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Chapter 7

The size that fits no-one
European monetarism reconsidered

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Introduction*

The European Union (EU) is full of paradoxes and the European Central Bank (ECB) is one of them. There are many others, deriving from the structural determinants of EU law-making and from the 'architecture' of EU decision-making as well as from an apparent institutional inability to concede or learn from mistakes. The German scholar, Martin Jänicke, in his book *State Failure* (1986) uses the metaphor of the 'tank/*Panzer*' to describe the 'privilege of not having to be intelligent' and of pressing on, regardless of immediate consequences. The metaphor is arguably applicable to the operations of the European Central Bank, to its attendant fiscal policy arm, the Stability and Growth Pact (SGP), and to its predecessor and model, the German Bundesbank:

> A tank driver can be stupid and blind. In contrast to the cyclist, he does not need to adapt to the annoying obstacles of the environment. Problems are 'externalised': It is not the tank driver that is damaged but the environment. In the case of the

* This is a slightly expanded version of a paper given in León, Spain, in September 2011.

> cyclist, on the other hand, the problems of an adaptive method of driving are completely internalised.
>
> (Jänicke 1986: 158)

The metaphor applies almost entirely to the institution, to the structure, and not to the people/agents that work in it and its associated System of European Central Banks (ECBS).[1] In many respects, the people working in such institutions adapt to their immutability with the intelligence of the cyclist. There is plenty of evidence to indicate that ECB insiders, like their Commission counterparts, don't subscribe to the institutional orthodoxies that bind their policy-making but resign themselves to maintaining the appearance of doctrinal uniformity as a *faute de mieux*. The ECB is probably too young to have generated a myth of infallibility, such as attached to the *Bundesbank* in the eye of (too) many people, but for that it enjoys the dubious privilege of being even more difficult to reform than its model. The Bundesbank Law of 1957 could, theoretically, have been modified by a parliamentary majority; the ECB, as prescribed by the Treaty on European Union of 1992, requires the unanimity of all member states to alter its statutory powers and its statutory responsibilities. It is this effective immutability, together with the lack of effective democratic accountability that provides the framework for the following analysis. How do we cope with a tank which has 27 drivers and neither a clear map nor a reliable compass?

This analysis is not value-free. It proceeds from a set of philosophical, ethical and politico-economic assumptions that inform the interpretation of structures, processes, events and 'facts'. The first is that of the extensive interdependence of contemporary human existence, which renders local, regional, national and international cooperation and solidarity an inescapable requirement of the survival of humanity and its habitat. The second is the observation/conviction that 'more equal societies almost always work better' (Wilkinson and Pickett 2010) and that significant inequalities of wealth, income, power and access to resources are corrosive of human progress. The third is that economic theory is at best a heuristic fiction for simplifying the understanding of partial processes, at worst a dangerous obstacle to the understanding of interdependent systems

[1] The participants at the conference in León confirmed this view of the necessary separation of institutions from those that work within them

of human organisation. The fourth is that political economy as an interdisciplinary discipline provides a more adequate basis for the diagnosis of socio-economic problems and for halfway appropriate prescriptive solutions.

Multiple asymmetries

The Bundesbank – the unquestioned parent of the European Central Bank – was the dominant actor in a German post-war political economy that was characterised by a severe separation of powers between the various institutions of macro-economic governance. Its autonomous conduct of monetary policy set it apart from the (democratically answerable) agents of fiscal policy at federal, regional and local level. For almost four decades, its institutional design stood out from all other dependent European central banks (apart from Switzerland's), in particular in the degree to which it predefined the fiscal room for manoeuvre available to subordinate finance ministries and municipal treasuries (cf. Leaman 2001: 114ff.). It eschewed counter-cyclical fiscal and monetary policy as part of its primary task of ensuring 'price stability', invoking the quantity theory of money in its statements on changes in short-term refinancing rates (Discount and Lombard), setting targets for future money-supply growth and frequently defying the preferences of the federal government with interest rate rises in periods of cyclical contraction (ibid., 193ff.). Nevertheless, the relative success of the German political economy in maintaining lower-than-average rates of inflation in the Stagflation decade 1974-1986 was credited in large measure to the Bundesbank (e.g. Balkhausen 1992), rather than to Germany's overall strengths as an innovative industrial and trading economy. This encouraged the popular (but syllogistic) view that operational autonomy was the precondition for a successful monetary policy.

The corollary of Germany's relative success in maintaining a low-inflation economic culture was the emergence of significant asymmetries in both the current account balances of European and OECD (Organisation for Economic Co-operation and Development) economies and correspondingly wide disparities in the central bank rates of Germany's European partners, as they sought to defend exchange rate parities with the German Mark (DM) and finance government borrowing; arguably the European Monetary System (EMS 1979 *et seq*.) reinforced the 'exchange market mayhem' (Eichengreen et al. 1995) by committing the system's central banks to

defend parities against speculative attacks, thereby facilitating significant arbitrage gains.[2]

