THE EURO CRISIS AND THE EROSION OF DEMOCRATIC LEGITIMACY: LESSONS FROM THE GOLD STANDARD

by

Matthias M. Matthijs
Assistant Professor of International Political Economy
School of Advanced International Studies
Johns Hopkins University
DC 20036
Tel: +12026635743; e-mail: matthijs@jhu.edu

American Consortium on European Union Studies (ACES)
EU Center of Excellence Washington, D.C.

ACES Cases, No. 2013.3

Stephen J. Silvia, American University, editor

Abstract

This paper makes four propositions. First, it argues that the euro's institutional design makes it function like the interwar gold exchange standard during periods of stress. Just like the gold exchange standard during the 1930s, the euro created a 'core' of surplus countries and a 'periphery' of deficit countries. The latter have to sacrifice their internal domestic economic equilibrium in order to restore their external equilibrium, and therefore have no choice but to respond to balance of payments crises by a series of deflationary spending, price and wage cuts. The paper's second claim is that the euro's institutional design and the EU's response to its 'sovereign debt crisis' during 2010-13 deepened the recession in the Eurozone periphery, as EMU leaders focused almost exclusively on austerity measures and structural reforms and paid only lip service to the need to rebalance growth between North and South.

As Barry Eichengreen argued in *Golden Fetters*, the rigidity of the gold standard contributed to the length and depth of the Great Depression during the 1930s, but also underscored the incompatibility of the system with legitimate national democratic government in places like Italy, Germany, and Spain, which is the basis for the paper's third proposition: the euro crisis instigated a crisis of democratic government in Southern Europe underlining that democratic legitimacy still mainly resides within the borders of nation states. By adopting the euro, EMU member states gave up their ability to control major economic policy decisions, thereby damaging their domestic political legitimacy, which in turn dogged attempts to enact structural reforms. Evidence of the erosion of national democracy in the Eurozone periphery can be seen in the rise of anti-establishment parties, and the inability of traditional center-left and center-right parties to form stable governments and implement reforms. The paper's fourth proposition is that the euro's original design and the Eurozone sovereign debt crisis further widened the existing democratic deficit in the European Union, as manifested in rising anti-EU and anti-euro sentiment, as well as openly Eurosceptic political movements, not just in the euro periphery, but also increasingly in the euro core.

The decisions of central bankers, long regarded as obscure, became grist for the political mill [during the 1930s]. The monetary authorities were attacked from the left for upholding outdated monetary doctrines and from the right for pandering to the demands of the masses. They consequently lost much of the insulation they once enjoyed.

Barry Eichengreen[1]

A central ingredient in the success of embedded liberalism […] has been its ability to facilitate the externalizing of adjustment costs. […] The primacy of domestic objectives over external financial discipline was established in the interwar period. The Bretton Woods adjustment process, when it worked, worked primarily to devalue the currencies of deficit countries and consequently to increase their domestic prices.

John Gerard Ruggie[2]

Monetary union means a restriction in national sovereignty, on national maneuvering room and the ability to go it alone. Participants lose the instrument of exchange rate adjustments. That strengthens pressures towards internal flexibility. In a monetary union, countries have to tackle and solve their economic problems and challenges in a similar way and with similar speed. If the countries decide fundamentally different answers, then great problems will arise.

Hans Tietmeyer[3]

[1] Barry Eichengreen, *Golden Fetters: The Gold Standard and the Great Depression 1919-1939*, New York: Oxford University Press, 1992, p. 9
[2] John Gerard Ruggie, "International Regimes, Transactions, and Change: Embedded Liberalism in the Postwar Economic Order," *International Organization* 36 (2), spring 1982, p. 413-415
[3] Hans Tietmeyer, President of the German Bundesbank from 1993 to 1999, said this in a speech in Florence (Italy) on November 28, 1996. Quoted in David Marsh, *The Euro: The Battle for the New GlobalCurrency*, New Haven: Yale University Press, 2011, p. 200

1. The Euro Crisis and the Consequences of Dis-Embedding Liberalism

This paper is not about the various causes of the Eurozone crisis, nor is it about the euro experience that led up to the sovereign debt crisis; it is about the ideational climate that underpinned the institutional design flaws of the euro and the consequences of those decisions made in the early 1990s. The ideas that informed the euro's institutional design would 'lock in' the future domestic response to the crisis and would make the politics of economic adjustment in Europe very problematic. In order to better understand the design flaws of the euro, and the sovereign debt crisis that resulted from it in 2010, we need to go back to the different lessons that were learned in Europe and the rest of the world from the collapse of the Bretton Woods system in the early 1970s.

This paper will explain the length and depth of the euro crisis as the logical consequence of the euro's institutional design, which was the result of an ideational consensus on sound money, price stability and ordo-liberal rules.[4] My first claim is that given its institutional setup agreed to in the early 1990s, the Eurozone worked in a similar manner as the interwar gold exchange standard during periods of economic stress. Also, just like the gold standard, the euro created a core of surplus countries and a periphery of deficit countries, in which the latter had to sacrifice internal domestic economic equilibrium in order to restore external equilibrium, and thus had no choice but to respond to balance of payments crises by a series of deflationary spending, price and wage cuts. My second claim is that the euro's institutional design and the EU's response to its sovereign debt crisis during 2010-13 has deepened the recession in the Eurozone periphery, as EMU

[4] See Kathleen R. McNamara, *The Currency of Ideas*, Ithaca: Cornell University Press, 1998.

leaders have focused exclusively on austerity measures and structural reforms and lack any coordinating strategy to rebalance growth between North and South.

As Barry Eichengreen has argued in *Golden Fetters*, the rigidity of the interwar gold standard contributed to the length and depth of the Great Depression during the 1930s. But he also underscored the incompatibility of the gold standard with legitimate national democratic government, as evidenced during the 1930s in Italy, Germany, and Spain.[5] My third claim builds on Eichengreen's observation, i.e. that the euro crisis instigated a crisis of democratic government in Southern Europe – not wholly unlike the one in the 1930s – and served as a reminder to Brussels that democratic legitimacy still mainly lied with the nation state level. By adopting the euro, EMU member states gave up their ability to control major economic policy decisions, thereby damaging their domestic political legitimacy, which has in turn dogged attempts to enact deep structural reforms. Evidence of the erosion of national democracy in the Eurozone periphery can be seen in the rise of anti-establishment parties and the inability of moderate center-left and center-right parties to form stable governments and implement reforms in Europe's Mediterranean periphery countries. My fourth claim, following from the third, is that the Eurozone sovereign debt crisis has further widened the existing democratic deficit in the European Union, as manifested in rising anti-EU and anti-euro sentiment, not just in the periphery, but also in the Eurozone core.

[5] Eichengreen, 1992; and Barry Eichengreen, "Is Europe on a Cross of Gold?" *Project Syndicate*, 11 May 2002. Online available at: http://www.project-syndicate.org/commentary/is-europe-on-a-cross-of-gold-

Background

The euro was legally born on February 7, 1992 when twelve countries signed the "Treaty of European Union" in Maastricht, a Dutch provincial city on the left bank of the river Meuse, one of medieval Europe's main commercial waterways. At the time, the creation of the single currency was praised as a visionary act of international statesmanship and a courageous step towards European political unity. The reasoning behind the idea seemed straightforward: through further economic convergence, EU member states would better align their core national interests and grow into a more politically integrated region, thereby forever relegating any potential military conflict between them to the distant past.[6] With the bedrock of the international state system still trembling from a triple shock – the fall of the Berlin Wall in 1989, the reunification of Germany in 1990, and the collapse of the Soviet Union in 1991 – Economic and Monetary Union (EMU) was Europe's imaginative and bold response to the new geopolitical landscape.[7]

EMU would incorporate a recently reunified Germany into an 'ever closer union' and tie Berlin's fate to the rest of Europe through a common currency and a common monetary policy. It would also reassure France and the rest of Germany's neighbors that the long dormant 'German problem' – a strong German state at the heart of Europe that was either too dynamic or too big for the rest of the continent – would never again resurface. Moreover, European elites widely shared the view that the forces of globalization, mostly evident in rapidly rising international trade and capital flows, meant a substantial hollowing out of the traditional nation-state, and therefore would require an answer at the

[6] See, for example, Ernst B. Haas, *Beyond the Nation State: Functionalism and International Organization*, Palo Alto: Stanford University Press, 1968
[7] David P. Calleo, *Rethinking Europe's Future*, Princeton: Princeton University Press, 2003, chapter 11

supranational level.[8] EMU was therefore also seen as the vehicle that would enable Europe to compete as a unified economic bloc with a rising Japan, a nascent North American free trade area, and other emerging giants, mainly in East and South Asia.[9]

In 2012, twenty years after the euro was born in Maastricht, and in the midst of the fog of a deep European 'sovereign debt crisis', most observers agreed that the single currency was part of a deeply flawed and poorly designed monetary union. While for most economists the problem was that the Eurozone did not meet any of the criteria that would have qualified it as an 'optimum currency area' (OCA), most political scientists saw an incomplete and half-finished monetary union, lacking a true fiscal and banking union, and bereft of a common debt instrument to deter the flight to safety out of crisis-stricken member countries. Some analysts took it one step further and compared the euro to Dr. Strangelove's "Doomsday Machine" – a scheme devised to eventually trigger a financial Armageddon, but once created, impossible to un-trigger.[10]

Crisis

What had happened? From the mid-1990s onwards, once economic growth had returned after the 1992-93 EMS crisis and recession, Northern European capital – in search of higher yields – had flowed *en masse* into Southern European markets in anticipation of the formal introduction of the euro in 1999. Institutional investors and many other

---

[8] See Alan S. Milward, *The European Rescue of the Nation State*, London: Routledge, 2nd edition, 2000

[9] See Calleo, chapter 12

[10] The reference is to Stanley Kubrick's cult movie "Dr. Strangelove," a Cold War black comedy starring Peter Sellers, the inventor of the machine. See, for example, Edward Hugh, "Dr. Strangelove and the euro 'Doomsday Machine'" *CNN Business 360*, 22 September 2011. Available online at: http://business.blogs.cnn.com/2011/09/22/dr-strangelove-and-the-euro-doomsday-machine/ and Hugo Brady, "Europe needs a Rooseveltian break with fear," *Centre for European Reform*, 27 July 2012. Available online at: http://www.cer.org.uk/publications/archive/bulletin-article/2012/europe-needs-rooseveltian-break-fear

financial market participants implicitly assumed that the impending adoption of the euro in those countries was a *de facto* guarantee against any future sovereign default, which shaved off most of the existing national risk premiums that had prevailed on Mediterranean country bonds. The initial result of these financial flows was rapid interest rate convergence, which held as long as economic times were relatively good – between 1998 and 2008 – and seemed to vindicate the view that the euro had brought about deeper economic integration in the Eurozone. But rather than leading towards convergence, as anyone just focusing on EMU sovereign bond spreads would have discerned, this process had actually resulted in unsustainably large intra-European balance of payments disequilibria.

