Addressing the Rationality of 'Irrational' European Responses to the Crisis: A Political Economy of the Euro Area and the Need for a Progressive Alternative

Dimitris P. Sotiropoulos
The Open University Business School, UK.
Emails: dimitris.sotiropoulos@open.ac.uk, d.p.sotiropoulos@gmail.com

John G. Milios
Department of Humanities, Social Sciences and Law,
National Technical University of Athens
Email: john.milios@gmail.com

Spyros Lapatsioras
Department of Economics, University of Crete
Email: lapatsioras@econ.soc.uoc.gr

Abstract

Although the analysis of the contemporary crisis in Europe has many different aspects, this paper limits its scope to the issue of economic policy. Thanks to the 'unconventional' role of the ECB, which does not function as a traditional lender of last resort, the euro has become a mechanism for austerity. Its introduction has established a particular form of symbiosis among different capitalist economies. The project of the euro must be grasped in systemic terms: this mechanism amounts to a particular organization of economic strategies and forms of political power. It is therefore meaningless to criticize the putative irrationality of the policies implemented; it is necessary, rather, to unmask their innate social logic. Mainstream economic discussions focus on the problem of moral hazard and set it as a fundamental strategic target of policy making. In the context of the present version of euro area, this emphasis leads to policy-making regimes in which austerity is the only way to deal with economic imbalances. In other words, austerity is offered as alternative to economic instability. What is urgently needed is a progressive policy setting that overrides this unfortunate trade-off. The paper will address this issue from the viewpoint of (international) political economy.

1. Introduction

Half a decade has passed since the subprime market financial meltdown, which was the onset for the Euro Area (EA) crisis. The European project has entered its second, less optimistic phase. The stylized facts of the first phase have been widely discussed during the last years, not always in an illuminating or coherent way. Cross-country differentials in growth and inflation, persistent current account (or financial account) imbalances, real effective rate appreciation (mostly for countries with current account deficits), and the setting up of a leveraged and highly integrated banking system were the most striking developments. Having in mind the crisis of the ERM (Exchange Rate Mechanism) of the European Monetary System (EMS),[1] all these events may give a feeling of *déjà vu*. Nevertheless, both the protagonists and the stage (the institutional framework) are different this time; we have not seen the final act yet. Given the character and the long history of the euro project and given its nature as a mechanism for organizing the interests of capitalist elites, anticipating its demise is not a safe bet.

The EMU (European Monetary Union) is a sui generis monetary union: one without a central authority possessing the typical characteristics of a capitalist state. Two other points about the EMU are also worth mentioning. First, the EMU sets up a context of symbiosis that elevates default risk to secure austerity. Second, it must rely on the elimination of 'moral hazard' as the only way to let different capitalist formations be governed according to the neoliberal agenda, thus aggressively promoting the interests of capital. Official responses must not block the functioning of financial markets, even during the crisis; they must exist only in a status of complementarity to markets (see the analysis in Sotiropoulos *et al* 2013).

The paper revisits and challenges the theoretical roots of the mainstream political responses to the crisis. It also sets the background for the discussion of an alternative anti-austerity context. This debate is crucial since Europe is in the midst of an institution building process.

2. The two narratives about the crisis: a context of discussion

The two different viewpoints about the crisis can be presented with the help of the following balance of payments identity. To simplify things, we shall assume that current account balance *CA* is identical to trade balance (*NX*).

1 See Sotiropoulos (2012) and Sotiropoulos *et al.* (2013; Ch. 6 and 10).

$$Y - (C + I + G) = NX \equiv CA = S_H + S_F + PB \tag{1}$$

Let us focus on the right side of the identity. S_H is the net savings of households, S_F is the net savings of firms and *PB* is the public budget, which is in turn the net savings of the public sector. Net savings are equal to net capital outflows that increase residents' holdings of foreign liabilities. It is obvious that if net savings become negative, this amounts to net capital inflows from abroad.

