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The endless Eurozone crisis, where do  
we stand? A Classical-Kaleckian overview

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**Abstract** - It is not easy to untangle the logic that in the past led to creation of the European Monetary Union (EMU) and that is currently guiding the prevailing Eurozone (EZ) policies. Although lacking the right institutions, which can be seen as the *ultimate* root of its crisis, the ten years of the EMU could be celebrated in 2008 with some fanfare. The EMU even seemed a success, judged from the point of view of imbalanced growth of some peripheral countries that masked its deflationary stance. This imbalanced growth was the *proximate* cause of the EZ financial crisis. In the paper we shall review the main causes of the EZ financial crisis, interpreted as a balance of payments crisis; the role of the European payment system TARGET 2 in buffering its violent blast; the Classical-Kaleckian rationale of the German malevolent mercantilism; the inadequate EZ policy measures to respond to the crisis; possible alternative solutions. Unfortunately, rather than pushing towards the creation of a different set of European institutions, the prevailing crisis resolution philosophy resembles a late vindication of the original deflationary Euro-bias.

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**Keywords:** European Monetary Union, financial crisis, Germany, neo-mercantilism, balance of payment, capital flows, sudden stops, TARGET 2, OMT

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# The endless Eurozone crisis, where do we stand? A Classical-Kaleckian overview<sup>1</sup>

Sergio Cesaratto

...German socialists rose and drove the war-lord from his throne. ...With the German Emperor out of the way, Germany would have no surplus to sell abroad. By the very nature of the socialist state, the German population would consume all that it produced. Of course, it would trade abroad certain things it produced for things it did not produce; but this would be quite different from an unconsumable surplus.

Jack London (1908)

## 1. Ultimate and proximate roots of the Eurozone crisis

The story of the Eurozone (EZ) crisis is the tale of an imperfect currency union. It is not yet fully understood which political processes led to the European Monetary Union (EMU) on 1st January 1999 when the infra-Eurozone exchange rates were fixed permanently. From a rational point of view, the national leaders and their economic advisors certainly knew that the European Union was not a so-called optimal currency area. Various considerations possibly led to this imperfect union. France and Italy were not happy with the European Monetary System (EMS), the fixed exchange-rate that preceded the EMU from 1979 until 1999. The German unification in 1989 and the fall of the iron curtain possibly accelerated the process - Germany has traditionally been eastward-looking, and monetary unification was perhaps seen as a way to lock this country to West Europe. Finally, through the common currency, the elites of peripheral countries hoped to import the famous German labour discipline.<sup>2</sup> Be that as it may, the monetary union lacked the institutions

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<sup>1</sup> This paper is based on my introductory speech to the Economy4Youth meeting on 22-3 November 2012 in Madrid. I thank Carlo D'Ippoliti and Jorge Uxo for preliminary comments and Giancarlo Bergamini for valuable help in improving the exposition. Questo lavoro apparirà in forma definitiva su *Studi economici*.

<sup>2</sup> As pointed out long ago by Simonazzi and Vianello (1999, p. 236 my translation): “the high interest rates and restrictive budget policies required to defend exchange rate stability in the ‘new EMS’ period [1987-1992] imposed such a high cost on some countries to induce markets not to consider it sustainable in the medium term: Italy and Great Britain were obliged to leave the EMS, and even France could still stay in only with an enormously wider fluctuation band.” This showed the failure of the mainstream philosophy behind the “new EMS”, viz. the idea that the commitment to a fixed parity with the DM, although implying a restrictive monetary policy, would have the positive consequences of a persistent decline in inflation rate, recovery of competitiveness and through credibility, lower interest rates, in a self-fulfilling virtuous cycle (ibid, pp. 236-7). Thus the “quite high social costs sustained by France to keep a stable parity with the Mark – and the fact that, none the less, financial speculation did not give respite to the Franc, betting precisely on the unsustainability of those costs in the long run – made of the French government the main champion [of monetary unification]” (ibid, p. 237). This solution was accepted by Germany “in order to obtain France's consent to reunification and to the prospective enlargement of the European Union to the ex communist countries of Eastern Europe” (ibid). The origins of the monetary union must thus be found in a variety of factors that include “the employment of the foreign exchange rate as an instrument of discipline ... and other

that could make it sustainable in the long run, as recommended by earlier unification plans and by the prescient analysis of Kaldor (1971) and later Godley (1992), namely a significant federal budget with regional redistributive functions (cf. Ramanan 2012b and 2012c). The union was designed in negatives, so to speak. To prevent national governments from taking excessive advantage of lower interest rates, the Maastricht Treaty created the famous Maastricht fiscal constraints. In addition, the ECB was assigned a monetarist statute with the sole objective of controlling inflation (so that it inherited the Bundesbank function of keeping German wages in check). The objective of full employment was assigned to national labour-market flexibility policies, that is to competitive internal devaluation strategies: no to a wider federal budget, no coordination of fiscal and monetary policies, no unified bank supervision or crisis resolution mechanism.<sup>3</sup> If some intellectual ignorance is part of the explanation, we suggest that this was the result of coalescence of Germany's lack of interest in a fully-fledged union - later labelled a tax-transfer union in German public debate - with that of the more inflation-prone partners mainly interested importing German discipline. As actually designed, the EMU can therefore be considered a quasi-gold-standard monetary system, a traditional labour disciplinary policy tool since it binds national sustainable inflation rates to that of the most virtuous country.

Although the right institutions were lacking, which can be seen as the *ultimate root* of the ensuing EZ crisis, the ten years of the euro could be celebrated in 2008 with some fanfare, in spite of surfacing anxiety (European Commission 2008). The EMU even seemed a success, judged from the point of view of certain peripheral countries. A number of (un)fortunate events, recalled in the next section, temporarily masked the disciplinary and deflationary stance of the EMU. Paradoxically, it was only when those (un)fortunate events generated the EZ financial crisis that by imposing austerity measures, the European elites could begin to inflict the hardship of the monetary union on the European population. In this sense, the euro has not failed: through the crisis it is finally delivering the discipline expected by its designers.<sup>4</sup>

In the next sections we shall recall the main *proximate causes* of the EZ financial crisis, interpreted as a balance of payments crisis; the role of the European payment system TARGET 2 in

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more genuinely political aims (such as that of tying Germany to Europe in the case of France ...)” or, in the case of Italy, that of cutting financial support to the political-business lobbies in power (ibid, p. 236). Finally, one should not forget that Italy's admission to the EMU was advocated by the German and French industrial lobbies, more interested in keeping a strong competitor aligned than of its violation of the Maastricht parameters (ibid, p. 235).

<sup>3</sup> For a useful comparison with the U.S. banking union, see Gros (2012).

<sup>4</sup> According to a journalist source (Palast, 2012), this is Robert Mundell's view: far from regarding the euro as a failure from the point of the theory of optimal currency areas, the father of this theory regards it as a success.

buffering its violent blast; the Classical-Kaleckian rationale of the German mercantilist behaviour; the insufficient EZ policy measures to solve the crisis; possible alternative solutions.

