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# EUROPE’S PARADOXES

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## *abstract*

*The essay aims at highlighting some fundamental paradoxes affecting the very structure of the European Union in its current organization. The currency union is not only insufficient, but ultimately impairing the economic efficiency of the Eurozone. The economic issues that the European Union project was designed to respond to do not correspond to the present circumstances. The European institutions and the European left-wing parties have lost sight of the proper parameters of social justice. Left-wing parties endorsing pro-capital policies and supranationalism deployed to overcome nationalism are the two main paradoxes that have a damaging impact on the present development of European institutions.*

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## *keywords*

*Eurozone, crisis, austerity, economy, paradoxes*

- 1. Introduction** When Diego Fusaro asked me to contribute to this issue of *Phenomenology and Mind* I was honoured and found the opportunity to address an audience completely different from the economic profession to be very stimulating. I suppose his kind invitation was motivated by the unexpected success of my book *Il tramonto dell'euro*, that reanimated the debate on the process of European integration in Italy. In this book, building on the work by Frenkel and Rapetti (2009), who extended the Minskyan theory of boom and bust cycles to a centre-periphery setting, I showed how the Eurozone crisis depends on the excesses of private, not public finance. I also pointed out how this crisis is an integral part of the political project of the euro, much in the same way as currency pegs have always been an integral part of the imperialistic aggressions used on emerging countries everywhere since 1980 (Diaz-Alejandro [1985] is the first relevant reference). More specifically, once you interpret the euro as a neoliberal project, aimed at compressing the lower classes' incomes and rights, the Eurozone crisis appears as a success, rather than a failure. Indeed, even if the euro will eventually disappear (the "irreversibility" dogma has been seriously questioned during the 2015 Greek crisis), most of its adverse effects on the European welfare are likely to be persistent, if not irreversible. The book happened to anticipate a number of further contributions, such as Constâncio's (2013, 2014) analysis of the Eurozone crisis in terms of private imbalances and the debate between Streek (2013) and Habermas (2013) on democracy and European unification. However, my work was anything but original: as I showed in my book, and as I will revisit throughout this paper, the project of European monetary integration has been the cause of much perplexity among *progressive* intellectuals in Europe since at least Meade (1957). Indeed, the very fact that books like mine, or debates such as the one between Habermas and Streek, may seem original today, is the more striking proof of the bewildering success of the neoliberal counterrevolution, whose main goal, perfectly achieved, is to bring the European intellectuals to unlearn from the Eighties onwards what they had learned since the Fifties thanks to WWII. The question then arose as to what language I should use. Prof. Fusaro gave me complete freedom of choice, but ultimately I had as many degrees of freedom as any other contributor: zero. To take full advantage of this opportunity, we are forced to use English – the language I also use in my economics career – because English is the most popular language worldwide (particularly so, here in Europe). This is not a minor point. Contributors to this issue, like me, could probably converse in each other's language. But we are an elite (which is why we write academic papers): in other words, we belong to the small set of human beings that for one reason or another can afford to be cosmopolitan. Indeed, this isn't an anecdotal remark,

therefore it is worth spending some words to highlight why the language issue is so important in analysing the Eurozone political and economic crisis.

For years, the economic profession has been making a huge effort in order to ferry its status from the realm of human sciences to that of natural sciences, from “moral philosophy” to “natural philosophy”. This attempt largely predates the neoliberal counterrevolution. “Technicians” ruled during the 1929 crisis,<sup>1</sup> as they do now in most distressed countries, and the mathematisation of economics goes at least as far back as the 18th century (think for instance of Quesnay’s (1758) *Tableau économique* or of Bentham’s (1789) “felicific calculus”). The main reasons for this attempt to “technicise” a human science, or, in other words, to “harden” a soft science are summarized by Keynes (1936, Ch. 3, Par. 3) as follows in describing Ricardian economics (i.e., what we would call nowadays “neoliberal” or “neoclassical” economics):

That it reached conclusions quite different from what the ordinary uninstructed person would expect, added, I suppose, to its intellectual prestige. That its teaching, translated into practice, was austere and often unpalatable, lent it virtue. That it was adapted to carry a vast and consistent logical superstructure, gave it beauty. That it could explain much social injustice and apparent cruelty as an inevitable incident in the scheme of progress, and the attempt to change such things as likely on the whole to do more harm than good, commanded it to authority. That it afforded a measure of justification to the free activities of the individual capitalist, attracted to it the support of the dominant social force behind authority.

It is indeed true that, for whatever reason, many economists mistake “science” for one of the many languages of science: mathematics. As a consequence, these colleagues of mine have an unpleasant inclination to dismiss sociology, philosophy, psychology, and so on, as mere hobbies. And it is also true that the quest for “intellectual prestige”, or “beauty”, sometimes leads economists to pretty hilarious results, such as Thomas Sargent’s (1987, p. 202) lengthy discussion of the quite arbitrary relation between the roots of a labour demand equation and the design of the Parthenon. But, as Keynes reminded us over 80 years ago, the whole point of this otherwise clumsy attempt to present themselves as “true scientists” is political, and it is a very dangerous one, if you still believe in democracy. It is the attempt to present “social injustice” as an “inevitable incident in the scheme of progress”; to disguise as “virtue” the narrative that legitimates the self-interested will of the “dominant social force behind the authority”; to affirm the TINA (there is no alternative) principle.

In other words, it is the euthanasia of politics.

I belong instead to that minority of economists who recognize economic decisions to be essentially political. As a consequence, I am firmly convinced that any assessment of an economic project must reckon with its political dimension: it must delineate the project’s consequences on the distribution of income, it must reveal what vested interests are involved, and it must evaluate whether and how a political mediation among those interests could be reached. When the need for political mediation is hindered by technical jargon, economic reforms are likely to lead to politically unstable outcomes, in which instability inevitably benefits the strong.

This is the reason why, when you approach the current model of European economic integration, you are forced to take seriously into account the feasibility of a European-level

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<sup>1</sup> A good example is Heinrich Brüning, German chancellor from 1930 to 1932, well known for his austerity policies, that paved the way to the rise of Adolf Hitler.

democratic political process. Language is crucial, because on one hand it is said a European-level political process is needed (though in my view largely not sufficient) in order to make the *current* model of European economic integration sustainable, yet on the other hand you cannot have democracy without a demos, and you cannot have a demos without a logos.

