Juncker's State of the Union address was as significant in what it didn't propose as what it did propose – it looks like the Commission is already walking back from, or at least stalling on, ideas it had previously floated in its 'reflection paper' on deepening the Economic and Monetary Union released earlier this year. These included ideas of creating a European unemployment insurance scheme and an investment protection scheme, both of which would go some way towards meeting longstanding French calls for some form of financial transfers from the core (Germany) to the small and mid-sized economies in the EU, albeit with destructive conditions attached. There was no mention of these proposals in Juncker's September speech.

The Commission President firmly told the periphery states that their hope for a common bank deposit insurance scheme is on ice until they start following Germany's orders on risk-reduction. His exact words were: "To get access to a common deposit insurance scheme you first need to do your homework."

Over decades of core vs periphery fights over debt and investment, the outcome is always the same – the so-called peripheral states surrender more and more power over their spending, borrowing and taxation to German-dominated institutions in exchange for the promise of aid or financial transfers that simply never come.

Economic convergence means less democracy

Many of the problems regarding trade imbalances, the lack of surplus recycling mechanisms and the tendency towards divergence are acknowledged by EU and Eurozone leaders. Some of the solutions they propose, such as the creation of an increased budgetary capacity for the Eurozone, the reduction of place-based debt by the creation of Eurobonds, and the introduction of a European unemployment insurance scheme, may actually be effective in terms of promoting convergence among the euro area's members and reducing the tendency towards crises.

But of the numerous proposals made by the Commission, or by Macron or others, for some form of surplus recycling within the Eurozone, most are utterly insufficient to address the underlying structural problems, and they all demand trade-offs in rights, democracy and popular sovereignty. Take the proposals in the Commission's Reflection Paper on the Future of the EMU and other recent policy documents. You want to see a European Unemployment Insurance Scheme? The tradeoff is the "harmonisation" of labour relations and anti-worker reforms. You want an "investment protection programme" to ensure public investment is maintained during an economic downturn? The tradeoff is the maintenance and even tightening of the macroeconomic straitjacket of the Fiscal Compact. You want a budgetary capacity to redirect funds towards areas of need? The tradeoff is complete fiscal union and total control of members' budgetary dcisions.

Many of the solutions put forward by progressive economists such as Stiglitz and Varoufakis – of increasing economic integration with the goal of achieving effective surplus recycling within the monetary union – are economically sound and would likely have a stabilising effect, weakening the strong tendency towards divergence. But when formulated by the EU institutions they invariably impose further conditionality and require further transfer of economic powers away from member states and therefore away from local communities and elected local, regional and state governments.

Progressive people will not oppose redistributive mechanisms or transfers from the core to the so-called peripheral states to correct the imbalances that damage our economies, and of course we are in favour of protecting investment levels in the crisis-hit countries. But we should definitely oppose them if they are linked to conditionality. Social rights cannot be dependent on economic performance or a state's following of the fiscal rules. The left in Europe shouldn't fall for the trap of agreeing to surrender more ground in terms of economic decision-making powers to the Commission in exchange for these crumbs from the table. That does not mean all proposals for further cooperation should be opposed on principle. But in these conditions, with this balance of political forces, agreeing to accept these kinds of proposals – whether they are put forward by conservative or progressive forces – is to take a step backward. In the current context, the deepening and expansion of the Eurozone should be resisted by the left. If this sounds like a defensive position, that's because, unfortunately, it is.

Restore fiscal policy to member states

In the short term, member states should vote to reject the incorporation of the Fiscal Compact into the Treaty on the Functioning of the EU at the end of this year in the Council. The Stability and Growth Pact should be immediately revised with a view to exempting public investments from the budgetary rules and allowing countercyclical economic policies and economic recovery to take place.

In the medium term, the intergovernmental Treaty on Stability, Coordination and Governance (Fiscal Compact) and the European Semester surveillance process should be terminated, and proposals for the creation of an EMF and other transfers of surveillance powers over member states' fiscal policy to new bailout fund mechanisms should be rejected. The longer-term goal should be to re-nationalise macroeconomic policy and fiscal powers in member states.

Make monetary policy work for people

The ECB's quantitative easing programme, and particularly its corporate securities purchasing programme, is pumping billions in to banks to the benefit of large corporations and major polluters, without providing genuine stimulus to the real economy. QE for banks and corporations should be replaced by the direct transfer of newly created money to governments so they can engage in green investment, and by QE for people, with payments to individual households.

Expand the ECB's mandate

The ECB's mandate must cover not only inflation but also employment and growth, like the other major central banks across the world.

The lack of transparency and accountability of the ECB needs to end. The ECB plays a fundamentally political role and it must be held accountable to the European Parliament.