## **2. The strange case of the EZ balance of payment crisis**

As said, up until the crisis the euro seemed a success, particularly if judged from the point of view of Spain, Ireland and also Greece. Not much so for Portugal and Italy.<sup>5</sup> Portugal already had its demand-led boom in the years before the monetary unification and joined the currency with a negative current account (CA), which explains its later stagnation. Both countries - but of course this partially also concerns the other southern countries - likely began to suffer from a loss of competitiveness due to more than one factor: an over-valued real exchange rate, the competition from the EU new entrants and from the emerging economies, the stagnation of domestic aggregate demand that depressed productivity growth. As is well known, in Spain, Ireland and also Greece domestic demand was instead sustained by a construction boom fed by foreign capital flows. The events of these three countries have usefully been compared to that of the financial crises in the emerging economies (Frenkel, 2012; Cesaratto, 2012a).<sup>6</sup> financial liberalisations and fixed exchange rates can easily lead to foreign indebtedness at temporarily low interest rates; to a residential investment-led growth and housing bubbles; to a fast growth of domestic demand; to growing CA deficits; to a worsening net international investment position (IIP), that is to a growing net foreign-debt; and finally to a balance of payment crisis. This happens when foreign financial investors stop the refinancing of the peripheral foreign debt and begin to withdraw their investment (what is named “sudden stops and capital flows reversal”).<sup>7</sup>

Unlike in traditional financial crises – which referring to Reinhart and Rogoff’s well-known expressions (see Cesaratto, 2012a) we may label “‘this time is different’ unfortunate sequence of events” – these events took place in a currency union which, by definition, is endowed with a union payment system. The very existence of the Eurozone (EZ) payment system, the famous TARGET 2 system (T2), has impeded the eruption of the standard foreign debt crisis, with attendant debt restructuring and currency devaluation, which has been typical of the emerging economies. In this kind of crisis, characteristically the IMF intervened to assure that the indebted countries could continue to repay the interest and the principal of their foreign debt (so the IMF “saved” the lenders); normally the debt was renegotiated; fiscal austerity measures were imposed to obtain a CA

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<sup>5</sup> Yifu Lin and Treichel (2012) present a useful birds-eye review of national cases.

<sup>6</sup> For a comparison of the flaws of the EZ and those of the international monetary system, see Eichengreen (2012).

<sup>7</sup> Interpretation of the Eurocrisis as a balance of payment crisis is rejected by Randall Wray (see Ramanan 2012d and my exchanges with Wray reported in Cesaratto 2012b). In favour of the interpretation suggested here see, inter alia, Merler and Pisany-Ferry (2012); Yifu Lin and Treichel (2012).

surplus necessary to assure the future ability to serve and repay the debt (including that to the IMF); the currency devaluation relieved a bit the pain in this effort. Notoriously, Argentina by refusing to repay 75% of her debt avoided the IMF austerity measures and, also helped by a buoyant price of her exported commodities, could manage a demand-led recovery. What has happened in Europe is that, through T2, the foreign debt of the peripheral countries has “changed hands”: from a liability towards private lenders (who withdrew their loans) it has become a sort of “official” liability towards the Eurosystem.

### 3. Interpreting the T2 recycling mechanisms<sup>8</sup>

To appreciate the working and meaning of T2 in the EZ balance of payment crisis, let us first consider a national interbank payment system. When a deposit (say €100) is moved from Bank A to Bank B, at Central Bank (CB) level a corresponding amount of reserves moves from the reserve-account of Bank A to the reserve-account of Bank B, as shown in figure 1 through the balance sheets of the two banks. Given the bi-directional nature of the payments, these flows clear over about one day. If not, e.g. if Bank A loses more deposits (reserves) than it receives, Bank A has to borrow the necessary reserves on the interbank market: banks with excess reserves lend to banks that lack them. If the interbank market is not working (as during a financial crisis or in a moment of panic like 11 September 2001 etc.) the central bank lends the money.

Central Bank	
Assets	Liabilities
	100 reserves Bank A 100 reserves Bank B

Commercial Bank A		Commercial Bank B	
Assets	Liabilities	Assets	Liabilities
100 reserves	100 deposit	100 reserves	100 deposit

- Figure 1 -

Consider now the Eurozone and Eurosystem (ECB *plus* national CBs). Typically a peripheral bank (say Santander) loses deposits in favour of a core-EZ bank (say Deutsche Bank -

<sup>8</sup> Useful expositions of the working of TARGET2 include Febrero and Uxò (2012); Cecioni and Ferrero (2012); Cecchetti et al. (2012).

DB) because of CA imbalances (e.g. more payments are made for imports than received from exports) or increasingly since 2011 because of capital flight from the periphery to core-Europe.

*Step 1.* Suppose Santander transfers a deposit (€100) to Deutsche Bank (DB). This is done through TARGET 2 (T2), which is the name of the interbank payment system of the EZ: as in domestic systems, transfers between commercial banks are done through transfers of reserves through the central bank; within the EZ they are made through the Eurosystem (as in figure 2). Santander asks the Bank of Spain (BoS) to make the payment (€100) to DB; for this purpose the BoS asks the ECB to credit (€100) to BuBa; BuBa finally credits (€100) to DB. Once BuBa creates reserves (€100) in favour of DB (a liability for BuBa), it matches the liability with a T2 claim (€100) on the ECB. The ECB, in turn, matches the liability with BuBa with a claim (€100) on BoS (a T2 liability for BoS), which finally matches this liability with a claim (or a fall in existing liabilities) (€100) on Santander.<sup>9</sup>

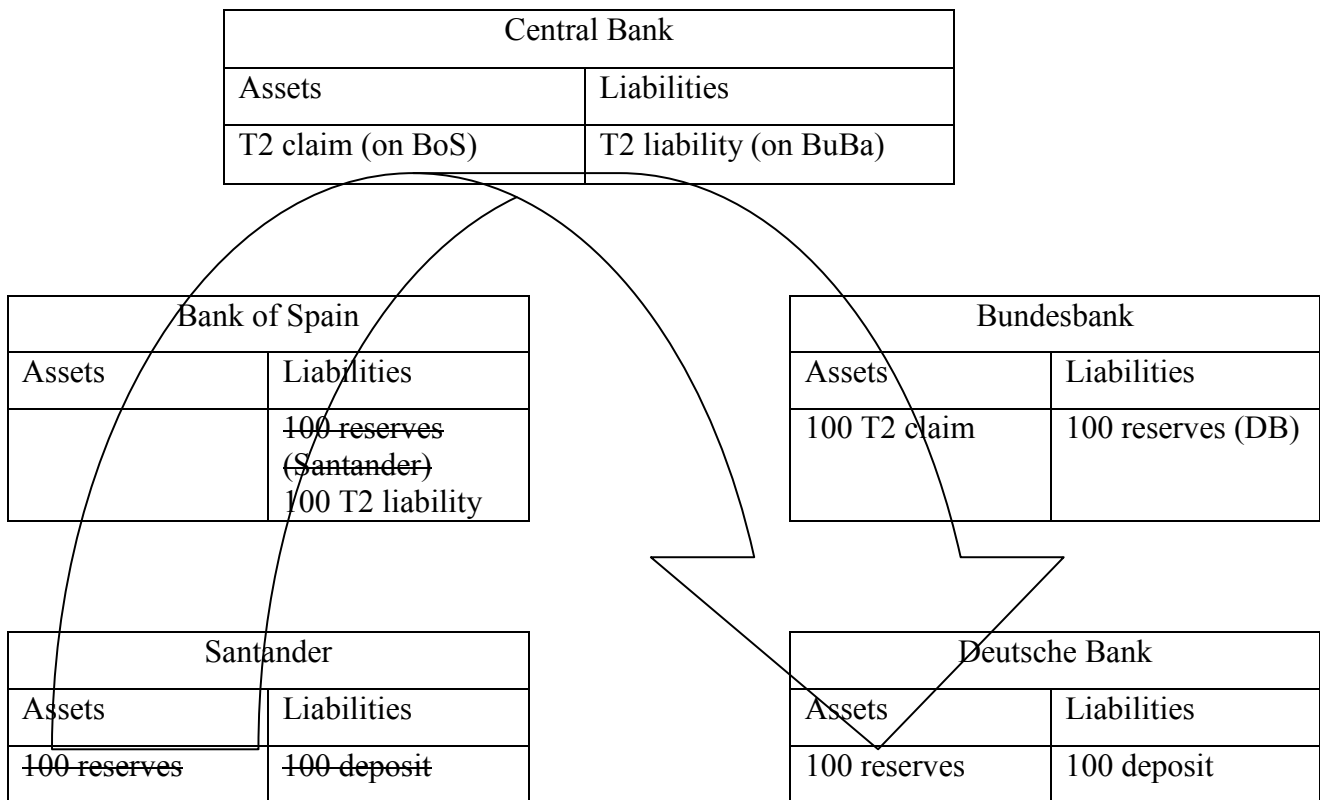
*Step 2 (ante-crisis).* As in domestic systems, once it has received a payment from Santander, DB tends to have acquired reserves (€100), while Santander would have lost reserves (€100).<sup>10</sup> As blogger JHK (2012) notes:

“While TARGET2 resolves asset-liability matching associated with such payments, it leaves in its wake a revised distribution of bank reserves originally issued by these two different banking systems. In our example, the payer Spanish central bank (Banco de España) will have eliminated reserve balances it previously issued, by debiting the paying commercial bank (Banco Santander), and the payee German central bank (Bundesbank) will have created new reserves it now issues by crediting the payee commercial bank (Deutsche Bank).”

