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Finance-dominated capitalism, re-distribution and the financial and economic crises – a European perspective

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Working Paper, No. 14/2012

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Finance-dominated capitalism, re-distribution and the financial and economic crises - a European perspective*

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Abstract

In this paper the euro crisis is viewed as the most recent episode of the crisis of finance-dominated capitalism. Therefore, two major features of finance-dominated capitalism, the increasing inequality of income distribution and the rising imbalances of current accounts, are analysed for a set of major Euro area countries. Against this background the euro crisis is examined, and it is shown that the economic policy reactions of European governments and institutions, narrowly interpreting the crisis as a sovereign debt crisis caused by irresponsible behaviour of some member country governments, are misguided and will lead to deflationary stagnation and an increasing risk of disintegration of the Euro area. For this reason, an alternative macroeconomic policy approach tackling the basic contradictions of finance-dominated capitalism and the deficiencies of European economic policy institutions and economic policy strategies is outlined. It is argued that, on the one hand, an institution which convincingly guarantees the public debt of Euro area member countries and, on the other hand, an expansionary macroeconomic policy approach, in particular in the current account surplus countries of the Euro area, need to be introduced.

Keywords: Finance-dominated capitalism, distribution, financial and economic crisis, European economic policies

JEL classification: E25, E58, E61, E63, E64, E65

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* The main arguments put forward in this paper are based on my forthcoming book “The Macroeconomics of Finance-dominated Capitalism – and its Crisis” (Hein 2012) and on the research results which have gone into that book. For a more detailed elaboration on the macroeconomic theory of finance-dominated capitalism, in particular, see the respective chapters in that book. For most valuable research assistance regarding the subject of the present paper I would like to thank Nina Dodig and Matthias Mundt. I am also most grateful for helpful comments to Trevor Evans and Milka Kazandziska.

1. Introduction

The financial and economic crises in Europe have occurred against the background of the long-run developments imposed by finance-dominated capitalism and neo-liberalism since the early 1980s. These developments have been characterised by de-regulation of national and international goods, labour and financial markets, in particular, re-distribution of income at the expense of (low) wages, and rising imbalances of current accounts at the global level and at regional levels, in particular within the European Monetary Union since its inception in 1999. The financial and economic crises, which started with the collapse of the subprime mortgage market in the US in 2007, which gained momentum by the breakdown of Lehmann Brothers in 2008 and which led to a serious recession at the world scale with a decline in real GDP in many advanced capitalist economies not seen for generations in 2008/09, has turned into a currency crisis, the euro crisis since 2010. This crisis is threatening the further existence of the euro because of the specific institutional conditions for economic policy making in the Euro area. First, the explicit guarantee of public debt of member countries by the monetary authority of the currency union, the European Central Bank (ECB), is excluded from the treaties and regulations of the EU. Therefore, member country governments issue debt in a common currency, the euro, but not in their own currency, in the sense that their own central bank would guarantee the monetisation of this debt if required. Second, fiscal transfers among member countries have also been ruled out by the treaties, so that government debt of a single member country is not guaranteed by the community of member country governments as a whole. Third, there have been no efficient mechanisms to prevent the building up of internal and external macroeconomic imbalances across the Euro area countries, which in the crisis contributed to the rapid increases in government deficits and debt and to the massive doubts regarding the creditworthiness of some member countries, given the first two deficiencies.

In this paper we interpret the euro crisis as the most recent episode of the crisis of finance-dominated capitalism. Therefore, we will first analyse the dimensions of increasing

inequality for the major European countries during the period of finance-dominated capitalism. Our analysis will focus on the Euro area member countries Austria, Belgium, France, Germany, Greece, Ireland, Italy, the Netherlands, Portugal, and Spain. Having analysed the trends towards increasing inequality, we will then deal with the current account imbalances within the Euro area which have developed in the business cycle prior to the crisis and distinguish two extreme types of development, the debt-led consumption boom type and the export-led mercantilist type. Against this background we will then examine the euro crisis and the misguided economic policy reactions by European governments and European institutions. Since the dysfunctional economic policy institutions and misguided economic policy making are threatening the further existence of the euro as a currency, we will finally draft an alternative macroeconomic policy approach overcoming these deficiencies. The final section will sum up and conclude.

2. Rising inequality in the period of finance-dominated capitalism and neo-liberalism – the European case

The neo-liberal period since the early 1980s and the emergence of finance-dominated capitalism have been associated with considerable redistribution of income in major European countries.¹ With respect to functional income distribution we observe a massive redistribution at the expense of labour and in favour of broad capital income. The labour income share, as a measure taken from the national accounts and corrected for the changes in the composition of employment regarding employees and self-employed, has shown a falling trend in most of the Euro area member countries considered here since the early 1980s, with cyclical fluctuations due to the well known counter-cyclical properties of the labour income share. In order to eliminate cyclical fluctuations of the labour income share, we have calculated cyclical averages for the three business cycles from the early 1980s until 2008 (Table 1). On average

¹ For similar analysis on a broader set of countries see Hein (2011a, 2011b, 2012) and Hein/Mundt (2012).

over the cycle the labour income share has fallen in all countries in our data set except Portugal, from the first cycle (early 1980s to the early 1990s) to the third cycle (early 2000s until 2008). The fall has been most substantial in Austria and Ireland with more than 10 percentage points of GDP at factor costs, and in Greece, Italy, France and Spain with more than 5 percentage points of GDP. In Belgium, Germany, and the Netherlands the labour income share has fallen by less than 5 percentage points of GDP at factor costs.

Table 1: Labour income share as percentage of GDP at current factor costs, average values over the business cycle, early 1980s – 2008				
	1. Early 1980s – early 1990s	2. Early 1990s – early 2000s	3. Early 2000s – 2008	Change (3. – 1.), percentage points
Austria	75.66	70.74	65.20	-10.46
Belgium	70.63	70.74	69.16	-1.47
France	71.44	66.88	65.91	-5.53
Germany	67.11	66.04	63.34	-3.77
Greece ^{a)}	67.26	62.00	60.60	-6.66
Ireland	70.34	60.90	55.72	-14.61
Italy	68.31	63.25	62.37	-5.95
Netherlands	68.74	67.21	65.57	-3.17
Portugal	65.73	70.60	71.10	5.37
Spain	68.32	66.13	62.41	-5.91

Notes: The labour income share is given by the compensation per employee divided by GDP at factor costs per person employed. The beginning of a business cycle is given by a local minimum of annual real GDP growth in the respective country.
^{a)} adjusted to fit in 3 cycle pattern
Source: European Commission (2010), author's calculations

Three main channels through which financialisation and neo-liberalism have negatively affected the share of direct labour in national income can be identified (Hein 2011b, 2012, chapter 2). First, the sectoral composition of the economy has changed in favour of the high profit share financial corporations and at the expense of the non-financial corporate sector and the government sector with lower or zero profit shares. Second, overhead costs, in particular top management salaries and interest payments, and profit claims imposed on the corporate

sector by shareholders have increased. This has caused the mark-up on direct unit labour costs in pricing of firms in incompletely competitive markets to rise and the share of labour income to fall, because the mark-up has to cover overhead costs and profit claims. Third, the bargaining power of workers and trade unions has been weakened, triggered by shareholder value orientation and short-termism of management, increasing relevance of the financial sector with weak trade unions relative to the non-financial and the government sector with stronger trade unions, the threat-effect of liberalisation and globalisation of finance and trade, deregulation of the labour market, and downsizing or abandoning government demand management policies.

With respect to personal income distribution increasing inequality can be observed in many of the European countries in our data set from the mid 1980s until the mid 2000s. Taking the Gini coefficient as an indicator, this is true for the distribution of market income, with France and the Netherlands being exceptions (Table 2). In Germany, Italy and Portugal the Gini coefficient has risen considerably. If we include redistribution via taxes and social policies by the state, Belgium, France, Greece, Ireland and Spain have not seen an increase in their Gini coefficients, with considerable declines in Spain, France and Greece. The other countries, however, have also experienced an increasing inequality in disposable income in the period of neo-liberalism and finance-dominated capitalism. This increase was particularly pronounced in Austria, Germany, Italy, and Portugal. Although tax and social policies have reduced income inequality in all the countries under investigation, in many countries this has not prevented an increase in inequality over time. This is also the conclusion the OECD (2008) draws for a broader set of countries and from the application of other measures of income inequality.

Table 2. Gini coefficient before and after taxes							
Gini coefficient before taxes							
Country	mid-70s	mid-80s	around 1990	mid-90s	around 2000	mid-2000s	Change from mid 80s to mid 2000s
Austria	...	...	...	...	...	0.43	...
Belgium	...	0.45	...	0.47	0.46	0.49	0.04
France	...	0.52	0.51	0.48	0.50	0.48	-0.04
Germany	...	0.44	0.42	0.46	0.48	0.51	0.07
Greece	...	...	...	...	...	...	...
Ireland	...	...	...	...	0.43	0.42	...
Italy	...	0.42	0.44	0.51	0.52	0.56	0.14
Netherlands	0.42	0.47	0.47	0.48	0.42	0.42	-0.05
Portugal	0.46	...	0.44	0.49	0.48	0.54	0.08 ^{a)}
Spain	...	...	...	...	...	...	...
Gini coefficient after taxes							
Country	mid-70s	mid-80s	around 1990	mid-90s	around 2000	mid-2000s	Change from mid 80s to mid 2000s
Austria	...	0.24	...	0.24	0.25	0.27	0.03
Belgium	...	0.27	...	0.29	0.29	0.27	0.00
France	...	0.31	0.30	0.28	0.28	0.28	-0.03
Germany	...	0.26	0.26	0.27	0.27	0.30	0.04
Greece	0.41	0.34	...	0.34	0.34	0.32	-0.02
Ireland	...	0.33	...	0.32	0.30	0.33	0.00
Italy	...	0.31	0.30	0.35	0.34	0.35	0.04
Netherlands	0.25	0.26	0.28	0.28	0.28	0.27	0.01
Portugal	0.35	...	0.33	0.36	0.36	0.38	0.03 ^{a)}
Spain	...	0.37	0.34	0.34	0.34	0.32	-0.05
Notes: Data refer to cash income of households and are broken down to individuals. The income attributed to each individual is adjusted for household size, but does not distinguish between adults and children.							
a) change from mid 70s to mid 2000s							
Source: OECD (2010), author's calculations							

3. Imbalances in the Euro area

Against the background of rising inequality in personal income distribution in many countries and falling labour income shares associated with financialisation and neo-liberalism since the

early 1980s, different ‘types of capitalism under financialisation’ have developed,² which are complementary and which have fed rising current account imbalances in the world economy, but also at regional levels, and in particular so in the Euro area. The current account of the Euro area has been roughly balanced on average over the cycle from the early 2000s – 2008 (European Commission 2010), so that in the aggregate current account surplus member countries have their respective deficit counterparts within the Euro area. Of course, individual Euro member states also have surpluses or deficits vis-à-vis the non-Euro area rest of the world. But these roughly cancel out for the Euro area in the aggregate.

