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Working Paper

Monetary disunion: The domestic politics of Euroland

MPIfG Discussion Paper, No. 14/17

Provided in Cooperation with:

Max Planck Institute for the Study of Societies (MPIfG), Cologne

Suggested Citation: Streeck, Wolfgang; Elsässer, Lea (2014) : Monetary disunion: The domestic politics of Euroland, MPIfG Discussion Paper, No. 14/17, Max Planck Institute for the Study of Societies, Cologne

This Version is available at:

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MPIfG Discussion Paper 14/17

Monetary Disunion

The Domestic Politics of Euroland

Wolfgang Streeck and Lea Elsässer



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Monetary Disunion: The Domestic Politics of Euroland

MPIfG Discussion Paper 14/17
Max-Planck-Institut für Gesellschaftsforschung, Köln
Max Planck Institute for the Study of Societies, Cologne
October 2014

MPIfG Discussion Paper
ISSN 0944-2073 (Print)
ISSN 1864-4325 (Internet)

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Abstract

Regional disparities within the European Union have always been perceived as an impediment to monetary integration. This is why discussions on a joint currency, from their very beginning, were linked to compensatory payments in the form of regional policy payments. Structural assistance to poor regions and member states increased sharply at the end of the 1980s. Today, however, fiscal support has to be shared with the new member states in the East. Moreover, due to the financial crisis, the cheap credit that poor EMU member countries enjoyed as a result of interest rate convergence is no longer available. We predict that in the future, some sort of financial aid will have to be provided by rich member countries to poor ones, if only to prevent a further increase in economic disparities and related political instability. We also expect long-lasting distributional conflict between payer and recipient countries far beyond current rescue packages, together with disagreement on the extent of aid required and the political control to be conceded by receiving countries to giving countries. We illustrate the dimension of the distributional conflict by comparing income gaps and relative population size between the center and the periphery of Europe on the one hand and on the other, between rich and poor regions in two European nation-states characterized by large regional disparities, Germany and Italy. While income gaps and population structures are similar in the two countries to those between Northern Europe and the Mediterranean periphery, regional redistribution is much more extensive in the two nation-states. We conclude that this presages a difficult future for the domestic politics of Euroland.

Zusammenfassung

Regionale Disparitäten in der Europäischen Union galten immer als Hindernis für den währungspolitischen Integrationsprozess. Aus diesem Grund waren die Verhandlungen über eine zukünftige Währungsunion von Anfang an mit Forderungen nach Ausgleichszahlungen in Form von regionalpolitischen Hilfsprogrammen verknüpft. Strukturhilfen an arme Regionen und Mitgliedsstaaten wurden Ende der 1980er-Jahre erhöht. Heute müssen die entsprechenden Mittel allerdings mit den neuen Mitgliedsstaaten im Osten geteilt werden. Zudem können die ärmeren EWU-Mitglieder seit der Finanzkrise keine günstigen Kredite mehr aufnehmen. Wir gehen davon aus, dass es auch in Zukunft finanzielle Transfers von den reichen zu den armen Mitgliedsstaaten geben müssen, selbst wenn sie nur dazu dienen, stärkere wirtschaftliche Disparitäten und damit einhergehende politische Instabilität zu verhindern. Zudem können über die gegenwärtigen Rettungsmaßnahmen hinaus lang anhaltende zwischenstaatliche Verteilungskonflikte zwischen Geber- und Empfängerländern erwartet werden, in welchen es vor allem um den Umfang der Finanzhilfen und die im Gegenzug verlangte Abgabe politischer Kontrolle durch die Empfänger von Transfers gehen wird. Um die Dimension des Verteilungskonflikts zu veranschaulichen, vergleicht der Aufsatz Einkommenslücken und relative Bevölkerungsgrößen zwischen Peripherie und Zentrum der EU mit denen zwischen armen und reichen Regionen zweier Nationalstaaten mit starken regionalen Disparitäten, Italien und Deutschland. Während Einkommenslücken und Bevölkerungsstruktur in den beiden Nationalstaaten denen innerhalb der EWU ähneln, ist die regionale Umverteilung in den Nationalstaaten weitaus höher. Wir schließen daraus, dass die Innenpolitik der Eurozone konfliktreich sein wird.

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Monetary Disunion: The Domestic Politics of Euroland

What will the internal politics of the European Monetary Union (EMU) – in short, of Euroland – be like once current rescue operations have been declared successful (if they ever are)? Euroland is a unique construction: an association of sovereign states that have pooled their sovereignty on monetary and, increasingly, economic and fiscal policy in collective institutions such as an independent central bank, a supranational bureaucracy and a council of their heads of government. While Euroland is not a state, and is not intended to become one, it may be described as an *international market regime*: a supranational governance arrangement – a polity – constituted by international treaties on a common “internal market” with a common currency. This polity, like any other, has domestic politics, although these consist in large part of international relations and the foreign policies of constituent states. Figuring prominently within them will be the economic disparities and the institutional heterogeneity between the latter, and the conflicts over economic sovereignty and economic distribution between Euroland regions constituted as nation-states to which they give rise. This paper will explore aspects of the interregional domestic conflicts to be handled in a Euroland polity consisting of nation-states and international relations.

1 EMU, EU, Europe

We begin by taking exception with Angela Merkel’s famous dictum: “Scheitert der Euro, so scheitert Europa.”¹ Euroland is not Europe. Not even the European Union is Europe: after the experience of the crisis, Norway and Switzerland will be even less willing than before to join. Apart from Iceland, it is only the remaining Balkan countries and, perhaps, Turkey that are waiting for admission. As far as the EMU is concerned, it is worth remembering that only nineteen of the 28 European Union members belong to it in the first place.² Denmark, Sweden and the United Kingdom – three European nations of considerable import – have reserved the right to remain outside,³ and today it is less likely than ever that they will change their minds. Moreover, the crisis has caused the UK to demand a significant loosening of the European Union.⁴ Inside Euroland, the

1 “If the euro fails, Europe fails.” Angela Merkel in the Bundestag, May 19, 2010.

2 With the formal accession of Lithuania in 2015. Six of the nineteen EMU members have fewer than 2 million inhabitants.

3 Danes and Swedes decided against membership in national referenda (1992 and 2003). The UK and Denmark are formally exempted from having to join, while Sweden is informally allowed to remain outside due to expected popular opposition.

4 In a speech on the future of the European Union in January 2013, the British Prime Minister

division between the Western European center and the Mediterranean periphery has deepened as a result of conflicts over austerity and is presently being institutionalized, in the Fiscal Pact and otherwise.⁵ Whether the Eastern European countries that are already members of the European Union and the Balkan countries waiting to be admitted to it will want to accede to the EMU as well – in other words, whether there will be an Eastern European periphery in addition to the Southern one – will above all depend on the benefits they can expect. We will return to this.

Plans for European monetary union go back well into the 1960s (Issing 2010; James 2012). When the EMU was finally instituted in the 1990s, it was a project of European governments, in particular the government of France, who were tired of having to follow German monetary policy and hoped to achieve a more accommodating European monetary policy by Europeanizing the Bundesbank. Germany gave in – to relieve anxieties over unification in 1990 and after its government had convinced itself that with the right treaty language, its traditional hard currency policy could be made that of the European Union as a whole. In the South – not just in Italy but also in France – significant factions of the political establishment looked forward to using monetary union with Germany as a tool to discipline their national political economies, especially their trade unions. In the 1990s, nationalist modernizers became closely allied with neoliberal, globalization-oriented economists who in Italy were based in particular at the Banca d'Italia and at Bocconi University in Milan. At the same time, others hoped for cheap credit to allow for accelerated economic growth or politically profitable tax cuts, and some may have placed their hopes on financial compensation from the North. The divergent motives and expectations related to the EMU were never resolved and have continued to exist side by side up to the present day, where they underlie the often contradictory positions taken by different players on crisis management and institutional reform.

revealed plans to renegotiate the UK's relations with the EU and promised to hold a referendum on Britain's membership in the EU before the end of 2017 if his party won the next election. He stated that "power must be able to flow back to Member States, not just away from them ... Countries are different." The full speech can be accessed here: <http://www.spiegel.de/international/europe/the-full-text-of-the-david-cameron-speech-on-the-future-of-europe-a-879165.html>.