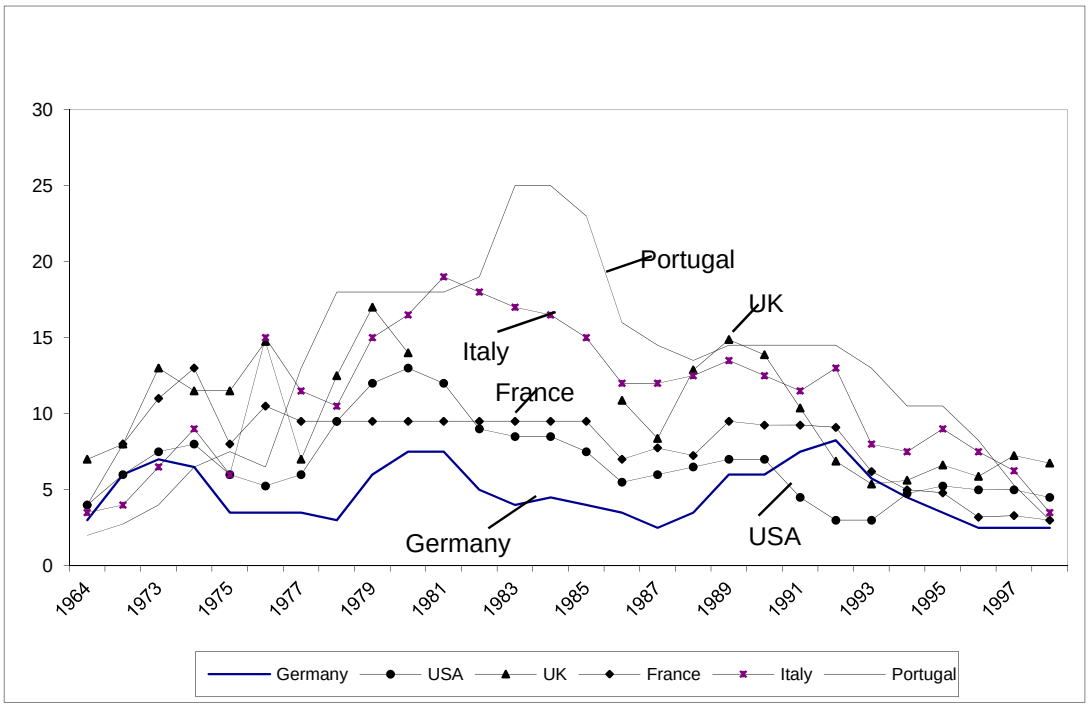


Figure 7.1: Central bank discount rates 1964–1998 in selected OECD countries.

It was against the background of the chronic imbalances in the economies of the EMS member states *and* the unexpected collapse of the Soviet bloc *and* imminent German unification that the dormant plans for European Monetary Union (EMU) were revivified and accelerated. The need to contain any further strengthening of German economic hegemony – 'Bundesbank hegemony' according to Le Gloannec (2001) – informed the crisis diplomacy of 1990 and 1991. The fact that the primary vehicle of this policy of containment was the cloning of the Bundesbank in a supranational institution has been the subject of considerable debate (Marsh 1992; Kennedy 1991; Dyson and Featherstone 1999; Leaman 2001); the likening of the Maastricht Treaty and Germany's abandonment of the totemic D-Mark to the Versailles Treaty (*Le Figaro,* 18 September 1992) underscores the extreme ambiguity of the birth of the euro.

[2] It was only when the EMS' fluctuation bands were widened from +/- 2.5% to +/- 15% in August 1993 that the feeding frenzy at the expense of EMS member states subsided.

Suffice it to say that the qualification process for EMU, its policy architecture and its operational processes institutionalised the asymmetries embodied in Germany's lop-sided system of economic governance and pre-programmed further imbalances in European economic relations before and after 1999 and in particular in the current period of severe regional and global crises. The most obvious asymmetry is the decision to press ahead with a supranational monetary union and maintain national responsibility for fiscal policy, i.e. not to implement a parallel political union – a deficiency underscored by Bundesbank representatives among others (cf. discussion in Leaman 2001: 221f). Within this new nexus, however, the insistence (by the Bundesbank and the German Finance Ministry) on strict convergence criteria as conditions of membership and an on-going commitment to budgetary consolidation by all member states represented a much tighter replication of Germany's subordination of fiscal policy to monetary policy preferences (Heise 2002); the Stability and Growth Pact (1997) and the more recent the Economic and Financial Affairs Council (ECOFIN) commitments to aggregate balanced budgets over the economic cycle and even more recent German moves to install a 'debt brake' on state bodies,[3] reinforce this subordination, establishing what Abelshauser observed of German economic policy-making – that there was 'no place for Keynesianism' – as a general rule for Eurozone states (Abelshauser 1983: 106ff).

What is notable about the Maastricht Convergence Criteria is that they omit a number of measures that might be considered essential for the establishment of an Optimal Currency Area (cf. Arestis and Sawyer 2011). While the narrowing of disparities in rates of inflation and market interest rates is an important precondition for commercial activity to prosper in an open-market, single currency union, the limitation of fiscal convergence criteria to annual public sector borrowing and overall state debt was always questionable.

- Not only were the ceilings for PSBR (three per cent of GDP) and state debt (60 per cent) arbitrary and inflexible as guides to fiscal (un)sustainability (Eichengreen 1996), but there is a

[3] In 2009, both houses of the German parliament approved the introduction of a 'debt brake' (*Schuldenbremse*), which committed the federal government to respect a public sector borrowing requirement (PSBR) ceiling of 0.35% of GDP from 2016 and the 16 regional governments to incur no budget deficits at all after January 2020.

critical absence of any notion of the state's ability to maintain the provision of public goods and absorb exogenous shocks through a robust and well-resourced tax system. Convergence to a minimum tax ratio and an approximate harmonisation of tax bases, in particular for mobile factors like corporate capital, would have rendered EMU much less vulnerable to cyclical disturbances in its weaker periphery and much more capable of achieving the modernisation objectives of the Lisbon Agenda or Europe 2020 through properly targeted programmes of innovation and productivity enhancement.

- Also absent from the convergence criteria was any consideration of the disparities in current account balances which had grown significantly throughout the OECD since the 1970s and were indicative, in the case of countries with persistent and chronic deficits, of societies that were living beyond their means (producing less than they consume) and secondly of a constant need to rebalance their economies through the capital account. It is no coincidence that economies with low tax ratios (Greece, Ireland, Portugal) had significant current account deficits before 2008 (Table 7.1) and, after increasing problems raising money through sovereign bond auctions, were obliged to apply for assistance through the EFSF. The dependence on imported capital and low tax ratios are also evident across all of the newer member states, with serious implications for their ability to converge with the levels of economic performance of their EU15 partners.

- Rates of employment/unemployment were also not considered significant enough to demand a degree of convergence, even though unemployment is indicative of macro-economic performance weaknesses, for example in unit wage costs, systems of wage-setting, levels of productivity, poorer education and training infrastructure and, not least, domestic demand.

- The neglect of macro-economic demand as a factor in the determination of wealth-creation as well as in the setting of prices and wages – which frequently varies from one national economy to another – is typical of the mind-set of neo-liberal theorists with their emphasis on supply-side conditions. This problem includes, crucially, neglecting the strength of

demand as reflected in the changing distribution ratios of income and wealth. One of the greatest blind-spots of monetary policy, as exercised by both the Bundesbank and the ECB, was the neglect of a redistribution of national income resulting from the deflationary imperative and the deregulation of financial markets. In an early statement on its core operating principles, the ECB asserted confidently that: 'Maintaining price stability *avoids the large and arbitrary redistribution of wealth and incomes* that arises in inflationary as well as deflationary environments, and therefore helps to maintain social cohesion and stability' (ECB 1999: 40, emphasis in original).

