



MPIfG Discussion Paper 16/15

**Forced Structural Convergence in the Eurozone –
Or a Differentiated European Monetary Community**

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Max-Planck-Institut für Gesellschaftsforschung, Köln

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Abstract

Eight years after the onset of the “Great Recession,” the eurozone is deeply split between “Northern” EMU economies that seem to be doing reasonably well and “Southern” countries that continue to struggle with socioeconomic catastrophe. This paper argues that the continuing malaise is a consequence of the structural diversity among Northern and Southern economies and of an asymmetrical euro regime that must try to enforce the structural convergence of their political economies. The present regime is vulnerable, however. It may fail economically should its rules have to be relaxed, and it may fail politically should it no longer be possible to suppress North–South conflicts. In light of these risks, the paper concludes by presenting the outline of a differentiated European Currency Community that would accommodate structurally diverse but highly interdependent economies in a flexible two-level regime.

Keywords: Europe, monetary union, structural convergence, democracy

Zusammenfassung

Acht Jahre nach dem Beginn der „Großen Rezession“ ist die Eurozone tief gespalten zwischen Ländern, welche die Krise erfolgreich überwunden haben, und anderen, die nach wie vor mit deren katastrophalen Folgen zu kämpfen haben. Der Grund sind fundamentale Strukturunterschiede zwischen „nördlichen“ und „südlichen“ Mitgliedsökonomien und ein einheitliches Euro-Regime, das strukturelle Konvergenz erzwingen muss, um die Stabilität der Währungsunion zu sichern. Dieses Regime kann jedoch ökonomisch scheitern, wenn seine strikten Regeln gelockert werden müssten, und es kann politisch scheitern, wenn es nicht länger gelingen sollte, den potenziell explosiven Nord-Süd-Konflikt zu unterdrücken. Angesichts dieser Risiken skizziert das Papier am Ende das Konzept einer flexiblen Europäischen Währungsgemeinschaft für strukturell unterschiedliche, aber wirtschaftlich eng verflochtene europäische Wirtschaften.

Schlagwörter: Europa, Währungsunion, strukturelle Konvergenz, Demokratie

Contents

1	Introduction	1
2	The Monetary Union: Failure of an asymmetric regime	2
	The EMU destroys existing governing capacities	2
	The euro regime: Convergence through austerity and supply-side reforms	4
	Structural differences of Northern and Southern political economies	7
	The asymmetric impact of the present euro regime	16
3	The political economy of forced convergence	20
	Forced convergence may work	20
	Is the prize worth winning?	21
4	A disaster of political legitimacy	24
	Legitimacy on the national level	24
	Legitimacy on the European level	25
	The specter of politicization	27
5	Searching for more symmetric modifications of the present regime	29
	Back to no bail-out rules?	29
	Forward to the transfer union?	30
	Reducing Northern surpluses	32
6	Differentiated monetary integration in a European Currency Community	40
	Rules for state insolvency and “amicable divorce”	41
	Learning from the faults of the EMS	41
	Toward a two-level European Currency Community	43
	Assistance in transition	45
7	Conclusion	46
	References	47

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1 Introduction

Twenty-eight years ago, in 1988, the famous Cecchini Report on the “Costs of Non-Europe” (Cecchini et al. 1988) tried to assess the benefits that Europe would lose if it failed to complete the single-market program by 1992. The Delors Commission presenting the report was enthusiastic about the “permanent boost to the prosperity of the people of Europe” that the Single Market would bring about (Cecchini Report 1988). Only two years later, in its own report “One Market – One Money,” the Commission (1990) was equally certain of the additional economic benefits that the single currency would generate. In the meantime, we know that the EU members of 1992 have been trailing the OECD in cumulative economic growth and that since 1999 growth in the eurozone has been weaker than in the rest of the EU.¹ From an economic perspective, therefore, two of the great triumphs of European integration do not appear to have been particularly successful in comparative terms.² But that is not my present concern.

Whereas Cecchini had looked at the potential economic costs of non-integration, I will be looking at the real politico-economic and democratic costs imposed by the monetary over-integration of structurally heterogeneous “Northern” and “Southern” political economies. Unlike the European Monetary System (EMS) of 1979, its more flexible predecessor regime, the European Monetary Union (EMU) explicitly removed or rigidly constrained national problem-solving capacities without, however, creating European capacities that could address the diversity of national economic conditions. The result was, first, a dramatic failure of economic governance resulting in the euro crisis and, then, the creation of a new euro regime which, through centralized controls over national policy choices, is meant to save the common currency by enforcing structural convergence on the “Northern model.” In this paper, I will first reconstruct the economic logic supporting the present asymmetric regime, highlight its extremely unequal impact, and explain the reasons for its incompatibility with democratic legitimacy on national and European levels. I will then survey proposals that might moderate or modify the present EMU, and I will finally discuss the option of moving toward a system of differentiated monetary integration that could accommodate structurally diverse and highly interdependent European political economies.

1 Cumulative economic growth 1992–2015: EU 40 percent vs. OECD 49 percent; 1999–2015: Euro area (EA 11) 22 percent vs. EU 26 percent (World Bank data).

2 Undeterred by past performance, in 2014 the “Cecchini Revisited” report commissioned by the European Parliament promised additional economic growth of 5 to 8.63 percent if the remaining obstacles to market integration in the EU were to be removed (Pataki 2014).

2 The Monetary Union: Failure of an asymmetric regime

Capitalist economies are inherently unstable. But after the catastrophe of the Great Depression and the Second World War, capitalist states developed tools for macroeconomic stabilization. Even though their effectiveness had been challenged in the 1970s by the oil-price and stagflation crises following the demise of the Bretton-Woods regime of stabilized exchange rates (Scharpf 1991), the instruments of monetary, fiscal, and exchange-rate policy were still employed by European states before they joined the EMU in 1999. In order to manage the ups and downs of their economies, governments could employ restrictive monetary policy and fiscal restraint to dampen inflationary booms; they could support economic recovery through fiscal reflation and an accommodating monetary policy; and they could also combine monetary and fiscal adjustment with changes of the exchange rate in order to correct external imbalances. None of these interventions worked perfectly, of course, but they did allow democratically accountable governments to significantly influence the economic fate of their countries.

Moreover, from 1979 to 1999, the EMS was designed to deal with external imbalances and exchange-rate fluctuations between hard- and soft-currency economies. It was meant to protect member state currencies against speculative attacks in international capital markets but also allowed agreed-upon currency realignments to correct persistent external imbalances. By and large, and until it was upset by the mismanagement of German unification (Higgins 1993; Marsh 2009), the EMS worked reasonably well (Höpner/Spielau 2015). However, exchange rate realignments were politically controversial, and some governments resented the dominance of the Bundesbank in monetary coordination – which, together with political concerns raised by German unification, provided a window of opportunity for the “integrationist” Delors Commission and its neoliberal or monetarist economic supporters to mobilize political support for its “One Market – One Money” program (McNamara 1998; Dyson/Featherstone 1999).

The EMU destroys existing governing capacities

The Monetary Union removed not only the option of currency realignment but also the capacity to influence the course of the national economy through national monetary policy. Moreover, the capacity for national fiscal expansion was practically eliminated by the Stability Pact. At the same time, however, member states were also freed from the discipline of international currency markets and the threat of balance-of-payments crises. Exchange-rate and monetary policy became exclusive competences of the European Central Bank (ECB), whose institutionally protected independence was thought to be justified by its unequivocal mandate to preserve price stability in the eurozone (Dyson 2000). This loss of national problem-solving capacity was not compensated with functionally equivalent European governing powers.

The EMU had no budget of its own and thus no capacity for countercyclical fiscal intervention. Whereas the ECB's centralized monetary policy was able to stabilize average inflation rates in the eurozone, its "one-size-fits-all" policy instruments could not respond to structural divergence and the non-synchronized ups and downs and "asymmetric shocks" of the former hard- and soft-currency member economies. Hence, its uniform interest rates were too low for economies with higher rates of growth and inflation and too high for economies in a recession with low rates of inflation – and real interest rates diverged even more. Instead of stabilizing eurozone economies, it deepened the recession of 2002 in low-inflation Germany and fueled credit-financed booms of consumer spending and real-estate bubbles in Greece, Ireland, and Spain.

The result was a dynamic divergence of external balances in the eurozone, where the rising current account deficits of booming economies were sustained by credit flows financed by the rising export surpluses of stagnant economies like Germany. When inter-bank lending stopped in the International Financial Crisis of 2008/09, credit-dependent economies collapsed, and state deficits escalated as governments came to the rescue of overextended banks. In early 2010, finally, when capital markets challenged the solvency of the Greek state and seemed to threaten others, state credit crises were interpreted as a euro crisis that might ultimately endanger the European Union itself.

All this is now common knowledge (Jones et al. 2016). It is also understood that blaming the crisis on the fiscal irresponsibility of debtor governments was, at best, a half-truth for Greece and totally wrong for Ireland and Spain, where fiscal performance from 1999 to 2008 had been exemplary – and far better than in Germany. Nevertheless, the fiscal blaming frame prevailed in May of 2010, when Germany and other surplus governments (fearing the impact of Greek insolvency on their own banks and economies) decided to ignore the no bail-out rules of the Maastricht Treaty. They reluctantly provided intergovernmental rescue loans for Greece, then for Ireland and Portugal, and later for other states as well. In all these cases, loans were linked to strict "conditionalities" requiring drastic cutbacks in public expenditure – ostensibly to reduce state deficits and debt and thus the danger of future financial challenges and potential euro crises – all of which seems well explained by the constellation of national economic interests, actor perceptions, and the bargaining powers prevailing at the time (Iversen/Soskice 2015; Schimmelfennig 2015).

In addition to their insistence on fiscal retrenchment, the Commission (2010) and the ECOFIN Council also began to focus on the external balances of debtor states and on the role that current account deficits might have played in the crises. As these "imbalances" were reflected in greatly overvalued real effective exchange rates, their proximate cause was assumed to be a loss of international "competitiveness" generated by above-average increases of unit labor costs.³ As a consequence, the "structural reforms" imposed on debtor states included requirements without immediate fiscal effect, the purpose of

3 It has been shown that this supply-side explanation does not generally fit the facts (Wyplosz 2013; Sanchez/Varoudakis 2013; Jones 2016; Storm/Naastepad 2016).

which was to reduce unit labor costs (amounting to an “internal devaluation”) through “supply-side” measures such as the liberalization of services, the deregulation of employment protection rules, the reduction of minimum and replacement wages, and the institutional weakening of unions and collective bargaining (Tsoukalis 2016).

The euro regime: Convergence through austerity and supply-side reforms

The basic logic of the initial euro-rescuing policies, which combined financial support to avert state-credit crises with conditionalities imposing fiscal austerity and supply-side reforms, is maintained and generalized in the permanent euro regime that has been installed in all eurozone states since 2011. It combines the intergovernmental European Stability Mechanism (ESM) as a permanent source of conditional emergency credits with the European Semester, the “Six Pack” and “Two Pack” legislation, the Fiscal Compact, and the elements of a future Banking Union. Apart from the latter, however, there is no outright creation of European capacities and governing resources that could substitute for the national macroeconomic competences that were lost in the EMU.

Instead, the basic assumption of the present euro regime is that the euro crisis should and could have been averted by member states using their remaining national competences – that is, without being able to correct the destabilizing impulses of uniform ECB monetary policy and without the option of currency realignment. Retrospectively, it assumes (and most economists would probably agree) that if Southern governments had rigorously practiced fiscal austerity and supply-side reforms in the years before 2008, they might have avoided credit-financed booms and the rise of external imbalances, which subsequently produced state-credit crises. When applied prospectively, however, the belief that fiscal austerity and internal devaluation would also ensure recovery from the “Great Recession” was based less on consensus economics than on the model of German recovery from its deep recession in the early 2000s. There, export-led recovery had allegedly been achieved (after an initial violation of the 3-percent deficit rule) through welfare-state cutbacks and union wage restraint. In other words, the new euro regime relied not only on controversial supply-side economic theory but also seemed to have some real-world plausibility.

In any case, the crisis seemed to have demonstrated that at least some eurozone governments acting on their own could not be trusted to use their available competences in ways that were compatible with the overall stability of the Monetary Union. If the Maastricht Treaty’s no bail-out clause had been applied, of course, the Greek insolvency might have provided powerful incentives for good behavior in the future (Sandbu 2015). Since the clause was ignored, and with the permanent European Stability Mechanism (ESM) in place, creditor governments and eurozone authorities saw reason to worry about moral-hazard problems.

Since enforceable “conditionalities” and Troika controls could only be imposed when a government had actually applied for rescue loans, the new regime was designed to create a system of “precautionary conditionalities.” Hence, the “Excessive Deficit Procedure” (EDP) and the “Macroeconomic Imbalances Procedure” (MIP) now authorize the Commission to continuously assess the economic and fiscal performance of member states and to issue country-specific recommendations that not only will prescribe national fiscal policies but may also – over the full range of member-state competences – specify national action which, in the Commission’s view, could help avoid the rise of external and internal imbalances in a particular economy. These instructions will not merely rely on persuasion and public “naming and shaming” through the European Semester; they may ultimately be enforced through severe financial sanctions that the Council could avert only through a “reverse qualified majority” vote (Degryse 2012; Bauer/Becker 2014; Seikel 2016).

If this regime had been in place and had been rigorously enforced between 1999 and 2008, it might have prevented economic overheating and the rise of external deficits in Greece, Ireland, and Spain. But after 2010, the requirements of fiscal austerity and wage-reducing reforms were imposed on economies struggling with a deep crisis, a huge output gap, and inordinately high rates of unemployment. Why such a regime should have been politically accepted is puzzling. Since Germany is presently doing well under these rules, it may be expected to defend the regime (Iversen et al. 2016); and since Germany and other creditor states have greater bargaining power in the informal (Varoufakis 2015) processes of the ECOFIN Council’s Eurogroup, power asymmetries are sometimes seen as a sufficient explanation (Marsh 2013; Kundnani 2014; Story 2014; Tsoukalis 2016; Steinberg/Vermeiren 2016). Even authors who put more of the blame on the misguided macroeconomic theory of the present regime and on the ill-designed institutions of the Monetary Union will trace these back to the influence of German *ordo-liberalism* and the long shadow of the Bundesbank (De Grauwe 2012; De Grauwe/Ji 2013; Blyth 2013; Young 2014; Stiglitz 2016; Brunnermeier et al. 2016).

