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Abstract

The European response to the financial *cum* sovereign debt crisis in the Eurozone is leading to a democratic crisis of the state. It has exposed a tension between the national and the supranational in a multi-level polity whilst opening up new political cleavages between the core and periphery of Europe. This dilemma has become particularly acute for programme countries that are either directly or indirectly in receipt of non-market financial funding from the troika[♣]. In the absence of exchange rate adjustments, Ireland and southern European countries must pursue an internal devaluation that shifts the entire burden of adjustment on to fiscal and labour market policy. National governments, regardless of political partisanship, are required to comply with external EMU mandates and liberalise their welfare states, cut public spending and impose structural reforms in the labour market. The core argument of this paper is that imposing a *one-size-fits-all* adjustment to diverse economic problems across different *varieties of capitalism* is the real source of the Eurozone crisis. By using a cross-country comparative analysis of Greece, Ireland, Italy, Portugal and Spain, I conclude that this is an outcome of inbuilt institutional and macroeconomic asymmetries in the EMU. But it is leading to unprecedented electoral volatility and a legitimation crisis of the democratic state in Europe.

Keywords

International Political Economy, Varieties of Capitalism, Eurozone Crisis

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[♣] The Troika refers to the International Monetary Fund (IMF), the European Central Bank (ECB) and the European directorate general for economic and financial affairs (ECOFIN).

Introduction

The European response to a financial *cum* sovereign debt crisis in a currency union without a centralised fiscal treasury or political government is an experiment in crisis management. It has exposed a tension between the national and the supranational in a multi-level polity. No level of this multi-level governance system has the policy instruments to solve the crisis[1]. Monetary policy remains supranational (i.e. European) across seventeen national governments with diverse fiscal, welfare state and labour market regimes[2]. These countries have conflicting interests in terms of who should bear the burden of adjustment. For the sake of argument, we can identify this as a tension between creditor and debtor countries, or between the core and periphery of the Economic and Monetary Union (EMU) in Europe[3]. Much of the economic literature argues that if countries engage in an internal devaluation, impose structural reforms in the labour market and implement austere fiscal policies, the crisis will be resolved[4]. This might be true, but it ignores the fact that this is fundamentally a *political* crisis. Europe lacks the strategic capacity to coordinate a response within a currency regime that distributes the burden of adjustment evenly across debtor and creditor nations[5].

The EMU member states currently have limited policy discretion to pursue an autonomous response to the crisis. In the absence of exchange rate or interest rate adjustment, the entire burden of adjustment must fall on domestic prices and wages. In effect, membership of the EMU means that national governments only have one policy instrument at their disposal: internal devaluation and structural reforms of the labour market[6]. From a political perspective, national governments must comply with the external mandates of EMU membership by reducing their budget deficit to 3 percent of GDP. The negative impact this has on employment is legitimated by the economic assumption that labour cost competitiveness and export-led recovery is the only way to generate the conditions for economic growth. To achieve this, national governments are being encouraged to impose structural reforms in product and labour markets as means to enhance cost competitiveness. It is this assumption that a convergence in market competition policies will lead to institutional convergence in political economic outcomes – across diverse democratic states in the Eurozone – that I challenge in this paper.

To do this I draw upon and reconceptualise the core tenets of the varieties of capitalism (VoC) theory, in the study of comparative political economy[7], and propose a new framework based on macroeconomic growth regimes. I argue that the domestic organisation of distinct political economies in the north and south of Europe has interacted with transnational European institutions to produce *divergent* economic and employment growth patterns since the establishment of EMU. The source of the economic crisis was the attempt to join together institutionally diverse capitalist democracies into a single currency whilst failing to account for the asymmetric effects this would produce. Northern European countries, I argue, are built around the institutions of a small open export-driven model of economic growth. Southern European countries, on the other hand, are institutionally conducive to an

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[1] See Fabbrini, Sergio (2013) on this collective action problem

[2] See Scharpf, Fritz (2011) for a detailed analysis of this monetary constraint on national adjustment strategies

[3] The European Union has 27 member states. The EMU (currency) consists of 17 member states: Germany, France, Austria, Netherlands, Finland, Luxembourg, Belgium, Slovenia, Slovakia, Malta, Cyprus, Estonia, Ireland, Italy, Greece, Spain and Portugal. All EU member states (except the UK and Denmark) are obliged to become members of the Euro currency when they satisfy the entry criteria.

[4] See Buti & Carnot (2012) for an analysis that reflects the perspective of the ECB

[5] See Pontusson, J., Raess, D (2012)

[6] See Armingeon & Baccaro (2012a) on the limited variation in policy choices available to Ireland and southern Europe

[7] This is not only related to Hall and Soskice (2002) but a political-economic research tradition that includes, to name but a few: Albert, M. (1991), Boyer, R (1990), Esping-Andersen (1990), Crouch, C (1993), Hirst & Thompson (1997) Campbell, J.L. (2001), Streeck & Thelen, (2005), and Scharpf (2012). The core insight is that cross-national differences in outcomes can be explained by historically embedded institutions and politics. I am specifically interested in combining the core insights of the Anglo-American and German tradition in comparative political economy. Both missed the importance of the Eurozone as an international political regime.

economy based around domestic demand in the non-tradable sectors of the economy. My contribution to political science is to illustrate how these growth models are *systematically connected* in the Eurozone, and to analyse the EMU as an emergent multi-level polity in itself.

In this sense, the article critiques the narrow focus on nation-states in the VoC framework and proposes to analyse the core and peripheral countries of EMU as *regions* within a structurally imbalanced currency regime. It is an international case study on what happens when diverse democratic states with distinct political economies are integrated into, and subsequently attempt to adjust, in a currency union without a centralised federal government. But this is not to say that VoC has nothing to say about the complex problems facing national governments in the EMU. I push the VoC argument to its logical conclusion and argue that if nation-states operate according to their own distinct political and institutional logic (in my framework; conflicting macroeconomic growth regimes) then it is questionable whether some member-states should remain in the Eurozone. The European Union (EU) needs a *variegated* response to the crisis that provides the flexibility for member states to carve out an autonomous economic and employment growth strategy at the national level. If this is not forthcoming then it is perfectly rational for some member-states to consider leaving the EMU, particularly those countries who are not in a position to compete in international markets.

The core argument of the paper, therefore, is that European policymakers assumed that competitive convergence through market integration was possible between diverse capitalist democracies. It failed to appreciate the institutional diversity between the north and south of Europe. In the aftermath of the financial crisis the one-size-fits-all fiscal and structural adjustment programs are perpetuating this assumption of convergence. The remainder of the paper is structured as follows: first I outline a new VoC theoretical framework that analyses the EMU as a political economy with two interactive macroeconomic growth regimes. Second, using this framework, I trace the origins of the Eurozone crisis to capital inflows and current account imbalances, which directly emerged after the establishment of EMU. Third, I detail the policy response of ‘internal devaluation’ in Ireland and southern Europe. Fourth, I analyse the political consequence of this for the Eurozone as a whole. I conclude that the *one-size-fits-all* program of adjustment is leading to an unprecedented legitimacy crisis of the democratic state in Europe, with unforeseen political consequences for the EU.

The Diversity of Capitalist Democracies in the Eurozone

The central research finding in comparative political economy over the past twenty years is that what governments do is conditioned by the structure of the political economy. According to Hall and Soskice (2002), the organisation of a country’s political economy includes the structure of corporate governance, industrial relations, finance, social protection, the labour market, education and training[8]. The relations within these subsectors and their historical evolution over time produce different varieties of capitalism. From a political science perspective, they condition the type of public policy choices that governments are likely to pursue in times of economic crisis and growth. In the Eurozone, one can argue that there are two variants of capitalism. Northern European countries – Germany, The Netherlands, Austria and Finland – are often described as coordinated market economies (CMEs)[9]. They have centralised unions and employers with the capacity to autonomously coordinate collective bargaining and labour market outcomes. In addition, they have embedded democratic state traditions committed to social protection and income security. They have traditionally relied upon export-led economic growth as a mechanism to generate employment. Hence, their macroeconomic structure supports a preference for stable fiscal policies[10].

[8] Hancké, Bob et al (2008) highlighted the importance of demand-led southern European economies as a distinct variety of capitalism. But there was limited attention paid to the systematic relation between these regimes and northern CMEs *within* the EMU.

[9] See Streeck (2009) and Hassel (2012) for an account of institutional change in Germanys CME model.

