Article by an MPIfG researcher
Fritz W. Scharpf: Comment: The Eurocrisis as a Victory of Neoliberalism? In: J. E. Fossum, & A. J. Menéndez (eds.): The European Union in Crisis or the European Union as Crisis? (Oslos: ARENA Centre for European Studies, 2014), pp. 143-154
The original publication is available at the publisher's web site:
https://www.sv.uio.no/arena/english/research/publications/arena-reports/2014/arena-report-2-14.html

Comment

The eurocrisis as a victory of neoliberalism?

Fritz W. Scharpf
Emeritus Director, Max Planck Institute for the Studies of Societies

The Monetary Union: Another instance of the EU's neoliberal bias?

The EU's Single-Market legislation, the Commission's competition policy, and the ECJ's progressive extension of the domain of economic liberties have had a liberalising and deregulatory impact on the economies, societies and institutions of EU member states. And the 'conditionalities' imposed in response to the eurocrisis on the recipients of rescue credits are even more direct in their liberalising impact. Like the supply-side programs which Margaret Thatcher and Ronald Reagan had adopted in the 1980s, they insist not only on fiscal austerity but also on a wide range of 'structural reforms' requiring liberalisation, deregulation, privatisation, tax cuts, welfare cutbacks, wage cuts and union busting. It seems reasonable to ask, therefore, whether the Monetary Union itself should also be seen as part and

[*] My paper which was discussed at the Oslo conference had been prepared for another occasion. Hence the conveners asked me to elaborate, among other issues, on the relationship between policies adopted in response to the euro crisis and an alleged general bias of European integration in favor of neoliberal policies. After further reflection, my comments represent a more radical version of my remarks at the conference.

parcel of a general neoliberal thrust of European economic integration. On a superficial level, one might even consider conspiracy-theoretic explanations suggesting that the anticipation of this outcome should also have motivated the policy makers that brought it about. In fact, however, the story is more interesting.

The Bundesbank model did not fit.

In the political sphere, the creation of the Monetary Union was strongly influenced by the perceived success of the Bundesbank's monetarist policies in achieving price stability and economic growth in the German economy in the turbulent 1970s and in the 1980s. The European Monetary System (EMS) of 1979 had been an attempt to share this success and to avoid currency fluctuations through a commitment to monetary coordination. In effect, this placed the Bundesbank in a position of hegemonic leadership: In order to maintain agreed-upon exchange rates, other central banks had to mirror German monetary policies. This worked smoothly for the structurally similar political economies of the 'DM block', but it strained the political and institutional capabilities of 'soft-currency countries'. From time to time, these had to accept politically painful devaluations – which were also reflected in the higher interest rates they had to pay. For their governments, therefore, it seemed plausible to demand an end to German hegemony by re-creating a Bundesbank-like regime at the European level whose policies would fit the general state of all economies in the eurozone. And the geopolitical constellation of German unification provided the window of opportunity in which these demands were accepted by a reluctant German government.

What the political proponents of Monetary Union had not taken into account, however, were the essential preconditions of the Bundesbank's success story which did not exist in the eurozone:

- Bundesbank policies were precisely targeted on the current inflationary pressures and growth potential of an individual economy.
- These policies were broadly accepted and respected as a beneficial constraint on government fiscal policy and on the wage-setting strategies of Germany's large, powerful and economically sophisticated industrial unions.

- The redistributive German welfare state and fiscal equalisation rules were generous and effective enough to keep inter-regional disparities of economic growth, employment and incomes at low levels.

Under these conditions, 'monetarist coordination' could in fact ensure inflation-free economic growth and relatively low unemployment without a need for neoliberal supply-side policies. Similar institutional conditions also existed in the quasi 'corporatist' Austrian, Dutch, Belgian or Finnish political economies – which had facilitated monetary coordination among the hard-currency or 'DM-block' countries in the EMS. But they did not exist in the future eurozone.