Table 7.1: Tax ratios and current account balances in Europe 2008.

Central and East Europ. Countries	**Tax Ratio***	**Current Account Balance***	**Countries of the EU15**	**Tax Ratio***	**Current Account Balance***
Albania	22.9	-11.3	Austria	43.4	3.8
Bosnia-Herz	41.2	-15.8	Belgium	46.8	-2.6
Bulgaria	34.4	-24.4	Denmark	50.0	2.0
Cyprus	36.6	-9.7	Finland	43.6	1.7
Czech Rep	36.3	-3.0	France	46.1	-1.9
Estonia	31.1	-10.8	Germany	40.6	6.6
Hungary	37.3	-8.2	Greece	33.5	-14.4
Latvia	30.4	-15.1	Ireland	34.0	-4.5
Lithuania	20.9	-14.9	Italy	42.6	-3.4
Macedonia	29.3	-14.0	Luxembourg	36.4	5.5
Malta	35.2	-7.7	Netherlands	39.5	7.5
Montenegro	28.0	-39.6	Portugal	37.0	-12.1
Poland	33.8	-5.5	Spain	37.3	-9.5
Romania	28.1	-13.8	Sweden	49.7	8.3
Serbia	34.1	-18.6	UK	39.0	-1.7
Slovakia	29.5	-6.5			
Slovenia	39.3	-4.7			
CEEC Ave	**31.7**	**-13.7**	**EU15 Ave**	**41.3**	**-1.0**
Baltic Ave	**27.5**	**-13.6**			
Visegrad + 1	**35.2**	**-4.5**			
Western Balkans Ave	**30.3**	**-18.1**			

Note * As proportion of GDP. Averages are mathematical not weighted.

Sources OECD, CIA, Eurostat, own calculations.

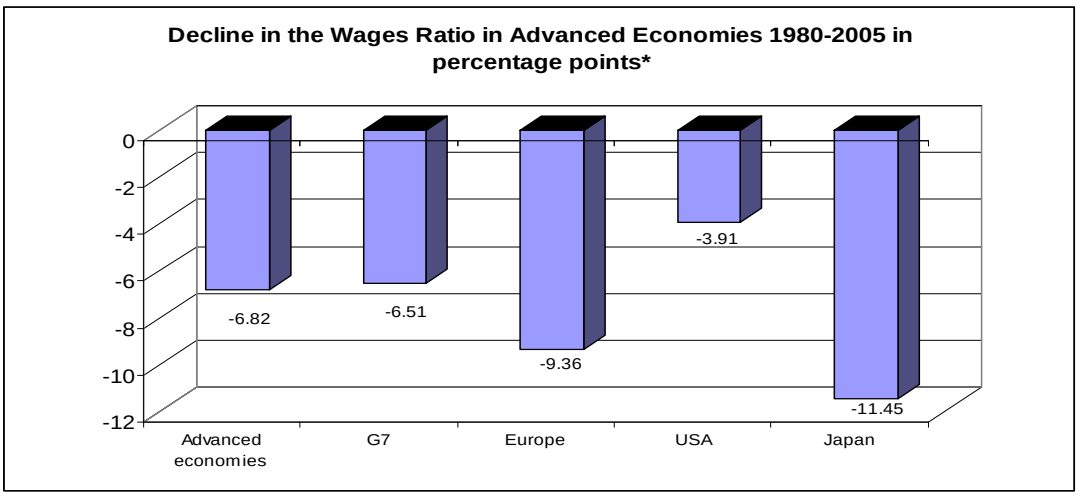


Figure 7.2: The redistribution of income in advanced economies 1980-2005.

Source IMF, *World Economic Outlook* April 2007, data for Figure 5.7.

Figure 7.2 indicates the dismal reality of the colossal redistribution of gross national income (market incomes before taxes and transfers), illustrated by the decline in the share of wages and salaries in the national income of advanced countries in the period of neo-liberal deregulation. Europe's record (a fall of 9.36 percentage points in 25 years) is significantly higher than the average for advanced economies. The fall in the wages ratio corresponds to a similar rise in the profits ratio. There is little doubt that the dominance of the deflationary imperative under the Bundesbank's hegemony of the EMS (Le Gloannec 2001: 123), and subsequently under the fiscal constraints of the Stability and Growth Pact, contributed to this process. Bibow describes the dominant deflationary imperative as 'lived German stability culture with one own goal after another' (Bibow 2011: 279). The redistribution, over which the ECB presided with apparent equanimity, had a critical effect on domestic demand structures in Europe, where typically private household demand makes up almost two thirds of aggregate demand. For those Eurozone economies, like Germany, Austria, the Netherlands and Belgium which are heavily dependent on net exports and which benefit from low stable real exchange rates and low unit labour costs, the German model has brought marginal gains. But, with high levels of intra-regional trade in the EU27 and the Eurozone in particular, the weakening of domestic demand through stagnating real wages ultimately becomes a negative sum game for all. Net disparities, after

taxation, social insurance contributions and state transfers are factored in, show a similar trend (OECD 2011; Schäfer 2009).

Given that there had been persistent warnings about the reduced latitude in macro-economic policy for states that no longer had recourse to exchange rate devaluations to increase their trade competitiveness, the fixation on budgetary consolidation as a central fiscal condition of EMU membership indicates a dogmatic insistence on the sufficiency of market forces to rectify any residual national asymmetries in the political economy. This is confirmed in the ECB's first monthly report in January 1999 which asserts that:

> Maintaining price stability in itself [*sic*] contributes to the achievement of output or employment goals. The logic underlying both the Treaty and the Eurosystem's stability oriented monetary policy strategy is therefore that output and employment goals are best served by a monetary policy that focuses on price stability.
>
> (ECB 1999: 40)