[10] See Carlin and Soskice (2011) on the importance of macro-economic choices in an open economy

On the other hand, southern European countries in the Eurozone – Spain, Italy, Greece, Portugal and Cyprus – are often described as mixed-market or Mediterranean varieties of capitalism[11]. They have fragmented trade unions and employers with limited capacity to autonomously coordinate collective bargaining and labour market outcomes. They have weak welfare states and a significant amount of social security occurs through family relations. Traditionally, they have generated economic growth through domestic demand. This gives priority to wages, and consumer spending, over profit-generation in export markets. Prior to EMU, this organisational structure lent itself to an accommodating monetary and fiscal policy, with governments regularly devaluing the currency to offset a loss of competitiveness and the inflationary impact of a rapid increase in domestic prices. Wealth is often held in fixed assets such as property, and corporate governance is dependent on close business relations among family-run firms[12]. Ireland can also be characterised as a mixed-market economy, but more liberal in orientation. It differs from the north and south of Europe in that it has a business cycle closer to the UK and USA, and a much more flexible labour market.

The core argument of this paper is that the attempt to join together these two different varieties of capitalism into a shared currency within a multi-level polity without a centralised political government is the real source of the Eurozone crisis. As stated in the introduction, we can describe the organisation of the political economies in southern Europe as conducive to a growth model based on wage-led domestic demand. In contrast, the organisation of the political economy in northern Europe is conducive to a growth model based on profit-oriented export-driven demand. Both of these regimes, however, are *systematically* connected. That is, the strong export base of northern Europe requires high-levels of domestic consumption in the south. The EMU is a semi-closed trading area with less than ten percent of trade leaving the Eurozone, but predominately going to other countries in the EU[13]. The EMU was designed as an unaccommodating currency regime that provided unprecedented autonomy to the European Central Bank (ECB). This primarily benefited the export-driven model of northern Europe. This would not be a problem in a federal state system such as the USA, but it is a problem for a polity such as the EMU with no capacity for banking, fiscal, wage, employment or labour market coordination – to offset the asymmetric impact of a financial crisis[14].

The core problem with empirical research in the VoC tradition was that it failed to analyse the monetary relationship between these macroeconomic growth models *within* the EMU[15]. The Eurozone is a semi-closed trading area operating in an international money market without a central government. VoC research was predominately focused on the institutional complementarities between sub-sectors of the economy within the *nation-state*, and the comparative advantage this provided to multinational firms in the export sectors. This provided important insights into why cross-national variations in public policy outcomes persist, particularly those pertaining to the labour market. The core conclusion, much like Esping-Andersen's (1990), was that domestic *institutions* are deeply embedded and difficult to change. But it did not allow for a systematic analysis of the financial sector. This is all the more unusual when one recognises that, with few exceptions, money driven domestic demand is what drives most capitalist development. Hence, I want to highlight one variable that VoC researchers have paid insufficient attention to, and which is crucial for understanding the origins and consequences of the Eurozone crisis: the monetary relationship between different political regions *within* the EMU. This

[11] See Jackson & Deeg (2006) for a different approach to studying varieties of capitalism

[12] See Molina, O and Rhodes, M (2006) for a more detailed account of mixed-market economies but with no reference to EMU

[13] Hancké, Bob (2013) makes this argument in a recent book. It prioritises wage setting institutions and but does not analyse the EMU as a political regime in-itself with different macro-economic growth models.

[14] This was a central theme at a conference hosted by the European University Institute (EUI) on 'The Euro crisis and the state of European democracy'. The online book edited by De Witte, Bruno; Heritier, Adrienne; Trechsel, Alexander H, can be read here: http://cadmus.eui.eu/handle/1814/27016

[15] In this sense I want to integrate the literature on capitalist diversity in comparative political economy with the core insights of the study of Europeanisation, particularly the critical German tradition which puts emphasis on the multi-level structure of decision-making in Europe.

requires moving beyond the methodological nationalism of the VoC framework and examining the Eurozone as an international regime with competing varieties of capitalism.

Taking a more international political economy perspective seriously will illustrate the importance of analysing the growing *political* tension between creditor and debtor nations within a multi-level polity such as the EMU. Institutional analyses in the VoC tradition paid insufficient attention to the declining fiscal capacity of the state to manage crises in a global monetary system[16]. In this sense, VoC has proven to be an insufficient framework for explaining government responses to the boom and bust periods of financial expansion in the EMU. Within Europe, there are not only distinct macroeconomic growth regimes but also democratic state traditions with distinct tax and spend profiles. What makes for a successful fiscal strategy in Italy, France, Greece or Ireland is not the same as in Germany and the Netherlands. But despite very different institutional traditions these member-states pooled their national sovereignty into a complex multi-level polity that would restrict the fiscal capacity of democratically elected governments to be responsive to the distributional demands of the electorate in a crisis (such as using macroeconomic policy to generate demand). As will be argued in section (4) all member-states have to adjust by driving down domestic prices and wages, despite the negative impact this has for the Eurozone as a *whole*.

It is by integrating an empirical analysis on the interactive effect of joining together distinct capitalist growth regimes within EMU that I contribute to international political economy. The question is not just whether the nation-state or EMU can sustain institutions for economic efficiency but whether they can maintain the legitimacy for democratic order in the face of financial markets. I will now use this framework to empirically analyse the origins of the sovereign-debt crisis in the Eurozone: financial market integration and the creation of cheap money.

The Origins of the Eurozone Crisis: Cheap Money

The Eurozone is composed of seventeen linguistically diverse countries and has a combined population of 317 million people. It has a GDP of €9.4 trillion and accounts for 14.6 percent of global trade (the second largest in the world)[17]. But, importantly, only ten percent of this GDP actually leaves the Eurozone, and predominately goes to other EU countries. As argued in the previous section, this means that the Eurozone, in effect, is a semi-closed trading economy. A gain in competitiveness for one country, by definition, can only come at the expense of another country. The implication is that trade has become a *zero-sum game* among seventeen nation-states sharing the same currency. That is, unless a country can gain in market share outside the Euro area it will come at the expense of another EMU partner. This has exposed a horizontal political tension between the member states of the EMU. Germany accounts for over 26.7 percent of Eurozone GDP, and is by far the largest exporter from the trading area. Given its economic resources, it is a rule maker rather than a rule taker when designing the policies of EMU. From a macroeconomic perspective, fiscal reflation in a closed economy will stimulate aggregate demand. But this Keynesian policy assumes that the closed economy is governed by a homogenous nation-state. This is not the case in a polity composed of nation-states with competing economic interests, institutions and economic philosophies[18].

The core problem at the heart of the Eurozone crisis is a structural imbalance between export-led economies with current account surpluses (Germany, The Netherlands, Austria and Finland) and countries with current account deficits (Italy, Spain, Greece, Portugal and Ireland) that emerged directly *after* the establishment of the EMU in 2000 (see Figure 1[19]). These divergent trends are usually taken to illustrate the underperformance and loss of competitiveness by the 'GIIPS' (Greece, Ireland, Italy, Portugal and Spain) countries in the Eurozone, and were central to the establishment of

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[16] This argument is influenced Pierson, Paul (1994, 1996 and 2001). See also Streeck and Mertens (2013).

[17] See De Grauwe, P., & Ji, Y. (2013). Panic-driven austerity in the Eurozone and its implications. *VoxEU. org*, *21*.

[18] See Peter Hall (2012a, 2012b)

[19] I use the most similar/ most different research design to select these four regions of EMU. I take Ireland and Spain as representative cases of the periphery. They both had asset price booms and now carry large levels of private debt. Germany and the Netherlands are representative the CME creditor core. Combined they illustrate the broader trend and macroeconomic imbalances between north and south of Europe since the creation of the single currency.

the new EU Commission 'macroeconomic scorecard' in 2011[20]. The indicators in this scorecard are firmly focused on how to improve the balance of payments for debtor countries, through holding down unit labour costs. This, by definition, promotes competition in wages among member states as a strategy for economic development. Coordinated wage restraint by centralised unions and employers, made possible by domestic institutions, is certainly one of the core factors in explaining the export-oriented strategy of small open economies in Europe[21]. Germany, despite its size, is perhaps the best example of this. But from the perspective of EMU as a whole, what this approach to wage competition fails to appreciate is the negative impact it has on the exporting capacity of other countries sharing the same currency. This is all the more problematic if we accept that within the Eurozone there are two different macroeconomic growth models in the north and south: export-profit and domestic-wage demand. In this context, holding down wages in a semi-closed trading area negatively affects *all* member-states but particularly those countries dependent on domestic demand.