2.1 The post-crisis official narrative: the case of reflective causality

The post-crisis official narrative argues that when an economy faces current account deficits (or reductions in its surpluses), it is a sign of 'imprudent' and 'reckless' domestic behavior both of the private (firms and households) and public sectors. In this sense, the EA current account imbalances are a 'bad' macroeconomic development and must be corrected. It must be emphasized that the pre-crisis official explanation of the very same phenomenon was radically different. Current account imbalances were welcomed as the optimum means to support and accommodate the catching-up process between the European 'core' and 'periphery'. Relevant and further reasoning on this discontinuity in the official narrative can be found in Sotiropoulos *et al.* (2013: 184-6). However, just to highlight the point, even in March 2008 Trichet, the ECB president, ensured that "the fundamentals of the euro area economy remain sound and the euro area economy does not suffer from major economic imbalances" (cited in Mayer 2012: 100).

The post-crisis official narrative gradually targeted the economies in deficit as solely responsible for the imbalances because of private sector *dis*-saving, public sector *dis*-saving, or both. This is a moralistic kind of reasoning, suggesting that these economies are 'profligate', 'reckless' and 'incontinent' living 'beyond their means'. This argument is the result of a particular reading of the causality in the above balance of payment identity (1): let us say it favors a *reflective causality*. Negative *CA* (or *NX*) is seen as aggregate consumption (living standards) that exceeds the productive capacities of the economy ($C+I+G > Y$). In this line of thought, a current account deficit can hold because overborrowing from abroad either boosts domestic demand at levels that overtake productive capacity *Y*, or, alternatively, masks the structural gaps in competiveness and productivity. In this sense, 'cheap' finance or risk mispricing is the necessary closure of the argument.

Therefore the suggested cure for the rebalancing of negative current account positions is domestic deflationary policies in the deficit countries (asymmetric responses in the context of the EMU). This in turn means the curbing of wages and public spending (public benefits) and the privatization of public goods (fiscal consolidations). Imbalances are ‘bad’ on the part of deficit countries or at least sub-optimal and therefore attacking interests of labor must be the proper economic response. The resulting policy mix should reflect the neoliberal agenda. Recession is seen as the proper way to bring profligate countries back to the path of economic virtue. We clearly deal here with a recession-led political agenda. The logic is summarized by Figure 1.

[FIGURE 1 NEAR HERE]

2.2 An alternative explanation: the case of a structural causality

An alternative political agenda must be associated with an alternative explanation. This is a crucial political issue and not a hair-splitting debate among academics. The above post-crisis official argument fails to capture the dynamics of contemporary capitalism. This is because it treats the financial side of the balance of payments identity as a passive reflection of either the trade balance or the autonomous investment decisions of private and public agents. This is a line of reasoning that neglects the real workings of modern finance.

The alternative explanation should take into account two basic points.[2] First, the financial account has its own autonomy and does not simply fill the gaps of the current account trends. Second, the financial account imbalances create their own dynamics both in surplus and deficit countries. In the case of a monetary area with the characteristics of the EA, the market-based rebalancing is very likely to take the form of a typical balance of payments crisis (because of a sudden stop in financing). This outcome actual fits the facts of the EA crisis. Thus, the financial side of the story should not be underestimated, especially in an historical era of significant cross border financial flows. It also gives another dimension to the discussion. Current account imbalances set a vulnerable symbiosis between economies in surplus and deficit. It is a problem whose roots and consequences concern the pattern of economic symbiosis along with the institutions that hold the symbiosis together.[3]

To illustrate the point, we shall reformulate the identity (1) as follows:

2 For a relevant discussion see Sotiropoulos *et al.* (2013). For a mainstream intervention with a similar perspective see Turner (2013).

3 For a more elaborated discussion of the same argument see Sotiropoulos et al. (2013), Milios and Sotiropoulos (2010), Milios and Sotiropoulos (2013).

$$net\ capital\ inflow = net\ imports \tag{2}$$

Causality in this identity is a structural one: it is defined by the dynamics of capitalist development. This means that there are no straightforward functional relations between the two sides.