Distinguishing the ‘types of capitalism under financialisation’, first, we have the ‘debt-led consumption boom’ type; second, there has developed a counterpart, the ‘export-led mercantilist’ type; and third, in between these two extremes we have the ‘domestic demand-led’ type. In the ‘debt-led consumption boom’ type it is debt-financed consumption demand which allows for flourishing aggregate demand and the realisation of rising profits against the background of redistribution at the expense of (low) labour incomes and stagnating real investment, which is another feature of finance-dominated capitalism.³ In the ‘export-led mercantilist’ type it is export surpluses which stabilise aggregate demand and take care of the realisation of profits.⁴ The third type, the ‘domestic demand-led’ type, can neither rely on export surpluses, which distinguishes it from the second type, nor on flourishing debt-financed consumption, which distinguishes it from the first type.

Since the intra Euro area current account imbalances have exploded in particular since the early 2000s (Figure 1), in the course of recovery from the burst of the new economy boom of the late 1990s, we take cyclical average data for the business cycle of the early 2000s until

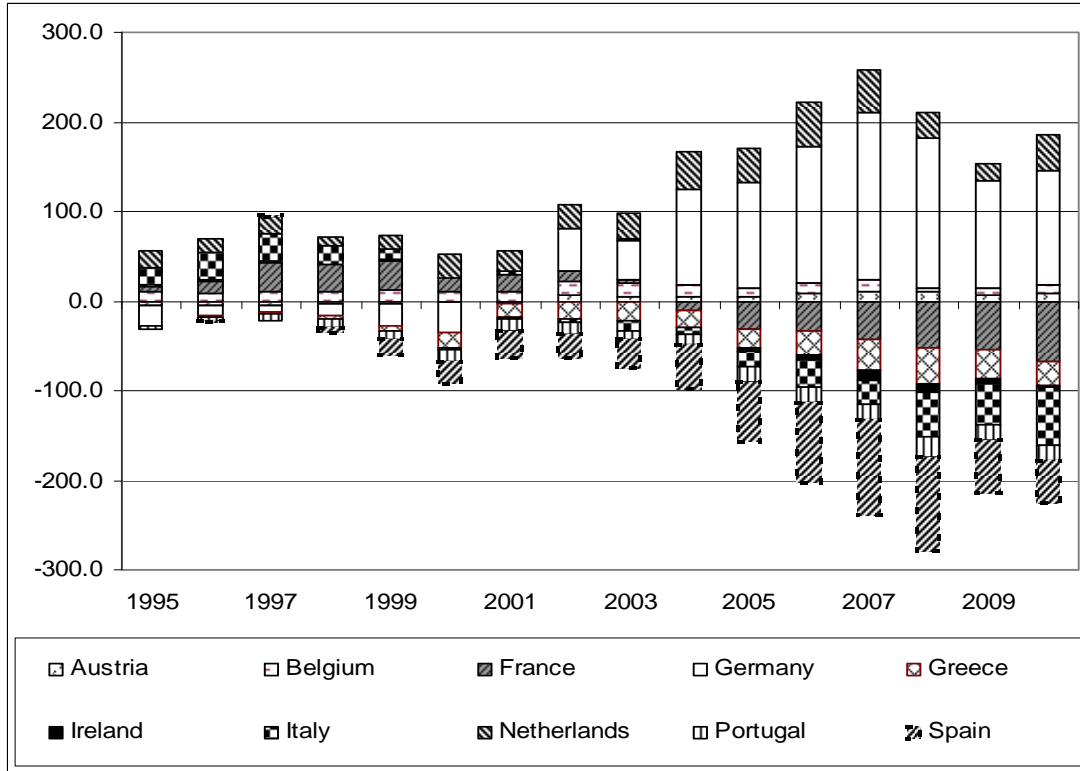
² For similar analyses for the global scale see van Treeck/Hein/Dünhaupt (2007), Bibow (2008), Fitoussi/Stiglitz (2009), UNCTAD (2009), van Treeck (2009), Wade (2009), Hein/Truger (2011), Stockhammer (2010a, 2010b), and Hein/Mundt (2012).

³ On the depressing effects of finance-dominated capitalism, or ‘financialisation’, on investment in real capital stock see Hein (2012, chapter 3) and the references provided there.

⁴ Note that from national accounting we obtain: Gross profits net of taxes = Gross investment + Export surplus + Government budget deficit – Worker’s saving + Capitalists’ consumption (Kalecki 1971, p. 82).

the 2008/9 crisis to distinguish these models and allocate the countries examined in this paper to them.

Figure 1:
Current account in billions ECU/euro, selected Euro area countries, 1995 – 2010



Source: European Commission (2011a), author's representation.

Table 3a: Key macroeconomic variables for ‘debt-led consumption boom’ economies, average values for the business cycle from the early 2000s – 2008			
	Greece	Ireland	Spain
Financial balances of external sector as a share of nominal GDP, per cent	12.49	2.88	7.10
Financial balances of public sector as share of nominal GDP, per cent	-5.74	-0.13	-0.03
Financial balance of private sector as a share of nominal GDP, per cent	-6.75	-2.74	-7.07
Financial balance of private household sector as a share of nominal GDP, per cent	-11.44	-6.29	-1.54
Financial balance of the corporate sector as a share of nominal GDP, per cent	4.69	3.55	-5.53
Real GDP growth, per cent	3.89	3.92	3.02
Growth contribution of domestic demand including stocks, percentage points	4.10	3.26	3.82
Growth contribution of private consumption, percentage points	2.79	1.87	1.74
Growth contribution of public consumption, percentage points	0.49	0.59	0.93
Growth contribution of gross fixed capital formation, percentage points	0.79	0.79	1.14
Growth contribution of the balance of goods and services, percentage points	-0.20	0.66	-0.81
Net exports of goods and services as a share of nominal GDP, per cent	-10.97	12.23	-4.69
Change in labour income, share as percentage of GDP at current factor costs, from previous cycle, percentage points	-1.40	-5.17	-3.71
Growth rate of nominal unit labour costs, per cent	3.47	3.95	3.31
Inflation (HCPI growth rate), per cent	3.41	3.50	3.33
Growth rate of nominal effective exchange rates (relative to 23 countries), per cent	1.60	2.81	1.53
Growth rate of real effective exchange rates (relative to 23 countries), per cent	2.91	4.97	2.82
Notes: The beginning of a business cycle is given by a local minimum of annual real GDP growth in the respective country			
Source: European Commission (2010), author’s calculations			

**Table 3b: Key macroeconomic variables for ‘export-led mercantilist’ economies,
average values for the business cycle from the early 2000s – 2008**

	Austria	Belgium	Germany	Nether-lands
Financial balances of external sector as a share of nominal GDP, per cent	-2.26	-3.90	-5.55	-7.15
Financial balances of public sector as share of nominal GDP, per cent	-1.45	-0.56	-2.09	-0.85
Financial balance of private sector as a share of nominal GDP, per cent	3.70	4.46	7.64	8.00
Financial balance of private household sector as a share of nominal GDP, per cent	4.68	4.25	5.90	0.16
Financial balance of the corporate sector as a share of nominal GDP, per cent	-0.98	0.21	1.74	7.84
Real GDP growth, per cent	2.13	1.84	1.44	1.96
Growth contribution of domestic demand including stocks, percentage points	1.26	1.70	0.85	1.43
Growth contribution of private consumption, percentage points	0.76	0.63	0.18	0.37
Growth contribution of public consumption, percentage points	0.28	0.45	0.16	0.75
Growth contribution of gross fixed capital formation, percentage points	0.19	0.62	0.49	0.35
Growth contribution of the balance of goods and services, percentage points	0.77	0.14	0.58	0.52
Net exports of goods and services as a share of nominal GDP, per cent	4.35	4.02	5.56	7.63
Change in labour income, share as percentage of GDP at current factor costs, from previous cycle, percentage points	-5.54	-1.58	-2.71	-1.64
Growth rate of nominal unit labour costs, per cent	1.05	2.02	0.17	1.88
Inflation (HCPI growth rate), per cent ^{a)}	2.12	2.34	1.78	1.94
Growth rate of nominal effective exchange rates (relative to 23 countries), per cent	1.21	1.48	2.09	1.37
Growth rate of real effective exchange rates (relative to 23 countries), per cent	0.55	1.58	0.14	1.56
Notes: The beginning of a business cycle is given by a local minimum of annual real GDP growth in the respective country				
Source: European Commission (2010), author’s calculations				

**Table 3c: Key macroeconomic variables for ‘domestic demand-led’ economies,
average values for the business cycle from the early 2000s – 2008**

	France	Italy	Portugal
Financial balances of external sector as a share of nominal GDP, per cent	1.25	1.59	9.40
Financial balances of public sector as share of nominal GDP, per cent	-3.18	-3.16	-3.65
Financial balance of private sector as a share of nominal GDP, per cent	1.93	1.57	-5.75
Financial balance of private household sector as a share of nominal GDP, per cent	3.80	3.91	1.54
Financial balance of the corporate sector as a share of nominal GDP, per cent	-1.87	-2.34	-7.29
Real GDP growth, per cent	1.64	0.73	0.82
Growth contribution of domestic demand including stocks, percentage points	2.13	0.81	1.04
Growth contribution of private consumption, percentage points	1.24	0.44	1.05
Growth contribution of public consumption, percentage points	0.38	0.27	0.20
Growth contribution of gross fixed capital formation, percentage points	0.56	0.08	-0.25
Growth contribution of the balance of goods and services, percentage points	-0.50	-0.08	-0.19
Net exports of goods and services as a share of nominal GDP, per cent	-0.52	-0.07	-8.08
Change in labour income, share as percentage of GDP at current factor costs, from previous cycle, percentage points	-0.97	-0.88	0.49
Growth rate of nominal unit labour costs, per cent	2.01	2.95	2.41
Inflation (HCPI growth rate), per cent	1.98	2.36	2.68
Growth rate of nominal effective exchange rates (relative to 23 countries), per cent	1.84	1.92	1.26
Growth rate of real effective exchange rates (relative to 23 countries), per cent	1.98	3.12	1.59
Notes: The beginning of a business cycle is given by a local minimum of annual real GDP growth in the respective country			
Source: European Commission (2010), author’s calculations			

