

The Economic Restucturing of the European Union in the Aftermath of the Great Recession

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Abstract

The main objective of the paper is to analyse the socio-economic transformation of the European Union in the aftermath of the financial crisis. The article attempts to render problematic the premise of the crisis responses by critically examining the recent macro-economic reforms that demonstrate the resilience of the monetary orthodoxy. The paper looks at the sovereign debt calamity, which should be read as the failure rather than the cause of the economic crisis, and the lack of a U-turn in the policy course of competitive austerity. The post crisis reforms, envisaged by the Fiscal Compact, the Six-Pack, the Two-Pack, and the Euro-Plus Pact, are characterised by an intensified disembedding tendency that has reified the neoliberal creed. On the one hand we have the appearance of a depoliticisation of EU politics because decisions are made in a technocratic manner, but at the same time there is an expression of power that is profoundly political in that those who proclaim the state of exception are setting the boundaries of the post-crisis political settlement, which is neoliberal 2.0.

1 Introduction

Recent years have witnessed an increase in the accounts that resort to Polanyi in order to explain the socio-economic transformation of the European Union. Contrary to the critical political economy literature (Apeldoorn, Drahakoupil and Horn, 2008; Overbeek and van Apeldoorn, 2012; Höpner and Schäfer, 2010) that identifies a never-ending marketisation in the EU project, some scholars (Caporaso and Tarrow, 2009; Copeland, 2009) proclaim the return of Polanyi to Brussels. This paper follows Burawoy's (2010: 312) advice for countering such optimistic accounts with 'uncompromising pessimism'.

Unlike the voices who asserted that the swinging of the pendulum from disembedded to embedded capitalism is upon us (Gills, 2009), this paper claims that the crisis has not heralded an end to the market society. Polanyi's (1944) double movement is predicated on contingent forces rather than automatic oscillations, thus one should avoid imputing transformative potential to the crisis when no countermovement has coalesced (Dale, 2012). Notwithstanding the short return to direct state intervention in the name of saving the banks, the neoliberal institutional separation of the market from societal regulation has remained intact. If anything the crisis has further deepened the monetary and fiscal integration in the EU with its distinct neoliberal design (Blyth, 2013, 2014; Lepavistas et al., 2013).

Rather than initiating a U-turn in the policy course of competitive austerity, the looming sovereign debt calamity, which should be read as the failure rather than the cause of the economic crisis (Brassett *et al.*, 2010), has propelled a deepened economic and fiscal integration along neoliberal lines. The idea of the self-regulating market is deeply ingrained in the recent austerity measures that further consolidate the neoliberal edifice. The post crisis reforms, envisaged by the Fiscal Compact, the Six-Pack, the Two-Pack, and the Euro-Plus Pact, are characterised by an intensified disembedding tendency that has reified the neoliberal creed. The recent reforms reaffirm the non-death status of the neoliberal creed. The politics around the construction of the crisis narrative and the subsequent solutions that it engenders, which many scholars persuasively argue are hardly related to the underlying problems, are very powerful evidence of the entrenchment of the monetary orthodoxy (Blyth, 2013, 2014; Krugman, 2012; Lapavistas *et al.*, 2012; Gamble, 2009).

Kauppi (2005) in his efforts of explaining the structuration process of the European political field emphasised that researchers should pay attention to the situational action that captures the temporality of history. In doing so, researchers should analyse the situational factors, like the opportunity moment or the *kairos*, which is distinct from the structure. One such *kairos* in our case was the Great Recession that created opening for a change of the neoliberal course. However, regrettably the recent economic crisis not only did it fail to play the role of a *kairos* capable of inducing a U-turn in the macroeconomic policy, but it further reified the monetary orthodoxy.

It is in the management of the sovereign debt crisis, whereby the peripheral states were wrongly accused of not introducing structural adjustments to their economies, that we best see how the 'partial eclipse' of the economic liberalism instigated by the crisis has 'enabled its defenders to argue that the incomplete application of its principles was the reason for every and any difficulty laid to its charge' (Polanyi, 1944: 149). Rather than the very design of the EMU, the first point of attack by the neoliberal apologists was the lavish collective agreements in the periphery and the labour market rigidities, which allegedly led to a crisis of competitiveness (Tsoukala, 2013). The article attempts to render problematic the premise of the crisis responses, which were justified by a successful fabrication of the facts by the same economic liberal thinking that advocated return to stable exchanges and balanced budgets during the interwar period as explained by Polanyi (1944).

The article starts with an examination of few key indicators that show the magnitude of the economic downturn followed by a critical appraisal of the Fiscal Compact. The third and the forth sections examine the fiscal profligacy myth and the actual causes of the crisis which can be found in the finance-led growth model respectively. The article continues with the discussion of the scaling up of the macro-prudential policy regime. The seventh and eight sections address the structural problems with the Eurozone and the reasons why austerity does not work respectively. The article concluded by examining the ECB responses to the crisis.

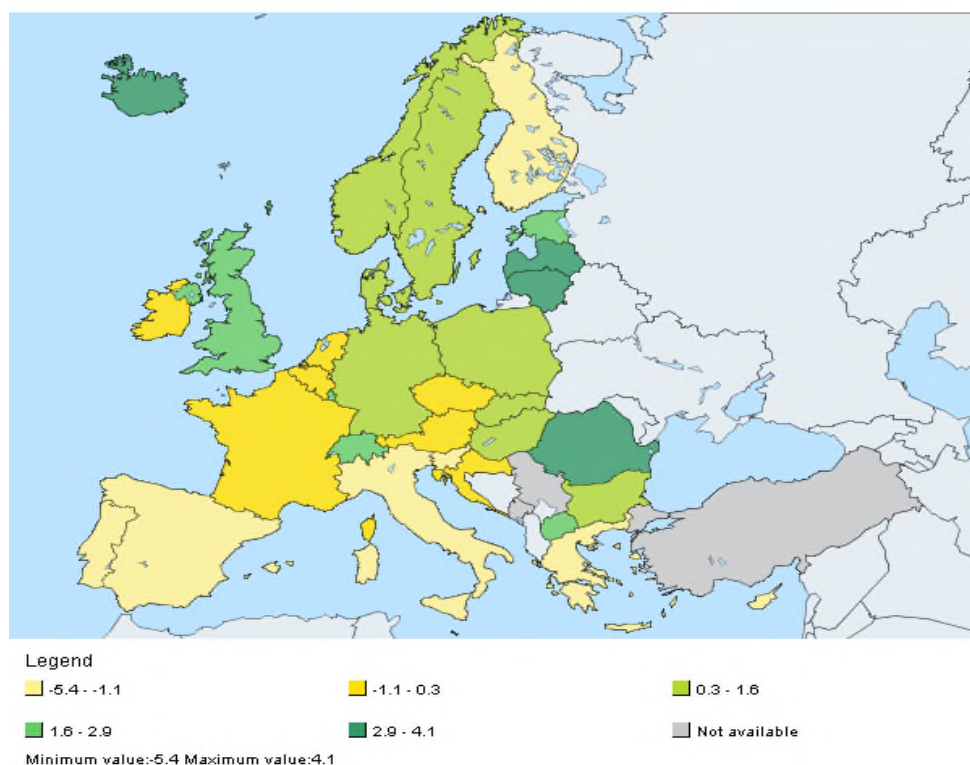
2 Economic Recession

The recent economic crisis, which turned into a chronic ailment for Europe, has not left a corner of the world unaffected and the many reports are here to remind us of its consequences. While some countries like the USA have restored their pre-crisis economic output, the European Union is still engaging in fire-fighting missions (Streeck, 2012; Schmidt, 2014; Blyth, 2013). Few basic indicators demonstrate the magnitude of the on-going crisis whose end seems nowhere near. Following the major contraction of output in 2008 reflected in the fall of real GDP growth rate by 4.5% in the EU27, the data for the subsequent years shows a clear sign of depressed economies despite the initial spike in 2010 that is a reflection of the emergency bailout measures. In a clear contrast to the positive recovery in the US and Japan, Eurostat reports a GDP growth of -0.4% in 2013 and 0.1% in the third quarter of 2014 in the Eurozone which is mainly driven by the contraction of the German economy.



Figure 1. Real GDP Growth Rates Source: Eurostat

Real GDP growth rate - volume
Percentage change on previous year - 2013



Source of Data Eurostat

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Short Description: Gross domestic product (GDP) is a measure of the economic activity, defined as the value of all goods and services produced less the value of any goods or services used in their creation. The calculation of the annual growth rate of GDP volume is intended to allow comparisons of the dynamics of economic development both over time and between economies of different sizes. For measuring the growth rate of GDP in terms of volumes, the GDP at current prices are valued in the prices of the previous year and the thus computed volume changes are imposed on the level of a reference year; this is called a chain-linked series. Accordingly, price movements will not inflate the growth rate.

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Figure 2. Map of Real GDP Growth Rates 2013 Source: Eurostat

The economic downturn and stagnation is manifesting itself in unsustainably high unemployment rate in 2013 that reached the high levels of 10.9% and 12.1% in the EU27 and the Eurozone respectively. However, the severity of the figures fades in comparison to the youth unemployment data which stands as high as 24% in the Eurozone, and reached alarming levels of 50% in Spain and Greece in 2013. Just like during the crisis in the 20s, the restoration of the currency and stable exchanges implies a subordination of social concerns via ‘governmentally adjusted prices and wages’ i.e. deflation (Polanyi, 1044: 241).

