Original Article

The imbalance of capitalisms in the Eurozone: Can the north and south of Europe converge?

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Abstract The European response to the sovereign debt crisis has exposed a tension between the national and the supranational in a multilevel polity while opening up new political cleavages between the north and south of the Economic and Monetary Union (EMU). This dilemma has become particularly acute for programme countries that were either directly or indirectly in receipt of non-market financial fundingfrom the troika. Drawing upon a new international political economy approach to comparative political economy, this article argues that joining together two distinct macroeconomic growth regimes is the real source of the euro crisis: domestic demand-led models, which predominate in southern Europe, and export-led models, which dominate the landscape of northern Europe. European policymakers assume that all member states can converge on an export-led model of growth. This vision of convergence is exacerbating rather than resolving the *imbalance of capitalisms* at the heart of the Eurozone.
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Introduction

The European response to a financial *cum* sovereign debt crisis in a currency union without a centralized fiscal treasury or political government is an experiment in crisis management. It has exposed a tension between the national and the supranational in a multilevel polity. No level of this multilevel governance system has the policy instruments to solve the crisis. Monetary policy remains supranational (that is, European) across 19 national governments with diverse fiscal, welfare state and labour market regimes (see Höpner and Schäfer, 2010; Scharpf, 2011). These countries have conflicting interests in terms of who should bear the burden of adjustment. For the sake of argument, we can identify this as a tension between creditor and debtor countries, or between the core and periphery of the Economic and Monetary Union (EMU) in Europe.

EMU member states currently have limited policy discretion to pursue an autonomous response to the crisis. In the absence of exchange rate or interest rate adjustment, the entire burden of adjustment must fall on domestic prices and wages. In effect, membership of the EMU means that national governments only have one policy instrument at their disposal: internal devaluation and structural reforms of the labour market (Buti and Carnot, 2012; Armingeon and Baccaro, 2012a). From a political perspective, national governments must comply with the external mandates of EMU membership by reducing their budget deficit to 3 per cent of GDP. The negative impact this has on employment is legitimated by the economic assumption that labour cost competitiveness and export-led recovery is the only way to generate the conditions for economic growth. To achieve this, national governments are being encouraged to impose structural reforms in product and labour markets as a means to enhance cost competitiveness. It is this assumption that supply-side structural reforms will lead to a convergence in export-led growth models across different national models of capitalism that I challenge in this article.

To do this I draw upon and re-configure the core variables of the varieties of capitalism (VoC) theory in the study of comparative political economy, and propose a new framework based on *macroeconomic growth regimes*. I argue that the domestic organization of different political economies in the north and south of the Eurozone has interacted with transnational European monetary policy to produce *divergent* economic and employment growth patterns since the establishment of the EMU. The causal source of the economic crisis was the attempt to join together two distinct models of growth, domestic demand (south) and export led (north), into a single currency while failing to account for the asymmetric effects this would produce. The decline in competitiveness associated with current account imbalances was a logical consequence of Monetary Union. Northern European countries, I argue, are built around political coalitions and institutions that are conducive to an export-driven growth regime. Southern European countries, on the other hand, are institutionally conducive to growth models based around domestic consumption in the non-tradable sectors of the economy (Johnston, 2012).

In this sense, the article critiques the narrow focus on cost competitiveness and manufacturing in comparative political economy and proposes to analyse the ‘core’ and ‘peripheral’ countries of the EMU as interconnected *regions* within a structurally imbalanced currency union. It is an international case study on what happens when diverse capitalist democracies with distinct growth models are integrated into, and subsequently attempt to adjust in, a currency union without a centralized federal government. In this regard, I push the VoC theory to its logical conclusion and argue that if member states of the EMU operate according to their own distinct political and institutional logic (in my framework, conflicting macroeconomic growth regimes) then it is questionable whether some member states should remain in the Eurozone.

The EMU needs a *variegated* response to the crisis that provides the flexibility for member states to carve out an autonomous economic and employment growth strategy at the national level. If this is not forthcoming then it is perfectly rational for some member states to consider leaving the euro, particularly those countries that are not in a position to compete in international export markets. The remainder of the article is structured as follows. First, I outline a new VoC theoretical framework that analyses the EMU as a political economy with two interactive macroeconomic growth regimes that have become incompatible under monetary union: domestic demand and export led. Second, using this framework, I trace the origins of the Eurozone crisis to capital inflows that financed current account imbalances between these growth regimes. Third, I detail the policy response of ‘internal devaluation’ in demand-led growth regimes in southern Europe, and the question as to whether external competitiveness is the core problem facing these countries. Fourth, I analyse the political consequence of this one-sided adjustment for European integration.

The Diversity of Capitalist Democracies in the Eurozone

The central research finding in comparative political economy over the past 20 years is that what governments do is conditioned by the structure of the political economy. According to Hall and Soskice (2001), the organization of a country’s political economy includes the structure of corporate governance, industrial relations, finance, social protection, the labour market, education and training (Hassel, 2012). The relations within these subsectors and their historical evolution over time produce different economic systems with distinct variants of comparative advantage. From a political science perspective, the underlying political coalitions of these institutions condition the type of public policy choices that governments are likely to pursue in times of economic crisis and growth (see Hay, 2004; Hall, 2012a).

In the Eurozone, one can argue that there are two variants of capitalism. Northern European countries, such as Germany, the Netherlands, Austria and Finland, are often described as coordinated market economies (CMEs). They have centralized unions and employers with the capacity to autonomously coordinate collective bargaining and labour market outcomes. In addition, they have embedded welfare state traditions committed to social protection and income security. They have traditionally relied upon export-led economic growth as a mechanism to generate employment. Hence, their macroeconomic structure supports a preference for stable fiscal policies and supply-side labour market reforms (Iverson and Soskice, 2013).

