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Policies to overcome stagnation: the crisis, and the possible futures, of all things euro

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This article argues that the Europe's continuing economic underperformance, particularly in the eurozone, is neither a function of insufficient information (policymakers do not know the right policies) nor ideology (policymakers are unable to recognize the right policies due to ideological priors). Rather, this article places the continuation of policies that cause stagnation in a longer historical context. Building upon the insights of Kalecki (1943) regarding the political limits of full employment policies, it is argued that the shift from a regime that generated inflation, low profitability, and a high degree of equality to one that generates deflation, high profitability, and inequality has hamstrung the ability of policymakers to respond positively to the situation at hand. This has generated structural pressures for political realignment across cases that compound the economic problems of stagnation while exacerbating tensions between different European 'Varieties of Capitalism.' The result is a set of 'second-best' strategies that lead to second-best outcomes in both politics and economics that further stress the already stressed economies and polities of Europe.

Keywords: *stagnation, economic policy, eurozone, Kalecki, regime change, populism, varieties of capitalism, macroeconomic imbalances*

JEL codes: *B20, E00, F00, N00*

1 INTRODUCTION

The FFM conference, 'The spectre of stagnation: Europe in the world economy,' was held in October 2015. A mere 3 months later the specter that the conference feared, and which was already obvious to the participants, finally materialized before the rest of the world. Growth forecasts were revised down, again, and not just for Europe, but for the whole world (*Financial Times* 2016). Factors previously cited as growth-enhancing, such as low oil prices and low interest rates, were suddenly seen by financial markets as growth-retarding, with both being 'too low,' as reflected in market volatility in early 2016 (Blyth 2016). And when a bastion of not just economic orthodoxy, but the main promoters of 'structural reforms,' 'flexibility,' and 'austerity' for the past 25 years – the Organisation for Economic Co-operation and Development (OECD) – issued a report in February 2016 saying that now is the time for all not 'to tighten,' as ex-European Central Bank (ECB) head Jen Claude Trichet argued in 2011, but to deploy a massive fiscal response, then we know that stagnation is already here (OECD 2016). So what, then, are the policies to overcome stagnation, especially for a diverse set of countries united by a 'one size fits none' currency, and where fiscal policy has been made quasi-illegal? Finding positive policies has never been the problem. Table 1 gives an obvious list.

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Table 1 Some different policy targets to overcome stagnation

Stop squeezing fiscal policy to hit completely arbitrary deficit and debt targets
Halt deflation with more than just an aggressive monetary expansion
Unblock credit channels so that lending can resume
Move beyond structural reform to restart growth
Build more complete European Institutions

And that those policies will never happen is equally obvious. First, to stop squeezing, one has to admit that austerity hasn't worked. Given the electoral stakes for governing parties that have taken their countries through austerity programs, there is no way in which that volte-face can happen without their removal from office and a simultaneous cognitive revolution in Brussels. Second, the ECB has been desperately trying to halt inflation since 2011 with the Very Long Term Refinancing Operations (VLTROs), and now with full-blown Quantitative Easing (QE). Two years ago, in his 2014 Jackson Hole speech, Mario Draghi asked for fiscal policy to 'play a more supportive role,' and later in Milan he said the same thing (Draghi 2014). He is still waiting. Third, the ECB has been trying to unblock lending channels since 2011, again via VLTROs, Targeted Long Term Refinancing Operations (TLTROs), and again with QE. But 'unblocking credit channels' means actually dealing with the €1.2 trillion in non-performing exposures (loans) scattered around the system while trying to get people in a recession to borrow more (PWC 2013). Making banks recognize these losses, in an environment of low growth, at the same time as they are being required to build much bigger capital buffers, is also a big ask that so far has gone unanswered. Fourth, undertaking 'serious' structural reforms in an environment of low growth simply retards growth (Eggertsson et al. 2013). And fifth, as electoral results throughout Europe increasingly show, and the reality of Brexit takes effect, the appetite for building a full financial union, a banking union with deposit insurance, and devolving more power to Brussels to create stronger fiscal institutions simply is not there (Matthijs/Blyth 2015). So, as Lenin once had it, 'what is to be done?'

2 THE POLITICAL AND ECONOMIC RISKS TO GROWTH AND RECOVERY

With the OECD coming out against more austerity, and in favor of fiscal policy, they join the IMF, the US Treasury, and almost everyone (except the European Commission and the German government) in urging a more aggressive fiscal stance. The OECD's report bluntly stated that growth prospects have 'practically flat-lined' and that 'a commitment to raising public investment would boost demand and help support future growth' (OECD 2016). I can only agree. But I can also state just as bluntly that despite all the evidence marshaled to make this case overwhelming (see, most recently, Gechert 2015), it's still not going to happen for the political and economic reasons given in Table 2.