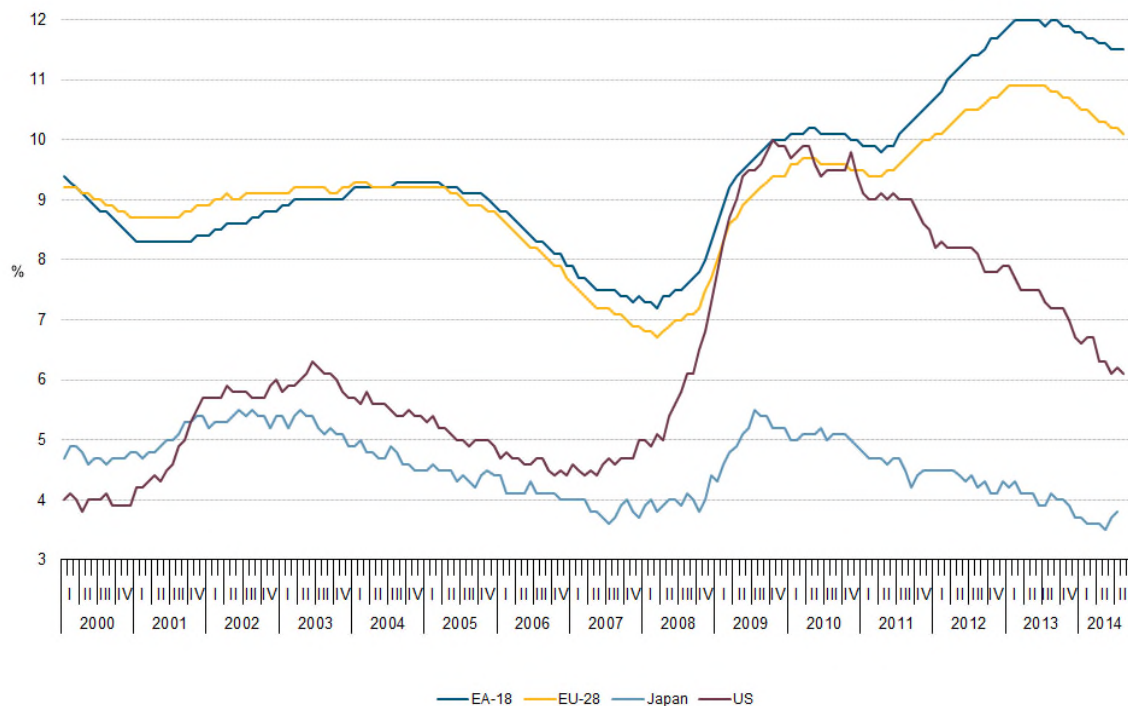


Figure 3. Unemployment Rates Source: Eurostat

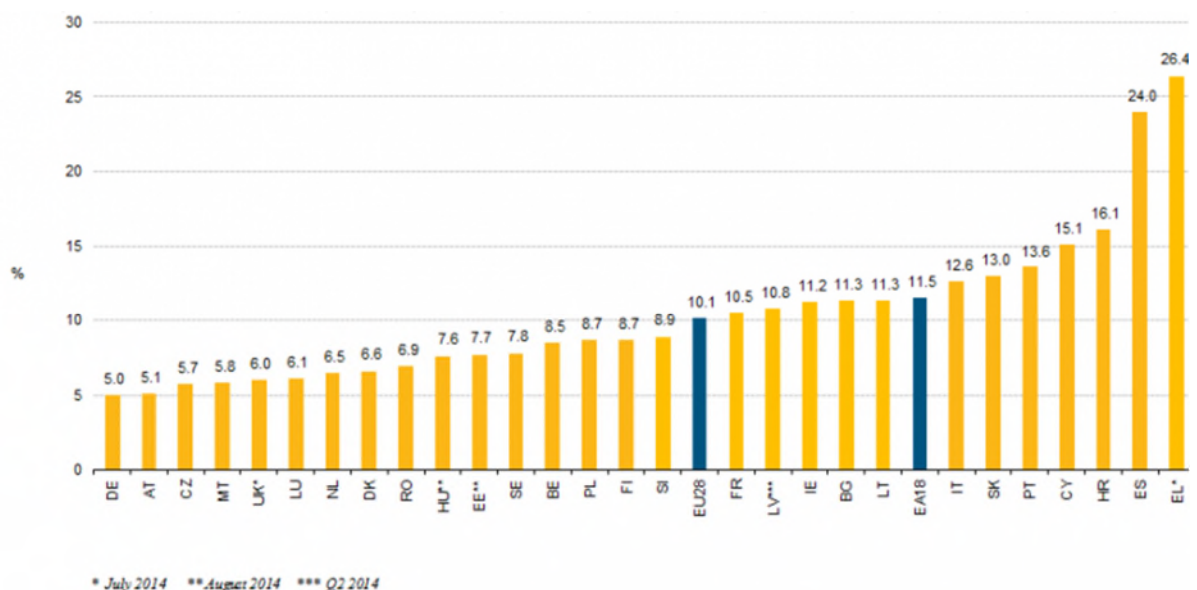


Figure 4. Unemployment Rates, seasonally adjusted September 2014. Source: Eurostat

Despite the dire unemployment figures, member state governments have not formulated any tangible growth strategy that will boost the economic activity within the EU. Contrary to the ample evidence, the European politicians are neurotically clenching to the belief that all we need for a recovery to unfold is for the markets to gain confidence (Hemerijck, 2012). The proposed solution of fiscal tightening originates from a skewed twisting of cause and effect, wherein deficit spending is projected as the cause of the Great Recession. In the construction of the crisis narrative in the EU we are seeing what Watson (2014) has called a delinking of the symptoms and the disease, whereby the proposed solutions fail to address the primary systemic cause of the calamity. And every attempt is made to conceal the fact that it was the financial crisis that enticed some governments to acquire debt by bailing out their banks (Brassett *et al*, 2010). Although scholars have warned that the austerity policies would not necessarily cure the patient (Hemerijck, 2012; Schmidt, 2014; Pivetti, 2013; Palley, 2013), the politicians are depriving the population of a quick recovery by pursuing fiscal consolidation in times of depressed demand. Thus, Polanyi's (1944: 148) argument is even more valid today than ever, when:

the repayments of foreign loans and the return to stable currencies were [time are again] recognized as the touchstone of rationality in politics; and no private suffering, no restriction of sovereignty, is deemed too great a sacrifice for the recovery of monetary integrity.

Figure 5 clearly demonstrates the urgency with which the government deficit and debt have been restored towards the Stability and Growth Pact benchmark, which for Ireland represented a significant reduction. Deficit spending became anathema and deficit was reduced from 6.4% in 2009 to 3.7% of GDP in 2012. In the second quarter of 2014 Eurostat reports further reduction of Eurozone government deficit to 2.5% of GDP. The most recent attempts on the part of the social-democratic governments in Italy and France to engage in fiscal activism in order to boost their depressed economies have fallen on deaf ear in the Commission which under the new Fiscal Compact needs to approve their proposed budgets for 2015.

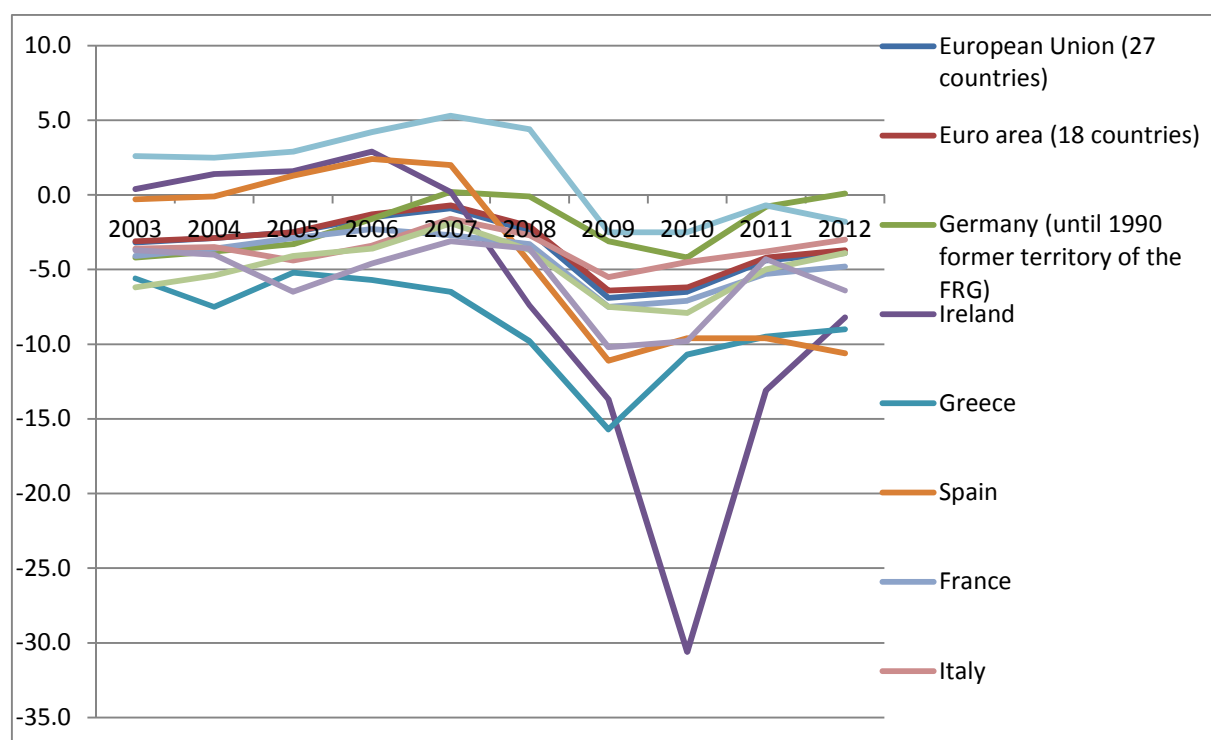


Figure 5. General Government Deficit/Surplus as a Percentage Change of GDP Source: Eurostat

Numerous volumes have come to the conclusion about the continued persistence of neoliberal ideas and practices that do little to reduce the debt to GDP ratio (Lapavitsas *et al.*, 2012; Gamble, 2009; Krugman, 2012; Schmidt, 2014). Despite the short-lived return of the Keynesian ideas during the liquidity squeeze in the first phase of the crisis that required a significant state intervention, once the immediate collapse of the banking system was prevented the story narrative changed and European leaders stopped blaming the self-regulating Anglo-Saxon capitalism and directed all the efforts at the fiscal consolidation. Blyth (2013) calls this sudden change in narrative the greatest 'bait-and-switch' in history whereby private debt became public liability, all the while putting the blame on fiscal profligacy. Notwithstanding the member states' efforts of cutting government deficits and debt, the austerity measures which ignore the importance of aggregate demand negatively influenced the economic output (Blyth, 2014). The lower GDP growth rates, in turn, create further strain on the already difficult debt position by the mere denominatory effect i.e. the cut in spending was in vain in the context of depressed economic output (Blyth, 2014). Figure 6 shows the increase in Eurozone government debt to GDP ratio.



Figure 6. Eurp Area Government Debt to GDP **Source:** Trading Economics

3 Fiscal Compact

That the cracks in the neoliberal edifice caused by the financial crisis do not seem fatal is best seen in the post-crisis policy reforms in the Eurozone. The revised Stability and Growth Pact now consists of preventive arm, which leaves the policy options of early warning and policy advice to the Commission and obliges countries to comply with the Medium-Term Objectives, and the dissuasive arm with its semi-automatic sanction envisaged under the excessive deficit procedure and Regulation (EC) no. 1177/2011. In late 2011 five Regulations and one Directive, the so called Six-Pack, were adopted with the aim of strengthening the budgetary surveillance mechanism. In addition the Euro Plus Pact (European Council, 2011) that includes non-euro area countries stipulates closer coordination of the economic policies within the European Semester. The looming sovereign debt calamity, which should be read as the failure and not the cause of the economic crisis (Brassett *et al.*, 2010), has propelled further economic and fiscal integration that culminated in a new intergovernmental treaty signed on the 2nd of March (Treaty on Stability, Coordination and Governance, 2012). The treaty envisages following of a stricter dictum from the Commission which now grants the ECJ the right to impose fines, no bigger than 0.1% of the GDP on non-complier states. Although the idea of bestowing the EU with the neo-viceroy authority over the Greek budgetary policy was ruled out, the resent changes are yet another indictment of democracy.