Over the years, EMU gradually widened the pre-existing gap between a financially more orthodox Northern core of 'surplus countries' that mainly saved, invested, produced and exported, and a debt-laden Southern periphery of 'deficit countries' that predominantly borrowed, consumed and imported.[11] This economic divergence, made possible by the euro's institutional design, which allowed capital to flow freely and quasi risk free across EMU borders, created the fertile soil for the European sovereign debt crisis. When the bankruptcy of US investment bank Lehman Brothers in the autumn of 2008 triggered the Global Financial Crisis, the Eurozone's structural imbalances would be exposed.[12] The main consequence for the periphery of such a crisis was a painful process of economic

[11] One could make the comparison with the U.S. housing market between 1997 and 2007. There, a growing imbalance was created between aggressive lenders on the one hand, implicitly backed by quasi-government owned agencies Fannie Mae and Freddie Mac, and increasingly 'subprime' borrowers taking on excessive mortgage debt on the other hand.

[12] As Warren Buffett once remarked: "It's only once the tide goes out that you learn who's been swimming naked." As quoted in The Economist, "Indecent Exposure," 5 August 2007. Online available at: http://www.economist.com/node/9609521

adjustment, given that by joining the euro they had given up two national shock absorbers – devaluation and inflation – leaving austerity (or deflation) as the only viable option on the table. In the absence of any solidarity mechanism at the EU level – where the North would inflate while the South would deflate, or fiscal transfers from North to South to ease the financial blow – the whole burden of adjustment fell onto the periphery, even though the core was just as much to blame for the crisis. In a cruel twist of irony, the sovereign debt crisis thereby reawakened old political divisions on the European Continent; the very problem the euro was introduced to put to rest once and for all.

In their scramble to keep the euro together, the North – led by Germany – insisted that the periphery's 'irresponsible borrowing' was to blame for the crisis. The periphery countries therefore needed to implement strict budgetary austerity measures and enact far-reaching structural reforms, which were considered to be necessary medicine to rebalance their economies. Many in the South – especially in the big economies of Italy and Spain – retorted that those policies were misguided and only focused on the borrowers while giving the lenders in the North a 'get out of jail free' card. Austerity only made the debt problem worse in the short term, lacked any symmetric response of stimulus and inflation in the North, and ultimately threatened to tear apart the already fragile social fabric in periphery countries. Hence, there was a real danger that continued austerity would lead to political extremes, which would only serve to accelerate the breakup of the Eurozone, as the argument in the South went.

The long duration and depth of the euro crisis, which plunged the Eurozone back into recession by the end of 2011, has not only called into question the wisdom behind the euro’s original design, or the overall logic of economic integration underpinning ‘ever closer union,’ but has also caused a crisis of democratic governance in the EU. Policy matters previously thought to be the primary responsibility of the nation state level – such as labor market policies, social security, budgetary priorities, taxation policies and the overall size of a government’s bureaucracy – now fall increasingly under the direct supervision of the European Commission in Brussels. As national leaders, especially in the Eurozone periphery, started to realize that the euro was no longer a magical instrument that enabled them to borrow at low German rates, but a compact that severely constrained their national economic policy options, long-standing left-right divisions between ‘Latin’ *Neo-Keynesians* (who focus on demand stimulus and are in favor of more policy discretion) and ‘Germanic’ *Ordo-Liberals* (who rely on strict rules and emphasize deficit reduction and austerity) on how to respond to a severe recession reemerged front and center in the overall EU debate.

As the euro crisis intensified, the monetary policy decisions of the European Central Bank in Frankfurt became gradually more politicized, while the fiscal policy decisions by the national governments came under increasing scrutiny by the European Commission. The consensus that existed from 2003 onwards, prior to the euro crisis, i.e. that monetary policy needed to be focused solely on price stability and fiscal policy be conducted by rule (The Stability and Growth Pact’s 3 percent deficit-to-GDP and 60 percent debt-to-GDP ratios), but should allow for some substantial political discretion during hard times, would be shattered by the euro crisis in the summer of 2010.

Structure of the Paper

The paper will proceed in six further sections. Section two sets up the theoretical framework of the politics of economic adjustment during crisis periods. It will propose a simple typology on how to better understand the distributional consequences of the chosen method of adjustment. This section will also analyze the changing European consensus on the use of monetary and fiscal policy from 2003 onwards and lay out one by one the four propositions of the paper, which will then be elaborated upon in the subsequent four sections. Section three makes the case for comparing EMU with the interwar gold exchange standard, focusing on the method of domestic adjustment during periods of stress. Section four examines the economic impact of Europe's response to its sovereign debt crisis in the four 'peripheral' countries of the Mediterranean, i.e. Greece, Italy, Portugal and Spain (GIPS) and compares it with the policy response to and the impact of the 1992-93 EMS crisis, when all four shock absorbers were still technically on the table. Section five focuses on the domestic impact of austerity on political legitimacy in the four GIPS countries, while section six discusses the rise of anti-EU sentiment and the EU's growing democratic deficit in this context. Section seven concludes.

2. The Politics of Adjustment: Theoretical Framework and Four Propositions

There exists already a rich and influential academic literature that deals with the politics of economic adjustment during periods of crises, much of which examined the different national responses during the Great Depression of the 1930s, or the Great Stagflation of the 1970s.[13] This literature focuses either on structural forces, such as globalization or

[13] See, for example, Peter Katzenstein, *Small States in World Markets: Industrial Policy in Europe*, Ithaca: Cornell University Press, 1985; Peter Hall, *Governing the Economy: The Politics of State Intervention in*

‘Europeanization’ which redefine interests, the mechanics of coalition building during periods of uncertainty, the path dependent power of institutions, or the path shaping power of ideas. Zeroing in on interests, institutions, or ideas as its main independent variable, this literature tries to explain a country’s domestic policy response to international economic crises, using various rational choice, historical, or constructivist lenses.

These different theoretical approaches have given us great insights into the political economy of economic crises and most of these studies, some of them truly path breaking, have looked at major advanced industrialized countries that had significant ‘political agency’ or policy maneuver room during hard economic times. One of the main points this paper makes is that exactly such agency was crucially absent in the member states of the Eurozone during the sovereign debt crisis that started in 2010, given the institutional design of the euro.

a. Method versus Burden of Adjustment

A useful way to approach the political problem of economic adjustment is to differentiate between the ‘method of adjustment’ a government will embrace in the face of a crisis, and which socio-economic groups – can either be domestic or international – will suffer the main ‘burden of adjustment.’ Table 1 below proposes a new typology of how to think about the four main possible policy responses or shock absorbers during a crisis. The

---

Britain and France, Oxford: Oxford University Press, 1986; Peter Gourevitch, *Politics in Hard Times: Comparative Responses to International Economic Crises*, Ithaca: Cornell University Press, 1986; Beth Simmons, *Who Adjusts? Domestic Sources of Foreign Economic Policy during the Interwar Years*, Princeton: Princeton University Press, 1994; Mark Blyth, *Great Transformations: Economic Ideas and Institutional Change in the Twentieth Century*, Cambridge: Cambridge University Press, 2002; and Matthias Matthijs, *Ideas and Economic Crises in Britain from Attlee to Blair*, London: Routledge, 2010.

method of adjustment can either be mainly 'internal' (deflation or inflation) or 'external' (devaluation or default); while the burden of adjustment can either fall broadly on debtors or creditors (national or foreign), or alternatively, on domestic workers or owners of capital.

Table 1: Typology: Method vs. Burden of Adjustment

<table>
<tr><td rowspan="4">Method of Adjustment</td><td rowspan="2"></td><td colspan="2">Burden of Adjustment</td></tr>
<tr><td>Debtors/Workers</td><td>Creditors/K Owners</td></tr>
<tr><td>Internal</td><td>DEFLATION (austerity measures)</td><td>INFLATION (demand stimulus)</td></tr>
<tr><td>External</td><td>DEVALUATION (currency realignment)</td><td>DEFAULT (debt restructuring)</td></tr>
</table>

The first possible response, 'deflation,' in the top-left quadrant, usually entails a combination of spending cuts and tax increases on the fiscal side and interest rate increases on the monetary side and is transmitted into the macro economy mostly internally, i.e. by affecting domestic economic activity in the short term and lowering an economy's wages and prices in the medium term. The main burden of adjustment in the case of austerity falls on either debtors, who see the real value of the debts they owe increase, or on workers, who tend to have relatively little savings, and might suffer either through lower nominal wages (and fixed rent or mortgage payments, for example), lower benefits and less generous government services, or higher unemployment. Creditors and capital owners, on the other hand, will see the real value of their savings and outstanding loans increase, and will generally be better off.

The second possible response, 'inflation,' in the upper-right quadrant, is the other 'internal' method of adjustment, usually enacted through direct increases in government spending and cuts in taxes on the fiscal side, or interest rate cuts on the monetary side, and normally has a short-term effect on stimulating domestic economic activity by pushing up aggregate demand, and raising prices and wages in the medium term. In this case, the burden of adjustment will mainly fall on creditors and capital owners, who will experience a drop in the real value of their capital and savings, while debtors and workers will tend to benefit, either through lowering the real value of their outstanding loans, higher nominal wages, or better employment and promotion prospects.

