The Euro Crisis and the Neoliberal EU Policy Regime: Signs of Change or More of the Same?

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The Euro Crisis has painfully exposed the weaknesses of the European economic policy regime. Unlike the Anglo-Saxon countries, where the global financial crisis began, it is the euro area that is teetering on the brink of deflation now and it is only in the peripheral euro area countries that the crisis has turned into a depression. So how do Europe's elites want to reform the European policy regime? Are they questioning the neoliberal model or merely modernising it? To get a glimpse of the future of the Economic and Monetary Union (EMU) this blog takes a detailed look at the Five Presidents' Report on "Completing Europe's Economic and Monetary Union,"[1] which represents the most comprehensive single statement by the European institutions thus far about the direction EMU should be heading. Our assessment is that the report sets out to permanently and institutionally codify the structural adjustment programmes which have been applied to the crisis economies whilst at the same time providing further impetus to cross-border financial speculation. The report recommends a single-minded focus of national policy on "fiscal responsibility" and competitiveness through eroding of labour standards, and a renewed push for financial liberalisation in the form of a Capital Markets Union. The propositions for a common fiscal policy lack detail, and there is no mention of reform of the European Central Bank toward a genuine lender of last resort. The report does not aim at restructuring the two neoliberal growth models that have characterised Europe before the crisis: a debt-driven and an export-driven model. The restrictive fiscal and monetary policy regime which ultimately was critical in turning a financial crisis into a sovereign debt crisis remains essentially unaltered. Hence, there is little reason to believe that the problems of the EMU will be resolved by the implementation of the plans outlined in the report. We will therefore contrast it with progressive Keynesian policy proposals.

The Five Presidents' Report

The Five Presidents' Report is divided into five sections. The first section sets out the planned timetable for the proposed reforms which is comprised of three stages, with the final one to be reached by 2025, by which time all reforms, it is hoped, will be in place. As we shall argue, important measures which would be required to be urgently implemented are, if mentioned at all, delayed as far as possible, whereas the most damaging measures are prioritised.

The five presidents of the European institutions: Jean-Claude Juncker, President of the European Commission; Jeroen Dijsselbloem, President of the Eurogroup; Martin Schulz, President of the European Parliament; Mario Draghi, President of the European Central Bank; and Donald Tusk, President of the European Council.

In the second section, the report reaffirms that a sustainable EMU requires that all member states "converge to the highest level of prosperity" (Juncker 2015: 7). Yet, the report still clings to the belief that such convergence can be achieved through supply-side reforms of the same kind which have been unsuccessfully applied throughout the periphery since the crisis. The idea of establishing "National Competitiveness Authorities" in all member states is the most concrete proposal in this section, and it is believed to be of such importance that it should be implemented as soon as possible. The focus of these authorities is clearly envisioned to be on a fairly narrow definition of competitiveness, related to prices and especially wages. Member states are expected “to converge towards the best performance and practices in Europe” (p. 7) which can easily be read as a euphemism for a race to the bottom in terms of labour standards. The ultimate aim of convergence is supposed to be a similar level of resilience against disturbances, without direct reference to the levels of employment or income at which this should be achieved. The original aim of convergence (i.e. “convergence to the highest level of prosperity”) is apparently presumed to be an automatic outcome of supply-side reforms. “[E]fficient [read: flexible] labour markets that promote a high level of employment and are able to absorb shocks without generating excessive unemployment are essential: they contribute to the smooth functioning of EMU as well as to more inclusive societies” (ibid). There is little reference to the idea of a genuine social Europe beyond platitudes to the effect that “Europe’s ambition should be to earn a ‘social triple A’” (p. 8). Eventually, this new convergence process is envisioned to become binding for member states with standards which “should focus primarily on labour markets, competitiveness, business environment and public administrations, as well as certain aspects of tax policy (e.g. corporate tax base).” The potential pitfalls of this approach are clear: the winners of this intra-European competitive race (which are likely to be those countries currently already enjoying competitive advantages) will continue to rely on the export-driven growth model which characterised economic developments in a subset of Eurozone countries prior to the crisis. The Capital Markets Union, discussed below, on the other hand, will serve to strengthen the forces which led to the debt-driven growth model representing the counterpart to the export-driven one. These growth models emerged in a situation in which wage shares were falling in Eurozone economies, most of which are wage-led (that is, they are economies in which an increase in the share of wages in national income leads to an increase in aggregate demand and GDP), since growth had to come from sources other than domestic demand out of wage-income.[2] The report’s proposals, especially those in the second section, may well lead to a further decline in wage shares, and are thus antithetical to what progressive Keynesians advocate based on empirical findings about demand regimes.[3]