As a matter of fact, the current model of European economic integration calls for further political integration in order to obviate in a politically sustainable way the social costs of a single currency. However, it is extremely dangerous to move politics to the supranational level – especially within this model of European integration – because this would unavoidably deprive the lower classes of a voice. Moreover, this further compression of democracy would occur in an institutional framework in which the traditional checks and balances between the three powers of a sovereign State (legislative, executive, and judicial) have *de facto* been suppressed in favour of a hierarchical system, where a fourth power, the monetary one, personified by the “independent” central bank, constrains the other three.<sup>2</sup> This fourth power has no political legitimacy (bank officials, unlike legislators, are not elected), is not controlled by the executive power, and it is basically not controllable by the judiciary power (Gruber and Benisch, 2007). A feature almost completely overlooked in the debate on the “democratisation” of Europe.

While I find extremely unpleasant that some colleagues refuse to recognise their “technique” as the prosecution of politics through other means, I also find it highly suspect the “primacy of politics” boldly asserted by many political leaders. The primacy of politics looks pretty much like the new “l’intendance suivra”. To say the least, in the European project “l’intendance n’a pas suivi”. Sometimes the nature of a problem dictates a logical hierarchy: I never heard of an engineer claiming the primacy of engineering over physics, and in any case I would feel very uncomfortable in crossing a bridge designed by such a professional. I am not claiming here the “laws” of economics should be recognized a status similar to that of physics. I am rather pointing out that there is some truth in historical materialism. Furthermore, I would like to instil in the reader a constructive feeling of suspicion: don’t you find it strange that the supposedly right-wing proponents of the primacy of technique, and the supposedly left-wing proponents of the primacy of politics, both agree on the “sound money” principle (in both its “outward-looking” worship of fixed exchange rates, and its “inward-looking” worship of price stability)?

In this paper I make an attempt to rebalance the debate by revisiting some simple unlearned economic facts about the economic and social consequences of monetary unions and putting them in the perspective of the current Eurozone debate. The first section deals with the

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<sup>2</sup> The technical dimension of central bank independence is disciplined by the article 123 of the *Treaty on the functioning of the European Union*: “Overdraft facilities or any other type of credit facility with the European Central Bank or with the central banks of the Member States (hereinafter referred to as ‘national central banks’) in favour of Union institutions, bodies, offices or agencies, central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of Member States shall be prohibited, as shall the purchase directly from them by the European Central Bank or national central banks of debt instruments”. By ruling out the monetization of deficits (presumably on the assumption that it can bring about inflation) this article exposes elected governments to the blackmail of what we are used to call “the markets”, i.e., private financial institutions. The political dimension of the independence principle is regulated by the article 130: “When exercising the powers and carrying out the tasks and duties conferred upon them by the Treaties and the Statute of the ESCB and of the ECB, neither the European Central Bank, nor a national central bank, nor any member of their decision-making bodies shall seek or take instructions from Union institutions, bodies, offices or agencies, from any government of a Member State or from any other body. The Union institutions, bodies, offices or agencies and the governments of the Member States undertake to respect this principle and not to seek to influence the members of the decision-making bodies of the European Central Bank or of the national central banks in the performance of their tasks.” The recent developments of the Eurozone crisis cast serious doubt on the actual relevance of this article.

(purposely?) misunderstood link between fixed exchange rates and austerity policies. The second section moves a step forward, by examining the economic logic of the Optimum Currency Areas theory – which provides the economic rationale for a further political integration in Europe. Against this backdrop, the third section analyses some revealing paradoxes of the current Europeanist narrative. The final section draws some conclusions.

The political and the technical dimensions of the crisis we are experiencing are basically two sides of the same coin.<sup>3</sup> I think it is useful to remind the layman that both have been to a large extent foretold by the economic profession. As proof, have a look at the following two quotes. The first one – more “political” in spirit – comes from Lord Nicholas Kaldor (1971):

It is a dangerous error to believe that monetary and economic union can precede a political union or that it will act (in the words of the Werner report) ‘as a leaven for the evolvment of a political union which in the long run it will in any case be unable to do without’. For if the creation of a monetary union and Community control over national budgets generates pressures which lead to a breakdown of the whole system it will prevent the development of a political union, not promote it.

The second one – apparently more “technical” – from Paul Krugman (1997):

The clear and present danger is, instead, that Europe will turn Japanese: that it will slip inexorably into deflation, that by the time the central bankers finally decide to loosen up it will be too late.

We are now experiencing pressure over national budgets (we call it austerity), and its disruptive effects on social and political cohesion (both domestic and international), as foreseen by Kaldor (and many others like Thirlwall, 1991; Godley, 1992; Feldstein, 1992, 1997). Above all, we are now experiencing deflation: something we never expected to see again in Europe, and something we considered for more than two decades as a Japanese endemic, but non-contagious, disease.

The words of Kaldor and Krugman may now seem exceptionally prescient, but they just stated some trivial consequences of well-known features of any monetary union, features that were well understood in the Seventies by the economic profession and the public at large. Let me say it again: at the time, these opinions were shared not only among top-level “technicians” like Kaldor and many others, but also among politicians. I insist on the fact that since these consequences were well-known, they were expected and desired as a part of a wider political project.

This is probably more evident from an Italian perspective: both because Italy had one of Western Europe’s strongest communist parties, in which the issue of European monetary integration was debated heatedly, and because some prominent ideologues of the Europeanisation (such as Altiero Spinelli) were Italian.

While searching the archives of the Gramsci foundation in Rome, Marco Palombi (2014), an Italian journalist, was able to find the minutes of the Party’s committee meetings, held when the Parliament was discussing Italy’s accession to the European Monetary System (EMS). In

## 2. The political economy of dysfunctional monetary unions

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<sup>3</sup> While I think the “political”/“technical” dichotomy to be intrinsically deceitful, I adopt it here for the sake of the argument in the meaning it has acquired in the general debate. As we shall see below, Kevin Featherstone (2001) has provided one of the most thorough and illuminating analyses of the role of technocracy in the European project.

the meeting held on December 12th, 1978, Luciano Barca, a prominent communist leader, answered insightfully to the Europeanist plea of one of his party fellows: “Europa o non Europa questa resta la mascheratura di una politica di deflazione e di recessione anti operaia”.<sup>4</sup> “Europe” was (correctly) understood as “social injustice” (to borrow Keynes’s words). Similar views were expressed, in more or less secret meetings, as well as in Parliament sessions, by prominent politicians such as Giorgio Napolitano (who would later on become President of the Italian Republic).<sup>5</sup> Since then some of those people have died, and almost all of the survivors have changed their minds, becoming fierce advocates of the euro. Why this happened would be an interesting question for an historian to answer, and part of the answer will undoubtedly be oligarchic capture (Del Savio and Mameli, 2015).