If the only risks to growth were economic, the challenge would be easier. But the problem of restoring growth is essentially political, especially in Europe, as the left-hand side of Table 2 lays out. That austerity policies have caused economic contraction in the eurozone rather than its expansion is now well documented (Blyth 2015a). What is less recognized is how pro-cyclical austerity interacts with systemic deflation to produce a world where simply knowing the right policy isn't going to make it happen. To see why this is the case, we need to go back to 2011 and the Long Term Refinancing Operations (LTRO) launched by the then-new ECB governor, Mario Draghi.

Table 2 Obstacles to recovery policies

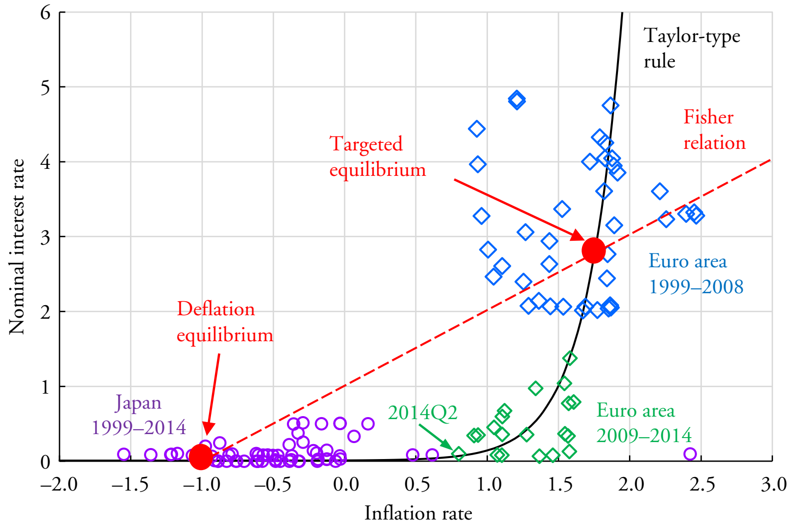
Political risks to growth and recovery	Economic risks to growth and recovery
Problem: The problem of generating recovery in the face of counterproductive policy is multiplied when policymakers continue to insist on fiscal restriction, even when deflation has become systemic.	*Problem:* The eurozone recovery, to the extent that it exists, is predicated upon the EU as a whole running an export surplus against the Rest of the World.
Result: The hollowing-out of the political party systems that have made the EU possible.	*Result:* Demand is external and fragile, and it sets different European 'Varieties of Capitalism' against each other.

3 THE SUDDEN AND SURPRISING END OF INFLATION – EVERYWHERE

Fear over the potential break-up of the eurozone reached an all-time high in the summer of 2012 as interest rates on Italian and Spanish bonds peaked at 7 percent. In response, Mario Draghi made a speech in London in July 2012 where he promised to do 'whatever with takes, within our mandate … to save the Euro' (Draghi 2012). Actions followed words in September 2012 with a bond-buying program called the Very Long Term Refinancing Operations (VLTROs), and with a program to 'promise to buy everything if needed/do whatever it takes' called Outright Monetary Transactions (OMTs). Investors seemed to take Draghi at his word as yields fell, while OMT was never actually used. But what did happen due to OMT, and the prior €2 trillion in VLTROs and liquidity assistance to banks that these programs made possible, was that lots of banks in the periphery of Europe were incentivized to buy lots of local bonds, banking the spread between the VLTRO loan rate and the bond yield, using the latter to improve their balance sheets while using the purchased bonds to shore up bank capital (Blyth 2014).

The ECB's policy at this juncture was expected to be the reduction of debt through financial repression, and the necessary condition for this policy was inflation. The eurozone had to get growth going again while materially reducing its now austerity-bloated debt stock.[1] Basically, now that debt was held by a 'captive audience' (local banks dependent upon ECB liquidity), the policy would be to drop the coupon, lengthen the maturity, and run an inflation rate rather higher than the yield on the bond and after 10 years about a third of the debt would be inflated away, which was how debt was reduced everywhere in the 1950s (see Reinhardt/Bellen Sbrancia 2011). But it turned out to be much harder than anyone expected to generate inflation. It turns out that when you do multiple simultaneous austerity experiments across the world while obliterating the ability of labor to command any reasonable share of the surplus, you can in fact permanently alter the long-run growth curve of an economy, all of which makes it rather hard to get inflation 'back up' to target (see Martin et al. 2015). This led

1. Around 50 percent of the rise in debt over 2007 baselines in the periphery was due to the shrinkage of the economy owing to austerity policies making the same stock of debt bigger as a proportion of GDP – the so-called 'denominator effect.' See Sandbu (2015).