The idea of the self-regulating market is deeply ingrained in the recent reforms. Not only that the new treaty constrains the fiscal autonomy of the member states by requiring *ex ante* reporting and approval of their budgets (Article 6 of the Fiscal Compact, 2012), it also constitutionalizes neoliberalism. The new revisions stipulate that states should transpose the rules of budgetary rectitude into their national legislation and preferably into their constitutions, as already done by Spain and Italy. Consequently, not only are the EU citizens disenfranchised with regard to their control over the monetary policy, but also with the fiscal rules, which now will have even stronger neoliberal accent. While the old Stability and Growth Pact set only limits and gave much freedom to states when it comes to the content of the policies, the new treaty states that ‘the content and format of these programmes [adjustment programs for states in excessive deficit procedure] shall be defined in European Union law’ (Article 5 of the Fiscal Compact, 2012).

Polanyi (1944: 233) observed that unlike the constitutional safeguards during the seventeenth-century which were directed against interference from the Crown, the new constitutionalism guarantees protection from the people. So in similar way that the Chartist movement was considered as impeachment to the Constitution (Polanyi, 1944), the plan for holding referendum on the bail-out in Greece was likewise perceived as a violations from the EU Treaties by the EU leadership (Tsoukala, 2013). The instalment of unelected leaders Papademos and Monti in Greece and Italy respectively showed that democracy can be hold to ransom if international debt obligations demand that.

From a Polanyian point of view the problem is not the creation of a closer fiscal and banking union, but the constitutive neoliberal features of the same i.e. the very act of scaling up a policy area to the EU level does not make the structure disembedded, but their substance that sets competitiveness as its objective and internal devaluation as its means. Harmes (2006) is right in his assertion that the disembedding tendency is dominant in the EU, but for the wrong reasons. The asymmetry in the competences between the EU and member states does not disembed the economy. Hypothetically we can have asymmetric governance that is underpinned with social democratic norms instead of neoliberal ones.

The new treaty is reminiscent of the Žižek (2009) reformulation of Klein's shock doctrine that claims that the recent crisis would serve as a pretext for further neoliberalization. The sovereign debt crisis has allowed few officials, like Rehn, Barroso, van Rompuy, Trichet, Juncker, Draghi to utter the 'state of exception' in the economy and impose onto states austerity measures under the European Financial Stability Facility. It appears as though the crisis instead of providing a fertile ground for a U-turn in the policies of competitive austerity has instead exacerbated the problem. The Euro Plus Pack, although represents a watered down version of the Competitiveness Pact, seems to go a step further with the flexibilization of the wage relation. While pro-growth expenditure is denied to labour, the financial capital gets a preferential treatment because a double standard applies when it comes to the deficit created by the bank bailouts. Despite the recent approval of the Compact for Growth and Jobs worth €120 billion (European Council, 2012) and the unorthodox monetary policy by the ECB, we are still operating within a rationality that prioritises the slashing of deficit spending.

The recent developments hide a paradox. On the one hand we have the appearance of a depoliticization of EU politics because decisions are made in a technocratic manner, but at the same time there is an expression of power that is profoundly political in that those who proclaim the state of exception are setting the boundaries of the post-crisis political settlement, which is neoliberal 2.0. Although the protagonists try to essentialise the undertaken measures by portraying them as natural responses, Žižek (2010) is right when he perceives them as a political, and not a mere technocratic choice. Put in the words of Hardt and Negri 'politics does not disappear; what disappears is any notion of the autonomy of the political' (2000: 307).

At the level of appearance the surge in intervention with the bank bailouts might contradict the self-regulating market. However, that intrusion in the free-market is completely understandable from a Polanyian standpoint because when non-intervention contradicted the self-regulating market 'in such a *conflict the self-regulating market was invariably accorded precedence*' (1944: 155). Thus, we should not be beguiled by the increased state intervention in the form of bank bailouts, as all is done in the name of the self-regulating market. What follows might be a state-led neoliberalism (Watson, 2009). Bruff (2014) and Žižek (2010) have even proclaimed the birth of a new type of neoliberalism, with an authoritarian accent, where the functioning of the market can be ensured even at the price of democracy and the recourse to more policing can be justified by the idea of the self-regulating market. Because the neoliberal creed has proven resilient even in the post-crisis period, Caporaso and Tarrow's (2009) and Copeland's (2009) assertion that Polanyi has returned to Brussels is premature and unwarranted.

4 The Fiscal Profiligacy Myth

When examining the politics around the return to the Gold standard in the inter-war period, Polanyi (1944) observed that thanks to the misrepresentation of facts inflated wages and budget deficits were the first line of attack from economic liberals. Does not the same hold true for today's crisis narrative presented by key political figures? It takes no more than a quick glance at the public debt data for any laic to realise the unwarranted accusation levied against the peripheral states in Europe, the so called PIIGS club consisting of Portugal, Ireland, Italy, Greece and Spain, by the austerity hawks. With the exception of the Greek public debt and its persistent government deficit, which was masked thanks to the help of creative accounting and dubious derivative arrangements (cross-currency swaps using fictitious exchange rates) made by Goldman Sachs, the EU countries with public debt averaging around 85% of their GDP did not have less unsustainable fiscal position compared to the US or Japan with their respective debts of 100% and 200% of GDP (Lapavistas *et al.*, 2012). On the contrary, Ireland and Spain were following the Maastricht convergence criteria and had their public finances in a very neat order prior to the financial crisis (Palley, 2013; Pivetti, 2013). Table 4.5 clearly shows that the upward trend of sovereign debt started only with the gigantic bail-outs for the over-leveraged European banks, which were over-sized compared to their American counterparts. Blyth (2013) argues that if in the US, where the combined assets of the six largest banks did not exceed 60% of the US GDP, the banks were 'too big to fail', in Europe banks were 'too big to bail' because their assets were exceeding their country's respective GDP by far more than in the US. Namely, in the UK the assets of the biggest four banks were 394% of GDP, in Germany the assets only of the Deutsche Bank was 80% of the GDP, in France the top three banks had assets of 316% of GDP, in Ireland the top three banks had assets worth 400% of GDP etc. (Blyth, 2013: 82-83).

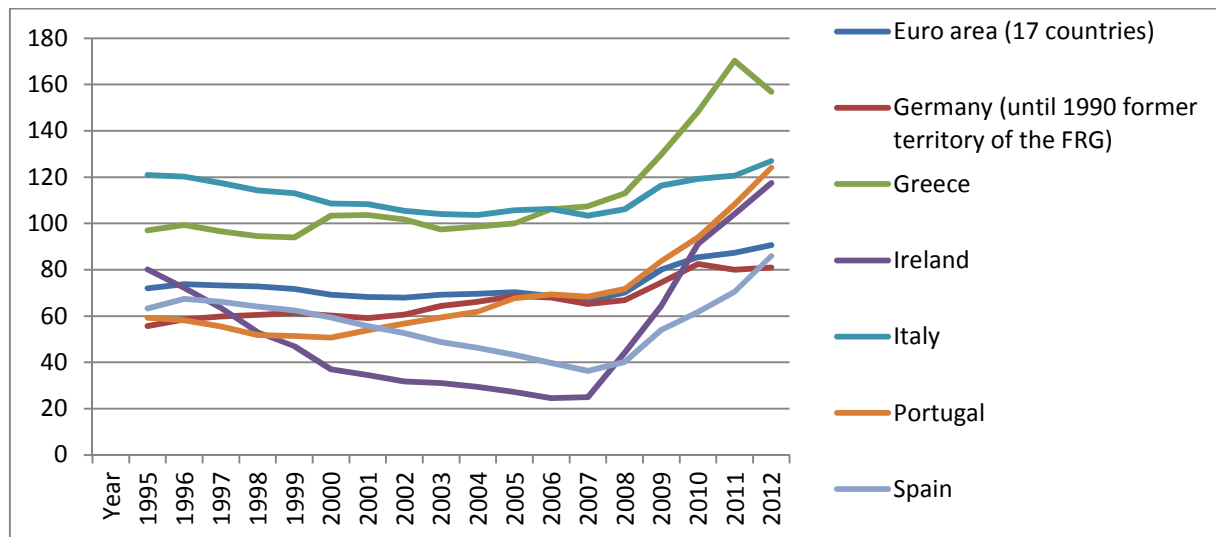


Figure 7. General Government Gross Debt as a Percentage of GDP Source: Eurostat

The newly emerged fiscal crisis is just the symptom of a much complicated underlying cause of the crisis which can be found in the contradictions of the financialisation of global capitalism. Streeck (2011) who sees the crisis not as a temporary deviation from the equilibrium, but as a constant feature of capitalist development, argues that the sovereign indebtedness is the 4th stage of the crisis that manifested itself previously in three major crises:

1. First in late 60s with the rising inflation and expanding welfare state following the full-employment commitment,
2. Then in the 80s following the disinflationary policies of Reagan and Thatcher that inaugurated the neoliberal era which led to rising public debt and stagnant growth,
3. And finally in the early 90s the stage of privatised Keynesianism emerged which increased the private indebtedness.

It is only after the banks bailouts in Europe, which socialised the private debt, when the sovereign debt crisis started to materialise. It is the sheer size of the bailout undertaking, which in Ireland stood at 230% of GDP and in the whole of the EU at 4.5 trillion euros or 37% of the GDP, which created a strain on the public finances (Wigger and Buch-Hansen, 2013).