That may be so, more or less. What I find interesting, however, is that the creation of the EMU was not supported by Germany, but by some of the best and the brightest non-German European monetary economists, such as Tommaso Padoa-Schioppa (1994/2003), along with the Delors Commission and the governments of all countries that later joined the single currency. The present regime, moreover, is not only defended and justified by Germany and its Northern allies, but it was also proposed, designed, justified, and elaborated by the Commission. It is fully supported by the ECB and has not yet been rejected even by the governments of the countries suffering most under its strictures. One may surmise, therefore, that arguments supporting it may appeal not only to German economists, lawyers, central bankers, and ministers. And the catchword in those arguments appears to be “convergence.”

For the “Five Presidents” of the European Union, “*the notion of convergence is at the heart of our Economic Union*” – and it has been from the beginning (Five Presidents’ Report 2015). When (mainly American) economists had initially warned that Europe with its diverging economic structures was not an “optimal currency area” (e.g., Eichengreen 1990, 1992; Feldstein 1997), their empirical assessment had not been in dispute. Under the EMS, governments had been painfully aware of the divergence between hard- and soft-currency economies and the political costs of currency realignments (Höpner/Spielau 2015), while the central bankers of soft-currency economies had resented having to accommodate inflationary pressures. The Commission (1990), however, had promised that the Monetary Union itself, through greater capital mobility and more intense market competition, would soon generate the structural convergence that was indeed considered essential for the proper functioning of the common currency.

After that expectation was dramatically refuted in the first decade of the EMU,⁴ the Commission (2010), the Council, and the ECB concluded that since convergence had not come about through market forces, it had to be brought about through state action. And since member states could not be relied on to take the necessary action, the required measures had to be defined and enforced by a European regime. In a most remarkable document (Five Presidents’ Report 2015), the presidents of the European Commission, the European Council, the European Parliament, the European Central Bank, and the Eurogroup have jointly asserted that the EMU cannot reach its goals as long as the *structural* and *cyclical* divergence among eurozone economies persists. At the same time, they have implicitly acknowledged that divergent economic cycles and asymmetric shocks would indeed require some loosening of fiscal austerity at the national level and also “a mechanism of fiscal stabilization for the euro area as a whole.” Nevertheless, such concessions to the need for targeted macroeconomic intervention should only be considered “*in the medium term, as economic structures converge towards the best standards in Europe*” (ibid.: 4).

In the Presidents’ view, therefore, the present euro regime is not designed to promote the rapid recovery of crisis economies, for which the pro-cyclical enforcement of fiscal austerity is implicitly conceded to be counterproductive. Instead, structural convergence must have priority. Hence, the present regime of fiscal austerity and wage-reducing reforms must not only be maintained, it must be reinforced and extended through an additional system of national “Competitiveness Authorities” and through an even “stronger Macroeconomic Imbalances Procedure” with legally binding “high-level standards defined in EU legislation.”

4 The “one-price” argument did more or less hold for export industries. What had been ignored was the fact that external competition would not correct the divergence of wages and prices in the large domestic sectors of Southern economies.

Structural differences of Northern and Southern political economies

In order to assess the implications of enforced structural convergence, one first ought to have a clear understanding of the type of structural differences that may affect the macroeconomic performance of eurozone economies. Before they joined the Monetary Union, the member states of the EMS had been described as either hard- or soft-currency economies whose different inflation dynamics had resulted in periodic revaluations or devaluations of national currencies. These differences are represented by cumulative exchange-rate adjustments vis-à-vis the deutsche mark (DM) in the decade before the EMS was shaken in the turbulences following German unification (Table 1). At that time, the hard-currency group had included Austria, Germany, the Netherlands, and Finland, whereas Greece, Portugal, Spain, and Italy appeared as the core members of a soft-currency “club med,” which to a somewhat lesser extent also included France, Ireland, and Belgium.

Table 1 Change of DM exchange rates 1979–1989, in percent

Austria	3.62
Germany	0.00
The Netherlands	–2.98
Finland	–7.06
Belgium	–23.68
Ireland	–29.12
France	–31.58
Italy	–37.89
Spain	–41.87
Portugal	–68.24
Greece	–69.30

Sources: Bundesbank; Fxtop; own calculations.

After the Maastricht commitment to create the EMU, these differences were reduced under the influence of the accession requirements. These had specified upper limits on public-sector deficits and debt, which governments might perhaps meet through creative budgeting. Beyond that, they required convergence to low inflation rates – whose divergence had been the proximate cause of the need for currency realignments under the EMS regime. In the end, and contrary to many expectations, all soft-currency economies were also able to meet the inflation criteria – through severely restrictive monetary policies and through the heroic efforts of governments and unions to suppress the rise of unit labor costs from the mid-1990s onward (Ferrera/Gualmini 2000; Hassel 2003). However, once accession had been achieved, national central banks lost control. Nor were the exceptional efforts to suppress inflation through social pacts maintained by governments and unions. Hence, the original differences between hard- and soft-currency economies reasserted themselves.

Unlike the EMS, the EMU had no instruments that could deal with these differences. The Stability Pact provided only (weak) controls over public-sector deficits but was not concerned with divergent rates of inflation. While the ECB was able to control average inflation in the eurozone, its uniform policies could not be targeted at individual

Table 2 Rise of consumer price index, 1999–2008, in percent

Germany	16.71
Finland	18.30
France	18.56
Austria	21.08
The Netherlands	21.89
Belgium	23.31
Italy	24.17
Portugal	30.25
Spain	34.21
Greece	34.80
Ireland	42.36

Source: OECD; own calculations.

national economies – where they instead tended to generate destabilizing and divergence-enhancing procyclical effects (Enderlein 2005; Enderlein et al. 2012; Geiger/Spahn 2007; but see Issing 2005). In any case, differences in national inflation rates persisted and even increased during the first decade of the EMU (Table 2).

At the same time, the single currency had freed EMU states from the discipline of having to defend their balance of payments. It had thereby also cut the linkage between national imports and exports which, before 1999, had generally prevented imports from running far ahead of exports, whereas runaway exports would be reined in by rising exchange rates. In the Monetary Union, by contrast, there were no automatic correctives that would prevent a persistent divergence of national imports and exports. Thus, in effect, exports tended to increase more than imports in former hard-currency economies, whereas in former soft-currency economies the rise of imports generally exceeded that of exports (Table 3). The resulting rise of current account deficits in former soft-currency economies is by now considered the root cause of the state-finance crises that culminated in the euro crisis of 2010.

Under the EMS, the discussion of differences between hard- and soft-currency economies had mainly focused on government fiscal policies and accommodating or non-accommodating national monetary policies. Since monetary choices were eliminated in the EMU, the Stability Pact had focused on preventing “loose” fiscal policies alone. Hence, when the euro crisis happened nevertheless, it was quasi-automatically attributed to the “fiscal irresponsibility” of debtor states – an explanation which, though it was patently absurd for Ireland and Spain, still plays a pernicious role in justifications of the present euro regime. At around the same time, however, the Commission (2010) had more plausibly begun to focus on external imbalances and the excessive dependence of deficit economies on capital inflows as a proximate cause of the euro crisis. In its view, external deficits were the symptom of a loss in international competitiveness that had been caused by excessive increases of unit labor costs. Indeed, current accounts and unit labor costs had diverged between 1999 and 2008, and they appear to be strongly related (Figure 1).

Table 3 Imports and exports as a percentage of GDP 1999, 2008

	Imports			Exports		
	1999	2008	Change in %	1999	2008	Change in %
Germany	26.33	37.89	42.38	27.04	43.46	60.72
France	23.51	29.14	23.92	25.72	27.39	6.48
Italy	21.47	27.74	29.23	23.24	26.95	15.96
Ireland	73.54	75.60	2.80	86.61	84.21	-2.77
Belgium	60.10	79.21	31.80	63.90	79.70	24.72
The Netherlands	54.90	63.02	14.79	60.24	71.64	18.93
Austria	38.94	48.97	25.76	39.44	53.15	34.77
Finland	28.63	41.43	44.70	37.60	45.08	19.88
Portugal	36.82	40.84	10.91	26.47	31.13	17.58
Spain	28.34	30.44	7.41	26.40	25.32	-4.09
Greece	28.35	36.35	28.20	19.19	23.37	21.74

Source: OECD.

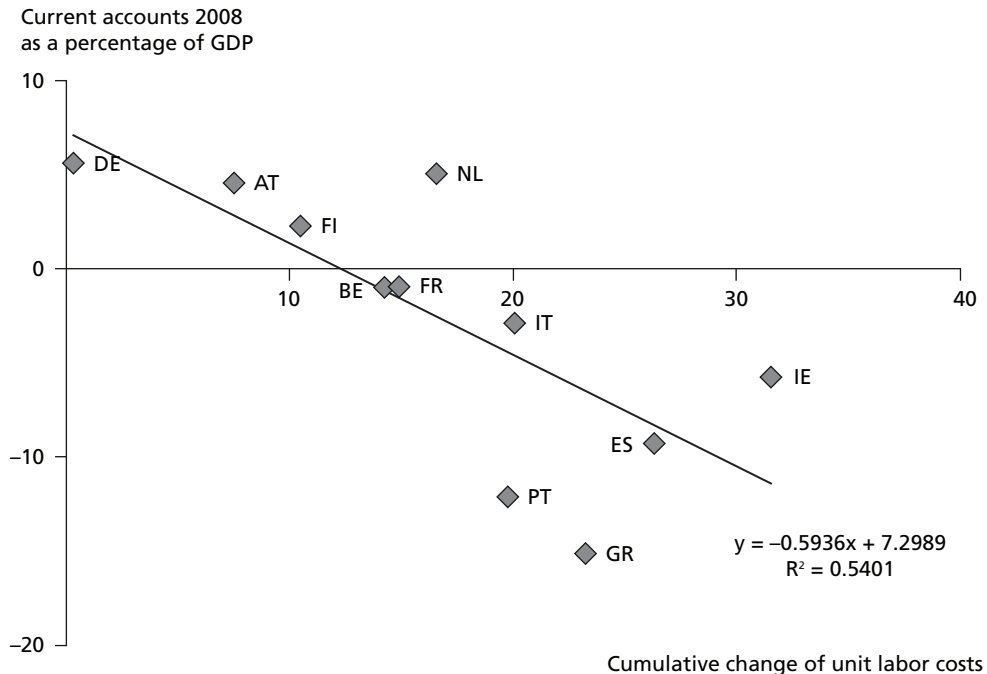
Since the realignment of nominal exchange rates was no longer available, external imbalances would now have to be corrected through internal adjustment. Assuming a causal chain that started with excessive wage increases affecting domestic inflation and export prices and then current accounts, the Commission was quick to invoke neoliberal supply-side explanations:⁵ it must be institutional “rigidities” of labor and product markets that explain the failure to reach balanced external accounts. Hence, what is needed are “structural reforms” increasing price and wage flexibility. Moreover, since current account deficits (rather than surpluses) were seen as the proximate causes of the crisis, such reforms had to be targeted at factors causing above-average increases of unit labor costs in deficit economies, rather than at the below-average increases in surplus countries like Germany. In other words, the purpose of reforms had to be “internal devaluation” and a structural reduction of wage pressures in deficit economies.

The Commission’s supply-side emphasis is also shared by a less dogmatic theoretical and empirical literature focusing on the influence of wage-setting institutions on macroeconomic performance. Thus, Calmfors and Driffil (1988; Calmfors 1993) had proposed a simple hump-shaped relationship between real-wage increases and the centralization of wage negotiations. Wage rises are expected to be low in decentralized (firm-level) bargaining, where unions cannot exercise market power.⁶ And they are also expected to be low in highly centralized (economy-wide) bargaining systems, where economically rational union leaders are assumed to “internalize” the effects of wage increases on inflation and (anticipating the effect of monetary and fiscal restraint) on

5 There is also a more recent literature promoting a demand-side explanation of the euro crisis (Wyplosz 2013; Jones 2016) that would have supported very different policy conclusions to which I will return below.

6 That is not generally plausible. In decentralized bargaining, wage setting is likely to be highly volatile, with rapid rises during an upswing and rapid declines during a downswing of the economy, and it will be highly unequal, with steep rises in regions, sectors, and skill groups where demand is high. This, apparently, is the ideal pursued by “structural reforms” imposed by the Commission and the Troika on the labor markets of crisis economies.

Figure 1 Current accounts 2008 and the rise of unit labor costs 1999 versus 2008 (index 2010=100)



Source: OECD.

unemployment. By contrast, wage-push inflation is expected from an intermediate level of centralization, where union leaders exercising bargaining power in smaller units are assumed to ignore the external effects of wage settlements on the rest of the economy.

The model is useful because it attempts to explain macroeconomic differences as the outcome of strategic choices by rational and self-interested collective actors (union leaders, in this case) under the influence of nationally differing institutional settings.⁷ In other words, it tries to explain the presence or absence of a national *capacity*⁸ for *voluntary wage restraint*.⁹ In its original form, however, the model is incomplete in two regards: it does not explicitly model the dual and potentially conflicting utility functions of union leaders – who must try to raise the incomes but also protect the existing jobs of their members – in collective bargaining over wages. Its implicit focus is on

7 It should go without saying that all rational-choice models of collective bargaining are associated with huge *ceteris-paribus* clauses. They can help to formulate and criticize expectations about general tendencies, but they cannot predict, or be “tested” by, the outcomes of specific interactions under historically contingent conditions (Scharpf 1997).

8 Whether an existing capacity is actually exercised depends also on the political context. As long as governments were thought to ensure full employment in any case, the interest in real wage increases dominated union strategies even in the highly centralized Swedish system of the 1970s (Scharpf 1991: ch. 6).

9 Compulsory wage controls were tried and failed in the 1960s and 1970s (Scharpf 1991: ch. 5).

expanding economies, where jobs are not directly threatened. In such cases, the rise of inflation may indeed be treated as a “collective bad” whose avoidance presupposes a capacity to overcome collective-action problems among a plurality of bargaining units. In a declining economy with rising unemployment, however, the threat of job losses will be experienced as a “private bad” by individual workers – which should induce unions to accept wage concessions regardless of the degree of centralization¹⁰ (Scharpf 1991). This latter omission may also explain the model’s lack of attention to the crucial difference of union responses in the exposed (traded) or sheltered (non-traded) sectors of the economy.