What the divergence in current account balances in figure 1 actually illustrates is that from 2000 to 2008 Ireland and Spain imported more than they exported[22]. Capital flew out of countries where exports exceeded imports, such as Germany, to purchase assets located in countries with increased domestic demand (Ireland and Spain), fuelling domestic prices and house price booms[23]. Since 2000, Germany's current account surplus (€192.2bn) has been identical to the combined current account deficit of Greece, Italy, Portugal and Spain[24]. This export of capital meant that these deficit countries became indebted to surplus countries, with the implication that their economies become heavily reliant on private credit to fuel domestic demand (see Figure 2). All of this was made possible by a one-size-fits-all monetary policy by the ECB and a single interest rate that made cheap credit widely available for peripheral member states after entry to the EMU. Hence the current account imbalances occurred because private banks in some member states took advantage of negative interest rates, and the absence of exchange rate restrictions, and began borrowing excessively on the European money markets for domestic consumption. VoC theorists failed to analyse this financial relation because it was focused on the domestic export strategies of manufacturing firms.

But the increase in capital inflows from the core to the periphery is precisely what the political leaders who signed up to EMU wanted and got from the single currency[25]. For Germany, it provided an anchor for a stable exchange rate that would benefit its export-driven model within Europe. It removed the volatility of exchange rate fluctuations and the ability of its trading partners to devalue their currencies relative to the Deutschmark. It provided an integrated European finance market that was highly profitable for German banks. France, on the other hand, feared the economic might of German reunification, and sought a tool that would generate the conditions for a federal Europe that would decrease rather than increase the power of German money[26]. For Ireland, Italy, Spain, Greece and Portugal, the EMU would reduce the cost of borrowing and facilitate capital inflows for national investment. All these countries got what they wanted. This is less a case of economic calculation but distributional politics. The critical mistake was that policymakers assumed that a convergence in ECB market interest rates, in addition to strict fiscal policies to be embedded in the Growth and Stability Pact, would provide the conditions for an *institutional convergence* in business cycles across diverse capitalist democracies in the Eurozone. This has proven to be a fundamental mistake.

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[20] See European Council (2011): The Euro Plus Pact: stronger economic policy coordination for competitiveness and convergence,

Conclusions of the European Council of 24/25 March 2011, Annex 1, EUCO 10/1/11 REV 1, Brussels.

[21] See Carlin, Wendy and Soskice, David (2009)

[22] See De Grauwe, Paul et al (2012)

[23] See Fitzgerald et al (2012)

[24] The economic problems in Italy are somewhat different to other deficit countries. Italy has always had high-levels of national debt. Its economic crisis is directly related to declining productivity and beyond the scope of this paper.

[25] See Moravcsik, Andrew (2012)

[26] This historical dimension to the politics of elites in European integration has been central to European political science but not comparative political economy.

The assumption of institutional convergence was not present in the negotiations that led to the European Monetary System (EMS) in the late 1970s. During this period there were competing perspectives between the 'monetarists' and the 'economists'[27]. The German Chancellor, Helmut Schmidt, refused to accept a shared currency until there was real convergence in fiscal policy regimes. The monetarists, on the other hand, argued that a currency union would itself lead to economic convergence and eventually a political union in Europe. After Maastricht, there was a blurring of the two positions. It was assumed that a single interest rate would lead to market convergence but only if the ECB was constructed in the image of the Bundesbank, and complemented with strict fiscal rules to be imposed on member countries. A deeper analysis, reflecting much economic literature on rational expectations, argued that 'structural reforms' in product and labour markets is what will really drive institutional convergence[28]. Countries that implemented *supply-side* structural reforms would generate the conditions for price and wage flexibility, and therefore develop the capacity to adjust their economies in the aftermath of an asymmetric shock. This is the core economic idea that underpins the European response to the crisis today.

The problem with this perspective, however, is that it completely ignores the fact that this is a crisis of the monetary system in Europe. It assumes that committed governments with the 'correct' techno-economic policies can easily overcome structural debt problems. The prescribed structural adjustment programmes in Ireland and southern Europe are premised on the assumption that if governments liberalise their welfare state, decentralise collective bargaining and flexibilise the labour market they will eventually generate the conditions to compete with the German model of capitalism in international export markets. It is certainly true that Germany introduced deeply contested structural reforms in the post-EMU era (usually captured under the 'Hartz reforms'), which created significant political and distributional turmoil for both SPD and CDU-led coalitions. In this regard, Germany has the legitimacy to prescribe structural reforms as a panacea to the economic and employment crises in southern Europe. But it would be a mistake to assume that these reforms underpin the competitive resilience of the German economy. This can be traced to the embedded corporatist institutions that provide economic actors with the resources to negotiate political compromises and solve complex economic problems[29]. Germany had the strategic capacity to carve out an autonomous response and develop an export-led strategy that complemented the monetary constraints of EMU. Ireland and Southern Europe do not have this industrial base.

Hence, whilst divergent current account imbalances within EMU certainly indicate the different long-term growth potential of southern and northern European economies, and therefore their capacity to pay off debt and achieve lower interest rates on government bonds, they primarily reflect two different macroeconomic growth models (consumption versus exports) that became systematically connected through the European financial market. Deficit countries (in the private and public sector) borrowed cheap money from surplus countries to feed domestic demand. This may or may not have crowded out their export sectors. But given that the Eurozone is a semi-closed trading economy, it would have been systematically impossible for all countries to pursue a German export strategy. Each participant benefitted from the financial exchange. Furthermore, this is precisely what the policymakers of EMU had intended. However, they did not achieve their expected institutional convergence in the export organisation of national political economies across member-states.

The Real Impact of EMU: Macroeconomic Divergence

The outcome of joining these different varieties of capitalism together was that post-EMU wage-driven economies experienced a financial orgy, fuelling divergent and uncoordinated business cycles (see figure 3). Investors threw their money at risky investments, leading to asset price bubbles and subsequently private sector debt. The Euro currency as an isolated variable did not *cause* this but it made some member states extremely vulnerable to financial markets and a sudden stop in capital

[27] See Mourlon-Druol (2012) for a history of elites decision making in the formation of EMS

[28] See Peter Hall (1992) on the importance of economic ideas during this transition period.

[29] See Streeck, W (1991) and Culpepper, Pepper (2012)

inflows. This is precisely what happened to Ireland and southern Europe from 2008 to 2012[30]. In fact, the extent of capital inflow is the single most important variable for analysing which member-states got into trouble in the aftermath of the financial crisis[31]. In the Eurozone, countries experiencing a boom in domestic demand borrowed excessively either for private spending (Ireland and Spain) or public spending (Greece). The outcome of these credit bubbles was strong economic and employment growth in the *domestic* economy. This provided national governments with unprecedented fiscal resources to satisfy the legitimate political-distributional demands of their electorates.

Hence the real impact of EMU was not macroeconomic convergence but an explosion in cross-border capital flows, cheap credit and an inevitable rise in monetary debt cross Ireland and southern Europe (see figure 4 and 5). None of the peripheral countries had the policy tools to control the awesome power of cheap money. But from a VoC perspective it was perfectly rational for these countries to take advantage of the absence of exchange rate restrictions. Their domestic economic and political institutions are more conducive to facilitating domestic-consumption than export-led growth. The problem was not economic growth based on domestic demand in itself, but the composition of the investments that were made. In Ireland and Spain the banking sector invested cheap money into the commercial and housing mortgage markets, leading to an asset-price boom[32]. This, in turn, created the perverse effect of higher inflation rates in countries such as Ireland when compared to the pre-EMU period. During this period, the ECB was targeting the average Harmonised Consumer Price Index (HCPI) across member states experiencing diverse business cycles. The problem with this measure is that it did not consider asset-price inflation[33]. Hence, the ECB completely missed the impact of house price inflation on national competitiveness – measured in unit labour costs – across the EMU periphery. They were primarily focused on traditional product markets, not the financial sector.

The divergence in competitiveness shown in figure 6 reflects an increase in the overall share of the non-tradable sectors (construction, domestic retail and public administration) in the economy. Divergent wage-setting institutions, associated with different varieties of capitalism, certainly contributed to this but it was generally caused by the inflow of capital imports from surplus countries (Germany). When these capital flows went into reverse during the international financial crisis the deficit countries got into economic difficulty. Hence, it is not competitiveness *per se* that is the underlying problem of current account imbalances in the north and south of Europe but the accumulation of *debt*. On the one hand this can be explained by the fiscal recklessness of political parties in government (Greece), but it was primarily the result of reckless behaviour by private market actors in private finance markets. This was made possible by an integrated and liberalised European money market that began with the abolition of capital controls in the 1980s, followed by the harmonisation of financial regulations in the 1990s, and culminated in the single currency: EMU[34]. No amount of supply-side oriented structural reforms will resolve this financial problem.