5 Causes of the Crisis: Securitisation

The very immediate cause of the financial crisis can be credited to the freezing up of liquidity following the crash of the sub-prime mortgage market in the US, in which the over-leveraged European banks were implicated. The scholarship identifies two simultaneous and interrelated processes that directly led to the emergence of many bubble markets, be it a dot.com stock bubble or housing bubble: disintermediation and securitisation (Blyth, 2013; Panitch and Konings, 2009; Krugman, 2012; Lewis and Perry, 2012). The two processes can be connected with several important events:

- a) the emergence of the giant diversified corporation that could bypass commercial banks' loans by investing in business from retained earnings and engaging in intermediation itself (Blyth, 2013),
- b) the Volcker shock that rose interest rates incentivised corporations to search for alternative funding to the pricy loans offered by commercial bank, which they found in the securities market; which, in turn, led to the rise of the investment banks that become principals rather than mere agents in the securities trading (Hager, 2012),
- c) the repeal of the Glass and Steagall Act, which insulated commercial banks business from investment activities by the Financial Services Modernisation Act in 1999, which indirectly led to the creation of 'too big to fail' credit institutions (Gamble, 2012). The erosion of the post-Great Depression banking regulation allowed commercial banks to make use of the deposits on its balance sheet in their risky investment in the securities markets (Panitch and Konings, 2009). This blurring of the boundaries between the insurance, commercial, investment and retail businesses of financial institution amplified the problem of systemic risk that eventually threatened all segments of the financial system in the world.
- d) the exemption of investment banks from the Securities and Exchange Commission's net capital rule of maintaining a debt no bigger than 12 times their equity in the US in 2000s, which led to a spectacular increase of 42% in the leverage of the self-monitoring investment banks from 2001 to 2007 (Hager, 2012). The large leverage ratio i.e. the ration between assets (loans and mortgages) relative to equity

(reserve capital) was a disaster waiting to happen, especially if the value of the assets falls as was the case with the plummeting of the housing prices in 2007 (Blyth, 2013).

Following the disintermediation banks increasingly relied on the shadow-banking system for securing their short-term access to cash. The emergence and increase in the volume of the shadow-banking is identified as the most important cause of the financial crisis in 2007 because it allowed for the problem of maturity mismatch between the short-term liabilities (deposits) and long-term assets (mortgages) to flourish in the financial system. Schwartz (2012) argues that the privatised Keynesianism has eroded the protection against maturity mismatches secured by the welfare state that maintained a safe credit supply by matching long term liabilities (pensions) with long-term assets (mortgages). In the neoliberal era no longer are the pension funds the main holders of mortgage assets, but instead banks borrow in short-term repo markets and invest in long-term assets, such as mortgages. Following the emergence of effectively universal banks in the US a combination of very sophisticated financial instruments were put in place that implicated all segments of the industry and led to a maturity mismatch (Blyth, 2013; Schwartz, 2012; Major, 2012; Panitch and Konings, 2009):

1. creation of collateralised-debt obligations (CDO), a derivative,¹ that re-bundled different mortgages payments into a homogenous pool, which is later sliced and sold into tranches with varying risks, which ended on the books of various institutions across the globe including major European banks. As the demand for these securities increased, banks resorted to even more lending to risky category of clients.
2. the above CDO securities were traded by banks via structured investment vehicles (SIV), a separate accounting entities that were not part of the banks' balance sheets, hence allowing banks to run high leverage ratios. The trading of CDO via SIV created maturity mismatches whereby banks borrowed short-term in the repo market to finance their purchases of CDO consisting of long-term assets (tranche mortgage payments). SIV enabled banks to profit thanks to the differentials between the lower interest rates at which they could borrow short-term funds and the higher interest rates at which they could lend long-term loans.
3. banks resorted to credit default swaps (CDS) when trading CDO as a way of hedging against the risk of default, which was minimal when the house prices were high. However, the risk probability modelling of the issuers of the CDS, based on the assumption that the probability of default follows a classical bell-shaped curve, proved as miscalculated as the risk assessment of the rating agencies that assigned AAA ratings to the mortgaged-backed securities that flooded the markets. The virtuous cycle in the early 2000s turned into a vicious downward spiral in the late 2000s. When the probability of mortgage default increased, the CDO were devalued, which in turn increased the CDS insurance claims. It is the very connectivity of the whole financial industry which made the whole risk systemic. The default of the investment bank Lehman Brothers immediately dried the liquidity of the insurance giant AIG.

When in the 90s the dot.com bubble burst investors looked for alternative investment in assets that were not only uncorrelated to equities, but were assets 'uncorrelated in their own class', which they found in the real estate and pushed the price up by 70% in the US and 170% in Ireland (Blyth, 2013). However, following the drop in the house prices in 2007 and the rise of interest rates by 4% points by the Federal Reserve between 2004 and 2006 as a response to the falling dollar, mortgage defaults increased from 4% in 2006 to 17% in 2007, especially among subprime borrowers, who represented 28% of the mortgage market and relied on creative home equity management dependent on ever-rising house prices (Panitch and Konings, 2009). As the value of the mortgage-backed securities fell banks could no longer use them as sound collateral on the repo markets where banks raised short term funds. The over-leveraged banks inability to borrow led to the infamous liquidity squeeze. The banks' asset-dumping, including high-quality ones, in order to secure funding for their operations, triggered a contagion in the whole system that froze lending and raised inter-bank rates.

Major (2012) identifies two causes for the exponential growth of the asset-backed securities, which in Europe increased 500% from 1995 to 1997:

- a) the Basel rules incentivised banks to securitise their assets because it enabled them to engage in regulatory arbitrage of the capital requirement. The rigidity of the Basel I's 'risk bucket' categories, whereby all private sector claims were assigned the same risk of 100%, stimulated banks to cherry-pick i.e. invest in riskier assets within the same 'risk bucket'. Basel II introduced internal-based ranking system and entrusted private rating agencies to assess the risks.
- b) the inflation targeting of independent central banks that lowered the interest rates and incentivised investors to look for higher yield alternatives.

If in the nineteenth-century *laissez-faire* capitalism the Gold standard and constitutionalism were the two instruments which voiced the interests of the City of London as Polanyi (1944) has rightly observed, then the Basel banking regulation that was supposed to eliminate the systemic risk problems, combined with the inflation targeting and price stability objectives of the technocratic central banks were the epitome of the reinvented self-

¹ Derivatives are unconventional assets that derive their value from an underlying asset. They are contract, a bet against a movement of interest rate, price etc.

regulating market doctrine in the neoliberal era. Little did the average European borrower know about the sophisticated financial instruments erected in the regulatory vacuum, yet it was the sole subject that bears the burden of the recession.

6 Post-Crisis Macro-Prudential Policy in the Eurozone

Knowing the actual cause of the crisis, it is disconcerting to see how little the post-crisis reforms have addressed the uninterrupted trend of securitisation. It remains to be seen how much the post-crisis reforms would mitigate the risk of even bigger financial crisis. In the effort to curb the systemic risk in the financial system, the European countries have scaled up the macro-prudential policy framework at the EU level under the new Single Supervisory Mechanism, mainly by creating a European System of Financial Supervision consisting of:

- a) the three European Supervisory Authorities: the European Banking Authority, the European Securities and Markets Authority, and the European Insurance and Occupational Pensions Authority,
- b) the European Systemic Risk Board (ESRB), which was established following the suggestion of the Larosière group (Regulation EU/1092/2010).

The key objective of the ESRB (ESRB/2013/1) is to keep an eye on the excessive leverage, exposure to various bubbles, maturity mismatches in the financial industry, which entails monitoring of the financial cycle by focusing on various indicators of potential vulnerabilities such as credit and property prices fluctuations. The new macro-prudential rules that are in line with the Basel III guidelines provide the national authorities with various instruments: the counter-cyclical capital buffers (up to 2.5% of risk-weighted assets), global systemically important institutions (G-SII) buffer (between 1% and 3.5% of risk-weighted assets), other systemically important institutions (O-SII) buffer (up to 2% of risk-weighted assets), the limits on loans-to-value caps etc. The ECB is empowered to establish higher capital buffers than the one required by the national authorities within the new Single Supervisory Mechanism within the Eurozone (Council Regulation 1024/2013/EU).

The new regulation and the supervisory measures are not without its critiques. Jablecki (2012: 13) argues that they both acted 'pro-cyclically by, on the one hand, encouraging banks to acquire sovereign exposures and, on the other, punishing banks for these exposures after they had been acquired'. The new Capital Requirement Directive (2013/36/EU), following the Basel III, which maintains the Basel II Liquidity Coverage Ratio that requires banks to hold high-quality assets to cover their net outflows over 30 days, has been blamed for the exacerbation of banks' vulnerability. Namely, the requirement to hold highly liquid assets which consisted of cash, central bank reserves and government bonds has been credited for the excessive banks' balance-sheet exposure to Eurozone governments' sovereign debt (Jablecki, 2012). In addition, the supervisory policy of European Banking Authority (EBA) by applying the same capital adequacy rules to sovereign bonds irrespective of whether they are on the trading or the banking book has created a problems for banks in need for additional capital requirements because the increase of sovereign debt risk was suddenly badly reflected on the bank balance-sheets (Jablecki, 2012).

But the chief problem with the ESFS is that it inaugurates four highly powerful technocratic bodies that are insulating key political decisions from democratic control. Their technocratic nature is a perfect example of the new constitutionalism, discussed by Polanyi (1944: 234) directed at protecting the market not from arbitrary interference from above, but from the people. Polanyi (1944) made a distinction between the seventeenth-century and nineteenth-century constitutional protection which were directed against intrusion from the Crown and the people respectively. His nineteenth-century constitutionalism is akin to Gill's (1998) new constitutionalism in that despite their difference in form given their distinctive epochs, they share a common enemy against which capital is protected, the people. Although the creation of Single Resolution and Supervisory Mechanisms are essential parts of the new Banking Union, the lack of financial backstop and a common Deposit Insurance Scheme makes the effectiveness of the new reforms questionable (Blyth, 2014).

7 Structural Problems with the Economic and Monetary Union

The crisis in Europe might have started with the liquidity squeeze in the repo markets, but its escalation can be credited to the problems inherent in the design of the Economic and Monetary Union. The EMU is not an overnight project, but it has a long history behind. Both the EMU and its predecessors, the Snake system in the 70s with its band of fluctuations and the European Monetary System I with its Exchange Rate Mechanism based on European Currency Unit, represent a policy response to the problem of exchange-rate volatility (Bache *et al.*, 2011; Cafruny and Ryner, 2007). The debates on the economic benefits of the currency union were not settled at the time of the creation and are not settled now, but nonetheless the EU embarked to create an asymmetric scaling up of monetary policy, all the while maintaining a fiscal sovereignty, which Krugman (2012) identifies as the fatal error. In doing so, Cohen (2012) argues the EU has tried to have the cake and eat it too. The Maastricht Treaty specifically outlawed the monetary financing of deficits (article 123) and contained a no bailout clause (article 125) (Buti and Carnot, 2012). This lack of a fiscal transfer union would play to be one of the major structural weaknesses of the EMU during the Great Recession.