Source: Antolin-Diaz (2014).

Figure 1 Europe's deflationary problem

to the situation Draghi faced in 2014, which is seen in Figure 1. It's still the same situation that he faces today.

4 THINKING LIKE KALECKI IN A DEFLATIONARY WORLD

In Figure 1, the equilibrium position of euro-area member states had shifted from the Taylor-rule 'sweet spot' before the crisis to looking dangerously like Japan, with one exception. Japan is, despite its very high debt levels, a rich society, whose citizens are very old and treat government debt as an intergenerational gift. The consequences of deflation in such a society are benign, at least for pensioners, which is most of those who vote. In an austerity-shocked economy such as Greece or Portugal, deflation creates a much less benign distributional and electoral politics that is summarized in Table 3.

Table 3 maps out how euro area electoral politics have played out since deflation established itself in Europe in 2013. Anti-austerity movements such as Spain's *Podemos* and Italy's *Five Star* movement were initially seen as temporary reactions that would die down as recovery took hold. They have not acted according to the script because the recovery has not taken hold, but rather, deflation has. As of late January 2016 one third of euro bonds were negative yielding (Bloomberg 2016). Yet even if mainstream commentators foresaw the end of inflation, they still missed was how deflation empowers such movements by generating a kind of 'Anti-Kaleckian' politics.

Unlike periods of inflation, which are best thought of as a class-specific tax on creditors, deflations create a 'second-best' problem for everyone regardless of the assets they hold. For example, should investors invest now, or wait until the assets in questions are cheaper? Should labor accept a lower wage today, knowing that prices will fall tomorrow? In the aggregate, these choices are suboptimal as everyone's first-best action in the moment leads to second-best outcomes down the line (lower investment and growth,

Table 3 The anti-Kaleckian politics of deflation

Losers	Winners
Creditors: Real value of debt goes up but ability to collect goes down	*Debtors:* Can't pay, won't pay, will vote
Center-left and center-right parties: Vote share at elections collapsing, new left and right parties seen to be a mortal threat	*Populist and nationalist parties of the left and the right:* Anti-austerity, anti-creditor, pro-debtor coalitions (NF, AfD, SNP, Syriza, Podemos, Corbyn's Labour Party)

lower consumption), in a kind of 'Lipsey–Lancaster Second-Best' effect – generalized.[2] But crucially for politics in demand-shocked high unemployment countries with lots of debt, such as the eurozone periphery, deflation increases the value of debt but undermines the ability of debtors to pay it back. This is not to say that in the short term debtors 'benefit,' in a material sense, from deflation. They do not. Rather, it is their resistance to and defection from mainstream politics that powers the populists of both left and right.

Debtors in crisis countries may vote more for left than right, recognizing that bailing other people's banks comes at their expense. Reciprocally, debtors in creditor countries may vote more for populists of the right, who want to enforce creditor contracts all the harder, so long as such enforcement always falls on foreigners. Yet the reality produced by these dynamics is more nebulous. Contemporary populism in Europe breaks down the settled categories of left and right. For example, the British Labour Party, even under Jeremy Corbyn, wants to stay in the EU and accepts the need for budgetary consolidation. The French National Front, in contrast, wants out of Europe, argues for an expansionary fiscal policy that is more redistributive, and is against the Trans-Atlantic Free Trade Treaty. If you ignore the pronounced racism of the latter, which party is, in the minds of voters rather than intellectuals, more to the left?

As such, the results across cases are reactionary (in the neutral sense of the word) anti-creditor pro-debtor coalitions eating away at mainstream party vote shares.[3] Seen in this way, and as I have argued elsewhere, *Syriza* in Greece, the *National Front* in France, *Sinn Fein* in Ireland, *UKIP* in the UK, the *SNP* in Scotland, and *Podemos* in Spain, are then more similar than different (Blyth 2015b). They are all, regardless of left or right political stances, at base anti-creditor, anti-market, pro-national, populist movements that constitute a threat, not just to macroeconomic stability, but to the very idea of Europe as it has been constructed over the past 30 years, with the euro at its core (ibid.). What deflation produces then is 'anti-Kalecki.' Recall that Kalecki famously argued that permanently full employment will produce inflation and eat profits as it becomes costless for labor to move from job to job, bidding up wages and destroying 'the right to manage' in the process (Kalecki 1943). This will lead to a 'cost-push wage-pull' spiral of inflation that will be met by employer mobilization and a capital strike, until 'order' is restored. As an account of the 1970s and 1980s written in the 1940s this is incredibly prescient, as Wolfgang Streeck (2014) has recently reminded us. But it also works in reverse, and for today, as can be seen in Table 4.[4]

2. Which is, coincidentally, one of the longstanding results in economics, along with the Sonnenschein–Mantel–Debreu theorem, which shows formally why structural reforms on their own cannot achieve the goals that their advocates set for them.
3. Even if, in some cases, relief is only for your own native debt holders.
4. After all, if inflation and deflation are symmetric, then theories about one state should also apply to the other state.