Figure 2a

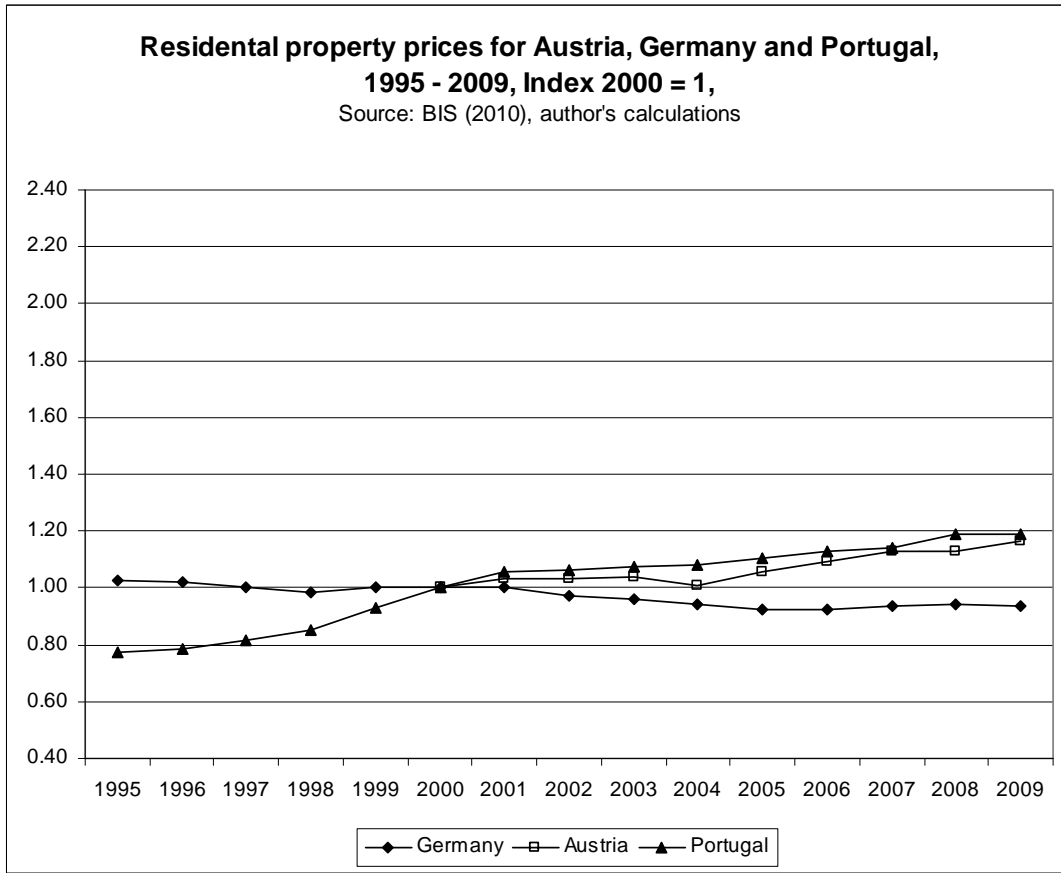
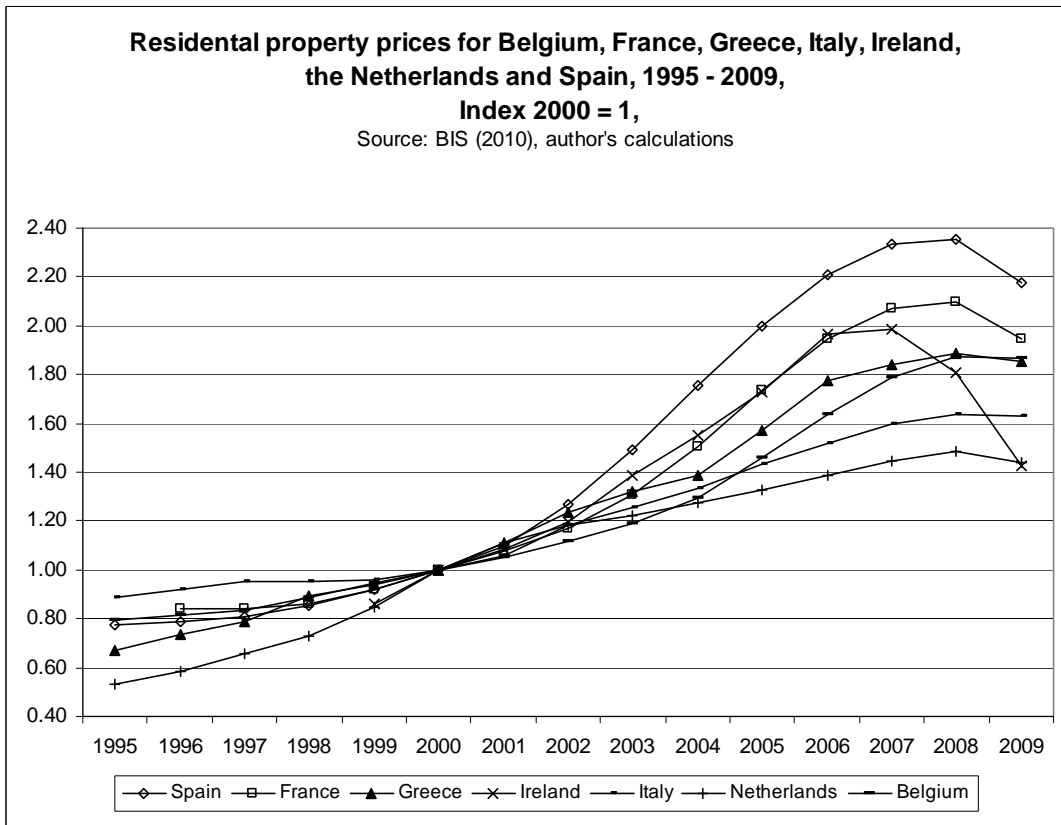


Figure 2b



	Gross debt			Net wealth		
	1995	2000	2005	1995	2000	2005
Austria	34	...	88 ^{a)}	...	...	...
Belgium	57	...	75 ^{a)}	...	...	...
France	66	78	89	461	547	752
Germany	97	111	107	541	575	578 ^{a)}
Greece	...	...	...	...	...	...
Ireland	48	82	141	...	618	775
Italy	32	46	59	702	820	936 ^{a)}
Netherlands	113	175	246	369	528	515
Portugal	54	...	125 ^{a)}	...	...	...
Spain	59	83	107 ^{b)}	540	646	935 ^{b)}

Notes: ^{a)} 2006, ^{b)} 2004. Debt refers to total liabilities outstanding at the end of the period. Net wealth is defined as non-financial and financial assets minus liabilities. Data is from national statistics.
Source: Girourard/Kennedy/Andre (2007, p. 9), Goodbody Stockbrokers (2009, p. 30)

In the cycle of the early 2000s, the ‘debt-led consumption boom’ type can be found in Greece, Ireland, and Spain (Table 3a). All these economies have seen considerable increases in residential property prices and/or in wealth-income ratios in the period considered here (Table 4, Figure 2b). This increase in notional wealth, together with liberalised financial markets and weakened conditions of creditworthiness, was conducive to soaring consumption demand and hence considerable growth contributions of private consumption and domestic demand. Relatively high real GDP growth as compared to the ‘export-led mercantilist’ countries, but negative financial balances (as a share of nominal GDP) of the private household sector and thus increasing private household debt were the consequences. This also translated into negative balances of the private sector as a whole – with the corporate sector being in surplus in all countries of this group except Spain. The public sector contributed to the negative domestic financial balance in all the countries, but to a different degree – considerably in Greece, but only marginally in Ireland and Spain – we will come back to this in more detail in the next section. Since aggregate domestic expenditures exceeded national income, these countries had to run current account deficits, i.e. the financial balances of the external sector were positive for each of the countries pursuing the ‘debt-led consumption boom’ type of

development. In particular Greece and Spain had to rely on the inflow of foreign financial resources. Strong domestic demand growth in the ‘debt-led consumption boom countries’ was accompanied by negative growth contributions of the balance of goods and services in these countries but Ireland, where the growth contribution of external demand was positive, too.⁵ For these countries, above Euro area average unit labour cost growth and inflation accompanied by nominal appreciation of the euro, and thus a loss of competitiveness of domestic producers (positive rates of change in the effective exchange rate) have contributed to the deficits in the balance of goods and services and in the current account. The ‘debt-led consumption boom’ economies were thus the Euro area demand engines of the cycle from the early 2000s – 2008.

The counterparts to the ‘debt-led consumption boom’ economies at the Euro area level were the ‘export-led mercantilist’ economies. This group consists of Austria, Belgium, Germany, and the Netherlands (Table 3b). These economies were characterised by surpluses in their balances of goods and services and in their current accounts, i.e. the financial balances of the respective external sectors were in deficit. Although some of these countries (Belgium, the Netherlands) had seen considerable increases in wealth-income ratios and/or in residential property prices, whereas others had not (Austria, Germany) (Table 4, Figures 2a-b), financial balances of private households (as a share of nominal GDP) remained in surplus. The financial balances of the private sectors were strongly positive in each of these countries. Growth contributions of private consumption and domestic demand were moderate, as for Austria, Belgium, and the Netherlands, or very weak, as in the case of Germany, and these countries relied considerably on the positive growth contributions of the balance of goods and

⁵ In the case of Ireland, the current account deficit (and the positive financial balance of the external sector) was not due to a deficit in external trade but rather a deficit in the flows of primary incomes. Although the balance of goods and services in Ireland was positive, we have not included it into the ‘export-led mercantilist’ group of countries discussed below, because Ireland, as the other ‘debt-led consumption boom’ countries, showed a negative balance of the private sector and of the domestic sectors as a whole. Surpluses in the balance of goods and services were thus required in order to meet the payment commitments associated with the negative balance of primary incomes and to avoid an even larger deficit in the current account.

services. Only in Belgium was the growth contribution of external demand rather small. The basis for external surpluses were thus weak domestic demand, on the one hand, but also low unit labour cost growth and low inflation, on the other hand. For ‘export-led mercantilist’ countries the real effective exchange rate relative to 23 industrial economies increased to a lesser extent than in the ‘debt-led consumption boom’ countries, implying an increase in price competitiveness of the former relative to the latter. The ‘export-led mercantilist’ countries have thus benefitted from regional demand being driven by the ‘debt-led consumption boom’ countries. However, following this model came at a price: GDP growth in the export-led countries remained well below GDP growth in the debt-led economies, and in particular the more closed large economy of Germany performed even worse than the more open and smaller economies of Austria, Belgium and the Netherlands.

In the cycle of the early 2000s to 2008, France, Italy and Portugal can neither be considered to have been ‘debt-led consumption boom’ economies nor ‘export-led mercantilist’ economies. Growth was rather domestic demand led. Although France and Italy saw significant increases in net wealth-income ratios and in residential property prices (Table 4, Figure 2a), whereas Portugal did not (Figure 2b), financial balances of private households remained positive in all of the three countries. The corporate sector had negative balances in these countries and together with negative public sector balances this meant current account deficits, which were considerable particularly in Portugal.

Although not experiencing a debt-led consumption boom, growth was driven by domestic demand in the face of rising (Portugal) or only weakly declining (France, Italy) labour income shares and considerable public deficits in each of the countries. The balances of goods and services were negative and so were the growth contributions of external demand. The loss of price competitiveness with respect to the ‘export-led mercantilist’ Euro area countries, i.e. higher unit labour cost growth and higher inflation than in these countries, may have contributed to the external deficit. GDP growth remained particularly weak in Portugal

and Italy, whereas France had higher growth than the stagnating mercantilist economy of Germany, but lower growth than the rest of the countries in our data set.