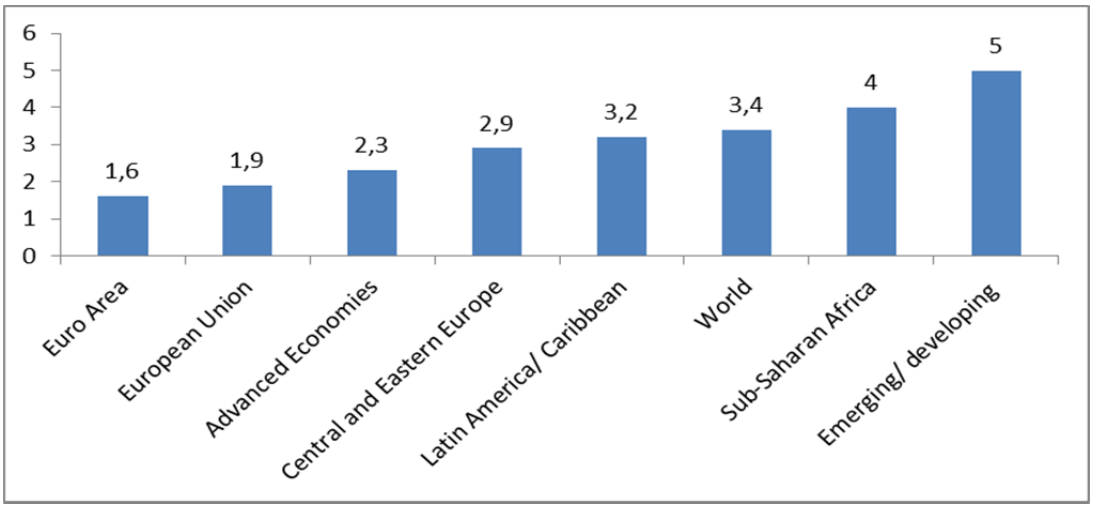


Figure 7.3: Average annual growth of real GDP in selected world regions 1990-2010.

Source IMF *World Economic Report* 2011, Database.

This faith in both the effective transmission mechanism of supranational monetary policy and the consequent benign effects on employment and growth was borne out neither in the preparatory phase for EMU (1992-98) nor in the subsequent growth cycles; in both periods the Eurozone remained the weakest region for real GDP

growth (Figure 7.3) and a weak performer in reducing unemployment.

The causes lie arguably in both the flaws of monetary theory and the neo-liberal theory of efficient markets and in a seeming unwillingness/institutional inability to diagnose the critical changes that were affecting the global political economy, most notably in the financial sector.

The privatisation of money

One of the core articles of faith of monetarist theory is that a central bank, through the judicious deployment of its key instruments – short-term refinancing rates, open-market operations – can control the demand for credit, limit the growth of the money stock in its jurisdictional sphere of influence and thereby maintain price stability (actually mild inflation). Accordingly, the ECB established two central 'reference values' by which its performance could and should be measured: price inflation of approximately (but not exceeding) two per cent per annum and money stock (M3) growth of 4.5 per cent per annum. As Table 7.2 indicates, the Harmonised Index for Consumer Prices in the Eurozone showed inflation rates consistently above the reference value but not by much, suggesting the successful fulfilment of the ECB's core task.

Table 7.2: Consumer price inflation (HICP), unit wage costs (UWC) and oil prices (Oil) 1991-2010 in the Eurozone economies; annual increase in per cent.

	HICP	UWC	Oil
1991-1995	3,2	2,5	-6,4
1996-2000	1,6	0,8	19,0
2000	2,1	1,3	81,3
2001	2,3	2,7	-10,1
2002	2,3	2,2	-4,7
2003	2,1	1,8	-5,2
2004	2,1	0,9	21,3
2005	2,2	1,2	46,1
2006	2,2	1,0	18,5
2007	2,1	1,7	-0,2
2008	3,3	3,6	24,8
2009	0,3	3,9	32,3
2010	1,6	-0,6	36,0

The accompanying data, however, indicate that there is little evidence for wage-push inflation – a primary target of monetarist

orthodoxy – and overwhelming evidence for imported inflation via oil prices, in part driven by increased demand for oil from emerging economies but also, as demonstrated by a recent United Nations Conference on Trade and Development (UNCTAD) report, by speculation and the 'financialisation of commodity markets' (UNCTAD 2011: 19). Unit wage costs grew by an annual average of 1.5 per cent between 1996 and 2007; (the surprising jump in UWCs during the global crisis – see Table 7.2 – derives in large part from a combination of lower capacity utilisation and labour-hoarding). The average annual rise in oil prices was 21.6 per cent. Consumer price inflation was also affected by increases in 'administrative prices', namely rises in rates of VAT and excise duties, in part to compensate for reductions in direct rates of taxation. There was also little evidence of the business cycle overheating, as reflected by the modest development of GDP and its component domestic demand factors (Figure 7.4). With GDP growth averaging 1.8 per cent between 2000 and 2008, private consumption in the Eurozone grew by an annual average of 1.4 per cent, state consumption by 1.9 per cent and gross investment by 1.8 per cent. Real net disposable income grew even less strongly in core EU countries like Belgium, Germany, Italy and the Netherlands.[4]

The modest growth of GDP was driven predominantly by exports (annual rate of growth of 5.7 per cent in the Eurozone between 1991 and 2007). ECB data for sectoral contributions to value-added within the Eurozone also demonstrate the relative sluggishness of the primary and secondary sectors compared to financial services,[5] but conceal the contribution that financial assets made to manufacturing profits in this period.[6]

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[4] OECD figures available at: <http://www.oecd-ilibrary.org/economics/real-household-net-disposable-income_hsinc-table-2011-3-en>.

[5] Financial services enjoyed average annual growth rates of value added of 3.9% between 1996 and 2000, 2.1% between 2001 and 2005, and 1.8% between 2006 and 2010; the figures for manufacturing are 2.8%, 1.2% and -0.7%; ECB Statistics Pocket Book (August 2011).

[6] Bundesbank data show marked increases in the ratio of financial assets to real assets in recent decades; cf. Leaman (2009).