Table 4 Positive and anti-Kaleckian equilibria in the OECD in the 1970s and 2010s

Inflation: the debtor's paradise of the 1970s (positive Kalecki)	Deflation: the creditor's paradise of today (anti-Kalecki)
Positive inflation	Secular disinflation
Labor's share of national income at all-time high	Capital's share of national income at all-time high
Corporate profits at all-time low	Collapse in wages
Unions strong	Unions weak
Inequality low	Inequality high
National markets	Globalized markets
Finance weak	Finance strong
Central banks weak	Central banks strong
Parliaments strong	Parliaments weak

The current crisis is therefore not just a hangover from the financial crisis best treated with a policy mix of 'loose money and tight fiscal' policy that is then 'righted' with a doubly loose mix. Rather, this might just be the endogenous undermining of a global macroeconomic regime that has been 40 years in the making. Just as the 'positive Kalecki' equilibrium undermined itself when the bargain between creditors and debtors broke down due to inflation-squeezing creditors in the 1970s, so the 'anti-Kalecki' equilibrium of the current moment may be collapsing, again due to a breakdown in the bargain between creditors and debtors, this time due to deflation, squeezing debtors to the point of revolt. As Table 5 shows us, this is predictable because periods of inflation (Kalecki) and deflation (anti-Kalecki) create a very different politics of collective action.

The current moment is then the outcome of a reversal of power between creditors and debtors due to persistent deflation (and its side effects of rising inequality and winner-takes-all politics). In a persistent deflation, especially in austerity-shocked high-unemployment countries with weak labor movements and low growth, yields compress and creditors worry about their spreads, demanding repayment of debt at all costs. Macroeconomically, this makes the situation worse, but micropolitically it empowers debtors since they cannot pay, will not pay (voluntarily at least), and have the right to vote.[5] This is why the parties of the center-left and center-right, but especially the center-left – the bulwarks of both the European project and the neoliberal economic order that it enshrines – lose vote shares in deflations since they are (correctly) identified as being pro-creditor parties that are demanding debt repayment in an already unequal system from those with the least assets (Karreth et al. 2013; see also Blyth 2015c).

We are now two electoral cycles out from the start of the crisis and center-party vote shares everywhere in Europe are collapsing on the left, and are being chipped away at on the right, with Portugal being the latest country to follow the trend.[6] This process is effectively hollowing-out the party systems and parties that made the European project possible. But the new pro-debtor parties are not yet governing, and in an institutional set-up such as the EU, where there are 'member states' and not 'nation states,' to use Chris Bickerton's (2013) distinctions, there is not much governing that they could do even if they were in charge, lacking effective fiscal and monetary tools. So the ECB remains the 'leader of last resort,'

5. It also engenders an intergenerational skew in terms of who has assets and who does not.
6. Consider that arguably the most successful conservative party in Europe at the moment, the British Conservative Party, won re-election in May 2015 and managed to increase its vote share over the prior election by a half a percent despite the collapse of its coalition partner and the complete implosion of the opposition Labour Party.

Table 5 The politics of macroeconomic regimes

Collective action under inflation	Collective action under deflation
Capital's interests clear	Fallacy of composition at the level of interest formation
Labor on defensive and fragmented	Emergence of anti-creditor coalitions that want to capture the state
Neoliberal offensive at level of ideas and institutions State weakened, finance ascendant	Creditor–debtor stand-offs at the level of the state (domestic austerity) and internationally (EZ crisis)
Result: The transformation of the postwar order (1980–2000)	*Result:* The transformation of the neoliberal order (2015–?)

while fiscal policy remains off the table since going there would undermine the credibility of governing center parties, the enforcers of the 'creditor's paradise' everywhere, who are already under siege from their own publics. Their political survival demands that we 'stay the course' even if that course is headed straight for the rocks.