In a historical project like the EA, combining countries with different growth prospects will necessarily bring about financial account imbalances.[4] This is a condition that makes participation in a monetary union appealing to capitalist powers of both less and more developed capitalisms. However, this leaves net imports as the adjustment variable in the above equation. Ceteris paribus, net imports (or the trade balance in general) is the factor that is more likely to accommodate the financial flows of capital in the context of catching-up (growth and profit rate differentials) than vice versa. Trade imbalances and REER (real effective exchange rate) divergence were the results of the process of European symbiosis: it is a weakness that pertains to the whole setting and is linked to strong capitalist development in deficit countries.

3. On the political importance of the theoretical debate

The discussion about the causality of the balance of payments identity has important political consequences.

3.1 Reflective causality and the devaluation of labor

The argument which sees the financial account imbalances as flexible adjustment to the corresponding trade imbalances, albeit its alternative versions, is in fact a *labor devaluation project*. The macroeconomic rebalancing concerns the economies in deficit that must proceed with some sort of asymmetric adjustments, reducing the international value of labor. More or less this point summarizes the official EA strategy of dealing with the crisis: *recession-led neoliberal reforms*. In this context, the ruling European political elites have presented any deviation from austerity and neoliberal reforms as 'moral hazard', i.e. as a reckless and populist policy that undertakes high risks, expecting others (the other European countries or future generations) to pay for these risks.

4 During the pre-crisis period cumulative changes in sovereign debt were usually unimportant. The amount of sovereign debt depends on growth prospects within the EMU and the character of domestic economic policies. Countries with high debt and high growth prospects can easily accommodate tax relief for capital without deterioration in the debt dynamics. This was one of the basic results of the first phase of the EA.

The primarily asymmetric type of responses which have been implemented so far (the burden of adjustment falls heavily on the labor of the distressed economy) are in line with the neoliberal governance of the EMU[5] (the emphasis on moral hazard) and they prefer to use sovereign debt as a means to austerity (lower taxes for capital and privatizations) and devaluation of labor (better conditions for capitalist exploitation). In this sense, they are economic policies which are genuinely designed to miss their declared fiscal targets but retain as a strategic horizon the 'sustainable' reorganization of economic and social life to the benefit of capital. This is the message of Figure 2. It depicts the changes of the last three years (the numbers for 2013 are estimates) in unit labor costs, sovereign debt and unemployment for the economies of the EA (except Luxemburg). What is presented by the state and European officials as a story of success is actually as story of disaster for the majority of society.

[FIGURE 2 NEAR HERE]

Economic recession (reduction in final demand) is used as means for imposing favorable conditions of capital valorization (it reduces unit labor costs and real effective exchange rate −REER− and boosts exports in relation to imports − the ultimate end is to reshape the social conditions of labor reproduction), and it increases debt and unemployment. At the same time, debt overhang is also used as means for fiscal consolidation and further neo-liberalization of the capitalist state. In a midst of a recession, a country with a current account deficit cannot put its sovereign debt on a sustainable track by solely relying on labor devaluation and fiscal consolidation: these actions will not be sufficient to generate sovereign net savings and reduce borrowing costs. A possible current account rebalancing based on asymmetric responses by a deficit country will extend over a long period. This means a prolonged period of recession or poor economic growth, which will also be associated with a severe deterioration in the living conditions of the population and the quality of the democracy. This is not so much a re-adjustment but a conservative social reshaping led by an authoritarian state interference.

European governments and the ECB have been unwilling so far to do 'the right thing in time' in order to decisively mitigate the consequences of the crisis. There are institutional limitations but this is a poor excuse and it downplays the important room for policy actions which still exist even within the current context of EMU. It is a mistake to interpret this behavior as 'irrational' or 'short-sighted'. The drastic intervention into the crisis would undermine the usage of debt overhang and economic

5 For an exposition of the argument see the analysis in the Appendix.

recession as tools for the devaluation of labor. It would undermine the strategic rule of 'moral hazard' as a governance model to the benefit of capital since it would create the real 'hazard' of blocking austerity and neoliberal reforms. It is exactly this event that from a class point of view must be considered as irrational for the capitalist power.