4. Euro crises and misguided policy reactions

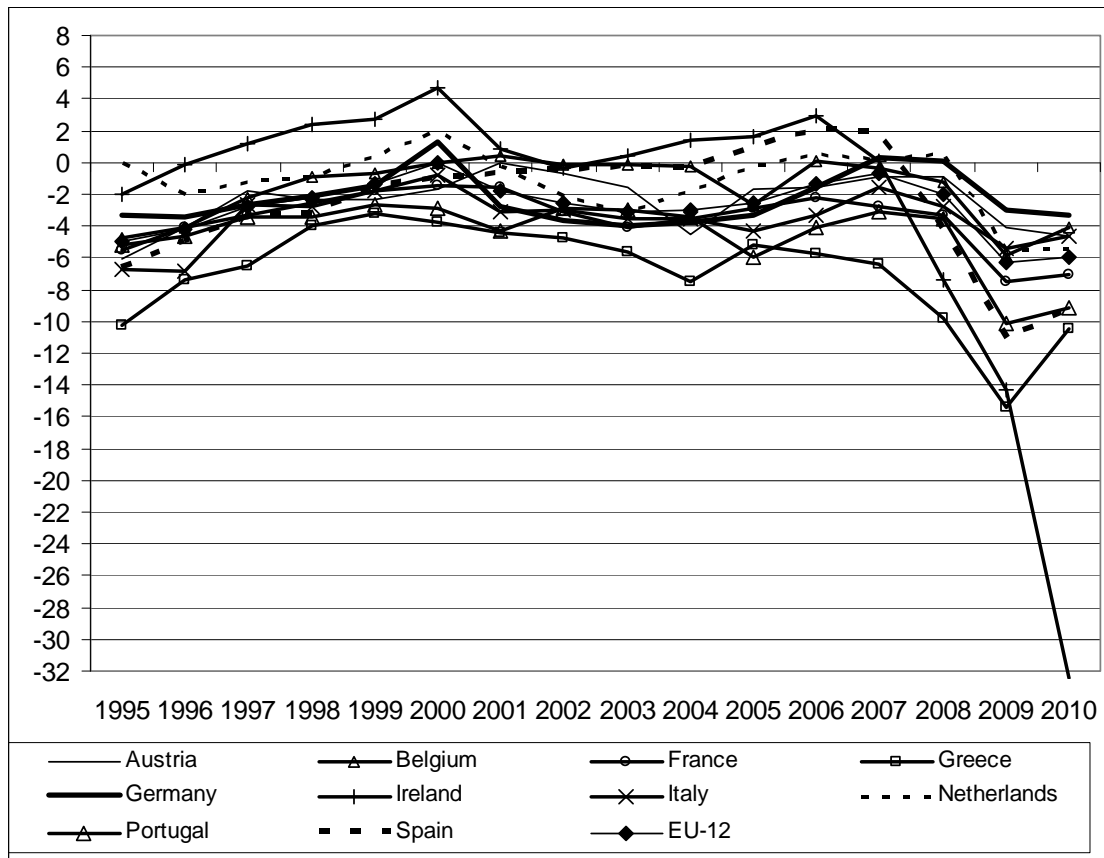
When the crisis hit the European economies in 2008/09, the three ‘types of capitalism under financialisation’ outlined in the previous sections were affected and real GDP declined in all of the countries in our data set, in some of them considerably, without any clear pattern regarding the intensity of the crisis (European Commission 2011a). In the course of the crisis government deficits increased in order to stabilise the private real and financial sectors and government debt to GDP ratios jumped up (Figures 3 and 4). This seems to be the reason why the current euro crisis is considered as a crisis of government deficits and debt by many observers – above all by the dominating economic policy makers in Germany, the European Commission and the European Council.⁶ A first look at the developments might even seem to confirm this view. Since the start of the global financial crisis in 2007 the, up to that point in time, almost negligible spreads of government bonds of Euro area member states relative to the benchmark German bonds increased, most notably for Greece, Ireland, Portugal, and Spain (GIPS) (see Figure 5). This development continued, especially for Ireland and Greece and particularly so in mid-2009. In spring 2010, the development escalated dramatically again in the Greek case. Emergency measures had to be taken in order to prevent a Greek government default. The relief provided by the rescue package for Greece (€ 110 Billion) by the Euro area countries and the IMF, and by the European Financial Stability Mechanism (EFSM) and the European Financial Stability Facility (EFSF) set up subsequently to prevent further problems for other governments proved to be very short-lived.⁷ In October 2010

⁶ See for example the argument of the German Federal Ministry of Finance (2011) in the German Stability Programme submitted to the European Commission and the European Council (2011a) in its proposal for the ‘Euro Plus Pact’.

⁷ See European Commission (2012a) for information on the Greek Loan Facility and European Commission (2012b) for information on the European Financial Stability Mechanism (EFSM), the European Financial

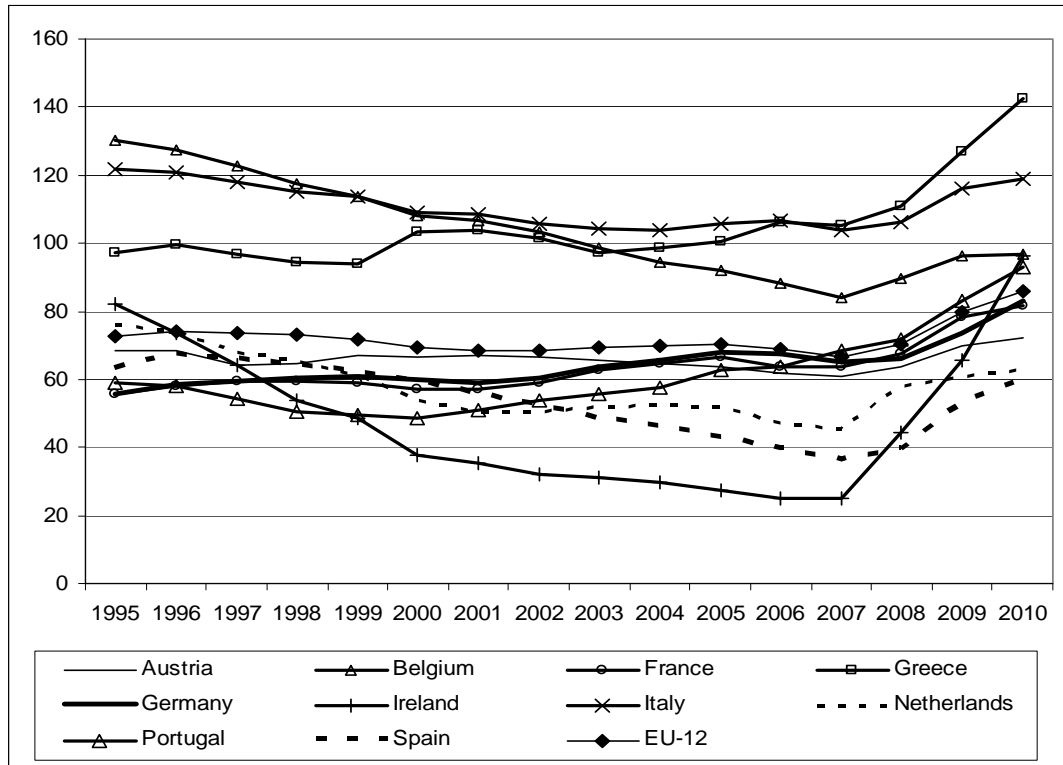
spreads for Irish government bonds increased dramatically again so that in November of the same year, the Irish government finally decided to request assistance by the EFSM, the EFSF and the IMF (€ 85 Billion). In spring 2011, the Portuguese government had to do the same (€ 78 Billion). And in the course of 2011 the Greek government debt problem worsened again, such that in late 2011 a more than 50 per cent voluntary loss of private holdings of Greek government and an increase and extension of the rescue package were agreed, using the EFSF as a financing vehicle.

Figure 3:
General government financial balance relative to GDP, selected Euro area countries, 1995 to 2010, in per cent



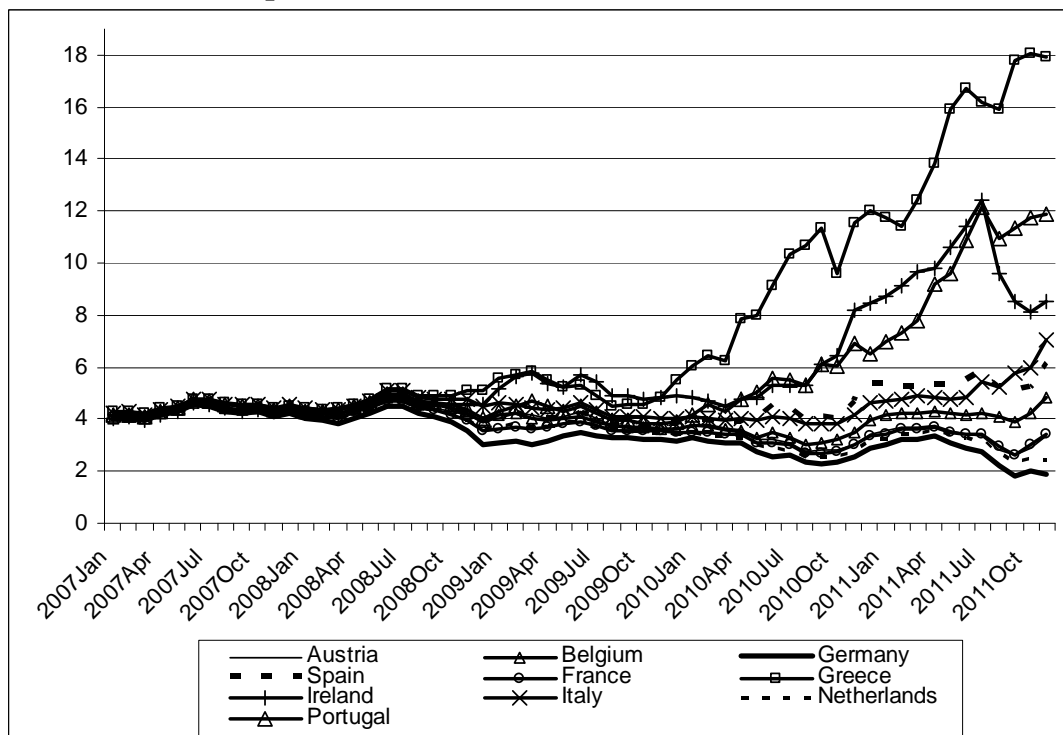
Source: European Commission (2011a), author's calculations

Figure 4:
General government gross consolidated debt relative to GDP, selected Euro area countries, 1995-2010, in per cent



Source: European Commission (2011a), author's calculations

Figure 5:
10-year government bond yields, selected Euro area countries, January 2007 – November 2011, in per cent



Source: ECB (2011a), author's representation

Since mainstream economics and economic policy debates see the high and rising government debts as the main reason for the crisis, the failure of the Stability and Growth Pact (SGP) to contain government deficits and debt is therefore considered to be the most important problem to be tackled in the Euro area. From that point of view the main threat for the euro is caused by governments, which have run irresponsibly high deficits leading public finances to the brink of default. The current debate over the reform of the economic policy framework in the European Union (EU) and the Euro area is therefore still dominated by the paradigm that has led to the crisis.