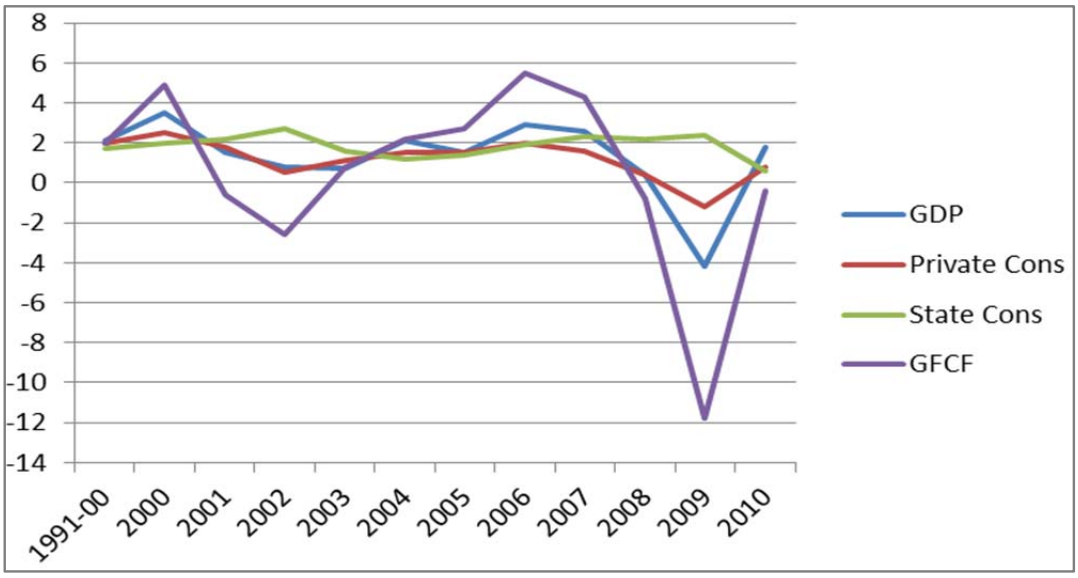


Figure 7.4: Annual growth of GDP and its domestic components in the Eurozone economies 1991-2010 in per cent.

Source European Central Bank (monthly statistics pocketbook, various).

What is more revealing is the development of the money supply within the Eurozone; Figure 7.5 reveals a consistent and significant overshoot in the expansion of M3 between 1999 and 2008 beyond the 'reference value' target of 4.5 per cent; by 2003, this overshoot was arguably embarrassing enough for the ECB to announce that it would 'no longer review the reference value for M3 on an annual basis because experience has shown that the underlying medium-term trend assumptions cannot be expected to change frequently' (ECB 2004: 64).

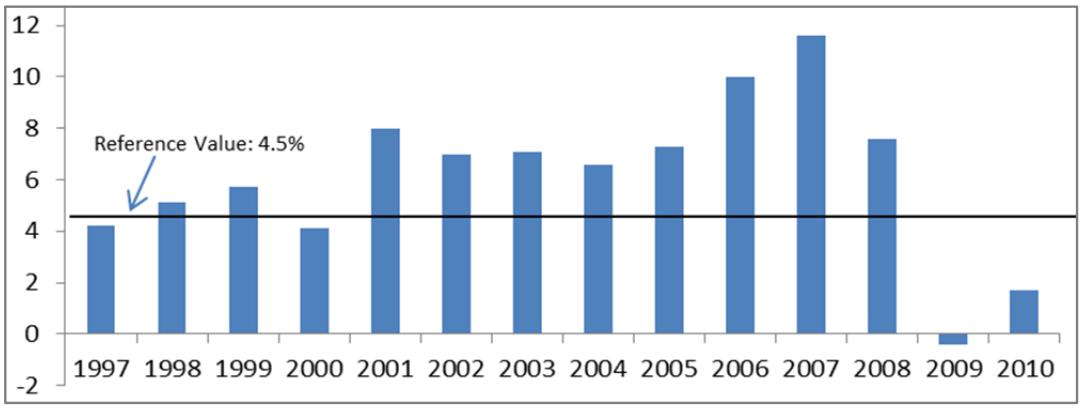


Figure 7.5: Growth of Money Stock M3 in the Eurozone.

Source European Central Bank.

This development and the extraordinary accompanying statement reflect, first and foremost, the relative powerlessness of the ECB – along with any central bank in the era of financialisation – to control directly the volume of base money: where banks and other financial institutions indulge in hyper-leveraging, through the multi-layered securitisation of loans and future income streams (where bond issues are given top credit ratings), 'the central bank, if requested, cannot refuse to back these loans, if the system is to maintain its viability' (Mellor 2010: 44). As Lapavitsas and Saad-Filho note: 'consequently, the central bank cannot control the quantity of base money [...] loans make deposits, deposits make reserves, and credit money determines base money' (2000: 311-12).

The limited demand for central bank refinancing of retail and investment bank loans before, but particularly after 2008 is fairly evident; it demonstrates in recent history at the very least that rates of return on certain classes of investment were high enough to make the refinancing costs less relevant in an environment where, overall, growth was anaemic and unevenly spread between sectors. The era of 'monetary accumulation' (Altvater 1991) was ensuring *pro tem* strong demand for financial 'products, which effectively diverted corporate reserves and 'normal' borrowing away from productive investments, with their higher rates of return. Additionally, however, the expansion of the interbank-market together with the facility of securitisation allowed banks to operate in part separately from systems under the notional control of central banks, reinforcing their ability to create money *ex nihilo*:

> Banks began to tap into the flow of money available by selling the debts they were issuing as an asset for investment, that is, as a security. Like the traders who once swapped the debts they held for ready bank money, banks started to swap the debts they held for ready money market finance. Investors would buy bank debt at a discount and receive a profit as the loans matured. This was a tremendous benefit for the banks' balance sheet because whereas in the past banks kept the loans they made on their books, now they were sold on and were therefore 'off balance sheet' and did not count against any lending ratios or against profits. More importantly, instead of loans that were slowly being paid off, the banks had more ready cash to expand

> their business. The more debts the banks sold on the more profit they made against capital.
>
> (Mellor 2010: 47)

The securitisation of credit card debt and later of mortgage debt was dominated by US investment banks, but their 'asset-backed' securities were bought by European and other finance houses on an increasingly large scale. Mortgage-backed securities multiplied from 55 billion to 2,117 billion US dollars between 1990 and 2006 (Mellor 2010: 48). A high proportion of these securities were channelled through 'structured investment vehicles', subsidiary entities of the major finance houses but increasingly held 'offshore' to avoid both tax liabilities and regulatory monitoring. This colossal 'shadow banking' system, which operated beyond the reach of even the weak influence of central banks, was regarded with benign indifference by the ECB, the Federal Reserve and the Bank of England; it has nevertheless been estimated to have totalled between USD 10 and 12 trillion by 2007, according to John McFall (2009), the chair of the UK Treasury Select Committee. It has also been estimated that, at the height of the derivatives boom, the total value of traded derivatives contracts stood at USD 2.29 quadrillion dollars (USD 2,290,000,000,000,000) (cf. Leaman 2011).