In the sheltered sector, where goods and services are locally produced and locally consumed, wages affect the costs of production as well as household incomes and potential domestic demand. To some extent, therefore, rising unit labor costs may result in price increases that can be passed on to consumers without endangering employment. In the exposed sector (and under fixed exchange rates), however, price increases are constrained by international competition. Hence, increases of unit labor costs above the international level are likely to entail job losses, either because of a loss of export sales or because of a loss of profitability. Regardless of the size of bargaining units, rational unions in the exposed sector are therefore always bargaining in the shadow of international competition and of potential job losses. They should thus be expected to be generally more cautious in their wage demands than sheltered-sector unions that have less reason to fear the loss of existing jobs.

Since all economies include both sectors, mere differences in the relative sizes of their exposed and sheltered sectors should thus have an effect on the general propensity to generate wage-push inflation. Moreover, rational unions in a fully centralized system would not merely attempt to dampen the rise of inflation in the domestic economy; they would also have to balance the benefits of (non-inflationary) general wage increases against the possibility of job losses in the exposed sector. By contrast, in a decentralized system of wage setting with smaller bargaining units, unions in the sheltered sector should generally be expected to seek higher wage increases than unions in export industries. But since intersectoral spillovers might affect export prices, export-sector unions should also have an interest in formal or informal wage coordination across sectors (Driffil 2006; Hancké 2013).

This suggests that any model trying to explain the persistence of above-average and below-average increases of unit labor costs by reference to national wage-setting structures should include two dimensions: institutional differences in the capacity of unions to achieve voluntary wage restraint, and differences in the relative size of the exposed and the sheltered sectors.

10 With Keynesian beliefs, a centralized union may in fact try to dampen the macroeconomic decline by maintaining wage incomes and domestic demand, whereas decentralized bargaining units may deepen the recession through downward wage competition.

With regard to the first dimension, several decades of comparative research in the neo-corporatist and the varieties-of-capitalism frameworks have provided a rich source of theory and evidence that enables one to assess the capacity for either centralized or coordinated strategic wage setting in the industrial-relations systems of eurozone economies (Scharpf 1991; Hancké 2013; Höpner/Lutter 2014; Nölke 2016). The potential for centralized wage setting used to be highest in Scandinavian political economies and in Austria, whereas Belgium, the Netherlands, and Germany were generally regarded as systems with a potential capacity for intersectoral wage coordination. While union density has gone down everywhere, export-sector unions continue to be relatively strong. In Anglo-Saxon economies, by contrast, coordination is impeded by competition between small unions; and in Southern political economies, unions tend to be divided by political affiliation, and union density and politicization tend to be greatest in the public sector. Hence, political inter-union conflicts will stand in the way of voluntary wage coordination – except that the extreme weakness of export-sector unions in France may in fact favor a stronger role of the state in wage setting.

The second dimension is implied in recent work on the difference between export-led and domestic demand-led national “growth models” (Hall 2014; Johnston/Regan 2016; Baccaro/Pontusson 2016; Hope/Soskice 2016). What matters most in the present context is the pragmatic implication that the success of export-led economic growth depends critically on the relative size of the export sector.¹¹ If it is large, wage restraint and the rise of exports may indeed pull the economy out of a recession, whereas the increase of exports alone may not do much for an economy that depends on growth in a large sheltered sector.

Taking the share of exports in GDP in 1989 and 1999 as a proxy measure,¹² one finds that the relative sizes of the exposed and sheltered sectors varied greatly in Western Europe. Among the smaller eurozone economies, there is a striking difference between Belgium, the Netherlands, and Ireland with very large export sectors; Austria and Finland with relatively large export sectors; and Greece, Spain, and Portugal, where the export sectors are relatively small.¹³ Among the larger economies, which generally have

11 To be clear: economies with both large and small exposed sectors may be equally viable internationally, as long as export incomes are sufficient to pay for the country’s imports. But in a recession, only countries with a large export sector can hope to achieve economic *recovery* through strategies favoring export-led *growth*.

12 The proxy is incomplete since the definition of the exposed or traded sector refers to production not only for export but also for domestic consumption in competition with imports. In effect, therefore, the exposed sector is larger than the export sector.

13 The question, which I will not pursue here, is what may explain the initial differences among economies of similar size. In Southern Europe, a potential influence may be the long shadow of fascist (and protectionist) “state corporatism” (Schmitter 1974). By contrast, the rise and persistence of export-led growth in the “small open economies” (Katzenstein 1985) of Northern Europe probably started from an initial endowment in goods and services with a large international market (timber and pulp, iron ore, steel and shipbuilding, trading and shipping, etc.) and a subsequent emphasis on high value-added portfolios that were internationally attractive but also vulnerable (Wierds et al. 2013; Storm 2016).

Table 4 Exports as a percentage of GDP: 1979, 1989, 1999

	1979	1989	1999
Germany	17.87	22.36	27.04
Italy	22.46	18.57	23.25
France	20.58	21.48	25.72
Spain	13.77	16.68	26.40
Greece	15.17	15.95	19.26
Portugal	21.19	29.46	26.47
Finland	29.56	23.01	37.60
Austria	30.96	35.10	39.44
Ireland	44.47	58.87	86.72
The Netherlands	48.17	55.41	60.24
Belgium	49.40	62.90	63.90

Source: OECD.

fewer exports and imports than do small economies, Germany, France and Italy had relatively small, and quite similar, export shares until 1989 (Table 4).

In combination, these dimensions suggest a fourfold table with clear implications for differing wage dynamics: economies with a large exposed sector and wage-setting institutions that allow voluntary wage restraint should be expected to avoid inflationary wage push (Figure 2). By contrast, economies with a large sheltered sector and with fragmented or competing unions should tend to generate above-average increases of unit labor costs. With this classification, two of the fields correspond roughly to the earlier distinction between hard- and soft-currency economies, which in the present discussion are also described as Northern and Southern political economies.

In Field (1) we find former hard-currency economies that had large export sectors *and* coordinated wage setting in the decades before 1999. That clearly includes the Netherlands, Belgium, Austria, and Finland. By contrast, Field (3) describes economies with a relatively small export sector and relatively high wage pressures, including Greece, Spain, Portugal, as well as Italy and France, countries that had also been members of the former soft-currency group. But there are two countries that do not seem to fit the pattern: Ireland and Germany.

Structurally, Ireland should be located in Field (4), combining a very large export sector (due to its position as the gateway to Europe for US multinationals) with British-style decentralized and inflation-prone industrial relations. In the run-up to the Monetary Union, wage pressures had been dampened by temporary “social pacts” and costly government policy concessions (Hassel 2003; Regan 2011). After accession, social pacts ended and wage push was further stimulated by an unimpeded boom in the real-estate and construction industries. Once the bubble burst and employment collapsed in the crisis, the decentralized wage-setting system also facilitated a dramatic fall of unit labor costs – which in the meantime has in fact contributed to some export-led recovery of the Irish economy.

Figure 2 Characteristics of Northern and Southern political economies

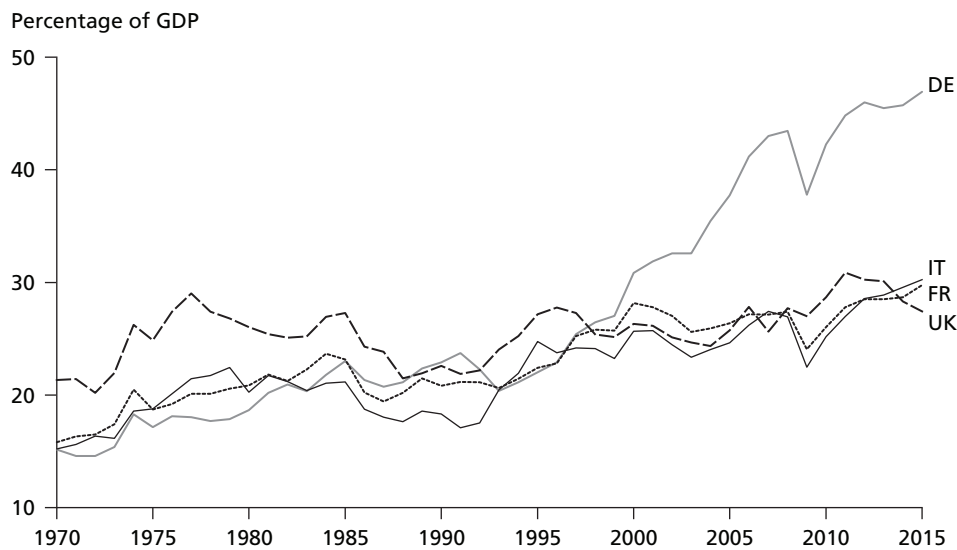
	<i>Large export sector</i>	<i>Large domestic sector</i>
<i>Voluntary wage coordination</i>	(1) Northern	(2) ???
<i>No wage coordination</i>	(4) ???	(3) Southern

More interesting for theory and more important in practice is the German case. In line with other large economies, which generally have less trade than smaller ones, the relative size of the German export sector was quite moderate until the end of the 1980s; it was at about the same level or even below those of the UK, France, and Italy. By reference to its economic structure, it should have pursued a demand-led growth strategy. If it nevertheless appears as the extreme case of a hard-currency economy, this cannot be fully explained by its industrial-relations system – where wage setting is not centralized but determined at the sectoral level and where public-sector unions have at times launched very aggressive wage campaigns (Scharpf 1991). What has mattered consistently, however, is the stability orientation of the independent Bundesbank, which responded with rigorous monetary restraint to all inflationary impulses, whether originating from wage increases in the exposed or sheltered sectors, from public-sector deficits, or from oil-price hikes – with no regard to its impact on economic growth or unemployment. In effect, the wage-setting practices of German unions were thus forced to resemble those appropriate to export-led growth strategies – except that their expected rewards were automatically frustrated by currency fluctuations in the 1970s and by currency realignments under EMS in the 1980s. In the end, Germany had the hardest currency but experienced neither export-led nor demand-led economic growth in the seventies and the eighties.

But why did the German hard-currency wage-setting practices continue when the Bundesbank finally lost its punitive power after the country entered into the Monetary Union? There should eventually be a long answer to this question (Scharpf 2017). But the short one is, simply, that for the first time since the end of the Bretton Woods regime, these practices were rewarded rather than frustrated by currency realignments. Thus, the exceptional rise of German exports which had begun in the mid-1990s¹⁴ was

14 The rise of the export share starting in the mid-1990s is best explained by the expansion of international demand for German investment goods after the fall of the Berlin Wall and by the opportunities to outsource the production of components to low-wage regions with skilled industrial work forces in Central and Eastern Europe (Scharpf 2017). Both of these factors also benefited Austria, but they could not be exploited to the same extent by the UK, France, and Italy.

Figure 3 Exports as a percentage of GDP in large European economies, 1970–2015



Source: OECD.

not dampened by a rise of the exchange rate but continued unchanged in the Monetary Union – with the effect of transforming the sectoral structure of the economy from one with the appropriately small export sector of a large European economy to a different one where the share of the domestic sector has shrunk and where the export sector has increased to a size that used to be characteristic of small open economies (Figure 3).

Since Germany has now also come to fit the pattern defined in Field (1) of Figure 2, all eurozone economies can now be described by one of two structural patterns: Northern economies, which are structurally defined by the combination of a large export sector with an institutional capacity for wage restraint, include Germany, Austria, the Netherlands, Belgium, Finland and presently Ireland as well, whereas Southern economies, which combine a large domestic sector with industrial relations systems that tend to generate wage-push inflation, include not only Greece, Spain, and Portugal, but also Italy and France. In the literature, this division is sometimes associated with deep cultural differences between a “Germanic” and a “Latin” Europe (Agamben 2013), but the “North–South” distinction is also used without cultural connotations by political economists like Torben Iversen and his colleagues (2016).

At this point, and with a better understanding of the nature and the hardness of structural (sectoral *and* institutional) differences among eurozone economies, we return to the question raised at the end of the last section. After 1999, the impact of the uniform regime of the original Monetary Union on member states with persistent structural differences caused the dramatic economic divergence that culminated in the euro crisis of 2010. Since the new euro regime, which was put in place after 2011 to stabilize the EMU, is once more imposing uniform rules on eurozone economies that continue to

be structurally different, its immediate impact will again be asymmetric. The question is therefore whether it will also founder on the hard rock of these structural differences, or whether it will ultimately achieve the structural convergence on which not only the report of the Five Presidents but all “integrationist” manifestos and plans must place their hope.

The asymmetric impact of the present euro regime

Since the euro crisis started as a state solvency crisis, it was perhaps inevitable that initial responses, and the conditionalities attached to bail-out loans, emphasized fiscal retrenchment. And since the crises occurred in economies whose current account deficits had made them vulnerable to external financial challenges, it also seemed plausible to impose “structural reforms” intended to achieve “internal devaluation” by reducing unit labor costs (Schimmelfennig 2015). But it is much less plausible that the Commission, the ECB, and eurozone governments – in their search for a long-term regime that would attain “what EMU was to be: a place of prosperity based on balanced economic growth and price stability, a competitive social market economy, aiming at full employment and social progress” (Five Presidents 2015) – should simply have generalized the immediate crisis responses of fiscal restraint and supply-side reforms without systematically considering their impact on structurally heterogeneous eurozone economies. It appears, however, that they have done just that.

Apart from the banking union, the new regime has not yet created any additional European capacities for macroeconomic management. The Excessive Deficit Procedure and the Fiscal Compact have tightened the rules limiting public sectors deficits and debt; they have greatly extended the Commission’s supervisory, preventive, and corrective functions; and they have strengthened its independence from the Council in enforcing recommendations through severe financial sanctions. There is no recognition, in other words, that a fiscal stimulus might be required in a recession. Similarly, the Commission’s (2012b) “Scoreboard” for the Macroeconomic Imbalances Procedure defines limits for external deficits more restrictively than for external surpluses. And it only defines upper limits for private sector credit and debt, house prices, and changes of unit labor cost, but is not concerned with the possibly deflationary effects of public and private sector savings, declining property values, or the possibility of excessive wage restraint. The main emphasis, however, is on reducing unit labor costs in order to improve international competitiveness – and thus to achieve export-led economic growth (Commission 2012c).¹⁵

15 In the frame of supply-side economics, one might also hope to achieve a profit-led rise of investments in the sheltered sector of the economy – which, however, is not explicitly invoked by the Commission or the Five Presidents in their justification of the euro regime.