However, some important urgency measures have been taken to stabilise financial markets and prevent government defaults. These are, first, the introduction of the European Financial Stability Facility (EFSF) as well as the European Financial Stabilisation Mechanism (EFSM) and the European Stability Mechanism (ESM), which will assume the role of providing external financial assistance to Euro area member states in trouble, originally scheduled for June 2013, already in July 2012, and most recently the extensions of the stabilization tools for the EFSM and ESM agreed at the meeting of the heads of state or government of the Euro area and EU institutions in July 2011 (Council of the EU 2011b). The latter includes allowing the EFSF and the ESM to finance recapitalization of financial institutions through loans to governments and to intervene into secondary government bond markets under certain conditions. Second, and maybe more importantly, the interventions of the ECB into secondary government bonds markets, buying government debt of those countries which are in trouble, have so far prevented a collapse of these markets and have provided some relief for the countries under attack.⁸

But these measures are far from solving the major institutional deficiencies, i.e. the lack of an explicit guarantee of public debt of member countries by the ECB. The meeting of the European Council (2011b) in December 2011 did not even consider the proposal of

⁸ For information on these interventions see ECB (2011b).

Eurobonds (or Stability Bonds) put forward by the European Commission (2011b) which could have been a first step towards the remedy of the problems. And there is no general political support – to say the least – for the interventions of the ECB into government bonds markets aimed at stabilising these markets and dampening the upwards pressure on interest rates on government debt.

The rescue measures for the financial sector, furthermore, have been combined with the requirements of restrictive fiscal and wage policies as conditions to get access to the EFSF and the ESM, a tighter SGP, a new ‘Euro Plus Pact’, and a ‘New Fiscal Compact’ among Euro area member countries, which will impose deflationary pressures on major parts of the Euro area and will thus prevent stabilisation (or reduction) of public debt-GDP ratios.⁹

In March 2011, for example, the European Council (2011a, p. 2) “endorsed the priorities for fiscal consolidation and structural reform. It underscored the need to give priority to restoring sound budgets and fiscal sustainability, reducing unemployment through labour market reforms and making new efforts to enhance growth”. In particular, the European Council (2011a, p. 2) requires reductions of the structural budget deficits of “well above 0.5 per cent of GDP” for 2012 in most countries, in order to restore ‘confidence’.¹⁰ The ‘Euro Plus Pact’ agreed upon at that meeting is mainly targeted at improving competitiveness by means of monitoring wage setting, in particular in the public sector, at labour market reforms increasing ‘flexicurity’, promoting life-long learning and reducing taxes on low-paid labour, and at improving sustainability of public finances by means of extending effective retirement ages, reducing early retirement and implementing fiscal rules (i.e. ‘debt brakes’) into national legislation. These commitments in the ‘Euro Plus Pact’ are to be reflected in the

⁹ See the agreements of the meeting of the Economic and Financial Affairs Council (ECOFIN) on 15 March 2011 (Council of the EU 2011a), the conclusions of the meeting of the European Council (2011a) on 24/25 March 2011, the statement by the heads of state or government of the Euro area and EU institutions on 21 July 2011 (Council of the EU 2011b), and state by the Euro area heads of state and governments on 9 December 2011 (European Council 2011b).

¹⁰ See also the agreement the ECOFIN regarding the reform of the SGP and the surveillances of economic policies (Council of the EU 2011a).

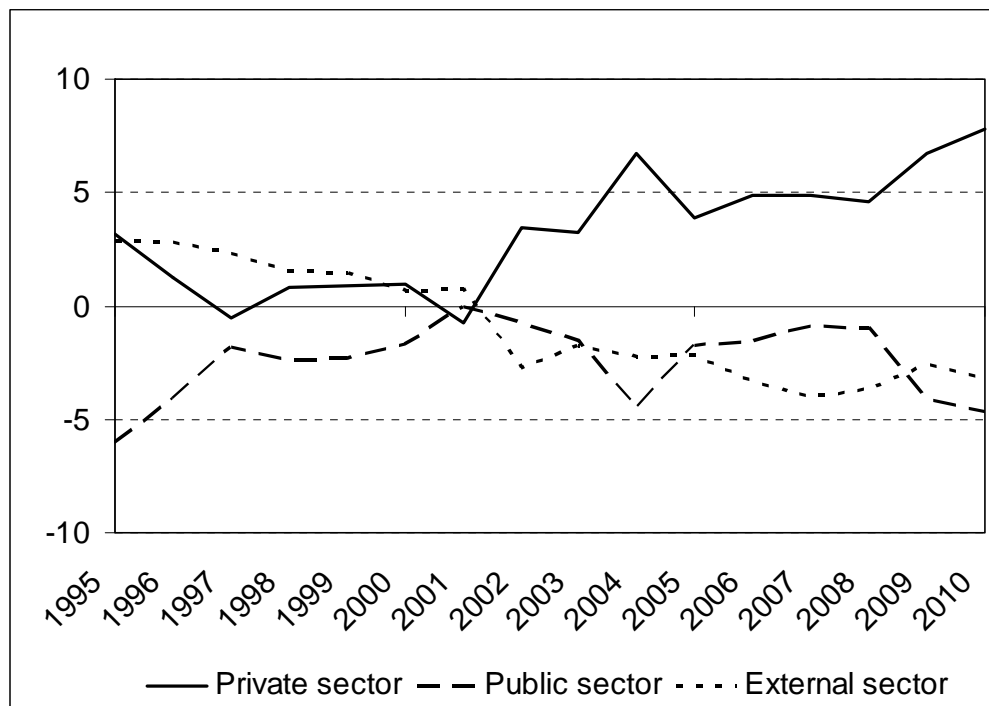
annual National Reform and the Stability Programmes, which are assessed by the Commission, the Council, and the Eurogroup in the context of the so called European Semester, and will thus have a major impact on European economic policies in the years to come.

This approach was underlined by the agreement of the Euro area heads of state and governments in December 2011 (European Council 2011b). The ‘New Fiscal Compact’ reinforced the target of balanced or in surplus government budgets, i.e. structural deficits should not exceed 0.5 per cent of GDP. This target is to be introduced into the national legal systems at a constitutional level. Further more, deviations from this target are to trigger automatic correction mechanisms. Such automatism, including sanctions imposed by the European Commission, shall also be applied if a country breaches the 3 per cent of GDP limit for its government deficit, unless a qualified majority of the Euro area member states is opposed. Furthermore, it has been agreed to reduce government debt exceeding the 60 per cent of GDP threshold by 1/20 per year, irrespective of the macroeconomic constellation.

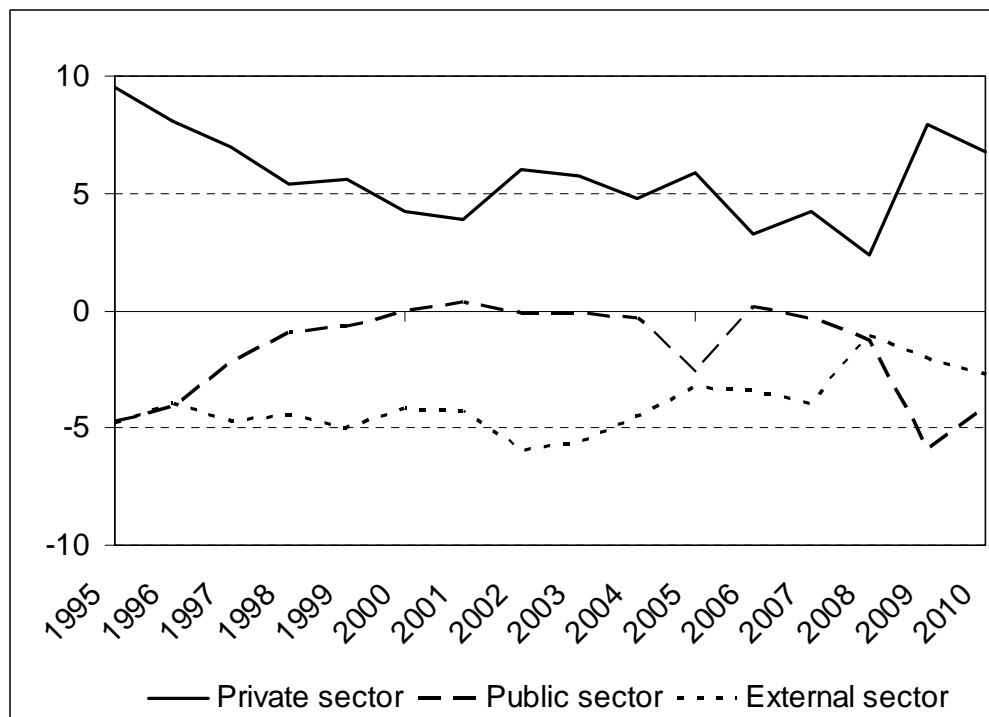
Taking a look at the data, many doubts regarding the interpretation of mainstream European policy advisers and makers regarding the origin of the euro crisis are raised (Figure 3). For Greece, of course, the picture seems clear, as the budget deficit was very large over the whole period since the mid-1990s. For Portugal, however, the picture is less clear, as the budget deficit was not larger than that of Germany for a long period of time. And most strikingly, both Ireland and Spain looked perfectly in order before the crisis as they seemed to follow the SGP in an almost ideal manner. Ireland ran a budget surplus of 3 per cent of GDP in 2006 and Spain had a surplus of 1.9 per cent in 2007. Turning to gross government debt in relation to GDP (Figure 4), the evidence for the purely fiscal view of the crisis becomes even weaker: Portugal used to have a considerably smaller debt burden than Germany. And in 2007 gross government debt in relation to GDP was only 25 per cent in Ireland and 36 per cent in Spain, far below the 60 per cent threshold of the SGP.