- 5 Under the various agreements on debt reduction negotiated during the crisis, debtor countries, all of them located on the Southern periphery of the EU, will for decades have to have their budgets approved by the European Commission, which will in effect be acting on behalf of the rich center states in the North. See, for example, Scharpf (2013) on the so-called "Excessive Imbalances Procedure" and similar control instruments.

2 EMU, USA

Economically as well as institutionally, Euroland is characterized by enormous internal heterogeneity.⁶ Regional disparities within Euroland, in the form of national disparities between member states, far exceed regional disparities among the federal subunits of a country as diverse as the United States. The range of per capita income between the poorest and the richest states of the U.S. has always been much smaller than the range between the poorest and the richest member states of the EMU.⁷ GDP per capita in Connecticut, the richest state, is roughly twice as high as in the poorest state, Mississippi – a pattern that has been fairly stable since the 1990s. In Euroland, in contrast, Germany's GDP per capita in 1995 was eight times higher than Slovakia's, by far the poorest country at the time.⁸ Excluding Slovakia, per capita income in Germany was three times that in the second-lowest country, Slovenia. In 2012, while Slovakia has almost caught up with the other poor countries, per capita income in the richest EMU country, Belgium at the time, was 2.8 times as high as in the poorest (2012).

The same picture results if we look at more comprehensive measures of income variation. Throughout the last two decades, the coefficient of variation of per capita income between Euroland countries was consistently higher than between U.S. federal states.⁹ While the regional income spread in the U.S. has been roughly constant since the early 1990s, with the coefficient of variation fluctuating between 0.156 and 0.160, national incomes in Euroland began to converge in the mid-1990s. Still, even excluding Slovakia, variation has remained considerably above the United States, declining from 0.286 in 2000 to 0.252 in 2008, to rebound to 0.278 after the crisis (2012). Note that in the wake of the financial crisis, income inequality has risen between Euroland countries but not between U.S. states. As there is no fiscal union in the European Monetary Union, there are no automatic fiscal stabilizers in Euroland, unlike in its member states. Automatic stabilizers, as built into taxation, pension, and unemployment insurance systems, help countries equalize the regional effects of economic shocks by transferring resources to regions most hit by an economic downturn “without the explicit intervention of a country's fiscal authority” (in 't Veld et al. 2012).

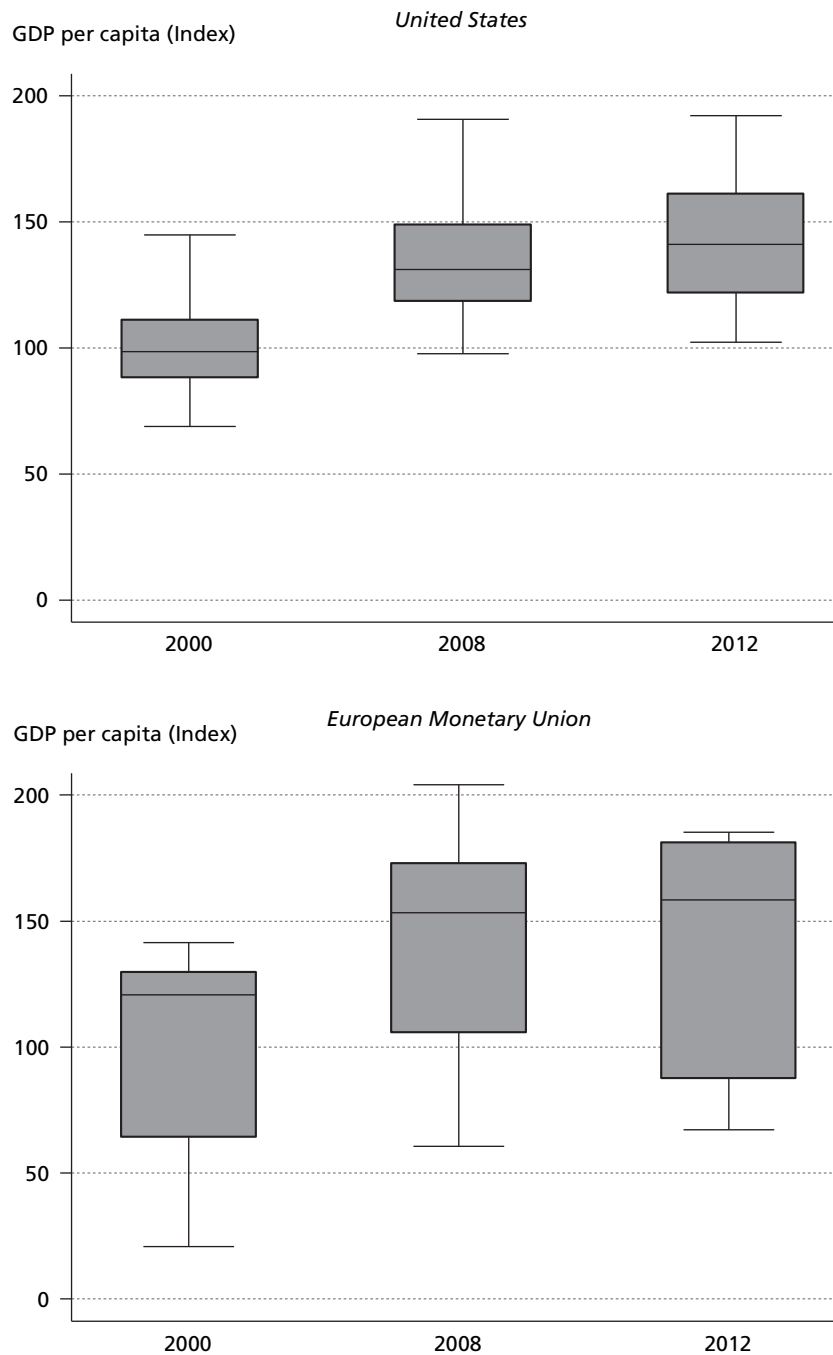
6 The American bank J. P. Morgan has calculated the heterogeneity of different actual and hypothetical currency unions using more than 100 economic, social, and political indicators. It turned out that the twelve most important EMU member states form a less homogeneous union than would the countries that belonged to the Ottoman Empire around 1800; all countries on the fifth parallel north latitude; and all countries with a name beginning with the letter “M”. J. P. Morgan, *Eye on the Market*, May 2, 2012.

7 Federal states and member states, respectively, with less than or around one million inhabitants are excluded. Among them are outliers such as Luxemburg, the District of Columbia and Alaska, which have an extremely high per capita income due to unusual economic conditions.

8 Slovakia had a GDP per capita of only 2,800 Euros in 1995. In comparison, per capita income in other relatively poor countries like Greece and Slovenia was 8,500 and 8,100 Euros, respectively.

9 Again, countries and states with a population of around one million or less are excluded.

Figure 1 Variation in average per capita income, U.S. Federal States and EMU member states, 2000, 2008, 2012



Average per capita income in 2000=100. Excluding states with less than 1 million inhabitants.
Source: Eurostat; Bureau of Economic Analysis; United States Census Bureau.

The extent of regional disparities between the territorial subunits of the United States and Euroland is perhaps best pictured by box plots representing the distribution of per capita incomes among territorial subunits (Figure 1). The boxes' lower bounda-

ries mark the 25th, the upper boundaries the 75th percentile; the thin lines above and below the boxes indicate the range of the distribution. The smaller the box, the more compressed are the central fifty percent of the cases around the median, which is represented by the line inside the box. We use standardized values to enable comparison between data in different currencies. The figure visualizes the true extent of the variation in regional per capita income as well as the dramatic difference in regional diversity between the U.S. and Euroland. It also shows the highly skewed nature of the Euroland distribution – skewed toward the bottom – as compared to the relatively continuous distribution in the United States.

3 The political economy of Euroland

Today's pro-euro coalition includes the export industries of surplus countries, in particular Germany. Allied with them are the trade unions that organize their workers, who share the interest of their employers in assured access to a large "internal market" where they can sell their products at prices undistorted by the politics of national exchange rates. Exporters in Northern surplus countries also appreciate the fact that, because of the participation of the Mediterranean deficit countries, the external value of the common currency is lower than what a Northern European or German currency would be. Furthermore, there is a long-standing alliance of liberal economists and European technocrats who, for partially different reasons, want to make money exogenous to national politics, so as to preclude national political interference with European "market forces." In the Mediterranean countries, monetary union can also count on the support of large segments of a growing urban middle class to whom a devaluation of their national currency would mean higher prices for imported consumer goods, such as German luxury cars or kitchens. Moreover, high income earners obviously like the freedom of capital movement that comes with monetary union, as it allows them to take their money abroad whenever they want, above and beyond financial integration in the internal market.