The third section contains proposals regarding the Banking Union and the Capital Markets Union. Out of all the projects described in the report, these two are the furthest developed with detailed proposals for implementation. In addition to the already agreed single supervisory and single resolution mechanisms, the report once more suggests the creation of a European Deposit Insurance Scheme for the Banking Union; a proposal which has so far proved controversial, with Germany frequently opposing it. The creation of a Banking Union composed of these three pillars is indeed desirable to help ensure that banking crises do not turn into sovereign debt crises. However, it remains questionable whether the proposed size of the resolution- and deposit-insurance funds would be sufficient to withstand the collapse of a major European bank.[4] If this is not the case, national budgets would again have to be used for bank rescues, which would further reduce the already slim fiscal manoeuvring space available to Eurozone members during crises. But there is an even bigger problem: while the aim of the Banking Union is to improve the stability of the financial system, the report’s proposals for the Capital Markets Union are likely to lead to increased *instability*.

There is no attempt at serious financial reform or regulation in the report. It shies away from proposing a break-up of large universal banks or at least the ring-fencing of investment banking from commercial banking operations, the taxation of financial wealth, or regulation of the shadow banking sector. At the same time, the proposed Capital Markets Union (CMU), which is to be implemented as soon as possible, is likely to further increase the systemic importance of large universal banks. The proposition for the CMU, which has been interpreted as a concession to the UK and its oversized financial sector,[5] is framed as providing an opportunity for channelling financing into productive investments, particularly of SMEs. However, the report makes no practical suggestions as to how this would be achieved. Capital market financing of firms is indeed less developed in continental Europe than in the United States, but even there SME finance is primarily bank-based. Rather than helping SMEs the most likely effect of CMU is to further increase the power of large banks. Indeed, one cannot help but think that the detailed proposals relating to the CMU which have been put forward[6] are actually *designed* to lead to this outcome. For instance, the proposed rules on due diligence and self-attestation in the so-called “Simple, Transparent and Safe Securitisation”

(STS) scheme clearly favour market participants with superior resources and analytical capabilities. The whole proposed regulatory framework to a significant extent reflects the interests of the financial sector[7] (rather than those of the real economy, which the CMU is allegedly designed to help) and will facilitate the emergence of a renewed era of credit-led booms driven by the securitisation of mortgage loans in which the largest banks are the major players. As such, rather than to act against the conditions which led to the emergence of rising indebtedness and growing current account imbalances in the periphery, the European institutions aim to provide new impetus for speculation. The report argues that the CMU will increase financial stability by "provid[ing] a buffer against systemic shocks" (p. 12). This appears highly naïve in light of the experiences of the peripheral countries during the crisis and those of developing countries with capital market liberalisation. Both examples show that international capital flows tend to be highly volatile and *pro-cyclical*. They tend to aggravate rather than alleviate difficulties during times of crisis and uncertainty. More financial liberalisation will not solve the problem of financial instability.

In the fourth section, the report attempts to address the shortcomings of the European fiscal framework. Remarkably, and despite the importance of the issue, this section is in fact the shortest in the entire report. The proposals are accordingly vague. The section first reaffirms the commitment to the rules binding national fiscal policies and makes suggestions for stricter implementation. The role of the ECB, and the fact that its restrictive mandate (which prevents it from supporting national fiscal policies as any other modern central bank does) is essentially the only reason that these fiscal rules are necessary in the first place, are not mentioned in the entire document. The report then raises the prospect for fiscal policy at the Eurozone level. In the European context, it constitutes progress that the five presidents make the case for a European fiscal policy, but their understanding of the role of fiscal policy is extremely narrow. The measures, according to the report, will only take the form of automatic stabilisers without scope for discretionary policy.[8] However, the crisis has shown that active, discretionary fiscal policy is necessary and can be (and has been) very effective especially during recessions.[9] But in Brussels and Berlin, such things cannot be spoken about in polite company. The fiscal policy framework is only envisioned to be implemented at the second stage of the reform process. This is ironic at best. Greece, Spain, Italy and Portugal need government spending now, not in ten years. In addition, the report envisions that economies would only be able to benefit from this framework by meeting the strict conditions outlined in the rest of the report. The framework is not viewed as a tool to promote convergence and is hence a far cry from the fiscal and welfare policy proposal we outline below. Fiscal orthodoxy is thoroughly entrenched in Europe and the priorities set by the report are strikingly at odds with what is necessary to return growth and prosperity to all of Europe.