On the other hand, southern European countries in the Eurozone, Spain, Italy, Greece, Portugal and Cyprus, are often described as Mediterranean VoC (see Hay and Wincott, 2012 for a detailed analysis of welfare regimes). They have fragmented trade unions and employers with limited capacity to autonomously coordinate collective bargaining and labour market outcomes. They have weak welfare states, and a significant amount of social security occurs through family relations. Traditionally, they have generated economic growth through domestic demand. This gives priority to wages, and consumer spending, over profit-generation in export markets. Before the EMU, this organizational structure lent itself to an accommodating monetary and fiscal policy, with governments regularly devaluing the currency to offset a loss of competitiveness and the inflationary impact of a rapid increase in domestic prices. Wealth is often held in fixed assets such as property, and corporate governance is dependent on close business relations among family-run firms.

This article hypothesizes that the attempt to join together these two distinct capitalist growth regimes into a single currency is the real source of the Eurozone crisis. Before monetary union these models of growth could co-exist without producing external imbalances between one another, but not afterwards (see Figure 1). The organization of the political economy in southern Europe is conducive to a growth model based on domestic consumption and high inflation. In contrast, the organization of the political economy in northern Europe is conducive to a growth model based on export market, and low inflation. Both of these regimes, however, became *systematically* connected through the single currency. That is, the strong export base of northern Europe required high levels of domestic consumption in the south, which was largely funded through the capital account and external lending. In VoC theory, most research was focused on the supply-side coalitions that benefit

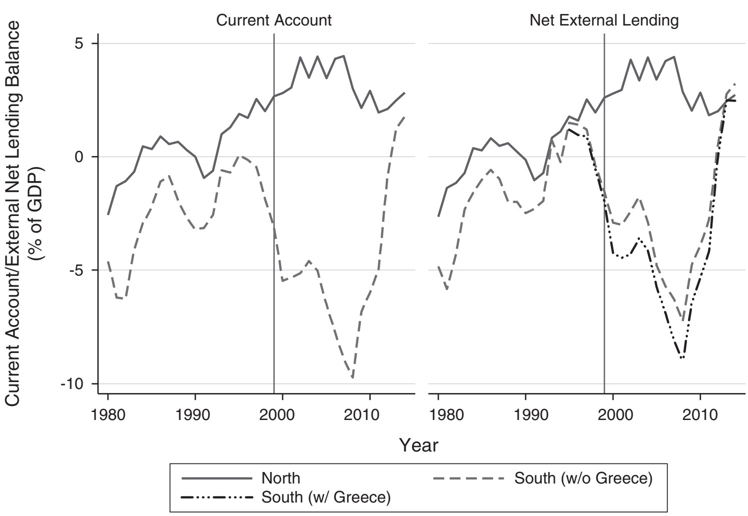

Figure 1: External balances between the EMU's domestic demand and export-led economies (1980–2014).
Note: Northern economies include Austria, Belgium, Finland, France, Germany and the Netherlands. Southern economies include Greece, Ireland, Italy, Portugal and Spain.
Source: European Commission's Directorate General for Economic and Financial Affairs (2014), adapted from Alison Johnston and Aidan Regan (forthcoming).

MNC firms in the export-oriented manufacturing sectors of northern Europe, not how they affected *domestic consumption* or service expansion in the non-traded sectors (Johnston and Regan, forthcoming).

These asymmetries (reflected in Figure 1) can only be observed by adopting an international political economy (IPE) perspective and examining member states of the EMU as integrated *regions* in a euro-financial market. The EMU is a semi-closed economy area with less than 10 per cent of trade leaving the Eurozone and predominately going to other countries in the EU. The EMU was designed as an unaccommodating currency regime that provided unprecedented autonomy to the European Central Bank (ECB). This primarily benefited the export-driven model of northern Europe. But as will be shown in the empirical sections ('The consequence: Creditor and debtor bargaining in Europe' and 'Discussion: Rethinking the political economy of European integration') it also generated unprecedented outflows of capital from the core economies of the Eurozone, fuelling domestic consumption in those regions that previously relied upon domestic demand to generate economic and employment growth. The dominant causal explanation for the current account imbalances is a loss of competitiveness measured in unit labour costs or the price deflator. What is not acknowledged is that the institutional factors that created these imbalances were a *consequence* of monetary union. Hence, focusing on external competitiveness and unit labour costs misdiagnoses the problem and cure.

To explain the disequilibria between northern and southern regions of the Eurozone, I subsume fiscal, wage and monetary policies to create a two-dimensional typology of macroeconomic growth models (see Table 1). This leads to a distinction between the domestic consumption and profit-export-oriented countries within the EMU, which directly corresponds to the previously 'hard' and 'soft' currency regimes of Europe. Northern export-driven countries have long given up the instruments of monetary policy to stabilize their currencies. This is not the case for southern Europe. Upon entry to the EMU it was assumed that these high-inflation countries would converge on the stability-oriented macroeconomic policies of northern Europe. It was assumed that convergence would take place through the interest-rate price mechanism. As will be shown in the next section, the total opposite occurred. Their macroeconomic regimes diverged (buyers and sellers of money with

Table 1: Macroeconomic growth Regimes in the EMU

	North	*South*
Currency	Hard – low inflation	Soft – high inflation
Monetary	Stability-oriented	Adjustable-oriented
Fiscal	Counter-cyclical	Pro-cyclical
Labour	Corporatist	Non-corporatist
Macroeconomic	Profit export	Domestic demand
Eurozone	Interdependence of financial banking institutions in both regimes	

a single interest rate) and trade imbalances widened. Internal demand, previously fed by wage increases, was now sustained by a decline in interest rates and debt accumulation.

But *who* exactly is responding to the monetary impulses associated with the single currency, and through what process do domestic institutions shape the strategy of these actors in reinforcing a growth regime based on either consumption or exports? In the traditional VoC framework it is the rational expectations of individual firms. In my framework it depends upon the producer group coalitions and the extent to which these are anchored in the export or non-tradable sectors of the economy (see Schmidt, 2002, for a similar argument on the role of the state in shaping European VoC). I consider the strategies that these political coalitions pursue an *outcome* of the growth regime (Johnston and Regan, 2014).