The political fallout within the EMU when these credit bubbles burst is now part of European history. In Ireland and southern Europe, the level of private and public debt accumulated was quickly made visible to citizens and markets. Increased tax revenues made possible by a period of full employment and high growth collapsed when domestic demand contracted. Governments stepped in to guarantee the bad debts of their banks. Fiscal deficits increased and debt-GDP ratios soared. In the absence of a lender of last resort (i.e. the equivalent of the Federal reserve), international investors panicked. Government bond yields rapidly diverged and the fragility of the Eurozone was exposed[35]. Greece, Ireland and Portugal were catapulted out of international finance markets and had to resort to ECB-IMF-EU (troika) loans to avoid a sovereign default. In return for this 'bailout' these member-

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[30] See Lane, Philip (2012)

[31] This variable has been consistently pointed out by Martin Wolff, chief economics commentator for the Financial Times

[32] This is not to deny the variation among these countries. For a more detailed analysis see Monastiriotis, Vassilis, Niamh Hardiman, Aidan Regan, Chiara Goretti, Lucio Landi, J. Ignacio Conde-Ruiz, Carmen Marín, and Ricardo Cabral (2013)

[33] See Hay, C. (2009).

[34] See Sadeh, T., & Verdun, A. (2009).

[35] See De Grauwe, P. (2012).

states were required to implement an aggressive *internal devaluation*: public sector adjustment and structural reforms, on the assumption that wage competitiveness was the fundamental problem.

The sovereign-debt crisis soon spread to Spain and Italy. Whilst these countries have not been directly priced out of the international bond markets, they required emergency funding from the ECB to keep their banking systems and economies liquid. In return for this they too must impose structural reforms and cuts in public expenditure. Hence, rather than confront the asymmetric implications of joining together different varieties of capitalism into a shared currency, and propose a shared solution to an interconnected private banking crisis, European policymakers shifted the burden of adjustment on to the debtor countries in Ireland and southern Europe. The policy response of 'internal devaluation' is designed to save the common currency and the best way to do this, it is argued, is for member-states to follow the structural reforms of Germany. But what are the political implications of this economic strategy for collective decision-making in the European Union?

Responding to the Eurozone Crisis: Internal Devaluation.

There are four important political science observations to be made about the European response to the financial *cum* sovereign debt crisis, and the proposed solution of internal devaluation. First, it was not supranational institutions such as the European parliament or commission that managed to impose a one-sided adjustment across the Eurozone, but the *European Council*. The new executive powers that have emerged from the EU Council in the aftermath of the crisis have created a mode of governance that mirrors an executive federalism with no formal legislative legitimacy[36]. The outcome is an inter-governmental regime that gives ultimate priority to fiscal stability as the primary solution to the financial imbalances at the heart of the Eurozone. In particular and reflecting the intergovernmental mode of decision-making that has emerged, Germany has succeeded in getting all member states to pursue individual national austerity policies aimed at an internal devaluation, and to institutionalise this into a new Eurozone 'fiscal compact'. This has given the EU Council unprecedented procedures and capabilities to both monitor and sanction member states for violating the rules of austerity[37]. It gives priority to inter-state bargaining and competitiveness within the EMU.

Second, in the Eurozone, unemployment has crept above 12 per cent. But this masks the deeper asymmetric implications of the unemployment crisis in Ireland and southern Europe (Figure 7). The unemployment rate is 27 per cent in Greece, 26 per cent in Spain, 17 per cent in Portugal and almost 15 per cent in Ireland. More worrying, however, is the distribution of this crisis within countries. The cross-national youth unemployment rate in Spain, Italy, Portugal and Greece varies between 42 and 56 per cent[38]. Most of this is the outcome of a contraction in *domestic consumption*, not industrial output. To overcome the unemployment crisis these wage-driven economies are being encouraged to adopt labour market supply-side reforms, as a complement to fiscal retrenchment, in order to generate long-term growth. But there is only negligible research on the effectiveness of these reforms in international political economy[39]. Empirically, it is widely accepted that structural reforms only work as a long-term strategy in a period of strong economic growth, and when complemented by social security policies that ensure high levels of income replacement[40]. From 2002, this was accepted and embedded in the policy discourse of the EU Commission on Labour and Social Affairs, which attempted to promote the 'flexicurity' regimes of Nordic economies. Since the crisis, however, the policy response to labour market problems has been dominated by ECOFIN. The outcome is that national governments are adopting policy responses that contradict not complement their domestic institutional political economies. This, however, can only be understood if we prioritise the demand side of macroeconomics, rather than the supply-side, as assumed in traditional VoC theory.

[36] This argument has also been advanced by Jürgen Habermas (2012).

[37] See Croon, J. & Maduro, M. P. (2012).

[38] See Gros, Daniel. "Europe's Recurrent Employment Problems." *CEPS Policy Brief* 271 (2012).

[39] See Armingeon & Baccaro (2012b), and Avdagic, Sabina & Salardi (2013) for recent analyses

[40] See Hemerijck (2012), Bonoli, G (2005) and Morel, N., Palier, B. and Palme, J (2011)

Third, the priority accorded to fiscal stability and structural reforms that has emerged from the EU Council completely ignores the central problem facing member-states in Europe: how to regain control over financial markets. The frustrated attempts to regulate the international financial system and its parametric expression in the EMU are being blockaded by political fragmentation among nation-states. This is particularly the case for Coordinated Market Economies (CMEs) such as Germany, who jealously guard their prerogatives to defend their domestic export sectors, and are therefore reluctant to build new supranational capacities for political action. The fiscal pact ultimately sets the seal on the intergovernmental mode of national regulation which makes it possible for national governments to narrowly promote the specific interests of their national variety of capitalism – blocking off a supranational response[41].

Finally, and most importantly for the theoretical argument being developed in this paper, the ECB-inspired fiscal stability agenda promotes a one-size-fits-all solution that does *not* take into account the need for differential adjustment programmes in the north and south of Europe. It rules out flexible interventions that are tailored to the specific economic growth models, political institutions and economic cultures in each member state[42]. The underlying cognitive argument used to validate this strategy is the notion of Ricardian equivalence or 'expansionary fiscal contraction'[43]. It is assumed that a shrinking public sector will lead to increased competitiveness in the private sector, which in turn will kick start an economic recovery based on export-led growth. The subsequent improvement in the current account, it is argued, will send a signal to international financial markets that the government has the capacity to pay back its long-term borrowings. The problem with all of this, of course, is that it is based on minimal empirical data[44]. It is based on the same logical argument that was used to create the EMU in the first place, namely that a one-size-fits-all adjustment can solve diverse political problems, and lead to market convergence.

From a VoC perspective, the divergence in outcomes and the failure to resolve the crisis by shifting the burden of adjustment on to deficit countries is unsurprising. There is not a complementary institutional fit between the national fiscal and labour market policies of each member state and EMU. Monetary policy remains Europeanised yet the institutions to transmit this to the real economy remain national, with the result that the various ECB monetary easing programs since 2011 are not having the assumed expansionary effect on the real economy. Banking, much like fiscal, wage, social and labour market policies operate at the national, not European, level[45]. Hence, the assumption that an institutional complementarity between all these sub-spheres of the economy can be achieved through the implementation of stricter rules is not possible if one accepts that there are different varieties of capitalism in Europe. But it does draw our attention to the complexity of decision-making among heterogeneous democratic states in a multi-level polity during hard economic times, and it is on this point that a theory focused on the nation-state, such as VoC, has limited explanatory power.

The Political Consequences for Eurozone Governance

Political leaders at the national level in creditor and debtor countries are operating in a complex institutional matrix that offers competing incentives and constraints on their behaviour. They have to respond to the popular preferences of domestic electorates to ensure re-election and simultaneously respond to the interests of other political leaders at the EU level, to ensure their membership of a 'government of governments'[46]. In the aftermath of the Eurozone crisis this has become an asymmetric tension. Those countries with the most economic resources are in a significantly stronger

[41] See Iversen, T., & Soskice, D. (2012).

[42] To a certain extent this reflects the limited influence of research in comparative political economy on policy-making among political elites. Orthodox economics dominates the policy response. See Blyth (2013)

[43] This is based on a discussion with an ECB official monitoring the Irish adjustment.