The two domestic policy responses in the bottom row of table 1 will primarily affect economic activity through the balance of payments; hence I refer to these as the two 'external' methods of adjustment. In the bottom-left quadrant, a government can choose a policy of 'devaluation,' i.e. to lower the value of its currency vis-à-vis its main trading partners, which will give a short-term boost to exports and make domestic firms more competitive with foreign firms, but will lower the purchasing power parity of workers and pensioners, whose nominal incomes are fixed, and who will bear the brunt of the adjustment since devaluation usually goes hand in hand with higher prices of imported goods and services. Debtors who have outstanding loans in foreign currencies will also be significantly worse off. However, this quadrant is a bit more complicated, since workers in export industries might be able to keep their jobs, and benefit from devaluation in that way, and obviously capital owners will also see their purchasing power damaged by devaluation. So, devaluation tends to hit debtors and workers more, but also harms capital owners, depending on their consumption patterns. It is probably the response that spreads the burden of adjustment the most equally across society.

The final response, 'default,' signifies that the government chooses not to make good on its promise to pay back its outstanding sovereign debt, either partially or not at all, which will mainly affect the creditors to the government and capital owners in the short term. In the case of debt restructuring, the government's creditors could either be domestic citizens or foreign nationals. If foreign nationals hold most of the outstanding debt, the default option becomes considerably more attractive for a government, given that the domestic fallout from default will be relatively restrained, passing on the burden of adjustment to foreigners. This final option usually leads to a deep recession, which will affect all socio-economic groups in society, and is usually considered only as a last resort.

Between 1945 and the early 1970s, countries in financial distress could dispose of all four economic shock absorbers (or a combination thereof) to help them out of a crisis. What John Ruggie called the "embedded liberal" compromise, which was struck in 1944 at Bretton Woods, had incorporated the main lessons from the Great Depression and allowed countries to combine internal (full employment) with external (balance of payments) equilibrium through a system of fixed exchange rates, capital controls and domestic discretion over monetary policy. Nixon's closure of the gold window in 1971 heralded the beginning of a new era of flexible exchange rates, deregulation, and rising international capital flows. Most industrialized countries – including the U.S., Japan, Britain, Australia, and Canada, and later the emerging economies of China, India and Brazil – kept all four shock absorbers firmly on their menus. While everybody talked the talk of market discipline and strict economic policy rules during the early 1990s, in practice they were all careful enough to preserve their domestic fiscal and monetary policy levers with a variety of capital controls, exchange rate measures, and downright prohibitions.[14] In other words, they all firmly preserved the main tenets of the embedded liberal compromise.[15]

The exception was continental Europe, where France and Germany, along with other members of the then European Community, gradually surrendered their national economic sovereignty and eventually agreed to tie their economic fate together by creating a single currency – the euro – in the early 1990s. With the euro's adoption, EMU members put in place a forever-fixed exchange rate to supplant their national currencies, controlled by an independent central bank focused exclusively on price stability, but with no de facto lender of last resort functions or common debt instrument. By doing so, European leaders removed two shock absorbers, inflation and devaluation, from their menus of choice. Given the growing importance of international financial markets, and the importance of sovereign credit ratings for the liquidity of most countries' bond markets, default also became a much less appealing option, in effect leaving deflation as

[14] See Matthias Matthijs, "How Europe's New Gold Standard Undermines Democracy," Harvard Business Review Blog Network, August 24, 2012. Online available at: http://blogs.hbr.org/cs/2012/08/how_europes_new_gold_standard.html
[15] Ruggie, 1982

the only possible response. By constructing the euro, European elites in effect 'disembedded' the Bretton Woods compromise from their national politics, but without putting in place a supranational mechanism of solidarity. During a crisis, international commitments would again take precedence over domestic concerns, just like they did during the interwar gold standard.[16]

Most advanced industrial countries – from the U.S. to Britain, and Japan to Brazil – could spread the burden of adjustment over their political economy's different constituencies, making the politics of adjustment during hard times a lot more sustainable and less 'political.' In the Eurozone, on the other hand, where countries in the periphery suffered a series of liquidity and solvency crises, the only possible domestic response was austerity, given the euro's institutional design adopted in the early 1990s. This of course put the main burden of adjustment on debtors and workers, seemingly letting off creditors and capital owners Scot-free. In a political climate, which puts at least part of the blame for the crisis on excessive lending and 'reckless' bond investors, and with an increasing income gap between rich and poor, higher levels of poverty and rising unemployment, the proposition that a majority of a democracy needs to suffer the main burden of adjustment – in higher taxes, lower wages, and lower public benefits – is bound to be problematic. Furthermore, if such a policy, with significant distributionary consequences, would be imposed from a growingly unpopular supra-national entity in Brussels, no matter what political outcome national elections produced, the limits of legitimate democratic governments would be tested.

[16] Eichengreen, 1992

b. Eurozone: Supra-national Monetary Policy vs. National Fiscal Policy

During the mid-1990s, the overriding consensus in Europe was for a politically independent central bank, with a narrow mandate to focus on price stability, and the need for economic convergence. At the insistence of Germany and the Bundesbank, the Maastricht Treaty established a series of convergence criteria on budget deficits, levels of inflation, long-term interest rates, and overall levels of debt, which formed the foundation for the Stability and Growth Pact (SGP) that was agreed upon by Europe's leaders in 1997. At the heart of the SGP was the 3 percent deficit-to-GDP rule, and an 'excessive deficit procedure,' since many European countries, most notably Italy and Belgium, had overall debt levels well in excess of the maximum 60 percent of GDP as determined by the SGP. Limiting member countries' annual fiscal deficits was seen as the most crucial step for the launch of the euro in 1999, and afterwards, for the Eurozone's stability.[17] As has been well documented by now, both central founding members – France and Germany – were actually the first two countries to break the 3 percent rule in 2003, triggering an excess deficit procedure by the European Commission in Brussels, which was blocked by the European Council, made up of heads of state. Romano Prodi, the President of the Commission at the time, famously called the SGP "stupid," in reference to its rigidity in applying the deficit rule, and pointed out that more flexibility would be needed to interpret the rules going forward.

[17] Marsh, 2011, pp. 202-11

Table 2: Changing Consensus on Economic Policy in the Eurozone (2003-2013)

		Economic Policy Tool	
		Fiscal Policy	Monetary Policy
Timeframe	2003-2010	**Discretion** (Tax and spending legitimate domain of national politics)	**Rule** (ECB sole mandate of price stability, no debt monetization)
	2010-2013	**Rule** (Balanced budgets cornerstone of new Fiscal Pact – 'quasi-automatic' sanctions)	**Discretion** (LTROs, OMTs) (Role ECB much more 'politicized' since euro crisis)

The fiscal transgressions of both Berlin and Paris led the European Council to relax the SGP in 2005, by allowing more political discretion in deciding whether a breach of the 3 percent rule was truly a violation of the spirit of the Pact. The 3 percent and 60 percent rules were maintained, but the decision to start an excessive deficit procedure against a member country now relied on a set of predetermined parameters. These included the exact moment in the business cycle, the overall level of debt, the duration of a period of slow growth, or whether the deficit was mainly the result of structural reforms that had been enacted and would lower the deficit permanently over the longer term, as had been the case of Germany in the early 2000s. So, from 2003 onwards, there was a new reigning consensus on the use of fiscal and monetary policy in the Eurozone. Monetary policy remained under the technocratic control of the ECB, and was conducted 'by rule.' The ECB's only mission was to maintain price stability as measured by an inflation rate of “close to but below 2 percent.” On the fiscal side, the reforms of the SGP in March 2005 allowed for considerably more political discretion over levels of domestic spending and taxation, even though member states promised to remain faithful to the 3 percent norm. From 2005 onwards, fiscal policy was firmly under the political control of the national governments. This consensus is summed up in the top row of table 2.

With the onset of the European sovereign debt crisis in 2010, there has been a marked shift in the consensus on monetary and fiscal policy in the Eurozone. With Greece’s admission in the fall of 2009 that its deficits were a lot higher than earlier reported, the main cause of the crisis was believed to be ‘fiscal’ and the 2005 reforms of the SGP was seen as one of the main culprits for letting the proverbial fiscal cat out of the bag. The argument went that as soon as France and Germany, the two founding members of EMU, broke the rules, and were let off without punishment by the European Commission, this opened the door to other countries – who were not in the midst of deep structural reforms to their labor and product markets (as in the case of Germany) – to start running excessive deficits. Even though this argument only really holds for Greece – and most notably not in the cases of Ireland and Spain, who were both deeply affected by the crisis – the obsession with fiscal policy changed the consensus from ‘discretion’ to ‘balanced budget’ rules. This formed one of the main principles of the new Fiscal Compact that was agreed upon by 25 of 27 member states in December 2011, and signed in March 2012, which considerably limited temporary deviations due to exceptional circumstances and put in place an automatic correction mechanism.[18]

[18] The exact name of the “Fiscal Compact” is the Treaty for Stability, Coordination, and Governance

Furthermore, since 2010, the policies of the European Central Bank in Frankfurt, which had enjoyed independence just like its German predecessor, the *Bundesbank*, in whose image it was built, have become a lot more 'politicized' given that the ECB has started to interpret its mandate a lot more 'broadly' than had originally been envisaged.[19] Given that the impact of its market interventions – from two rounds of Long Term Repurchasing Operations (LTROs) in late 2011 and early 2012, which put significant amounts of liquidity in the European banking system, to ECB President Mario Draghi's statement that he would do 'whatever it takes' to save the euro, to the announcement of potentially open-ended Outright Monetary Transactions (OMTs) in early September 2012 – have been crucial for the survival of the Eurozone, the ECB has gained remarkable political clout in fighting the crisis. Indeed, many financial market participants see it as the only institution capable of effectively taking control of the crisis.

Many voices in Europe now claim that the ECB should go even further and outright buy the bonds of the countries under stress in the periphery, which would lower their sovereign debt yields, and jumpstart economic recovery. Even though the ECB has so far stopped short of outright interventions, but clearly holds the key to taming the crisis, most analysts applaud its new discretion and policy flexibility. However, more discretion on the part of the ECB brings up the question of political legitimacy. If it is the only actor that is capable of doing something in the short term, and does not suffer from the Olsonian logic of collective action, as do Eurozone finance ministers, should its decisions

[19] See Dorothee Heisenberg, *The Mark of the Bundesbank: Germany's Role in European Monetary Cooperation*, Lynne Riener, 1999

not be subject to some democratic control? This changed consensus in economic policy in the Eurozone since 2010 is summed up in the bottom row of table 2.