Figure 4 Divergent North–South impacts of expansionary and restrictive policies

		<i>North</i> <i>Export/domestic sector: 70:30</i>		<i>South</i> <i>Export/domestic sector: 25:75</i>	
		Export sector	Domestic sector	Export sector	Domestic sector
<i>Policy response to a recession</i>	Fiscal and wage reflation	Large losses	Small gains	Small losses	Large gains
	Fiscal and wage restraint	Large gains	Small losses	Small gains	Large losses

These policies have highly asymmetric impacts on Northern and Southern economies that are struggling to recover from the “Great Recession” of 2009/10 under the constraints of single currency. Their combination of fiscal consolidation and wage restraint will support the “flight into exports” through which Northern countries with large export sectors and with a capacity for voluntary wage restraint have tended to respond to economic downturns or even deep crises like those in Sweden in the early 1990s or in Germany in the early 2000s. But their immediate economic effects will be catastrophic in Southern economies whose export sectors are too small to generate much economic growth, whereas their large domestic sector is pushed even deeper into recession by the combination of fiscal austerity and wage depression.

The asymmetry is illustrated in Figure 4 by reference to ideal-type Northern and Southern economies (resembling the Netherlands and Spain, respectively, in 2008). It assumes that in response to the “Great Recession,” both countries could have chosen one of two responses – either to reflate domestic demand in order to generate growth in the sheltered sector or to reduce prices and wages to increase external competitiveness and exports. In the Netherlands, demand reflation would have had little effect on the small domestic sector,¹⁶ whereas a decline of international competitiveness might have damaged the large export sector. In Spain, by contrast, the large domestic sector would have benefited from demand reflation, whereas fiscal austerity and wage depression would have deepened the domestic recession without generating much export-led growth.

If both types of member states had enacted their nationally preferred policies, however, economic divergence in the eurozone would have escalated once more, and the next euro crisis might well have destroyed the Monetary Union. Instead of seeking a compromise solution (which, as I will discuss below, was probably not available), the new euro regime took sides: its rules imposing fiscal austerity and wage compression on all eurozone economies are those that Northern governments would have chosen for themselves in light of the structural opportunities and constraints of their own

16 Fiscal reflation, in particular, would be inefficient for small open economies as most of the deficit spending would spill out into increasing imports, rather than boosting the domestic economy.

Table 5 Economic performance, 2008–2015

	Current account	Unit labor costs	Exports as % of GDP	GDP	Employment rate	Public debt as % of GDP
	2015	Cumulative changes 2008–2015				
Germany	8.49	15.62	7.95	18.12	5.53	9.28
France	–0.04	10.67	8.67	9.41	–1.73	41.68
Italy	2.19	9.00	12.20	0.26	–4.05	31.21
Ireland	4.45	–19.16	47.24	14.44	–6.09	137.91
Belgium	–0.03	11.19	4.38	15.63	–0.96	16.40
The Netherlands	9.12	8.20	14.49	6.17	–3.92	25.13
Austria	2.56	15.83	0.48	15.49	0.39	23.24
Finland	0.14	18.83	–18.78	6.97	–3.52	85.62
Portugal	0.45	–3.51	29.47	0.28	–6.03	78.93
Spain	1.40	–4.82	30.93	–3.14	–10.35	154.99
Greece	–0.06	–4.99	28.88	–27.26	–17.30	67.60

Sources: Eurostat; OECD; own calculations.

political economies. At the same time, they are also the rules which no autonomous and politically accountable Southern government should have chosen in response to a deep economic crisis and in light of the structural constraints of its political economy. In short, the economic impact of the present euro regime is fundamentally asymmetric. It fits the structural preconditions and economic interests of Northern economies, and it conflicts with the structural conditions of Southern political economies – which it condemns to long periods of economic decline, stagnation, or low growth.

Eight years after the beginning of the crisis, the euro regime has in fact succeeded in eliminating the current account deficits of Southern economies, and it could also take credit for reversing the rise of unit labor costs (Table 5). As a consequence, export shares of GDP have risen in all Southern economies. Ireland, with its very large export sector, seems to be on the road to export-led recovery, whereas GDP in Southern economies has hardly risen or is still lower than it was in 2008. In any case, employment rates have declined significantly, and in 2015 unemployment was still excessively high in Greece (25 percent) and Spain (22 percent). Moreover, fiscal austerity has reduced domestic demand and economic activity in the domestic sector to such an extent that public-sector debt was not reduced but actually continued to increase in all Southern states after 2010.

By contrast, Northern economies and Germany in particular seem to have done much better under the post-crisis regime.¹⁷ In international debates, the asymmetric impact of the present euro regime is increasingly recognized, and many critics are quick to explain it as a consequence of hardball bargaining by Germany and its Northern allies. As I suggested above, that may explain responses at the onset of the euro crisis, but not necessarily the design of the subsequent euro regime. In any case, the asymmetric distribution of bargaining power would have changed if Southern governments, individually

17 The relatively weak performance of the Dutch economy was due to the collapse of a housing boom, and Finland suffered from weak Russian demand and from the failure of NOKIA, which was a major part of its export sector.

or as a group, had been willing to question their membership in the Monetary Union – which would have threatened not only some big French and German banks but also the advantages which export-dependent Northern economies have been deriving from the single currency (Scharpf 2014).

In actual fact, not only all European authorities – the Commission, the ECB, and the European Parliament – and Northern governments, but also all Southern governments and their parliaments were and still are committed to maintain the Monetary Union. This suggests that they all share the overriding purpose of defending the common currency and preventing another euro crisis. From that perspective, however, the initial asymmetry of euro-rescuing policies seems to have been inevitable. Putting it bluntly, the proximate cause of the euro crisis was not current account surpluses, but the vulnerability of externally over-indebted economies to financial challenges (European Council 2011: §4). Since these were arising in Southern member states, the measures were targeted at the manifest deficiencies in their performance.

However, once the initial requirements of fiscal retrenchment and supply-side wage compression for the crisis states were in place, the subsequent euro regime was largely shaped by path-dependence. Changing the rules for Southern states by allowing fiscal reflation would again have increased public-sector deficits and the risk spreads of their state bonds. Even if expansion were to be financed through Eurobonds, rising domestic demand would again increase imports, current account deficits, and the dependence on sustained capital inflows. At the same time, relaxing the downward pressures on unit labor costs would have prevented the intended improvements of export competitiveness. In other words, changing the original approach would have counteracted the program that had just been imposed on crisis countries and, perhaps even more important, would have meant having to deny the economic assumptions and expectations on which these conditionalities had been based.

So, if the Monetary Union was to be maintained, and if both the structural divergence of Northern and Southern economies and the starting date of the euro crisis in 2010¹⁸ are taken as givens, the asymmetric direction of the initial euro rescuing policies and their continuation in the present euro regime appear to have been pretty much inevitable. But that will, of course, not ensure the regime's economic and political sustainability over the longer term.

18 If the structural divergence of Northern and Southern economies had not been ignored in the original design of the Monetary Union, a euro regime with a starting date of 1999 might have been more symmetrical. Instead of budget deficits, it could have taken inflation differentials as its target variable. And as national fiscal and wage policies were the only remaining instruments for the macroeconomic management on the national level, low-inflation member states in a recession like Germany might have been allowed, or even required, to reflate fiscally, whereas high-growth Ireland and Spain would have had to practice fiscal austerity and wage restraint even though their budgets were in surplus. Whether such a differentiating and flexible regime would have been economically and politically sustainable after 1999 is, of course, uncertain. It seems obvious, however, that it could not have been introduced as an immediate response to the crisis of 2010.

3 The political economy of forced convergence

Under the present regime, the prospects for Southern economies, societies, and polities are dismal indeed. Whereas Ireland, with its large export sector, is recovering from the crisis and Spain is benefiting from the decline of other Mediterranean tourist regions, even rigorous demand and wage depression will at best allow very slow economic and employment gains in other economies that continue to depend primarily on a large domestic sector. In other words, eight years after the beginning of the crisis, there is no prospect that economic stagnation and underemployment in the South will be overcome any time soon.

But what about the longer term?

Forced convergence may work

The *Five Presidents' Report* (2015) discussed above insists that a viable Monetary Union presupposes structural convergence among eurozone economies, and it is committed to the belief that the consistent and persistent enforcement of the present euro regime will in fact achieve it. By implication, this belief is also shared by Southern governments, all of whom are so far committed to the Monetary Union, regardless of the economic and social damages imposed by the present euro regime. They might prefer more flexible and symmetric enforcement, but since the Northern economies seem to be doing well under the EMU, whereas Southern economies are in trouble, there can be no question about the direction of the structural change that must be achieved.¹⁹ In that sense, Agamben (2013) is right: the present euro regime must indeed be seen as an effort to impose a “Germanic” socioeconomic model on “Latin” societies. Indeed, the rules and precepts imposed by the present regime seem well designed for this purpose.

That is obviously the purpose of past and present requirements for structural reforms intended to inhibit the rise of unit labor costs²⁰ and thus to increase export competitiveness through “internal devaluation.” What is less obvious, however, is the crucial role of fiscal austerity in the structural transformation of Southern economies. Since it has not succeeded in reducing public-sector debt, it is often considered to be counterproductive

19 This is not necessarily a concern of Northern governments. Germany had originally envisaged a smaller and structurally more coherent Monetary Union (Schäuble/Lamers 1994) and might still prefer it today if the transition could be managed in an orderly way. But the defense of inclusive membership appears to be a crucial concern of eurozone authorities and of modernizing elites in the South who – ever since Mitterrand’s conversion to *franc-fort* policies after 1982 – seem to have resented the soft-currency character of their own political economies.

20 From what has been explained above, however, it follows that “reforms” meant to reduce union power and to increase wage competition can, at best, bring about more wage flexibility but not the capacity for wage restraint that is characteristic of Northern political economies.

and condemned for its negative impact on the domestic economy (De Grauwe/Ji 2013; Blyth 2013; Stiglitz 2016). Paradoxically, it is precisely this apparent failure that points to austerity's most effective contribution to structural convergence: by reducing domestic demand, fiscal retrenchment has not only helped cut imports and thus current account deficits, but it is actually shrinking the size of the domestic sector. Capacities that are underemployed will disappear as firms go bankrupt and skilled workers are laid off. Thus, even if exports would not be increased much by wage depression, the *relative* size of the export sector will increase as the domestic sector is reduced through the continuing decline or stagnation of domestic demand. This effect is most obvious in Greece, where GDP declined by 27 percent between 2008 and 2015, whereas the share of exports in GDP increased by 29 percent (Table 5). Similar sectoral shifts are underway in other Southern economies, as well.

If fiscal austerity and the downward pressure on unit labor costs are maintained and if the relative size of the domestic sector is shrinking, this also implies that the structural basis of the characteristic Southern "growth model" is eroding. Moreover, as the relative and absolute size of the exposed sector increases, so will the share of the total labor force whose jobs are directly affected by international competition. Even if wage-setting institutions should not change, the generally lower wage pressures in the exposed sector are thus likely to dampen average wage-push inflation in the economy at large. By the same token, the rising share of workers and firms with an interest in export-led economic growth is also likely to have an effect on the politics of industrial policy. In other words, Southern political economies would gradually come to approximate the structural characteristics of the Northern model – with a relatively large sector that is exposed to international competition and with wage-setting practices that are less prone to generating wage-push inflation.

In purely economic terms, therefore, enforced structural convergence does not appear impossible in principle. It may succeed in the long run if the present regime is enforced long enough and if it is not derailed through another financial crisis in the eurozone or in the global economy. In that sense, the present euro regime should be seen as a technocratic gamble with huge economic uncertainties – on which I will not speculate here. But it seems interesting to question the attractiveness of the goal if it could be approximated.

Is the prize worth winning?

Critics of the present euro regime often suggest that the target of convergence on the Northern model is self-contradictory for the eurozone as a whole. Not all economies could aspire to be like Germany because not all could run current account surpluses at the same time (e.g., Krugman 2012). Now it is true enough that any trade surplus must be matched by a deficit somewhere else in the world. But if convergence were achieved,

the eurozone itself would operate as a large integrated economy whose exchanges with the rest of the world are moderated by an exchange rate. And if we then assume that it will continue to be governed by the present precepts of fiscal restraint and wage restraint, it would operate like the German economy did during the period of flexible exchange rates from the end of the Bretton Woods regime in the early 1970s to the run-up to the Monetary Union in the early 1990s. During that period, Germany was only exceeded by Switzerland as the paradigmatic hard-currency and low-inflation economy. Nevertheless, German current accounts were roughly in balance between 1970 and 1999, and the German export share of GDP rose only slowly and roughly in line with other European economies of similar size (Figure 3 above).

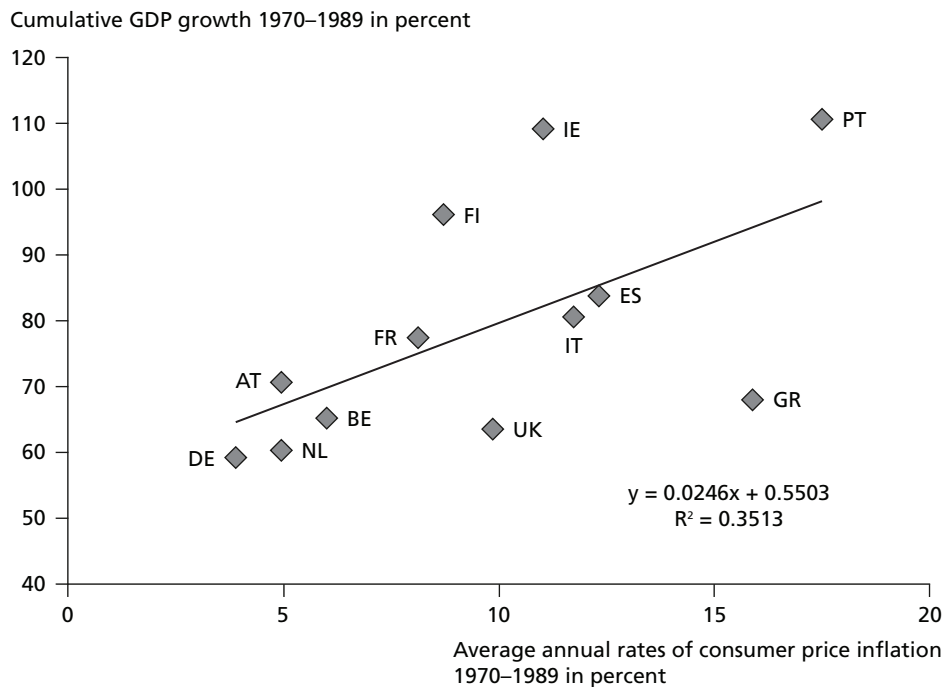
In other words, hard-currency policies will be able to increase competitiveness (and have the effect of beggar-thy-neighbor practices) only under conditions of worldwide fixed exchange rates or among the members of a monetary union. For Germany in the 1970s and 1980s, however, any competitive advantages that unions might have expected to achieve through wage restraint were effectively neutralized through automatic or agreed-upon exchange-rate realignments. Unless the ECB would be willing and able to intervene in international currency markets to achieve a significant undervaluation of the euro, any economic advantages which a convergent eurozone might expect from emulating Germany would also be neutralized by changes of the euro exchange rate.