Without going into details, what we should expect in the near future is the application of the same rule: policy responses always one step behind the workings of markets. Despite its contradictions, this process can secure the final target of European capitalism: the creation of a 'white Chinese worker' in the EU. Possible future plans and financial innovations (banking union; debt restructurings, pay-backs and write-offs; redemption bonds, safe bonds, or even Euro bills etc.) will not be designed as solutions to the misery of the working people but will just serve this single strategic scope. The real issue in the European crisis is not the contradiction between North and South, nor that between debtors and creditors but the fundamental contradiction in capitalism: the one between capital and labor.

3.2 Structural causality and the need for an anti-deflationary agenda

The agenda of depression-led reforms across Europe is based on a (necessarily) wrong theoretical explanation of the crisis. It is a political project that gradually reshapes the economic and social context of the EA to the benefit of capital: it totally reorganizes the conditions of reproduction of labor power. In doing so it creates different monetary tiers within the EA. It thereby undermines what it claims to be its basic target: the unity and singularity of the common currency.

The anti-austerity agenda needs an alternative theoretical explanation from the 'orthodox' one, that comprehends and emphasizes the financial character of contemporary capitalism. It sees the EA contradictions as a result of a particular form of symbiosis in a neoliberal framework that fosters capitalist interests, and it addresses these problems on the European level. It sets forth an agenda that defends a symmetrical expansionary adjustment that destroys the different tiers within the EA and gives emphasis to the interests of labor. It is not just another technocratic suggestion but a different perception of the economic policy and the responses to the crisis.

Let us recall Polanyi's (2001) historical insight as it was expressed in 1944. In a historical context bearing many similarities to the contemporary one, he argued that liberalism, when in crisis, needs a kind of 'conservative interventionism' in order to reproduce itself. We believe that Polanyi's insight still holds. In our era, capitalist states do not seem so helpless, not even the European ones. They intervene in a decisive manner to restore the dynamics of the markets and to finance the building up of mechanisms and institutions to further squeeze social incomes and public benefits (reshaping the terms of the reproduction of labor power). The resulting situation seems to be that of a free economy under a strong government (or strong governance in the case of EU), as Polanyi might have put it. The key target of contemporary capitalist strategies is the subordination of the stability of employment and incomes to the successful functioning of financial markets. An unstable and dichotomized social regime seems to be the fruit of this process. However, this 'authoritative' type of intervention obviously indicates that there are many different solutions to the debt overhang. Conservative state intervention does not cease to be an 'intervention' inventing all the necessary mechanisms and institutions that may be used for a different policy mix.

4. The ECB as vehicle of a progressive alternative

As mentioned above, austerity policies are not only unable but they actually do not aim at resolving the sovereign debt overhang in the EA. Austerity strategies use debt as means to reinforce neoliberal reforms throughout Europe.

Technically, there are three alternative ways to deal with the problem of debt: (i) persistent primary surpluses, which cannot be achieved in an environment of falling incomes, recession and contracting demand caused by austerity programs; (ii) nominal growth rates higher than implicit interest rates, which again cannot be the case in the present environment; (iii) unconventional policies and debt restructuring. Growth prospects are weak and fragile, in particular under the current predicament in the EA. Recession-led reforms may satisfy the interests of capital but are unable to put growth back on track, at least in the medium turn. Hence, a serious solution to the debt problem should necessarily come from debt restructuring and unconventional policies.

The case of Greece is a very good example to illustrate why a trivial debt hair-cut may be an inappropriate solution for debt sustainability, especially when it takes place in a deflationary environment and does not protect pension funds and individual depositors. Furthermore, as bank balance sheets contain a significant portion of existing public debts, traditional debt write-offs will leave the economies with vulnerable financial sectors. In the worst scenario, debt write-offs will trigger a new financial crisis. Governments will need to seek resources for bank recapitalization. This would easily cancel any relief offered by the write-offs, paving the way for fundamentalist neoliberal policies that would seek outside 'help' and 'supervision', i.e. would condition this outside 'help' to a new austerity agenda.

If we leave aside the rather special case of small over-indebted EA economies, debt forgiveness all over EA is rather unfeasible, given the magnitude of the overall

EA sovereign debt (9.2 trillion euros, which means that writing-off 50% of it would amount to forgiving at least 4.6 trillion euros). Also, such a resolution finds strong resistance from European working classes in creditor countries. It is also a complicated solution that cannot easily negate the external supervision of the debtor countries. This is an important issue for those who favor progressive policies because debt restructuring should not, by any means, be conditional on austerity policies.