In an important sense, monetary union amounts to a return to an international gold standard. Conceived as the crowning completion of the internal market of 1992, the EMU eliminates national political discretion from the international political economy of the Euroland part of Europe. While monetary union offers a robust solution to some of the coordination problems of an increasingly internationalizing capitalist economy, it eliminates devaluation as a last resort for member countries lagging in "competitiveness" – i.e., producing at higher unit labor costs than other member countries.¹⁰ A common currency makes it impossible for countries producing at higher unit labor costs to mask their low competitiveness by cutting the value of the currency in which

10 In fact, it does so even more strictly than could an international gold standard, which as Keynes among others noted was always subject to some degree of national manipulation, in particular through central bank intervention.

foreign customers pay for their products and thereby lowering their prices without having to lower the wages and entitlements of their citizens. Having lost the option of manipulating their unit of account, they have just two ways left out of low and potentially declining incomes and high and potentially growing unemployment: they may either lower the costs or upgrade the value of their products – bring down their prices to match their international market value or raise their international value to match their national prices. The former replaces external devaluation with what has come to be called “internal devaluation,” raising productivity by cutting wages, pensions and public expenditure – euphemistically referred to as “structural reforms” – in order to lower costs. The latter would raise productivity by upgrading production factors and products, relying on regional industrial policy fueled by external financial aid and development assistance, to justify the high prices needed to pay for high costs. Both paths promise convergence in economic performance under the common currency and may, in principle, be combined.

Euroland, as we have pointed out, is highly heterogeneous economically, even in comparison with the United States. This fact was not unknown to the EMU’s founding fathers. They expected, however, that free access of weaker national economies to the European internal market and enhanced confidence of investors in their monetary and political stability would result in these economies catching up through higher long-term growth, with time and, perhaps, with a little help from their friends. Others recognized early on that there were also structural issues. For example, the Canadian economist Robert Mundell, the leading authority on the subject, was well aware that Euroland was far from an “optimum” currency area, as lack of labor mobility across national borders and pronounced differences in the structural composition of national economies were likely to make the EMU highly vulnerable to “asymmetric shocks.” More important for him, however, was that monetary union would make it impossible for national governments to avoid liberal reforms by temporarily restoring competitiveness through devaluation.¹¹ For those who followed in his footsteps, including the neoliberal hardliners at the Bundesbank who finally fell in line with the Kohl government, monetary union as constituted by the Treaty was – or rather had to be – a giant European convergence program under which the Mediterranean countries would learn – and indeed would have to learn – to reform their institutions, in particular their labor markets, in line with the requirements of life under a hard currency regime like the German one.¹² Behind

11 Already in 1973, Mundell dismissed concerns about divergence between European countries making monetary union impractical with a clearly political argument: “Rather than moving toward more flexibility in exchange rates within Europe the economic arguments suggest less flexibility and a closer integration of capital markets. ... On every occasion when a social disturbance leads to the threat of a strike, and the strike to an increase in wages unjustified by increases in productivity and thence to devaluation, the national currency becomes threatened. Long-run costs for the nation as a whole are bartered away by governments for what they presume to be short-run political benefits” (Mundell 1973: 147, 150).

12 As noted, there were influential sympathizers with this view in the respective countries themselves, for example at Bocconi and the Banca d’Italia. The French were more ambivalent: while

this was general confidence in the salutary educational effects of unbridled competition, and in economic rationality of the German kind ultimately carrying the day even in countries like Italy or Greece.¹³

Less optimistic on convergence is a strand of literature more or less in the “varieties of capitalism” tradition (Streeck 2011), which emphasizes the stickiness and inertia of existing national economic institutions, established political power structures and conflict lines, and habituated political-economic practices. The tenor is that national economies that are as different from one another as in Europe, and are likely to remain so for a long time, cannot be equally viable under a common, one-size-fits-all monetary regime. Some – in particular countries of the German type, with the Netherlands, Austria, and Finland mentioned most often in addition to Germany – will prosper while others, especially the Mediterranean countries, will suffer (Hall 2012). Different national economies need different national monetary regimes that fit their specific conditions.¹⁴ Analytical concepts used to make the case vary: Baccaro and Benassi, for example, in an unpublished paper, speak of profit-led and demand-led economies; others distinguish export-led and domestic demand-led growth (Johnston and Regan 2014) or export-savings and consumption-credit regimes (Mertens 2013).¹⁵ Related arguments have been made by economists for some time, among them Martin Feldstein (2011) and Charles Blankart (2013).¹⁶ While they all expect European Monetary Union either to break apart or cause highly divisive conflicts among member states, some see Germany rising to quasi-imperial dominance in Europe at the expense of the weaker economies of the South while others, including a number of German economists sympathizing with the new anti-euro party, AfD, expect Germany to be blackmailed by a majority of EMU members into subsidizing underperforming Mediterranean economies and ways of life.¹⁷

Delors celebrated “the German model,” the Left, and perhaps Mitterand, may have hoped for the euro to be a little less German and a little more French.

- 13 Those who did not share that confidence, like the President of the Bundesbank from 1993 to 1999, Hans Tietmeyer, remained skeptical on EMU, although they only rarely spoke up in public.
- 14 See Ralf Dahrendorf, sociologist and one-time European Commission member, in a December 1995 (!) interview in *Der Spiegel*: “The currency union is a grave error, a quixotic, reckless, and misguided goal, that will not unite but break up Europe. [SPIEGEL: But the essential idea is precisely convergence.] Dahrendorf: It won’t work, for their economic cultures are too different ... The currency union project instills into countries German behavior, but not all countries want to act like Germany. For Italy, occasional devaluations are much more useful than fixed exchange rates, and for France higher state expenditures make much more sense than rigid adherence to a stability doctrine that is used mainly by Germany.”
- 15 See also, in a similar vein, Armingeon and Baccaro (2012), Collignon (2013), Hancké (2013), Höpner and Lutter (2014), Höpner and Schäfer (2012), Iversen and Soskice (2013), Ramskogler (2013), Scharpf (2013), and others.
- 16 Blankart (2013) gives a detailed historical and institutional account of the different functions especially of money as an institution and public spending as a tool of policy and politics in Germany and France, elaborating with impressive erudition on the intuitions of Dahrendorf as quoted above.
- 17 The reason why German liberal economists have come to oppose an institution like the EMU that had originally been designed to their taste is their Public Choice-like lack of confidence

Table 1 “Fair value” of the euro in U.S. dollars for the Eurozone and six national economies of EMU member states; actual exchange rate of euro for U.S. dollar

	Fair value	Over/Under valuation (percent)	Actual rate
Germany	1.53	–13.2	1.36
Eurozone	1.33	–2.3	
Spain	1.26	5.4	
Portugal	1.24	7.3	
France	1.23	7.8	
Italy	1.19	12.1	
Greece	1.07	24.4	

Source: Morgan Stanley, 2013: FX Pulse – Waiting to Buy Risk. Morgan Stanley Research. Accessible online: http://www.morganstanley.com/institutional/research/pdf/FXPulse_20130117.pdf

However that may be, hopes for convergence among EMU member countries have not materialized, and initial catch-up growth in the early 2000s is now seen as largely artificial, caused by speculative investment made possible by fundamentally unjustified access to cheap credit.¹⁸ That growth ended in 2008 when what is now seen as irresponsible lending ended, laying bare the continuing deficits in competitiveness. To the extent that lagging competitiveness in peripheral countries is explained by their institutions, the common denominator of the literature is that EMU countries have different proclivities to inflation, some needing higher inflation than others to reach a socially acceptable level of employment and growth.¹⁹ Everything else being equal, being unable to adjust their exchange rates, lagging countries may have to live with a steady decline in competitiveness as their inflation rates continue to be above those of other countries under the same (hard) currency regime. How far apart EMU member countries are today with respect to their competitiveness is indicated by a calculation of what would be the “fair value” exchange rate of their national currencies if they had one. While in 2013 the fair value of the euro compared to the dollar was, at 1.33, slightly lower than the actual exchange rate (1.36), for Germany the euro was undervalued by more than 13 percent whereas for Italy and Greece it was overvalued by 12 and 24 percent, respectively (Table 1).