While the implications of monetary integration for income distribution were evident to progressive intellectuals, “European federalists” were perfectly aware monetary integration would bring about economic crises. However, they considered crises to be desirable “window of opportunities” for the progress of Europeanisation. This rather cynical theorization of economic crises as an *instrumentum regni*, in anticipation of the shock doctrine set out by Naomi Klein (2007), is well described by Roberto Castaldi (2012), and has been openly endorsed by protagonists of the European construction such as Romano Prodi (Barber e Norman, 2001). In this section we explore the economic reasoning behind those political processes. By attempting to re-learn what neoliberalism wanted us to unlearn we will set the stage for the discussion of currency areas in the next section.

### 2.1 The simple economics behind the European crisis

Let us start from a simple economic fact. Unless: (1) a country is endowed with all the natural resources it needs, or (2) a country is the issuer of the international liquidity tender (i.e., of the currency used for the settlement of international exchanges of goods and services), then it needs to export.

This statement may seem odd. Why “export”? A country deprived of some resources will obviously need to *import* them. However, unless this country can issue an internationally accepted legal tender, before importing something, it will need to sell something else abroad in order to earn the international liquidity needed to pay for its imports. This is the rationale of the balance-of-payments constraint, which plays a crucial role in post-Keynesian growth theory since Thirlwall (1979). It should be noted that, much like every individual, countries are not always “liquidity constrained”: in principle there is no need to earn money *before* spending it, provided you either have some cash reserves to spend, or you can get credit from your supplier (i.e., from the exporter country, which will usually have money to lend, for the very reason that it is getting money in return for what it exports). As a consequence, if a country does not export enough to cover its imports’ costs, either its external assets (its stock of foreign reserves or claims defined in foreign currencies) will decrease, or its external liabilities (the debts of its firms, households, and government with foreign creditors) will increase. This means that its net external assets (assets minus liabilities) will fall, or, in other words, its net external liabilities (also known as “foreign debt”) will increase. Put it in yet another way: if a country has a “structural” (i.e., persistent) deficit in its trade balance, which means that imports always exceed exports, its external (or foreign) debt (its debt vis-à-vis foreign lenders) will keep increasing. Sooner or later this debt will need to be repaid, which implies that the

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<sup>4</sup> “Europe or not, this is just a deflationary, anti-labour policy in disguise”.

<sup>5</sup> In Bagnai (2012) I present to the reader his 1978 declaration against the entry of Italy into the European Monetary System stressing its similarities with many current analyses (e.g., those provided by Paul Krugman in his blog). The unlearning process appears in all its fearful evidence.

deficit will need to be reversed. It is imperative to keep in mind that most of these cross-border credit/debit relations occur between *private* agents.

Now, consider a country X whose external balance is in equilibrium, and whose exports consist mostly of some good A. If for whatever reasons the rest of the world does not need, does not like, or cannot afford good A anymore, country X will witness a fall in its exports. Since we assume trade was initially balanced, a decrease in exports implies that the country will run an external deficit, i.e., that the country's net external liabilities will increase (the country will get more indebted). Unless the country is able to reverse this situation, eventually its external debt will become unsustainable: the country (i.e., some of its residents) will not be able to service its debt anymore, and there will be what the economists call a "balance-of-payments" crisis. The Eurozone crisis is actually a balance-of-payments crisis, determined by the massive accumulation of foreign debt by southern countries: debt that piled up in order to finance the purchase of goods and services from northern countries (that benefited from selling their goods, as every seller does). In other words, it is a foreign debt, not a sovereign debt crisis. Despite being still overlooked in the public debate, this pattern is evident in the data. As shown for instance in Bagnai (2012), the countries that were hit hardest by the crisis had below average public expenditure, and in at least two cases (Spain and Ireland) below average public debt. Moreover, even in two of the "stressed" countries with a large public debt stock (Greece and Italy), public debt had been either decreasing (Italy) or constant (Greece) before the crisis, whereas the foreign debt in all stressed countries had been increasing. This foreign debt was mostly private, rather than public. In other words, it was money lent to domestic firms and households by foreign private banks, rather than money lent to the domestic government (by citizen or banks).<sup>6</sup> Before being called to rescue private financial institutions, as a rule governments have little or nothing to do with the financial imbalances, so if you really want to understand the crisis please forget about "sovereigns". This interpretation of the crisis not only fits the facts, it is also endorsed by the highest Eurozone institutions and is now widely accepted in the scientific literature. In a speech held in Athens on May 23rd 2013, the vice-president of the ECB, Vitor Constâncio (2013) declared that the crisis "originated mostly from rising private sector expenditures, which were in turn financed by the banking sectors of the lending and borrowing countries."<sup>7</sup> What we are witnessing in the Eurozone since 2009 is a badly managed balance-of-payments crisis.

Why do balance-of-payments crises occur? Mostly because of exchange rate rigidity. And why was the Eurozone crisis so badly managed? Partly because of the complete exchange rate rigidity induced by the single currency.

I will give you two orthodox views why. First, let's go back to basics. Robert Mundell's (1961) seminal article, that established the study of optimal currency areas as an autonomous branch within international economics, begins with these wise words:

It is patently obvious that periodic balance-of-payments crises will remain an integral feature of the international economic system as long as fixed exchange rates and rigid wage and prices level prevent the terms of trade from fulfilling a natural role in the adjustment process.

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<sup>6</sup> If an Italian household goes to an Italian bank and takes an Italian mortgage in order to buy an Italian house in Italy, but the Italian bank got the money it lends by selling bonds abroad, the private debt of this Italian households is added (unconsciously and indirectly) to the Italian foreign debt. If an Italian macho buys a German car in order to pick up an Italian girl, getting advantage of cheap financing provided by a German consumer credit firm, well, this is again private foreign debt.

<sup>7</sup> This speech was later published in a refereed journal as Constâncio (2014).



Now, let's have a look at the most recent scientific literature. Ghosh et al. (2014) remind us that:

The emerging market (EM) financial crises of the 1990s (all of which occurred under some form of pegged regime), the large current account deficits in Eastern European countries in the run-up to the global financial crisis, and the ongoing efforts of several Eurozone periphery countries are all testament to the delayed and more difficult external adjustment under fixed exchange rates.