The shift in the economic policy consensus in Europe from monetary rule to monetary discretion, and from fiscal discretion to fiscal rule, makes the 'deflationary' box of table 1 in which most countries of the European periphery find themselves all the more cumbersome. In the past, even though they had no influence over the monetary policies of the ECB, they at least had some short-term discretion to stimulate their economies by fiscal means, either by cutting taxes or increasing spending. Since 2010, with the fiscal consensus in Brussels and Frankfurt shifted to balanced budgets, with strict supranational control of national budgets, those countries are even firmer stuck with austerity and deflationary policies. Even though the ECB could do more to fight the crisis, given its newfound policy discretion, there is nothing individual member states can do to control or influence those policies. And given that the ECB has thus far stopped short of outright buying bonds of countries in distress, out of fear that that would dampen the enthusiasm for fiscal and structural reforms, Frankfurt has become part of the deflationary problem.

c. Four propositions and Four Cases

Building on the typology juxtaposing method and burden of adjustment, as developed in part (a), and the changing economic policy consensus in the Eurozone between 2003 and 2013 as explained in part (b), I make the following four propositions on the Eurozone sovereign debt crisis in this paper:

1) Proposition 1: During periods of stress, the Eurozone's only available domestic adjustment mechanism is one of deflation (or internal devaluation), and therefore works in a similar manner as the fixed exchange rate regime of the interwar gold exchange standard during the 1930s.
2) Proposition 2: The euro's original design and the EU's institutional response to the sovereign debt crisis, i.e. austerity, have not only made the recession worse in the periphery countries but have exacerbated the debt problem they were supposed to solve.
3) Proposition 3: The Eurozone sovereign debt crisis has created the fertile soil for the rise of extreme and anti-establishment parties in the Eurozone periphery.
4) Proposition 4: The crisis has led to growing nationalism and anti-EU sentiment by widening the welfare gap between North and South and questioning European solidarity, thereby deteriorating the existing 'democratic deficit' in the European Union.

The paper will address those four propositions in the next four sections, and focus on the four countries of the Eurozone that border the Mediterranean Sea, namely Greece, Italy, Portugal, and Spain (referred to in group as the 'GIPS' countries), and form the core of the Eurozone periphery. This means that I am omitting Ireland and other small Eurozone member countries such as Cyprus, Malta and Slovenia, which also have been affected by the sovereign debt crisis. The point is that those four relatively small cases (with maybe the exception of Ireland, which has a radically different political economy than the rest, and in some ways is more dependent on Great Britain than on the Eurozone) are heavily dependent on what happens in the big four countries of the Eurozone periphery, and therefore there are strong reasons to believe that the external validity of the findings in these four GIPS countries would be quite high.[20]

3. The Euro vs. the Gold Exchange Standard: The Case for Comparison

There are few Englishmen who do not rejoice at the breaking of our gold fetters. We feel that we have at last a free hand to do what is sensible. The romantic phase is over, and we can begin to discuss realistically what is for the best.

John Maynard Keynes[21]

Lawrence Broz and Jeffry Frieden have noted that "[exchange rate] regime decisions involve trade-offs with domestic distributional and electoral implications: thus, selecting an exchange rate regime is as much a political decision as an economic one."[22] It would be no different for the Eurozone: the institutional design that was chosen in the early 1990s was not a mere technocratic one, but one that would have far-reaching political implications. If one considers the Eurozone to be one country that is completely integrated economically and politically, then of course it has a flexible exchange rate regime, given that the euro's value vis-à-vis the U.S. dollar, the Japanese yen or the British pound is determined by market forces. Any external adjustment in the case of a

---

[20] The Irish economy already had to adjust much earlier, i.e. in early 2008, compared to the Mediterranean.
[21] John Maynard Keynes, *Essays in Persuasion*, New York: Harcourt, Brace and Company, 1932, p. 288
[22] A. Lawrence Broz and Jeffry A. Frieden, "The Political Economy of International Monetary Relations," *Annual Review of Political Science* 4, 2001, p. 3

Eurozone imbalance with the rest of the world could take place via an appreciation or a depreciation of the euro. Given that the Eurozone was broadly in balance with the rest of the world by 2010, external adjustment with the rest of the world economy was not the problem.

The real issue for the Eurozone is one of intra-EMU adjustment, where current account imbalances between, for example, Italy and France, or Spain and Germany, have to be settled by 'internal' adjustments, which could happen through inflation in surplus countries or deflation in deficit countries, or a combination of the two. Given the ECB's commitment to low inflation and a one-size-fits-all interest rate policy however, the burden of adjustment will be on the deficit country alone to deflate. This fundamental asymmetry was also present in the gold exchange standard, under which surplus countries could shift the burden of adjustment to countries in deficit, forcing them to adopt severe measures of austerity, with disastrous historical consequences during the 1930s.[23]

A number of academic and non-academic observers have made the explicit link between EMU and either the pre-1913 gold standard or the interwar gold exchange standard, some of them pointing out the differences while others mainly seeing the resemblances. Barry Eichengreen argued that even though there are similarities between the euro and the gold exchange standard, in that both systems acted as constraints on reflationary actions, this did not mean that the euro's fate would be similar to that of the gold standard.[24] He saw four differences between the euro in 2012 and the gold exchange standard in the 1930s:

[23] Eichengreen, 1992, p. 15
[24] Eichengreen, 2012

the existence of a single central bank to coordinate monetary action as opposed to multiple ones; the presence of much more generous welfare states in today's Eurozone economies compared to the situation in the 1930s; better conditions for a cooperative response at the European level under the euro; and the fact that a disintegration of the euro would be a lot more disruptive than the abandonment of the gold exchange standard proved to be during the Great Depression.[25] In an NBER working paper, Eichengreen and Peter Temin pointed out another analogy between the euro and the gold exchange standard, i.e. the need for international coordination, lamenting that the Eurozone's various mechanisms for such intra-EMU coordination – the SGP, the Excessive Deficit Procedure, and the Broad Economic Policy Guidelines – have been honored mainly in their breach. In their paper, they made a strong case for flexible exchange rate regimes, noting that fixed exchange rates might "facilitate business and communication in good times but intensify problems when times are bad."[26]

Harold James argued that there is a certain appeal of comparing the euro with the pre-1913 gold standard. This comes from the fact that there is more pressure on deficit countries to adjust through austerity than for surplus countries to adjust by inflating. However, he also believes that euro pessimists are too quick to claim that the adjustment process is politically unsustainable, since they are missing the very real possibilities that the gold standard afforded individual countries, compared to the Eurozone's institutional setup.[27] James suggests that individual Eurozone members' national banks should be able to have more leeway in setting their own domestic interest rates, as was the case during

[25] Ibid.

[26] Barry Eichengreen and Peter Temin, "Fetters of Gold and Paper," *National Bureau of Economic Research*, Working Paper 16202, July 2010. Online available at: http://www.nber.org/papers/w16202

[27] Harold James, "Golden Rules for the Eurozone," *Project Syndicate*, April 3, 2012. Online available at: http://www.project-syndicate.org/commentary/golden-rules-for-the-eurozone

the classical gold standard, which went a long way towards stabilizing the single currency. Writing on the "Economists' Forum" of the Financial Times, Edward Gottesman also made the explicit comparison, referring to the euro as the "21st century gold standard." Gottesman was convinced that adjustment by (external) exchange rate devaluation would be a lot quicker than through internal devaluation, which would be slower and much more uneven.[28]

David Marsh, in a recent book on the history of the euro, stated that Giscard d'Estaing, who was President of France from 1974 to 1981, believed that "the road to European money was part of a journey that had been abandoned when the Gold Standard ended."[29] Marsh also detected a similar line of thinking in Helmut Schmidt, who also saw the need for a return to the stability of the pre-war gold standard.[30] Finally, Harris Dellas and George Tavlas, in a working paper for the Bank of Greece, contended that the Greek sovereign debt crisis happened exactly because of the *absence* of an adjustment mechanism like the one that existed under the classical gold standard. For them, if the euro had actually worked like the gold standard, countries with excessive current account deficits would have experienced an outflow of gold, higher interest rates, lower money and credit growth, and much more automatic adjustments in wages and prices.[31]

---

[28] A. Edward Gottesman, "Is the euro the 21st century gold standard?" *Financial Times*, Economists' Forum, August 13, 2002. Online available at: http://blogs.ft.com/economistsforum/2012/08/is-the-euro-the-21st-century-gold-standard/

[29] Marsh, 2011, p. 75

[30] Ibid., p. 76

[31] Harris Dellas and George S. Tavlas, "The Road to Ithaca: the Gold Standard, the Euro and the origins of the Greek sovereign debt crisis," *Bank of Greece*, Working Paper 149, November 2012

Of course, the gold standard analogy with today's Eurozone is far from perfect. There are some notable differences, as other authors have pointed out. First and foremost, there is the ECB, which can print its own gold, as it were, even though it has shown its reluctance to do so throughout the crisis. Second, it is far from clear that leaving the Eurozone would bring similar quick economic benefits to say, Greece, as it brought to the United Kingdom when it chose to abandon the gold standard in 1931. That of course might prove not to be a big enough deterrent if the economic situation does not get better in the medium term. Third, automatic fiscal stabilizers are a lot more advanced today in Europe than they were during the interwar period, and welfare states are more generous and better developed, meaning that economies could more likely sustain longer periods of deflation today than they could 80 years ago. Also, the classical gold standard in fact did have an automatic adjustment mechanism, with surplus countries experiencing an inflow of gold and therefore inflationary pressures, while deficit countries saw an outflow of gold and thus automatic deflation. One of the problems, however, of the interwar gold exchange standard is that those automatic adjustment mechanisms no longer functioned when countries resorted to beggar-thy-neighbor policies and trade protectionism.