What would be different if structural convergence were achieved is the greater action space of EMU-wide macroeconomic policy. In Germany, the Bundesbank's uncompromising commitment to price stability meant that it did not actively fight recessions but shortened recovery periods (Schettkat/Sun 2009). Thus, it not only constrained the rise of domestic demand but also imposed a stop-go pattern on domestic investments that limited the expansion of productive capacity. In effect, what Germany gained from its stability policies was only price stability – combined with the pride of having a hard currency (Figure 5). But in comparison to its less rigid European neighbors, it paid for it with significantly lower increases of income and with declining employment (Scharpf 1991, 2017).

In the present context, these reminiscences have two implications. If the Monetary Union would be able to achieve structural convergence on the Northern model and if the present euro regime were to continue unchanged, then the economic course of the eurozone as a whole should resemble the German performance in the 1970s and 1980s. The effects of price stability and wage restraint on international competitiveness would be neutralized by a rising euro exchange rate, and the present headline promise of export-led economic growth would be frustrated. But as the euro would then be a hard currency, its stability in international financial markets should be secure.

However, as a very large and structurally more coherent economy that is linked to its international environment through flexible exchange rates, the eurozone would not *have to* repeat the German experience of the 1970s and 1980s. A future euro regime might

Figure 5 Inflation and real GDP growth, euro area and United Kingdom, 1970–1989



Sources: OECD; World Bank; own calculations.

instead aim at somewhat less price stability and more economic growth, perhaps approximating the position of France in Figure 5. This had been Mitterrand's hope when he insisted on the Monetary Union. Although the hope was unrealistic for the heterogeneous eurozone of 1999, it might be realized after structural convergence – just as the Five Presidents (2015) are also envisaging countercyclical national and European fiscal policies after convergence.

To conclude, the present euro regime amounts to an attempt to enforce the structural convergence of eurozone economies on the Northern model. In purely economic terms, this does not appear strictly impossible. If convergence should be achieved, it not only would stabilize the common currency but might also allow more attractive macroeconomic options to be realized in the eurozone. In contrast to some of their critics, such as Paul Krugman (2012), Marc Blyth (2013), or Joseph Stiglitz (2016), I thus do not consider the promoters and defenders of the present euro regime to be either ignorant or dogmatically blindfolded. They should at least be given credit for constructing a gigantic, and indeed hubristic, gamble of technocratic social engineering whose visionary goal is the creation of an integrated European economy that is fit for competition in the ever more contested global markets.

4 A disaster of political legitimacy

The present euro regime, as I have tried to show, is an economic gamble that might succeed if it is not busted in another economic or financial crisis. But given the enormous economic, social, and moral transition costs it imposes, the structural transformation of Southern political economies must also be seen as a political gamble whose failure might destroy the Monetary Union and shake the post-Brexit European Union as well. In any case, however, the political institutions and processes which are necessary for its economic success have the effect of destroying the democratic legitimacy of government in some member states and of ruling out advances toward democratic government in Europe for a long time to come.

Legitimacy on the national level

The fundamental legitimacy problem of the present euro regime is the asymmetry of its impact. In Northern member states, export-led models of economic growth are profiting from fixed exchange rates in the EMU, and the rules of the euro regime are generally compatible with the preferences of dominant national interests, including unions in export industries. As there is no shared sense of economic and social decline ascribed to the EMU, its *output legitimacy* is not in question. Since the euro regime is compatible with the existing institutions and practices of hard-currency political economies, there is also no sense of a manifest external interference with the autonomy of national self-government (Walter 2016). That does not rule out dissatisfaction with the ECB's interest-rate policy and worries about the anticipated liability for bail-out loans, which may be politically exploited by protest parties. It also does not rule out dissatisfaction with the social implications of hard-currency practices. But even if the rise of social inequality is blamed on fiscal austerity and supply-side reforms, these are challenged and publicly defended as the contestable policy choices of politically accountable national governments. They will not necessarily disrupt the *input legitimacy* of responsive and responsible government.

In Southern political economies, however, conditions are much less favorable. Since the beginning of the crisis, euro-rescuing policies and the new euro regime had a massive negative impact on the large domestic sectors of Southern economies; economic growth was depressed and has, after eight years, at best barely recovered to pre-crisis levels. At the same time, unemployment – and in particular youth unemployment – has risen to record levels and is coming down only slowly, in part through out-migration. Under these conditions, *output-oriented* legitimating arguments might rely either on counterfactual comparisons with the presumed catastrophe of exit from the Monetary Union or on the uncertain promise of a better future after structural convergence has been achieved. The appeal of the latter argument would be limited, however, since it would also highlight the purposeful destruction of cultural and institutional traditions and practices considered part of the collective identity of “Latin” societies.

In the *input-dimension*, political dissatisfaction, opposition, and protests have escalated in Southern polities as the misery of economic decline, mass unemployment, and the loss of welfare-state support has continued to take its toll, year after year – and as the unequal impact of the regime on Northern and Southern countries has become ever more obvious. It was never expected that the policies required by the Commission-defined “Memoranda of Understanding” would be chosen and implemented through autonomous national political processes. Instead, they were enforced step-by-step through the partitioning of agreed-upon rescue loans in small tranches that would be withheld until the Troika of inspectors from the Commission, the ECB, and the IMF confirmed perfect compliance. In “program countries,” governments were thus never re-elected after 2010. Since the outcome of national elections or even referenda so obviously does not matter, public support for democracy itself has dramatically declined (Armingeon et al. 2016).

For the same reasons, the present euro regime presumes that democratic governments will be tempted to resist fiscal-austerity and supply-side recommendations. In the European Semester, therefore, budget proposals must be submitted to the Commission before they are introduced in parliament; and under the Excessive Deficits and Imbalances procedures, country-specific recommendations may ultimately be enforced by severe financial sanctions. Nevertheless, European authorities and Northern governments continue to search for even more powerful methods of centralized controls and enforcement. Thus, the Commission (2013) did propose “Convergence and Competitiveness Contracts” in which agreements on specific structural reforms would be supported by financial assistance – which could then be withheld in cases of insufficient implementation. Other suggestions include the installment of a “European Finance Minister” who, in some versions, would have the power to veto member states’ budgets (Enderlein/Haas 2015).

Under the present regime, autonomous national policy choices are only acceptable if they conform to the functional imperatives that are considered necessary for achieving structural convergence. As there is reason to think that constituency interests and preferences in Southern political economies are likely to conflict with these imperatives, the euro regime must necessarily have the power to constrain and, if necessary, disable the democratic responsiveness of Southern governments and hence the *input-oriented* democratic legitimacy of Southern polities.

Legitimacy on the European level

On the European level, arguments asserting *output-oriented* legitimacy would begin by hailing the Monetary Union as the crowning achievement of economic integration whose collapse would strike a fatal blow to the commitment to European political integration. In spite of the huge economic and social transition costs and risks implied by the present regime, not only European authorities and the governing majorities of all

eurozone states but also pro-European elites in business, labor unions, the media, and academe continue to believe that the Monetary Union is serving the European common interest.

However, the normative persuasiveness of these arguments is undermined by the glaring inequality of the regime's impact on Northern and Southern economies (Tsoukalis 2016). The pertinent comparison is to the monetary integration that preceded German unification in 1990. Its economic impact on East and West Germany was also extremely unequal. In the German case, however, the commitment to integration could not override the normative concern over its distributive injustice. Even though the extremely expensive German "transfer union" was highly inefficient in economic terms (Sinn/Sinn 1994), both parts of the country have treated it as a self-evident obligation under the normative criteria of distributive justice and equality in a political community.

Now, the eurozone is not a morally integrated political community that could oblige the winners to compensate the losers. By reverse implication, however, the elite consensus appealing to a *common* interest in defending the Monetary Union also lacks the power to persuade the victims of the present regime. As a consequence, the question of distributive justice cannot be resolved on the European level. Nor can it be declared normatively irrelevant. For the time being, it has been suppressed into the separate containers of national public spaces where it is poisoning European issues with mutual recriminations and deepening resentment.

In the South, the focus will be not only on the dismal economic outcomes and the enforced transformation of culturally salient institutions and practices, but also on the glaring injustice of an asymmetric regime which must surely have been brought about by ruthless German power in collusion with a neoliberal Commission and a European Central Bank serving banking and capital interests. How else could it be that the economic failure of the present regime, six years after the beginning of the euro crisis in 2010, is not acknowledged, and that all demands for relaxing fiscal constraints, for cutting excessive public debt, for risk sharing through Eurobonds, or for burden sharing through a common unemployment insurance have been so flatly rejected?

In the North, by contrast, distributive justice plays no role in public debates about the Monetary Union. Southern troubles are blamed on corrupt governments, incompetent bureaucracies, and misguided public opinion. Southern protests are seen as manifestations of anti-German resentment, a lack of gratitude for generous rescue loans, or at best an ignorant resistance against necessary and helpful reforms. In any case, they must be taken as manifest symptoms of the moral hazard encountered by all attempts to stabilize the Monetary Union, and as justification for ever tighter rules, more controls, and more severe sanctions.

So far, these fundamentally conflicting political interpretations and challenges have not (yet) clashed directly. On the national level, frustration, resentment, and recriminations

have been articulated in tabloids, talk shows, internet platforms, mass demonstrations, and violent protests. But they were generally kept off the official agenda by the perceived lack of alternatives – which was reinforced by the outcome of the Greek drama of 2015. Matters were seen to have been settled on the European level, and unilateral noncompliance could only provoke economic, legal, and political catastrophes.

In politics on the European level, however, issues of distributive justice in the EMU and the conflicts of citizen interests, perceptions, and demands played no role at all in the platforms of the mainstream party families or the campaigns of their *Spitzenkandidaten* during the last elections of the European Parliament (EP). Worse yet, when the Six-Pack legislation tightening the excessive-deficit rules did in fact allow the EP to play a role in designing parts of the present euro regime, its only concern was to make the enforcement of austerity rules and the imposition of sanctions against member states struggling with economic and social crises even more inflexible and automatic than even the Commission and the Council had thought necessary. And in the deliberations of the Eurogroup of the ECOFIN Council, as Varoufakis (2015) found out to his surprise, the only allowable topic was, of course, compliance with the present rules.

In short, the present regime has the advantage of being based on existing and legally binding rules – with the consequence that all challenges must face the insurmountable obstacle of having to achieve (nearly) unanimous agreement (Tsebelis 2016). In effect, then, a coalition between Northern and Southern governments, technocratic European authorities, and a pro-European Parliament that is decoupled from its constituents has so far prevented the politicization of conflicts over the asymmetric euro regime.

And they have reason to keep it that way.

The specter of politicization

To appreciate this conclusion, consider a counterfactual. Let us assume that the critical institutional requirements of input-oriented democratic legitimacy on the European level were in place. These would include the existence of Europe-wide mass media, accessible in the languages of all member states, providing credible information, unrestricted comments, and transnational discussions on issues on the European political agenda; they would also include the existence of national media covering the politics and public debates of other EU member states on these issues.²¹ Let us further assume a system of political accountability in which European policy makers are made to depend

21 Under present conditions, however, such accounts might not contribute to transnational understanding but provoke an avalanche of “post-truth” responses in the social media that could harden the intransigence of national political public opinion.

on citizens, mediated through politically responsive political parties and a European Parliament whose members must actively compete in local constituencies.²²

It seems obvious that, with these institutions in place, a more democratic Union could not continue to suppress the fundamental distributive conflict between Northern and Southern eurozone societies into separate national containers. It could not prevent its discussion in Europe-wide and national media, talk shows, and public debates. European political parties could no longer avoid addressing it in their campaign manifestos; and individual candidates would have to take a stand in their local constituencies. As a consequence, a European Parliament with full legislative powers (including the power of legislative initiative) could not avoid putting the present euro regime and its continuation on the European political agenda.

If that were to happen, however, the politicized conflicts over economic and social interests and over normative claims to solidarity and distributive justice could not be settled with democratic legitimacy on the European level (Streeck 2015). As I have argued in a related paper (Scharpf 2016b), fundamental conflicts of interest, values, and identity cannot be resolved in consensus, and if a solution were to be imposed by majority rule under the *no-demos* condition prevailing in the European polity, the outcome would be resisted as an unjustifiable exercise of tyrannical power. If the goals, means, and foreseeable consequences of the present euro regime had to be determined in public debates among democratically accountable representatives on the European level, then, in effect, the Monetary Union in its present shape could not survive. Since a democratic European Union could not keep this fundamental conflict from the European political agenda, it also follows that whoever is presently committed to the preservation of the Monetary Union should not, at the same time, advocate the further democratization of European policy making.

In short, the present euro regime can only be maintained through a depoliticized technocratic regime on the European level that is supported by asymmetric intergovernmental bargaining power and the force of existing European law. It may, of course, founder not only economically but also politically as protests and adverse election results may force some member states into open noncompliance or exit from the EMU. In that sense, the present euro regime is not merely an economic gamble, as I said above, but also a political gamble on the bet that economic convergence will succeed visibly and in time to avert political explosions that may destroy not only the Monetary Union.

22 These requirements do not presuppose first-past-the-post elections in single-member districts. They can also be met in systems of proportional elections where the total number of seats won by a party depends on its share of total votes, but where all candidates must stand locally and must succeed on their local votes.