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<sup>9</sup> As blogger JHK (2012) aptly summarises: “‘TARGET2’ is the ‘TransEuropean Automated Real-time Gross Settlement Express Transfer System’. This is the payment and clearing system that connects the 17 national central banks of the Euro system to each other, using ECB books as the payment clearing house. It is an interconnecting system for 17 different operational issuers of the Euro. A transfer of funds from one Eurozone national banking system to another affects reserves issued in each banking system. If a Spanish bank customer transfers Euros from a deposit account with Banco Santander to Deutsche Bank in Germany, Santander loses a deposit liability and Deutsche Bank gains one. The German central bank credits Deutsche Bank with a reserve balance to match its deposit liability. Deutsche Bank then has a nominal balance sheet that is in balance, asset for liability. The German central bank has created its own liability in issuing those reserves to Deutsche Bank. Therefore, it also requires a matching asset (or some matching liability reduction) in order to achieve balance in its own balance sheet, asset for liability. No bank, central or commercial, will accept a banking customer liability without such offset, since that would entail a loss of balance sheet equity. The Eurosystem provides the required adjustment using TARGET2. The German central bank will offset its reserve liability with a TARGET2 asset as a claim on the ECB. This becomes an ECB liability, which the ECB covers with its own TARGET2 claim on the Spanish central bank. TARGET2 nets all such bilateral claims across all central banks in the Euro system, arriving at an individual net result for each central bank against the system as a whole. The ECB becomes the clearing house for all such original bilateral central bank claims. And the ECB ends up with its own balance sheet profile of TARGET2 assets and liabilities, with the 17 NCBs as counterparties.”

<sup>10</sup> Note that €100 is an approximation since the DB has now more deposits and therefore needs more reserves, while the opposite is true for Santander.



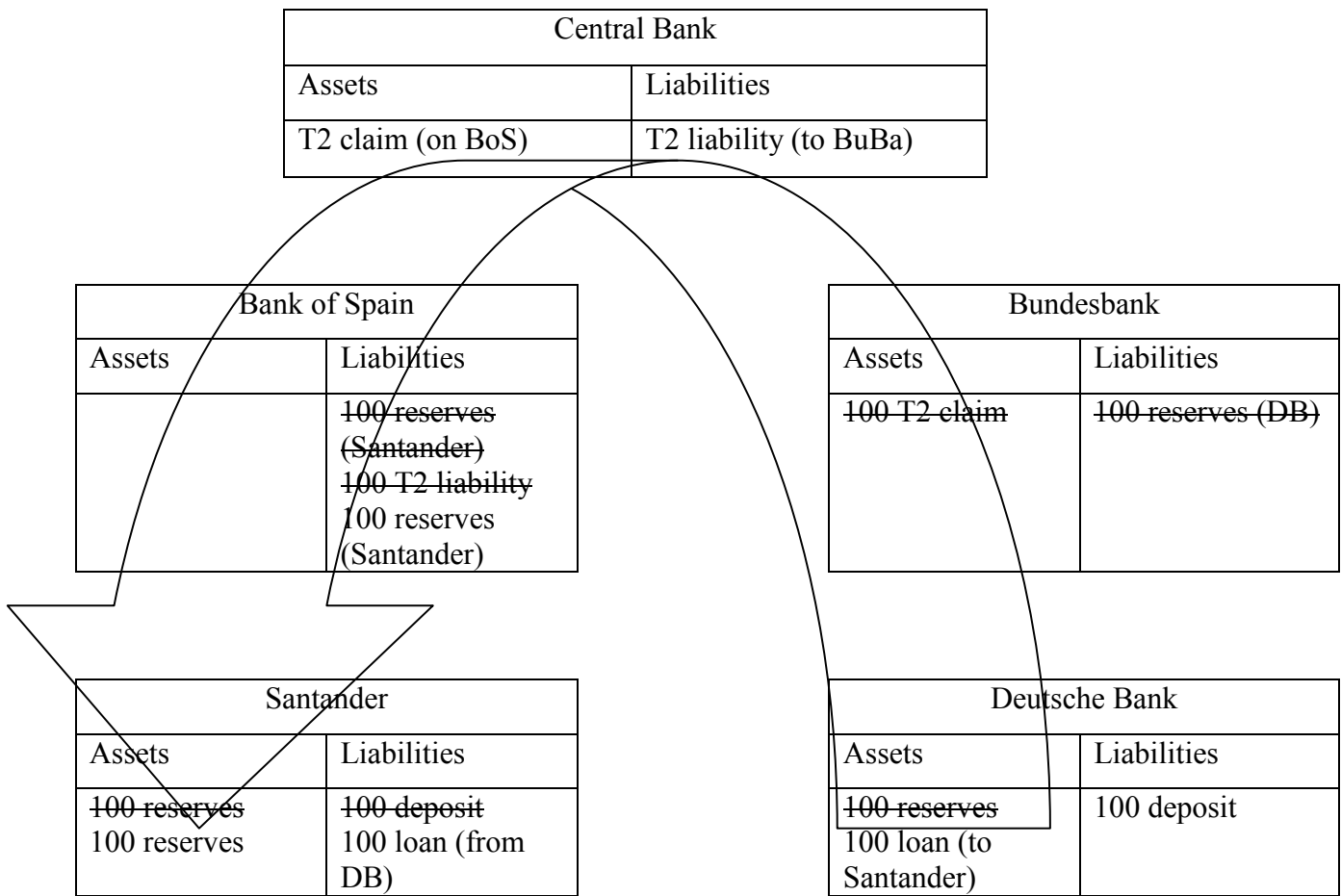
- Figure 2 -

Normally, DB would lend the excess reserves (€100) to Santander (which is in general more profitable than leaving them idle in its reserve account at BuBa). If this happens, the reserves just travel along the T2 route in the opposite direction to step 1, clearing the claim/liability T2 positions of the two CBs (as in figure 3).<sup>12</sup> That is, when DB lends part of its reserves (€100) to Santander, BuBa correspondingly cancels some liabilities (€100) to DB and loses part of its T2 claims (€100) on the ECB. Simultaneously Santander sees its reserve account at the BoS replenished (+€100); BoS sees its liabilities to Santander increase (+€100), but having received a transfer via T2, it can cancel part of its previous T2 liabilities (-€100). So the “official” T2 BoS liability vs. the BuBa claim is cleared, replaced by “private” liability of Santander towards DB. This worked until the crisis. T2 was roughly in balance; of course the net international investment positions [IIP] within the EZ were not, but they consisted of private loans.<sup>13</sup>

<sup>12</sup> This reverse path of the reserves that DB lends to Santander is overlooked by Cecchetti et al. (2012, p.3 and graph 4) in their otherwise neat description of T2.

<sup>13</sup> Significantly, T2 claims and liabilities are part of the IIP of a country.





- Figure 3 -

*Step 2 (post-crisis).* However, suppose that the EZ interbank loan market breaks down, as has happened since about 2009. In this case TARGET2 still allows Santander to transfer a deposit to DB (be it a payment for an import from Germany, or a German withdrawal of private financial investment in Spain). In any case Santander cannot recover the lost reserves via a loan from DB. So the T2 imbalances are not cancelled out by a private transaction in the opposite direction (as in step 2 above). At this point BoS replenishes Santander's reserve account (with €100) through one of the possible short or long term refinancing operations available in the Eurosystem (as in figure 4).