The Maastricht Treaty instituted a set of five Convergence Criteria which states had to meet prior to accession to the EMU. In addition the Stability Growth Pact was introduced in 1997 in order to constrain the possibility of inflationary debt monetisation (Buti and Carnot, 2012). Two opposing camps had crystallised at the onset of the EMU: those who believed in the coronation theory that advocated a currency union constituted by a small core of countries and those who supported the locomotive theory that called for more inclusive club (Cohen, 2012). The latter won the day following the incredible leniency in the application of the convergence rules that led to the admission of some countries which have not met the 60% public debt threshold like Belgium and Italy. Derogations from the excessive deficit procedure continued to be tolerated following the introduction of the euro, especially when they were committed by countries like France and Germany in 2003, which, in turn, Buti and Carnot (2012: 902) argue has ‘eroded the sense of collective discipline’. So, not only did the EMU lack a credible preventive mechanism, it lacked a corrective system for dealing with a crisis, which proved detrimental following the most recent financial crisis in 2007, when it took the EU few years to formulate the European Financial Stability Facility in May 2010, which was succeeded by the European Stability Mechanism following a strenuous ratification process.

The theory about Optimal Currency Area, which has been selectively implemented in the case of the Eurozone, deserves a special mention. The creation of the common currency was marked by two opposing camps: the economist, mainly Germany, who believed that the optimality should be achieved ex-ante and the monetarist, supported by France, who advocated the ex-post approach (Snaith, 2013). While the theory itself is a subject of serious disagreements in the academic community, including the ones between the early and late Mundell’s writings when the orthodoxy was fixed and floating exchange rate system respectively, it is clear that the EU did not constitute an Optimum Currency Area and the introduction of the EMU and its structural reforms did not turn it into an OCA (Moravcsik, 2012; Snaith, 2013). For an OCA to function the participating countries need to have compatible business cycles, have labour mobility and wage flexibility, which allows workers from depressed regions to move to better-off ones (Krugman, 2012). Or alternatively, automatic stabilisers, whereby surplus states finance the deficit one, should be in place. And unfortunately the Eurozone lacks both fiscal transfer mechanism and labour mobility to deal with the pervasive asymmetric shocks.

In the 90s the prospect of EMU membership improved the low inflation credibility of the peripheral countries and their cost of borrowing were slashed (Gros, 2012). The systemic mispricing of sovereign risk led to unwarranted low yields of PIIGS bonds and started the Eurobubble or the bond spread bubble, which translated into various consumption bubbles in the periphery (De Grauwe and Yuemei, 2012; Krugman, 2012). Although, the interest rates converged downwards the PIIGS yield were still slightly higher than the low yields of the German bonds, which gave incentives to hoard on the former more (Blyth, 2013). Cheap money started flowing towards the periphery, which manifested itself in property bubbles in Ireland and Spain and increased public consumption in Greece and Portugal. Local banks in Ireland and Spain did not have the deposit base necessary for extending their lending practices, so they borrowed from the wholesale markets. The increased investment led to 100% increase in house prices, which further fuelled the construction boom (Krugman, 2012; Blyth, 2013). The flow of capital spurred the growth in the periphery; however it was a debt-financed growth. And when growth rates exceed cross capital formation rate, as was the case with Ireland and Spain, it demonstrates the existence of property bubbles (Varoufakis, 2013). The excessive lending has increased the private indebtedness of the periphery, which soared up to 331.8% in Ireland, 214% in Spain and 254% Portugal in 2012 (Eurostat, 2014).

Besides the increased indebtedness, the cheap flow of money in the periphery negatively affected their competitiveness. Their debt-fuelled growth was reflected in a rise of wages. The increase in the unit labour costs (wages adjusted for productivity) was up to 35% in PIIGS countries compared to a mere 9% increase in Germany throughout the 2002 (Krugman, 2012). The financial crisis inaugurated a trend of wage moderation in the periphery following the dictum of the austerity policies. This unit labour cost differentials in EMU was the drive of competitive divergence and led to current account imbalances.

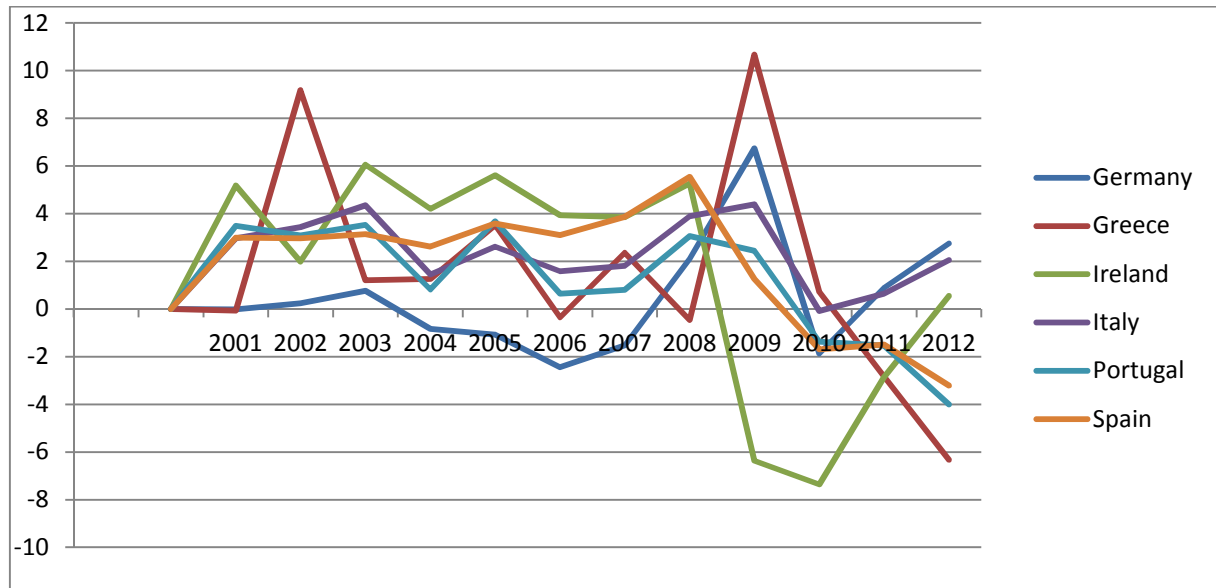


Figure 8. Unit Labour Costs – Annual Growth Rate *Source: OECD*

While the peripheral countries experienced debt-financed growth, consumption and property bubbles, rising inflation (Figure 7), rising wages, low savings rate (Figure 8), Germany was in the complete opposite predicament. Throughout the 2000s Germany experienced stagnant growth, below the average inflation, wage moderation and rising competitiveness. However, German competitiveness has nothing to do with efficiency or rising productivity, but should be credited to the squeeze of wages which part of the Agenda 2000 of the Social Democratic Party in 2003 (Lapavitsas *et al.*, 2012; Cafruny and Ryner, 2007; Moravcsik, 2012). Figure.6 shows that Germany underwent negative growth in unit labour costs from 2003 until the beginning of the financial crisis 2007.

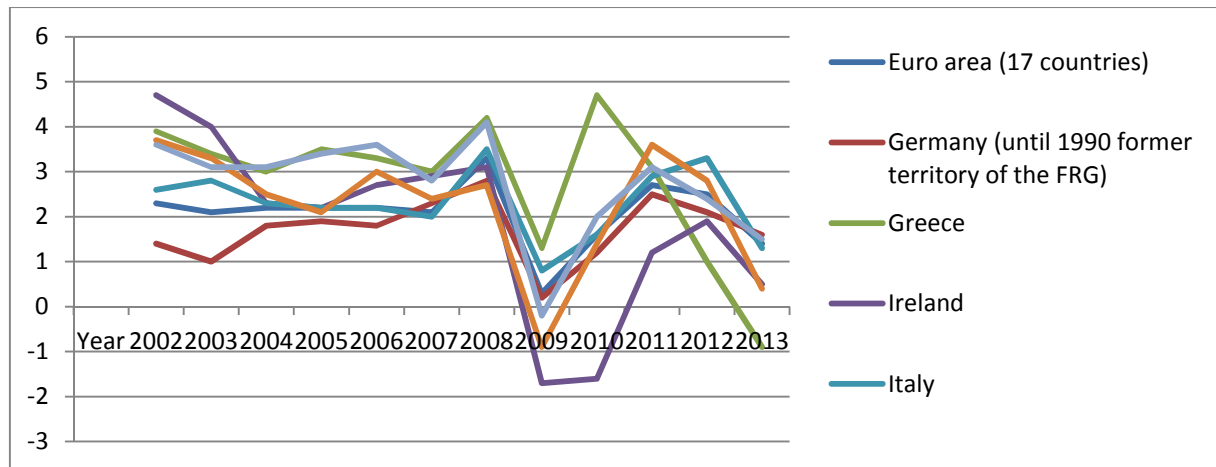


Figure 9. Harmonised Indices of Consumer Prices –Annual Percentage Change *Source: Eurostat*

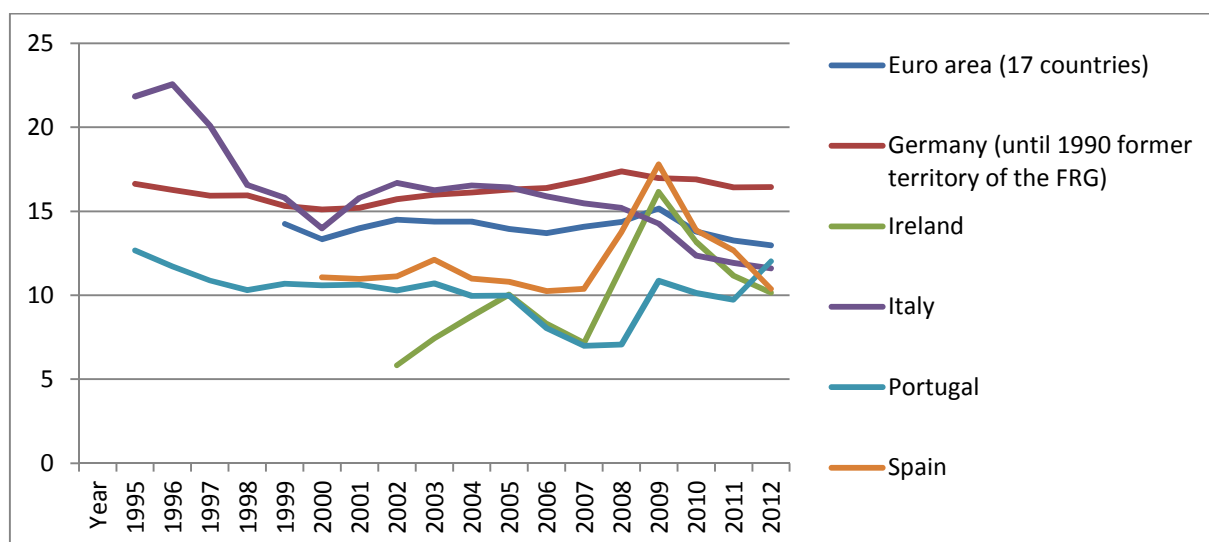


Figure 10. Household Saving Rate *Source: Eurostat*

The wage squeeze policy induced lower domestic demand in Germany, which further exacerbated the competitiveness divergence between Germany and the periphery. German export became more competitive on the market, which, in the context where intra-EU trade constitutes 60% of the share of total trade in the EU, which is balanced with the rest of the world (see Figure 10), led to current account imbalances within the Eurozone. So, even if the euro appreciates with respect to other currencies, German export will continue to be competitive because the real exchange rate of Germany is 40% lower of what it would be if the deutsche mark was in circulation (Moravcski, 2012). Although Young and Semmler, (2011) emphasise that the German export is marked by price inelasticity i.e. a drop in real exchange rate would not affected it much, following the introduction to the euro the German export grew twice as much as that of other Eurozone members, while domestic demand fell by 1.5% (Young and Semmler, 2011).