5 ECONOMIC RISKS COMPOUND THE POLITICS

Many analysts today worry that QE is simply a badly disguised attempt to manipulate exchange rates and grow via exports (for example, Ruben 2015). Or perhaps the worry is that it is increasing inequality (see Bank of England 2012). It's probably doing both, but both perspectives miss the point that what Draghi is actually doing with all his monetary might is desperately trying to halt deflation. Boosting exports is a secondary effect of this, and increasing inequality is a nasty side effect.[7] The eurozone has indeed put its stock in growing its way out of the crisis through exports.[8] But until deflation is fully arrested, this strategy cannot be sustained.

This policy direction has confounded those who said that the eurozone as a whole could not sustain an export-led growth strategy since it was too big to do so vis-à-vis the rest of the world (for example, Blyth 2015a: 142–143). So the question becomes: can exports alone produce sufficient growth to power the continent out of deflation and into growth even if Draghi manages to draw a line under deflation? The answer is: probably not, but trying to do so may have some unexpected results that may in fact undermine the European project still further. In short, if the anti-Kaleckian politics undermines the EU's political compact, then the drive for exports as the route to growth may quite literally drive the continent apart economically.

6 EXPORTS, SAVINGS, AND EUROPEAN VARIETIES OF CAPITALISM

A powerful framework for analysing stability and change in comparative political economy was introduced by Hall/Soskice (2001) with their notion of 'Varieties of capitalism.' Broadly, they posit two stable equilibria (macroeconomic regimes) under conditions of

7. One might add that importing a bit more inflation would also help. I thank Sebastian Gechert for this insight.
8. See, for example, the pre-crisis statement of intent in European Commission (2006).

globalized and financialized capitalism. The first is what they term a 'Liberal Market Economy (LME)' characterized by stock-market finance, a weak/small labor movement with general skills, competitive technology acquisition among firms, low levels of transfer spending by the state, and volatile labor markets. The second is its opposite, the 'Coordinated Market Economy (CME),' characterized by patient capital, strong(er) labor with control over skill formation, firms that cooperate on technology, high levels of welfare spending, and long-term employment contracts being the norm (ibid.).

The framework has been criticized for its failure to cope with change and its inapplicability to specific economies (Blyth 2003). But as an ideal-type contrast it usefully illuminates recent developments in Europe. While the typical LME to CME contrast is the Anglo countries (LMEs) to the Germanic countries (CMEs), one can usefully apply the framework to Europe as a whole, as Hall (2014) has recently done, analysing different types of CMEs within Europe.

In this application, Northern CMEs live off export-led growth, save too much, and send capital to the Southern domestic demand-led CMEs, who then run deficits and consume too much (ibid.). This was the well-known 'vendor financing' structure of capital flows and trade in the EU prior to the crisis (Harrison 2011). What Hall's perspective adds is how these flows were institutionally determined by the interaction of these different varieties of European capitalism. Specifically, how the export orientation and high private savings of the Northern countries interacted with the 'low public saving plus domestic consumption' orientation of the Southern states to produce unsustainable structural imbalances. Building on Hall, I argue that what these institutional inter-linkages and the feedback loops they produced through the banking system of Europe have done is to create strong pressures for all of Europe's economies, regardless of their variety, to converge on the Northern model of export-led growth.[9] Hall's division of the continent into 'export-led' Europe and 'consumption-led' Europe is not theoretical – it is empirical. And it has been turbocharged by an unintended consequence of the austere policy response to the crisis of 2010–2012 that in many ways mirrors the policy response of states affected by the East Asian Financial Crisis of 1997–1999.

7 WHEN IN DOUBT – EXPORT YOUR WAY OUT

The 1997–1999 Asian and 2010–2012 European crises are both, at base, balance-of-payments crises caused by global financial integration and complacency about financial risk. In the 1990s, Asia was a beneficiary of large cross-border capital inflows where local currencies pegged to the US dollar created the illusion of little risk and high returns. Thailand, Indonesia, Malaysia, and South Korea then played a role analogous to that of peripheral eurozone countries in the 2000s. Absorbing huge capital inflows from areas with lower rates of return, the East Asian states generated large current-account deficits and accumulated debts in a currency they could not print. A classic 'sudden stop' to those capital flows in 1997 resulted in a series of financial panics precipitating currency collapses and defaults throughout the region. To combat this vulnerability, within a decade Asia shifted from having US dollar liabilities equivalent to 10 percent of GDP to owning net external assets of 20 percent of GDP. They became structural surplus countries.

In response to its own self-inflicted 'sudden stop' of 2011, Europe pulled the same macroeconomic trick. Prior to 2007, the Central and Eastern European economies of Poland,

9. For an excellent account of how these financial feedback loops operated prior to the crisis, and indeed generated the crisis, see Jones (2015).