Central Bank	
Assets	Liabilities
T2 claim (on BoS)	T2 liability (to BuBa)

Bank of Spain	
Assets	Liabilities
100 loan to Santander	<del>100 reserves (Santander)</del> 100 T2 liability 100 reserves (Santander)

Bundesbank	
Assets	Liabilities
100 T2 claim	100 reserves (DB)

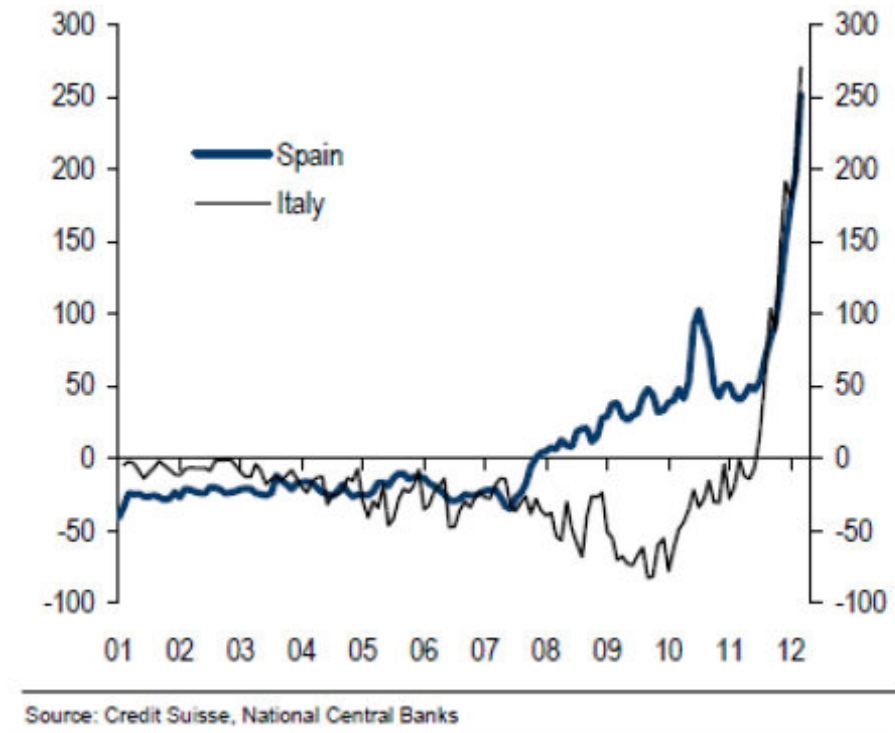
  

Santander	
Assets	Liabilities
<del>100 reserves</del> 100 reserves	100 deposit 100 loan from BoS

Deutsche Bank	
Assets	Liabilities
100 reserves	100 deposit

- Figure 4 -

To sum up, T2, the Eurosystem payment scheme, is just a little more complicated than a domestic payment scheme. In the Santander/DB example, the Spanish bank loses reserves to make a payment to the German bank and this generates a T2 liability for BoS. Symmetrically a T2 claim is generated by BuBa on the ECB, while DB sees its reserves increase at BuBa. Normally DB would lend its excess reserves to Santander and the T2 “return journey” of the payment will clear the T2 imbalance while Santander replenishes its reserve account at BoS with this loan. Symmetrically the T2 claim of BuBa on the ECB and the excess reserves of DB at the BuBa are extinguished. Once the interbank loan market freezes (a manifestation of sudden stop of capital flows), the TARGET 2 balances no longer clear. T2 liabilities and claims persist and grow, especially after collapse of market confidence leads to the withdrawal of former loans from CA surplus to CA deficit countries, as figure 5 shows for Italy and Spain.

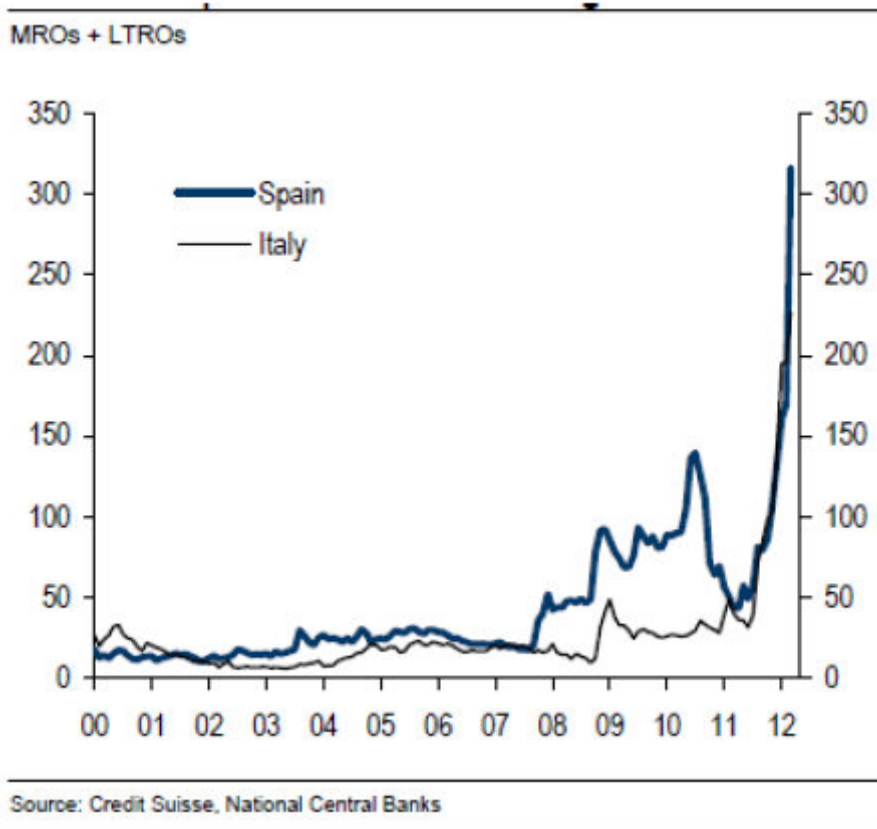


Source: Credit Suisse (2012)

- figure 5 Target 2 net liabilities: Italy and Spain -

As seen above, like in a domestic banking system, also in a currency union, the CB must intervene as a lender of last resort when the inter-bank market breaks down. So must the Eurosystem with respect to Santander: the BoS would automatically re-create reserves in its favour through short (main refinancing operations), long-term (long term refinancing operations) or discretionary re-financing operations (emergency liquidity assistance) if Santander has no more collateral.<sup>14</sup> So we have figure 6, strikingly symmetrical to figure 5.

<sup>14</sup> As JKH (2012) aptly notes: “While TARGET2 resolves asset-liability matching associated with [the EZ] payments, it leaves in its wake a revised distribution of bank reserves originally issued by these two different banking systems. In our example, the payer Spanish central bank (Banco de España) will have eliminated reserve balances it previously issued, by debiting the paying commercial bank (Banco Santander), and the payee German central bank (Bundesbank) will have created new reserves it now issues by crediting the payee commercial bank (Deutsche Bank). Each national central bank may choose to correct [if necessary, that is if the interbank market breaks down, Ed.] its share of the reserve redistribution effect that results from net TARGET2 payments. The Spanish central bank may proceed to replace reserves lost. The German central bank may proceed to withdraw reserves gained. This requires domestic monetary adjustment that is operationally distinct from the international TARGET2 reserve effect.”