Final consumption expenditure of general government

Units: Percentage of GDP

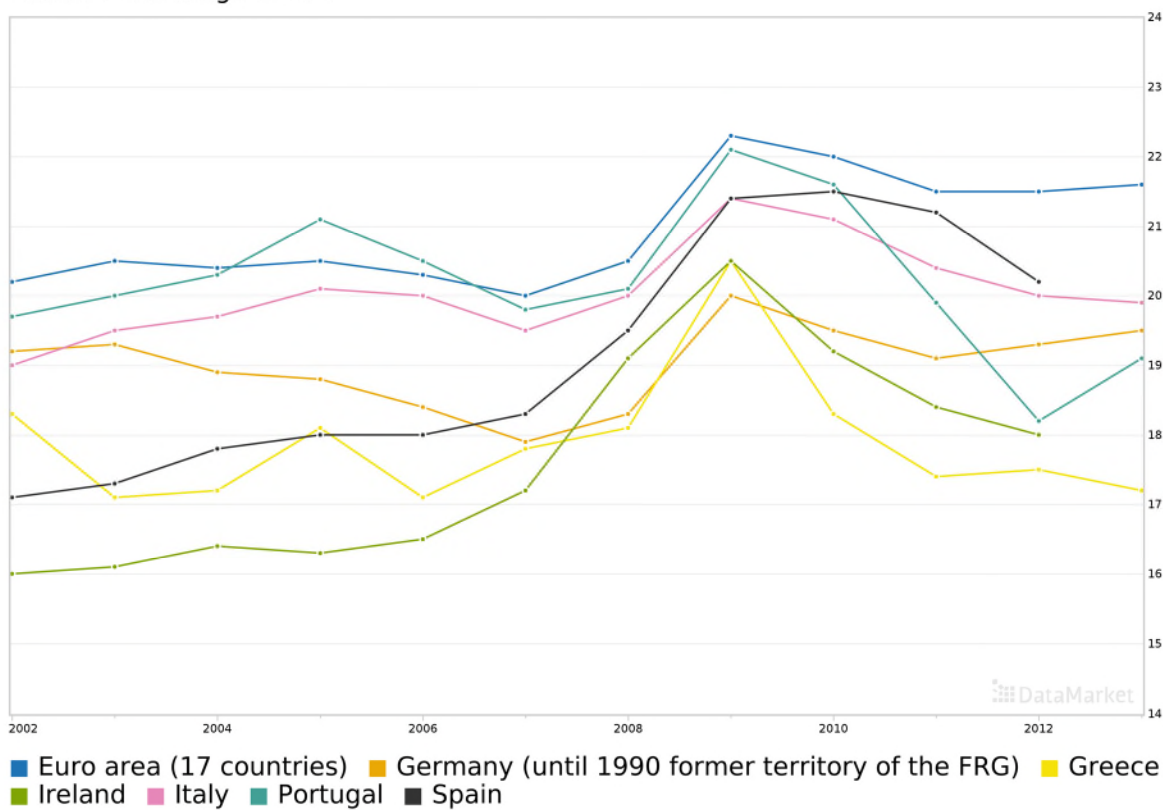


Figure 11. Government Expenditure Percentage of GDP **Source:** Eurostat

Final consumption expenditure of households and non-profit institutions serving households

Units: Percentage of GDP

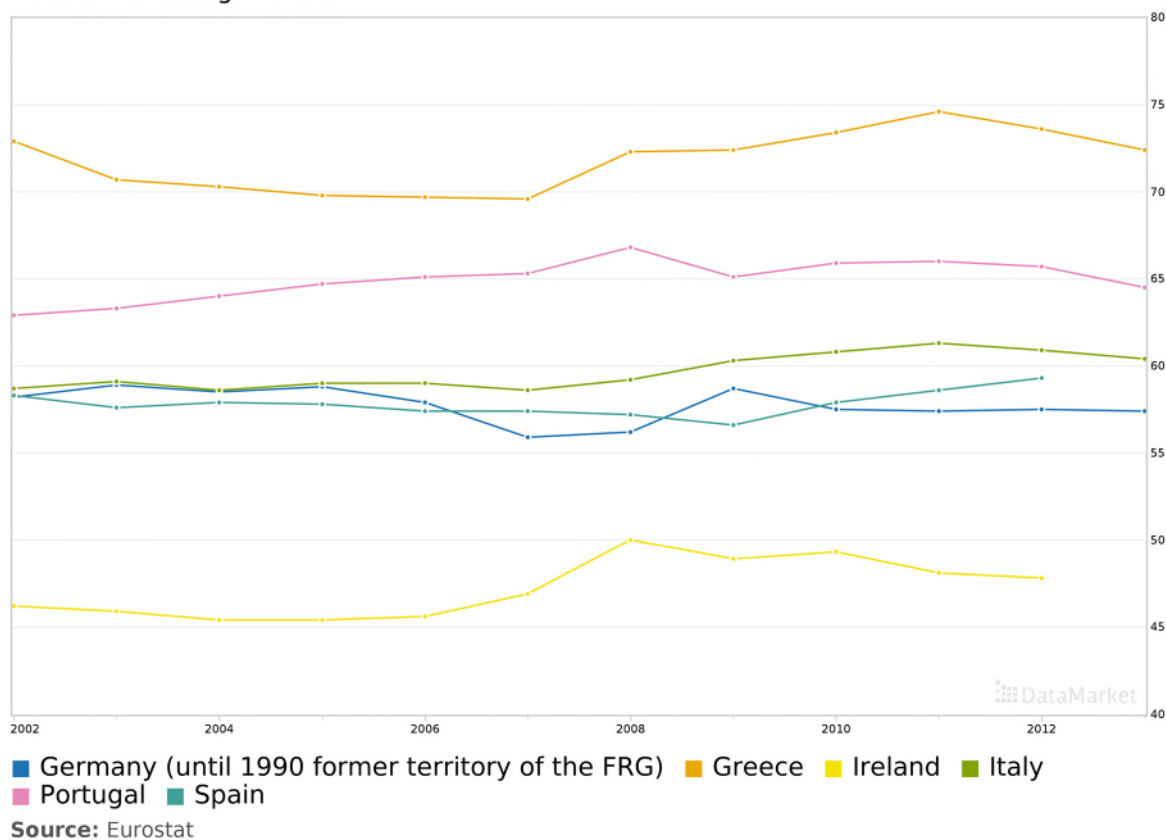


Figure 12. Household Expenditure Percentage of GDP Source: Eurostat

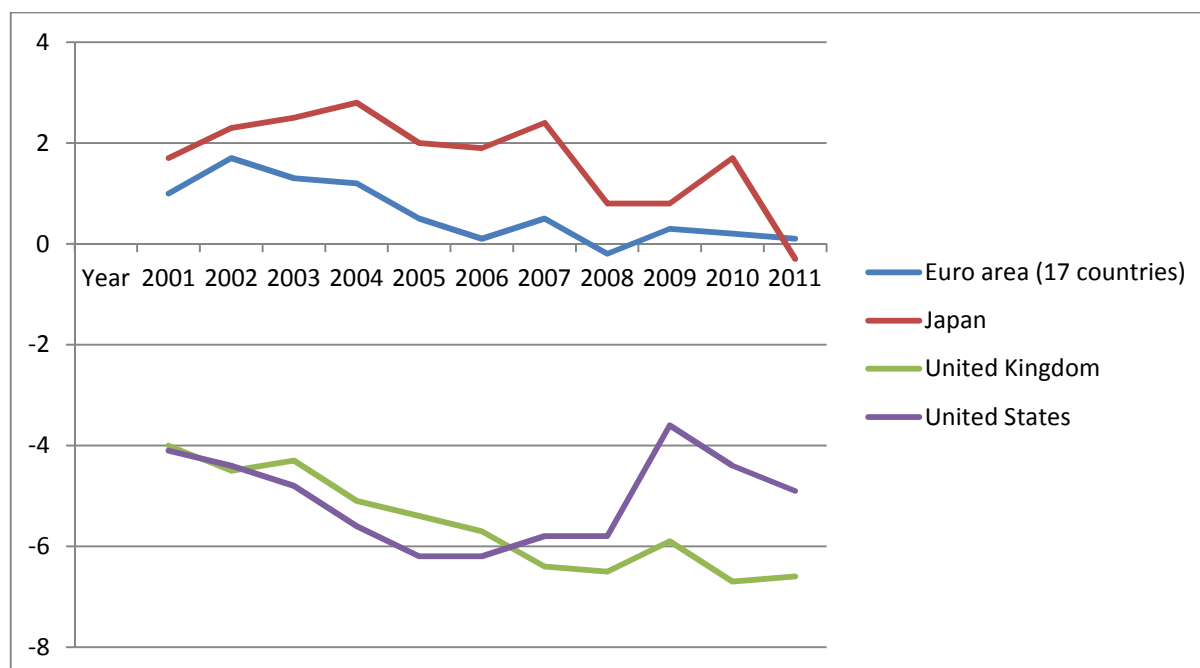


Figure 13. Balance of International Trade in Goods Source: Eurostat

Figure 13 clearly shows the contrast between the surplus in Germany, which exports 69% of its products in the EU, and the deficit in the periphery, whose EMU membership has curtailed their ability to improve their

competitiveness relative to Germany. By forsaking their monetary autonomy, the periphery has forsaken their ability to resort to devaluation as a means of adjusting their competitive position (Buti and Carnot, 2012; Overbeek, 2012). The only option available within a currency union is internal devaluation i.e. downward adjustment of wages, which is a very difficult policy to pursue. Economists have warned that devaluation is by far more effective in reducing effective wages and correcting competitiveness, because wages tend to fall only slightly even during economic downturns (Krugman, 2012). Internal devaluation or deflation only works in the interest of creditors, who would be negatively affected in case of currency devaluation.