I will now use this framework to empirically analyse the systemic origins of the Eurozone crisis before analysing the impact and consequences for decision making in the EMU. The article concludes with a discussion on the imbalance of capitalisms within the Eurozone. Cases are selected on the basis of their growth regime. In this article, I use the terms 'core', 'Northern' and 'export-led models' interchangeably to describe the EMU economies that have emerged from the crisis unscathed (Austria, Belgium, Finland, Germany, the Netherlands and to a lesser degree France). Likewise, I use the terms 'periphery', 'Southern' and 'domestic demand-driven models' to describe EMU countries that have come under crisis (Greece, Italy, Portugal, Spain and to a lesser extent Ireland).

The Origins: Cheap Money

The Eurozone is composed of 19 linguistically diverse countries and has a combined population of 317 million people. It has a GDP of €9.4 trillion and accounts for 14.6 per cent of global trade (the second largest in the world). Before the crisis, only 10 per cent of this actually left the Eurozone, and predominately went to other EU countries. This means that the Eurozone, in effect, is a semi-closed trading economy (see De Grauwe and Ji, 2012). A gain in competitiveness for one country, by definition, can only come at the expense of another country. The implication is that trade has become a *zero-sum game* among nineteen nation-states sharing the same currency. Unless a country can gain in market share outside the euro area it will come at the expense of another EMU partner. This has exposed a horizontal political tension between the member states of the EMU. Germany accounts for over 26.7 per cent of Eurozone GDP, and is by far the largest exporter from the trading area. Given its economic resources, it is a rule maker rather than a rule taker when designing the policies of the EMU. From a macroeconomic perspective, fiscal reflation in a closed economy will stimulate aggregate demand. But this Keynesian policy assumes that the closed economy is governed by a homogenous nation-state.

The core problem at the heart of the Eurozone crisis is a structural imbalance between export-led economies with current account surpluses (Germany, the Netherlands, Austria and Finland) and countries with current account deficits (Italy, Spain, Greece, Portugal and occasionally Ireland) that emerged directly *after* the establishment of the EMU in 2000 (see Figure 1). These divergent trends are usually taken to illustrate the underperformance and loss of competitiveness by the 'GIIPS' (Greece, Ireland, Italy, Portugal and Spain) countries in the Eurozone, and were central to the establishment of the new EU Commission 'macroeconomic scorecard' in 2011, and subsequent economic reforms (see De la Porte and Heins, 2014).

The indicators in the new euro economic governance regime are firmly focused on how to improve the balance of payments for debtor countries, through holding down unit labour costs. This, by definition, promotes competition in wages among member states as a strategy for economic development. Coordinated wage restraint by centralized unions and employers, made possible by domestic institutions, is certainly one of the core factors in explaining the export-oriented strategy of small open economies in Europe (Höpner and Lutter, 2014). Germany, despite its size, is perhaps the best example of this. But from the perspective of the EMU as a whole, what this approach to wage competition fails to appreciate is the negative impact it has on the exporting capacity of other countries *sharing* the same currency. This is all the more problematic if we accept that within the Eurozone there are two different macroeconomic growth models in the north and south: export profit and domestic consumption. In this context, holding down wages in a semi-closed trading area negatively affects *all* member states, but particularly those southern Europe countries dependent on domestic demand.

The divergence in net international investment positions outlined in Figure 2 illustrates that from 2000 to 2008 southern European countries imported more than they exported, thereby funding the current account imbalances highlighted in Figure 1. Capital flew out of countries where exports exceeded imports, such as Germany, to purchase assets located in countries with increased domestic demand (Greece, Ireland, Portugal and Spain), fuelling domestic prices through either private sector house price booms or public sector spending. Since 2000, Germany's current account surplus (€192.2 billion) has been identical to the combined current account deficit of Greece, Italy, Portugal and Spain (DeGrauwe, 2013). This export of capital meant that these deficit countries became indebted to surplus countries, with the implication that their economies become heavily reliant on external credit to fuel domestic demand.

This change in the net international investment position was made possible by a one-size-fits-all monetary policy by the ECB and a single interest rate that made cheap credit widely available for rising *domestic consumption*. Hence, the current account imbalances occurred because private banks in some member states (and the public sector in Greece) took advantage of negative interest rates, and the absence of

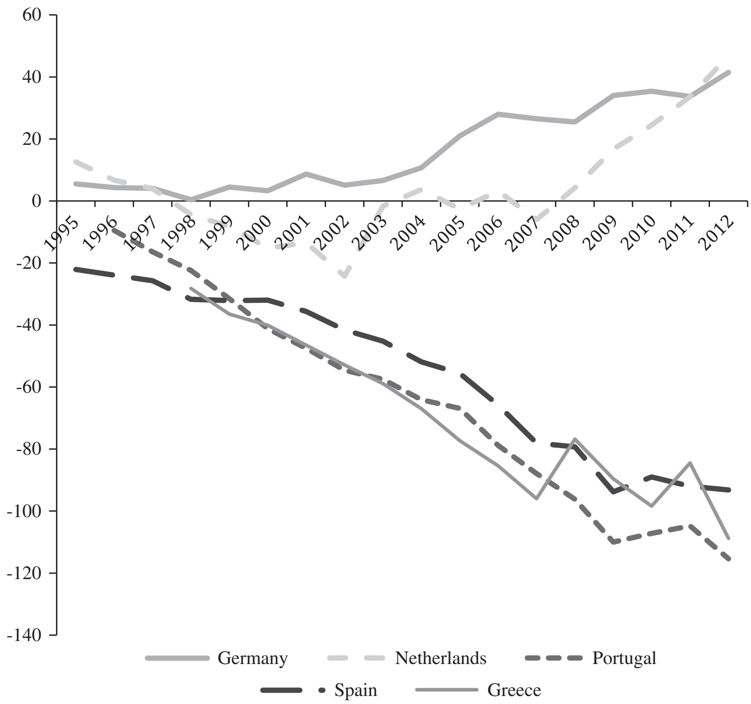

Figure 2: Net international investment as percentage of GDP.
Source: European Commission's Directorate General for Economic and Financial Affairs (2014).

exchange rate restrictions, and began borrowing excessively on the European money markets for domestic consumption. VoC theorists failed to analyse this financial relation because it was focused on the domestic *exporting strategies* of manufacturing firms, which predominately applied to northern CME countries. Therefore, they missed the deep asymmetry of European monetary integration that was emerging.