Source: Credit Suisse (2012)

- fig. 6 Spanish and Italian borrowing from the ECB -

If we combine the two aspects – the creation of persistent credit-liability positions at T2, and the increasing borrowing of the periphery from the ECB, it is *as if* the *same* reserves that were previously lent by DB when confidence prevailed, and that are now deposited at the ECB, are now lent by the ECB through its BoS branch, by virtue of the decentralised management of the refinancing operations in the Eurosystem. As an adviser to the President of the ECB Mario Draghi authoritatively put it: “Target claims ultimately arise from [or lead to, Ed.] liquidity-providing operations with commercial banks in the euro area – but actually from [to] those undertaken by the NCB of another country. ... Target claims and those on commercial banks in NCBs’ own countries are essentially two sides of the same coin.” (Thimann 2013). So the T2 claim of BuBa and the claim of BoS on Santander are just “two sides of the same coin.”

Seen from either perspective (private or “official”), the net IIP of Germany (Spain) is the same, but now Germany (Spain) is (automatically) lending (borrowing) through T2, while BoS creates liquidity, although this operation is formally separate from the emergence of T2 claims/liabilities (“the two side of the coin”). If this combination did not exist, however, the entire bank system would break down.

Notably, the growing T2 imbalances not only reflect the necessity to finance the persisting CA deficits of the periphery but, more importantly, capital flight from periphery to core countries. Since 2009 for PIGs, and hugely since 2011 for Spain and Italy, foreign investors have refused to roll-over (re-finance) previous debt.<sup>15</sup> For instance, foreign banks have increasingly refused to re-finance Italian sovereign debt. When a tranche of Italian debt held by a German investor expired, a corresponding value was credited to her deposit at, say, Unicredit and then transferred to DB. This is done automatically through T2, giving rise to a T2 liability for Italy and a credit for Germany. But how could the Italian State find the money it returned to the German investor? This was made possible, for instance, by the special three-year Long Term Refinancing Operation (LTRO) launched by the ECB in December 2011 (1 trillion Euros at 1% interest rate) and used by the Italian banks to buy Italian sovereign bonds. Again, it is *as if* the ECB were lending the money that the Germans withdrew from Italy. A privately held Italian foreign debt has become an “official” T2 liability.

In view of the above, T2 can be interpreted as a CA surplus recycling device in favour of deficit countries, something that recalls Keynes’s proposal of an International Clearing Union (Cesaratto, 2012a, p. 25). Not only can T2 accomplish the recycling of current deficits, but it can also fix capital flight (repatriation of early loans that financed previous CA deficits) from indebted countries, transforming, as we have seen, private loans into “official” T2 loans. In principle T2 may substitute the private financing and rollover of deficit countries *ab libitum*, but there are of course limits to what Minsky defined as “Ponzi finance”. The austerity measures imposed by the EU on indebted countries may thus be seen as a way - unfortunately not the best - to generate CA surpluses so as to guarantee servicing and possibly reduction of their net foreign debt.

The German conservative economist Hans-Werner Sinn has not been wrong in calling T2 a “stealth bail-out” of the periphery, although he has been silent about German responsibilities in this crisis (see section 4) and exaggerated current damage to the German economy (e.g. Sinn and Wollmershäuser, 2012; Sinn, 2012).<sup>16</sup> I agree that this re-shuffling of liabilities has not made German credits safer, contrary to the initial opinion of De Grauwe and Yi 2012a (inspired by Whelhan [2012] and later partially recanted in De Grauwe and Ji [2012b]; see also blogger Ramanan [2012a]). In a sense, T2 helped gain time, but this time has so far been wasted by EZ

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<sup>15</sup> So the T2 imbalances originate *both* from the difficulty of deficit countries to find private loans to finance present CA deficits, and from the refusal of former lenders to roll-over loans that financed past CA deficits. A third cause, generally considered less relevant (so far), is capital flight by residents of deficit countries.

<sup>16</sup> T2 does not actually cause any current harm to the German economy, as the debate has shown. This does not imply that Germany does not incur any risk, as any creditor country does. T2 might just postpone the day of reckoning.

governments. While no reforms of the institutional architecture of the EZ have been attempted, the EZ, encouraged by a wrong diagnosis of the crisis, has pursued painful adjustment through austerity and competitive deflation, economically unsuccessful in rebalancing Europe and restore growth, and that might prove politically unsustainable given its social costs.

#### **4. A wrong diagnosis of the crisis and the role of German mercantilism**

The EZ governments have indeed basically backed the dominant German interpretation of the crisis as caused only by borrowers - although the German Social Democrats also vaguely accuse deregulation of the financial sector - and by the fiscal profligacy of the peripheral governments. This interpretation overlooks the fact that the peripheral CA deficit financed by northern capital flows sustained imports from core-Europe. It also neglects that in Ireland and Spain the fiscal crisis was also the result of the bailout of private banks, that before 2008 Italy violated the fiscal pact much less than Germany and France, and that Italian public debt dated back to before the EMU. While the Greek centre-right government might have relied too much on endless cheap foreign support for public debt, it should not be forgotten that Greece has also been an excellent market for German exports. Be that as it may, lenders are just as responsible as borrowers. However, core-Europe is responsible for the crisis in an even more important way: its neo-mercantilist behaviour. Financial liberalisation, the initial fall in devaluation risk (“convertibility risk” as Draghi calls it) and the consequent indebtedness of the periphery brought about by the EMU have indeed been essential for this behaviour.

This is an old story (Cesaratto and Stirati 2011). Since the early 1950s Germany took advantage of fixed exchange rates to pursue an export-led model, what has been aptly named “monetary mercantilism” (after Holtfrerich 1999). The three institutional pillars of German low-inflation model were:

- a paternalistic State committed to the general welfare of the working class (the famous Bismarkian social state), to business and foreign trade (the German government clearly has foreign trade and foreign investment policy as its top priority), to education and research, to training the labour force, particularly by export-oriented companies.<sup>17</sup>

- an accommodating labour movement and cooperative labour market institutions;<sup>18</sup>

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<sup>17</sup> Discussing my own interpretation of German mercantilism (Cesaratto, 2011), Klein and Weirowsk (2011, p. 16) underline that in Germany the “[p]ublic debate about funding for universities is dominated by the alleged ‘need to maintain Germany’s competitiveness in world markets’. This explains lavish funding for departments of engineering, sciences and, in general, for technical universities”. Moreover, the “government-sponsored short labor scheme ensures employees and employers against export volatility and thereby reduces persistence in unemployment” (ibid, p. 17) absorbing the cyclical costs of reciprocal commitment of firms and workers in order to favour company-specific training. See also Carlin and Soskice (2009) and Simonazzi and Vianello (1999, pp.234-5).

<sup>18</sup> A discussion about the origins of this stance can be found in Giersch et al. (1992, pp. 73-9).

- the Bundesbank as the watchdog of German labour discipline (Cesaratto and Stirati, 2011, pp. 73-75).

Wage moderation, the relative compression of the domestic market and the other countries' Keynesism made the model successful: it has guaranteed a high standard of living in a self-fulfilling model in which the pursuit of trade surpluses promoted domestic labour discipline. The model was reinforced at the inception of the euro by SPD-inspired labour reforms. Although the model assured relatively high wages, these generally lagged behind productivity growth (Giersch et al., 1992. pp. 72, 132, 198), so following Kalecki, we can regard it as a way for capitalists to maximise "internal surplus" - that is, what remains of the social product after paying wages - and get rid of it (to *realize* it in Marxian terms) in foreign markets.

Just to focus our view, a simple Classical/Kaleckian explanation of mercantilism and its contradictions, based on well-known Kaleckian equations, is as follows.<sup>19</sup> Income distribution is defined by:

$$P = W + \Pi,$$

where  $P$  is the social product,  $W$  is the wage bill,  $\Pi$  are profits. We also have:

$$P = C + Z + E - M,$$

where  $C$  is workers' consumption – which is equal to  $W$  if workers' marginal propensity to consume is 1 and capitalists' marginal propensity to consume is 0;  $Z$  is autonomous expenditure by the capitalists [luxury consumption and investment financed out of bank loans: here we endorse the endogenous money approach according to which, in synthesis, banks create loans, loans create deposits, deposits create reserves, cf. Lavoie 2000];  $E$  are exports and  $M$  imports. Thus:

$$P - W = Z + E - M, \text{ or}$$

$$S = Z + X$$

where  $S$  is capitalists' surplus and  $X$  the trade balance. The capitalists' surplus, appropriated by capitalists can be absorbed by  $Z$  and by net exports.<sup>20</sup>

If the trade balance is in equilibrium,  $X = 0$ , a given capitalists' surplus must be absorbed by capitalists' consumption and investment. If not, the "external" surplus plays the role of absorbing part of it:  $S - Z = X$ .