Several of the former soft-currency states had been able to meet the quantitative accession criteria of the Monetary Union through heroic political efforts. But their economic, institutional and political structures continued to generate inflationary dynamics that were stronger than those in former hard-currency countries. Hence centralised monetary policies of the European Central Bank (ECB), which had to target average economic conditions in the eurozone, could not fit the economic conditions of all member states. Moreover, national economic and political actors would also differ in their responses to monetary impulses. In other words, the Monetary Union was far from constituting an 'optimal currency area' (OCA) in which central-bank policies would 'transmit' basically similar monetary impulses to all member economies. On theoretical grounds, this suggested that uniform monetary policies were likely to generate macroeconomic divergence among the members of the eurozone – and these implications had been clearly spelled out in a series of publications by (mainly American and Keynesian) macroeconomists.

Why were the theoretical warnings ignored?

In the run-up to the Maastricht Treaty, the preconditions of the Bundesbank's success and their theoretical implications were ignored. On the political level, the larger Germany was willing to demonstrate its continuing loyalty to European integration by sacrificing the Deutsche Mark, while others were eager to end the Bundesbank's hegemony. But the warnings derived from OCA theory were also disregarded by the central bankers in the Delors Committee who had proposed Monetary Union in 1989, by the Commission economists celebrating the single currency as the

culmination of market integration in their 1990 report entitled 'One Market – One Money', and by the majority of Continental academic economists. It is at this point that the influence of neoliberal theory seems to have made a difference.

The monetarist mainstream of the 1990s had moved beyond the Bundesbank's pragmatic approach in the 1970s or the monetarism of Milton Friedman (who, incidentally, was among the critics of the Economic and Monetary Union, EMU). Under the influence of 'rational-expectations' models, the 'new classical macroeconomics' denied the capacity of monetary and fiscal policy to affect real economic growth and employment even over the medium term. Since rational economic actors would anticipate and discount the effects of macroeconomic interventions, these could only affect the rate of inflation. As a logical consequence, therefore, the unconditional commitment of monetary policy to price stability became a free good, and so did the commitment of fiscal policy to balanced budgets.

From this perspective, the theory of optimal currency areas and the warnings derived from it appeared as a throwback to the Keynesian illusions of the 1960s and the pretensions of macroeconomic steering which had failed in the 1970s. And while the heterogeneity of eurozone economies could not be denied, the market-driven responses of rational actors to the common currency would ensure economic convergence without government intervention. Hence the Commission was confident that the eurozone, though it was not initially an OCA, would soon become one since liberalised capital markets and the removal of exchange-rate risks would facilitate the optimal allocation of capital and thus accelerate the catch-up development of less advanced member economies. In short, all that was needed to make the EMU a success was a firm commitment of the ECB to price stability, and rigid rules on public-sector deficits that would prevent national governments from creating inflationary pressures affecting the eurozone as a whole.

While both of these requirements were installed as binding rules in the Maastricht Treaty and the Stability Pact, there was no reference to the coordination of wage setting – which had played a crucial role in the Bundesbank model. In the paradigm of the new classical macroeconomics, wage setting was not a policy variable. The theory assumed wage flexibility, rather than an institutional capacity of

industrial-relations systems to achieve wage coordination. Hence if wages were mentioned at all in the analyses promoting and defending the Monetary Union, it was only to emphasise flexibility. How this was to be achieved, and what governments could do about it, was left unexplored.

But neoliberal beliefs collapsed in the eurocrisis

By now there is no question that the warnings derived from OCA-theory had been well founded. Nevertheless, the early years of the Monetary Union had seemed to confirm optimistic expectations. The ECB succeeded in keeping average euro inflation rates below the level that the Bundesbank had once achieved, and nominal interest rates fell everywhere to German levels. As a consequence, however, real interest rates were relatively high in Germany and other low-inflation countries. The ensuing depression of domestic demand pushed the German economy into a long recession with rising unemployment. It was eventually overcome through union wage restraint and supply-side reforms of the labour market which favoured an export-led recovery – and hence rising current-account surpluses. In the former soft-currency countries with higher inflation rates, by contrast, real interest rates were extremely low, fuelling a credit-financed surge of domestic demand. It generated economic growth with rising employment and real wages (much of it in the real-estate sector). And it also caused imports to rise much faster than exports – which were handicapped by the rise of unit labour costs. As a result, current-account deficits and thus the need for capital imports, increased steadily.