Besides the fact that these two sources are particularly authoritative, this is not “cherry picking”. Each and every handbook on elementary macroeconomics will teach you that exchange rate flexibility is an important adjustment mechanism. Even heterodox economists, such as Roberto Frenkel and Martin Rapetti (2009) agree on this point: exchange rates pegs are a constant feature in the imperialistic aggressions used on emerging countries.<sup>8</sup>

Let us go back to the “country X” story above. When it buys good A from a supplier (exporter) in X, a foreign purchaser has two options. Either he pays in the currency of X (after buying it from some bank in exchange for dollars or another reserve currency) or he pays directly in dollars (and then the supplier himself will buy national currency in exchange for dollars in order to pay his workers, domestic suppliers, and so on). Both ways, dollars will be sold and the currency of X will be bought. A demand for country's X goods is ultimately a demand for country's X currency. This implies that if the rest of the world does not want good A anymore, the demand for the currency of X will fall.

Now, if the demand for A falls, X has an obvious solution: make it cheaper. There are two means to this end: if X operates in a flexible exchange rate regime, the demand for its currency will fall, bringing about a depreciation of X national currency, which will make A cheaper for the foreign purchaser (the price in foreign currency of A will fall even if its price in the domestic currency is unaffected); if instead X operates in a fixed exchange rate regime, in order to make A cheaper for the foreign purchaser, it is the price of this good in the domestic currency that must fall.<sup>9</sup> For this to occur, the costs incurred by the domestic producers must fall. Since prices of raw materials are generally outside the control of the domestic economic agents, domestic producers can only intervene on labour cost.

In other words: if the exchange rate is fixed, in case of an adverse shock to external trade, the wage level *must* fall in order to avoid a balance-of-payments crisis.

**2.2 A step forward: the political economy of austerity** If you re-read the Mundell quote above, you will see that this need for wage “flexibility” (i.e., for downward wage adjustments in case of balance-of-payments crises) is “patently obvious” to him, and indeed it is to every economist. In order to avoid a balance-of-payments crisis, something has to give; if the exchange rate can't, wages have to, or the country will eventually go bust because of its external debt. This is why, back in the Seventies, it was “patently obvious” to communist leaders that European monetary integration was “wage deflation in disguise” and European federalists knew that the single currency would bring about “creative political destruction” through the occurrence of crises in the European economy.

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<sup>8</sup> It is worth noting that five years after Frenkel and Rapetti (2009) even the IMF, through Ghosh *et al.* (2014), recognizes that fixed exchange rates (“some form of pegged regime”) have always played a role in the emerging market financial crises.

<sup>9</sup> Technically speaking, in order to keep the exchange rate fixed, the central bank of X will have to “clear” the market by buying X currency in exchange of reserve currency. Purchases from the central bank will sustain the price of the currency, but cannot last forever: once the official reserves are exhausted, X currency will depreciate anyway.



It is important to stress that the underlying adjustment mechanism is inherently asymmetrical. It is the deficit country that will be forced to cut wages. In purely abstract terms, its balance-of-payment problems could be solved if the rest of the world decided to carry out a top-down income redistribution, thus raising the wages of its workers. This would restore the competitiveness of the stressed country, by simply allowing the workers of the stronger, creditor country to share the benefit of their higher productivity. This is precisely what many people are asking Germany to do now (e.g., Krugman, 2013): perform more expansionary policies. Unfortunately, this is fanciful economics and politics.

For a foreign purchaser, it is largely irrelevant whether good A becomes cheaper in the deficit country X, or more expensive elsewhere.<sup>10</sup> If any of those two things happens, he will prefer to buy good A in country X, where it is relatively cheaper and X's economy will recover.

However, why on Earth should a creditor country, which by definition has enough liquidity to provide for its needs, wish to reduce its external surplus by adopting more inflationary policies, therefore making the adjustment of country X easier, but endangering its own position? Creditor countries can wait, debtor countries cannot: if the latter do not adjust, they will run out of cash to buy vital resources. This is the very reason why the burden of the adjustment is borne by them: because they have no choice. Nothing has changed since Thucydides: "the strong do what they can and the weak suffer what they must".<sup>11</sup>

Because of the political motives that were obvious to Thucydides (which is the reason why we still read him) the adjustment must occur through wages cuts in stressed countries. Therefore, every currency union has an intrinsic deflationary bias, i.e., it will react to external shocks with a general lowering of the average price level (remember Krugman's words quoted at the beginning of this section).

This is because wage cuts in the "weak" country (country X in our example) are the preferred adjustment mechanism for the "dominant social classes" of *both countries*: the strong one (i.e., net foreign creditor), and the weak one (i.e., net foreign debtor). Depreciation of X's currency would imply that foreign creditors would receive less "hard" currency than they had lent.

Wage cuts in country X are therefore a better solution for them. The same applies to country X's entrepreneurs, whose share in the national income will rise, if the workers' share falls through wage cuts. With both foreign banks and domestic entrepreneurs favoring wage deflation, it should not come as a big surprise that, whenever possible, capitalism chooses this adjustment mechanism, thus defending fixed exchange rate arrangements between strong and weak countries, as we have observed so many times throughout the world in the financial globalization era (Frenkel and Rapetti, 2009).

This is where austerity, i.e., the repression of the State, comes into the picture. There are three distinct mechanisms that imply the need for austerity as an adjustment mechanism in the case of a fixed exchange rate – and we saw all of them at work during the last crisis.

First of all, austerity is needed in order to induce a fall in wages. It is the old "industrial reserve army" story, nowadays embodied in what economists call the "Phillips curve" (Phillips, 1958). Wage growth and the unemployment rate are in an inverse relation: if you need to lower the first, you have to rise the second. Over time unemployed people exhaust their resources, and much in the same way as deficit countries, they are forced to "bear the cost of the adjustment" by accepting a lower wage. An often overlooked but extremely

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<sup>10</sup> For the sake of the argument I am using the usual assumption of a "two-country" world. As a consequence, if country X is in deficit, the "rest-of-the-world" country will be in surplus. This simplifies the exposition without sacrificing rigour.

<sup>11</sup> The only obvious difference being that nowadays the Athenians play the role of the Melians.

telling fact in the history of economic thought is that the neoliberal counterrevolution started with Friedman's (1968) presidential address at the American Economic Association, in which he questioned the existence of the unemployment/inflation trade-off. Since then, most of the neoliberal strategy has insisted on the fact that you cannot "buy" employment by allowing for more inflation, and that unemployment is voluntary (i.e., it is the choice of workers preferring leisure to labour at the prevailing equilibrium wage).<sup>12</sup> The trade-off was overwhelmingly confirmed by the data (Fuhrer, 1995; Gordon, 2013), but refuting it was instrumental in concealing the true motivation of "austerity" policies: the compression of wages through "competitive unemployment", rather than the need to "consolidate" public finance. This neoliberal strategy proved successful: the "ordinary educated intellectual" today has unlearned the link between austerity and competitiveness through wage repression, and hence ignores that fixed exchange rates imply the need to resort to austerity. This oblivion proves to be a major hindrance for any progressive political force in the Eurozone.