If peripheral countries that absorb "domestic" capitalists' surplus have no gold mines (or do not print an international currency, e.g. U.S. dollars), the core-country has to lend to the periphery

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<sup>19</sup> A full Classical-Kaleckian model is discussed in Cesaratto 2012c. On mercantilism see also Cesaratto 2013.

<sup>20</sup> One may note that since  $S = \Pi$ , and  $S = Z + X$ , then  $\Pi = Z + X$ , that is, capitalists gain what they spend, financed by banks, while workers get what they earn, after Michal Kalecki's famous dictum.

to let it to finance the trade deficit. Note that: (a) the core is not lending “savings” – in Keynesian-Kaleckian terms savings emerge only “at the end”, as the result of the trade surplus in the core;<sup>21</sup> (b) the capital flows from the core sustain the periphery’s exchange rate, aggravating its uncompetitiveness; (c) contrary to the neoclassical story, foreign lending only marginally sustains investment in fixed capital, but mainly consumption and typically residential investment. Of course, the process can go on as long as the core financial sector is ready to finance the periphery. Once the size of the debt and the expected inability of the country to redeem it through future CA surpluses begin to worry foreign lenders, they start to withdraw their loans and this generates a financial crisis (although in the EZ the latter has been softened by the mechanisms envisaged in section 3, and by the policy measures reviewed in section 5).

Note the parallel here between the U.S. and the EZ crises. In both cases residential investment bubbles (and more in general autonomous consumption financed by consumer credit) within a currency union sustained aggregate consumption from a middle class otherwise impoverished by decades of real wage stagnation (Barba and Pivetti, 2009). The geography, so to speak, changes, but the logic is similar. What is different is of course that the U.S. as a complete Federal Union had the will and means to deal with the crisis through monetary and fiscal policies and by implementing bank crisis resolution mechanisms, while the EZ as an imperfect Union fell short of a comprehensive solution.

Should the EZ periphery imitate the German model, as widely recommended? It depends. There is a “benign” form of mercantilism (Guerrieri and Padoan, 1986) that consists of a developmental state promoting welfare and productive capacity. This form of economic nationalism is not *per se* at odds with domestic demand-led growth and international economic cooperation. However, the German hyper-nationalistic economic model has always been a problem for the world economy, and it is basically incompatible with the working of the EZ. This behaviour has been defined as malevolent mercantilism. The suggestion that all EZ countries should imitate German malevolent mercantilism is a zero-sum game: a hopeless competitive deflation strategy that happens, however, to be at the core of EZ strategy.

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<sup>21</sup> There must therefore be some financial mechanism that permits the periphery to spend. This mechanism can be singled out by reference to the “endogenous money” view, according to which “loans create deposits, and deposits create reserves” (e.g. Lavoie 2003) and to T2 and refinancing mechanisms reviewed in section 3. Suppose then that Santander creates a loan (€100) in favour of a Spanish importer who uses it to pay a German exporter. The BoS will then transfer a corresponding amount of reserves (€100) through T2 (a T2 liability for BoS) to DB; at the same time BoS will lend an equal amount of new reserves to Santander “overnight”. If there is sufficient confidence in the interbank market, DB will lend its excess reserves to Santander who can thus return the overnight loan to BoS (who can in turn cancel its T2 liability). At the end of the day (literally!) it can be said that DB (or the German exporter) actually financed the Spanish importer, although the transaction was initially financed by the creation of a loan by Santander.



### 5. All German responsibility? It never rains but it pours

In view of the above, the deep causes of the euro crisis are quite complex. Both the core and the peripheral countries agreed to a quasi-gold standard set up:<sup>22</sup> the former since they rejected the idea of a deeper monetary *and* fiscal unification that could endanger the mercantilist model pursued since the early 1950s; the latter in the vain attempt of imitating the former. In the first ten years the competitive deflation bias of the EMU was masked by the “series of (un)fortunate events” that promoted faster but illusory growth in some peripheral countries. This avoided full stagnation in Germany whose paltry growth relied on exports (Bibow, 2013), albeit at the cost of growing and eventually unsustainable foreign indebtedness of the net importing countries. In Italy (and Portugal) growth was even weaker than in Germany. While Italy entered the EMU with a balanced CA, this progressively deteriorated, although not to the same degree as other fellow countries. Indeed Italy was not involved in the “series of (un)fortunate events.” Relatively fast growth of domestic demand cannot therefore be designated as the cause of that deterioration, directly due to larger imports and indirectly by inducing higher inflation and loss of competitiveness.

Other factors must have played a role in deterioration of the Italian CA and could have been observed “in vitro” in Italy, but it must also have applied to those other peripheral economies for which the relatively fast growth of domestic demand was the dominant determinant of foreign imbalances, all else being equal (European Commission, 2009, pp. 26-7). To begin with, Italy (as well as the other fellow peripheral countries) presumably felt the effects stagnation of domestic demand in Germany, its main export market. However, the main factor commonly pointed out is the rise in unit labour costs (*ULC*) and prices in Italy (and the rest of the periphery) with respect to Germany. This factor is usually relied upon to suggest nominal wage deflation and faster productivity growth as the recipe for the imbalances. There are various questions here.

First, one should not mistake nominal wage growth for real wage growth (e.g. Felipe and Kumar 2011). By looking at *ULC*:

$$ULC = \frac{w_n}{ALP} = \frac{w_n}{VA_r/L} = \frac{w_n}{(VA_n/P)/L} \quad (1)$$

we compare nominal wage ( $w_n$ ) growth with average labour productivity (*ALP*) growth, given by the ratio of value-added ( $VA_n$ ) and a price deflator ( $P$ ). The growth of *nominal* wages can well be higher than that of *ALP* without this implying that *real* wages have increased more than labour productivity. Indeed they have not in almost all *EZ* peripheral countries (e.g. Stirati 2011). The

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<sup>22</sup> One would be tempted to define it as an asymmetric gold standard, since the adjustment is only on deficit countries.

relatively faster growth of *ULC* is consistent with a change in income distribution unfavourable to wages. Let us write equation (1) as:

$$UCL = \frac{w_n}{VA_n/L} P \quad (2).$$

Equation (2) shows that the wage share on the nominal per-capita output may well fall while *UCL* increases, because prices are rising faster. In this case *ULC* is rising not because real wages are rising, but as a result of an increase in non-wage incomes reflected in price inflation. This is only partially offset by the fall of the wage share, that is, nominal wages partially caught up in the distributional conflict. Inflation in Italy – and partially also in other peripheral countries – is therefore the result of a conflict of income distribution that may affect nominal magnitudes, e.g. export prices, important for competitiveness in a fixed exchange rate context. Wage earners are not, however, the winners.

In Italy and elsewhere, sluggish labour productivity growth has been seen not to help relaxation of the inflationary outcome of distributive conflict. Leaving aside the conceptual problems behind this indicator, two explanations might be suggested: (i) depressed demand in Italy has not favoured efficient utilisation of plants and labour in the short run and innovative investment in the long run; (ii) Italy has presumably abandoned relatively higher value-added sectors in favour of industries with lower value-added per unit of product and productivity growth (e.g. in the service sector).<sup>23</sup>

Given nominal exchange rates, higher domestic inflation leads to revaluation of the real effective exchange rate (*REER*) and to a loss of external competitiveness.<sup>24</sup> The empirical estimations of *REER* provide mixed results regarding the loss of external competitiveness of Italy and other peripheral countries, depending on which deflator is used and often on the specific study (see e.g. European Commission, 2009, p. 20; Bayoumi et al., 2011; Grennes and Strazds, 2012; Simonazzi et al., 2012). In the case of the *REER* with extra-EZ markets, moreover, variations in

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<sup>23</sup> This may have been both a cause and a result of the various factors discussed in the text.