5 Searching for more symmetric modifications of the present regime

The paragraph above expresses the dismal conclusion of my attempt to assess the economic and political implications of the eurozone's monetary regime in its present form; and the paper could properly end there. However, on the basis of what I have learned in the process, I find it useful to continue instead with some informed speculation about the economic and political feasibility of modifications or alternatives that are being presently discussed or, in my view, ought to be discussed.

In this exploration, I will not include the official or semi-official proposals for a further tightening of the screws of the present regime through more automatic sanctions and a further "transfer of sovereignty" to the President of the Eurogroup or a European finance minister with the power to intervene directly in national budgetary and legislative processes. In my opinion, this form of deepening technocratic integration would only increase the risks of a political explosion implied by the present regime. Similarly, I will not discuss those presently unrealistic visions that hoped to exploit the euro and the euro crisis (and now, Brexit) as an opportunity for moving further toward a European "Political Union" and ultimately a federal "European Republic" with all the taxing, spending, and regulatory powers (and the democratic legitimacy) that are needed ensure the economic, social, and political sustainability of the EMU (Collignon 2003, 2013; Bofinger et al. 2012). Instead I will focus on seemingly pragmatic proposals that would maintain or restore the institutional framework of the EMU but would introduce important modifications of the present regime that are thought to avoid or ease the present North–South asymmetries and conflicts.

Back to no bail-out rules?

The first such option is a call to return to the Maastricht rules. In a scathing critique of the counterproductive economic and antidemocratic political effects of the mismanaged euro crisis, Martin Sandbu (2015), an editorial commentator at the *Financial Times*, still considers the euro worth keeping. In his view, the present malaise has not been caused by basic flaws of the single currency but by the disregard of Maastricht rules. eurozone policy makers were wrong to encourage (or, in the Irish case, to force) governments to rescue overextended private banks, and they were even more wrong to then prevent state insolvency and to impose tight fiscal constraints on the recipients of rescue loans. In effect, the euro regime has opted to preserve the sanctity of the stock of outstanding debt (and thus the interests of private creditors) and to reduce the flow of new credit that could have generated economic recovery. What would have been needed instead were insolvency procedures and bail-ins of the owners and creditors of private banks and a radical restructuring of the sovereign debt of insolvent states.

In other words, the single currency would be in better shape if the Maastricht prohibitions against financial bail-outs and monetary state financing had been strictly observed, rather than circumvented after 2010. Even now it would be better to scrap the ever tighter controls over an ever wider range of national policy choices imposed by the present euro regime. Instead, politically accountable national governments should be responsible for the viability of their economies and the liquidity of state finances within the common currency, and future creditors should be made aware of the ultimate risks involved. In Sandbu's view, a return to the rules of the original Treaty would point the way toward a politically stable and economically prosperous future of the eurozone.

In economic terms, of course, this gold-standard solution would only work if Southern political economies were able to autonomously generate the same internal devaluation which the present euro regime is trying to impose – except that the discipline would appear to be self-chosen because sanctions would be inflicted by anonymous market forces,²³ rather than by the Commission, the ECB, and the Eurogroup Council. Politically, however, the feasibility of this proposal (as of all proposed alternatives to the present regime) would depend on unanimous agreement. It is hard to see why Southern governments, after all the sacrifices that they have already been forced to make under the present regime, should opt for an alternative that would not loosen economic constraints but remove the present protections against state insolvency. Likewise, on the Northern side, it is hard to see why governments should want to replace the direct controls of the present regime over the solvency of debtor states with a solution that implies the risk of having to write off the huge public- and private-sector creditor positions that have accumulated in the meantime.

Forward to the transfer union?

While conservative proposals moving the EMU back to a strict enforcement of the Maastricht prohibitions appear politically unpromising, there may be less of a constraint for moves in the opposite direction toward solidaristic North–South burden sharing. Even though all suggestions of a “transfer union” will provoke immediate protests in Berlin, they find political support not only in the South but also in the European Parliament and among pro-European and/or center-left political parties and publics elsewhere. Moreover, Commission economists and the ECB are responsive to efficiency-oriented and fiscal-federalist theoretical arguments favoring the widening of risk pools in banking resolution, deposit insurance and unemployment insurance, the mutualization of state liabilities through euro bonds, and the potential growth effects of a much

23 From a democratic-theory perspective, that would indeed make a difference. Democratic self-government is compatible with having to cope with external obstacles, challenges, and hard times, but it is not compatible with being bound by the decisions of an external authority (Pettit 1997).

larger “Juncker fund” supporting “strategic investments.” Quite apart from technical arguments favoring the efficiency of risk sharing, economies of scale, and the potential gains from cooperation, there are also widely appealing normative arguments supporting solidaristic burden sharing among the member states of the European Union (Sangiovanni 2013; Tsoukalis 2016; Stiglitz 2016; Ferrera 2016). More specifically, if the problems of the Monetary Union are defined as consequences of an ill-designed venture that was jointly undertaken in the expectation of mutual gain, standard arguments in legal and moral theory would also suggest that a grossly uneven distribution of the costs of failure should justify claims for compensation.²⁴

On a more pragmatic political level, such moral arguments and political demands are primarily directed at Germany, the member state with the largest economy that, at present, is also seen to be the greatest beneficiary of the EMU. Even though George Soros and some economists have suggested that the eurozone would benefit most from a German exit, it seems clear that, for political reasons, Germany is least able to renounce its commitment to any symbol of European integration. But that also implies that its underlying bargaining position would be quite weak if European authorities and governments in the Eurogroup should seriously push for more expansion, burden sharing, and redistribution²⁵ – even in the absence of concessions to the habitual German demands for progress toward a “Political Union” (Bauer/Becker 2014; Kundnani 2014; Story 2014). In future crises, in other words, Germany may not be able to resist demands that would gradually transform the present euro regime into one where acute Southern economic and political problems would call quasi-automatically for the relaxation of present rules and for compensation through more burden sharing.

Although a transfer regime might not only have moral support but could also in time become politically feasible, its economic and political implications are likely to be unfortunate for Southern political economies and for the eurozone as a whole. Fiscal transfers would, of course, be better than the mere relaxation of fiscal constraints or even rescue loans because they would not themselves increase public-sector indebtedness and, hence, the vulnerability of recipients to negative ratings on international capital markets. The main objection is, however, that all these proposals would directly counteract the justifying purpose of the present euro regime – its promise to ensure the sustainability of the Monetary Union and also the international viability of all its member states through the enforced structural transformation of Southern political economies.²⁶

24 After German unification, similarly, a decidedly non-nationalistic argument for West–East equalization appealed to the fact that both parts of the country had started and lost the war together.

25 Such demands, coming especially from Italy, seem to be on the increase at present (Goodman 2016).

26 That problem would also affect proposals envisaging other sources of non-debt fiscal expansion, such as “helicopter money” and other versions of direct monetary finance (Turner 2016: ch. 14) or of “GDP bonds” that would simulate a form of equity-based state financing (Brunnermeier et al. 2016: 115, 385).

Whatever form such proposals may take – relaxed austerity rules; financial support for state budgets, social insurance systems, or private banks; direct investments in public infrastructure or subsidies to private investment or straightforward revenue sharing – they all would increase aggregate domestic demand and reduce the pressures of structural adjustment. They will thus perpetuate the structural inhibitions to convergence on the Northern model. Therefore, under the conditions of a continuing Monetary Union, the likely outcomes would resemble those of the Italian Mezzogiorno and of East Germany – that is, regions that after seventy-five years of North-South transfers and twenty-five years of West-East transfers, respectively, have not yet attained economic self-sufficiency and whose social viability continues to depend on the generosity of external contributions (Streeck/Elsässer 2016).

In other words, economic asymmetries and political dependence would be perpetuated. At the same time, overall economic growth would be impeded as a consequence of the financial burdens imposed on Northern economies.²⁷ Nevertheless, if the Monetary Union must be preserved, a transfer union may well become politically feasible or even inevitable, and it would surely be preferred by many over a continuation of the present regime of forced structural convergence. That is not meant to say, however, that it would open the path toward an economically, socially, and politically attractive future for the eurozone.

Reducing Northern surpluses²⁸

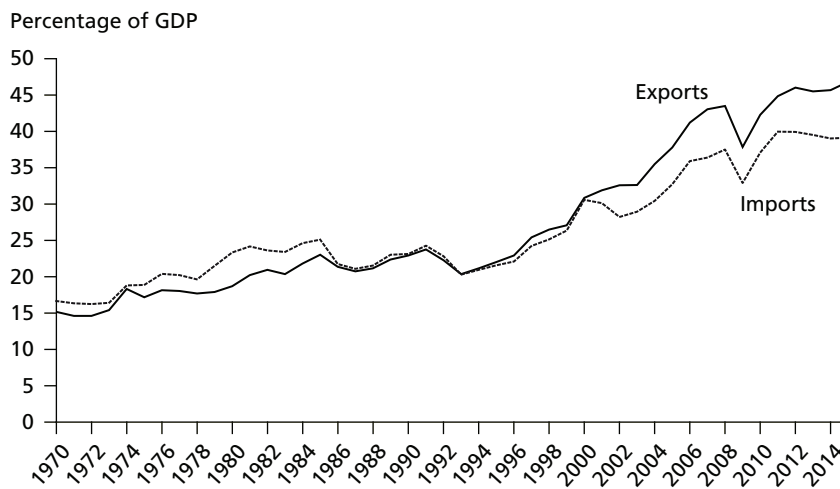
The present regime is asymmetrically designed to achieve structural convergence in the eurozone by constraining domestic demand and reducing labor costs in Southern political economies. Since their purpose is to overcome the *structural* causes of excessive external deficits, these constraints must be maintained even though practically all Southern economies are presently achieving external surpluses. Nevertheless, as Southern deficits have declined, critical attention has been shifting to the much bigger surpluses which Germany and the Netherlands have continued to accumulate. In this discussion, the focus is not on fiscal redistribution but on more symmetric rules enforcing convergence. It is assumed that the distance to be covered by Southern adjustment would be reduced by structural adjustments in the North.

In the abstract, this does not appear implausible. In the EMS, currency realignments would have been less frequent if the Bundesbank had been less stability-fixated. And even if it is not assumed that in the EMU Southern deficits would completely disappear

27 As governments could not simply confiscate current account surpluses, transfers would have to be paid for through tax increases and spending cuts, which would reduce domestic demand in the North.

28 The following section has benefitted greatly from discussion with my colleague Martin Höpner.

Figure 6 Imports and exports as a percentage of GDP, Germany 1970–2015



Source: OECD.

if Northern current accounts were in balance (which would only happen if the eurozone were a closed economy),²⁹ surpluses must be matched by deficits somewhere. Moreover, Northern surpluses are pushing up the euro exchange rate, and they had facilitated the credit flows that financed Southern deficits after 1999. Hence, if Germany (and other Northern economies) were to export less and import more, the burden of Southern adjustment would be lightened.

So what are the causes of persistent trade surpluses³⁰ in the eurozone, and what are the measures that could reduce them under the present euro regime? In this context, a look at the historical record of the German trade balance suggests an interesting narrative and a plausible explanation for the persistence of German surpluses in the Monetary Union (Figure 6). The figure is revealing in several respects. Historically, the German export sector was quite small, smaller even than in Italy and France in certain periods (Figure 3). The increase was slow from 1970 to the end of the 1980s but, after a decline caused by German unification, the increase has been significantly steeper from about 1993 onward. The reasons for this sudden (and exceptional) steepening of the export trajectory after the fall of the Berlin Wall are interesting (Scharpf 2017), but need not be explored here. What matters is that, throughout the period from 1970 to 1999, German imports either exceeded exports or rose roughly in step with them. Trade surpluses, if they occurred at all, were short-lived and quite small. The dramatic change came after

29 The share of total German exports going to the eurozone declined from 45 percent in 2004 to 36 percent in 2015, whereas the share of imports from the eurozone declined from 42 percent to 37.5 percent (BDA 2016).

30 Current account balances reflect not only imports and exports of goods and services but other trans-border payments as well, whose external economic impacts are less clear and which I will not consider here.

1999, when imports fell significantly behind the unchanging rise of exports and when subsequently the gap even widened instead of closing again.

Trade deficits after the early 1970s had been a consequence of rising DM exchange rates in an inflationary international environment (Scharpf 1991). They had dampened the price competitiveness of German exports and increased the price attractiveness of imports (including tourist travel). After the decline of international inflation in the mid-1980s, however, Germany saw a roughly parallel increase of both imports and exports until 1999. With regard to the present problem, Figure 6 thus suggests that the rise of the German trade surplus after 1999 and its persistence should be seen as an effect of the elimination of exchange rate adjustments in the Monetary Union.

Moreover, the figure also seems to suggest that the German trade surplus did not come about by the impact of EMU on German exports.³¹ In any case, the share of exports in German GDP continued after 1999 to rise on roughly the same trajectory that had steepened in the mid-1990s. But EMU seems to have had a manifest impact on German imports.

The explanation appears to be quite straightforward: Germany had entered the EMU as the “sick man of Europe” in an extended recession with unemployment rising to 11.5 percent in 2005 – and thus with stagnating wages. Moreover, the government reduced unemployment benefits and social spending in order to correct its violation of the Stability Pact’s deficit rule.³² As in all recessions, therefore, domestic demand and hence imports took a plunge, while exports continued to rise as before. Before the EMU, an export–import gap of this magnitude would then have been closed by a significant rise of the nominal exchange rate, which would once again have dampened exports and lowered import prices. But as this correction was no longer available, the gap continued and even widened subsequently. In that sense, the rise and persistence of the German trade surplus since 1999 was and still is a consequence of the Monetary Union.

If this interpretation can be sustained by a more comprehensive analysis of the factors involved (which I cannot provide here), and if it is also assumed that the burdens of Southern adjustment would be reduced if this gap could be closed, potential measures aiming at more symmetrical adjustment could focus either on reducing German exports or on increasing German imports, or both. The former would favor a supply-side perspective on reducing export competitiveness, whereas attempts to increase German imports would generally favor a demand-side perspective.

31 If there had been an effect, the export trajectory should have risen more steeply after 1999.

32 In other words, the German response to the recession provided the perfect model for the present euro regime’s generalized requirements of fiscal austerity and internal devaluation.