Needless to say, a government will never announce to its constituency: "Hi guys! We are going to get a number of you fired, so the other ones will moderate their wage requests and our economy will become more competitive". This could cause an upheaval. Governments would rather speak of "labour flexibility", or "structural reforms". They would rather declare, as Mario Monti did to CNN anchorman Fareed Zakaria on May 20, 2012, that "we're actually destroying domestic demand through fiscal consolidation" in order to gain "a better position in terms of competitiveness because of the structural reforms" (Governo Italiano, 2012). But even in this politically acceptable jargon, the message is the same: expenditure cuts and tax rises are needed in order to suffocate the purchasing power of domestic economic agents, thereby causing unemployment, and hence a cooling of wages and prices that will restore external competitiveness. The same applies to labour "flexibility": when the workers are easier to fire, employers increase their bargaining power, which in turn leads to a rise in unemployment and a fall in wages. I wish to stress again that this mechanism not only conforms to common sense and to what we are witnessing, not only it is consistent with the Marxian idea of industrial reserve army, but it is also completely standard and widely accepted economics. In assessing the impact of labour market deregulation in Europe, Blanchard and Giavazzi (2001) conclude that:

Such a shift can initially generate both a decrease in the real wage and in the labor share, and either no improvement (if the contract curve is vertical) or an increase (if the contract curve is upward sloping) in unemployment. Both implications seem to fit the facts.<sup>13</sup>

The second reason why under fixed exchange rates austerity is needed, is that the most urgent action to take when you have too much debt is to stop piling up other debt, i.e., stop spending in excess of your earnings. Once again, at the macroeconomic level the answer is austerity. The "destruction of domestic demand" mentioned by Monti had the immediate goal of repressing

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<sup>12</sup> In technical terms, the refutation of the Phillips curve, i.e., of the role of labour market in determining wage and price dynamics, was the theoretical underpinning for the monetarist claim that inflation is a "purely monetary" phenomenon, and that monetary policy had no long-run consequences on either output or employment.

<sup>13</sup> One may wonder how a reputed economist such as Blanchard, who was so aware in 2001 of the recessionary impact of labour market reforms, may have coordinated an international body like the IMF, that advocated and sometimes, like in Greece, imposed such reforms during the last recession. Once again, the answer is left to the historians.

income, and hence expenditure, including imports, thereby dampening the accumulation of further foreign debt.<sup>14</sup>

Finally, austerity (as both spending cuts and tax increases) is needed by the government to gather the financial resources needed to rescue private financial institutions. In other words, austerity is the main instrument through which the socialization of the financial losses determined by a balance-of-payments crisis is achieved (after some years of privatization of profits). Protracted external imbalances need to be financed, and usually they are by exporting countries' banks (Constâncio, 2013, 2014). With the benefit of hindsight, financing persistent imbalances is never a wise practice: sooner or later the music will end (to use Keynes' famous "Musical chairs" metaphor), and someone will not be able to secure a chair for himself (translation: some households and firms in the debtor country will go bust and some creditor country's bank will have to bear the costs of these defaults). This is not news: it has happened again and again for at least 3769 years.<sup>15</sup> So why do banks keep lending money to "imbalanced" countries' firms and households? For three reasons: self-interest (banks earn money by lending money); coordination failure (everybody thinks they are more clever than the others); moral hazard (everyone knows that the State will intervene to rescue private financial institutions).<sup>16</sup>

The success of neoliberal brainwashing is indisputable. Its greatest achievement is to have instilled in most progressive intellectuals the "sound money" principle in at least two insidious forms. Firstly, through the idea that the benefits of "competitive devaluations" are fanciful. Secondly, through the idea that inflation has adverse consequences on the lower classes' incomes. This wholehearted adhesion of left-wing thinkers to the *Grundnorm* of the City is the intellectual equivalent of cetacean stranding: a phenomenon as fatal as difficult to understand. Besides the fact that the groundlessness of the "sound money" principle is stressed by the economic literature as well as economic experience,<sup>17</sup> a simple tactical reasoning shows that

### 2.3 Exchange rate flexibility and the stranding of the Left

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14 As a matter of fact, unlike in 1992, where we had both austerity and a sizeable realignment of the exchange rate, in 2012 the adjustment of the Italian external balance occurred mainly through the fall of imports (exports have not yet recovered to a pre-crisis level).

15 I take the starting date as 1754 B.C., the year in which Hammurabi's code was engraved. Among other things, the code also regulates defaults, and we can take this as evidence that defaults occurred even at that time. This is a good argument against the "this time it is different" rhetoric.

16 The strange case of Italy's government credits towards Greece is a perfect example. Longo (2015) has shown that on September 2009 the exposure of the Italian government towards Greece was zero, while that of German and French banks totaled 123 billion euros. Then the European Financial Stability Facility (EFSF) and the European Stability Mechanism (ESM) were set-up, to which the Italian government contributed 50 billion euros. On September 2014, the exposure of the Italian government towards Greece had reached, through these funds, 41 billion euros. Needless to say, meanwhile the exposure of German and French banks had dropped to 16 billion euros. The money deposited in those "stability mechanisms" came partly from taxes such as the IMU (Imposta Municipale Unica), a tax on real estate properties re-introduced by the Monti government. The Italian taxpayer had to contribute to the rescue of imprudent Northern banks: austerity (in the form of taxes) was the tool for this massive socialization of losses.

17 The "sound money, sound finance" principle revolves around two theoretical proposition: (1) money is exogenous (i.e., perfectly controllable by monetary authorities), and (2) money causes inflation (remember the previous discussion of the role of the Phillips curve). Both propositions are disproved by the recent research and empirical evidence. The prevailing view today is that money is created "out of thin air" by the banking system whenever it extends a loan to an economic agent. As a consequence, it depends on a number of endogenous factors and is not perfectly controllable by the central bank. Both central banks (McLeay *et al.* 2014) and academics (Werner, 2014) agree on this point. As an indirect evidence, it should be noted that the ECB has never been able to keep money creation at the stipulated rate of 4% per year. As for the relation between money creation and inflation, it will be enough to consider that the 1000 billion Long Term Refinancing Operation (LTRO) launched in 2011 by the ECB ended up in outright deflation. After such a failure, even Mario Draghi (2015) conceded recently that central banks cannot fully control inflation without the help of governments (i.e., of fiscal policy).

in the “sound money” world there is no room for a Left of whatever kind. In fact, if exchange rates and price stability are the best defense of the workers’ purchasing power, trade unions and labour parties are of no use: an “independent” central bank will be largely sufficient! Several Pavlovian responses explain this suicidal attitude, and it is worth debunking the most frequent ones.