<sup>24</sup> The definition of the real exchange rate (*RER*) at time *t* is:

$$\varepsilon = \frac{e_t P_t}{p_t}$$

where  $p_t$  are domestic prices expressed in the national currency,  $e_t$  the quantity of a foreign currency per unit of national currency, so  $e_t p_t$  are domestic prices expressed in that foreign currency, and  $P_t^f$  are foreign prices expressed in foreign units of account. The *REER* is the average of the *RERs* weighted by the share of trade with each specific foreign country:  $REER_t = \sum_{i=1}^n \omega_i \varepsilon_{it}$ .

nominal exchange rates, particularly that with the US dollar, have played a major role (e.g. Bayoumi et al., 2011; Darvas, 2012; Chen et al., 2012, p. 3).

Given the resilience of exports from certain peripheral countries like Spain (European Commission, 2009, p. 27) - also Italy according to some scholars (Ginzburg, no date) - a possible suggestion is that overvaluation of *REER* is only one component in the development of EZ-imbbalances, besides the events mentioned in sections 2 and 4 (European Commission, 2009, p. 26; Gualier et al., 2012; Darvas 2012; Di Nino et al. 2012) and along with emergence of new competitors recalled below.

Nonetheless, the standard recipe for a more trade-balanced EZ is to force domestic wage and price deflation by fiscal contraction to readjust the *REER*. This should be supported by structural reform in the labour market to stimulate flexibility of wages and in use of the labour force (to spur labour productivity); and in good markets to reduce price stickiness, particularly in the sectors not exposed to foreign competition and with corporative and monopolistic protections – positions that would also explain some of the non-wage income gains in income distribution. While there is some merit in fighting those protections, the standard recipe is objectionable. The pernicious effects of deflation on debtors are widely known, but must be recalled since the difficulties of indebted households and companies affect the solvency of banks and states (the Argentinean experience in this regard is recalled by Damill et al. [2013]). Secondly, depression of aggregate demand humiliates productivity and impairs investment - including investment in public infrastructure, education and research. Finally, competitive deflation at international level is a zero-sum game. Inspired by an analysis ascribing the periphery problems to excessively rigid labour market institutions and excessively high real wages – again a wrong diagnosis of the crisis – the widespread labour market reforms and wage deflation have negatively affected overall EZ consumption demand, thus aggravating the crisis.

While the alternative EZ re-balancing recipe emphasises the need for German-led aggregate demand reflation and tolerance for “nice little inflation”,<sup>25</sup> other authors underline the EZ periphery’s increasing difficulty in meeting the current from eastern European countries and emerging world economies so as to fully benefit from a recovery of demand in core-Europe. The

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<sup>25</sup> In the second half of the fifties, Germany was asked to have “a nice little inflation” to reduce its trade surplus followed in 1957 by the threat by the European Payment Union to declare the Deutsche Mark a “scarce currency” so to adopt, under the provision in the original rules of the International Monetary Fund, discriminatory measures against German exports (Boarman 1964, p. 83). Then as now, however, “the suggestion that German internal policies be adapted to the inflationary conditions prevailing in deficit countries” is considered an “unpleasant joke” (Boarman, 1964, p. 85; Cesaratto and Stirati, 2011, p. 23).

former have been favoured both by the German policy of outsourcing part of production to Eastern Europe and at least in some cases by a competitive exchange rate against the euro (Grennes and Strazds, 2012; Simonazzi et al 2012). China has been an eager importer of German cars and machinery, while its exports have displaced those from southern Europe, presumably also not helped by an appreciated euro (Chen et al., 2012).

While this “demand-side” pessimism might be justified, the current EZ austerity policies compressing aggregate demand in the domestic and most proximate markets do not support the economies of scale, productivity growth and investment needed for competitiveness of peripheral countries’ firms. Rebalancing would be helped by reflation and some inflation tolerance in core-Europe, accompanied by a more competitive euro exchange rate against the dollar (Darvas, 2012) – to which many emerging currencies are pegged – and other currencies. A change in these policies also appears to be a necessary prerequisite for a needed upgrade of the peripheral supply side.

As we have seen, the main pillar of EZ re-adjustment strategy has unfortunately been wage and price deflation in the periphery through austerity policies. The accompanying pillar has been a “do as little and late as possible” strategy of avoiding disordered collapse of the euro. If on the one hand austerity can well be defined as the present main cause of the EZ crisis, and a peril for the world economy, on the other it is an expression of the original design of the euro: the combination of Germany’s lack of interest in deeper fiscal and monetary union, inconsistent with its mercantilist model, and the disciplinary aspirations of peripheral elites.

## 6. Eurozone acronym paraphernalia<sup>26</sup>

The main policy instrument deployed by the EZ to deal with the crisis has been bail-out packages (cf. EFSF, 2012) used to rescue Greece, Ireland and Portugal and to avoid contagious defaults and euro exits by these countries. The loans did not avoid double restructuring of Greek debt in March and November 2012, also as a result of fiscal austerity attached as a condition to the loans, undermining rather than sustaining the adjustment process in peripheral countries.<sup>27</sup> Moreover, bail-out funds are an inadequate instrument for the two larger troubled countries, Spain and Italy, both because of the figures involved and the simple reason that they are among the main contributors or guarantors of the funds. Austerity measures have been justified on the basis of the “credibility” thesis: once credibility in controlling public accounts is restored, interest rates will fall and confidence and growth will return. During the crisis, mounting evidence has undermined this

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<sup>26</sup> “European bureaucrats seem afflicted by *acronymia* – the belief that a suitable sequence of letters [and labels] can solve any problem” (Das, 2013, p. 2).

<sup>27</sup> Conditionality on loans from the IMF was usually at least accompanied by the currency devaluation that sustained exports, by definition impossible in the EMU.

argument, showing that the negative effects of austerity on output, employment and tax revenues were far from restoring credibility and growth (Zezza, 2013; Blanchard and Leigh, 2013). Austerity seems to be the main enemy of credibility.

Although invoked by many authoritative economists, the EZ Treaties and particularly German opposition have impeded the most obvious action that the ECB could take to calm down the markets, that is to act as a potential lender of last resort with regard to sovereign debt. This inaction, associated with the lack of coordinated European fiscal counter-cyclic measures and a solution to the (mainly Spanish) bank crisis, meant that Spanish and Italian sovereign debt were drawn into the financial crisis in 2011. Fear of moral hazard on the part of peripheral governments has been a major argument used by the German establishment to put aside the idea of direct and resolute ECB support of sovereign debt - although evocation of this support, which has never materialised, was aired as a possible reward when harsh and counterproductive austerity measures were imposed on Italy starting in summer 2011, and later even a change in government.

The power of a resolute CB is shown by comparison of the Security Market Programme (SMP) launched by the ECB in May 2010 - that led to the purchase of about €200 billion peripheral sovereign bonds (including Italian and Spanish) without much effect on sovereign spreads - and the Outright Market Programme (OMT) launched in September 2012 – that by including unlimited commitment to support sovereign debt led to an (albeit limited) fall in sovereign spread of about 150 basic points in Italy and Spain. OMT as such never materialised, due to the political stigma of fiscal conditions imposed on participating countries. Nonetheless, the Draghi's mere announcement was enough to produce some benefits. This showed public opinion what experienced economists knew well: that interest rates are determined by determined central banks and not by markets. The austerity clause entailed by the OMT and the limited commitment to a substantial reduction of sovereign spreads are its weak aspects. The ECB's explanation is that precisely because the SMP was not accompanied by a conditional austerity clause, this limited the effectiveness of ECB action, since any moral hazard on the part of supported governments threatened ECB independence (Draghi as quoted by Reuter [2012]). Two criticisms have been levelled at this argument. On one hand, the stigma of an internationally imposed austerity-memorandum is such that “[i]nstead of avoiding market pressures, the triggering mechanism requires that financing problems of ‘at-risk’ countries get worse before the ECB will act” (Das, 2013, p. 4). In other words, while the clause discourages countries from entering the program, they implement austerity anyway and without any ECB commitment to substantially reducing sovereign spread, and fiscal retrenchment progressively worsens the situation. On the other hand, what happens if after self-inflicted austerity, a desperate government finally comes under the OMT umbrella but “austerity fatigue” (the social impact of

austerity) leads it to violate the conditions? This may be expected, since OMT entails continuation of austerity and only a limited reduction of spread.<sup>28</sup> Will the ECB stop the programme, again leading countries and the EMU to the verge of a lethal crisis (e.g. Buchheit and Gulati, 2012)? Austerity therefore does not create the political credibility that the ECB is calling for, it just destroys it.