Differences in economic performance between the territorial subunits of a currency union, national or international, inevitably elicit a political response. While national governments may neglect the plight of poor regions at their political peril, such neglect is hardly possible in a union of sovereign states whose poorer members have, at

in Mediterranean governments carrying out the “economic reforms” supposedly necessary for economic convergence, as well as suspicion about Kohl-style international opportunism of German governments caving in to combined pressures from France and the Mediterranean periphery for financial redistribution from Germany.

18 Credit was cheap because of a rapid decline of long-term interest rates during the run-up to EMU, from 17 percent (Greece) and 12 percent (Portugal, Italy, Spain) in 1995 to only 5 percent in 2000. Between 2000 and 2008, net external debt increased from 20 percent of GDP to 80 percent in Greece, Spain and Portugal, and 40 percent in Italy.

19 Or, the other way around: their institutionally determined non-accelerating inflation rate of unemployment (NAIRU) exceeds that of other, more “competitive” member countries.

least in principle, the option of secession.²⁰ Moreover, if economically weaker member countries are democracies, impoverishment resulting from low competitiveness may destabilize them politically, with unpredictable external effects. Just as regional disparities inside nation-states produce political pressures for some sort of inter-regional redistribution, national disparities in an international currency union will raise the issue of international redistribution. In both cases, there is likely to be resistance from those having to foot the bill, who will insist on transfers being kept as low as possible and conceived strictly as measures to enable recipients to become self-sufficient – with subsidies used for investment rather than consumption.²¹ Transfers in favor of lagging territorial units, whether in a country or in an international monetary union, are therefore typically designated as aid for economic development provided to enable recipients ultimately to stand on their own feet.

How economically effective such assistance can be – and how to prevent its diversion from investment to consumption – is a much debated question, especially at the international level where donor countries may also want to keep cooperative governments in office and stabilize existing regimes and their state machineries. Mainstream economics tends to oppose any regional assistance that involves financial transfers, claiming that it is only through “painful reforms”²² that low competitiveness can be cured. But while a position like this may perhaps be politically sustainable in a nation-state with a strong central government, such as Britain, it may break up an international currency union – not just because there are few if any examples of a neoliberal *Rosskur* working (Blyth 2013), but because imposing it from the outside on a national society would require a degree of international intervention in a country’s internal affairs that its citizens may be unwilling to tolerate. This is why the prohibition on international compensation payments in the Maastricht Treaty is no more than *pro forma*: with significant performance differences between countries joined in a monetary union, there is no way around some sort of inter-country redistribution; the question is only in what form.

20 The Maastricht Treaty on European Monetary Union does not provide for member country exit or exclusion. But what this means in effect has never been tested, and in a state of emergency there is no limit to institutional creativity. In any case, both exit and exclusion were explicitly discussed behind more or less closed doors at the height of the Greek debt crisis.

21 The equivalent in social policy is the replacement of “passive,” “decommodifying” benefits with “active” or “activating” ones.

22 That is, “internal devaluation.” The problem of neoliberal reform is that it expects governments to inflict on their citizens in the short run the very same suffering that is predicted to result for them from non-reform in the long run – in the hope that reform will, in the long run, restore the prosperity that has to be sacrificed in the short run.

4 The political economy of European regional policy

Financial assistance to Western Europe's Mediterranean fringe has a long history, documenting that European governments never had much confidence in spontaneous economic convergence. In the 1950s and 1960s, the six-country European Economic Community already provided regional assistance to Italy to help it manage the tensions between the rich North and the poor *mezzogiorno* (Irving 1976; Ginsborg 1990: 160, *passim*). Regional and social assistance programs were greatly expanded after the transition to democracy of Portugal, Spain, and Greece in the 1970s, and in particular upon the three countries' accession to what was to become the European Union. Designed to stabilize their Mediterranean *glacis* politically as well as economically, their objective was to prevent a return of fascism and military dictatorship and to avert the area from turning Eurocommunist (Webb 1979; Pons 2010). In particular, membership in the European Union and in NATO was to make it possible for the newly democratized Mediterranean countries to move onto a social-democratic development path and help them to avoid confronting their historical legacies of semi-feudal local and regional power structures associated with clientelism and corruption.

European regional policy was frequently reorganized, as were the institutions that govern it. Landmark reforms took place in 1988, leading among other things to a doubling of the structural funds by 1993 (George/Bache 2001). Today, structural funds amount to roughly one third of the budget of the European Union, equivalent to 0.3 to 0.35 percent of the combined GDP of European Union countries (2007–2012). Whether this has contributed to economic growth in recipient countries and to what extent is examined by a vast body of literature ranging from case studies to econometric analyses and macroeconomic simulations (for two overviews, see Ederveen et al. 2003; Bachtler/Gorzalak 2007). The results are, unfortunately, inconclusive.²³ Arguably, however, this does not speak against the *political* effectiveness of regional policy, to the extent that one of its purposes was and is to keep democratic governments in the Mediterranean and the pro-European social coalitions supporting them in power and happy.

As far as monetary union is concerned, it was always clear, and in fact was already a subject in the earliest discussions on a joint currency, that the elimination of devaluation would have to be accompanied by substantial compensation payments in the form of regional and structural aid to less competitive member states. During the negotiations on the Regional Development Fund in 1975, one main argument of the commission in favor of regional policies was that a future monetary union would not work without regional assistance programs (Bache 2006). The problem, as seen at the time, is clearly exposed in the "Report on the Regional Problems of the Enlarged Community" of 1973, better known as the "Thomson Report," which is worth quoting at some length:

23 For recent negative assessments, see Becker et al. (2012), Hesse et al. (2012), ZEW (2012).

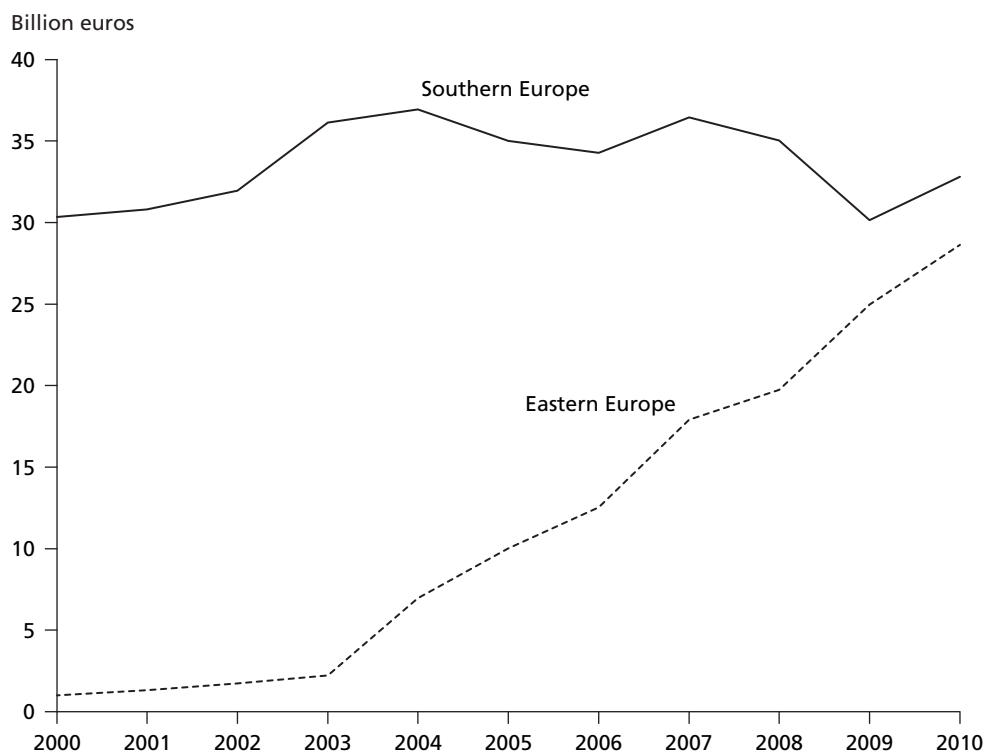
It is clear that rapid progress towards Economic and Monetary Union would be arrested if national economies had not undergone the transformations needed to avoid excessive divergencies between the economies of Member States. The reduction, by appropriate means, of regional imbalances is therefore a factor for accelerating those economic changes upon which the strength of Economic and Monetary Union will depend when it comes to abandoning recourse to parity changes as a way of restoring a fundamental balance. No Member State can be expected to support the economic and monetary disciplines of Economic and Monetary Union without Community solidarity involved in the effective use of such instruments; equally Member States must be prepared to accept the disciplines of Economic and Monetary Union as a condition of this Community support. (Commission of the European Communities 1973)

By the end of the twentieth century, however, European Union structural assistance to the future EMU member countries in the Mediterranean had to be shared with another set of newly democratized client states in the East, at a time when Western European countries were making first efforts to consolidate their public finances. While at the beginning of the 2000s, almost sixty percent of the structural funds were devoted to the Southern European countries, today their share has shrunk to only thirty percent, with that of Eastern European countries growing bigger and bigger (Figure 2).²⁴ Since 2009, payments to the East of Europe have exceeded support for the South. Luckily, as mentioned above, accession to the EMU had the welcome side effect for Mediterranean countries of significantly easing their access to credit. For the European Union, this meant that it could freeze its assistance to the Mediterranean, and in fact slowly reduce it, at a time when it had to increase its transfers to the new democracies in the East.