The myth of market convergence

The increase in capital inflows from the core to the periphery is precisely what the political leaders who signed up to the EMU wanted and got from the single currency (see Moravcsik, 1998, for a formal account). For Germany, it provided an anchor for a stable exchange rate that would benefit its export-driven model within Europe. It removed the volatility of exchange rate fluctuations and the ability of its trading partners to devalue their currencies relative to the Deutschmark. It provided an integrated European finance market that was highly profitable for German banks.

France, on the other hand, feared the economic might of German reunification, and sought a tool that would generate the conditions for a federal Europe that would decrease rather than increase the power of German money. For Ireland, Italy, Spain, Greece and Portugal, the EMU would reduce the cost of borrowing and facilitate capital inflows for national investment. According to Moravcsik (2012), all these countries got what they wanted. This was less a case of economic calculation than distributional politics. The critical mistake was that European policymakers assumed that a convergence in ECB market interest rates, in addition to strict fiscal policies to be embedded in the Growth and Stability Pact, would provide the conditions for an *institutional convergence* in business cycles across diverse capitalist democracies in the Eurozone. This failed to account for the fact that sensitivity to interest rates varies according to *domestic demand* and the propensity to import in each member state.

The assumption of institutional convergence was not present in the negotiations that led to the European Monetary System in the late 1970s. During this period there were competing perspectives between the 'monetarists' and the 'economists' (see Mourlon-Druol, 2012). Policymakers were deeply concerned about the real exchange rate and the inflation differentials that existed between northern and southern European countries, as outlined in Table 2. Absent national central banks and the capacity to actively target the nominal exchange rate, monetary union would exacerbate these differentials. It was for this reason that the German Chancellor, Helmut Schmidt,

Table 2: Nominal exchange rate changes and inflation averages for growth regimes in the EMU11

	Average annual change in the nominal exchange rate		*Average annual change in inflation*	
	1980s (%)	*1990–1998 (%)*	*1980s*	*1990–1998 (%)*
Austria	2.41	1.40	3.84	2.61
Belgium	−0.56	1.33	4.90	2.26
Finland	1.43	−1.27	7.32	2.24
Germany	2.89	2.00	2.90	2.73
The Netherlands	1.84	1.32	3.00	2.60
Export-led average	1.60	0.96	4.39	2.49
Greece	−11.67	−4.83	19.50	12.05
Italy	−2.41	−1.45	11.20	4.38
Portugal	−8.83	−0.87	17.35	6.59
Spain	−2.34	−1.57	10.26	4.44
Domestic demand-led average	−6.31	−2.18	14.58	6.87
France	−1.69	1.92	7.38	2.06
Ireland	−1.33	0.50	9.34	2.39
Oscillating demand/export economies average	−1.51	1.21	8.36	2.23

Note: Data from Johnston and Regan (forthcoming) taken from EU KLEMS (2010) European Commission's Directorate General for Economic and Financial Affairs (2014).

refused to accept a shared currency until there was real convergence in fiscal policy regimes and a commitment to coordinated wage restraint in the labour market.

The monetarists, who ultimately triumphed after Maastricht, argued that monetary union itself would lead to *economic convergence* and eventually a political union in Europe. It was assumed that a single interest rate in finance markets would lead to market convergence, but only if the ECB was constructed in the image of the Bundesbank, and complemented with strict fiscal rules to be imposed on member countries. A deeper analysis, reflecting much economic literature on rational expectations, argued that 'supply side structural reforms' in product and labour markets are what will really drive institutional convergence (see Hall, 2012a, b). Countries that implemented *supply-side* structural reforms aimed at liberalizing their labour markets would generate the conditions for wage flexibility, and therefore develop the capacity to adjust the price of their economies in the aftermath of an asymmetric shock. This is the economic idea that underpins the European response to the crisis today (see Rosamond, 2002, for a more in-depth analysis on the discourse of competitiveness in European economic policymaking).

The problem with the assumption of rational expectations, however, is that it ignores the fact that most euro countries are demand-led. The structural adjustment programmes in southern Europe are premised on the assumption that if governments reduce the welfare state, decentralize collective bargaining and flexibilize the labour market they will eventually generate the conditions to compete with the German export model in international markets. It is certainly true that Germany introduced deeply contested structural reforms in the post-EMU era (usually captured under the 'Hartz reforms'), which created significant political turmoil for both SPD- and CDU-led coalitions. In this regard, Germany has the legitimacy to prescribe structural reforms as a panacea for the economic and employment crises in southern Europe. But it would be a mistake to assume that these liberalizing reforms are the *ultimate reason* behind the competitive resilience of the German economy. CMEs have the strategic capacity to carve out an autonomous response and develop an export-led strategy to complement the monetary constraints of the EMU. Southern European countries do not have this institutional capacity for export-led growth (see Storm and Naastepad, 2014 for a discussion on Eurozone trade).

Hence, while divergent current account imbalances within the EMU certainly indicate the different long-term growth potential of southern and northern European economies, and therefore their capacity to pay off debt and achieve lower interest rates on government bonds, they primarily reflect two different macroeconomic growth regimes (consumption and exports) that became systematically connected through the European financial market. Deficit countries (in the private and public sector) borrowed cheap money from surplus countries to feed domestic demand. This may or may not have crowded out their export sectors. But given that the Eurozone is a semi-closed trading economy, it would have been systematically impossible for all countries to pursue a German export strategy. Each country, for a period, benefited from the import–export exchange. This is precisely what the policymakers of the

EMU had intended. However, they did not achieve their expected institutional convergence in the export organization of national political economies across each member state.