[44] See Blanchard, O., Jaumotte, F., & Loungani, P. (2013a and 2013b)

[45] See Mody, A.& Sandri, D. (2012). The eurozone crisis: how banks and sovereigns came to be joined at the hip. *Economic Policy*, *27*(70), 199-230.

[46] See Scharpf, Fritz (2012)

bargaining position to get other member states to comply with their interests. But simultaneously countries such as Germany must comply with European Union law[47].

Presently, the EU lacks all the pre-requisites of input legitimacy that characterise a nation-state. There are no European-wide political parties[48]; there is no European-wide capacity to generate revenue and no directly elected President or European government capable of acting in the common interest. Political cleavages and the public sphere remain an entirely national affair. Furthermore, the capacity to coordinate a European-wide solution to the Eurozone debt crisis is restricted by the multiple veto points built into sharing sovereignty in a multi-level polity. Policymaking and power relations are diffused across a wide variety of actors and institutions. It is for all these reasons that Fritz Scharpf has long argued that the EU is best characterised as a negative process of market-making that is structurally biased toward the promotion of neoliberal markets[49]. Even if social democrats wanted to turn the EU into a federal system capable of satisfying the most basic social contract implicit in national welfare states they would be incapable of doing so because of institutional asymmetries[50]. The outcome for Scharpf (2012) is a variant of Hayekian technocracy.

Supranational European institutions such as the European parliament, and to a certain extent the European Commission, have been side-lined during the crisis. They have been replaced by *intergovernmental* Eurozone summits between heads of state as the main forum for political decision-making. The Commission subsequently monitors and implements the outcomes, particularly the financial and economic affairs commissioner. In a context of crisis management, where creditor countries in northern Europe are being requested to distribute scarce resources to deficit countries in the south, this shift to national bargaining should not be surprising. But it draws our attention to the asymmetrical influence of powerful *nation-states*, as opposed to European political actors, in designing the structural adjustment programs in Ireland and southern Europe. Hence, contrary to the assumptions of pro-Europeans from Jürgen Habermas to Ulrich Beck, the crisis is not leading to more European integration but a return to the nation-state, with national governments defending the interests and comparative advantage of their national economies. The outcome is a German EMU.

The Political Consequences for the Democratic Nation-State

In Ireland and southern Europe there has been unprecedented electoral volatility at the national level under the Troika adjustment programmes. The general trend is that incumbent governments, regardless of partisanship, who implement economic policies that are imposed upon them by external actors, are being severely punished at the ballot box. In Ireland in 2011, the main party of the centre-right coalition, Fianna Fail, went from 77 seats in parliament to 20. This is unprecedented in Irish politics[51]. Its coalition partner, the Green party, lost all its seats at both the national and the local level. The current centre-right coalition, Fine Gael and Labour, won the election on the basis that they would renegotiate the Troika adjustment programme. This never materialised. The Labour party is suffering the most in electoral terms. It received 33 seats in parliament in 2011, its biggest electoral victory in history. In the current polls it is set to lose 18 of these seats. In a recent by-election it received less than 5 percent of the vote.

The Greek centre-left party, the Panhellenic Socialist Movement (PASOK), won 43 percent of the national vote in 2009. In 2010 it entered the Troika adjustment programme and began to implement the conditional austerity measures. In 2011 the Prime Minister, George Papandreou, resigned after a series of violent protests and the government collapsed. In the subsequent 2012 election PASOK suffered a historic defeat and barely secured 13 percent of the vote[52]. The newly-

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[47] During the crisis there has been growing tension between the ECB and the German polity. Many economic elites in Germany consider the EU as facilitating moral hazard among feckless peripheral state.

[48] With the ironic exception of the Irish-based '*Libertás*' which is a right-wing conservative libertarian party

[49] See Höpner & Schäfer (2010, 2012)

[50] See Sabel, C and Zeitlin, J (2010) on 'new forms of experimental governance' for an alternative perspective

[51] See Marsh, Michael (2012)

[52] See Dinas and Rori (2013)

emerged leftist party, Coalition of the Radical Left – Unitary Social Front (SYRIZA), under its new charismatic leader, Alexis Tsipras, took 27 percent of the popular vote. A government was formed by the centre-right New Democracy, which whilst losing 10 percent of the vote secured enough seats to form a minority government. A neo-Nazi party, Golden Dawn, won 18 seats in parliament. According to current polls (2013) it would win over 11 percent of the vote if new elections were held, giving it the balance of power in parliament[53]. The post-dictatorship political party system comprised by the centre-left and centre-right is collapsing.

In 2005, the Portuguese Socialist Party (PS) won 45 percent of the vote, which was reduced to 35 percent in 2009. In 2012 after entering the Troika adjustment it suffered its largest ever defeat, taking 28 percent of the vote[54]. In six years it lost over 30 seats. The current centre-right liberal party, the Social Democrats, increased its popular vote from 28 percent to 38 percent. But according to current polls it would be voted out of office if a new election were held, with a variety of emergent parties set to change the parliamentary landscape. The trend is identical to other EMU programme countries: sitting governments, regardless of political partisanship, are being voted out of office with new parties and social movements emerging that are likely to reconfigure the political landscape.

In Spain and Italy similar processes can be observed. A snap general election in 2011 was called in Spain after the perceived failure of the government to cope with the economic crisis. The ruling Spanish Socialist Workers' Party (PSOE), led by former Deputy Prime Minister Alfredo Pérez Rubalcaba, suffered its worst election since Spain's transition to Democracy in 1977[55]. It went from 43.9 to 28 percent of the national vote. The centre-right Peoples Party under Mariano Rajoy swept to power taking 44 percent of the popular vote. But Rajoy is now confronted with increased national separatist movements across Spain. This return to regional politics, particularly in Catalonia, is primarily driven by nationalist discourses that are in contradiction with pro-European integration[56].

It is in Italy, however, that there has been most political volatility. In 2013 the electorate rejected the technocrat Mario Monti and his Civic Movement. It received 10 percent of the vote, which is less than what had been obtained by the pre-existing centrist parties that he gathered to form his civic movement. While the Social Democratic Party, 'Partitio Democratico' (PD) led by Pier Luigi Bersani, emerged as the largest party, taking 29.5 per cent of the vote, this was 8 percent less than what they had achieved in the 2005 elections. The clear winner of the Italian elections was Beppe Grillo and the *Movimento Cinque Stelle* (Five Star Movement). This emerged out of nowhere to take 25 per cent of the vote, recording the largest ever vote share for a party entering its first election[57]. Berlusconi's centre-right 'Popollo Della Libertá' (PDL) emerged as the second largest party, taking 29 per cent of the vote. Some have lauded this as a political comeback, but it hides the fact that it was the biggest ever defeat for a sitting party in Italian elections, losing 16 per cent of its vote. This is much like what happened to the Christian Democrats in the late 1980s. The outcome of the election was that Italy found itself in the hands of the Eurosceptic Beppe Grillo, who does not play by the rules of representative democracy, heralding an unprecedented crisis for the Italian polity.

National governments across the Eurozone have opted for the *responsible* position of internalising the adjustment pressures associated with EMU membership and have prioritised the interest of corporate creditors over their citizens[58]. The problem with this, however, is that responsible governments are now implementing *irresponsible* economics. National governments have not been able to adopt a variegated response that is tailored to the specific needs of their domestic economies. This could be justified if fiscal consolidation and structural reforms solved the diverse economic problems facing these countries. The IMF (2013a and 2013b), among a whole host of other commentators, has since concluded that this is not the case. Their one-size-fits-all adjustment is

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[53] See Alco (2013).

[54] See Afonso et al (2013)

[55] See Kennedy (2012)

[56] See Wiley & Martinez (2010)

[57] See Regan, Aidan (2012)

[58] I develop this analogy of responsible and responsive government from Peter Mair (2009)

exacerbating the debt, employment and economic crisis. The outcome is growing popular support for anti-austerity political movements on both the far left and the far right. In this situation, both the input and output legitimacy of the democratic state in Europe is being called into question[59].

Rethinking Varieties of Capitalism

The response to the Eurozone crisis draws our attention to the declining *fiscal capacity* of the democratic state to shape distributional outcomes in capitalist democracies[60]. The institutional design of the EMU and the emergent economic governance regime underpinning it has added an additional constraint to this long-standing problem in Europe. It leads to four empirical observations that are particularly important for understanding the relationship between the debt crises and how to govern different varieties of capitalism in a complex multi-level polity such as the EMU.