The combined effect of EMU and the diversion of EU regional assistance to the Union's Eastern members is particularly visible in the Greek case (Figure 3). Even before EMU the interest rate the Greek state had to pay on new long-term debt declined from seventeen to six percent within five years, to reach a low of four percent in the mid-2000s. Simultaneously European Union structural assistance fell from four to two percent of GDP. In compensation, the government deficit, brought down, in preparation of EMU accession, from nine to three percent in 1999, exploded to reach almost 16 percent ten years later. In spite of this, due to the low interest rates made possible by EMU, the share of debt service in public spending remained almost unchanged until after the crisis while total public debt rapidly accumulated.

24 In the 1990s, structural aid from the European Union amounted to between 2.5 and 3.5 percent of GDP in Portugal and between 2.0 and 3.2 percent in Greece. In Spain, transfers from the structural funds ranged from 0.7 to 1.4 percent of the country's GDP, whereas in Italy financial assistance was always below 0.5 percent (EU Budget Financial Reports, own calculation). Today, receipts from European Union structural funds range between 1.5 and 2.0 percent in Portugal and Greece, and contribute only 0.5 percent to the GDP in Spain. Numbers do not include payments under the Common Agricultural Policy (CAP), as only regional and structural policy is explicitly targeted at poor regions, with the objective of regional and national convergence. Support from the structural funds (the two most important ones being the Regional Development Fund and the European Social Fund) is provided mainly for investment in infrastructure, human resources, and the productive environment, meaning small and medium-sized enterprises.

Figure 2 European Union gross transfers to Southern and Eastern Europe (2000–2010)

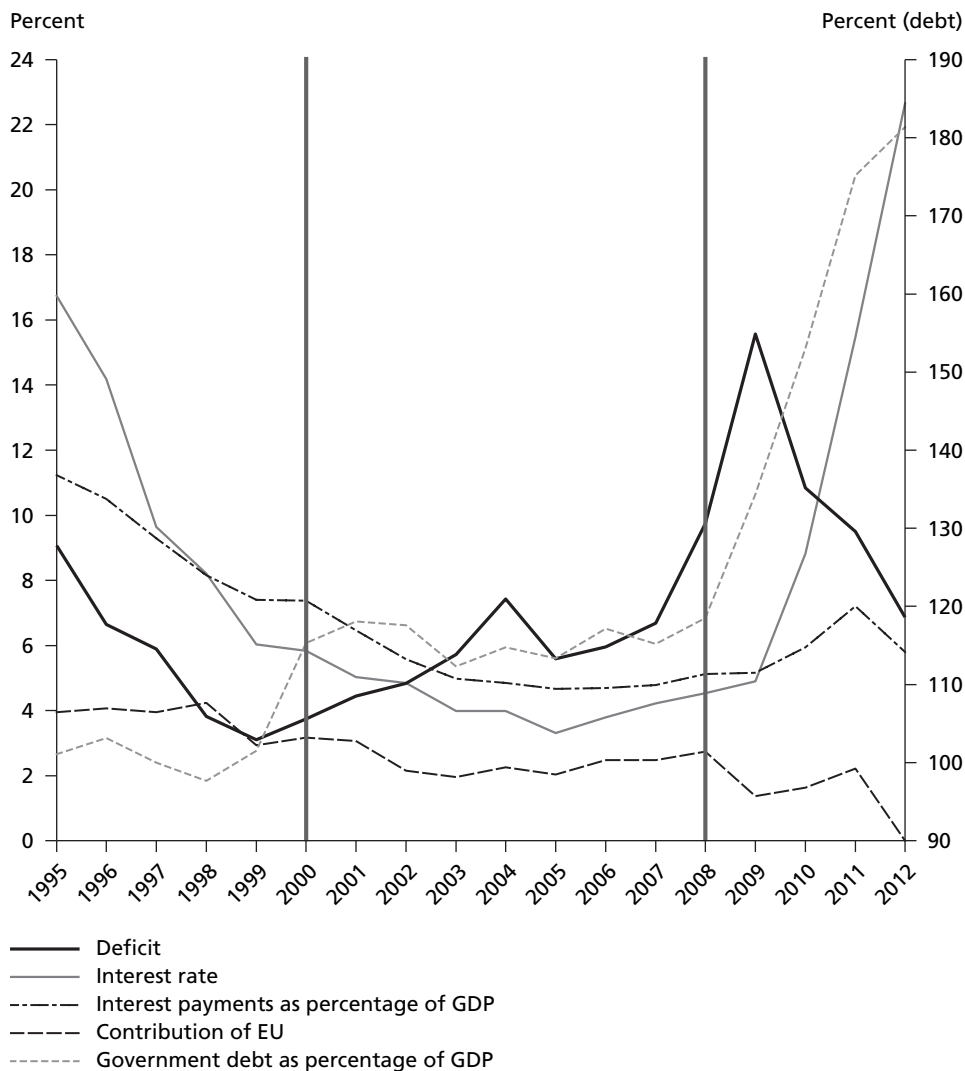


Source: EU Budget 2010 Financial Report.

Today the replacement of international fiscal transfers by international private credit – much in parallel by the way to the “privatization of Keynesianism” in the domestic political economies of the 1990s (Crouch 2009, 2011) – has collapsed, and with it the deceptive economic progress in Mediterranean countries. One way of reinstating credit would be by mutualization of the accumulated public debt of deficit countries, together with a guarantee by the rich countries of the North for repayment in the case of default. Even though Northern governments have powerful means at their disposal to hide commitments of this sort from their voters, however, it is far from certain that they would in the end go unnoticed. A return to direct fiscal assistance, as before 1999, is not unproblematic either, given that the number of countries that will be claiming support is now much higher, since it includes the Balkan states still waiting for admission to both the EU and the EMU. Moreover, member states at the center of the EMU have, more than ever, come under fiscal pressure themselves – by the global financial industry demanding consolidation of their public finances, as well as by the very tax competition they have in the past considered a central pillar of the European “internal market.”²⁵

25 It remains to be seen which new methods will be devised to keep deficit countries financially afloat in order to keep their political elites and, through them, their populations sufficiently “pro-European.” In this respect, an important role will be, and indeed is, played by the European Central Bank, which has for some time engaged in covert financing of government deficits by extending cheap credit to banks.

Figure 3 Greece: Monetary union and public finance



Sources: European Commission: EU-Budget Financial Reports; OECD National Accounts Statistics; OECD Economic Outlook Database.

Still, assessing the likely issues of contention and lines of conflict within EMU as a multi-state polity, it seems reasonable to assume that the current rescue operations in response to the debt crisis will not be the end of international financial assistance. Ongoing debates on a “European Marshall Plan” or a “European growth package” make a continuation of financial support into the foreseeable future seem likely, in whatever form and under whatever name. This holds true even if it was in fact possible to improve the competitiveness of peripheral countries in the neoliberal way: by cutting them off from financial assistance and leaving them with harsh structural reforms as their only remaining option. The risk of governments being voted out of office and EMU breaking apart as a result of popular discontent in its periphery would probably seem politically unacceptable. As long as member state governments in the South, and later in the East

as well, need to be democratically elected, they will therefore be in a position to extract some sort of financial aid, to enable them to build up a competitive infrastructure; prolong and thereby ease the internal devaluation process; buy political support to prevent the rise to power of an “anti-European” opposition party; or all of the above.