The relative immunity of transnational financial institutions and their non-bank counterparts to the ECB's main instruments of monetary control (interest rates and open market operations [OMOs]) is demonstrated by the extensive use of both interbank markets and the shadow banking system, but also by the limited number of financial institutions that actually required the ECB's open market operations; Frangakis (2011: 8) notes that in 2003 an average of only 252 out of a total of 6,776 financial institutions in the euro area were participating in short-term refinancing operations and just 136 in longer-term operations. The privatisation of money creation, beyond the control of central banks, was neither fully understood by central bankers nor properly identified as a systemic risk. The 'liquidity factories' (Phillips 2008: 185) were of benefit above all to territorially mobile corporations with their offshore Structured Investment vehicles (SIVs), whereas the credit conditions applying to nationally based SMEs were considerably less favourable (Carbo-Valverde et al. 2005). This of itself would strengthen the trend towards economic concentration.

As far as the ECB's conduct of monetary policy is concerned, Bibow identifies a record of 'asymmetrical interventions', in particular with its interest rate moves; up until 2008 these were characterised by poor timing, where the Bank was frequently too eager to raise rates but later reluctant to lower them despite signs of cyclical weakening (Bibow 2011: 280). This is analogous to the record of the Bundesbank, though arguably much less extreme both in terms of the intensity and length of deflationary rate rises (cf. Leaman 2001: 232ff). There is, to some extent admittedly, an element of the ECB seeking to underscore its credibility as an autonomous institution (Frangakis 2011: 7) and defying the preferences of democratic authorities, but again its actions and pronouncements have been less obviously political than its predecessor. In general, the ECB can be credited with a greater degree of pragmatism in its conduct of Europe's unique experiment in monetary union, albeit within an identifiably neo-liberal and monetarist set of preferences (Frangakis 2011; Arestis and Sawyer 2011).

While central bankers in Europe seemed to acknowledge that the boom in financial services entailed an increase in investment risk, there was – particularly in public statements – a general confidence that these risks could be cushioned by the new insurance vehicles deployed by the hedge fund sector. This confidence was best summarized by the IMF in its annual report for 2006, i.e. two years before the greater follies of the sector's risk management were revealed:

> [T]he dispersion of credit risk by banks to a broader and more diverse set of investors, rather than warehousing such risk on their balance sheets, has helped to make the banking and overall financial system more resilient.
>
> (IMF 2006: 51)

This confidence was reinforced by the fact that the global financial system had absorbed the major shocks like the collapse of the hyper-leveraged hedge fund, Long Term Capital Management in 1998, the end of the 'dotcom-bubble' in 2000 and the bankruptcy of Enron in 2001. The apparent ability of the financial services sector to deliver low-inflation growth and high returns strengthened central bank views that the boom could be sustained without the danger of major 'deflations' of asset bubbles. This confidence persisted until 2007. It is clear in retrospect that leading central bankers (Greenspan, Bernanke, Duisenberg, Trichet, King) were more impressed by the achievement

of relative price stability, and remained ignorant of the perilous levels of hyper-leveraging, the scale of shadow-banking and the abuse of secrecy jurisdictions underpinning the corporate world. Some worries were expressed by analysts within the Bank for International Settlements (cf. Tett 2009: 179ff.) at an earlier stage, but public expressions of concern remained limited; Trichet only raised doubts about 'elements in global financial markets which are not necessarily stable' at the World Economic Forum in Davos in January 2007. His statement is disarmingly honest:

> There is now such creativity of new and very sophisticated financial instruments, that we don't know fully where the risks are located. We are trying to understand what is going on but it is a big, big challenge.
>
> (Trichet, quoted in Tett 2009: 181)

A contributory factor to the previous indifference towards/ ignorance of systemic risks in the financial services sector on the part of the ECB was arguably the narrowness of its remit and the absence of any significant macro-prudential role, monitoring the diversification of financial institutions and the anatomy of the 'products' they sold to investors (Frangakis 2011: 16ff). However, this does not constitute an excuse.

In this context, a critical contradiction of the ECB's counter-inflationary stance is the deflationary zeal directed at consumer price inflation – the rise in the price of goods and services in the investment/production/consumption cycle – on the one hand, and the toleration or indeed applauding of the exaggerated appreciation in the value of specific asset classes, notably housing and share prices. The transformation of property finance and equity trading into dynamic vehicles for monetary accumulation had strong elements of the Emperor's New Clothes in the mind-set of economic and political elites in advanced economies. House-price inflation became the pre-condition for the expansion of the pernicious 'originate-to-distribute' system of covered bonds and their derivatives. Leveraged buy-outs and increasingly short-term shareholdings were the pre-condition for the artificial ramping-up of 'shareholder-value' at the same time as aggregate real investment ratios were declining. Hyper-leveraging above all created a dynamic which could only be sustained by serial increases in levels of

borrowing and money-creation and, by definition, by increasing levels of exposure to extreme adjustments. The proximity of this process to Ponzi schemes was considerably closer than most people were prepared to admit.

Monetary crisis management

European monetarism has been played out both through the haphazard and uncertain pragmatism of the ECB and through its negative fiscal extension in the Stability and Growth Pact. In addition to the arbitrary thresholds for PSBR and state debt set in the Maastricht Treaty and the SGP (see above) the *excessive deficit guidelines* were similarly arbitrary and increasingly honoured more in the breach than in the observance. The fiscal latitude, allowed to each member state, was always extremely narrow and it compounded the limitation of macroeconomic policy choices available to governments that no longer had the devaluation option to compensate for trade and payments deficits. The disparities in the productivity levels of euro area states (GDP per capita), which were significant before EMU, have not been narrowed (Wilder 2011), with similar and critical problems of divergence applying to the newer member states (Halmai and Vásáry 2011). The ECB itself acknowledged the weakening of productivity growth across the whole of the euro area, particularly in comparison to the USA; its 2006 study draws attention to the associated deficiencies in realising the competitiveness objectives of the Lisbon Agenda and proposes that "further efforts are needed to increase the share of R&D spending in a number of euro area countries" (ECB 2006: 24). While it is possible to blame those individual peripheral states with lower productivity for neglecting the appropriate investments in productivity-enhancing new technologies and in human capital, it is also quite legitimate to point the finger at the incessant pressure from ECOFIN and the ECB to consolidate budgets as a real and ideological obstacle to the process of convergence within the common currency zone. It would also have been appropriate for the Commission, together with ECOFIN to have included *positive* fiscal objectives within the SGP – minimum tax ratios, the strengthening of progressivity and transparency in taxation, expenditure ratio targets for education, training and innovation, etc. – rather than imposing the negative fiscal constraints of a growth-reducing austerity and relying on markets to allocate investment resources efficiently and evenly across all member states.