If one purely focuses on the adjustment mechanism of balance of payments imbalances in today's Eurozone, then a convincing case can be made that it does indeed function like the gold exchange standard. Just like in the 1930s, the main obsession of EU policymakers during the Eurozone crisis was to tame inflation, while in fact the real danger was one of deflation. Eichengreen observed the following about the ideational consensus during the 1930s: "There is no little irony in the fact that inflation was the dominant fear in the depths of the Great Depression, when deflation was the real and present danger. Precisely because this fear seems so misplaced, its pervasiveness cannot be overemphasized."[32]

The euro-gold standard comparison is compelling for four main reasons. First of all, just like under the gold exchange standard, the Eurozone today has only one adjustment mechanism, deflation, given that (a) external devaluation vis-à-vis other Eurozone members is impossible, (b) inflation is kept in check by the ECB while demand stimulus is hard under the new fiscal rules, and (c) default is the option of last resort given the importance of international financial markets for the liquidity of sovereign bond markets. Second, just like the gold exchange standard, the Eurozone has led to the formation of a relatively well-off and advanced core and a lagging, much poorer periphery, and the crisis has only widened that gap. The asymmetry stems from the fact that the core countries can force all of the adjustment exclusively onto the peripheral countries. Third, the ideological commitment of Europe's elite to the euro is just as strong as the financial and political elite's commitment to the sacredness of the gold standard in the 1920s and early 1930s. Fourth, the Fiscal Compact, which replaced the SGP, and was signed in March 2012, committed the Eurozone economies to balanced budgets and limited the scope for temporary deviations and calls for automatic correction mechanisms. This commitment to fiscal rectitude is reminiscent of U.S. President Herbert Hoover's obsession with balancing the budget, and his Treasury Secretary Andrew Mellon's view of how best to recover from the Great Crash in 1929.

[32] Eichengreen, 1992, p. 24

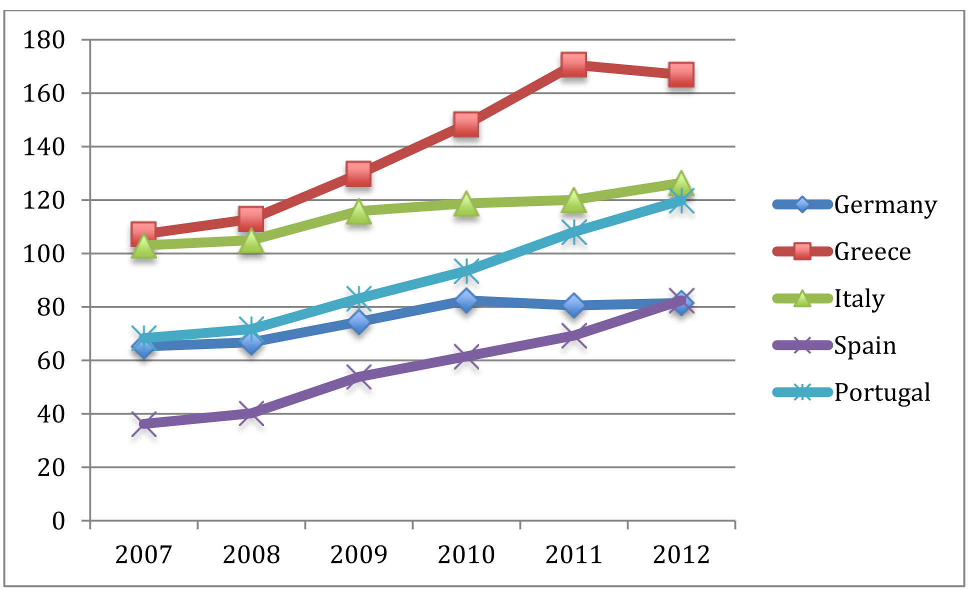
Just like the gold exchange standard, as Eichengreen has persuasively argued in *Golden Fetters*, contributed to the length and depth of the Great Depression, so did the institutional design of the euro and the EU's response to the sovereign debt crisis in 2010 lead to a worsening of the debt problem and a deepening of the recession due to a collapse in economic growth. This is the second proposition of this paper, to which I now turn.

4. Domestic Economic Impact of Austerity in Greece, Italy, Portugal and Spain

Liquidate labor, liquidate stocks, liquidate the farmers, liquidate real estate… purge the rottenness out of the system.

Andrew Mellon[33]

Figure 1: Public Debt, 2007-2012 (% of GDP)[34]



[33] U.S. Treasury Secretary Andrew Mellon's famous words of advice to U.S. President Herbert Hoover after the 1929 stock market crash. Quoted in Eichengreen, 1992, p. 251

[34] Figures 1 through 5 source: Economist Intelligence Unit (2013) and OECD (2013)

Beginning with the Greek bailout in the spring of 2010, the response of the so-called 'troika' (the ECB, the IMF, and the Commission) has been to emphasize debt reduction through fiscal austerity measures, in combination with structural reforms, in return for direct financial assistance and liquidity. As I have argued in sections 2 and 3, this was the logical response given Europe's choice to abandon the embedded liberal compromise in the early 1990s, which would leave austerity as the sole option on the table. As figure 1 illustrates, the deflationary policies that all four Mediterranean countries have been enacting since 2010 have only increased their debt-to-GDP ratios. At the heart of this problem is of course simple mathematics and logic. To bring debt-to-GDP ratios down one can either try to decrease the numerator (debt) or increase the denominator (GDP). Focusing on deficit reduction in the short term might trigger a recession, which will actually lower your economy's GDP, and increase your debt more as long as you are not balancing the books. Furthermore, new debt needed to be financed at much higher interest rates, given the risk premium over German bunds that financial markets started to demand at the onset of the crisis, while old debt had to be rolled over at higher interest rates as well. The only country that has managed to get its debt situation under control is Germany, and of course Greece, but only after a partial restructuring (or 'default') of its outstanding debt in 2011 and 2012.

Figure 2 shows how, apart from Greece, all Mediterranean countries had a strong recovery in 2010 after the global financial crisis was triggered in late 2008, and the world recession it caused in 2009. Greece saw the most dramatic collapse in its GDP, with a cumulative fall in economic activity between 2008 and 2013 of 24 percent, which is the equivalent of a full-blown depression. Portugal went into recession in 2011, and Spain and Italy also slid back into recession in 2012. At the same time, Germany's economy performed very well in 2011 with a strong growth rate of 3.1 percent, even though it has since slowed down to 0.9 percent in 2012.

Figure 2: Real GDP Growth, 2007-2012

The rise in overall ratios of debt-to-GDP and shrinking of economic activity in the GIPS countries translated into steadily rising levels of unemployment in 2012 (figure 3), with Greece topping the list with an unemployment rate of 24.6 percent, followed by Spain with 24.1 percent, Portugal with 15.7 percent, and Italy with 10.6 percent. At the same time, Germany saw its unemployment rate fall to historically low levels of 5.5 percent in 2012. But the true damage to the economy is illustrated in figure 4, which shows the evolution of youth unemployment between 2007 and 2012.

Figure 3: Unemployment Rate, 2007-2012 (%)

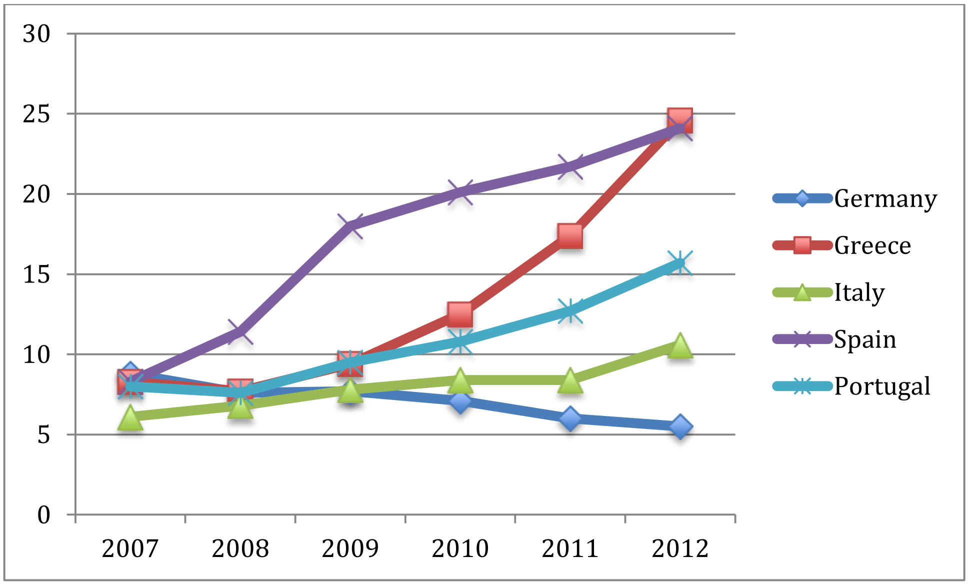
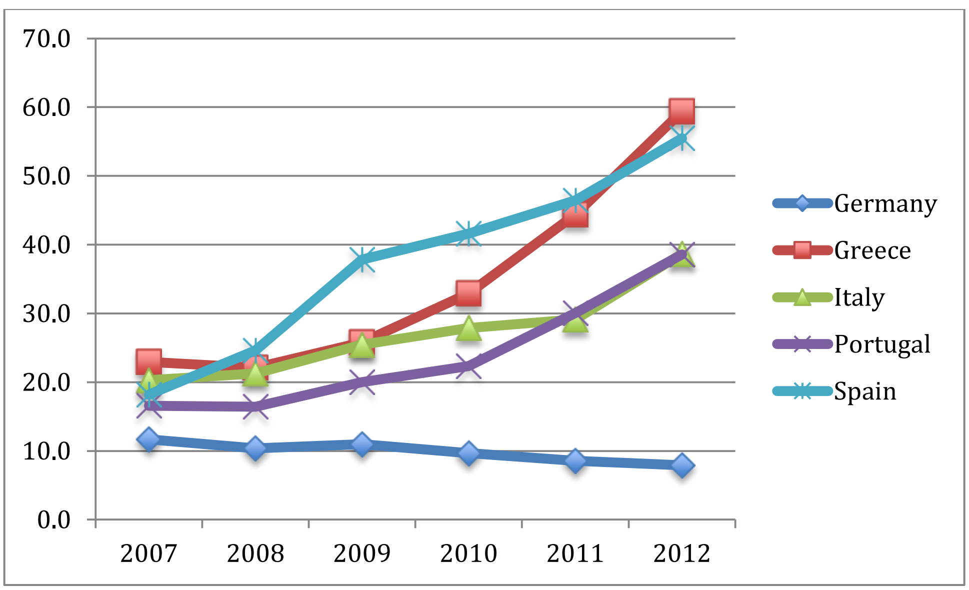