First, there is a growing gap in EMU countries between public revenue and public expenditure, with the implication that governments have to increasingly borrow money on international markets to service the state. In the aftermath of the Eurozone crisis governments stepped in to guarantee the debt of private markets. The outcome was a sovereign debt crisis. Rather than the state 'taxing' market activities to pay for the crisis, they now 'borrow' it from the same markets[61]. Most economic analyses have focused on the impact of this increase in public debt on the long-term growth potential of the economy[62]. What has not been analysed in sufficient detail is the impact of public debt on the ability of political parties in government to use discretionary fiscal spending to pay for the social investments we traditionally associate with the welfare state. The crisis of the democratic welfare state is precisely at this nexus between the irreconcilable tension between decreasing revenue and rising social expenditure.

Second, with less revenue and increased dependence on financial markets for expenditure, national governments have prioritised the interest of corporate creditors in negotiating fiscal adjustment. In the aftermath of the Eurozone crisis, the public finances in Ireland, Greece, Spain, Portugal and Italy were thrown off course by a sudden increase in the interest rate charged by finance markets for sovereign bonds[63]. A marginal increase in the rate of international borrowing alters the composition of domestic budgets. It means that a significant amount of expenditure must go on refinancing interest payments alone. The outcome is that national governments, regardless of political partisanship, are increasingly unable to use the taxpayer's money to invest in social projects that benefit citizens. They must satisfy the interests of a growing new constituency: private creditors and investors[64]. But if one accepts that different varieties of capitalism exist in Europe, the outcome is even bleaker for countries running a current account deficit. Cuts in social spending and an increase in the cost of borrowing decrease the capacity of southern European governments to build the institutional infrastructure and the research, training, social and educational opportunities that are necessary to compete with the social and coordinated market economies of northern Europe.

Third, contrary to the technocratic assumptions underpinning the EMU, it is not democratic pressure from citizens that is restricting the composition of budgetary adjustments but tax competition. The problem is a declining capacity of the fiscal state to raise revenue. For example, in the aftermath of the crisis successive Irish governments have adopted a strategy in Brussels of accepting and promoting fiscal discipline as a solution to macroeconomic imbalances. The international diplomatic strategy of aligning Ireland with austere northern Europeans is designed to protect its low corporate

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[59] This is not to say that large scale protests and dissatisfaction with the state and political parties are a problem for democracy. On the contrary, they may be a better indicator than elections.

[60] See Schafer, Armin and Streeck, Wolfgang (2013). It reflects the core argument advanced by Paul Pierson on the politics of permanent austerity.

[61] There is an emergent research agenda on this at the Max Planck Institute in Cologne, Germany. See Streeck & Mertens (2013)

[62] Such as Reinhardt and Rogoff (2010)

[63] The irony is that these markets were saved only months previously by state guarantees to bondholders in domestic banks.

[64] See Schafer, Armin and Streeck, Wolfgang (2013)

tax regime. Ireland has opposed all attempts at a coordinated transaction tax on financial trading in the EMU, which reduces the capacity of the EMU to collectively raise revenue within its jurisdiction to solve the crisis. The Irish policy to resist a European financial transaction tax was designed by the Clearing House Trading Company, a financial lobby group with a permanent committee in the Prime Minister's Office[65]. The Portuguese government has done likewise. In the midst of unprecedented cuts to social spending and increases in income tax, governments are simultaneously cutting corporate tax rates to incentivise inward investment. The interests of this growing new constituency for market-conforming governments – international creditors and the holders of financial assets – have significantly more influence on public policy than citizens[66].

Fourth, the priority accorded to repaying interest on debt places long-term restrictions on the ability of competing political parties to offer alternative choices to the electorate. This is directly observable in the GIIPS countries in the aftermath of the crisis. Political parties change yet policy remains the same. In a context in which citizens cannot influence government decisions, all claims to *input legitimacy* have been suspended[67]. The most minimal requirement of representative liberal democracy is that citizens can make a meaningful input to shaping collective policy choices (usually through elections or democratic corporatism). If this is empirically non-observable then it is fair to say that the democratic state is in crisis. This dilemma could be overcome, however, with claims to *output legitimacy*. That is, citizens in a democratic republic might accept the absence of input legitimacy in the interest of 'investor confidence' if the Euro-technocratic economic policies being implemented (cuts in public expenditure, decentralised collective bargaining, and structural reforms of the labour market) led to effective outcomes, such as economic and employment growth[68]. But this is not the case. For all the GIIPS countries in the Troika adjustment programme (directly or indirectly) the debt-GDP ratio has increased, economic growth has contracted and unemployment is rising, whilst budgetary deficits have been only marginally reduced.

Finally, if joining together different varieties of capitalism is a central factor in explaining the crisis, and the o*ne-size-fits-all* response of EMU is exacerbating this, it begs the question of whether leaving the Eurozone is an optimal strategy for some member states. Or to be more precise, would exiting the Euro currency a) halt the legitimation crisis facing the democratic state and b) provide the capacity to carve out a more flexible response at the national level? At present this is an open question. It is simply not possible to calculate the risks of what would happen if this were to occur. But if one pushes the argument in this paper to its logical conclusion, namely that there are different varieties of capitalism in the Eurozone, then it is hard to justify a country keeping a currency that requires an adjustment that exacerbates rather than solves its debt crisis. But this argument assumes that the EMU currency in itself is the problem, whereas in actual fact it is the *political* constraints of governing a multi-level polity with national competing interests that is the real source of the crisis. If Europe could develop the institutional and fiscal capacities that would provide the necessary flexibility for national varieties of capitalism to co-exist, and develop long-term autonomous growth strategies with the same currency, then exiting the EMU would not be necessary. But at present the empirical conditions for this transfer of sovereignty to Europe are non-existent.

Conclusion

This paper has argued that the attempt to join together different varieties of capitalism into a multi-level polity with a single currency without a central government is the real source of the Eurozone crisis. The European response prescribes a *one-size-fits-all* approach of fiscal austerity and structural reforms that has exacerbated the divergence between core and peripheral regions of the EMU. The asymmetric implication of the Troika induced adjustment is a crisis of the democratic state in Ireland

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[65] In this regard, Ireland is no different to Germany in defending the domestic interests of its national model of capitalism

[66] See Hacker and Pierson (2010) for a detailed analysis of this political dilemma

[67] Scharpf, Fritz (2012)

[68] This use of output legitimacy differs from Scharpf et al. I used to refer to the performance enhancing effects of decisions that are taken in a non-democratic manner but that simultaneously benefit citizens i.e. full employment.

and southern Europe. At national level, political parties change but policy remains the same. Creditors are prioritised over citizens. It is this empirical analysis of the emergent political and distributional tensions caused by EMU as a multi-level polity in-itself that distinguishes my contribution to the VoC literature in comparative political economy. The paper has concluded by arguing that the crisis can only be resolved by adopting a *variegated* response that is tailored to the specific institutional and political needs of each member state. Whether this requires some countries to leave the Eurozone is an open empirical question that necessitates further research.