A real investment plan

The Juncker Investment Plan and the EFSI has failed. It aims to use a small amount of EU funds to provide a public guarantee for the mobilisation of private capital. It promotes the privatisation of public goods by its promotion of public-private partnerships. Above all, it has not resulted in any substantial investment above the existing very low level. The Eurozone and the EU needs a new, genuine investment plan based on public investment in infrastructure and green energy. The role of the European Investment Bank could be re-cast and bolstered as a major investment instrument to direct needed investment into deficit countries – using newly created money from the ECB if necessary.

For capital to end its investment strike, business needs to believe it can make profitable investments in the productive economy. For demand to rise enough to create a favourable investment climate, workers in Europe need a pay rise. The internal devaluation policies and competitiveness agenda needs to be replaced by the goals of the creation of decent jobs, increasing workers' standard of living and social protection, and especially strengthening collective bargaining and collective agreements and extending the right to strike.

Structural reform of the Eurozone

The Eurozone needs structural reforms that can actually achieve upwards convergence, and effective surplus recycling when banks refuse to lend to deficit countries.

The most obvious reform in this regard is for the European Deposit Insurance Scheme proposal to proceed immediately, and without German-imposed conditions on risk that are designed to delay its implementation. Beyond that, the free movement of capital is one of the core principles of the EU but also one which has caused the most damage.

Rules should be set to limit the size and length of trade surpluses, and chronic and large current account surpluses should be discouraged by the use of penalty fines which can then be used to lower trade imbalances.

EU rules prohibiting state aid have largely acted to prevent governments intervening to ensure production and employment is maintained in an industry or service facing challenges. These rules prevent governments who may choose to do so from nationalising or renationalising industries or corporations, and from implementing an alternative industrial strategy.

Regulating the banking sector

The first two pillars of the Banking Union setting out rules on supervision and resolution have proven to be biased, inconsistent and totally ineffective at ending public bailouts and have exacerbated the too-big-to-fail problem by contributing to an increasing concentration of large banks.

The Bank Structural Reform proposal (currently blocked in inter-institutional negotiations), which aims to ring-fence banks' deposit channel from investment or trading activities, should immediately be implemented and capital requirements for the systemically important banks in the EU should be raised.

Flexibility and fundamental change

Policymakers should have a mature discussion, outside of the framework of an urgent crisis, about the possibility of the need for more fundamental change of the Eurozone, including the introduction of flexibility mechanisms in the euro exchange rate along the lines of the proposals outlined by Stiglitz in his book on the future of the euro, and including the option for future separate currency areas.

The option of a negotiated exit from the Eurozone should also be made legal and viable for member states that choose to do this as a result of their economic circumstances. Protections and guarantees should be developed for member states who want to remain within the Eurozone, who cannot be blackmailed or kicked out of the common currency against their will during a crisis.

Dealing with debt

The debt burden of the crisis countries remains a major obstacle to economic recovery, restraining governments from public investment (due to the Fiscal Compact and Stability and Growth Pact). The call made by the Greek government and others for a European debt conference to cancel odious, illegitimate and unsustainable debt should proceed in order to write off or write down the legacy debt in the crisis states.

It is not only governments that are burdened with debt. Euro-area banks held just over €1 trillion in non-performing loans (NPLs) last year. There is a clear overlap between the high level of NPLs and the impact of the financial crisis on the so-called periphery economies in the Eurozone, and a clear interaction between the austerity measures prescribed for these economies by the Troika and their inability to significantly reduce their NPL ratios. The general internal devaluation policies pursued by many member states have exacerbated the NPL problem.

But the solutions being proposed to resolve this problem by the Commission, the ECB and the EBA are to build a secondary market for securitised NPLs, and to develop a Capital Markets Union that revives shadow banking and financial deregulation. These proposals – to deal with toxic loans by promoting shadow banking and securitisation – are outrageous considering the role that these institutions and instruments played in the lead-up to the crisis, and must be resisted.

The other major proposal to deal with NPLs being proposed by the Commission, the ECB and especially the EBA, is for public funds to be used to write off these debts by using the precautionary recapitalisation loophole in the Banking Union legislation – another outrageous proposal considering the promises of EU leaders that the days of public bailouts for banks were over.

Change the Treaty

In the short and medium term there are a number of measures that should be supported and campaigned for by progressives in order to alleviate the economic and political crisis, improve the living conditions of working people across Europe, and improve the existing balance of political forces. Some of the key necessary reforms are outlined above, and many require the EU and Eurozone laws and rules. Crucially, they require the treaties to be immediately changed. The view that the EU treaties are set in stone must be challenged at every opportunity. If the treaties cannot be changed, then all those seeking fundamental change will by necessity turn to other options. Above all, the flawed and failed ideology of austerity that has shaped the architecture and policies of the Eurozone and the EU needs to be challenged during this political crisis, while an opening exists to convince people that it is possible to act to build a better, social Europe.❖