The chickens of the 'stupidity pact' (*The Economist* 22 October 2002 quotes Romano Prodi's description of the SGP as 'stupid') and of the deflationary imperative in general began to come home to roost in 2009, as EU27 economies were affected by different levels of severe contraction. The contradictions in European monetary policy became even more crass, however. The ECB reduced its repurchasing rate significantly (from 4.25 per cent in July 2008 to one per cent in May 2009) in the early stages of the crisis, eased its refinancing conditions; it extended the list of assets accepted as collateral, providing unlimited liquidity to the market, and bought up some 60 billion euros worth of high risk covered bonds. However, at an early stage in 2009 it was already talking about the withdrawal of special measures and the need to return to strict budgetary consolidation as soon as possible. This betokened at the very least a dramatic underestimation of the severity and probable duration of the new crisis of finance capitalism.

The Commission's contribution to crisis management was even more confusing: on the one hand, it put itself at the head of the efforts of core-EU15 states to neutralise the financial meltdown and to counteract their unprecedented recessionary contractions in 2008 and 2009. On the other hand, in the same period it was enjoining several new member states – most notably the three Baltic states – to address their budget deficits, even though their overall debt levels were considerably lower than the EU15 average, and even though they were all suffering double-digit recessions (see European Commission, 2009: 62, 85, 81, etc.; see also Leaman 2009: 12). Despite the extraordinary circumstances of global financial crisis, a severe regional recession and the first contraction of global trade for decades, the Commission also continued to implement 'excessive deficit procedures' (EDPs) in 2009 and 2010 (Table 7.3). 26 out 27 EU member states were in the throes of deep recessions, exceeding the EDP 'exceptionality threshold' of a two per cent contraction of real GDP, all the major finance ministries were seeking to prevent financial mayhem, sterilising toxic assets and taking major equity stakes in bankrupt banks, and the Economic and Financial Affairs Directorate was indulging in the tragi-comedy of issuing parking tickets in a war-zone.

Table 7.3: EU excessive deficit procedures 2008-2009.

Country	Date of the Commission report (Art.104.3/126.3)	Council Decision on existence of excessive deficit (Art.104.6/126.6)	Current deadline for correction
Bulgaria	12 May 2010	13 July 2010	2011
Denmark	12 May 2010	13 July 2010	2013
Cyprus	12 May 2010	13 July 2010	2012
Austria	7 October 2009	2 December 2009	2013
Belgium	7 October 2009	2 December 2009	2012
Czech Republic	7 October 2009	2 December 2009	2013
Germany	7 October 2009	2 December 2009	2013
Italy	7 October 2009	2 December 2009	2012
The Netherlands	7 October 2009	2 December 2009	2013
Portugal	7 October 2009	2 December 2009	2013
Slovenia	7 October 2009	2 December 2009	2013
Slovakia	7 October 2009	2 December 2009	2013
Poland	13 May 2009	7 July 2009	2012
Romania	13 May 2009	7 July 2009	2012
Lithuania	13 May 2009	7 July 2009	2012
Malta	13 May 2009	7 July 2009	2011
France	18 February 2009	27 April 2009	2013
Latvia	18 February 2009	7 July 2009	2012
Ireland	18 February 2009	27 April 2009	2015
Greece	18 February 2009	27 April 2009	2014
Spain	18 February 2009	27 April 2009	2013
UK	11 June 2008	8 July 2008	financial year 2014/15
Hungary	12 May 2004	5 July 2004	2011

Source European Commission. Available at: <http://ec.europa.eu/economy_finance/economic_governance/sgp/deficit/index_en.htm>.

The ECB, true to its word, sought to phase out its temporary emergency measures in December 2009, even though financial markets were still extremely reluctant to revivify interbank trading and expand overdrafts and long-term credit to non-banks. In her recent paper on the ECB's crisis management, Marica Frangakis provides graphic evidence for the commercial banks' deployment of the extra liquidity intended (by the ECB) for relubricating commercial credit lines (Figure 7.6).

The removal of emergency measures was reversed by the ECB in the spring of 2010, as the spill-over effects of state bank-salvage

operations and automatic stabilisers on state expenditure and borrowing generated the euro area's persistent and worsening sovereign debt crisis. A new 'Securities Market Programme' allowed interventions by the central banks of the Euro-system to be conducted in both public and private securities markets. With purchases of sovereign bonds only permitted via secondary markets, an unequivocal bias is evident, as Frangakis correctly observes:

> Thus in the face of the public debt crisis [...] the ECB aided the euro area banking system through the direct and indirect provision of funds – refinancing and buying bonds on the primary and secondary markets – whereas it aided the euro area governments through the indirect provision of funds only – buying bonds on the secondary bond markets. In monetarist terms, this is supply-side economics and in political terms, it is favouring the private sector over the public one.
>
> (Frangakis 2011: 14)



Figure 7.6: Deposits by monetary financial institutions with the Eurosystem (outstanding amounts in million euros), Sept. 1997 - Feb. 2011.

Source Frangakis 2011, p. 13.

Figure 7.6 demonstrates the fruitlessness of the ECB's efforts with the sudden upsurge in bank deposits back into the Eurosystem, rising by

over 800 billion euros between the end of 2008 and early 2010. The more recent (October 2011) focus on the solvency of a wide set of European banks (Donahue 2011) indicates, at the very least, that the recapitalisation of banks through the blanket provision of central bank liquidity ('quantitative easing' in UK parlance) has failed both to generate new expansionary circuits of private credit and to prevent the serial down-grading of the credit ratings of both banks and European states.

