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Planning laissez-faire: Supranational central banking and structural reforms

Benjamin Braun · Donato Di Carlo · Sebastian Diessner

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Abstract The mandate of the European Central Bank (ECB) does not extend to labor market and social policies at the national level. Why, despite the reputational costs, did the ECB act as a staunch advocate of structural labor market reforms from 1999 through 2015? We discuss this question through the theoretical lens of Karl Polanyi's *The Great Transformation*. Although Polanyi has been a key reference point for the debate on the social consequences of European economic and monetary integration, one of his key insights has received surprisingly little attention—that central banks have the power to mitigate the impact of international economic integration on domestic social protection. Polanyi regarded central banks—much like trade unions—as national-level institutions of non-market coordination, acting as a protective buffer against the functional pressures of the fixed-exchange-rate monetary regime that was the international gold standard. By contrast, the ECB, as a *supranational* central bank, embodies these functional pressures. This helps explain why, rather than protecting existing social structures against the logic of the fixed-exchange-rate monetary regime, the ECB has sought to protect the monetary regime by going out of its way to re-shape labor market institutions at the national level.

Keywords European Central Bank · Monetary integration · Structural reforms · Social protection · Karl Polanyi

Benjamin Braun (✉) · Donato Di Carlo
Max Planck Institute for the Study of Societies, Cologne, Germany
E-Mail: bb@mpifg.de

Sebastian Diessner
Faculty of Governance and Global Affairs, Leiden University, Leiden, The Netherlands

Planerin des laissez-faire: Die EZB und strukturelle Reformen

Zusammenfassung Da Arbeitsmarkt- und Sozialpolitik nicht unter das Mandat der Europäischen Zentralbank (EZB) fallen, kann sich letztere nur unter signifikanten Legitimitätskosten in diese Politikbereiche einschalten. Weshalb hat sich die EZB von 1999 bis 2015 dennoch offensiv für strukturelle Reformen eingesetzt? Wir diskutieren diese Frage mithilfe von Karl Polanyis *The Great Transformation*. Obwohl Polanyi einen wichtigen Bezugspunkt für die Debatte um die sozialen Folgen der europäischen Wirtschafts- und Währungsintegration darstellt, fand eine seiner wichtigsten Erkenntnisse überraschend wenig Beachtung: Zentralbanken haben die Macht, die Auswirkungen der Globalisierung auf den Arbeitsmarkt und das Wohlfahrtssystem abzumildern. Polanyi betrachtete Zentralbanken – ähnlich wie die Gewerkschaften – als nationale Institutionen der nicht-marktwirtschaftlichen Koordination, die als Puffer gegen den funktionalen Druck des Goldstandard-Regimes fungierten. Im Gegensatz dazu verkörpert die EZB als *supranationale* Zentralbank diese funktionalen Zwänge. Auf Basis dieser theoretischen Überlegungen wird verständlich, weshalb die EZB, nicht bestehende soziale Strukturen vor dem Währungssystem zu schützen versuchte, sondern stattdessen versuchte, die Arbeitsmarktinstitutionen auf nationaler Ebene durch Strukturreformen an die funktionalen Erfordernisse des Währungssystems anzupassen.

Schlüsselwörter Europäische Zentralbank · Wirtschafts- und Währungsunion · Strukturreformen · Sozialpolitik · Karl Polanyi

1 Introduction

The European Commission's slogan of "a Europe that protects", introduced in 2019, subtly diverges from the Treaty of Rome's commitment to "proper social protection." This is no accident. The euro area debt crisis accelerated labor market deregulation and welfare state retrenchment, and the idea of a "Social Europe" has been declared "dead" (Crespy and Menz 2015, p. 182; Streeck 2019, p. 139). At the same time, and particularly among those most affected by these developments, protectionist and nationalist sentiments have been on the rise (Walter 2021). Market-liberal Brussels watchers have read "a Europe that protects" as the bellwether of a new, non-liberal politics of protection (The Economist 2019).