Figure 6:
Sectoral financial balances as a percentage share of nominal GDP, selected Euro area countries, 1995 - 2010

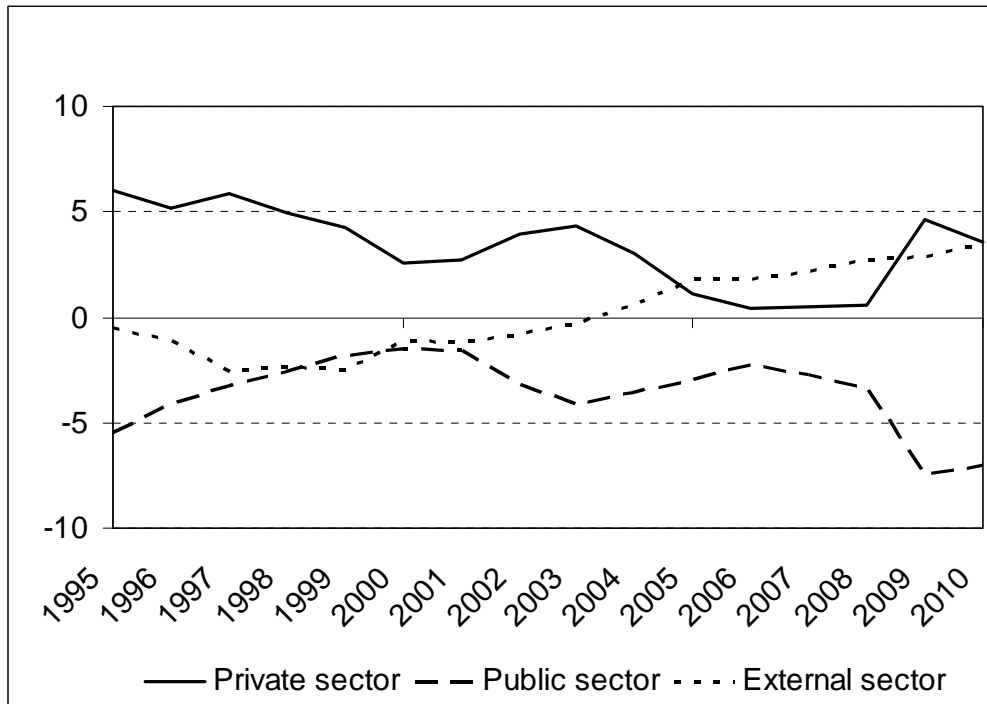
6a) Austria



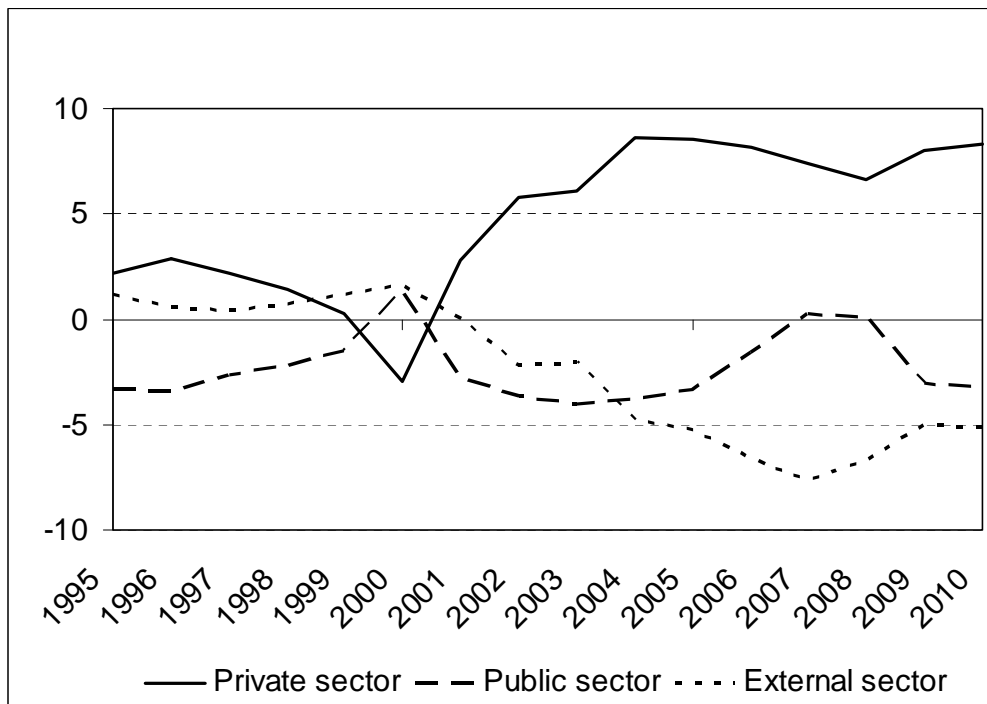
6b) Belgium



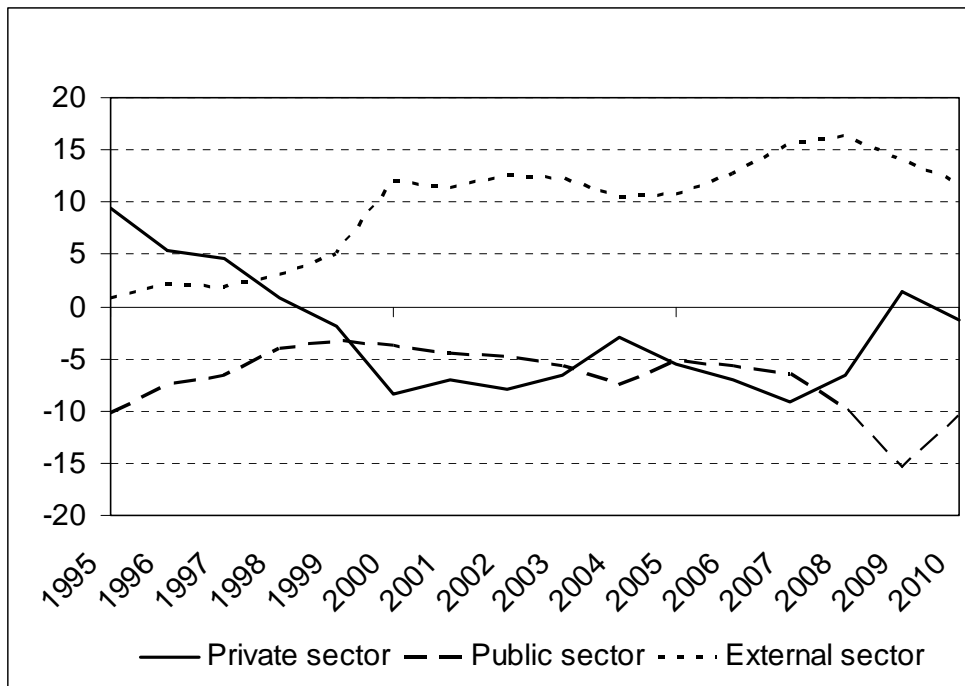
6c) France



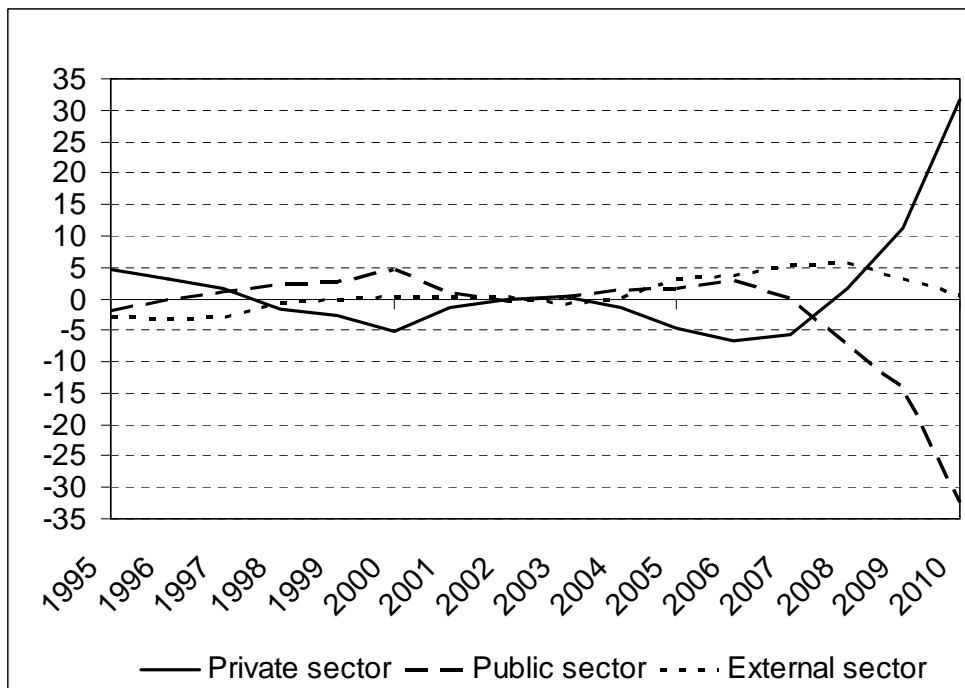
6d) Germany



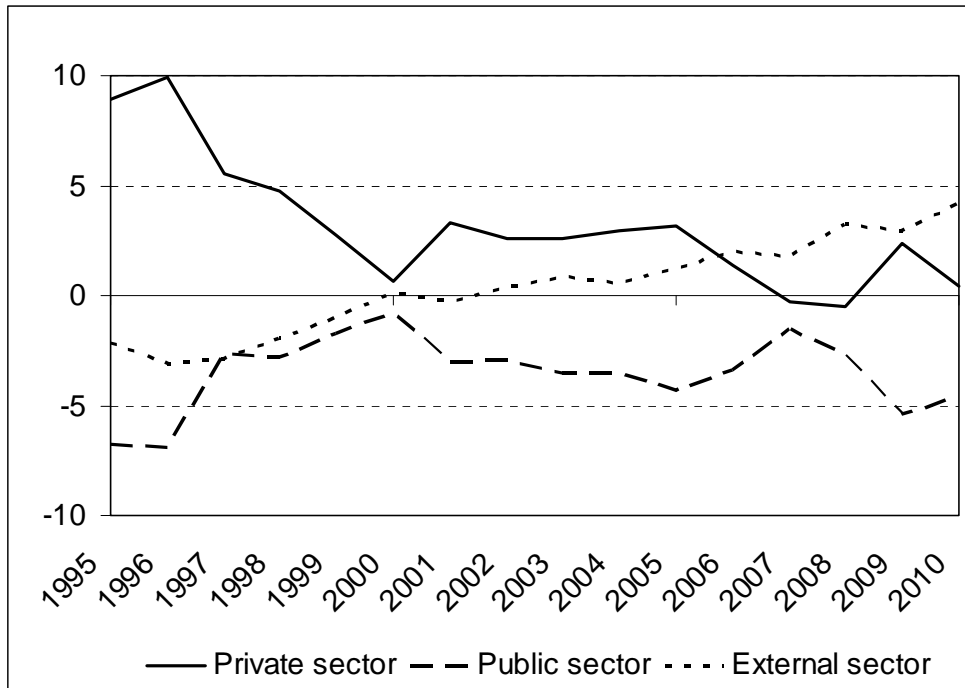
6e) Greece



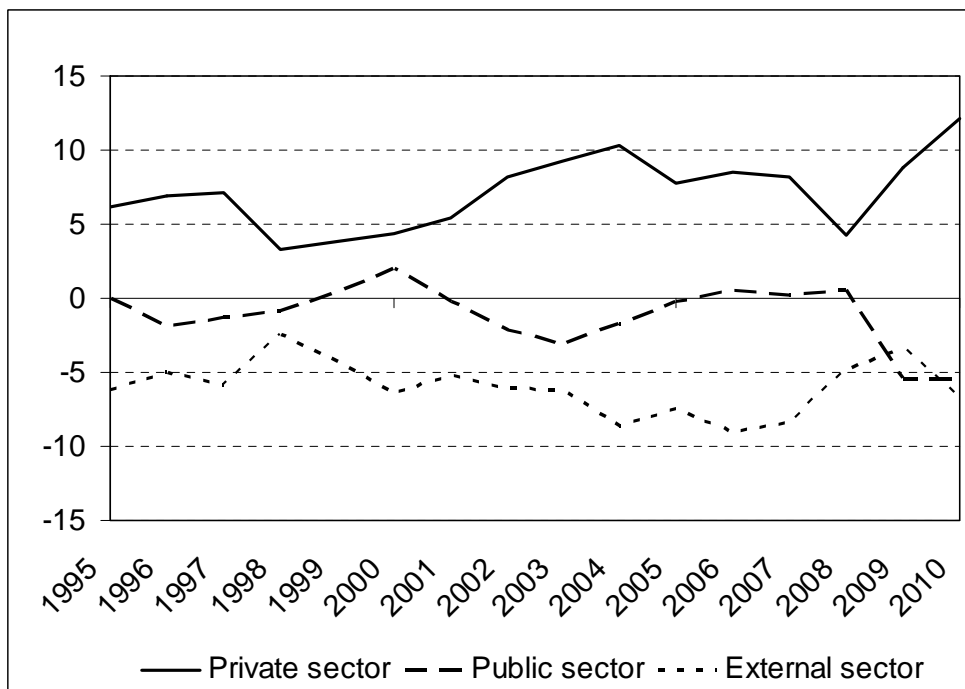
6f) Ireland



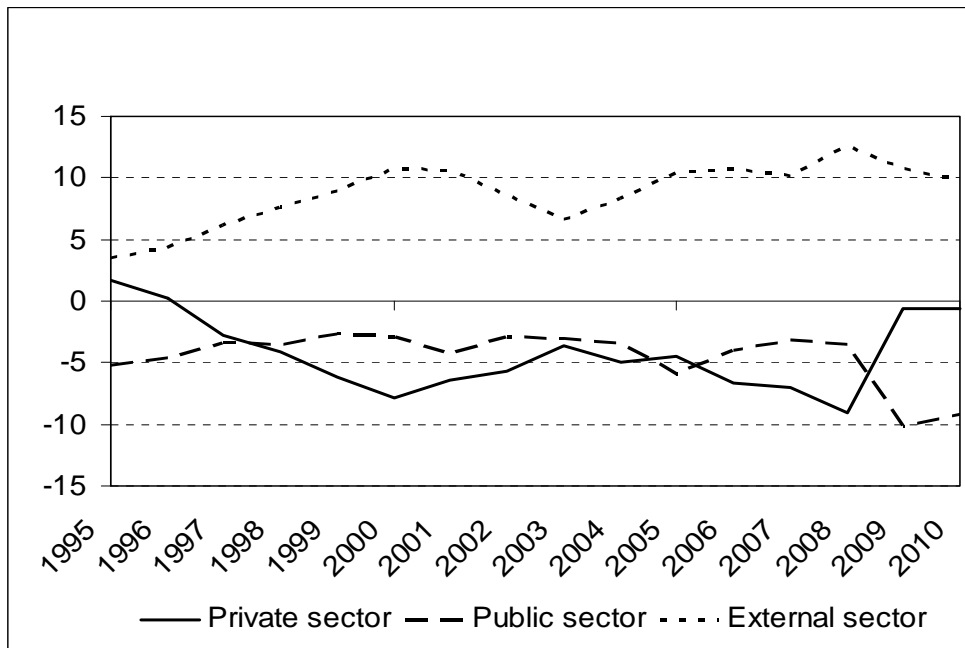
6g) Italy



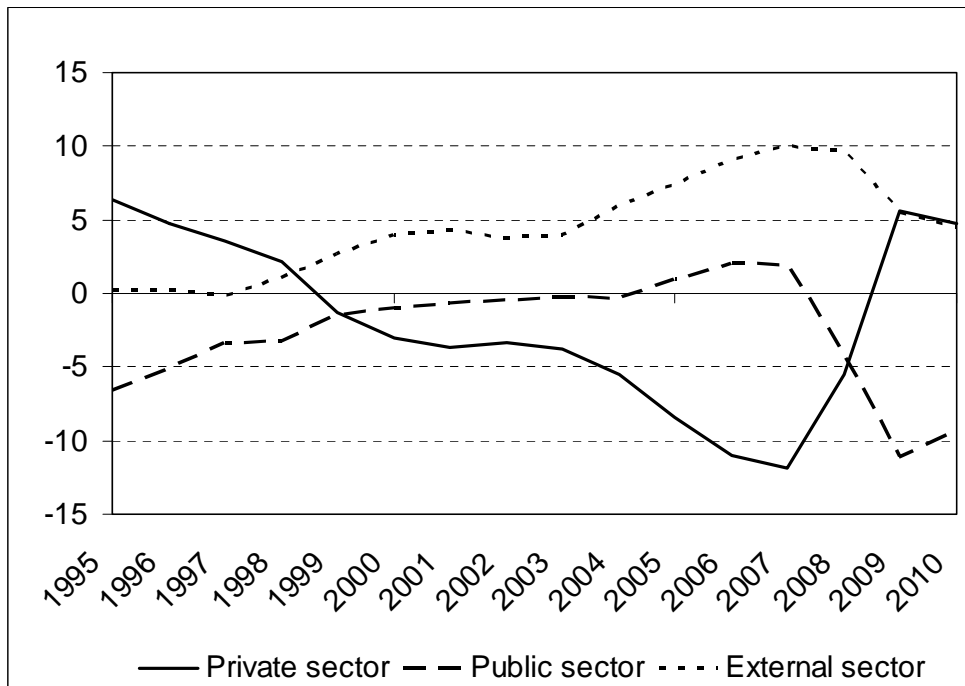
6h) Netherlands



6i) Portugal



6j) Spain



Source: European Commission (2011a), author's calculations

We observe a more complex picture, which against the background of the aforementioned institutional and economic policy deficiencies help to explain the current euro crisis,¹¹ if we take into account the interconnection of public, private and foreign deficits and surpluses:

$$\begin{aligned}
 & \text{Public sector financial balance} \\
 & + \text{Private sector financial balance} \\
 & + \text{Foreign sector financial balance} \\
 & = 0
 \end{aligned} \tag{1}$$

The dynamic debt-led consumption boom development before the crisis in Ireland (Figure 6f) and Spain (Figure 6j) was associated with huge deficits of the private sector and (relatively small) surpluses in the government balances and to a much larger extent with current account deficits against the rest of the world, i.e. surpluses of the respective external sectors. When the crisis hit, the private sector balances quickly turned into surplus and governments stabilising the economy had to accept dramatic increases in government deficits. Therefore, the ‘unsustainable’ government deficit turns out to be a consequence of unsustainable private and external sector balances before the crisis in the first place.

For the two other economies currently included in the rescue packages, Greece (Figure 6e), a debt-led consumption boom type, and Portugal (Figure 6i), a domestic demand-led type of economy before the crisis, both the private sector and the government sector continuously ran deficits after the introduction of the euro. Before the crisis, those deficits had to be financed by capital inflows and hence current account deficits of about 12 per cent of GDP in the case of Greece, and about 10 per cent of GDP in the case of Portugal. In the course of the financial and real crises, in both countries the government stepped in to prevent the economy from collapsing when the private sector reduced deficits or began to run surpluses again, leading to rising public deficits.

Therefore, it seems that the current euro crisis is rooted in earlier private deficits and current account imbalances and has not been caused by excessive public deficits. In the four

¹¹ For similar explanations see Uxo/Paul/Febrero (2011) and Stockhammer (2011).

countries outlined above, the private sector obviously tended to spend more than its income. This was associated with government surpluses (Ireland, Spain) or amplified by government deficits (Portugal, Greece), which led to very high and rising current account deficits in the four countries.

For Italy, a domestic demand-led economy before the crisis, the picture is less clear (Figure 6g). In this country the private sector balance was consistently positive. Therefore the government deficit could be financed partly by the private sector surplus and partly by the capital inflows associated with the moderate, but continuously rising, current account deficit. When the crisis hit, the improvement in the private sector balance was compensated mostly by an increase in the government deficit. A similar pattern can be observed for France (Figure 6c), another domestic demand-led economy in the Euro area. What is worrisome in both cases, is the continuous improvement of the external sector balances in both countries, i.e. the continuous deterioration of the respective current accounts.

Since the current account of the Euro area as a whole was roughly balanced in the period before the crisis, there must have been other countries within the Euro area in which the private sector consistently ran surpluses. If in such cases the government is not willing (or is prevented by the SGP) to run a correspondingly high deficit, then this will imply a deficit of the respective foreign sectors, i.e. current account surpluses. It does not come as a surprise that these characteristics hold for the export-led mercantilist countries of the Euro area Germany (Figure 6d), the Netherlands (Figure 6h), Austria (Figure 6a), and Belgium (Figure 6b), with Germany as the largest Euro area country being the most important mercantilist economy.¹²