The Impact: Divergence and Debt

The outcome of joining together these qualitatively distinct growth regimes was that post-EMU demand-led European countries experienced a credit boom, fuelling divergent and uncoordinated business cycles (see Figure 3 on credit flows). Investors threw their money at risky investments, leading to asset price bubbles and subsequently private sector debt (see Figure 4). The euro currency as an isolated variable did not *cause* this, but it made some member states extremely vulnerable to financial markets and a sudden stop in capital inflows. This is precisely what happened to Ireland and southern Europe from 2008 to 2012 (Lane, 2012). In the Eurozone, countries experiencing a boom in domestic demand borrowed excessively for either private or public spending. The outcome was strong economic and employment growth in the *domestic* economy. This provided national governments with unprecedented fiscal resources to satisfy the political-distributional demands of their electorates. Hence, the real impact of the EMU was not macroeconomic convergence but an explosion in cross-border capital flows, cheap credit and an inevitable rise in monetary debt cross the previous soft currency regimes (see Figures 4 and 5). None of the peripheral countries had the policy tools to control the awesome power of cheap money. But from a VoC perspective it was perfectly

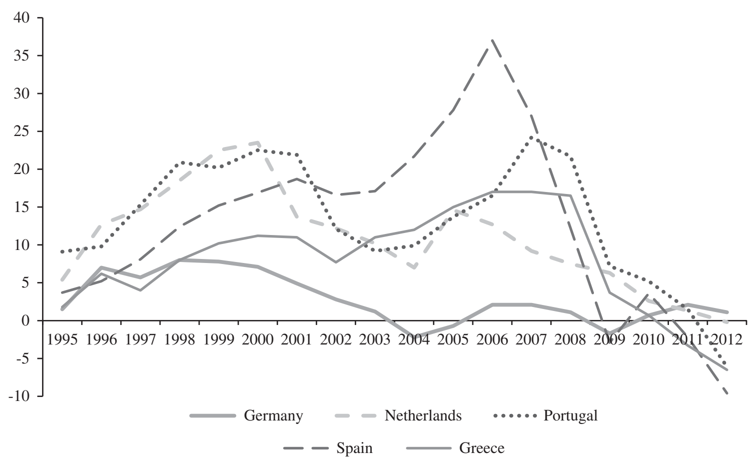

Figure 3: Private credit flows as a percentege of GDP (1995–2012).
Source: European Commission's Directorate General for Economic and Financial Affairs (2014).

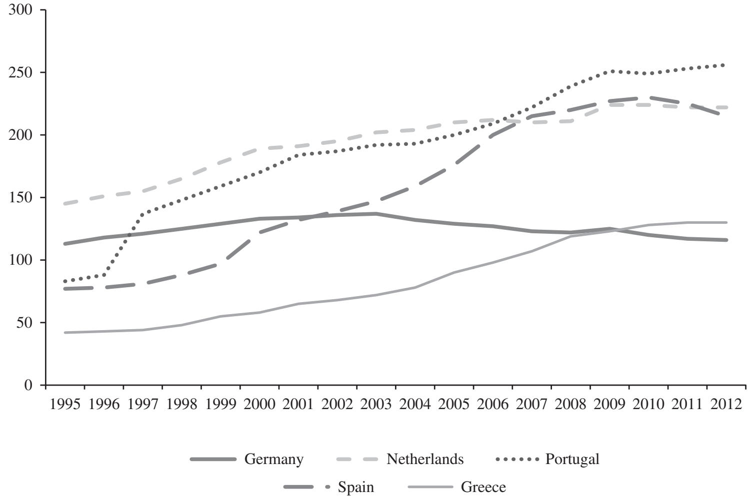

Figure 4: Private debt as a percentage of GDP (1995–2012).
Source: European Commission's Directorate General for Economic and Financial Affairs (2014).

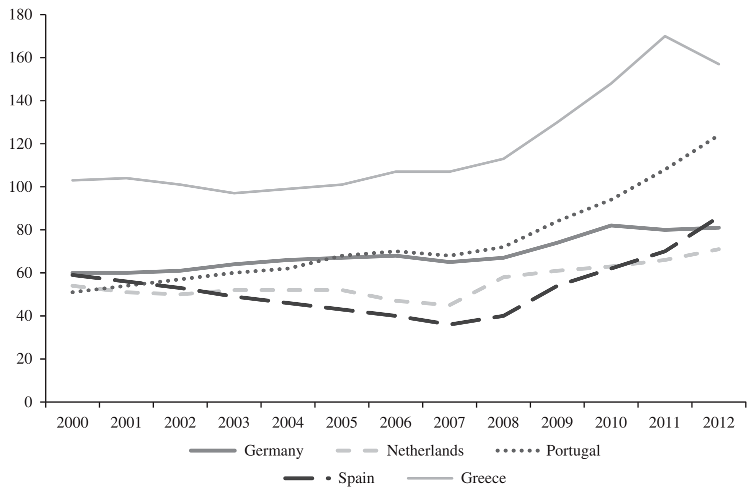

Figure 5: Public Debt as a percentage of GDP (2000–2012).
Source: European Commission's Directorate General for Economic and Financial Affairs (2014).

rational for these countries to take advantage of the absence of exchange rate restrictions. Their domestic, economic and political institutions are more conducive to facilitating domestic consumption than export-led growth. The problem was not economic growth based on domestic demand in itself, but the composition of the investments that were made. In Ireland and Spain the banking sector invested cheap money in the commercial and housing mortgage markets, leading to an asset-price boom (Dellepiane and Hardiman, 2012).

The EMU created the perverse effect of higher inflation rates in countries experiencing a growth in domestic demand when compared to the pre-EMU period. During this period, the ECB was targeting the average Harmonized Consumer Price Index (HCPI) across member states experiencing diverse business cycles. The problem with this measure is that it did not consider asset-price inflation. Hence, the ECB completely missed the impact of house price inflation on national competitiveness, measured in unit labour costs, across the euro periphery. They were primarily focused on traditional product-manufacturing markets, not the financial and/or banking sector.