Students of the tension between social protection and international economic integration have long been interested in the European Union (EU) as a unique case combining the highest levels of protection with the highest levels of economic and financial globalization (Scharpf 1997, pp. 18–19). An important part of this literature operates within the theoretical framework of Karl Polanyi's *The Great Transformation* (Polanyi 2001). From a Polanyian perspective, the fundamental question is whether the EU's supranational institutions act as the "prime mover in the move to a market society" or as the "active agent of the countermovement" (Caporaso and Tarrow 2009, p. 597). Most thoroughly scrutinized in this regard has been the European Court of Justice (ECJ). Caporaso and Tarrow have argued that, by following

a legal logic of integration and gradually enforcing an array of social rights applying to EU citizens, the ECJ has re-embedded the European Common Market (Caporaso and Tarrow 2009). In Höpner and Schäfer's contrasting analysis, the ECJ's jurisprudence has advanced a "market-enhancing" form of integration, thus contributing to the disembedding of national economies (Höpner and Schäfer 2012a). Similarly, Crespy and Menz have described the EU's second supranational body, the European Commission, as a "political entrepreneur" that has "all but [abandoned] traditional social democratic goals of decommodification of labour [sic]" (Crespy and Menz 2015, p. 756).

What has been strikingly absent from this literature on the social potential of European economic integration is *monetary* integration (Klein 2020). This oversight is surprising, first, because Polanyi treats both labor *and* money as "fictitious commodities" and both trade unions and central banks as institutions produced by the "countermovement" (Polanyi 2001, pp. 75–76). Crucially, they represent what Klein (2020, p. 6) has called "nonmarket modes of economic coordination": "Labor unions, embodying reciprocity, and organized central banking systems, embodying redistribution, both mark points at which collective political power functions to directly coordinate economic activity." Secondly, the impact of international economic integration on social protection is mediated by the monetary regime (Ruggie 1982). By irrevocably fixing their exchange rates, member states relinquished a crucial tool of macroeconomic adjustment. Pressures to commodify labor in adjustment to a fixed-exchange rate regime—a central theme of *The Great Transformation*—thus re-emerged under European Economic and Monetary Union (EMU). The strictures of the euro considerably amplified the *economic logic of integration* relative to the legal and political logics expressed through the ECJ and the Commission, respectively (Scharpf 2010, 2016) With the introduction of the euro in 1999, this economic logic of integration found its institutional expression in the European Central Bank (ECB). Since then, the relationship between economic integration and social protection has been shaped in Frankfurt as much as in Brussels and Luxembourg. This has been most evident in the ECB's near-two-decade campaign for the liberalization of national labor markets and social policy regimes via structural reforms, which we have analyzed in detail elsewhere (Braun et al. 2022).

In this essay, we draw on Klein's (2020) astute discussion of Polanyi to offer a broader theoretical reflection on the ECB's role in the enforcement of the (perceived) functional pressures of the monetary regime.[1] In doing so, we show that the supranational ECB has added a new twist to the political economy of central banking. According to Polanyi, national central banking evolved as an expression of the countermovement to the commodification of money under the international gold standard. Whereas Polanyi said little about potential *conflicts* between non-market coordination in the domain of money (central banks) and social protection in the domain of labor (social policies and trade unions), this conflict subsequently moved to the very center of macroeconomic governance (Klein 2020). A large literature has since studied the interaction between national central banks and national labor

[1] For earlier Polanyian analyses of EMU, see Holmes (2014); McNamara et al. (2015); Seccareccia and Correa (2017).

market policies and wage-setting actors (Hall and Franzese 1998; Hancké 2013; Scharpf 1991). However, the institutional setting of this interaction changed dramatically with EMU, which established a supranational monetary regime with its own supranational central bank. From the beginning, heterogeneous labor market institutions and social policies threatened divergent national inflation developments, which clashed with the ECB's one-size-fits-all monetary policy (Enderlein 2006; Vermeiren 2017). Whereas Polanyi would have expected a central bank to protect national economies from the disembedding pressures of the monetary regime, the ECB has instead embodied these very pressures. Rather than providing a non-market mode of economic coordination—the historical role of central banks according to Polanyi—the ECB attempted precisely the opposite by seeking to strengthen the market-mode of economic coordination through structural labor market reforms. In other words, the ECB acted as a—if not *the*—key planner of *laissez-faire* in the euro area.