Hungary, the Czech Republic, Slovakia, and Slovenia ran collective current-account deficits equivalent to 5 percent of GDP while the largest southern economy in the eurozone, Spain, was running a current-account deficit of 10 percent of GDP in 2008. All of which was made possible by North to South intra-European capital flows that played the same role as global capital flows from West to East a decade and a half earlier in Asia.[10]

And when that all went wrong in Europe, the crisis response was the same as in Asia a decade before, with austerity and the shift to running a structural surplus from structural deficits with Italy, Spain, Portugal, Greece, and Ireland all now running current-account surpluses of between 1 percent and 5 percent of GDP and the eurozone as a whole running a current-account surplus close to 3 percent of GDP.[11] Given this, European capitalism is being increasingly divided into export and consumption economies that are all under pressure to become export-led growth models. What's driving this again are the institutional differences between these economies, with Germany acting as the growth node in an export network that pushes the whole of the eurozone in one direction.

To see why this is the case, consider that while the export surplus of the eurozone in December 2015 was €24.3 billion, €18.8 billion of surplus came out of Germany.[12] Germany may be legendarily efficient, but how does 30 percent of the eurozone generate nearly 70 percent of the surplus? What's driving this process is how the institutional divergences and feedback loops that Hall correctly identified became so much more prominent after the crisis.

8 DIVERGENCE IN EUROPE'S VARIETIES OF CAPITALISM

During the 2000s, Central and Eastern European economies acted as sources of demand for European goods, services, and capital. Inheriting Communist economic institutions and assets, they effectively, in many cases, depreciated their capital stocks to zero and came to rely on foreign capital for both investment and consumption. Running large current-account deficits in the run-up to the financial crisis, GDP per capita in the economies of Poland, the Czech Republic, Hungary, and Romania caught up with that of the eurozone (Blyth 2015a: 216–226). These countries were also caught short by the sudden stop of capital that pushed Europe into recession in 2009–2010. But what shielded them, and amplified this structural shift to exports throughout Europe, was shifting a large part of the manufacturing base of Germany, and to a lesser extent Italy, to these countries over the prior decade.

9 GROWTH AMONG THE EXPORTERS

During this period the East and Central European countries became the parts suppliers and assemblers of what might be termed the 'greater German export complex.' The numbers involved are astonishing. An average of 25 percent of the total exports of the Czech Republic, Austria, Poland, Hungary, Slovenia, Slovakia, and Romania, with a high of 32 percent for the Czechs and a low of 19 percent for the Romanians, go straight to Germany.[13] Of those totals, an average of 10 percent of these countries' exports are in

10. All surplus and deficit figures here pulled from TradingEconomics.com.
11. TradingEconomics.com.
12. TradingEconomics.com.
13. All figures in this section are author's calculations from UN COMTRADE Database and the Atlas of Economic Complexity.

one category: parts and accessories of motor vehicles.[14] Averaging across related categories of exports, such as cars, trailers, tractors, etc., doubles these figures. Despite the shocks of 2009–2012, these economies have been running persistent current-account surpluses, out of their economies, into Germany, and then out into the world as finished goods. Data on German capital flows to Central and Eastern Europe in the 2000s, and recent trends in these countries' net international investment positions, suggests that German export firms effectively rebuilt the capital stocks of these countries and integrated them into their supply chains.[15]

Export-led growth is of course vulnerable to demand shocks in other countries, and shifts in the import preferences of key markets. For example, China's shift from exports to consumption, if it continues, suggests that large exporters of machine tools and intermediate goods, such as Germany, and by extension those that export to Germany, will be hurt. But when one delves deeper into the numbers, one finds that much of what Germany exports is high value added, where factors such as unit labor costs are not wholly determining (see Strom 2016). That is, while quality matters, making quality ever cheaper certainly doesn't hurt. For this group of countries – Germany, Hungary, the Czech Republic, Poland, Slovakia, Slovenia, and Romania – the fight against deflation and its effects on the euro exchange rate (even if they have their own currencies) is long-run positive for 'export' Europe. If the rest of the world as a whole slows down, then they are in trouble, but for now, they are at least growing. But what about that other variety of European capitalism whose growth model is based upon internal consumption and domestic demand, and for whom the budgetary squeeze of the past several years has led to extremely low or to no growth?