Current account balance (percent of GDP)

Units: % of GDP

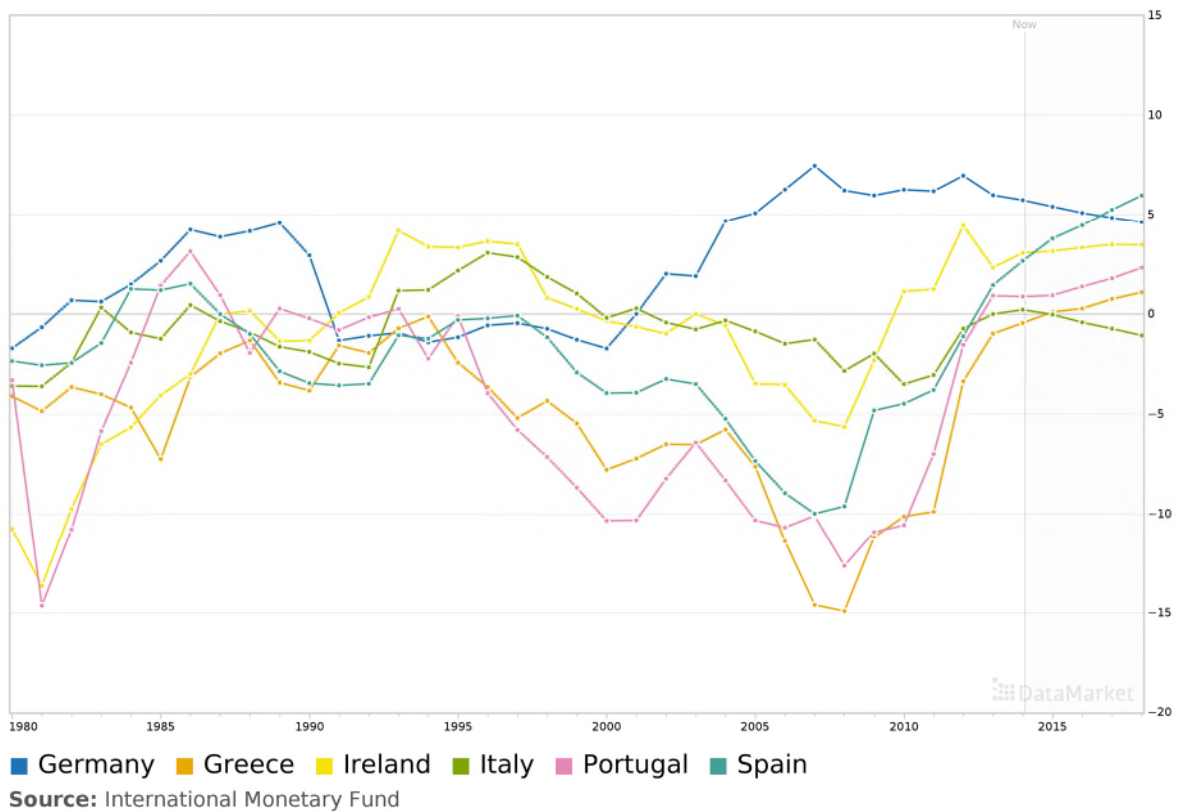


Figure 14. Current Account Balance *Source: IMF*

Blyth (2013) has christened the EMU a Gold standard type of monetary policy, which proves to be unsustainable in a democracy. The monetary union, which is the dream of monetary orthodox apologetics, just like dollarization and currency boards aims to discipline the political authority. The specificity of the currency union with its lack labour mobility and fiscal redistribution makes adjustment during economic downturn almost impossible. Both the creation of the EMU, which has reduced and constitutionalised the purpose of the monetary policy to that of price stability, and the continued insistence on austerity are the highest achievements of the idea of the self-regulating market. While society is doomed to bear the burden of the previously private debt, nothing is done to effectively deal with the structural flows of EMU that are the root cause of the balance of payments problem, which would not have been there if countries had monetary autonomy and ability to pursue devaluation and monetary expansion that would ameliorate the burden of debt (Palley, 2013; Pivetti, 2013). The constitutional design of EMU is itself conducive to uneven development i.e. creation of core and periphery (Lapavistas *et al.*, 2012). The envisaged macroeconomic scoreboard under the new European Semester has low potential of making the surplus states share the burden of adjustment, all the while every effort is made to push the periphery into painful and fruitless processes of structural reforms via the conditionality of their Memorandum of Understanding. Germany, which has profited from its current account surplus, does little to boost its domestic demand.

8 Reasons Why Austerity Does Not Work

It is not only that the EU has long time given up its commitment to full employment, which Cafruny and Ryner (2007) interpret to be a sign of welfare state retrenchment, but it has given up the efforts to correct the prolonged slump, which Kalecki (1943) observed was the only time the *laissez-faire* economists support minimal state

expenditure i.e. the so called regime of political business cycle. In his exploration of the political, but not economic, impediments to full employment, which can be achieved by public investment, Kalecki (1943: 323) concluded that 'obstinate ignorance is usually a manifestation of underlying political motives'. By adamantly pursuing austerity measures that have succeeded in hampering the aggregate demand, the public authorities have exacerbated the already difficult situation for those at the bottom end of the income scale. Even after four years of evident failure of the policy prescriptions of the authority hawks, the policy makers are unwilling to consider any alternative.

The austerity hawks got several things wrong, chief of which was the idea that the restoration of confidence is the only road to salvation. It is in their 'sustained effort of wilful ignorance' (Žižek, 2009: 9), that we see the resilience of the neoliberal policies. By falsely reducing the economy of the state with that of the household, the neoliberal thinking fails to realise the importance of systemic variables. Fiscal austerity does not work when the economy is performing sub-optimally, especially when even the low and sometimes negative interest rates fail to boost private consumption. Krugman introduces the three paradoxes: a) of thrift when saving negative affects income and production levels because everybody engages in it concomitantly, b) of deleveraging when everybody tries to liquidate their debt at the same time, and c) of flexibility when cut in wages due to conservative pressures reduces the available income for spending. The austerity apologists fail to realise the problem of low aggregate demand. Someone has to spend for somebody to be able to save (Blyth, 2013). The Memoranda of Understanding which demand cut in wages and reduction of government deficit translate into sharp drop of spending both private and governmental. The peripheral countries have a double burden of both getting their finances in order and supporting their ailing banks, yet the proposed solution of removing labour market rigidities is rooted in a power differential, whereby the low income earners are hardest hit. The structural reforms are needed, yet they need to be accompanied by aggregate demand policies especially in times of recession (Wolf, 2014).

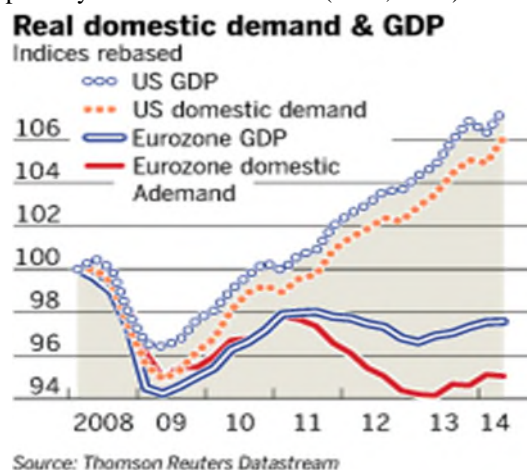


Figure 15. Real Domestic Demand and GDP Source: *Financial Times*

The EU in the post-crisis period is characterised by a situation when *the debtors can't spend, the creditors won't spend* (Krugman, 2012: 46). Soros (2013) has claimed that the crisis in the EU is easily preventable, but self-inflicted. There is a glowing consensus in the academic community that the austerity policies are the sole reason why Europe ended in a prolonged recession (Blyth, 2013; Krugman, 2012; Lapavistas *et al.*, 2012; Soros, 2013; Buti and Carnot, 2012; Overbeek, 2012; Pivetti, 2013; Palley, 2013; Streeck, 2012; Moravcsik, 2012). The predominance of the monetary orthodoxy demands that we solely focus on correcting market confidence via budgetary prudence, the infamous confidence fairy myth, which was also discussed by Polanyi (1944: 237) who observed that the invariable blame put on both inflated wages and unbalanced budgets is over simplification of a much deeper problem. Similarly, his contemporary, Kalecki (1943:324), claimed that the 'social function of the doctrine of 'sound finance' is to make the level of employment dependent on the state of confidence'.

The obsession with what the market thinks reminds me of a joke told by Žižek (2006) about a man who is admitted to a psychiatric facility based on his conviction that he is a seed of grain. After undergoing some treatment the patient is convinced that he is a human being and not a grain, which results in his dismissal. However, few minutes after his release he returns to the facilities trembling which surprises the doctor who asks him if he isn't yet convinced that he is human; to which the man replies: 'yes now I know that I am not a grain, but the chicken outside does not know that'. Are not our European leaders acting like this fellow?! They are now convinced that austerity is not working (at least some), but still they act as if it is working because the market is still oblivious of this fact. The only time the causal link between the reduction of government spending and increased confidence works is when the reduction in deficit could bring interest rates down, hence increasing investment and/or when lower budget could decrease the tax burden, hence increasing consumer spending (Krugman, 2012). However, in the presence of low interest rates, as is the case in the EU now, the reduction in public spending negatively affects the economy.

9 Responses: the Good, the Bad and the Ugly

It would do well to review the interplay between three set of measures following the liquidity squeeze precipitated by the burst in the subprime mortgage markets in the US. The first is the decision motivated by the ECB's obsession with price stability to raise interest rates to 4.25% in May 2008. Fearing a rise in the inflation rate, which was 2% points higher than the envisaged 2%, Jean-Claude Trichet made what in retrospect would be the 'Bed' decision. Such measure proved counter-productive in the wake of contracting European economies. Hence, it was soon afterwards, in October that the ECB revised its decision and cut interest rates to 1% (Dinan, 2010). Not only that the fear of inflation proved unwarranted, but soon a possibility of deflation emerged, with the low inflation and low growth rates (Krugman, 2012, Dinan, 2010). At the moment of writing the deflationary fear is intensifying in the midst of the record high unemployment, low demand and falling prices.

Polanyi (1944: 234; 1977) criticised the monetary orthodoxy for identifying inflation as an 'intervention with the right of property'. The inflation targeting regime is an archetypical disembedding measure whereby the creditors are protected from erosion of the real value of money. In the neoliberal era, just like during the *laissez-faire* regime, the *principle of improvement* demands not only a commitment to 'sound budgets', but also 'sound currency' (Polanyi, 1944: 236).