A progressive European political agenda should pursue the strategy of sovereign debt restructuring in the context of a comprehensive political shift, which can create room for alternative anti-austerity policies at the European level. This political strategy should focus on the status of the ECB. There are two basic reasons for proceeding in this manner. First, the ECB is the only institution that can easily implement interventions on a massive scale in the sovereign debt market. Second, the ECB substantively faces no solvency constraint and cannot go bankrupt; it enjoys unique credibility, which hinges partially upon its ability for self-recapitalization (i.e. writing checks to itself). However, a radical change in the policy orientation of the ECB has to take place. For this to happen, a new relation of political forces in Europe is necessary.

In the wake of the crisis, monetary policies in most of the advanced capitalist economies are widely seen as 'unconventional.' This makes the ECB unconventional in the double sense.

First, the ECB is an unconventional central bank in its origin, being without the backing of a uniform fiscal authority. The fundamental conception of the EA authorities is that focusing on inflation is the most efficient way to pursue full employment, fiscal stability and financial stability. Every attempt to allocate more responsibilities to the central bank would 'politicize' it, undermining its effectiveness. Short-term interest rates are acknowledged as the key monetary policy instrument.

Second, the ECB, like other central banks in the wake of the crisis, has been engaged in 'unconventional' monetary policies, adopting the much wider range of instruments made feasible by its balance sheet. Nevertheless, unconventional monetary policies can be effective only when executed by *conventional* central banks. This describes the *trap* that the ECB has fallen into. The ECB is called on to take unconventional action while lacking the institutional standards tools of conventional central banking.

The ECB has expanded its balance sheet by taking on long-term refinancing operations. Practically, these are liquidity ejections into the financial sector equivalent to the quantitative easing pursued by the Fed and the Bank of England. The only difference is that unlike the latter, the ECB has very tight limits in its purchase of government bonds. Hence, unconventional monetary policies in the EA take the form of repos operations for short and medium term time windows (LTRO, OMT).

This type of liquidity injection to the financial sector has been primarily absorbed by the banking systems in the so-called European ‘periphery’. However, liquidity seeks for safe havens, eventually flowing to the core economies as is obvious from the deposit drains and the cumulative TARGET2 imbalances. Large portions of this liquidity thus return as overnight deposits to the ECB. Bank loans are contracting in the economies under recession while domestic banking sectors are increasing their exposure to sovereign debt that cannot be purchased by the ECB. It is quite obvious that the restricted bond purchase program of the ECB and the liquidity provision (co-opting banks into securing funds for fiscal distressed governments) is not enough to deal with the problem. The different financial tiers that emerge within the EA undermine the results of the ECB monetary interventions (which are very cautious indeed: ECB is more concerned with the issue of ‘moral hazard’ which is the cornerstone of the European governance model).

ECB monetary policy is thus not expansionary enough, not unconventional enough (tight limits on the purchase of government bonds) and is implemented in a heterogeneous context that undermines its effectiveness, having significant effects on demand, growth and employment. This framework is only suitable for the continuation of austerity policies that reorganize European societies according to the neoliberal agenda and the interests of capital.

While the aim of this paper is not to go through the details of an alternative progressive plan as regards the ECB (many different authors, who do not necessarily come from the Left, openly flirt with similar ideas), the basic principles can be outlined here. The ECB acquires significant part of the outstanding sovereign debts (in market prices) of the countries in the EA and converts them into zero interest perpetuities. These will appear as assets in its balance sheet while there will be a proportional increase in the monetary base on the side of liabilities. Many authors have argued that this type of transaction is unlikely to be inflationary in the current economic environment. Debts will not be forgiven. Individual states will agree to buy them back in the far future. Hence, the ECB’s intervention in the sovereign debt market will have a necessary counterpart swap agreement with individual states. The latter will agree to buy back the perpetuities from the ECB’s balance sheet in a few decades’ time.