Figure 1: Current Account as a % of GDP

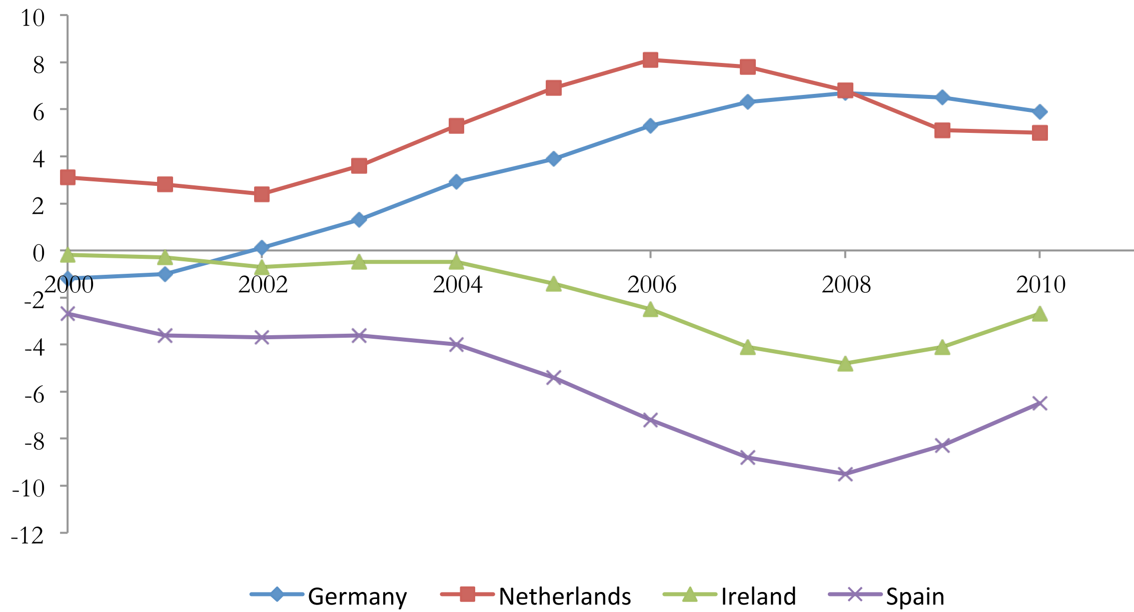
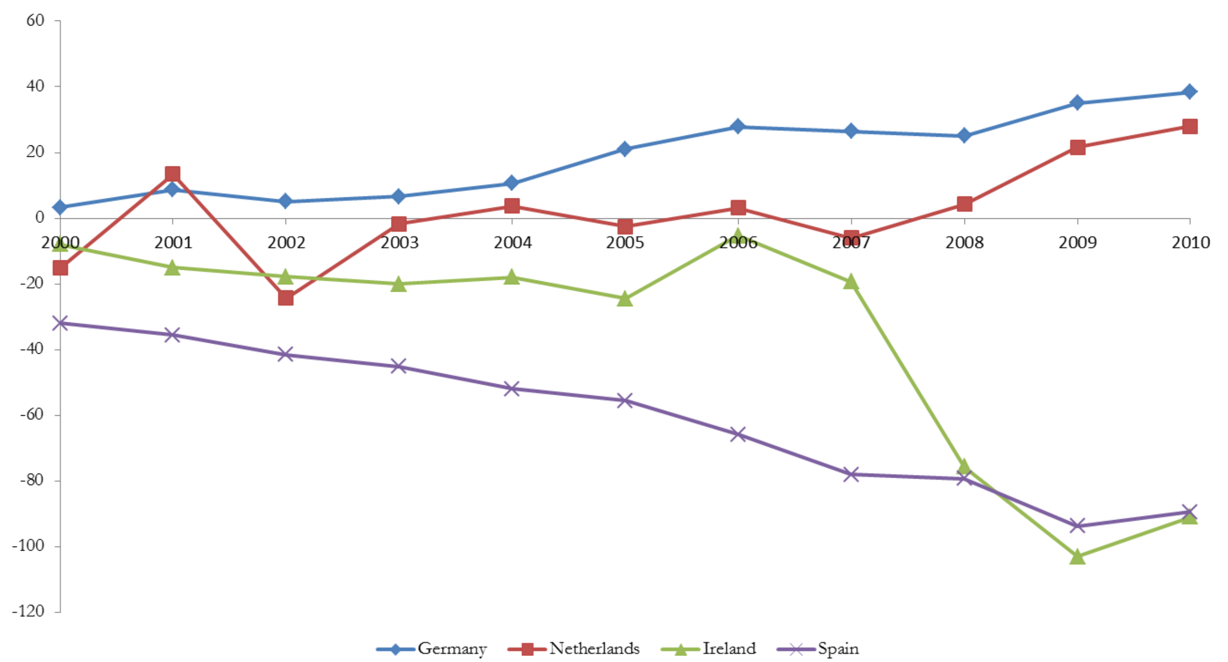
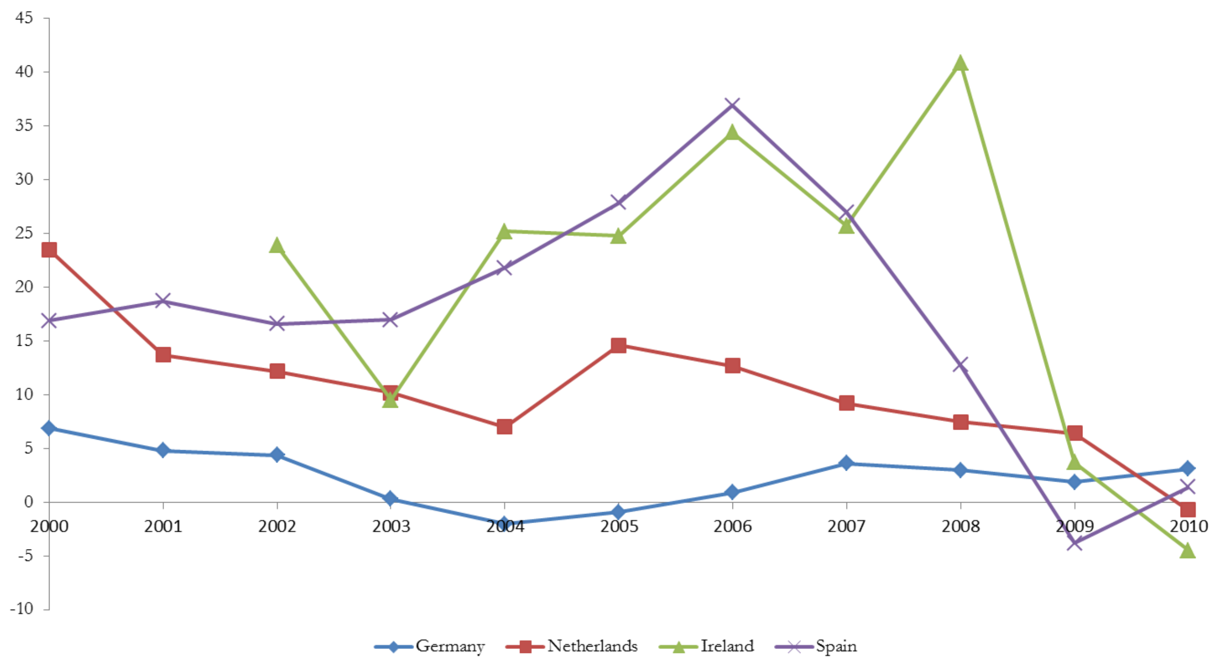


Figure 2: Net International Investment as % of GDP



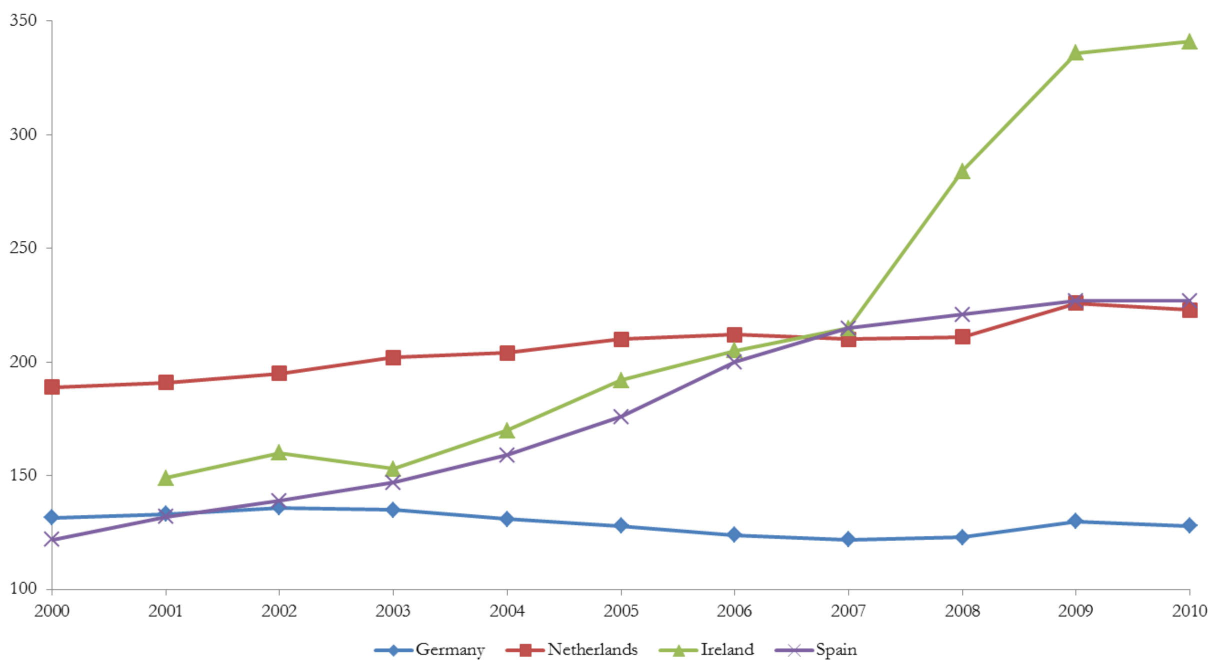
Source: EU Commission, Statistical Annex (2011)