The sovereign debt crisis has, above all, revealed the deficiencies of an asymmetrical EMU which has been subjected to a shock generated by a related asymmetrical global order, for which its overall guiding theory – monetarism and neo-liberal supply-sidism – is co-responsible. The neglect of demand factors in the construction of a union between countries of divergent levels of development, the neglect of fiscal harmonisation as a precondition for economic convergence and the minimisation of crisis-driven fiscal equalisation, the delusionary faith in the efficient allocation of resources among divergent economies via liberalised markets – these core deficiencies are as manifest in the shambolic management of the sovereign debt crisis as the failure of national and international regulatory regimes to diagnose the 'fool's gold' empire of global finance before September 2008.

Above all the sovereign debt crisis reveals the restored thraldom of fiscal states to the socially and ethically rootless army of financialised capitalism which they had just saved from self-destruction. In the absence of a correct appreciation of the scale of this crisis, the unresolved disparities of the asymmetrical union have rendered that union vulnerable to the same processes of rent-seeking speculation and ratings charlatanism (cf. Kettle 2010; Fricke 2011) that the neo-liberal disaster let loose on struggling democratic cultures.

The naivety of a one-size-fits-all monetarism has created an unsustainable European political economy, intractably rooted in an increasingly dysfunctional German model of export-led growth which cannot hope to resolve the dilemma of chronic current account surpluses and chronic current account deficits.

The widening of bond spreads, afflicting the Eurozone since the spring of 2010, was entirely predictable:

- The new risk-aversion of financial institutions was dramatically demonstrated by the sudden paralysis of the inter-bank market;
- Lower-than-average tax ratios in Greece, Ireland and Portugal, combined with rising external deficits, made these states both dependent on imported capital and less capable of generating future revenue streams to repay short-term loans (Table 7.1);
- The Irish state was overwhelmed by the scale of its commitments to salvaging its banking system, which involved sums of over 200 per cent of GDP and drove a modest state debt ratio (28.8 per cent of GDP in 2007) to over 100 per cent in three years.

Accordingly, the need for fiscal transfers from other euro area states was also predictable, given the level of exposure of German, French, Italian and other banks to the endangered bond issues of peripheral states. The absence of a refined system of fiscal equalisation within EMU, and in particular the absence of a common euro area bond, rendered the negotiations towards a stabilisation facility vulnerable to political/electoral pressures within individual member states, most notably within Germany with its brittle and unreflective new coalition. EMU heads of state were in consequence consistently behind the loop, reacting to rather than controlling events. The consequent cost of 'stabilisation' to all participant states is considerably higher than it needed to have been. More importantly, the conditionalities attached to the fiscal transfers are fatally informed by the simple logic of (German) austerity preferences and fail to address fundamental problems of divergence:

- Levels of productivity and unit wage costs – root causes of international competitiveness and hence current account deficits – can only be addressed by an intensified commitment of state resources to research, development and skill capacities within a country's economic culture;
- Low tax ratios, reinforced by beggar-thy-neighbour tax-rates (Ireland) or weak administration and compliance (Greece) are incompatible with an open and mutually supportive currency union; the 'free rider' option of poaching the tax bases of other member states, as pursued by Ireland, is corrosive of such support;

- Austerity, as demanded by Germany's export-led model, has demonstrably failed to encourage growth within the euro area, but has rather compounded the asymmetries of demand and the mal-distribution of income and wealth;
- In an integrated region of production and trade, the common pursuit of an export-led recovery is self-defeating; we cannot all trade our way out of recession and state debt.

The conclusions to be drawn from this brief survey of monetarist policies within Europe are sobering and challenging, but the real achievements of European integration can only be maintained by a decisive step-change in its institutional arrangements. There are clear doubts about the whether the leading figures of the EU and its member states have the ability or desire, collectively, to make that step change and to prevent the fragmentation that threatens the project. The conclusions would nevertheless seem to be:

1. The policy architecture of the euro area requires the formalisation of a fiscal union which allows both common sovereign bond-issuance and the flexible interpretation of deficit and debt levels to facilitate real convergence of productivity and unit labour costs; i.e. short-term sovereign debt expansion for weaker states must be acknowledged as a necessary pre-condition of economic modernisation, not as a structural obstacle to market-led growth *qua* 'crowding out'. Such flexibility must be conditional on the abandonment of free-rider fiscal strategies and the implementation of a common campaign to end tax evasion and tax avoidance.
2. There has to be a recalibration of demand within member states, which reverses the erosion of domestic demand through neo-liberal redistribution strategies in core states with chronic surpluses; this would have to involve wage-setting which matched wages to productivity gains and the restoration of effective tax progressivity throughout the EU27 (i.e. the abandonment of flat tax regimes) as a pre-condition for the improved provision of public goods.
3. The structural disparities between states with chronic external surpluses and states with chronic external deficits require a refined system of fiscal equalisation both within the euro area

but also within the EU27 as a whole; this would involve the enhancement of the admirable system of structural funds (Cohesion Funds) through measures targeted at the modernisation of weaker sectors in weaker regions. It would also mean bridging assistance to peripheral states to prevent any further erosion of welfare arrangements.

4. The interdependence of the secular economy of a highly integrated group of countries requires the harmonisation of key fiscal arrangements (a common corporate tax base, minimum rates of direct taxation and country-by-country reporting), the co-ordination of macro-economic policy institutions and a reduction in the 'democratic deficits' of current institutional systems. This has to mean an end to central bank autonomy, an increased role for the European Parliament and the acceptance of qualified majority voting in reform programmes relevant to macro-economic crisis-management.

The chances of these ideas being realised, not to mention of Europe adjusting to the inevitability of weaker growth patterns, cannot be high, judging by the current atmosphere of nationalist populism emerging within individual states. If Europe's deep crisis bore the physical signs of a destructive war, the chances of a collective enterprise aimed at restoring a sustainable economic and social order to the continent – as in the 1950s – would arguably be greater. The real nature of the crisis, however, looks like having economic consequences as critical as those of a continental war, without its severity being recognized soon enough by policy-makers. Weaning ourselves off an addictive dependence on hyper-leveraged finance capitalism will take decades of adjustment, to add to the challenges of demographic change and environmental sustainability.

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