Firstly, the “average Keynesian economist”<sup>18</sup> (henceforth, AKE) will object that price adjustment is the only adjustment mechanism in the neoclassical general equilibrium model (which is true), and therefore if you are Keynesian you *must* dismiss the role of prices.<sup>19</sup> I see no particular merit in opposing to one-sided thinking an equally one-sided response. To allow for some role of prices in determining the economic choices is *not* to harbor a naive confidence in the omnipotence of the price mechanism. One can recognize that markets very often fail,<sup>20</sup> while at the same time admitting that *biased* markets (e.g., markets where prices are systematically distorted) fail even more. This is particularly evident in the Eurozone, where imbalances exploded after the adoption of the single currency. The euro did not promote trade (provided this is a sensible goal for a progressive thinker): it reoriented trade to the benefit of the stronger countries (Berger and Nitsch, 2008), and this is definitely *not* a sensible goal for a progressive thinker, especially if one considers that the lower classes of the stronger countries did not benefit from this outcome; as evidence, take the increase of inequality in Germany (Kai and Stein, 2013).

Secondly, the AKE will argue that Keynes was an advocate of fixed exchange rates, as it is demonstrated by his role in the Bretton Woods conference, and hence a Keynesian *must* be in favor of fixed exchange rates. But this is a gross falsification. Keynes has not been a creator of the Bretton Woods system: he has rather been the loser of the Bretton Woods talks. He had not proposed a dollar-based fixed exchange rate system with no correction mechanism. He had proposed a system based on an international tender issued by a world bank, where both the deficit and the surplus countries would *pay* interests on their net foreign position (Fantacci and Amato, 2012). The rationale for forcing creditor countries to *pay* an interest on their net credits was based on the idea that this would force them to spend, instead of hoard, the international liquidity they had earned, thereby helping the deficit countries to overcome their problems. What the AKE overlooks is that in Keynes’s world Germany would be paying now several billions euro per year to a hypothetical world bank, as interest on its huge external *surplus*. But this was Keynes’s dream, a dream doomed not to come true for the very reason that it would be politically impossible to force a big global winner to abide by the rules of such a world bank.<sup>21</sup> In his theory (e.g., in the *Tract on Monetary Reform*; Keynes, 1923) and policy advise (e.g., in *The Economic Consequences of Mr. Churchill*; Keynes, 1925), Keynes is definitely in favor of exchange rate adjustment. Hence, if Keynesianism shall be considered as a religion (which I would advise against), the AKE should better acknowledge that his prophet was *against* an unregulated fixed exchange rate system.

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18 While I refer here specifically to Keynesian economist (both neo- and post-Keynesian), the Pavlovian responses I analyze in this section describe quite well the attitude of a wide range of supposedly “progressive” economists, including some Marxian and neo-Ricardian economists. While most readers will recognize these arguments, because they are consistently adopted in the public debate, it should be stressed that the same economists are rather shy to adopt the same line of reasoning in their scientific work (basically because these arguments are unsupported by scientific reasoning). As a consequence, no matter how familiar these statements may seem to the reader, it is practically impossible to provide adequate academic references for them.

19 Remember that the exchange rate is a price: the price of a currency in terms of another one.

20 By the way, so far in the paper I have tried to explain that the Eurozone crisis depends on a huge market failure, not on government profligacy, and I reminded you that even the ECB is on my side.

21 Proof: the US, that after WWII expected to become the biggest exporting country, because productive capacity elsewhere had been destroyed by the war, rejected the proposal. Quod erat demonstrandum.

Thirdly, most AKEs attach to devaluation the same negative moral judgment as any neoliberal economist. Quite often they jointly consider devaluation to be the economic equivalent of masturbation: something that provides a temporary relief, without addressing the issues (be them the growth of income or of population), thereby causing structural problems. In so doing, both the AKE and any neoliberal economist show a suspiciously one-sided view. More specifically, they systematically fail to acknowledge that someone's devaluation is by definition someone else's revaluation. This promotes a number of interesting questions. If devaluation is so shameful and makes you poor, revaluation must be glorious and able to make you rich. So, why are countries so shy about revaluating their currencies? If the benefits of devaluation are transitory, why was Germany so keen on adopting a currency that was clearly undervalued with respect to the Deutsche mark? This one-sided, standard view is disproved by sound economic reasoning, according to which exchange rate realignments can have lasting effects on long-run economic growth. Since Adam Smith (1776) we have known that the division of labour, and hence productivity, depends on the size of the market. Later on, Verdoorn (1949) confirmed that in a world of increasing return, productivity is positively affected by demand. As a matter of fact, there is no point in becoming more productive if you expect that your goods will not be sold. Dixon and Thirlwall (1975), building on Verdoorn's law and Gunnar Myrdal's (1957) concept of circular and cumulative causation, proposed a model in which a demand shock does have lasting effects on a country's productivity and hence long-run growth. In layman's term: a devaluation, by increasing the size of the market (promoting exports), may have a permanent effect on a country's productivity, by setting off a "virtuous" circle of increased competitiveness – hence increased access to foreign markets, hence increased productivity. In the last four decades this model found a huge support in the data (Thirlwall, 2011). You can also run this circle in the "vicious" direction: a revaluation, by shrinking a country's exports, may have lasting adverse effects on its productivity and competitiveness. In Bagnai (2015) I show that the euro set Italy on such a vicious circle. I insist on the fact that this reasoning belongs to the purest Keynesian tradition (Myrdal and Thirlwall are among the most prominent Keynesian scholars).

Fourthly, once upon a time progressive Keynesian thinking was able to go beyond the one-sided interpretation of exchange rate adjustment as "competitive" devaluation, i.e., as an unfair practice meant to purposely attack its own competitors. In fact, exchange rate realignment may have a defensive value, as a physiological response to the aggressions perpetrated by unfair partners through non-cooperative policies, e.g., through social dumping (restrictive income policies meant to compress the labour costs). James Meade (1957), starting from the premise that "full employment is more important than free trade for Europe", warned long ago:

If the European national governments are going to use monetary and budgetary policies for purposes of domestic stabilisation – if, for example, in their present situation of balance-of-payments surplus the German authorities are nevertheless going to use their monetary policy to prevent a domestic inflation [...] a greater use of the weapon of exchange-rate variations will have to be made.