Figure 3: Private Credit Flow as a % of GDP



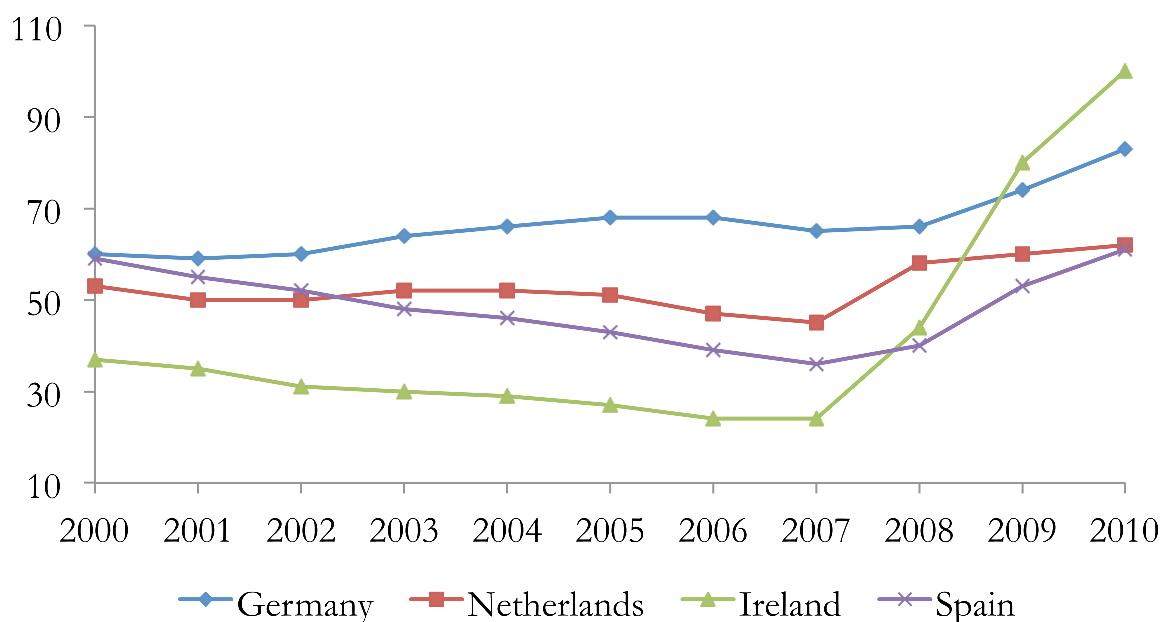
Source: EU Commission, Statistical Annex (2011)

Figure 4: Private Debt as a % of GDP



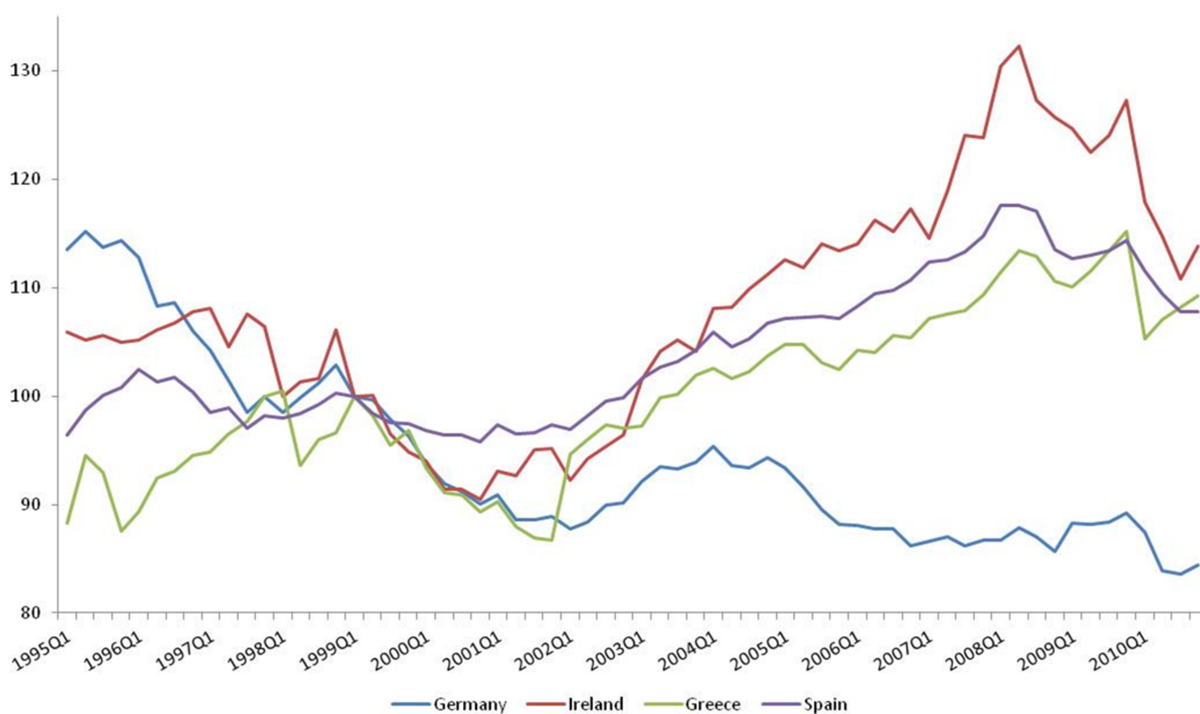
Source: EU Commission, Statistical Annex (2011)

Figure 5: Public Debt as a % of GDP



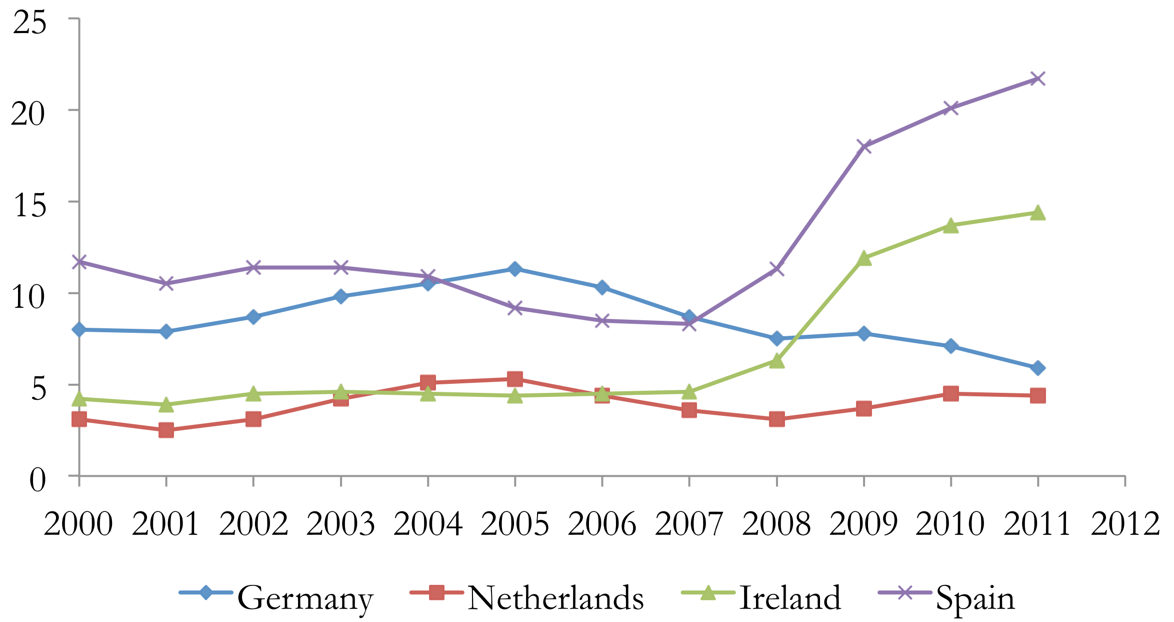
Source: EU Commission, Statistical Annex (2011)

Figure 6: Harmonised Competitiveness Indicators



Source: EU Commission, Statistical Annex (2011)

Figure 7: Unemployment as a % of Labour Force



Source: EU Commission, Statistical Annex (2012)

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