2 The ECB's two-decade campaign for structural reforms

The ECB defines structural reforms, in strikingly Polanyian terms, as policies that "change the fabric of an economy, the institutional and regulatory framework in which businesses and people operate" (ECB2017).[2] The extent of the ECB's advo-

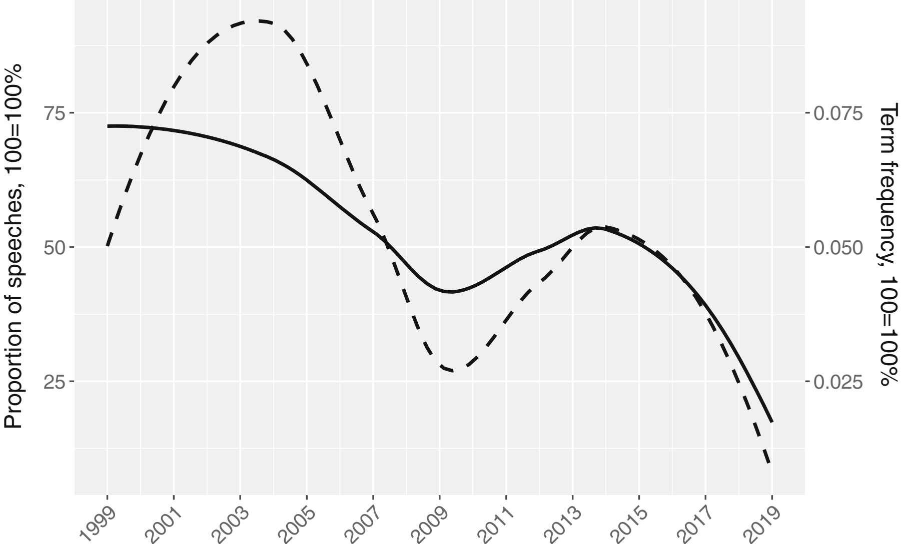

Fig. 1 "Structural reforms" and "structural policies" in ECB speeches, 1999–2019. *Note*: *Solid line*: proportion of speeches containing at least one reference to structural reforms/policies (lhs); *dotted line*: relative term frequency (rhs). *Source*: Braun et al. (2022)

[2] On the evolving meanings of "structural reform" in EU discourse, see Crespy and Vanheuverzwijn (2019).

cacy can be seen in Fig. 1. Despite lacking a mandate and the legal means to directly override national regulations, the ECB has acted as a keen supranational advocate of specific structural reforms in national labor markets and social policy regimes. Since its inception, it regarded the introduction of the euro as a catalyst for restructuring national economies:

> EMU has made it even more urgent to improve the flexibility of labor and goods markets. [...] it would very likely be the wrong answer if governments were to try to create a "social union", harmonizing social security systems and standards at a very high level. The ECB will continue to cajole governments into implementing necessary and long overdue reforms. (Duisenberg 1999, p. 185)

Concerned with high unemployment, the ECB initially acted as *translator* of the pressures of the monetary regime, employing discursive advocacy to persuade member states to implement market-enhancing structural reforms. When, in the mid-2000s, the ECB became concerned with divergent unit labor costs, ECB board members began to advocate for state-led wage restraint in the public sector, both in public discourse and in the backstage arena of ECOFIN and Eurogroup meetings. In the aftermath of the sovereign debt crisis, the ECB leveraged its newly acquired toolkit of formal and informal conditionality instruments to strong-arm Eurozone governments to pursue labor market liberalization, internal devaluation, and public sector wage cuts. The ECB's unique position as a supranational monetary authority, in fact, has afforded it additional, coercive powers to also *enforce* structural reforms in member states. The dependence of governments and their domestic banking systems on central bank liquidity allowed the ECB's "self-empowerment" (Heldt and Mueller 2021) to demand the implementation of reforms informally, while macroeconomic adjustment programs opened the door to the ECB's direct participation in the design of the Troika's conditionality agreements (Fontan 2018; Jacoby and Hopkin 2019; Lütz and Kranke 2014; Sacchi 2015; Woodruff 2016).

This two-decade long campaign for structural reforms constitutes a puzzle: The ECB lacks both a mandate and the legal means to shape labor market and social policies at the member-state level. Through a mixed-method analysis of speeches, parliamentary hearings, and interviews, we have shown elsewhere that the ECB faces a dilemma between governability and political legitimacy (Braun et al. 2022). This is because the euro area is composed of members with heterogeneous wage-setting and welfare institutions (Höpner and Schäfer 2012b) conducive to divergent developments in wage-price inflation (Johnston and Regan 2016; Di Carlo 2022). To render EMU governable by the means of a supranational monetary policy, the ECB deemed it necessary to "cajole" governments into implementing liberalizing structural reforms. By engaging in such advocacy, however, it pushed the boundaries of its statutory mandate, thus opening itself up to political contestation. When, from 2015 onward, that contestation—which occurred in the European Parliament as well as in the broader public sphere—threatened to undermine the ECB's legitimacy, the central bank wound down its reform advocacy. By the end of Mario Draghi's tenure, the term "structural reform" was virtually absent from the ECB's public discourse.