In the following section, we will explore the international configuration and the political-economic requirements, possibilities, and limits of regional assistance policy inside the EMU, whether to improve the indigenous potential for growth, support structural reform by buffering its economic and social costs, or stabilize pro-European national politics. To do this, we will look first at the structure of the EMU as a whole and then compare it with two member countries, Italy and Germany, with high regional disparities, associated in Germany with the introduction of monetary union with the former GDR in the course of unification.

5 Givers and takers: Distributional conflict in Euroland

There can be little doubt as to how member countries will line up on the issue of financial aid. Of the 18 states that are now in the EMU, five are economically weak and will remain so for a long time, while six others are mini-states with populations of less than two million. *Only five countries have relatively strong economies and more than five million citizens*, with three of them – Germany, France, and the Netherlands – accounting for a population of 162 million out of a total of 175 in this group. In other words, the EMU’s economically and politically relevant center consists of only three countries, while its Southern periphery consists of six²⁶ (and its future Southeastern periphery of no less than ten: Bulgaria, Croatia, Hungary, Rumania, and later Albania, Bosnia and Herzegovina, Kosovo, Macedonia, Montenegro, and Serbia).

Treating Euroland as an integrated international polity, a central issue of its domestic politics will be the nature and extent of the regional policies to be put in place, presumably to promote convergence in economic competitiveness. In a stylized account, two goods will be traded between the EMU’s center and periphery: *financial support* given by the former to the latter, and *political control* conceded in return by the latter to the former. This is because financial support will not be given unconditionally, not even if it is portrayed as an expression of “European solidarity.” Typically, giver countries will conceive transfers as assistance to becoming self-sufficient, at least for public presentation. While they will be keen on not paying more than necessary, whatever that may be, they will also insist that the money is used for investment rather than consumption, to the greatest possible extent, with the declared purpose for receiving countries to become self-sufficient. The latter, for their part, will want to maximize what they receive and use

26 Portugal, Spain, Italy, Malta, Greece, Cyprus.

Table 2 Center vs. periphery: Preferences on financial support and political control

	<i>Financial support</i>	<i>Political control</i>
<i>Center</i>	Minimize amount Maximize investment	Maximize international control
<i>Periphery</i>	Maximize amount Allow for consumption	Defend national control

part or all of it for consumption, if only to keep political discontent manageable. At the same time, they will strive to minimize the extent to which they have to concede control over domestic policies to giver countries, while these will demand that control over the use of transferred funds be international rather than domestic (Table 2).

How the EMU member states will divide into a ruling center and a ruled periphery, and at what economic cost for the former and political price for the latter, will have important consequences for democracy on both sides. External political control will constrain national democracy in receiving countries,²⁷ while the need to hide the true amount of transfers from an electorate that is itself facing fiscal austerity may do the same in giving countries. The terms of the exchange will also affect the attractiveness of the EMU to potential members. If transfers are extensive and international control over their use limited, rich countries like Denmark or Sweden may continue to remain outside while the poor countries of the European Southeast may have a strong incentive to join. *Vice versa*, if financial benefits are low due to fiscal constraints or political discontent in the center, and international political interference is strong, rich countries may be prepared to join while poor countries may prefer to stay out and become “anti-European,” or join only in order to change the terms of the settlement in alliance with the other poor countries. As a result, conflict inside the EMU would further intensify.

To get a sense of the problem load for a future EMU regional policy, we can compare income gaps and relative populations for different divisions between the European center and its Mediterranean periphery (Table 3). Taking Germany, France, and the Netherlands to be the center, different peripheries would be associated with different degrees of regional disparity. For example, Italy had a population in 2012 that amounted to 37 percent of the population of the three center countries, while its per capita income was 21 percent below the weighted per capita income of the latter. All four Mediterranean countries taken together were more than twice as big as Italy in relation to the center, while their income gap amounted to 29 percent.

27 See the so-called Fiscal Compact, entered into by all but two EU member states in 2012, in the form of an international treaty outside the European Union legal framework. It obliges states whose budgets are not in balance or in surplus to report to the European Commission and the Council and implement “reforms” as demanded by these. Noncompliance can be financially sanctioned by a fine of up to 0.1 percent of a state’s GDP.

Table 3 EMU: Population size and income gap (2012)

	Population	Percent D, F, NL	Income	Income gap
Italy	60.8	37.1	25,700	20.5
Spain	46.8	28.6	22,300	31.0
Greece	11.1	6.8	17,200	46.8
Portugal	10.5	6.4	15,600	51.7
I, ESP, GR, P	129.2	78.9	22,917	29.1
ESP, GR, P	68.4	41.8	20,444	36.8
D, F, NL	163.8	100.0	32,328	

What does this imply for the regional policy effort required to alleviate EMU regional disparities or at least contain political discontent in poor countries? Note that neither financial transfers nor the ample infusions of cheap credit after 2000 were sufficient in 2008 to prevent the collapse of regional competitiveness under the impact of fixed exchange rates. If this means that financial assistance would have to be significantly stocked up to effectively promote convergence – also in view of the current credit crunch – prospects must appear bleak. Not only will countries at the center be unable or unwilling to pay for more than a symbolic increase in European Union regional funds for the Mediterranean, but an ever larger share of the available financial resources will have to be devoted to Eastern Europe. This goes a long way toward explaining why Western European countries and the European Union place their hope for economic growth and EMU cohesion so desperately on neoliberal reform, even in the absence of any positive example.²⁸

6 For comparison: Germany and Italy

To learn more about the prospects of an EMU regional policy, we may look at the experiences of two member countries with high regional disparities, Italy and Germany. Both regard regional policy as essential for national cohesion. In 1990, West Germany entered into a much debated monetary union with an entirely uncompetitive East Germany, while Italy tried hard throughout the twentieth century to close the economic gap between its rich North and poor South. Although in both countries, considerable resources were transferred in a long-drawn effort to equalize living standards, regional inequalities are far from resolved. As a crude indicator of the two countries' current regional problems one may take the sum of the relative size of the population in peripheral areas and the difference in per capita income (Table 4). It turns out that Italy,

28 The latter may, in turn, explain the current recourse to a policy of cheap money, as pursued by the European Central Bank. This is in spite of the fear among central bankers that out-of-thin-air money production may spare countries the "reform" efforts that the central banks have unrelentingly demanded since the crisis began. Central bankers know better than others that excessive money production may easily cause a replay of the financial crisis of 2008.

Table 4 Center-periphery problem load: Germany, Italy and EMU

Center	Periphery	Problem load
Northern Italy	Southern Italy	94
West Germany	East Germany	52
D, F, NL	Greece	54
D, F, NL	Spain	60
D, F, NL	ESP, GR, P	79
D, F, NL	I, ESP, GR, P	108

with a figure of 94 (53 plus 41), is far worse off than Germany, where the sum of the two percentages is 52 (25 plus 27). We have applied the same measure to different center-periphery constellations inside the EMU, finding the German problem load to be comparable to a situation where the periphery in relation to the three countries of the center is constituted by either Spain or Greece. An Italian-level problem load is reached when the periphery consists of Spain, Greece and Portugal, or of all four Mediterranean countries including Italy.