Raising unit labor costs

The present discussion is generally dominated by the supply-side perspective. When the Commission (2010) first turned its attention to external imbalances, it focused on the relative rise of unit labor costs in deficit economies – which were blamed for a loss of international export competitiveness and thus for the rise of external deficits and for the subsequent state credit crises. Even though this explanation is now seriously challenged by a demand-side interpretation (Wyplosz 2013; Sanchez/Varoudakis 2013; Jones 2016),³³ it continues to shape the rules and measures addressed to Southern economies in the present euro regime. The same supply-side frame, however, is also shared by most authors discussing German export surpluses, except that their focus is now on below-average increases of unit labor costs and excessive union wage restraint in Germany, rather than on excessive increases of Greek or Spanish unit labor costs (see, e.g., Stockhammer 2011; Flassbeck/Lapavistas 2013; Bofinger 2015; Baccaro/Pontusson 2016; Stiglitz 2016, 41–43, 104–106).

Even if it could be shown that the exceptional rise of German exports after 1993 was primarily caused by union wage restraint – rather than by the fit between the German specialization in investments goods and the demand of expanding markets in Eastern Europe and China after the fall of the Berlin Wall (Wierdsma et al. 2013; Storm et al. 2016) – rising exports would not have generated (and did not generate until 1999) trade surpluses if imports had kept up with them. Hence, as long as it is assumed that it is indeed trade surpluses that may create problems for other economies,³⁴ their proximate cause appears to be the uncorrected decline of German imports. To the untutored mind, this suggests that a more symmetric euro regime should also address factors that can be expected to have a direct effect on aggregate demand, in general, and on the demand for imports, in particular. In fact, however, the focus is mainly on wages and on the international coordination of wage increases.

There is, of course, no question that rising real wages, unless they are saved, will also increase consumer demand; and rising unit labor costs, if they are passed on to product prices, will not only dampen exports but will also improve the price competitiveness of imports vis-à-vis domestic products on the domestic market. But the wage increases discussed in present proposals for voluntary or compulsory wage coordination are in fact quite moderate. In all eurozone economies, wage bargaining is supposed to apply a “golden rule” according to which the percentage increase of annual wages should correspond to the sum of national productivity increases plus the ECB’s targeted inflation

33 In the demand-side narrative, the causal chain starts with the dramatic decline of Southern interest rates in the run-up to the EMU, generating credit-financed domestic demand, increasing economic activity and employment in the sheltered sector, leading to rising imports and external deficits and finally also to rising wages in the exposed sector.

34 In the literature cited, it is not always clear whether the problem to be resolved is really the existence of export *surpluses* or simply the rise of German export *competitiveness* that is reflected in rising export shares in GDP.

rate (Pusch 2011; Flassbeck/Spiecker 2011; Flassbeck/Lapavitsas 2013). The implementation of such a rule is considered to be institutionally very difficult (Hancké 2013: ch. 3; Höpner/Lutter 2014). But even if it were pragmatically feasible, productivity-oriented wage coordination would take a very long time to remove external imbalances in the eurozone.³⁵

In other words, in order to alleviate the economic, social, and political burdens of Southern adjustment in the short and medium term, German wage increases in the export sector would need to significantly exceed the golden rule. In that case (assuming that employers and unions could be forced to comply), the countervailing impact on imports could not be ignored. Once exports were beginning to be challenged, the perceived threat of large job losses in the exposed sector would be likely to reduce domestic demand by pushing up household savings. In the deep crisis of 2009, for example, Figure 6 above shows that the decline of imports paralleled the decline of exports, even though an increase in unemployment had been avoided by labor hording in industry and massive job-protecting government interventions. But if the excessive rise of unit labor costs were adopted as a purposeful strategy to reduce German exports, there would be no labor hording in industry, and the government should not intervene to save jobs. Thus, given the large size of the German export sector and the low level of unemployment benefits, consumer demand and hence imports would decline significantly.

If wage increases could be focused on the sheltered sector instead, rising household incomes would be less likely to increase unemployment if price increases could be passed on to domestic consumers. In the public sector, however, where unions might be happy to fight for big wage increases, they are confronted with employers on the regional and local levels who, under the constraints of German fiscal federalism, have practically no control over their revenues – so that excessive wage gains exceeding given budget constraints would again entail job losses. In private-sector services, by contrast, some specialist unions organizing airline pilots or locomotive drivers are indeed highly effective in driving up their wages, but in general, service-sector unions are weak, and the bulk of temporary, part-time, and agency workers in low-wage services are practically not organized at all and have only recently come to benefit from the wage floor of a general minimum wage law.

Deficit spending and consumer credit

If wage increases significantly above the “golden rule” appear pragmatically unpromising, the German trade surplus might still be reduced through other measures that may increase aggregate domestic demand. Thus, when the Commission (2014a) finally took notice of German current account surpluses, it suggested good reasons for increasing

35 In the estimate of Flassbeck and Spiecker (2011: 186), the effective convergence of unit labor costs under golden-rule wage coordination would take at least another decade.

public investments and publicly financed employment in healthcare, education, and social services and for reducing non-wage labor costs in low-wage private services. In the third year of (small) public-sector surpluses, Germany could indeed afford some fiscal reflation. But even though analysts close to the government emphasize an urgent need for greater investment in public-sector infrastructure (Fratzscher 2015), and even though capital market theorists are insisting that the public sector ought to run a deficit since industry and households are presently in surplus (v. Weizsäcker 2014), not much has been happening. In fact, not much should be expected.

One reason is institutional. As was mentioned before, in German fiscal federalism, local and regional governments have practically no control over their own revenues. At the same time, however, the largest block of public infrastructure investments and practically all public and social services are provided and financed at the local and regional levels – and with very narrow constitutional constraints on federal subsidies (Wieland 2012). Hence, even if the federal finance minister were willing to ignore the fetish of the *schwarze Null*, a deficit-financed expansion of public-sector investments and services would be much more difficult to implement in Germany than it is in more centralized fiscal constitutions. The same would be true for significant tax cuts – which would, under the German system of revenue sharing, further constrain the resource base of struggling local and regional governments.

Another reason is ideological: public-sector deficits have bad press in Germany, where the Left and the Right tend to agree in principle that the state ought to be financed through taxes. Whereas conservatives may want to restrict the expansion of state functions, social democrats worry about the dependence of the state on private capital and about bottom-up redistribution if capital incomes must be paid by taxes on labor and consumption. Even though these in-principle preferences did not prevent massive fiscal reflation in 2008/09 to rescue banks and the automobile industry in the Great Recession, the idea that Germany should run a permanent budget deficit in order to compensate for external imbalances in the rest of the eurozone would be considered absurd by public opinion and by a government that just recently constitutionalized balanced-budget rules in German federalism and pushed EU member states to do the same under the Fiscal Compact.

If public-sector deficit spending is thus unlikely to generate a significant expansion of domestic demand, recommendations might focus on household demand. In comparison to Germany, credit-financed consumer spending has been shown to explain the better growth and employment performance of the British economy from the mid-1990s to the mid-2000s (Baccaro/Pontusson 2016). Unfortunately, however, German policy makers are more aware of the fact that easy credit in the UK – as in the United States, Ireland, or Spain – financed a housing boom that ended in a crash after 2007. In any case, German households appear to be much more resistant to the lure of consumer credit. Even though interest rates are now at an all-time low, the maxim of “*erst sparen, dann kaufen*” (Daniel Mertens 2015) still seems to shape German patterns of private

borrowing and saving. Since recent reforms to ensure the fiscal viability of the welfare state have greatly reduced the safety nets of unemployment benefits and of public pension insurance (Hassel/Schiller 2010; Carlin et al. 2014), it is hard to see what the government could now do to make households spend more and save less. That is pretty much also true for investments in industry which, if they are undertaken at all, are more likely to finance the outsourcing of production from high-wage Germany to lower-cost locations in Central and Eastern Europe or to the Far East (Dustmann et al. 2014).

*The option that is ignored: Import taxes*³⁶

The conclusion so far is disappointing: a more symmetric euro regime might help to ease the burdens of Southern adjustment and accelerate structural convergence in the eurozone through measures that would also reduce Northern – in particular German – trade surpluses. Unfortunately, however, the strategies that are generally considered do not seem to offer much hope. Wage increases exceeding the “golden rule,” sustained fiscal reflation, or policies stimulating credit-financed consumer demand and business investment appear to be either economically counterproductive or ineffective under present German conditions.

But does the focus on increases of unit labor costs and deficit-financed spending in fact exhaust the policy space in which an effective reduction of trade surpluses could be pursued? In my discussion of Figure 6 above, I have tried to identify the proximate cause of the rise of the German trade surplus in the early 2000s. What changed when Germany entered the EMU was not the rise of exports but the failure of imports to recover from their normal decline in a recession. In previous decades, this recovery would have been brought about by the quasi-automatic rise of the nominal exchange rate in a recession – which was now disabled among eurozone economies.

If this explanation is valid, it would also suggest the need to search for measures that could simulate the effect of exchange-rate realignments on trade balances. With regard to the German surplus in particular, what might have worked are measures simulating a rise of the nominal exchange rate in order to reduce the price of imports in relation to domestically produced goods. One such possibility might be the introduction of tradable “trade chits” – that importers would receive and exporters would have to acquire, or vice versa – which Joseph Stiglitz (2016, 287–289) proposed as an economically efficient instrument for correcting external imbalances in the eurozone.

Similar effects could be achieved even more simply within the existing VAT border regime that is needed to neutralize the effect of differing national tax rates on imports and exports. If a persistent German trade surplus is considered a major problem, the

36 The following suggestions have benefited from comments by Lucio Baccaro, Anna Berger, Hansjörg Herr, and Martin Höpner – who are nevertheless in no way responsible for them.

attractiveness of imports could be increased by simply applying a lower VAT rate. Whereas a rise of the nominal exchange rate would affect transactions with the rest of the world, the reduced VAT rate could be targeted more narrowly at imports from eurozone economies. Moreover, implementation would hardly increase transaction costs under the present VAT border regime.³⁷ Hence, variable VAT rates for trans-border trade in the eurozone³⁸ would indeed appear to be a relatively simple and direct tool for easing the burdens of structural transformation in a more symmetrical euro regime.

Of course, apart from probably violating present EU rules, this demand-side solution would also entail some substantive problems. If it is effective, the increase of imports would to some extent reduce import-competing domestic production which, through the rise of unemployment and increased saving, might in turn constrain aggregate demand and hence imports. Moreover, if the tax variations were permanent, they could produce undesirable structural effects – constraining the growth of the domestic sector in Germany and protecting inefficient export industries in the South.³⁹

In comparison to the present supply-side euro regime, however, variable VAT rates on trans-border imports and exports would also have several advantages. In economic terms, the effect is both more direct and, since it is operating through the system of relative prices, much less intrusive. In political terms, the variation of import and export taxes is likely to be less salient than direct interventions in national budgets, social legislation, or wage-setting institutions. And in comparison to proposals for wage coordination, the solution would not interfere with the autonomy of national wage-setting institutions. In light of these comparative advantages, it seems puzzling that the idea of variable VAT rates for imports has played absolutely no role in discussions castigating the amorality of German trade surpluses. One reason might be fatal flaws that are obvious to everybody except me. Or it could be that persistent German trade surpluses are not in fact seen as a significant problem for Southern economies. Or, finally, the proposal might violate a taboo that is so powerful that it prohibits discussion.

Indeed, the commitment to a common market free from tariffs and measures of equivalent effect has been the cornerstone of European economic integration right from the beginning in the Treaty of Rome. If it were accepted that trade imbalances could be moderated by variable taxes on trans-border trade, one might also be tempted to invent similar instruments to moderate the corresponding capital flows – or to impede capital flight and its disastrous impacts on banks and the real economy. In other words, if it

37 Technically, commercial importers would have to pay a lower VAT rate on imports, whereas exporters sending goods to private importers would add the lower German rate to the price charged.

38 Exactly this type of *Ersatzaufwertung* (substitute for an upward revaluation) was adopted by the German government in November of 1968 to combat “imported inflation” by a 4 percent variation of export and import taxes.

39 Undesirable structural effects might be minimized by introducing the variation of import VAT rates as a temporary measure with a degressive schedule.

were at all allowable to think about functional equivalents to the variation of nominal exchange rates, one would be on a slippery slope, at the bottom of which – in the words of a shocked colleague – one might “save the Monetary Union by sacrificing the Internal Market.”

That may indeed be the crucial issue. But if it is unthinkable that the “Four Economic Freedoms” could be compromised, it also follows from the arguments presented here that the EMU can only be stabilized by maintaining the present asymmetrical euro regime and the compulsory structural transformation of Southern political economies. In other words, the EMU and the sacralized principles of the Internal Market can only be saved jointly by intentionally destroying the democratic legitimacy, the social cohesion, and the life chances of the younger generation in Southern polities. If these consequences were well understood, Southern governments, left-of-center political parties, and pro-European publics might perhaps be more willing to question their unconditional adherence to the EMU.

6 Differentiated monetary integration in a European Currency Community

At present, there are two plausible fears which may explain the fundamental loyalty to the EMU even in the face of deep dissatisfaction with the impact of its present regime. The first is the belief that proposals for institutional change would necessarily amount to the destruction of the whole Monetary Union. There is, however, no need to abolish the common currency for those Northern and Eastern political economies whose interests and political preferences are well-served by it, or for member states that are politically committed to continue on a course of structural transformation under external supervision (Ferrera 2016). The second concern is the fear of economic and political isolation of countries that might otherwise be better off outside of the EMU. It is these fears which the following discussion primarily seeks to address.

Under present conditions, an individual exit from the common currency is indeed not an economically and politically viable option. Though its designers did not know how to make EMU work, they were devilishly clever in making it nearly irreversible. Even though in retrospect the move from the EMS to the EMU may be seen as a dreadful mistake, its reversal is almost universally ruled out by the anticipation of horrendous transition costs and irresolvable uncertainties (Tsoukalis 2016). Indeed, the designers of the EMU have done all they could to make membership irrevocable. Under the present rules, exit may happen as a disaster, but it is not a policy option that could be chosen by responsible governments as a lesser evil, no matter how devastating the euro regime’s impact is on its economy or society.

But these conditions could be changed.