During the first decade of the Monetary Union, the imbalances between the surplus and the deficit members of the eurozone were not treated as a cause for concern by national or European authorities. Since the deficits were easily financed through capital flows from surplus economies, the divergence was actually welcomed as an indication of successful capital-market integration and catch-up development. And even the dramatic rise of real-estate prices in Ireland and Spain did not worry the ECB which saw itself responsible only for consumer price inflation and, in any case, would not want to outguess the market valuation of assets. On the tenth anniversary of the Monetary Union, therefore, public celebrations of the resounding success of the euro were unaffected by worries over dynamically increasing external imbalances in the eurozone.

These beliefs collapsed, however, when the international (Lehman Brothers) financial crisis of 2008 caused a world-wide credit squeeze and a particularly deep economic crisis in those states that had become most dependent on capital imports. Private debt was transformed into public debt as governments were forced to save their overextended banks. And in the case of EMU member states with high current-account deficits, financial markets came to doubt their solvency – which then turned the economic crisis of deficit countries into a eurocrisis.

The eurocrisis and structural neoliberalism

The decision to save the euro and the subsequent series of euro-rescuing operations have led to far-reaching changes in the governance of the Monetary Union which have created a regime in which neoliberal policies became structurally entrenched. They no longer depend on actors' neoliberal convictions and are thus largely immune to theoretical challenges and political opposition.

The interest-based commitment to save the euro

When the possibility of Greek insolvency first arose at the end of 2009, a neoliberal response, which had quite a few supporters in Germany and other surplus countries, would have let the market take its toll. Moreover, rescuing the euro required the violation of the no-bail-out clause and the prohibition of monetary state financing – i.e., of two 'ordoliberal' principles that had been included in the Maastricht Treaty at German insistence. As a consequence, the decision to save the euro was and is still being opposed as a violation of liberal economic doctrines and of European and national constitutional law, whereas normative defences appealed to a basic commitment to European integration. What mattered in fact, however, were straightforward interest-based considerations.

From the perspective of Germany and other surplus countries, the accumulated export surpluses of their economies amounted to a huge creditor position which could collapse with disastrous consequences for banks and private savings if the euro were allowed to fail. At the same time, their exports and employment had come to benefit from greatly undervalued real exchange rates – which could not persist if the deficit countries were allowed to exit the Monetary Union. As a consequence, governments committed to save the euro at any cost had the full support of private financial institutions, of industry and

of organised labour, all of whom had reason to fear the potentially disastrous consequences of a euro collapse.

In short, the basic decision to defend the euro had no neoliberal underpinnings. But once that decision was in place, it implied that the challenges of the eurocrisis must be met under the structural constraints of the Monetary Union. It is these constraints, rather than any (probably persisting) neoliberal beliefs in Brussels and Berlin, that explain the liberalising impact of euro-rescue policies.

The new euro regime and its challenges

The eurocrisis had begun as a state-credit crisis that could have caused the insolvency of some EMU states. Ignoring the Maastricht rules on fiscal bail-outs and monetary state financing, these threats have so far been averted by rescue credits and unconventional ECB operations. At the same time, moreover, a new euro-governance regime is emerging that is meant to address and remove the causes of the crisis in order to ensure the future viability of the Monetary Union.

The analysis on which the new regime is based was presented by the Commission at the onset of the eurocrisis in its report on 'Competitiveness and Imbalances' which finally acknowledged that the Monetary Union, far from ensuring market-led convergence, had led to massive external imbalances and a dramatic divergence of economic competitiveness among its member states. These dismal outcomes, however, were not attributed to the disincentives of centralised macroeconomic policy in a non-optimal currency area, but rather to policy failures at the national level: Governments should have prevented the rise of external indebtedness through banking and credit regulation, and they should somehow have prevented the loss of international competitiveness through measures preventing above-average increases of unit labour costs. Since these imbalances are now seen to threaten the viability of the euro, they must be corrected under Commission guidance by the governments of the member states affected.

In essence, this analysis has shaped the 'conditionalities' imposed on the recipients of euro-rescue credits that are defined by the Commission, controlled by the Troika and sanctioned by the threat of state insolvency. And it has also informed the institutions and the policy instruments of a new governance regime of the Monetary

Union that applies to all EMU member states. Apart from the ECB's role as an unacknowledged lender of last resort for embattled eurozone governments and the centralised system of banking regulation that is still to be set up, the new regime has reinforced and tightened the constraints on national budgetary policies through the revised Excessive Deficit Procedure of the Six-Pack and Two-Pack regulations, the Fiscal Pact and the European Semester.