Figure 4: Youth Unemployment Rate, 2007-2012 (%)



The youth unemployment rate measures the level of unemployment for people below 25 years of age. Spain's youth unemployment more than tripled from an already high level of 18.2 percent in 2007 to 55.5 in 2012, Greece's almost tripled from a level of 22.9 percent in 2007 to 59.4 percent in 2012, Portugal's more than doubled from 16.6 percent in 2007 to 38.6 percent in 2012, while Italy's almost doubled from 20.3 percent in 2007 to 38.7 percent in 2012. At the same time, Germany saw its youth unemployment come down from an already much lower 11.7 percent in 2007 to just 7.9 percent in 2012. Caritas Europa, the global charity group, said in a report citing the European Commission's own statistics, that "this could be a recipe not just for one lost generation in Europe but for several lost generations."[35]

The economic downturn in Europe has also severely affected personal levels of economic well being in the GIPS countries. The GIPS countries saw a steep decline in their real average wages since 2009, which is shown on figure 5. Greece is the most dramatic case with real average wages falling with 7.1 percent in 2010, 9.1% in 2011, and 12.4% in 2012, which adds up to a cumulative fall of 26 percent. Furthermore, the crisis has increased the risk of poverty, especially for children. According to Caritas, by 2012, three out of every ten children in Greece, Italy, Portugal and Spain, were either living in poverty or had been pushed to the brink of poverty. The Eurozone crisis thus has created a sizeable "under-class" of inadequately fed and poorly educated young people with low morale and scant employment prospects. And worst of all, for the European project of integration, it has noticeably widened the gap between North and South.

[35] Claire Davenport, "Austerity's children becoming Europe's "lost generation,"" *Thomson Reuters*, February 14, 2013; Caritas Europa, "The Impact of the European Crisis," February 2013, available online at: http://www.caritas-europa.org/code/EN/inte.asp?Page=1505

Figure 5: Average Real Wages (% change)

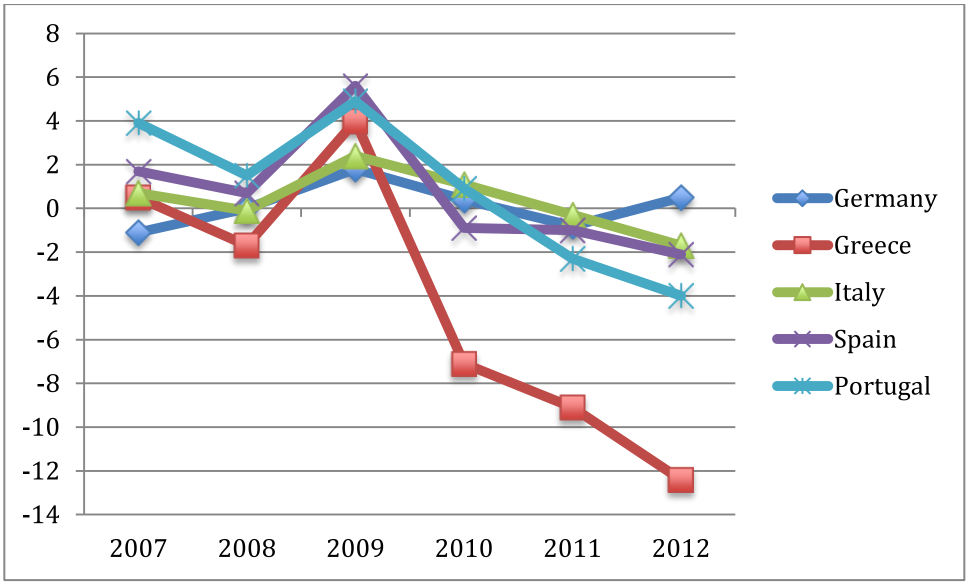
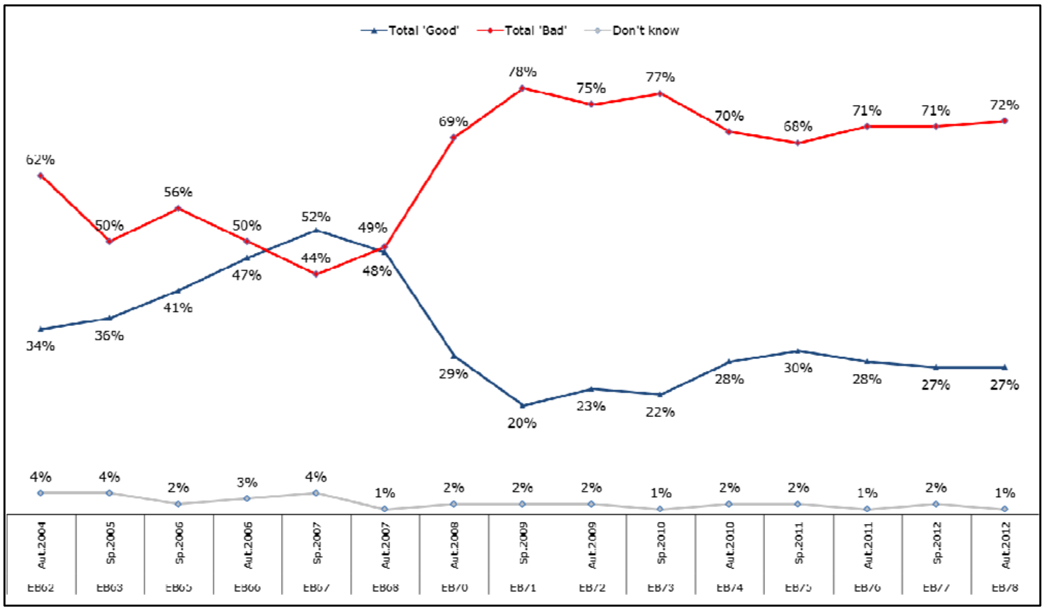


Figure 6 shows the evolution since 2004 of European Union citizens' judgment on how well their national economies are performing, and whether they expect things to get worse, or get better, as measured twice a year by the European Commission in their *Eurobarometer*. While an overwhelming majority (72 percent) judges the overall economic situation to be 'bad' during the fall of 2012, this masks the much starker regional differences. In Greece, 99 percent of all people polled thought their country's economy to be doing 'bad,' while in Spain 98 percent thought so, with 93 percent of Italians and 89 percent of Portuguese sharing a similar 'bad' judgment. If you compare those figures with Germany (75 percent judged the overall economic situation to be 'good'), Luxembourg (70 percent 'good'), Austria (65 percent 'good') and Finland (55 percent 'good'), you can only conclude that the divide between the Eurozone's Northern core and Southern periphery is substantial. It makes the calls for more intra-EMU 'solidarity' all the much louder. [36]

Figure 6: How would you judge the current situation in your national economy?[37]



Though no historical comparison is perfect, it is worth looking at the effects on economic growth after the 1992-93 EMS crises, when Italy, Spain and Portugal were all forced to leave the European Exchange Rate mechanism (ERM) temporarily and had to devalue their currencies vis-à-vis the German mark, the EMS' anchor currency.[38] The Italian lira left the ERM in mid-September 1992, and was immediately devalued by 7 percent. Between September 1991 and March 1995, the Italian government devalued the Italian

[36] Ibid., p. 7

[37] European Commission, *Standard Eurobarometer No. 78*, December 2012, p. 6. Online Available at: http://ec.europa.eu/public_opinion/archives/eb/eb78/eb78_en.htm

[38] Greece only joined the ERM later in the 1990s, so the comparison does not apply to Athens.

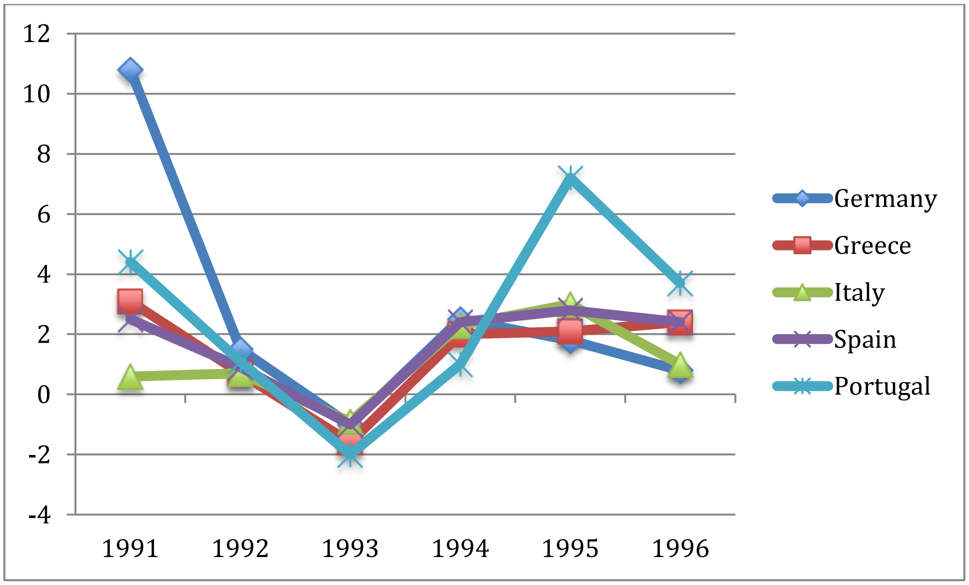
lira by more than 60 percent against the German mark in order to gain competitiveness.[39] It would only rejoin the ERM in late 1996. The Spanish peseta was devalued by 5 percent vis-à-vis the German mark in September 1992, while the Portuguese escudo and the Spanish peseta (again) were devalued by 6 percent in October 1992. In May 1993, the peseta and the escudo were again devalued further vis-à-vis the D-mark.