10 AN 'EVER CLOSER SQUEEZING' OF THE REST?

Excepting 2015, Italy hasn't grown in over a decade. But it too has moved parts of its supply chain into the eastern member states and is now running a (small) surplus. Portugal has gone from a 7 percent deficit to a 1 percent surplus. Spain has done the same, having gone from a 10 percent deficit to a 1 percent surplus. The two big outliers are France, which used to run a surplus and now runs twin budget and trade deficits of 4 and 1 percent, and, although outside the euro but in the EU (for now), the UK, which has twin trade and budget deficits of 6.2 and 4.9 percent respectively, but can at least devalue periodically, seems to live quite comfortably intermediating rest-of-the-world capital flows.[16]

What this suggests is that, even in the absence of any further political shocks, which is unlikely, and barring any further slowdown in the global economy, again unlikely, there will be intense pressure over the next few years for the larger consumption-led states – France, Italy, and Spain, but particularly France – to 'follow the leader' and shift towards exports. Spain has been able to do so, partially, but mainly because imports have fallen as consumption declined and unemployment rose. Given existing unemployment levels in these three very big countries, the type of structural reforms that Brussels and Berlin insist upon – those that increase unemployment – are likely off the table. While the Commission in particular has recently attempted to make the rules that empower it actually fit the

14. UN COMTRADE Database and the Atlas of Economic Complexity.
15. It is important to note that this is not a 'Rotterdam Effect,' where the number looks bigger than it is because of pass-through effects. Rather, Germany is a catalyst, not a pass-through in these relationships.
16. Figures from Trading Economics.com.

environment in which they are deployed, there are political limits to how far they can go in this direction (see Schmidt 2015). What has happened instead is that Italy, France, and Spain have increasingly ignored the rules. As such, a *de facto* 'end to austerity' in these countries in 2016 and 2017 and beyond that will attempt to raise effective demand is extremely likely. Given that German domestic demand is up in 2015, but is insufficient to raise demand in Europe as a whole, this should be welcomed (see Odendahl 2016). But to the extent that such a divergence on fiscal stances is compatible with the new fiscal framework of Europe – the six-pack, the fiscal compact, and the two-pack – which together effectively make fiscal policy illegal, remains in grave doubt.[17]

In short, if one part of the eurozone is running a surplus against the rest of the world and against the rest of Europe, and the new fiscal framework disavows offsetting fiscal adjustments, and all surpluses and deficits still sum to zero, then if the rules are fully enforced, France, Italy, and Spain may have to run a permanently contractionary policy in order to offset the surplus generated elsewhere in the eurozone. Again, if you can't inflate or devalue to adjust, and you are not allowed to default, permanent internal devaluation becomes the *de facto* fiscal stance regardless of one's declared intentions. Now bring the politics back in. If fiscal transfers are difficult to sell to the public, imagine how 'you need to shrink so that they can grow' will go over in a world of deflationary politics. Imagine how much this would empower the Front Nationale's claims against the EU as destroying France and what it would say to British Euroskeptics even if this time around they vote (narrowly) to stay in. This is how the economics makes the politics, already bad, much worse.

Take these two sets of problems together and it's easy to conclude that the future of all things euro may be less secure than even I thought a year ago (Matthijs/Blyth 2015: 249–271). But what does that mean for policy going forward? And what are the risks and opportunities ahead, even if we managed to get a better policy mix? This is what I turn to in the conclusion.

11 CONCLUSION: WHAT *IS* TO BE DONE – AND WHAT *CAN* BE DONE?

'What *is* to be done?' always begs the question 'what *can* be done?' Macroeconomists at the FMM conference in October 2015 seemed to me to cluster into two camps that represented both of these questions. In the 'is' camp were those for whom the lack of appropriate fiscal policies was primarily a question of information. That is, if the data shouted loudly enough, policy would change. In the 'can' camp are those (like me) who think that policy is a question of political power and that is what determines the feasible set of policies in any given moment.

One of the ways that this division expressed itself was in the Q and A on my panel when Andrew Watt was called out for being in favor of monetary activism – qua helicopter drops and negative rates – rather than for fiscal policies, which all the studies show

17. The six-pack sets out under what conditions an Excessive Debt Procedure (EDP) can be initiated against a member state, and stipulates which financial sanctions will be imposed if it is so designated. The fiscal compact requires EU member states to respect and ensure convergence towards the country-specific medium-term objective (MTO), with a lower limit on the structural deficit of 0.5 percent of GDP. The two-pack sets out simplified rules for the enhanced surveillance of member states facing financial instability, those receiving financial assistance, and those exiting a financial assistance program. The room for a positive fiscal policy in such a framework, when a country does not have its own currency, is highly constrained.

would have bigger and more permanent effects. I agree with the criticism, but disagree with its importance, for the following two reasons.