In a long-term perspective, these instruments of fiscal control might help to reduce the dependence of the democratic state on international capital markets – surely a worthwhile goal in principle. In the context of the acute economic crises of the deficit countries, however, short-term fiscal retrenchment did in fact increase public-sector deficits by reducing business activity, employment and public-sector revenues. Since these effects were so predictable, one must assume that the continuing insistence of euro-rescue policies on fiscal austerity is not primarily motivated by an interest in reducing the credit needs of crisis states. Instead, fiscal cutbacks appear to serve the same purpose as the 'structural reforms' that are imposed on the recipients of euro-rescue credits and that have been generally institutionalised through new 'Excessive Imbalance Procedure' included in the Six-Pack legislation. They are meant to deal with the divergence of competitiveness and external balances that the Commission's 2010 report had identified as a fundamental threat to the viability of the euro.

Even though the Commission-defined 'scoreboard' seems to treat surpluses and deficits symmetrically, the emphasis is clearly on external deficits: Current-account deficits imply a dependence on capital imports, and the loss of international competitiveness implies that the economy will not be able to reduce it through its export performance. And as deficit economies will depend on the ebb and flow of international capital markets, deficit states will remain vulnerable to speculative attacks on their solvency – which implies a permanent threat to the stability of the euro. Since these vulnerabilities do not exist in economies with current-account surpluses (even though these are also involved indirectly), the new euro regime is asymmetrically focused on the prevention and correction of external deficits.

Nominal vs. real devaluation

Before entry into the Monetary Union, deficits could have been directly addressed through a devaluation of the *nominal exchange rate* which would have reduced imports and increased export competitiveness. But since that remedy is no longer available, external balances can only be improved through measures reducing the demand for imports and the price of exports.

What is required, in other words, is an *internal* devaluation of the *real exchange rate* that requires domestic demand and wages to fall. Compared to nominal devaluation, this remedy is more difficult to achieve, and its distributive impacts are much more negative. That is not meant to suggest that nominal devaluation would be either painless or automatically effective. In the traded sector, it may increase price-sensitive demand for domestic products, but it will also increase the prices of imports and hence increase average inflation rates for everybody. And if unions should try to protect their real-income position by insisting on compensatory wage increases, the export advantages will be lost as the country gets caught in a devaluation-inflation spiral. In other words, to be economically effective, nominal devaluation does depend on unions that are able and willing to forego real-wage increases in order to improve employment in the traded sectors.

Internal or real devaluation by contrast must try to reduce domestic demand and to improve international competitiveness by reducing prices in the traded sector. Governments cannot achieve that directly, but they may reduce mass incomes through welfare cutbacks. They may try to increase price competition through privatisation and the deregulation of services. And they may reduce unit labour costs by lowering minimum wages and by increasing wage competition between job holders and unemployed job seekers. To that end, they may deregulate employment-protection rules, they may use welfare cutbacks to reduce reservation wages, and they may deny legal effect to collective-bargaining agreements.

All of these measures have in fact been included among the 'structural reforms' which the Commission defined in its 'Memoranda of Understanding' for Greece, Ireland and Portugal and in the recommendations addressed to the Spanish, Italian and recently also the French government. They resemble the supply-side

and union-busting policies pursued in the 1980s by the Thatcher government in the UK and by the Reagan administration in the United States, and similar measures were also part of the Hartz-IV reforms adopted by the Red-Green government in Germany in 2004. It is clear that they resonate with the policy precepts derived from the neoliberal paradigm. But that, by itself, does not yet explain the seeming inevitability with which they are now adopted and maintained by governments of all political persuasions.