The divergence in price competitiveness shown in Figure 6 reflects an increase in the overall share of the *non-tradable* sectors (construction, domestic retail and public administration) in the economy. Divergent wage-setting institutions, associated with different VoC, certainly contributed to this, but it was generally caused by the inflow of capital imports from surplus countries with an undervalued exchange rate (Germany). When these capital flows went into reverse during the international financial crisis the deficit countries with over-valued exchange rates got into economic difficulties. Hence, it is not competitiveness *per se* that is the underlying problem of current account imbalances in the north and south of Europe, but the accumulation of *debt* via the capital account (see Jones, 2014).

On the one hand, this can be explained by the fiscal recklessness of political parties in government (Greece), but it was primarily the result of a divergence in domestic

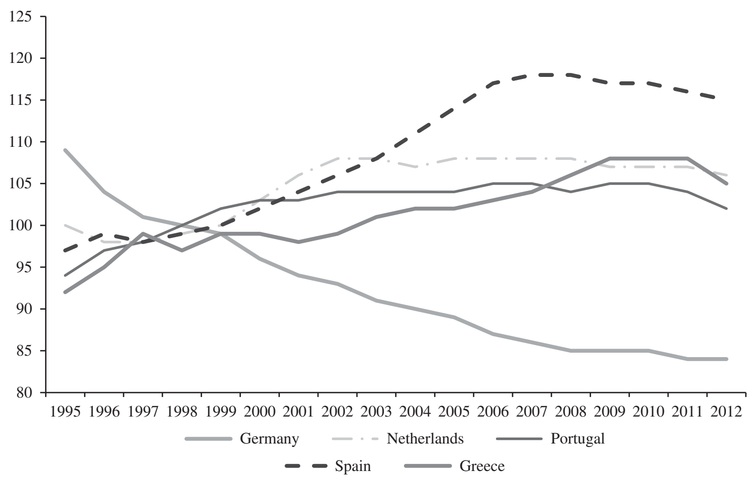

Figure 6: Real harmonized competitive indicators (1995–2012).
Source: ECB statistics (adjusted for Inflation against EMU 17 trading partners).

consumption funded by private finance. This was made possible by an integrated and liberalized European money market that began with the abolition of capital controls in the 1980s, followed by the harmonization of financial regulations in the 1990s, and culminated in the single currency: the EMU.

The political fallout within the EMU when these credit bubbles burst is now part of European history. In Ireland and southern Europe, the level of private and public debt accumulated was quickly made visible to markets. Increased tax revenues made possible by a period of full employment and high growth collapsed when domestic demand contracted. Governments stepped in to guarantee the bad debts of their financial sectors. Fiscal deficits increased and debt-GDP ratios soared (see Figure 5). In the absence of a central bank capable of acting as a lender of last resort, international investors panicked. Government bond yields rapidly diverged and the fragility of the Eurozone was exposed. Greece, Ireland and Portugal were catapulted out of international finance markets and had to resort to ECB-IMF-EU (troika) loans to avoid a sovereign default. In return for this 'bailout' these member states were required to implement an aggressive *internal devaluation*: public sector adjustment and structural reforms, on the assumption that external competitiveness and labour market rigidities are the main obstacles to an export-led recovery (see Monastiriotis *et al,* 2013, and Hardiman and Regan 2013, for a detailed analysis on the impact).

The sovereign-debt crisis soon spread to Spain and Italy. While these countries have not been directly priced out of the international bond markets, they required emergency funding from the ECB to keep their banking systems and economies liquid. In return for this they too must impose structural reforms and cuts in public expenditure. Hence, rather than confront the asymmetric implications of joining together different macroeconomic growth regimes into a shared currency, and propose a shared solution to what is fundamentally a Eurozone wide crisis, European policymakers shifted the burden of adjustment on to the public sector of deficit countries. The policy response of 'internal devaluation' is designed to stabilize the common euro currency and the best way to do this, it is argued, is for member states to converge with the export-led growth model of Germany. But the outcome is to collapse domestic consumption in countries traditionally reliant upon wage-led and subsequently debt-led growth for employment. It is this collapse in imports and the income effect of contracting domestic demand that explains the narrowing of external imbalances since 2012, and rapidly rising unemployment. With the exception of Ireland, southern European countries continue to have a significantly overvalued real exchange rate and the price deflator remains constant (see Figure 6).

The Consequence: Creditor and Debtor Bargaining in Europe

There are four important political observations to be made about the European policy response to the Eurozone debt crisis. First, it is not supranational institutions such as the European parliament or the EU commission that have emerged to coordinate the adjustment, but the *European Council*. The new executive powers that have emerged from the EU Council have created a mode of governance that mirrors an executive federalism with no formal-legislative legitimacy (Habermas, 2012). The outcome is an inter-governmental regime that gives ultimate priority to fiscal austerity and structural reforms as the primary solution to the imbalance of capitalisms at the heart of the Eurozone project. In particular and reflecting the intergovernmental mode of decision making that has emerged, Germany and other export-led economies have succeeded in getting all member states to pursue policies aimed at internal competitive devaluations, and to institutionalize this into a new Eurozone 'fiscal compact'. This has given the EU Council unprecedented procedures and capabilities to both monitor and sanction member states for violating the rules of austerity. It gives ultimate priority to national export competitiveness within the EMU, at the expense of domestic consumption and employment.