3 Polanyi and (supra)national central banking

Karl Polanyi considered the commodification of the factors of production—land, labor, and money—to be the defining feature of market society. The commodification of money reached its highest point in the international gold standard, under which countries committed themselves to maintaining fixed exchange rates by pegging their currencies to the price of gold. The effect was the unconditional subordination of "the stability of incomes and employment to the stability of the currency" (Polanyi 2001, p. 235; Ruggie 1982, p. 389). Disembedding these "fictitious commodities" from traditional modes of coordination and subjecting them to the market mechanism was a highly conflictual process that required a strong state: "laissez-faire was planned" (Polanyi 2001, p. 147).

In response to the disembedding of labor and money, a "countermovement" pushed for greater social protection (Polanyi 2001, p. 136). The challenge was to re-build institutions of "non-market coordination" through the institutionalization of trade unions and central banks (Klein 2020). Trade unions, collective bargaining, and social policies provided non-market coordination in the domain of labor. In the domain of money, central banking emerged as the key institution of non-market coordination: "a device developed for the purpose of offering protection without which the market would have destroyed its own children" (Polanyi 2001, p. 201). Indeed, central banking as a tool of macroeconomic stabilization "developed as a response to the pressure emanating from the gold standard" (Knafo 2013, p. 152). To facilitate internal adjustment and protect financial and economic stability, central banks learned to use a number of instruments of non-market coordination, including last-resort lending to address liquidity problems in the financial system; accumulation and active management of foreign currency reserves during episodes of capital flight; and interest rate policy to steer capital flows, credit creation, and thus macroeconomic conditions (Bazot et al. 2019).

The international gold standard was thus characterized by a double asymmetry, with striking parallels to the euro area (see Table 1). First, non-market coordination was asymmetric between the domains of money and labor. Whereas central banks provided substantial protection for financial investors, there were few institutional impediments to the price mechanism in the labor market. Under the classical gold standard in particular, absent or weak political and industrial democracy meant that workers bore the brunt of the burden of adjustment: "Calling for lower wages was the discourse of the gold standard" (Eichengreen and Temin 2000, p. 192). The second asymmetry concerned the distribution, between the core and the periphery, of monetary sovereignty. This asymmetry was at the heart of Polanyi's indictment of the gold standard:

> [O]nly countries which possessed a monetary system controlled by central banks were reckoned sovereign states. With the powerful Western countries this unlimited and unrestricted national monetary sovereignty was combined with its complete opposite, an unrelenting pressure to spread the fabric of market economy and market society elsewhere. (Polanyi 2001, p. 261)

Table 1 Non-market coordination at the national level, gold standard versus EMU

Institution of non-market coordination	Monetary regime Gold standard	EMU
Organized labor and collective bargaining	Weak but getting stronger	Strong but getting weaker
National central banking	Yes (in the core countries)	No

Source: The authors

In the creditor countries of the core, central banks were able to deploy their instruments of non-market coordination to mitigate adjustment pressures. Debtor countries on the periphery, however, often did not have a central bank and generally lacked the means to protect themselves against disruptive capital flows (Triffin 1946). This defenselessness was a feature, not a bug. Creditor countries actively interfered in the political and economic institutions of debtor countries to increase the likelihood of debt repayment (Polanyi 2001, p. 261). Even in developed European economies, "Labour Parties were made to quit office 'to save the currency'" (Polanyi 2001, p. 237). Laissez-faire was planned abroad, too.

World War II reversed the hierarchy between money and labor. Non-market coordination in the domain of money henceforth needed to be reconciled with non-market coordination in the domain of labor. At the heart of this "embedded liberalism" lay the Bretton Woods system of fixed but adjustable exchange rates, which prioritized national policy autonomy over international capital mobility and full employment over sound money (Ruggie 1982). With regard to non-market coordination, the tables had turned: whereas industrial labor was strong, collective bargaining institutionalized, and welfare states developed, central banks were subordinated to democratically elected governments (Goodman 1992).