Supply-side policies in the eurozone: inevitable and effective

In the crises of the early 1980s, the ascendancy of monetarism and supply-side theory was supported by the belief that Keynesian demand management had manifestly failed in the 'stagflation' period of the 1970s. In its policy implications, the new paradigm insisted that price stability must be ensured through monetary and fiscal restraint, while economic recovery should be achieved through wage cuts that will reduce consumer prices and thus increase the real purchasing power of domestic demand. Put into actual practice in the UK and the US, these policies did in fact achieve price stability whereas their expected effects on growth and employment were mostly counteracted by rising exchange rates. At the same time, however, the supply-side policies of the 1980s had a lasting negative impact on real wages and social inequality. In contrast to the 1980s, however, similar policies dealing with present crises in the eurozone are no longer a matter of political choice, driven by neoliberal convictions and perhaps also by the redistributive political influence of capital owners. They have become structurally entrenched.

In the Monetary Union, priority of price stability is enshrined in the Treaty. And the disregard of demand-side policies is no longer a matter of theoretical convictions denying their effectiveness: When faced with a recession or depression, governments can no longer resort to monetary and fiscal reflation or to devaluation. The only options that are still available to them are supply-side policies to reduce wages and prices. But if these policies appear similar to those adopted by Margaret Thatcher and Ronald Reagan in the 1980s, their economic effects in the Monetary Union are different from those predicted by supply-side theory, and they are also stronger than those that could actually be achieved in the UK and the US in the 1980s.

The supply-side theory of the 1980s had expected economic gains to be achieved through increases in the real purchasing power of domestic demand – and in the UK and the US, these gains were largely counteracted by currency revaluation. In the eurozone, however, exchange-rate movements are eliminated. And in the case of the German supply-side reforms of 2004, economic and employment gains were in fact achieved. But they were not achieved through a rise of effective domestic demand. Instead, union wage restraint and 'reforms' reducing reservation wages constrained domestic demand, including the demand for imports, whereas stagnant or falling unit labour costs increased the price-competitiveness of the traded sector. In effect, therefore, it was an export-led economic recovery through which Germany was able to overcome the EMU-induced recession of 2001-2005. But the price to be paid for recovery was a steep increase of social inequality.

The German experience seems to fit a theoretically plausible pattern: By preventing exchange-rate adjustments, the Monetary Union increases the effectiveness of supply-side responses to economic recessions. But these effects will not be achieved by the rise of real domestic demand. Instead, they will constrain the demand for imports and, depending on the state of export markets, they may also increase external demand. And as rising exports will not be impeded by rising nominal exchange rates, persistent supply-side policies will eventually result in increasing current-account surpluses – and in persistent internal devaluation which will be reflected the increasing under-valuation of real exchange rates.

Conclusion: Euro-rescue policies as a race to the bottom

For eurozone states caught in a recession, therefore, supply-side policies and internal devaluation are the only allowable national responses, and they are also likely to be more effective than they would be outside of the Monetary Union. But the rise of external surpluses must be matched by deficits elsewhere, and one country's gain of competitiveness implies corresponding losses among its trading partners. In other words, by removing the exchange-rate buffer the Monetary Union has dramatically increased the interdependence between national economic policies. And it has created structural constraints under which the only permissible and

potentially effective responses to an economic recession have the effect of 'beggar-my-neighbour' strategies directed at other members of the eurozone.

Worse yet, if these strategies are effective, their trading partners are also constrained to use supply-side 'structural reforms' in order to defend or restore their international competitiveness and to prevent the dangerous rise of external indebtedness. And so on, and so forth. In principle, therefore, the Monetary Union has created a vicious cycle of supply-side reforms and a constellation in which the alleged temptations of competitive nominal devaluation have been replaced with an institutionalised compulsion to engage in competitive real devaluation. The systemic effect is a 'race to the bottom' in which the member states of the eurozone are forcing each other to reduce unit labour costs by increasing the competition among jobseekers – through the deregulation of labour law, the dismantling of collective-bargaining institutions and the reduction of minimum wages and of social benefits for the unemployed.

All these are of course measures corresponding to the precepts of neoliberal economic theory, and the outcomes will also favour the incomes of capital owners and their agents over the incomes from work and the need of groups depending on public-sector services and transfers. But unlike similar policies adopted in the UK and the US in the 1980s, they do not depend on the neoliberal convictions of policy makers or on the political influence of capital interests, and they cannot be reversed by political changes to a Labour government or a Democratic administration. As long as the Monetary Union is maintained, supply-side reforms and competitive internal devaluation are institutionally entrenched.