The fifth section contains a number of token-propositions under the heading of democratic accountability which fall far short of what would be required to address the democratic deficit at the European level. There are to be additional debates in the European Parliament on economic matters. National parliaments of member states are reminded to exercise their right to invite a member of the European Commission. No mention whatsoever is made of additional decision-making powers for elected representatives or a wholesale democratic reform of the European institutions, strengthening the power of the Parliament vis-à-vis the Commission and the Council. The risks of delaying democratic reform are clear, particularly in crisis countries where austerity policies are perceived as being forced by unaccountable institutions. This will further strengthen the support of euro-sceptic parties, which are predominantly on the extreme right. On this dimension, the report thus clearly misses the aim of putting the EMU on a sustainable footing. Again, the section makes some unspecific comments regarding the setting up of a Euro Area treasury. However, the report also reaffirms that "[t]he Stability and Growth Pact remains the anchor for fiscal stability and confidence in the respect of our fiscal rules" (p. 18).

The EU Policy Regime and the Sovereign Debt Crisis

Thus, overall, the report provides little hope for a change of the EU policy regime. That this regime is indeed well-anchored in neoliberal and ordoliberal political and economic thought has been demonstrated at length by one of the present authors.[10] Its major features, including restrictions on national fiscal policy, liberalised goods and financial markets, a centralised, independent monetary authority focused on inflation targeting and an emphasis on competitiveness and flexibility of labour markets all fit well into these strands of thought. The regime is characterised by a strong belief in the efficiency of the market system, a distrust of state activity and an anti-labour bias. To these characteristics, one might also add a certain distrust of democracy, exhibited by the meagre proposals regarding the problem of the democratic deficit. It is well known that prominent neoliberals have at times been quite hostile to the idea of democracy, viewing the freedom of markets as the quintessential way to achieve personal freedom for all. These characteristics are also discernible in the Five Presidents' Report. Especially notable is the fact that the report does not at all touch upon the ECB, which is modelled on the archetypical example of an ordoliberal central bank, the German Bundesbank.[11] The crisis has shown that the ECB's current institutional setup is not feasible in serious economic downturns when a genuine lender of last resort is needed the most, which is the reason why it has found various creative yet overall insufficient ways to circumvent its mandate in practice.

The euro currency symbol sits on a sign outside the European Central Bank headquarters in Frankfurt, Germany. (Martin Leissl/Bloomberg via Getty Images)

What, if anything, can be done to truly fix the flaws in the EU policy regime and the construction of the Eurozone? Several critics regard the fixed exchange rate regime as the root of the problem.[12] In this view, the currency union is a vehicle for German/northern dominance through "neo-mercantilist" economic policies. According to them, Germany was more effective in constraining wage growth and gained a competitive edge over southern European countries. The euro system allowed Germany to pursue a growth strategy based on trade surpluses via wage suppression, with the root of the problem lying in fixed exchange rates which enabled this strategy. This reasoning leads some commentators to advocate an exit from the euro of certain countries or a wholesale breakup of the euro area. [13]

There is some truth in these arguments, but they miss out on important factors. Financialisation only plays a supporting role in this story as it allows for a recycling of German trade surpluses to finance southern Europe's imports. In fact, trade deficits were not only forced upon southern European countries by improved German competitiveness. Southern European countries were growing faster than northern countries and their growth pulled in imports. This growth was fuelled by a credit boom based on a property bubble, enabled by liberalisation of capital flows brought about through the monetary union. It came with rising household debt and proved highly unstable, but, from a macroeconomic point of view, it was not the growth rates that were unsustainable, it was their financing structure.

As regards the escalation of the crisis: the neoliberal macroeconomic policy regime of the euro area plays the central role. It is the separation of monetary and fiscal space that explains the uniquely European transformation of the global financial crisis into a sovereign debt crisis. And it is the refusal of the ECB to play the role of the lender of last resort to governments, not the fixed exchange rate regime, that forces national governments to adopt austerity policies. Why did the USA and the UK outperform the southern European countries despite a similar debt overhang? Because they used a strong devaluation to improve their competitiveness? No, the US devaluation early in the crisis was modest and Britain did not devalue at all. Rather it was the central bank financing of government spending under the mantle of quantitative easing that allowed them to run larger budget deficits than European countries while keeping interest rates low.[14]

A Keynesian Alternative

In contrast with the Five Presidents' Report, a progressive Keynesian economic strategy [15] would involve an economic policy mix that breaks thoroughly with neoliberalism. It would aim to solve the problems of the EMU without the need for a break-up.[16] It would use deficit spending for demand stimulation and have full employment as its overall goal. A Keynesian strategy aims for inflationary adjustment, which means higher demand growth in surplus countries.