First of all, what the 'information' camp, to my mind, misses is that in a world where fiscal policy is politically impossible, such monetary tools are not only a pretty good second best, their use is inevitable given the seriousness of the fight against deflation. If deflation really becomes systemic, the creditor class loses. Period. Schadenfreude apart, such a moment can throw up an even worse type of politics. The prospect of President Trump springs increasingly to mind. So I argued that rather than reject such policies out of principle, we should adopt them pragmatically and make sure they are used to the benefit of austerity-shocked debtors in the form a 'People's QE' and other initiatives.

Second, the other 'political' reason that fiscal policy is off the table, which again limits 'what can be done?' apart from the politics, is the problem of inequality. That is, in a world where the top 62 capitalists own as much as the bottom half of the world's population, the investor class does not need to invest to survive, but the rest of us need their investment to survive (Oxfam 2016). The distributional consequences of the investment function are therefore extremely asymmetric. If fiscal policy is synonymous with public investment, and the investor class is, to be crude, no longer composed of members of the public, then their opposition to 'useless stimulus' is likely to carry more weight than the findings of 1000 econometric studies.

In short, the problem of 'better policy' is political more than it is informational, and the political problem for fiscal policy is precisely that it will work and that it will cost the investor class, which is why it will not be tried. Yes, we all benefit from better fiscal policy, but some very powerful folks – those who have made off with 90 percent of everything for the past 30 years and are already doing very nicely with private financing initiatives, speculation against government debts, the outsourcing of jobs, and the chasing down of bankrupts both large and small – benefit less. That they can veto good policy is down to the politics of fiscal policy, not the economics. Further monetary activism can be done and is already being done.[18] As Churchill said about the Americans, 'they always do the right thing when they have exhausted all the other possibilities,' so we may eventually get to fiscal policy, but only after we have gone through all the other monetary possibilities, some of which may actually work.

Which brings me to the question of 'what do we mean by work?' Spain, for example, is heralded as a success by Europe's structural reformers, but under what metric is a country that can't form a government, and that has 20 percent unemployment, 100 percent debt to GDP, and a 5 percent deficit, a success?[19] The bar here is pretty low. In the current moment it seems to mean: stop deflation becoming systemic and save the Europe that has been built since Maastricht. But is this enough? In terms of our ambitions for growth, full employment and fairness: no. But we are not in charge. In terms of those issuing the orders from Brussels, Berlin, and Frankfurt, it probably is. A lower bar is, after all, easier to reach. And that lower bar may be more stable than we think.

Much of the commentariat in and for financial markets seems to think that they have a God-given right to an 8 percent real rate of return with safety and liquidity guaranteed, and that, if they don't get it, it's someone else's fault – China, QE, negative rates, low oil prices – to name but a few of the recent suspects (Blyth 2016). But let's think about this a bit differently. Let's assume that Draghi and unconventional monetary policy works at the low bar. That systemic deflation is avoided and the political supports of the system remain

18. The fact that leading bankers are whining about it with increasing fervor tells us all we really need to know about supporting it. See, for example, Folkerts-Landau (2016).
19. I thank Sebastian Rojo for this turn of phrase on Spain.

intact. What would happen then, in a world of low (but positive) growth, negative yields, and zero inflation?

Recessions typically occur when the credit markets (not stock markets) blow up, when inflation is attacked with high interest rates, or when there is a commodity price shock. Given that China has built all the infrastructure that it needs, that the EU can't agree to build what it needs, that the US can't agree that it needs to build anything, and that we are at the end of the commodity super-cycle as attested in oil and other prices, the last factor can be discounted. The fact of no inflation anywhere in a world of high unemployment rules out interest-rate shocks regardless of what Fed press conferences might intimate. That leaves the financial sector as a source of trouble. And while there are real non-performing loan problems in Europe and China, and real too-big-to-fail concentration issues in the US, and the world is still deleveraging, banks today have less leverage, higher liquidity ratios, and much tougher regulators.

The old world of banking, where 8 percent came along without trying, was a function of boosting leverage on a declining spread as global interest rates fell to near zero over a 30-year period. That world is not coming back. The shift from one Kaleckian equilibrium to the other made that spread, and also its disappearance, inevitable. Now, with inflation and rates long and low, if not negative, for an extended period of time, accompanied by low but positive growth, we may be entering a world that might be called 'secular stability' rather than secular stagnation. And what could upset this 'low bar' equilibrium? Those anti-Kaleckian forces that are turbocharged by deflation, if they really do represent the gravediggers of the current global macroeconomic regime, may be the only reason those in charge will finally turn to fiscal policy. The ECB and OECD have perhaps seen the writing on the wall in this regard and are keen to avoid it, hence the newfound appeal of fiscal policies. Maybe, in time, Brussels and Berlin will come to the same view, and those obviously sensible policies we all want to see in place will actually be considered to be not just economically necessary, but also politically possible.

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