Second, the asymmetric implication of pursuing supply-side reforms in the deficit countries, with macroeconomic growth regimes based on consumption, is a collapse in domestic demand. This in turn has led to a divergence in levels of unemployment across the north and south of Europe. At the time of writing, the unemployment rate is 27 per cent in Greece, 26 per cent in Spain, 17 per cent in Portugal and almost 12 per cent in Ireland. The cross-national youth unemployment rate in Spain, Italy, Portugal and Greece varies between 42 and 56 per cent (Gros, 2012). Most of this is the outcome of a contraction in *domestic consumption*, not industrial output. To overcome the unemployment crisis these economies are being encouraged to adopt labour market supply-side reforms, as a complement to fiscal retrenchment, in order to generate long-term economic growth. But there is limited empirical evidence to suggest that these reforms can work in economies dependent upon domestic demand (Baccaro and Rei, 2007). Empirically, it is widely accepted that structural reforms only work as a long-term strategy in a period of strong economic growth, and when complemented by social security policies that ensure high levels of income replacement (Hemerijck, 2012). Since the onset of the crisis the policy response to labour market problems has been dominated by labour market research in ECOFIN. This is narrowly aimed at structural reforms, and underestimates (or is indifferent to) the importance of government consumption and wage demand in sustaining employment.

Third, the priority accorded to fiscal stability and structural reforms that has emerged from the EU Council ignores the central problem facing policymakers in the Eurozone: how to regain control over financial markets. The frustrated attempts to regulate the international financial system are being blockaded by political fragmentation among nation-states. This is particularly the case for CMEs such as Germany, who jealously guard their prerogatives to defend their domestic export sectors, and are therefore reluctant to build new supranational capacities for political action. Simultaneously, countries such as Ireland refuse to accept a coordinated financial transaction tax because of domestic financial interests. The EU policy response, therefore, ultimately, sets the seal on the intergovernmental mode of national regulation, which makes it possible for national governments to narrowly promote the specific interests of their national variety of capitalism, thereby blocking off a coordinated response to rebalance the disequilibrium between the debtor and creditor countries (Fabbrini, 2013).

Finally, and most importantly for the theoretical argument being developed in this article, the northern European-inspired fiscal stability agenda promotes a one-size-fits-all solution that does *not* take into account the need for differential adjustment programmes in the south of Europe. It rules out flexible interventions that are tailored to the specific growth models, institutions and labour market problems of each member state. The underlying cognitive argument used to validate this strategy is the notion of Ricardian equivalence or 'expansionary fiscal contraction'. It is assumed that a shrinking public sector will lead to increased competitiveness in the private sector, which in turn will kick-start an economic recovery based on export-led growth. The subsequent improvement in the current account, it is argued, will send a signal to international financial markets that the government has the capacity to pay back its long-term borrowings. The problem with all of this, of course, is that it is based on assumptions of rational expectations (see Blanchard and Leigh, 2013). It is based on the same logical argument that was used to create the EMU in the first place: that a one-size-fits-all adjustment can lead to convergence in macroeconomic growth regimes. But there is not a complementary institutional fit between the national fiscal and labour market policies of each member state and EMU. Monetary policy remains Europeanized, yet the institutions to transmit this to the real economy remain national, with the result that the various ECB monetary easing programmes since 2011 are not having the assumed expansionary effect on domestic consumption. Banking, much like labour market policies, operate at the national, not European, level (Mody and Sandri, 2012).

Hence, the assumption that an institutional complementarity between all these sub-spheres of the economy can be achieved through the implementation of a singular monetary policy, stricter fiscal rules and labour market liberalization is not possible if one accepts that there are different VoC based around distinct growth regimes in Europe. But it does draw our attention to the complexity of decision making among diverse capitalist democracies in a multilevel polity during hard economic times, and it is on this point that a theory narrowly focused on the nation-state has limited explanatory power. It requires examining the Euro area from an international political economy perspective.

The outcome: Competitive internal devaluation

Political leaders at the national level in creditor and debtor countries are operating in a complex institutional matrix that offers competing incentives and constraints on their behaviour. They have to respond to the popular preferences of domestic electorates to ensure re-election and simultaneously respond to the interests of other political leaders at the EU level, to ensure their membership of the EMU. In the aftermath of the Eurozone crisis this has become an asymmetric tension. Those countries with the most economic resources are in a significantly stronger bargaining position to get other member states to comply with their interests. But simultaneously countries such as Germany must comply with European Union law. The outcome is that member states in the north and south of Europe are compelled to compete with one another through competitive internal devaluations, despite the asymmetric effect on their growth regimes.

Given the structural constraints of the monetary union, the only way to do this is to reduce the price of domestic wages and enhance labour market flexibility. The implication, however, is that those countries who rely upon domestic consumption to generate economic growth are now confronted with the prospect of a permanent decline in domestic demand (no wage or credit growth), growing levels of labour market dualization and high levels of unemployment. All of this could be overcome through a rebalancing of capitalisms within the Eurozone. But the heterogeneity and political interests of the social coalitions underpinning national labour and welfare institutions makes this highly unlikely (Höpner and Schäfer, 2012; Schimmelfennig and Winzen, 2014). It would require Germany to inflate by 5.5 per cent per annum and Spain to deflate by a similar margin (see Hans-Werner, 2012). This is not politically feasible, nor is it legally possible under the existing EU treaties (that is, the mandate of the ECB is price stability).

The EU lacks all the pre-requisites of input legitimacy that characterize a nation-state. There are no European-wide political parties, no European-wide capacity to generate revenue and no directly elected President or European government capable of coordinating the adjustment across debtor and creditor regions. Political cleavages and the public sphere remain an entirely national affair. Hence, the capacity to coordinate a European-wide solution to the Eurozone debt crisis is restricted by the multiple veto points built into sharing sovereignty in a multilevel polity. Policy-making and power relations are diffused across a wide variety of actors and institutions. It is for all these reasons that Scharpf (2009) has long argued that the EU is best characterized as a negative process of market-making that is structurally biased towards the promotion of neoliberal markets. Even if policymakers wanted to turn the EU into a federal system capable of coordinating a balanced adjustment between diverse growth regimes they would be incapable of doing so because of institutional asymmetries. The outcome for Scharpf (2012) is a variant of Hayekian technocracy whereby the ECB is the only actor capable of solving problems.