So far we have argued that in order to explain the euro crisis we should not focus on the government financial balances only, but should take into account the financial balances of

¹² For a more detailed analysis and critique of the mercantilist macroeconomic policy strategy in Germany and its implications for the imbalances in the Euro area see Hein/Truger (2007, 2009, 2010) and Cesaratto/Stirati (2010).

all three macroeconomic sectors. This has again brought to the fore again the current account imbalances among Euro area member countries which have escalated since the introduction of the euro. As we have outlined in Section 3, these imbalances have been the outcome of the two extreme ‘types of development of capitalism under financialisation’, i.e. the ‘debt-led consumption boom’ type, on the one hand, and the ‘export-led mercantilist’ type, on the other hand, which have also been observed in the Euro area in the face of financial deregulation and re-distribution at the expense of (low) labour incomes. In the course of the crisis of finance-dominated capitalism these imbalances triggered rising public deficit- and debt-GDP ratios which then, given the institutional lack of a convincing guarantee of public sector debt in the Euro area, provided the grounds for the euro crisis.

5. Getting out of the crisis

Getting out of the euro crisis requires addressing the long-run developments of finance-dominated capitalism which have caused the crisis of this type of capitalism, i.e. the inefficient regulation of financial markets, the increased inequality in income distribution, and the imbalances in the current accounts at the global and the European level, on the one hand. In Hein/Truger (2011) we have proposed a “Keynesian New Deal at the Global and the European Level” in order to tackle these roots of the crisis.¹³ This policy package should include, first, the re-regulation of the financial sector in order to prevent future financial excesses and financial crises, second, the re-orientation of macroeconomic policies towards stimulating and stabilising domestic demand, in particular in the current account surplus countries, and third, the re-construction of international macroeconomic policy co-ordination and a new world financial order, in order to rebalance the world and the regional economies. Within this broader framework, on the other hand, the European Union and the Euro area will

¹³ See also Hein (2012, chapter 7).

have to overcome the specific institutional and economic policy failures which have made the financial and economic crises a euro crisis.¹⁴

In what follows we will focus on the requirements to overcome the euro crisis, and we will base our arguments on the Post-Keynesian approach to macroeconomics and macroeconomic policies developed in Hein/Stockhammer (2010) as an alternative to the now discredited New Consensus macroeconomics, on which much of the existing economic policy framework in the Euro area is built.¹⁵ In order to improve the growth rate of the Euro area as a whole and to provide the conditions and incentives for each country to grow at a rate consistent with roughly balanced current accounts, major institutional reforms in the EU and the Euro area are required.¹⁶

First, the institutional setting of the ECB and its monetary policy strategy have to be modified so that the ECB is forced to take into account the long-run distribution, employment and growth effects of its policies, and to pursue a monetary policy targeting low real interest rates. In a first step, an adjustment towards the objectives of the US Federal Reserve might be helpful, which include stable prices, maximum employment and moderate long-term interest rates on an equal footing (Meyer 2001). In its monetary policy strategy the ECB should refrain from fine tuning the economy in real or nominal terms and should rather target low interest rates, such that long-term real interest rates remain below Euro area average productivity growth in the medium run. This should be conducive to real investment and growth in the Euro area as a whole. The ECB, moreover, ought to focus on financial market stability. Instead of the blunt instrument of the interest rate it should introduce those instruments which are appropriate to contain bubbles in specific asset markets in specific

¹⁴ On the ‘design faults’ of the European Monetary and Economic Union see more extensively Arestis/Sawyer (2011), however, without establishing any relationship of the euro crisis with the crisis of finance-dominated capitalism.