The example chosen by Meade is rather telling. In a world of adjustable exchange rate, the aggressive income policies carried out by Germany through the Hartz reforms (ILO, 2012) would have backfired by causing an appreciation of the German currency in response to the huge surplus determined by the compression of Germany's labour costs. Instead, the response to this imbalance came through competitive unemployment, in a European Union where free but unidirectional trade is more important than full employment.

Fifthly, the AKE's usual dialectic strategy is to call for a wider perspective, pointing out that there are examples of "neoliberal" governments practicing austerity even in flexible exchange rate settings. But in their case, austerity is a political choice. Under fixed exchange rates, or in a currency union, austerity becomes a logical necessity because for weaker countries no other short-run adjustment mechanisms apart from internal devaluation are available (in the sense of being both technically feasible and politically viable). Meade's message is still timely. Some degree of flexibility is useful in an economic system insofar as it is able to insulate the system from external shocks. Exchange rate flexibility insulates domestic labour markets from foreign countries' income policies (among other things). As a consequence, it makes no sense to blame austerity while praising the single currency. As Keynes (1925) put it, in condemning Mr. Churchill's gold fetishism, "he who wills the end wills the means": once your end is to keep a single currency (the modern equivalent of sticking to gold with an overvalued parity), the means will be internal devaluation and wage cuts. If you are not willing to allow for currency depreciation, you will be forced to depreciate labour, which is to say to depreciate human life. This is what is happening in Europe now on a largely unprecedented scale.

Sixthly, the AKE will argue that fixed exchange rates would be beneficial because they would avoid currency wars. But his argument makes no sense for a number of reasons. First of all, economic tensions must find a vent, and history tells us that if this does not occur through economic forces, it will occur through military force. In the good old days of the gold standard, the heyday of the "sound money" principle, trade policy was managed through gunboats. There are no reasons to assume that an exchange rate regime that favours the building of imbalances will be conducive to a more peaceful world. Quite the contrary; the defensive realignment of the exchange rate is an effective weapon against aggressive (or at least uncoordinated) policies, and as such it has a deterrence power that will favour cooperative outcomes among countries. It would be hard to contest that Europe was more cooperative before the onset of the Euro. Furthermore, a currency war occurs when a country devalues *despite* having an external surplus (and hence with the purpose, or at least the consequence, of expanding its imbalance).<sup>22</sup> But this is precisely what the Eurozone as a whole is doing now *because of the euro*. The purpose of the weak euro is to give some breath to the Southern Eurozone countries, crushed by the need to deflate their wages with respect to Northern Eurozone countries. In fact, by driving the euro towards parity with the dollar, in a situation in which the Eurozone features the largest current external surplus worldwide, Europe is fighting a currency war against the US. In other words, what we are witnessing here is another revealing paradox: we are fighting a currency war in order to preserve the euro that should have saved us from currency wars.

This partial list of historical falsifications, logical contradictions, and sloppy economic reasoning, should give the reader an idea of how successful the neoliberal ideology has been in leading the European left wing to a dead end. My bottom line is *not* that flexible exchange rates are a panacea. What I would like to stress is that income distribution, both between and within countries, is always the result of the conflict existing between the social forces of production, and there is no evidence that in a world of fixed economic policy rules (be they monetary, or fiscal, or whatever) this conflict will be more balanced – especially because the rules are usually defined by the dominant social class. You can take the fact that fixed rules have been the mantra of the neoliberal revolution, before becoming, more or less consciously,

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<sup>22</sup> It may be useful to remind that any positive balance-of-payments imbalance must correspond to a negative imbalance elsewhere (if there is a net exporter, there must be at least one net importer). Therefore, a country running a currency war is by definition forcing other countries to get indebted.



the mantra of a significant part of the European left as indirect (yet in my opinion decisive) evidence of this view.<sup>23</sup> From “Ventotene boys” to “Chicago boys”: sic transit gloria mundi.

A world of fixed exchange rates is a world where the shock-absorption mechanism moves from the FOREX to the labour market and a world where competitive unemployment replaces competitive devaluation. This may be difficult to understand, even for some colleagues (as it is for me to understand the intricacies, or even the basic principles, of their respective fields of research). Nevertheless, in my opinion an “ordinary educated person”, to paraphrase Keynes, should ask himself why neoliberal economists – precisely those who are so keen to praise the virtues of competition and the price system – have such a contemptuous attitude towards competition and price adjustments only when they take place in the FOREX market; and why central bankers, who usually come from the wealthy financial milieu, would be so compassionate towards the poor as to prevent inflation from endangering the purchasing power of their wages; and why people connected to the world of financial speculation are so keen to advocate fixed exchange rates or currency unions that allegedly prevent financial speculation. Don’t you hear some dissonance? We shall come to this later. Now it is more pressing to point out that in principle competitive unemployment does not need to be the end of the story: production factors (i.e., capital and labour) mobility could provide an alternative, supposedly less painful, adjustment mechanism, or at least a way to alleviate the deflationary bias intrinsic in every currency union. This was the main message of the so-called “Optimum Currency Areas” (henceforth: OCA) theory, whose purpose was to investigate which features of regions or States could allow them to withstand the unemployment costs induced by the adoption of a single currency.<sup>24</sup>

Factors mobility enters the picture in at least three different ways.

Firstly, as labour mobility. It’s true that workers in weaker countries will get unemployed, but they can move to stronger countries, where they will find work. Secondly, as private capital flows. Of course uncompetitive countries will endure “a delayed and more painful external adjustment” (in the IMF’s words), but since their lack of competitiveness is assumed to depend on a poor endowment of physical capital, and the return on capital is assumed to depend on its scarcity, if we free up capital movements, we should expect capital to go the opposite way of labour: from wealthier to poorer countries (where capital is more scarce and therefore expected to provide higher returns). Thirdly, as fiscal integration, i.e., public transfers of funds (Kenen, 1969). Is country X affected by a temporary shortage of foreign demand for the domestically produced good A? Well, this unfortunate situation will be less painful if the other members of the currency area are willing to transfer resources to country X, thereby allowing it to overcome its difficulties: depending on their nature, public transfers will substitute for private income (current transfers), or private capital transfers (capital transfers).

Mundell, the father of OCA theory, is known in the economic profession as the author of the open-economy Keynesian model. Each and every economist, therefore, associates Mundell with Keynes. However, Mundell’s reasoning is purely “Ricardian” (in Keynes terms), i.e.,

### **3. Optimum Currency Areas in theory and in practice**

#### **3.1 The normative theory of Optimum Currency Areas**

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<sup>23</sup> Just to make a very simple but extremely telling example, the ECB fixed target of M3 growth at 4% per year is an application of Milton Friedman’s (1960) *k*% rule. Besides the fact that this rule rests on the nowadays discredited view that money creation is exogenous to the economic system, one wonders how progressive intellectuals can feel comfortable in a world so deeply shaped by the ideology of the Chicago boys, whose most renowned contribution to economic policy was the design of economic reforms in Chile under Pinochet’s rule.