The European Commission has been replaced by *intergovernmental* Eurozone summits between heads of state as the main forum for political decision making. The Commission subsequently monitors and implements the outcomes, particularly the financial and economic affairs commissioner, reflected in the new 'macroeconomic imbalances and competitiveness' scorecard. This attributes ultimate responsibility for crisis adjustment to government executives at the national level. In a context of crisis management, where creditor countries in northern Europe are being requested to distribute scarce resources to deficit countries in the south, this shift to national bargaining should not be surprising. But it draws our attention to the asymmetrical influence of countries with export-led macroeconomic growth regimes in designing the structural adjustment programmes in southern Europe. Hence, the crisis of the monetary union in Europe has exposed the absence of coordinated problem-solving capacity in the single currency.

The outcome is that national governments are compelled to internalize the adjustment pressures associated with the single currency and implement national supply-side reforms of the labour market. Debtor governments, even if they wanted to, would not be able to adopt a variegated response that would stimulate the demand side of the macroeconomic equation (either by wage increases or public spending). This could be justified if fiscal consolidation and supply-side reforms solved the diverse economic problems facing these countries (that is, output legitimacy). The IMF (Blanchard and Leigh, 2013), among a whole host of other commentators, has since concluded that this is not the case. The question, therefore, is whether there are substitute instruments at the national level that go beyond 'supply-side' reforms in southern Europe and can lead to a rebalance of path-dependent capitalisms in the Eurozone?

Discussion: Rethinking the Political Economy of European Integration

It is worth re-examining the question on external imbalances in the EMU in order to answer the question as to whether the imbalance of capitalisms in the euro can be structurally reversed. The first and dominant explanation for external imbalances is that unit labour costs increased in the south relative to Germany. In the second explanation, the crisis was caused by an increase in the money supply. In the first case, the external imbalances were caused by a loss of competitiveness that is to be resolved through supply-side reforms and pay cuts. In the second case the competitiveness crisis was caused by financialization. Both agree, however, that internal devaluation is necessary to reduce domestic prices and wages. These perspectives differ on the causal mechanisms through which external imbalances occurred, but both are premised on the classical political economy assumption that current account imbalances are the *outcome* of countries not selling enough 'real' goods and services to their trading partners, and hence they both agree that money is *exogenous* to the real economy. But if we accept that some countries are *endogenously* conducive to an export-led or a domestic consumption-led capitalist growth regime, and that these became systematically dependent upon one another through euro-finance markets, then this classical political economy equation becomes deeply problematic. It mistakes cause for effect.

Membership of the EMU compels member states to adopt labour market supply-side reforms as a tool of adjustment in a recession because the implicit design of the monetary union assumes that current account imbalances are an external competitiveness problem created by wage inflation. VoC theory broadly accepts this classical political economy assumption. It differs by arguing that surplus countries have avoided a competitiveness crisis through their coordinated wage-setting institutions (see Hancké, 2013). In the context of a fixed exchange rate, supply-side reforms, should therefore facilitate an export-led recovery (even if it comes at the expense of increased inequality and enhanced labour market dualization). This theory can be applied to countries with an export-led macroeconomic growth model. But it is not applicable to countries reliant upon domestic consumption, and inflationary tendencies, for economic and employment growth. In Spain, Portugal and Greece exports account for between 20–25 per cent of GDP.

Many economists argue that Germany and other surplus countries should reflate their domestic economy and pursue a more neoliberal response to the crisis (see Buti, 2012, 2014) That is, they should spend more, let banks fail and encourage precisely what has happened in the United States. But given the export-oriented macroeconomic model endogenous to the political coalition underpinning the German growth regime, this is not likely to occur. The *proximate cause* of Germany's capacity to internalize the monetary constraints of the Eurozone can be traced to wage restraint and the supply-side labour market adjustments (popularly referred to as the 'Hartz' reforms) mentioned in the section 'The consequence: Creditor and debtor bargaining in Europe'. These are now being explicitly used by the DG for ECFIN as the model prescription for deficit countries with high levels of unemployment. But the core insight from comparative political economy on the *ultimate cause* of German export-competitiveness is that its growth regime is built around a path-dependent industrial infrastructure based on highly specific price-inelastic niche export markets.

Hence, if one accepts that the EMU has joined together distinct and path-dependent capitalist growth regimes, then there are four choices facing deficit countries if they want to retain membership of the currency union: accept trade imbalances and finance them through an increase in capital imports, reject the focus on export competitiveness and promote a wage-led recovery through enhanced domestic demand, spend the fiscal resources necessary to develop the productive capacity to compete with the German export model, or carve out an autonomous economic and growth strategy that is distinctively 'southern European'. Given the legal and political constraints of the EMU, the only possible solution is to pursue the second and last options. Both require some variant of inflationary wage-led growth. This can only come about if European policymakers accept that the causal source of the euro crisis was a debt-financed boom in domestic demand, rather than a loss of competitiveness in the export sectors. It is precisely the sustainability of a wage-led recovery that remains a crucial and unexplored part of the debate about the political economy of contemporary capitalism today.

This article has argued that the attempt to join together different VoC into a single currency without a central government is the real source of the Eurozone crisis. It hypothesized that the imbalance of capitalism can be traced to competing growth models (export and consumption) that became systematically dependent on one another with the onset of monetary union and financial market integration. The divergence in these capitalist growth regimes can be empirically observed in the capital flows, real exchange rates and net international investment positions of deficit and creditor countries. It is not national wage-setting institutions or competitiveness *per se* that is the core problem facing the EMU, but private debt created by financial markets. The *one-size-fits-all* policy response of fiscal consolidation and supply-side structural reforms perpetuates the myth of market convergence that caused the crisis because it continues to assume that all member states can generate the conditions for export-led growth. This, however, is systematically impossible in a semi-closed trading area such as the Eurozone. The structural effect of the single currency, therefore, is to exacerbate the imbalance of capitalisms within the EMU of Europe. In this sense, financial market de-regulation did not unravel the national CMEs of Europe, but it has fundamentally changed the political economy of European integration.

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