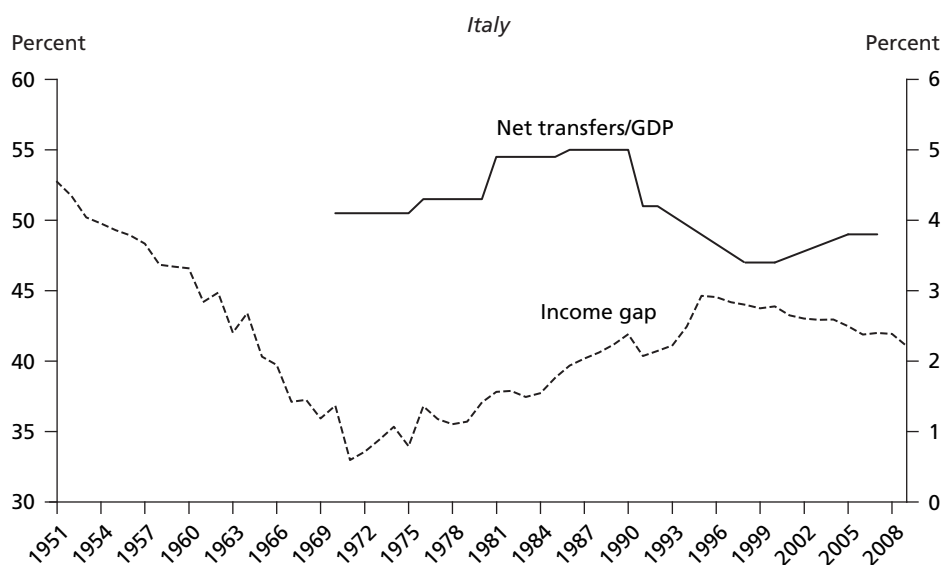
Going back to Germany and Italy, we can now tentatively explore the relationship between problem loads, fiscal transfers, and the success of regional policy over time. In Italy, transfers were as high as five percent of GDP in a period when, after the end of postwar growth, the national income gap began to increase for more than two decades. Recently the North-South income gap seems to have declined again and is now probably where it was in the early 1960s (Figure 4).²⁹ In Germany, where the peripheral population is proportionally far smaller than in Italy (25 percent as compared to 53 percent), transfers amounted to between three and four percent of GDP since the mid-1990s, which in effect was almost one-and-a-half times as much as in Italy.³⁰ *Still, the income gap has declined only very gradually since the mid-1990s.*

Why has regional policy in the two countries effected so little? Clearly, Italy suffers from a demography that is more unfavorable than Germany's, making transfers of a given percentage of GDP both more expensive for the paying and less substantial for the receiving regions. Another explanation points to the social structure of the *mezzogiorno* and the politics of the Italian South, causing economic aid to be appropriated by corrupt local power elites and criminal enterprises, or converted into an instrument of vote-buying by governing parties in the region or nationally. This has contributed to making help for the *mezzogiorno* highly unpopular with voters in the North, and every

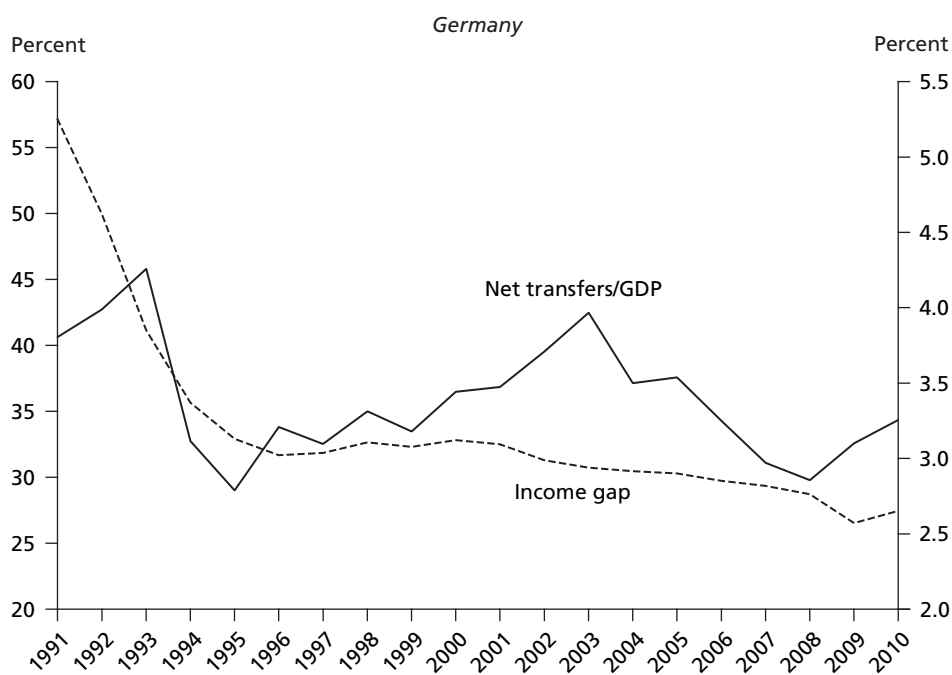
29 Data on Italy are from Daniele and Malanima (2007).

30 By far the biggest share of fiscal transfers in Germany is social security payments to East German citizens. Relative to the East German GDP, net social security payments amount to around 20 percent. Moreover, through the fiscal equalization system among the *Länder*, tax revenue is horizontally transferred from West to East. Furthermore, the federal government funds regional policy programs to combat the structural weakness of the East German economy (Kloß et al. 2012). The latter transfers come closest to those in the context of EU structural policy; they amount to five percent of the East German GDP. We have found no reliable information on the structure of fiscal transfers in Italy.

Figure 4 Regional policy in Italy and Germany: Income gaps and fiscal transfers



Net transfers to Mezzogiorno as percentage of GDP and per capita income gap (1951–2009).
Source: Vittorio Daniele, Paolo Malanima (2007); Istat.



Net transfers to East Germany as percentage of GDP and per capita income gap (1991–2010).
Source: Arbeitskreis VGR der Länder: Bruttoinlandsprodukt, Bruttowertschöpfung in den Ländern und Ost-West-Großraumregionen Deutschlands 1991 bis 2010; ifo Dresden.

new example of bribery and corruption reinforces resistance to further transfers. In fact, for almost two decades now, a separatist political party, the Lega Nord, commands a majority in several Italian regions north of Rome.

Comparing this to Germany, one may note that in Eastern Germany after unification, the entire ruling class of the former German Democratic Republic was replaced with political leaders, civil servants, and businesspeople imported from the West together with the full package of West German institutions. Corruption and vote-buying were almost nonexistent, certainly in comparison with the *mezzogiorno*, and issues of governance were resolved by putting in place an entirely new political establishment together with a fundamentally reconstructed administrative machinery. Still, differences in living standards between East and West Germany diminished only slowly if at all, *even though transfers were effectively higher than in Italy*. In fact, it is widely understood that present levels of regional support will have to be maintained when the current regional policy program for Eastern Germany runs out (Kloß et al. 2012). If transfers were significantly curtailed, regional disparities can be expected to increase again – implying that most of what financial aid has achieved up to now, after a quarter-century of *Aufbau Ost*, was to prevent the income gap from widening further.

7 Regional redistribution in an international polity

For the EMU this does not bode well. Even if some of the Mediterranean countries were soon able to stand on their own feet, the minimum effort required from the three countries forming the center of the EMU to avoid a further increase in international disparities is likely to be equivalent to the German effort for East Germany. Roughly speaking, this would require increasing the budget of the European Union at the minimum by three hundred percent, from about one to four percent of European Union GDP, at a time when member states are facing strong pressures for fiscal austerity.³¹ This does not take into account problems of governance, which will be considerable between sovereign countries. Unlike East Germany, and very much like Southern Italy, it will be out of the question to replace the old local elites with representatives of the center.³² Political deals will be inevitable which will more closely resemble Italian than German politics.³³ Perhaps most importantly, while in Germany and Italy there is still a (sometimes surprisingly strong) sense of national identity and obligation, this is clearly

31 Increasing a country's contribution to the European Union by three percent of its GDP would mean diverting roughly seven-and-a-half percent of its public expenditure to the Brussels regional assistance programs (assuming a government share in the national economy of around 40 percent). In Germany, where the federal government accounts for about one half of total public spending, the federal budget would have to increase by twice as much, about 15 percent.

32 Remember the Papademos and Monti experiments, which failed dismally. Greece is now governed by a coalition of the very same parties that contributed to the country's disaster after 2008.

33 Even in Germany, voters in the periphery matter, although they are less numerous than in Italy and there is much less clientelism there – apart from the fact that voters in the East will obviously pay attention to national parties' positions on "financial solidarity."