One can see from figure 7 that, while all countries were in recession in 1993, the recovery in 1994 and 1995 was a lot stronger and a lot quicker than was the case for the Eurozone sovereign debt crisis. Though the nature of the 2010 debt crisis is very different from the 1992-3 EMS currency crisis, and the world economy saw strong growth in 1994 and 1995 thanks to a booming American economy, one should not dismiss out of hand the role devaluation played in the Mediterranean recovery of the mid-1990s. In any event, the perception that those economies could recover as quickly as they did after a substantial devaluation is central to this paper's point, emphasizing the importance of the exchange rate as a crucial shock absorber during hard times. In further evidence of the effectiveness of some exchange rate flexibility, even under a fixed rate system, a 2003 IMF research paper by Solomos Solomou provided new evidence for the crucial role real exchange rate adjustment played in speeding up economic recovery in the periphery during the gold standard.[40] Compared to devaluation, deflation tends not only to be much slower but also a lot more unequal.[41]

---

[39] Mario Lorca-Susino, "Ten Years with the Euro. From the Single European Act to the Treaty of Lisbon," unpublished paper, 2010. Online available at: http://marialorcasusino.com/userfiles/file/Ten%20Years%20with%20the%20Euro.pdf
[40] Solomos Solomou, "Exchange Rates in the Periphery and International Adjustment Under the Gold Standard," *IMF Working Paper*, 2003, p. 17
[41] Gottesman, 2012

Figure 7: Real GDP Growth, 1991-1996



The crisis that engulfed the Eurozone from 2010 onwards had serious consequences for the economies of the periphery, with sharp falls in national income, rising debt, steep increases in unemployment, and truly disastrous levels in youth unemployment, but it has also started to have a negative impact on the Mediterranean countries' domestic political institutions. As a result, the euro crisis triggered a crisis of political legitimacy domestically, with electorates openly questioning the effectiveness of their traditional political class and policy elite, but also stirred up growing anti-EU sentiment in a way Europe had not experienced since the signing of the Treaty of Rome in 1957. I will briefly discuss both propositions in the next two sections, before concluding the paper.

5. Domestic Political Impact of Deflation in Greece, Portugal, Italy and Spain

But political resignation, alienation and cynicism, combined with growing hostility against "Frankfurt" and "Brussels", and a growing perception of zero-sum conflict between the donors and the recipients of the "rescue-cum-retrenchment" programs, may create the conditions for anti-European political mobilization from the extremes of the political spectrum. In the worst case, therefore, the attempts to save the Euro through the policies presently enacted may either fail on their own terms, or they may not only undermine democracy in EU member states but endanger European integration itself.

Fritz W. Scharpf[42]

As Eichengreen has argued, the interwar gold exchange standard in the end was doomed mainly for political reasons.[43] The big difference between the pre-1913 and interwar gold standard was the radically different political climate that emerged after the Great War. First, the spread of universal male suffrage as the norm across Europe made domestic economic policy goals such as high growth, rising standards of living, and low unemployment, which came at the cost of external equilibrium and currency stability, a lot more important. Second, the existence of powerful labor unions and social democratic parties to represent their direct interests made a policy of deflation or austerity a lot harder to swallow in a democracy, compared to say 1870, when there were no such constraints. The rise and consolidation of power by Mussolini in Italy in 1922, Hitler in

[42] Fritz W. Scharpf, "Monetary Union, Fiscal Crisis, and the Preemption of Democracy," *LEQS Annual Lecture Paper* 36, London: London School of Economics, 2011. Online available at: http://www2.lse.ac.uk/europeanInstitute/LEQS/LEQSPaper36.pdf

[43] Eichengreen, 1992, p. 25

Germany in 1933, and Franco in Spain in 1936 underscored the potential dangers of the popular discontent with the deflationary policies associated with the gold standard, which led to a sweeping overturn of fragile democratic settlements in interwar Europe.

I by no means want to argue that the introduction of the euro and the 2010 sovereign debt crisis will lead over time to new experiments with autocratic government in Southern Europe, as happened during the 1920s and 1930s. There is however a real danger, especially in Greece and Italy, but also in Spain and Portugal, of a significant and lasting shift of the electorate from the moderate center to more radical left wing or right wing extremes. Freedom House, for example, gave both Greece and Italy a lower ranking in its 2013 *Freedom in the World* Report, with Greece going from a score of 1.5 to 2 compared to two years earlier, with a lower score for 'political rights', while Italy went from a score of 1 in 2012 to a score of 1.5 in 2013, with a worse score in civil liberties, increasing from 1 to 2.[44] The Economist Intelligence Unit downgraded Greece, Portugal and Italy from 'full democracies' in 2010 to 'flawed democracies' in 2012, even though they expected the downgrade for Portugal to be temporary. Spain was also downgraded, but remained a 'full democracy' even though with the lowest score.[45] Also, trust in national parliaments across the European Union have gone down from 43 percent of the population in the spring of 2007 to 28 percent in the fall of 2012, with a similar downward trend in trust in national governments, falling from 41 percent to 27 percent over the same period. Again, there are stark differences between North and South, with

[44] Freedom House, 2013

[45] Economist Intelligence Unit, March 2013, country reports on Italy, Greece, Portugal, and Spain

trust in national political institutions at a much lower level in the Mediterranean countries.[46]

From a domestic political perspective, Greece and Italy were the worst affected by the euro crisis; their traditional political elites were unable to form governments that could cope with the debt crisis, and as a result saw anti-democratic experiments with unelected technocrats. In Greece, George Papandreou was forced to resign after he called for a national referendum in early November 2011 on the terms of a new EU-IMF bailout, and was replaced by Lucas Papademos, a former vice-president of the European Central Bank, with the tacit support of Brussels, until new elections were held in May 2012. Those elections turned out to be inconclusive, with the mainstream centrist parties unable to form a government, and the rise of extreme left political movement SYRIZA who refused to abide by the EU's terms, and an almost 10 percent share of the vote for extreme right neo-nazi party Golden Dawn. The country was forced to vote again in June 2012, under pressure of financial markets and while flirting with a Eurozone exit, and the Greek voters delivered a fragile coalition led by the center-right leader Antonis Samarras.

In Rome, Prime Minister Silvio Berlusconi effectively lost his majority, and proposed to resign under the condition that the legislature approve his austerity budget for 2012, which it duly did on November 12. Mario Monti, another unelected technocrat and a former European Commissioner for Competition, took over from Berlusconi with markets initially responding negatively as Monti's government formation was delayed. Monti lasted just over a year, after having pushed through a series of unpopular austerity

[46] Eurobarometer, Autumn 2012

measures, and tax and labor market reforms. The new elections in February 2013 delivered a devastating verdict for Monti, who scored just around 10 percent of the vote, with the new leftist anti-euro and anti-establishment “five star” movement led by an obscure and relatively unknown comedian, Beppe Grillo, achieving close to 25 percent of the vote. The center-right, led by Berlusconi, openly critical of Europe’s approach to the crisis, especially the ‘German’ view of austerity, almost beat the center-left led by Giuseppe Bersani. That election also produced an inconclusive result with a clear majority for the center-left in the lower house, but no majority in the senate. Finally, center-left politician Enrico Letta managed to put together a fragile new ‘centrist’ coalition, which included many technocrats in late April 2013, but it remains to be seen whether Italy’s new government can be effective and avoid new elections.

While Spain and Portugal have been governed by relatively stable center-right governments since 2011, and were likely to complete their four-year terms in 2015, reform fatigue has clearly set in, and Spain has to cope with a more strident secessionist movement in Catalonia. Both Portugal and Spain have also effectively lost their economic sovereignty, as both have had to submit to severe conditionality from the EU-IMF-ECB troika in return for a full-fledged bailout in the case of Portugal and a bank bailout in the case of Spain. In all four Mediterranean countries, austerity measures have fueled popular discontent, and all have seen riots and street violence increase since the onset of the 2010 crisis.

Part of the reason their countries' electorates are turning against their political elites is because of the perception that the elites no longer control their own country's future, but instead are being run by Brussels' unelected technocrats. No matter what the outcome is of a national election, it is clear that the deflationary course their countries have been put on by Europe since 2010 cannot be changed. This growing awareness of Europe's negative influence on a country's economy and welfare, as well as this perceived violation of their countries' sovereignties, has rekindled anti-European and anti-euro sentiments across the region. The already existing democratic deficit of the European Union seems to be growing wider as the crisis wears on. And interestingly enough, Euro skepticism has not just been on the rise in the Mediterranean, but also in the rest of the European Union, including Germany and Austria, both countries that ostensibly have 'gained' from the crisis, and are doing quite well economically.

6. The Rise of Anti-EU Sentiment across Europe

Who knows Olli Rehn? Who has ever seen the face of Olli Rehn? Who knows where he comes from and what he has done? Nobody. And at the same time, he is the one who tells us how to run our economic policy.

Paul Magnette[47]

While the Euro crisis has weakened domestic political institutions in all four countries of Southern Europe, the anti-EU and anti-euro sentiment has been on the rise since the dawn of the crisis. While European citizens' trust in their national governments and parliaments

[47] Paul Magnette, then Federal Minister of Belgium during a press conference in January 2012. Quoted in *De Standaard*, "Wie kent Olli Rehn?" (12 January 2012) – Olli Rehn is the Finnish European Commissioner for monetary and financial affairs.

has been falling since 2007, the same is true for their trust in the European Union, which started with approval ratings of 57 percent in the spring of 2007 and were down to 33 percent in the fall of 2012. Yet again, the overall number masks the significant North-South differences, with even lower ratings in Greece, Italy, Portugal and Spain.[48] Also the EU image has suffered. When asked whether "the EU conjure[s] up for you a very positive, fairly positive, neutral, fairly negative or very negative image," the total 'negatives' have gone up from just 14 percent in the fall of 2007 to 29 percent in the fall of 2012, and the total 'positives' have fallen from a high of 52 percent in 2007 to just 30 percent in 2012.[49] When asked about the single currency, the euro, specifically, there is also a worrying trend across the EU. While 63 percent of all Europeans supported the euro in early 2007 while 31 percent was against, only 53 percent still supported the euro in the fall of 2012, with 40 percent against. Here also, the EU wide average concealed the wide variety of opinions across the continent.[50]