A simple illustration can clarify the point. Let’s suppose that the ECB buys at market values a significant part of the Italian sovereign debt (accounting now to 132.7% of the country’s GDP). Let us thus assume that the ECB buys Italian sovereign debt to the level of 100% of the country’s GDP, and carries its nominal value forward for 7 decades (with a discount rate of 1%). Assuming a 3% average annual nominal growth for the next 70 years, by the time that Italy buys back the debt from the ECB its nominal amount will correspond approximately to 25% of its future GDP. This would be a manageable addition to the existing debt of the time. Italy will grow its way out of the debt overhang without any significant forgiveness and without any sacrifice from the working people in Europe. The same condition should be applied to other European countries as well.

This model of unconventional monetary interventions will give to progressive governments in the EA the necessary condition to develop social and welfare policies in the interests of the working classes. It will reverse the policy priorities and replace the neoliberal agenda with a program of social and economic reconstruction, with the elites paying for the crisis. The perspective taken here is of a more cohesive and more just society, in which social needs and the interests of the working majority will function as a policy prerequisite.

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Figure 1

The interpretation of the EA crisis in the context of 'reflective causality'

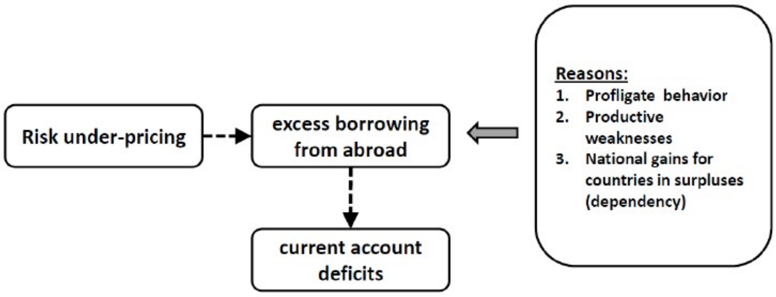
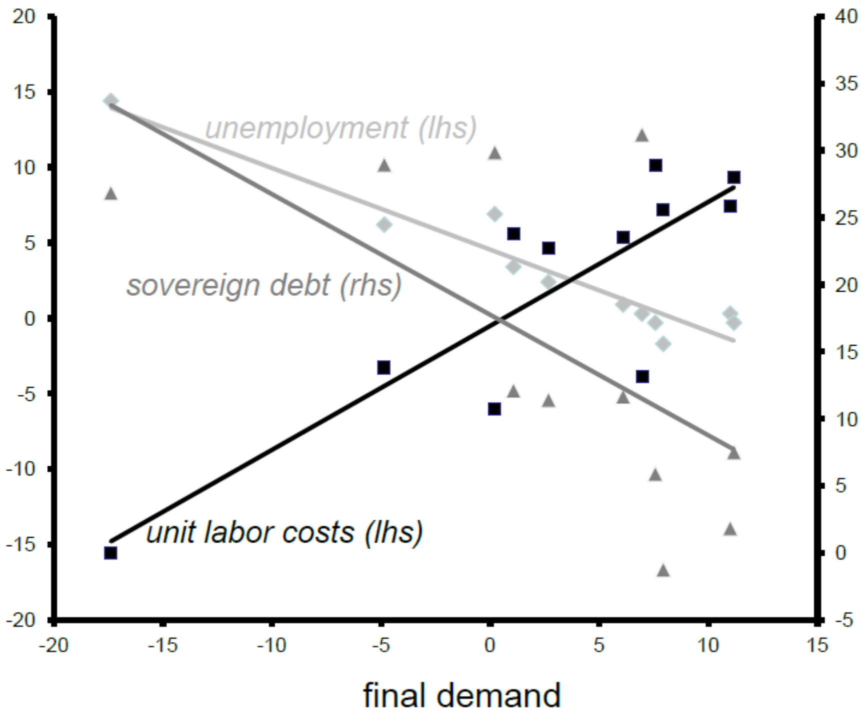


Figure 2

Changes in (nominal) unit labor costs, sovereign debt (per cent of GDP) and unemployment in relation to final demand for 2010-2013, EA countries



Source: AMECO database (our calculations; data for 2013 are estimations)