Admittedly, that some sort of conditionality (a fiscal rule) should be agreed upon once the ECB acquiesces to act as a lender of last resort. A credible fiscal rule might be stabilisation of sovereign debt/GDP ratios (not their reduction). This would be consistent with deficit spending policies as long as an accommodating monetary policy keeps the interest rate sufficiently low (Pasinetti, 1998). I would call it an “expansionary conditionality” or “Keynesian conditionality”. The rationale is that the savings obtained from the reduction in interest rates be used not to reduce the sovereign debt/GDP ratio, but to sustain aggregate demand; the larger fiscal revenues will help stabilize the ratio. In spite of the mounting evidence of the current and expected failure of austerity (e.g. Holland and Portes, 2012), actual EZ fiscal policy has gone in the opposite direction, imposing more stringent budget rules and public debt/GDP ratios within the 60% Maastricht rule (e.g. ECB 2012) through a reinforced Growth and Stability Pact (named “six pack”) and the so-called “Fiscal Compact”.

In December 2011, between the SMP and the OTM, Draghi launched the already mentioned huge programme of long-term liquidity provisions through a three-year LTRO. This operation is brought into perspective recalling the T2 story. As we have seen, the liabilities of the periphery towards private core-European investors were replaced by the “official” T2 liabilities towards the Eurosystem. Since most capital flight consisted of previous investment in peripheral sovereign debt

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<sup>28</sup> The ECB has refused to pre-commit to a precise reduction. A study by the Bank of Italy (Di Cesare et al., 2012) suggested that were the fears of a euro break-up excluded, the equilibrium spread between Italian and German ten-year Treasury bonds would be around 200 basic points. This has been taken as a hidden suggestion for an ECB target rate, after all not far from the one (between 250 and 300 basic points) prevailing at the time of writing (as an effect of the mere announcement of OMT). We tend to deny that 200 basic points is a justified spread. Its main explanation, the risk of sovereign default, is itself the result of CB actions (so is the ECB spread target that creates the risk, and not the other way round). So we believe that that specific target is suggested because it would keep troubled countries under pressure to continue austerity policies (which also, by the way, increase the risk of default), while avoiding social uprising. This strategy was aptly summed up by an op-ed in the *Wall Street Journal*: “I recently heard a prominent opposition politician from a stricken European country dismiss the shift in financial-market sentiment [the moderate calm in the financial market at the beginning of 2013], arguing that current policies are on the road to nowhere. When I asked him how he thought it would end, he answered with the “boiling frog” allegory: If you put a frog in scalding water, he said, it will jump out. But if you place it in cold water and slowly raise the heat, it will stay put, eventually being boiled to death. In other words, even if an explosion that propels a country out of the euro is avoided, the problems remain. Like the gradually boiling frog, the periphery countries may manage to stay in the euro but remain in depression, with continued emigration and de-industrialization.” (Dadush, 2013).

that foreign investors progressively refused to refinance (roll-over), banks used ECB liquidity to sustain their respective domestic sovereign debts. In Italy, for instance, the share of foreign-held public debt has fallen from 60 to 30 per cent, which does not mean that Italian foreign debt has fallen: private loans have just been substituted by T2 liabilities. What all this means is that fragile banks sustain fragile states, and fragile states back fragile banks,<sup>29</sup> probably the wrong way to tackle the sovereign crisis. Perhaps it was the only game in town until July 2012 when, on the verge of a euro eventual collapse, Draghi persuaded the German Chancellery that the ECB should act differently (as it had done launching the OMT, albeit with the above limits).

In summer 2012, the German Chancellery was also progressively convinced that some step in the direction of a European banking resolution mechanism should be taken. However, symmetrically to ECB action for distressed banks to sustain troubled states, ESM support to Spanish banks was conferred through the Spanish government, ignoring widespread advice that the deadly embrace between banks and governments should be broken. Only after the predictably months-long creation of a European supervising authority will the ESM be authorised to finance banks directly, probably with some financial ceiling. Moreover, Kapoor and Goodhart (2013) note that these measures will not solve the legacy of banks' problems, which will basically remain – for instance in the form of “bad banks” – on the shoulders of troubled states, since support will only go to viable banks. Similarly discouraging have been vague talk about a thin Eurozone budget – “common fiscal capacity” in European jargon. This budget “would represent a form of limited fiscal solidarity” to countries hit by “asymmetric shocks” and would be “structured in such a way that” it did “not lead to permanent transfers across countries” (European Council, 2013, p. 5). Germany's fear that this limited budget might be the premise for larger fiscal commitment has led to postponement of the measure.

### **7. Is there reason in this madness?**

It is not easy to untangle the logic that in the past led to creation of the EMU and that is currently guiding the prevailing EZ policies.

With regard to the past, the EMU can be considered a labour disciplinary device that suited the well-ordered core-EZ communities and the less organised peripheral countries fancying imitating the former. The series of unfortunate events pointed out in section 2 avoided an excess of deflationary bias of this quasi-gold standard set up, albeit at the price of increasing infra-EZ domestic and external imbalances. At the same time the monetary institutions of the EMU –

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<sup>29</sup> Although apparently profitable for banks, which borrowed cheaply and lent at higher rates, this did not shore up the safety of the government bills banks were buying.

TARGET2 and the refinancing operations – aided by indecisive government and ECB measures, impeded the ensuing balance of payments crisis and attendant collapse of the EMU, from occurring.

Rather than pushing towards the creation of a different set of European institutions, the prevailing crisis resolution philosophy resembles a late vindication of the original deflationary Euro-bias. Germany and its satellite credit-countries should, however, be worried about the long-run solvency of indebted countries, which certainly cannot be achieved only by a fall in peripheral imports, unless the fall of domestic output reaches unthinkable levels while their export capacity is unaffected. It is possible that core-countries rely on export-led growth of the periphery, obtained at the price of ruthless but eventually rewarding deflation. This growth should be driven by extra-EZ markets, since they cannot expect much help from the enduring mercantilism core-countries. A reaction to this policy, destabilizing at world level, is indicated by the currency war that began in early 2013. Germany's behaviour has often been associated with behaviour typical of a small country and is not worthy of a big player. To understand EZ strategy one therefore has to enter the German insular mentality: if a country does its duty to regain price competitiveness and discipline, then in the end success cannot fail to arrive. The idea of a fallacy of composition (Who is going to generate international demand in a vendor market?) is not grasped by dominant German public opinion, and even more unfortunately, by most of the German economic profession.<sup>30</sup> What is most depressing is the passive acceptance of this mentality by the other EZ countries. It confirms the riddle Simonazzi and Vianello (1998, p. 250, my translation) posed a long time ago, namely whether the European “design was merely that of remaining in an emergency until successful imposition of sacrifices and renunciations, which could be hardly be deemed necessary in normal times, in the name of the emergency.”

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<sup>30</sup> A serious accusation leveled at the German establishment by a respected Italian former central banker was that it wishes to resuscitate the Funk plan of 1936 for a German-dominated economic Europe (Savona 2012).



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