In a special "Eurobarometer" on the future of Europe, with fieldwork conducted in November 2011, and published in April 2012, questions on trust in the political system showed a marked discrepancy between whether citizens thought their voice counted in Europe or in their own country. Only 26 percent of EU citizens agreed that their voice counted in the EU, in contrast with 52 percent of EU citizens who agreed their voice did count in their own country. 65 percent of EU citizens did not agree that their voice counted in the EU, compared with only 43 percent who did not agree that their voice counted in their own country. On the question whether 'my voice counts in the EU' only

[48] Eurobarometer, Autumn 2012, p. 14
[49] Ibid., p. 15
[50] Ibid., p. 16

15 percent of Greeks, 16 percent of Italians, and 27 percent of Portuguese and Spaniards tended to agree, compared to 47 percent of Germans, and 55 percent of Belgians and Dutch. The same divergence is observed on the question whether 'my voice counts in my country,' with 15 percent of Greeks, 18 percent of Italians, 35 percent of Portuguese and 45 percent of Spaniards agreeing, while a total of 70 percent of Germans, 74 percent of French, and 81 percent of Dutch and Finnish agreed.[51]

Heather Grabbe, the head of EU affairs for the Open Society Institute, noted that her studies of anti-EU populists have shown anti-EU sentiment to be far higher and far deeper than election results have indicated since the onset of the 2010 crisis. Grabbe was quoted by the Financial Times as saying that "the euro crisis is a crisis of governance because people are feeling very angry and are looking for people to blame." According to Grabbe, they are mainly angry because they feel that their national governments have lost all control over the economy.[52] Anti-euro and anti-EU sentiment is not just on the rise in Southern Europe, but also in unexpected places like Austria and Germany. In Bavaria in Germany, for example, the anti-bailout Free Voters movement made significant inroads in regional elections and is aiming to upend the German national vote in September 2013 with a harsh critique of EU crisis management.[53] Also, a new party led by economists, jurists and Christian democratic rebels has been formed in Germany, openly calling for an end of the euro and a return to the German mark. Anti-euro sentiments are also brewing in Finland, with the True Finns party – which combines ethno-nationalism with

---

[51] European Commission, *Special Eurobarometer 379: The Future of Europe*, Brussels: 2012. Online available at: http://ec.europa.eu/public_opinion/archives/ebs/ebs_379_en.pdf
[52] Peter Spiegel, "Hostility to the EU deepens," *Financial Times*, January 16, 2013.
[53] Ibid.

left wing economic policies – nearly ousting the ruling government party in national elections in 2011, and Austria, where "Team Stronach" – an anti-euro party founded in response to the crisis – polled around 10 percent of the vote in two regional elections in early 2013.

7. Conclusion

The euro is much more than a currency. The monetary union is a community of fate. This is our historic task. If the euro fails, then Europe will fail.

Angela Merkel[54]

This paper has made four propositions. First, it has argued that the euro's institutional design made it function like the interwar "gold exchange standard" during periods of stress. Also, just like the gold standard, the euro created a core of surplus countries and a periphery of deficit countries, in which the latter had to sacrifice their internal domestic economic equilibrium in order to restore their external equilibrium, and thus had no choice but to respond to balance of payments crises by a series of deflationary spending, price and wage cuts. The paper's second claim was that the euro's institutional design and the EU's response to its 'sovereign debt crisis' during 2010-13 deepened the recession in the Eurozone periphery, as EMU leaders focused almost exclusively on austerity measures and paid only lip service to the need to rebalance growth between North and South.

[54] Angela Merkel, Speech in the Bundestag, 19 May 2010.

As Barry Eichengreen argued in *Golden Fetters*, the rigidity of the gold standard contributed to the length and depth of the Great Depression during the 1930s, but also underscored the incompatibility of the system with legitimate national democratic government in places like Italy, Germany, and Spain, which was the basis for the paper's third proposition: the euro crisis instigated a crisis of democratic government in Southern Europe underlining that democratic legitimacy still mainly resides within nation states. By taking on the euro, EMU member states gave up their ability to control major economic policy decisions, thereby damaging their domestic political legitimacy, which in turn dogged attempts to enact structural reforms. Evidence of the erosion of national democracy in the Eurozone periphery can be seen in the rise of anti-establishment parties, and the inability of traditional center-left and center-right parties to form stable governments and implement reforms. The paper's fourth proposition was that the euro's original design and the Eurozone sovereign debt crisis further widened the existing democratic deficit in the European Union, as manifested in rising anti-EU and anti-euro sentiment, as well as openly Eurosceptic political movements, not just in the euro periphery, but also in the euro core.

Bibliography

Blyth, Mark (2002), *Great Transformations: Economic Ideas and Institutional Change in the Twentieth Century*, Cambridge: Cambridge University Press

Brady, Hugo (2012), "Europe needs a Rooseveltian break with fear," *Centre for European Reform*, 27 July 2012. Available online at: http://www.cer.org.uk/publications/archive/bulletin-article/2012/europe-needs-rooseveltian-break-fear

Broz Lawrence A. and Jeffry A. Frieden (2001), "The Political Economy of International Monetary Relations," *Annual Review of Political Science* 4

Calleo, David P. (2003), *Rethinking Europe's Future*, Princeton: Princeton University Press

Caritas Europa (2013), "The Impact of the European Crisis," February, available online at: http://www.caritas-europa.org/code/EN/inte.asp?Page=1505

Davenport, Claire (2013), "Austerity's children becoming Europe's "lost generation,"" *Thomson Reuters*, February 14

De Standaard (2012), "Wie kent Olli Rehn?" January 12

Dellas, Harris and George S. Tavlas (2012), "The Road to Ithaca: the Gold Standard, the Euro and the origins of the Greek sovereign debt crisis," *Bank of Greece*, Working Paper 149, November

Economist Intelligence Unit (2013), "Country Reports" on Italy, Greece, Portugal, and Spain, London, March

Eichengreen, Barry (1992), *Golden Fetters: The Gold Standard and the Great Depression 1919-1939*, New York: Oxford University Press

Eichengreen, Barry (2002), "Is Europe on a Cross of Gold?" *Project Syndicate*, May 11. Online available at: http://www.project-syndicate.org/commentary/is-europe-on-a-cross-of-gold-

Eichengreen, Barry and Peter Temin (2010), "Fetters of Gold and Paper," *National Bureau of Economic Research*, Working Paper 16202, July. Online available at: http://www.nber.org/papers/w16202

European Commission (2012), *Standard Eurobarometer No. 78*, December. Online Available at: http://ec.europa.eu/public_opinion/archives/eb/eb78/eb78_en.htm

European Commission, *Special Eurobarometer 379: The Future of Europe*, Brussels: 2012. Online available at: http://ec.europa.eu/public_opinion/archives/ebs/ebs_379_en.pdf

Freedom House (2013), *Freedom in the World 2013*. Online available at: http://www.freedomhouse.org/report/freedom-world/freedom-world-2013

Gottesman, A. Edward (2012), "Is the euro the 21st century gold standard?" *Financial Times*, Economists' Forum, August 13. Online available at: http://blogs.ft.com/economistsforum/2012/08/is-the-euro-the-21st-century-gold-standard/

Haas, Ernst B. (1968), *Beyond the Nation State: Functionalism and International Organization*, Palo Alto: Stanford University Press, 1968

Hall, Peter (1986), *Governing the Economy: The Politics of State Intervention in Britain and France*, Oxford: Oxford University Press

Heisenberg, Dorothee (1999), *The Mark of the Bundesbank: Germany's Role in European Monetary Cooperation*, Lynne Riener

Hugh, Edward (2011), "Dr. Strangelove and the euro 'Doomsday Machine'" *CNN Business 360*, September 22. Available online at: http://business.blogs.cnn.com/2011/09/22/dr-strangelove-and-the-euro-doomsday-machine/

James, Harold (2012), "Golden Rules for the Eurozone," *Project Syndicate*, April 3. Online available at: http://www.project-syndicate.org/commentary/golden-rules-for-the-eurozone

Katzenstein, Peter (1985), *Small States in World Markets: Industrial Policy in Europe*, Ithaca: Cornell University Press

Keynes, John Maynard (1932), *Essays in Persuasion*, New York: Harcourt, Brace and Company

Lorca-Susino, Mario (2010), "Ten Years with the Euro. From the Single European Act to the Treaty of Lisbon," unpublished paper. Online available at: http://marialorcasusino.com/userfiles/file/Ten%20Years%20with%20the%20Euro.pdf

Marsh, David (2011), *The Euro: The Battle for the New Currency*, New Haven: Yale University Press, 2011

Matthijs, Matthias (2010), *Ideas and Economic Crises in Britain from Attlee to Blair*, London: Routledge

Matthijs, Matthias (2012), "How Europe's New Gold Standard Undermines Democracy," Harvard Business Review Blog Network, August 24. Online available at: http://blogs.hbr.org/cs/2012/08/how_europes_new_gold_standard.html

McNamara, Kathleen R. (1998), *The Currency of Ideas*, Ithaca: Cornell University Press

Merkel, Angela (2010), Speech in the Bundestag, May 19

Milward, Alan S. (2000), *The European Rescue of the Nation State*, London: Routledge, 2nd edition

OECD (2013)

Peter Gourevitch (1986), *Politics in Hard Times: Comparative Responses to International Economic Crises*, Ithaca: Cornell University Press

Ruggie, John Gerard (1982), "International Regimes, Transactions, and Change: Embedded Liberalism in the Postwar Economic Order," *International Organization* 36 (2), spring, p. 413-415

Scharpf, Fritz W. (2011), "Monetary Union, Fiscal Crisis, and the Preemption of Democracy," *LEQS Annual Lecture Paper* 36, London: London School of Economics. Online available at: http://www2.lse.ac.uk/europeanInstitute/LEQS/LEQSPaper36.pdf

Simmons, Beth (1994), *Who Adjusts? Domestic Sources of Foreign Economic Policy during the Interwar Years*, Princeton: Princeton University Press

Solomou, Solomos (2003), "Exchange Rates in the Periphery and International Adjustment Under the Gold Standard," *IMF Working Paper*

Spiegel, Peter (2013), "Hostility to the EU deepens," *Financial Times*, January 16

The Economist (2007), "Indecent Exposure," August 5. Online available at: http://www.economist.com/node/9609521