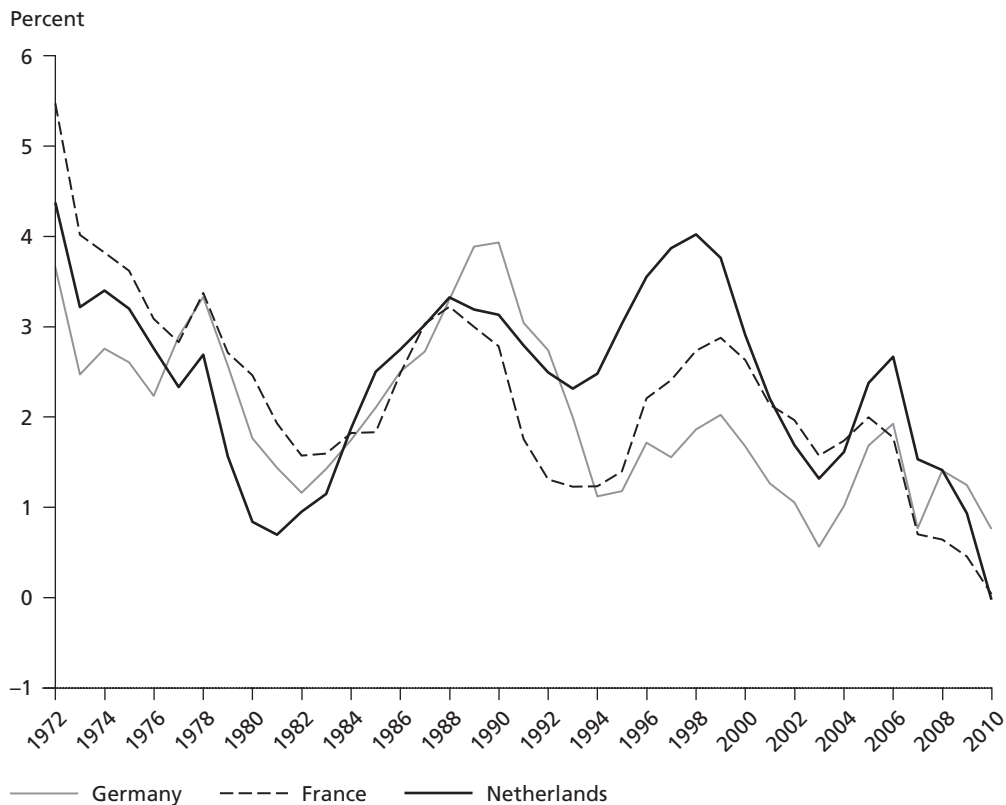
missing, or in any case is much weaker, between, say, the Netherlands and Portugal. It seems unlikely that such a sense can be developed on short notice for the purposes of stabilizing the EMU.

Would a supranational European federal state, governed by a democratically elected parliament, be better able than the European Union in its present shape to mobilize financial solidarity between the rich and poor regions of Euroland? Would political union on top of monetary union be the solution to the problem of regional disparities, as suggested among others by Jürgen Habermas (2013)? The experience of regionally diverse European nation-states speaks against this. Italy with its strong opposition in the North to further transfers to the *mezzogiorno* and the difficulties faced by the German federal government as it gets ready to prolong the *Aufbau Ost* are not the only examples – see Scottish, Catalan, and Flemish “nationalist” separatism. Indeed everywhere in Europe, under the impact of slow economic growth, richer regions increasingly resist subsidizing their poorer neighbors as public opinion grows ever more skeptical about the capacity of regional policy to make itself expendable. Even in a culturally and institutionally comparatively homogeneous country like Germany, the long-standing institution of *Länderfinanzausgleich* – the constitutional obligation of richer *Länder* to share some of their tax revenue with the poorer ones, to provide for *Einheitlichkeit der Lebensbedingungen* in all parts of the Federal Republic³⁴ – is currently being challenged by the richest Land, Bavaria, in the Constitutional Court. Can one expect transfers instituted by a European parliament between nation-states to be more popular with voters than transfers between regions instituted by national parliaments inside nation-states?

What exacerbates the problem in the European case is that, as we have seen, it is only three countries – Germany, France and the Netherlands – that are both rich and big enough to matter as providers of regional assistance to the Mediterranean and, later, Eastern peripheries. In a European parliament, they would have to face the possibility of the other countries using their numerical majority to raise the fiscal contributions they have to make to the union. This applies in particular to Germany – which will for an indefinite future have to attend to its own regional disparities – as France is not just economically weaker but has always reserved the choice of defining itself as a Mediterranean country if this fits its interests. This will make it impossible for Germany to agree to political union without extensive constitutional safeguards against being made the only major payer for the cohesion of the EMU and of Europe as a whole.³⁵

34 In English: uniformity of living conditions. The wording is from Article 106 (3) 2. of the German constitution.

35 Reasons to ask Germany to pay, good or not, are not hard to come by. They reach from the country's historical legacy to the fact that the German export industry is the EMU's most important beneficiary. The problem is that Germany, even in combination with France, is far too small to shoulder the burden. Moreover, arguments for Germany to pay for Euroland “cohesion,” plausible as they may seem from the outside, will be hard to sell to German voters, especially as fiscal austerity will begin to bite in Germany as well.

Figure 5 Germany, France, Netherlands: Economic growth (1972–2012)^a

a Five-year moving averages.

Source: OECD Economic Outlook Database: Statistics and Projections.

Can distributional conflict inside Euroland be mitigated in the way of the past, by high economic growth underwriting redistribution without detracting from the prosperity of the rich? While it is true that a rising tide lifts all boats, it seems improbable that such a tide will arrive in any foreseeable future. For two decades, growth rates in the center of the European state system have fallen. Restoring them to the level of the late 1980s – not to mention the 1960s – would require a secular turnaround that nobody can say how it could come about (for growth trends in Germany, France and the Netherlands, see Figure 5). If there is to be growth in the periphery, it will clearly not come from a “Marshall Plan” paid for by a prosperous hegemonic center.³⁶ The main support for the periphery

36 Under the Marshall Plan, formally European Recovery Program (ERP), the U.S. transferred around 13 billion US-dollars’ worth of economic aid to Western and Southern European countries in the four years between 1948 and 1951. This amounted to an average of roughly one percent of the yearly GDP of the United States during the period. On orders of magnitude, compare this to the estimates in Footnote 30, above. As to control, receiving countries under the Marshall plan were by and large free to decide how to use the aid provided to them, even though American authorities played a major role in its administration. A strict condition, however, was that the governments of countries receiving Marshall aid had to help the U.S. contain communism and use the funds accordingly. Most of the aid was in the form of American goods;

that the center will be able to afford will consist of recipes for neoliberal reform that cost nothing to those providing them. However, whether the bitter medicine of neoliberalism will work is uncertain, not to mention whether the patients will be ready to take it.

8 The emerging domestic politics of Euroland

What are the prospects for the European state system if, as is likely, its elites insist on defending the euro? Everything points to a long-drawn crisis, lasting for many years after the present emergency has been declared to be over. Political life in integrated Europe will be highly uncomfortable, both within and between member countries. International distributional conflict will be rampant, between a periphery of countries deprived of the capacity to devalue their currencies to improve their “competitiveness,” and a center suffering from overextension, especially once the Balkan states have been admitted to the European Union and the EMU. Financial support as can be made available to the periphery will not be nearly enough to help them keep up with the center, to say nothing of equalizing living conditions across Europe. In the most likely case, it will serve to keep in power “pro-European” coalitions that may, however, need to secure electoral support by means of anti-Northern rhetoric, making them seem, in Northern eyes, to be biting the hands that feed them.

The domestic politics of Euroland will likely be dominated by an ongoing and potentially ugly tug-of-war over entitlements and obligations to international financial solidarity. While the center will urge the periphery to implement “structural reforms,” so as to become self-sufficient, it will still have to provide financial subsidies of various kinds in order to insure against political instability. Discontent with the European construction, unless calmed by renewed economic growth, will require effective suspension of democracy in both the center and the periphery – in the latter by institutionalized curtailment of national sovereignty, like that under the Fiscal Compact, combined with political and economic intimidation of electorates; and in the former by a cartel of silence organized by the political class to hide the true costs of keeping Euroland together (costs which in effect amount to subsidies for national export industries). Government, renamed “governance,” will migrate to institutions insulated from political and electoral accountability, like the European Commission and, in particular, the European Central Bank (Mair 2013). Their advantage is that they are better placed than national governments to *rule by stealth* – for example, by surreptitiously extending credit to states that have lost access to capital markets, keeping the economy going by injecting into it potentially unlimited amounts of synthetic money, underwriting or mutualizing the

the remainder came as loans. Receiving countries had to submit four-year plans specifying what aid they needed and how they would use it. Revenue from the sale of American goods was used by receiving countries in accordance with bilateral agreements (Judt 2005).

bad debt of underregulated national banking systems, and insuring financial investors against governments defaulting on their loans. One may doubt whether this will make for economic stability or, for that matter, the “ever closer union among the peoples of Europe” proclaimed by the Treaties.

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