In addition to creating a formal right to leave the EMU without having to leave the EU, the feasibility of orderly exit presupposes at least three bodies of rules that would deal with state insolvency, with exit procedures, and with subsequent relations between exiting states and the EMU. None of these rules are likely to be designed well under the pressure of an acute crisis. Hence, they ought to be discussed and adopted in relatively calm times as precautionary amendments or additions to the general rules governing the eurozone.

Rules for state insolvency and “amicable divorce”

With regard to the first requirement, discussions about rules for state insolvency have been under way for some time on the international level (International Law Association 2010), and it should be possible to adapt these to the restructuring of excessive public-sector debt under conditions of the eurozone. A more difficult challenge will be the second requirement of procedures and rules facilitating the orderly exit of a member state from the EMU. To minimize repercussions in global capital markets, it would be highly desirable to avoid the uncertainties of controversial and long-drawn-out “Brexit-type” bargaining. It might thus be helpful to construct a small set of pre-defined “exit models” with well-balanced rules for different types of problem constellations. They all would need to include procedures for the transition to a national (or parallel) currency, for the treatment of public and private debts defined in euros, and for financial, legal, and procedural support during the transition period. While I lack the expertise to suggest specific solutions, I am encouraged to see that knowledgeable economists of very different theoretical and political persuasions appear to be quite sanguine about the availability and effectiveness of practicable options that would reduce the transition costs of a country’s exit from the EMU through a cooperatively managed “amicable divorce” (Stiglitz 2016: ch. 10; Sinn 2014, 2015: 480–492, 2016: 306–309).⁴⁰

Learning from the faults of the EMS

Even more important may be the third requirement of an economically and politically viable regime governing the future relations between exiting economies and the remaining EMU. It would have to be clear (which at present it is not) that leaving the EMU does not conflict with continuing membership in the European Union. Even then,

40 Like George Soros, Mervyn King, and other economists, Stiglitz (2016: 292–203) also suggests that transition would be much easier if Germany and other Northern economies would exit the EMU instead. In my view, this would be politically impossible. But Germany should have an interest in a smaller, structurally more coherent, economically more stable, and politically less conflict-ridden eurozone – and, hence, should be willing to facilitate the transition to a more flexible monetary regime (Sinn 2014; Scharpf 2015).

however, the prospect is bound to provoke disturbing concerns about the post-exit fate of economies that continue to depend on integration in the Single Market: They might suddenly have to cope on their own with turbulent capital markets and with speculative exchange-rate fluctuations that could wreak havoc on the viability of economically interdependent national industries and that might also trigger vicious price-wage-devaluation spirals that could overwhelm all national efforts at stabilization. With regard to these fears, however, promising solutions can be derived from a re-examination of the achievements and the deficiencies of the monetary regime that had preceded the EMU.

Before the post-unification crisis of 1992, the EMS regime of pegged but adjustable exchange rates had succeeded in achieving three purposes. It had helped reduce average inflation rates in Europe by obliging member states to use monetary and fiscal policies in order to keep their currencies within 75 percent of the agreed-upon exchange-rate bandwidth. At the same time, its Exchange Rate Mechanism (ERM I) had protected member currencies against short-term imbalances and speculative attacks by (symmetrically!) obliging central banks to intervene in currency markets in order to maintain the upper and the lower limits of their respective exchange-rate corridors. And finally, it had prevented the rise of persistent trade imbalances by allowing for agreed-upon currency realignments (Artis/Taylor 1993).

After an initial period of frequent adjustment, the EMS worked reasonably well, not only in dampening currency fluctuations and inflation rates but also in achieving a pattern of nominal exchange rates that reflected economic fundamentals and avoided the dynamic divergence of real effective exchange rates and the emergence of persistent external imbalances. The regime was vulnerable, however, because it lacked a central bank that was committed to the common interest. As exchange rates were defined pairwise between all national currencies, the Bundesbank in charge of the largest and hardest currency came to play a dominant role in all adjustments. Moreover, it had been allowed to insist – in the famous “Emminger letter” (Tietmeyer 2005: 79–80) – that it would not have to engage in monetary policies and currency interventions that might conflict with its basic commitment to price stability in Germany. As a result, the symmetry of interventions was incomplete, and currency realignments were more frequent than they otherwise would have been.

These had to be adopted through difficult and often highly confrontational intergovernmental negotiations (Marsh 2009; Höpner/Spielau 2015) in which Germany was typically forced to accept greater DM revaluations than was good for its domestic growth (see Figure 5 above). After 1987, however, revaluations were ruled out in the quest for even greater exchange-rate stability. When the Bundesbank then chose to brutally clamp down on the German post-unification boom, it triggered major crises in other member states which in fact destroyed the EMS (Marsh 2009).

The critical design fault that destroyed the Exchange Rate Mechanism (ERM) of the EMS has been corrected in its successor regime, the ERM II. It was created on January 1,

1999, for European states that would not immediately join the Monetary Union. Although all of its onetime members, except for Denmark, have now entered the EMU, the institutional framework of the ERM II still exists, and it remains available for new accessions. It differs from the ERM I in two crucial respects: the ECB retains its role as the central bank for the system as a whole, and the “central exchange rate” of a member currency is defined in relation to the euro, rather than in a network of bilateral rates among all currencies. As a consequence, market interventions to stabilize the exchange rate of a member state are also negotiated between its national central bank and the ECB, rather than among all national banks.

Under ERM II rules, currencies are presently allowed to fluctuate up to 15 percent above and below their agreed-upon “central exchange rate.” This wide bandwidth, which was introduced after the EMS crisis of 1992, may be narrowed by agreement so as to circumscribe the politically desired action space of national macroeconomic management. Hence, if the central exchange rate is initially set to correspond to the underlying economic fundamentals, stabilizing interventions in international currency markets should be required only in defense against speculative attacks – which, however, are likely to be deterred by the ECB’s quasi-unlimited fire power. Nevertheless, there have been a few cases of agreed-upon revaluations of currencies in the history of the ERM II (Commission 2014b). Thus, exchange-rate adjustments in response to persistent imbalances and changes in the underlying economic fundamentals continue to be available as well.

Toward a two-level European Currency Community

Until now (and except for Denmark), membership in ERM II has been a trial period in which candidates for EMU membership had to achieve perfect exchange-rate stability with the euro. Hence, even if present rules remained in place, the regime would change its function if it were to become part of a “European Currency Community” (ECC) that may permanently include two types of member states – those belonging to the EMU and those whose currencies are related to the euro through the ERM II. In spite of the heterogeneity of its membership, however, the ECC would be a most powerful player on the global scene. All of its member currencies would form a large “euro block” with the euro itself at the center and ERM II currencies connected to it by agreed-upon exchange rates and commitments to mutual support against external attack. In other words, its currencies would float together in a global environment of flexible exchange rates, and the euro block, represented by the ECB, would negotiate as a unitary actor in international negotiations about global, multilateral, or perhaps bilateral currency regimes. Contrary to frequent apprehensions, therefore, Europe’s influence in international monetary affairs might even increase as a consequence of the ECC.

One reason for this would be the reduction of internal conflicts if present political tensions between Northern and Southern EMU states are resolved through flexible

coordination in a two-level system of monetary integration. In this context, the members of a more coherent EMU would benefit from the greater effectiveness of uniform ECB monetary policies and perhaps also from the closer coordination, envisaged by the “Presidents’ Report,” between the monetary, fiscal, and economic policies among structurally convergent economies. As mentioned above, opportunities for further political integration might also allow the EMU to move beyond the present constraints of a rigid hard-currency regime toward a wider range of macroeconomic options.

The members of ERM II, by contrast, would not be required to be economically coherent and structurally convergent. The system could include members like Greece and other Southern political economies for whom the present coercion to achieve structural convergence appears economically, socially, or politically intolerable. Other members might resemble Denmark, the only current participant in ERM II; for them, structural convergence on the Northern model and EMU rules may be economically unproblematic, but their sense of political autonomy and democratic accountability may not allow them to submit to the directives, controls, and sanctions of centralized European authorities.

Regardless of their diversity, however, they all would depend on economic exchanges in closely integrated European markets and hence would benefit from protection against speculative currency fluctuations. Moreover, some of them might benefit even more from protection against downward currency speculation in situations where they are trying to fight a wage–inflation–devaluation cycle. If the ECC were successful, both ERM II and EMU members would enjoy the economic benefits of being able to trade in the European economic space under nominal exchange rates reflecting the underlying fundamentals of their respective economies.

In order to enjoy these benefits, however, ERM II members would have to forswear the temptation of competitive devaluation. Both the central exchange rate and the permissible bandwidth would have to be set and could only be changed by agreement with the ECB, and willful noncompliance would entail exclusion from the ECC. In other words, membership in the ERM II would not relieve states from the discipline of having to manage the conflicting requirements spelled out in the Mundell–Fleming Trilemma.⁴¹ But it would allow them to use appropriate macroeconomic instruments and more political discretion in doing so. And they would retain the safety option of being able to ask for a readjustment of the central exchange rate in the case of massive changes in economic fundamentals.⁴²

41 The trilemma, identified independently by both authors at about the same time, suggests that fixed exchange rates, capital mobility, and monetary autonomy cannot be strictly maintained at the same time (Mundell 1963b).

42 Unfortunately, Finland, whose (highly competitive) economy is suffering from the collapse of Nokia and the negative effect of EU sanctions on export demand from Russia, did not have this option under EMU.

Under these conditions, it might not be utopian to think that not only Sweden, Poland, and the Czech Republic, but ultimately also Norway, Switzerland, and a post-Brexit UK might come to prefer ERM II membership to either joining EMU or struggling on their own in international currency markets. In other words, flexible coordination in the ECC could indeed contribute to European integration and an enhanced European weight in world affairs.

Assistance in transition

More immediately, however, countries like Greece – for whom EMU has become a prison regime with destructive impacts on the domestic economy, the welfare state, and the political system – would need assistance in making the transition to ERM II. The need for such support was explicitly acknowledged by the German finance minister in the last paragraph of his “non-paper” of July 10, 2015, in which the possibility of Grexit (described as a “time-out” from EMU membership) was suggested. It proposed that

The time-out solution should be accompanied by supporting Greece as an EU member and the Greek people with growth enhancing, humanitarian and technical assistance over the next years.⁴³

The size, form, and conditions of such support would have to be negotiated, of course. Nevertheless, its purposes are well identified in the paragraph cited: technical support would be needed to facilitate the installation of a new currency, and humanitarian support would have to assist the rebuilding of minimal public and social services in areas where they have been devastated by austerity requirements. However, the third item, “growth enhancing assistance,” requires comment.

In section 5.2 above, I argued against proposals amounting to a “transfer union” that would ease the burdens of Southern adjustment in the context of the present EMU. By relaxing the pressures of fiscal austerity and internal devaluation, transfers would counteract the purposes of structural transformation; and as long as competitiveness was not restored, subsidies to private investments could not induce sustained economic growth. Moral appeals to European solidarity would be undermined by expectations of economic futility. But once Grexit and nominal, rather than real, devaluation would establish the preconditions of external competitiveness, the availability of financial support for productive investments and essential imports could play the same positive role for economic recovery which the US Marshall Plan played in postwar German reconstruction after a massive devaluation of the Deutsche Mark in 1949 (!) (Abelshauser 2011, 140–152). In other words, claims to solidarity and burden sharing that invoke a

43 www.sven-giegold.de/wp-content/uploads/2015/07/grexit_bundesregierung_non_paper_10_juli_2015.pdf.

common responsibility for damages inflicted by an ill-designed Monetary Union (e.g., Sangiovanni 2013; Tsoukalis 2016; Stiglitz 2016) would at least cease to be economically counterproductive.

7 Conclusion

In June and July of 2015, none of the three preconditions postulated above were in place. There were no general rules for dealing with state insolvency and the restructuring of public-sector debt; there were no standardized procedures allowing a state to leave the EMU without jeopardizing its membership in the EU; and there was no institutional framework defining the supportive relationship between the EMU and membership in the ERM II. But if this institutional background had existed, is it still plausible to think that the Tsipras government would have preferred the humiliation of accepting the even harsher conditionalities of another rescue loan to the Grexit option suggested by Germany?

From a Greek perspective, moving from the EMU to ERM II would have allowed devaluation to an exchange rate corresponding to the country's international competitiveness. It would have reduced imports and facilitated exports without the ruinous contraction of aggregate domestic demand and internal devaluation imposed by the present euro regime.⁴⁴ Moreover, with the background guarantees of ECB interventions, the new exchange rate would be protected against speculative attacks triggering a spiral of devaluation, wage push inflation, and further devaluation. This would allow governments and unions to work out a social pact that would plausibly combine wage restraint and social policy commitments in a way that is compatible with sustainable economic growth. At the same time, this scenario would more plausibly allay geopolitical fears in Washington and Brussels than the continuing enforcement of structural convergence with its risk of political collapse could promise.

Beyond that, the institutional preconditions discussed would allow the evolution of a two-level European Currency Community. The first tier would include a structurally more coherent Monetary Union combining a core group of Northern political economies and other members of the present eurozone who might not wish to jeopardize the gains already achieved through painful structural transformation or may have intrinsic preferences for hard-currency policies and export-led economic growth. Their

44 Like internal devaluation, external devaluation would also leave the country poorer in comparison to its neighbors. But while the rise of import prices would affect all consumers, internal devaluation achieved through depressing wages and rising unemployment will have to be borne by wage earners alone. In both cases, however, the gain in competitiveness would be nullified through subsequent wage increases.

members would benefit from more effective macroeconomic management and from opportunities for greater institutional and political integration. The second tier of a future European Currency Community would include economies for which enforced structural transformation appears unrealistic or that have strong political preferences for a greater degree of autonomy in macroeconomic policy choices, but would still appreciate the benefits of reduced currency fluctuations and of mutual support against speculative attacks associated with membership in the wider community.

Even more important would be the benefits for European integration itself. Allowing member economies to grow in accordance with their structurally conditioned “growth models” would help to overcome the persistent economic stagnation of the eurozone. At the same time, replacing the rigid institutional shell of a Monetary Union with a flexible two-level Community, and replacing enforced structural convergence with coordination among different political economies, would defuse the potentially explosive North–South conflicts that cannot be politically resolved at the European level. Economically and politically, therefore, Europe would become not weaker but stronger, internally and externally, through the transition from the coercive European Monetary Union to a cooperative European Currency Community, a community that could unlock capacities for European cooperation and political action that are presently paralyzed by the need to suppress the politicization of an irresolvable conflict.

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