¹⁵ For the NCM see Goodfriend/King (1997), Clarida/Gali/Gertler (1999) and Woodford (2003), and for detailed critiques of the NCM and its application in economic policy making, see Arestis (2009, 2011a, 2011b), Arestis/Sawyer (2004a), and Hein/Stockhammer (2010).

¹⁶ On the determinants of the balance of payments constrained growth rate see Thirlwall (1979, 2002) and on the application of this concept to the analysis of the imbalances within a currency area, i.e. the euro area, see Hein/Truger/van Treeck (2012) and Hein (2012, chapter 8).

countries or regions, i.e. credit controls or asset-based reserve requirements (Palley 2010). Further more, the ECB should act as a lender of last resort to the banking system, and it should guarantee public debt of the Euro area member countries, allowing these countries to issue debt in their ‘own currency’. This would immediately reduce the pressure imposed by ‘financial markets’ on those countries presently in crisis and would provide the conditions for a long-run oriented solution to the current account imbalances within the Euro area.

Second, the orientation of labour market and social policies towards deregulation and flexibilisation, still prevalent in the EU and the Euro area, will have to be abandoned in favour of re-organising labour markets, stabilising labour unions and employer associations, and adopting Euro area-wide minimum wage legislation.¹⁷ This could provide the institutional requirements for the effective implementation of stabilising nominal wage policies. Nominal wages should rise according to the sum of long-run average growth of labour productivity in the national economy plus the target rate of inflation for the Euro area as a whole. This would contribute to roughly equal inflation rates across the Euro area, and it would prevent mercantilist strategies based on nominal wage moderation.

Third, the SGP at the European level has to be abandoned and needs to be replaced by a means of coordination of national fiscal policies at the Euro area level which allows for the short- and long-run stabilising role of fiscal policies. Hein/Truger (2007) have suggested the coordination of long-run expenditure paths for non-cyclical government spending, i.e. those components of spending which are under control of the government. Such expenditure paths could be geared towards stabilising aggregate demand in the Euro area at full employment levels, and automatic stabilisers plus discretionary counter-cyclical fiscal policies could be applied to fight demand shocks. In order to avoid current account imbalances within the Euro area, these expenditure paths would have to make sure of the following: On average over the cycle and the average tax rate in each member country given, as a first approximation, the

¹⁷ Of course, this does not imply the same minimum wage rate for the whole Euro area, but country-specific minimum wages, which, however, should be set according to some Euro area wide rule.

government deficits in single countries, i.e. government spending (G) minus taxes (T), would have to be roughly equal to the excess of private saving (S) over private investment (I) in the respective country, such that the current accounts are roughly balanced at a high level of aggregate demand and employment ($S - I = G - T$),¹⁸ and GDP growth is close to the balance of payments constrained growth rate of the individual country.

As we have shown in Sections 3 and 4 above, the basic problem underlying the present euro crisis, apart from the absence of a convincing guarantee of Euro area member country public debt by the ECB, are the massive current account imbalances which have developed within the Euro area. Whereas on average over the pre-crisis period, GDP growth in Greece, Ireland, Spain and Portugal has exceeded their respective balance of payments constrained growth rates, GDP growth in Austria, Belgium, Germany and the Netherlands has fallen short of the respective balance of payments constrained growth rates. From this it follows, that the immediate task for the member countries is to adjust actual growth to the respective balance of payments constrained growth rates. This orientation is important in order to rebalance economic development in the Euro area, even if the ECB would guarantee public debt of Euro area member countries and thus contribute to stabilising the markets for public sector debt. However, we will conditionally relax this requirement below.

For the current account surplus countries this means that they should use expansive fiscal policies to increase domestic demand and adjust actual growth towards their balance of payments constrained growth rates. This provides the conditions for the current account deficit countries to reduce their deficits. For a transitional period, the current account surplus countries should also increase their rates of inflation relative to the rates of inflation in the current account deficit countries, in order to rebalance price competitiveness among Euro area member countries. Unit labour cost growth should therefore exceed the wage norm mentioned

¹⁸ This is, of course, the functional finance approach proposed by Lerner (1942) and more recently again by Arestis/Sawyer (2004b).

above, i.e. the sum of national productivity growth plus the Euro area inflation target, during the adjustment process.

The major task for the current account deficit countries, with the exception of Ireland,¹⁹ will be to improve their balance of payments constrained growth rates. This means, on the one hand, to contribute to a reduction of the inflation differentials with respect to the surplus countries, by means of unit labour cost growth below the sum of national productivity growth plus the inflation target. In order to prevent the risk of deflation in these countries during the process of adjustment, the Euro area inflation target should be increased above the rather ambitious present target of ‘below, but close to 2 per cent’ for the harmonized index of consumer prices (HICP). On the other hand, current account deficit countries have to increase the income elasticity of demand for their exports and to reduce the income elasticity of demand for imports by means of industrial, structural and regional policies; this means they have to improve their non-price competitiveness.²⁰

Even if these adjustment processes of actual and balance of payments constrained growth rates in each of the Euro area member countries take place, we would not expect complete adjustment in the short or medium run. Growth rates of member countries will differ due to productivity catch-up processes and it is hard to imagine that these differences in growth rates will be matched by reverse differentials in inflation rates or by inverse relative income elasticities of demand for exports and imports. In other words, it is not very likely that the more rapidly growing catching up countries will have lower inflation, higher income elasticities of demand for their exports, and lower income elasticities of demand for imports than the slowly growing more advanced economies, so that actual growth differentials will be

¹⁹ In the case of Ireland, the current account deficit was not due to a deficit in external trade but rather a deficit in the flows of primary incomes.

²⁰ Following Thirlwall (2002, p. 78), “The only sure and long-term solution to raising a country’s growth rate consistent with balance of payments equilibrium on current account is structural change to raise ε and to reduce π .” Remember that ε is the income elasticity of the demand for exports and π is the income elasticity of the demand for imports.

matched exactly by balance of payments constrained growth differentials. Therefore, current account surpluses and deficits will arise due to these differentials.

Coordinating fiscal policies and government deficits at the Euro area level should therefore take tolerable current account deficits associated with catch-up processes into account in the short and medium run. As shown in Hein/Truger/van Treeck (2012),²¹ in a currency union with a balanced current account with the rest of the world and therefore with a (close to) zero net foreign assets/liabilities position, a constant net foreign liabilities-GDP-ratio of the current account deficit member countries will be associated with a rising net foreign assets-GDP-ratio of the current account surplus member countries, provided that GDP growth in the deficit countries exceeds growth in the surplus countries. Alternatively, a constant net foreign assets-GDP-ratio of the surplus countries will be accompanied by falling net foreign liabilities-GDP-ratios of the deficit countries, or net foreign assets-GDP-ratios of surplus countries will be rising and net foreign liabilities-GDP-ratios of deficit countries will be falling. Sustainably higher growth than that of the surplus countries on Euro area average should therefore be the ultimate criterion for tolerable current account deficits in the coordination process of fiscal policies within the Euro area. Current account deficits of countries with a below surplus country average GDP growth rate, and the related current account surpluses of the surplus countries, should not be tolerated and should be tackled symmetrically, i.e. by both deficit and surplus countries, with the measures outlined above.

Current account deficits will have to be financed by capital imports. Appropriate financial regulations, avoiding excessive asset price inflation and credit bubbles, are key prerequisites for sustainable growth and for the stability of productivity growth catch-up processes and the related current account deficits and net foreign liabilities position. Long-term capital flows as a means of finance of acceptable current account deficits are therefore most important. Long-term direct investment may be the most stable and beneficial, but

²¹ See also Hein (2012, chapter 8).

structural effects (and also the outflow of profits) have to be taken into account, as the example of Ireland in the recent past has taught us. If capital inflows are financed by credit, the focus should be on long-term credit.

Therefore, the EU and the Euro area will have to develop institutions which take care of the transfer of the current account surpluses of the more slowly growing mature member countries to the catching-up less developed economies. First, the ECB will have to explicitly guarantee public debt of all member countries and thus stabilise financial markets and keep interest rates on government debt below the long-run nominal GDP growth rate of the respective country. Second, fiscal policies among the Euro area member countries will have to be coordinated along the lines developed above: On average over the cycle and the average tax rate in each member country given, the government deficits would have to be roughly equal to the excess of private saving over private investment in the respective country, taking into account acceptable current account deficits or surpluses given by catch-up processes and thus differential long-run growth rates. Third, the European Investment Bank, together with the European regional and structural funds and the government institutions of the recipient countries, should be involved in directing private capital flows into appropriate sectors and areas of the current account deficit countries which facilitate real catch-up processes and avoid bubbles in certain sectors (i.e. in housing or financial sectors).

6. Conclusions

In this paper we have interpreted the euro crisis in a broader context as the latest episode of the crisis of finance-dominated capitalism. We have analysed major features of finance-dominated capitalism, specifically the increasing inequality of income distribution and the rising imbalances of current accounts, for a set of major Euro area countries. Against this background we have then examined the euro crisis and the economic policy reactions of European governments and institutions. Since these policy makers narrowly interpret the

crisis as a sovereign debt crisis caused by irresponsible behaviour of some member country governments, their policy reactions and recommendations focussing on constraining government deficits and debt by means of tighter rules and deflationary policies are doomed to fail and will increase the risk of deflationary stagnation and finally disintegration of the Euro area as a whole. Therefore, we have outlined an alternative macroeconomic policy approach tackling the basic contradictions of finance-dominated capitalism and the deficiencies of European economic policy institutions and economic policy strategies. What is urgently required in order to prevent a worsening of the crisis in the Euro area is, on the one hand, a central bank which convincingly guarantees public debt of Euro area member countries. On the other hand, an expansionary macroeconomic policy approach, in particular in the current account surplus countries of the Euro area, needs to be applied in order improve income distribution and to overcome the imbalances which have arisen in the past and which are at the roots of the crisis.

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