First, wage policy would not aim at wage flexibility, but at an equitable income distribution that is consistent with relative trade positions. This would involve policies which would create a system of transnationally coordinated wage bargaining that takes into consideration issues of equity, domestic demand, and trade balances. It would *not* be a framework aimed at convergence to the lowest level of labour costs and requires a strengthening of collective bargaining structures and ought to be complemented by a European system of national minimum wages. This would be an alternative to the current system in which deflationary pressure is put on the deficit countries, and it would contribute, along with the second element of the progressive Keynesian strategy, to lowering current account imbalances in Europe both by increasing demand growth in the north and by leading to a convergence of relative costs.

Second, the financial sector needs restructuring and shrinking. Debt restructuring will in some cases be necessary to make debt manageable, but in general a Keynesian strategy aims at raising income rather than deleting debt. An inflationary environment would facilitate a reduction of debt burdens. To counteract the regressive distributional effects of bank rescues, a substantial wealth tax would have to be introduced. Bailed-out financial institutions would be put under public control to ensure change in management practises. Financial regulation would lean against asset price bubbles to control credit growth. This would help to contain the credit-fuelled booms which were an important factor driving current account imbalances prior to the crisis.

Third, there needs to be a robust mechanism of redistribution across regions, a redistribution that does not rely on generosity and bail-outs. This would consist of two elements. On the one hand, crisis countries require a Marshall Plan style investment programme to help them build up productive capacities and rebalance the structures of their economies away from sectors such as real estate. Such a programme could, for instance, be undertaken by a Eurozone treasury, or by the European Investment Bank. It would help to address any component of the current account imbalances which cannot be eliminated through adjustments in relative labour costs, promote employment and restructure the economies of southern countries toward higher value-added production. On the other hand, a European social security system should serve to redistribute income from prosperous to depressed regions without increasing debt levels. Both these measures would increase the resilience of the Eurozone at large against both symmetric and asymmetric shocks.

Fourth, the Keynesian policy package frees fiscal policy from the shackles of the present regime. Fiscal policy has to be used to ensure that aggregate demand is at a level consistent with full employment. This implies a strong anticyclical component. Part of this can be delivered by automatic stabilisers like unemployment benefits and a progressive income tax, but a substantial part will be discretionary policy. States need to be able to react if their economy is facing a recession or high unemployment. Specifically, this means that the southern European countries should see a large increase in government spending as their output levels are well below capacity. Ideally these expenditures would come out of a European budget, based on Eurobonds and backed up by a reformed ECB-mandate.

Quite independently of any economic considerations, a reform of the EMU would also have to seriously address the democratic deficit. Whilst, of course, there is no specifically Keynesian view on democratic reform, sensible proposals which would not impair any of the measures advocated here have been made.[17] Overall, the proposed programme would help to provide a change of course away from the policy framework based on neoliberal thought which both caused the crisis and is now preventing a recovery.

Recommended citation: Reissel, Severin and Stockhammer, Englebert. “The Euro Crisis and the Neoliberal EU Policy Regime: Signs of Change or More o the Same?” Near Futures Online 1 “Europe at a Crossroads” (March 2016).

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8. Automatic stabilisers are that part of fiscal policy which reacts automatically to economic fluctuations via changing the budget balance. For instance, in a recession, government budgets will automatically move toward deficits since tax revenues will decrease (the more so the more progressive the tax system is) due to falling incomes whilst expenditures on such programmes as unemployment benefits will increase. This effect can support aggregate demand to an extent, but often discretionary policy, meaning new spending bills or tax changes enacted by the government will be required to fully counteract a downturn.
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13. e.g. Lapavitsas, C., Kaltenbrunner, A., Lindo, D., Meadway, J., Michell, J., Painceira, J. P., Pires, A., Powell, J., Stenfors, A., Teles, N. and Vatikiotis, L. (2011): "Breaking Up? A Route Out of the Eurozone Crisis," *Research on Money and Finance Occasional Report* 3, November.
14. Quantitative easing stabilises the prices of financial assets, which is desirable in a financial crisis, but has regressive distributive effects. The rich benefit more from it than the poor, because they own financial assets. Thus a progressive policy mix has to combine wealth taxes with quantitative easing and bank rescues.
15. We use the "progressive Keynesianism" in this article to refer to what is known as the post-Keynesian strand of Keynesian economics. Post Keynesian Economics exhibits important analytical differences to mainstream interpretations of Keynes and also advocates more radical and wide-ranging policy proposals. A good discussion of these differences can be found at: http://wug.akwien.at/WUG_Archiv/2013_39_4/2013_39_4_0485.pdf
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