With the collapse of Bretton Woods, mounting capital mobility created a trade-off between exchange rate stability and national autonomy in monetary policy. In its attempt to combine moderate exchange rate stability, capital mobility and national policy autonomy, the European Monetary System (EMS)—with fixed yet adjustable exchange rates—strove for a tenuous midpoint in Mundell's trilemma (Bordo and James 2019, p. 250). The EMS allowed for the continued co-existence of non-market coordination of money and labor, albeit at the cost of exchange rate instability and conflicts between governments over currency realignments (Höpner and Spielau 2018). European monetary integration eliminated both instruments of non-market coordination. First, the creation of the European Central Bank severed the relationship between national independent central banks and coordinated wage setting in the Northern hard currency countries (Hall and Franzese 1998; Scharpf 1991, pp. 266–267). Second, the single currency removed the option of exchange rate devaluation for the Southern soft currency countries (Scharpf 2016).

Comparing EMU to the international gold standard through a Polanyian lens thus highlights one key parallel and two fundamental differences. The *parallel* lay in the political choice to prioritize fixed exchange rates, price stability, and full capital mobility over national policy autonomy. EMU and the gold standard thus occupy the same position in Mundell's trilemma (Bordo and James 2019). Indeed, while both regimes represent "extreme forms of fixed exchange rates," EMU goes further

still by eliminating national currencies altogether (Eichengreen and Temin 2010, p. 370).[3] The *first difference* is that, unlike the gold standard, the euro standard coexists with deep-seated national embedding institutions such as trade unions, collective bargaining and welfare states. The *second difference* is that the central bank is not a national-level institution in charge of a national currency, but a supranational monetary authority in charge of a supranational currency. In the domain of money, the ECB acted in a Polanyian fashion during and after the 2008 financial crisis, using its lender-of-last-resort powers to backstop and protect the financial system. By contrast, EMU set up a clash between non-market coordination of money and non-market coordination of labor. This clash has put pressure on member states to liberalize labor markets, cut back the power of organized labor, and decentralize wage bargaining systems, as amply documented in the literature (Rathgeb and Tassinari 2020; Theodoropoulou 2018; Van Gyes and Schulten 2015). In the attempt to render a heterogeneous monetary union governable, the ECB took it upon itself to translate, and subsequently enforce, the functional pressures of the supranational monetary regime.

4 Conclusion

The curious case of the ECB's structural reform advocacy sheds new light on the political economy of central banking. Polanyi and others have shown that national central banking evolved under the international gold standard to buffer the disruptive adjustment pressures on national economies. From this perspective, central banking evolved as an institutional mechanism for non-market coordination, designed to counter the commodifying pressures the international gold standard exerted on the fictitious commodities of money and labor. Through policies such as quantitative easing, the supranational ECB provided such non-market coordination and protection for the financial system, but not for labor. Instead, emulating the role played by the IMF in other parts of the world, the ECB translated—and subsequently helped to enforce—the perceived functional pressures of international monetary and financial integration.

The preceding discussion also speaks to the broader, Polanyi-inspired literature on the social potential of European integration. Notwithstanding the importance of the legal and political integration logics, embodied by the ECJ and the Commission, our analysis shows how and why the introduction of the euro elevated the economic logic of monetary integration, embodied by the European Central Bank. Despite lacking both a mandate and the legal means to directly override national regulations, the ECB has been a keen supranational advocate of market-enhancing integration in the field of labor market and social policy. Whether the ECB is constitutionally wedded to the role of "prime mover in the move to a market society" remains to be seen (Caporaso and Tarrow 2009, p. 597). Its recent shift from structural reform advocacy

[3] Adjusting the exchange rate remained a possibility under the gold standard but is impossible for EMU member states. Note, however, that TARGET2—the Eurosystem's payment system—provides a stabilizing "insurance mechanism" that was not available under the gold standard. See Schelkle (2017, ch. 9).

to calls for wage increases has been echoed in the US, where the Federal Reserve has signaled that it will prioritize employment and wage growth over consumer and asset price stabilization. Indeed, a case can be made that the ECB has been at the forefront of the formation of a new "technocratic Keynesianism" (van't Klooster 2021). Central banks may yet again become "active agents of the countermovement."

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