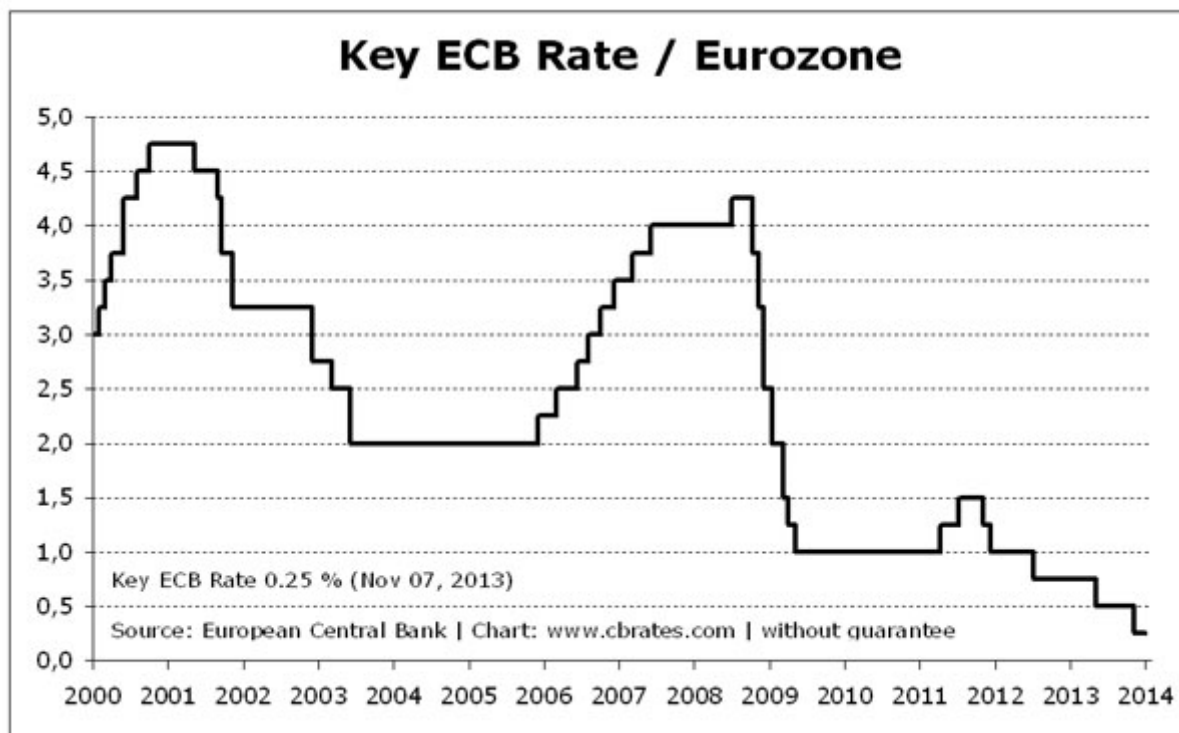


Figure 16. ECB Interest Rates Source: ECB



Figure 17. Harmonized Indices of Consumer Prices - Annual Percentage Change Source: ECB

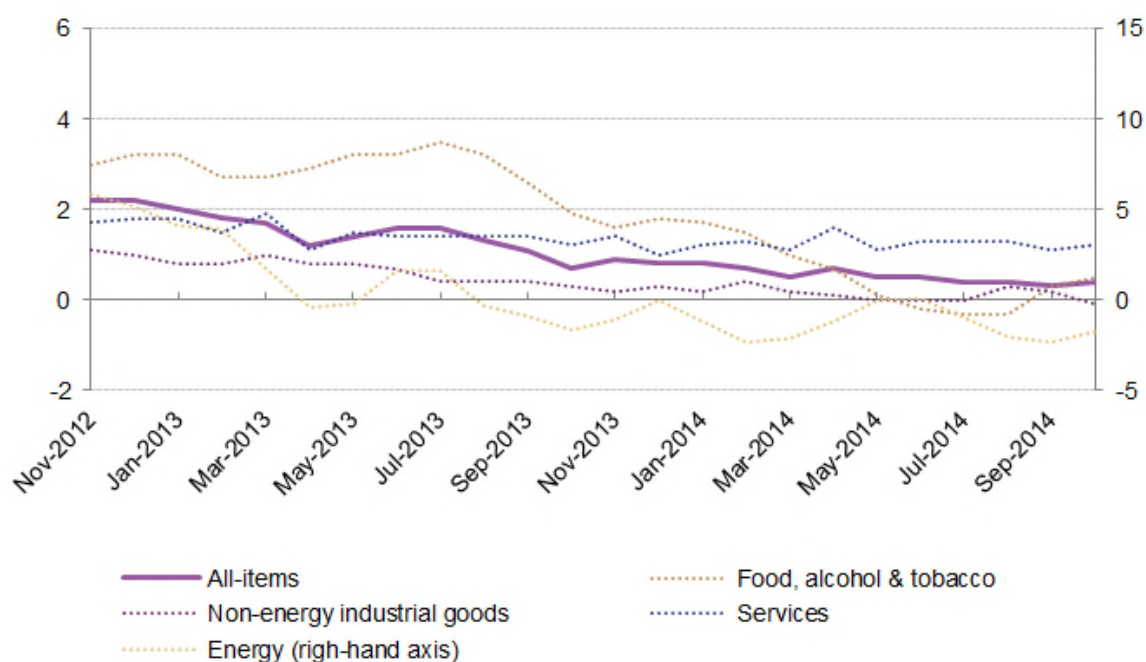


Figure 18. Annual Inflation and its Main Components *Source: Eurostat*

The second set of ‘Ugly’ measures that only deepening of the economic downturn in Europe was the inadequate political response to the Greek sovereign debt crisis. The belated first Greek bailout in May 2010, that consisted of separate bilateral loans some of which with interest rates as high as 6% and a support from the IMF, proved unsatisfactory, increased the bond yields and introduced the possibility of contagion that negatively affected the sovereign debt risk of all the PIIGS countries (Blyth, 2013; Varoufakis, 2013). The infamous German defiance and the initial triple NO response to Greek insolvency, the No to default, the No to interest rate relief and the No to a bailout, was negatively interpreted by the financial markets (Varoufakis, 2013). The EU leaders failed when speaking to the markets to reassure them against the possibility of default, which in turn, was negatively reflected in the huge spreads in the bond rates (Schmidt, 2014).

It was the financial market scare that punctured the spread bubble, which was accumulated due to systemic mispricing of sovereign risk when prior to the crisis the bond spreads were close to zero (De Grauwe and Yuemei, 2012). Jabłeck (2012) points out that it was the implementation of Basel II capital adequacy regulation in 2006, which assigned zero-risk to government bonds across the Eurozone and exempt sovereign debt from the ‘large exposure rules’, that led to a systemic under-pricing of the sovereign debt. In addition, the fact that the spike in spreads, which entered a self-fulfilling prophecy dynamic that threatened the survival of the Eurozone, was not affected by a change in economic fundamentals deserves an honourable mention. The bond spread bubble, which can be credited to the fallibility of the market participants, refutes the orthodox exogenous view of finance (Soros, 2013).

Finally, the third set of measures is concerned with the ECB efforts to save the banks, which unfortunately was not until the summer of 2012 that the ECB took it upon itself to do ‘whatever it takes to save the euro’. Under the leadership of Mario Draghi the ECB proved to be more decisive than the European politicians by increasing liquidity via various instruments (Schmidt, 2014). Besides its regular Short Term Refinancing Operations, repo, in December 2011 the ECB conducted its first Long Term Refinancing Operation with a three year maturity, which was followed with another one in February 2012 (ECB, 2014). In the context of a dried up interbank system, the two LTRO, which totalled to 1 trillion euros, provided liquidity to the troubled Eurozone banks (Gros, 2012; Varoufakis, 2013). In addition, it introduced 60 billion euros worth Covered Bond Purchase Programs (CBPP) which ended in June 2010 and 40 billion euros worth CBPP II which ended in October 2012, which provided cheap money to the banks by buying their debt securities (ECB/2009/16; ECB/2011/17). The ECB conducted interventions in debt markets under the Securities Markets Programme (SMP), which lasted from May 2010 until September 2012, with the intention of containing the rising yields on government bonds (ECB/2010/5) (Gros, 2012). The most significant effect of monetary policy was the introduction of the Outright Monetary Transactions program whose mere announcement without being used at all managed to lower the yields on government bonds in the periphery.²

² The ECB support in lowering down borrowing costs comes with strings attached because the OMT is extended provided that the country has applied for financial assistance from the European Stability Mechanism i.e. has undertaken adjustment measures.

Following the dire inflation figures the ECB announced its intention of buying asset-backed securitirs (ABS) which will expand its shrinking balance sheet which, Wolf (2014) argues should not have been allowed to shrink by 10 % of GDP from 2012-2014. Although the current ECB efforts should be applauded for being the sole measure that keeps Eurozone out of a crisis, the ECB has made few policy errors: a) first it raises interests rates sharply at the onset of the crisis; b) then it was hesitant to roll over a QE program and instead implemented the SMP which was coupled with sterilisation program aimed at keeping the supply of money constant i.e. the money injected into the bond buying scheme are effectively withdrawn by offering to banks equal amount of interest-bearing deposits. Such action on the part of the ECB effectively deprive the Eurozone from quantitative easing (QE) measures, which was ferociously pursued by the US, UK and Japan; c) it took four years to state that it will backstop the euro with its OMT program; and d) waited even longer to announce its ABS program.

In the context where the interest rates cannot be further cut because negative interest rates will punish banks for holding funds, and when the fear of inflation are non-existent, the ECB could afford a major QE program that will supply funds to the depressed economies. The ECB's adamant refusal to deploy a very effective tool in boosting the economy is indicative of the predominance of the disembedding tendency. Polanyi's (1944: 237) conclusion about the financial sector ability to 'obstruct any domestic move in the economic sphere which it happens to dislike, whether its reasons are good or bad' is applicable to the current predicament. The most recent ECB moves to introduce negative interest rates of -0.5% is the last resort of prevention of an impending deflatory spiral in the Eurozone, where inflation had fallen from 0.7% earlier in the year to 0.3% in September 2014. Mario Draghi seems to have realised the danger of the prolonged recession epeiclaly in the wake of the recent European Parliament elcection where the radical parties increased their share of the votes. However, the ECB's rections have come always too late, lagging behind the swift QE policies of the US, UK and Japan for more than five years. The ECB has been able to prevent further financial meltdowns, but the continued commitment to austerity policy continues to exhibit detrimental effects on the real economy.

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