<sup>24</sup> The Optimum Currency Area is an old and still burgeoning body of economic literature. I will not attempt to survey it in full here, and I will consider only the argument most frequently evoked in the debate as a rationale for the “more Europe” solutions of the current Eurozone crisis.



“neoliberal” (in modern parlance). In his story everything revolves around two principles: firstly, the remuneration of the factors of production depends on their relative scarcity; secondly, freedom of movement, whenever possible, will unleash benign market forces that will solve any problem. Unfortunately, although these mechanisms are easy to represent in mathematical terms (you just need to draw a line from the upper left to the bottom right corner of your sheet and call it a “demand schedule”), the real world does not always conform to them.

Let us consider first labour mobility. It should solve the unemployment problem in stressed countries because unemployed people would simply disappear (looking for jobs elsewhere); it should solve the deflation problem because owing to their relative scarcity the workers who remain should be paid more. However, the *logos* strikes back. OCA theory does not take into account cultural barriers: it would be rather difficult for a Greek grocer to find a job as a bricklayer in Finland.<sup>25</sup> In the presence of cultural barriers, migration not only comes at huge human costs, but it is also adversely selective: in a huge depression, i.e., precisely when this adjustment mechanism becomes crucial, only the most educated people can afford to leave, while the others cannot. As a result, migration does not solve the problem: the “survivors” in the weaker regions are paid less, not more, and unemployment does not fall, for two concurring reasons. Firstly, for a demand-side reason: people who leave take their payrolls with them. In other words, when one worker goes away, not only his supply to the local labour market falls, but also his demand for local goods. Hence, even by assuming that the remuneration of labour would be determined by scarcity, rather than by class conflict and the industrial reserve army (or the Phillips curve, if you prefer), the survivors would be paid less because there would be less demand for the goods they produce (and hence less demand for labour). Secondly, for a supply-side reason: the presence of cultural barriers determines an adverse selection. It’s mostly low-skilled workers who stay at home, which implies that the average earnings in the depressed region will fall, and that innovative business will quit. Italy and Germany are two telling “natural experiments”.

As for private capital mobility, the discussion so far should have pointed out that it is part of the problem, rather than the solution. This is an old story, going at least as far back as Chapter 12 of Keynes’ *General Theory* (“The state of long-term expectation”). Capital flows follow mostly a short-term, speculative logic, because in markets organized according to the principle of “liquidity” (i.e., of the marketability of credit/debit instruments)

It is not sensible to pay 25 for an investment of which you believe the prospective yield to justify a value of 30, if you also believe that the market will value it at 20 three months hence.

The very reason why private banks financed Southern country imbalances (the root of the crisis, in the ECB’s words) is precisely this short-termism. As Keynes warned us, short-termism is intrinsic to the modern organization of markets, which is largely the same as the one he described in his chapter 12 (definitely worth reading, also because it was written when mathematical jargon was not deemed essential). Therefore, forget the fairy tale of capital flowing where it is more needed on a long-term perspective. Indeed, economic reasoning

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<sup>25</sup> This example is purposely absurd: I would like to point out to the layman the fact that in standard macroeconomic models “labour” is an homogeneous factor of production, one that can be employed indifferently in any economic activity. In real life, intersectoral mobility is even more difficult than international mobility. Yet, both are needed for the OCA neoliberal fairy tale to work.

justifies the instinctive aversion to private finance that most progressive intellectuals have. Would this aversion be rational, rather than sentimental, the question should then arise as to why defend the single currency, whose evident rationale is to make private capital movements easier by suppressing exchange rate risk, and hence to promote private finance, by protecting the latter – but not the taxpayer – from the cost of its wrong investment choices. Consider now the third requisite of an OCA: public transfers, or, in other words, fiscal integration (i.e., the integration of public finance). In the present European debate, this is the bulk of the “more Europe” argument: “Europe” we are told, “does not work, but give it a true federal budget, and everything will be fine”. Once again, this debate is anything but new. Two years after Kenen (1969) introduced the fiscal integration requirement in the OCA theory, Kaldor (1971) described it as follows:

A full monetary and economic union is unattainable without a political union; and the latter pre-supposes fiscal integration, and not just fiscal harmonisation. It requires the creation of a Community Government and Parliament which takes over the responsibility for at least the major part of the expenditure now provided by national governments and finances it by taxes raised at uniform rates throughout the Community. With an integrated system of this kind, the prosperous areas automatically subsidise the poorer areas; and the areas whose exports are declining obtain automatic relief by paying in less, and receiving more, from the central Exchequer. The cumulative tendencies to progress and decline are thus held in check by a “built-in” fiscal stabiliser which makes the “surplus” areas provide automatic fiscal aid to the “deficit” areas.

In Lord Kaldor’s reflection, the optimal path goes as follows: fiscal harmonization (same taxes and tax rates in the whole area), fiscal integration (fiscal stabilizers based on automatic anti-cyclical transfers), then political union, and finally monetary union. As you know, we do not even have fiscal harmonization.<sup>26</sup> But this is a minor problem. The major problem is the stubborn unwillingness of the “more Europe” advocates to understand the economic nature of fiscal integration – and hence its actual political viability and effectiveness. Yet they can be partially excused for this because the economic profession did little to help people understand the true nature of the problem.

For a number of reasons, including the fact that this leads to nice mathematical models (Bagnai, 2013), the economic analysis of OCA has been framed in an “asymmetric shocks” setting. In other words, the main problem with OCA seems to be that the international consumer is “flighty like a feather in the wind” (to quote Verdi’s most famous aria): one day he likes good A produced by country X, the following day he likes good B produced by country Y, and the following day who knows? This is what the economic profession usually calls “asymmetric” (or “idiosyncratic”) shocks: to the extent that a particular country is specialized in some particular product, a fall in the demand for this product will affect the country adversely. Other countries will be fine, but the situation could be reversed. The country that suffers today could thrive again tomorrow, and the country that is booming today could be affected by an idiosyncratic shock tomorrow.

In this “every-dog-has-his-day” model, any mechanism of automatic transfers from thriving to failing countries would be politically sustainable (irrespective of its effectiveness) because it

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<sup>26</sup> The debate on Greek VAT rates has made clear to everybody that in Europe tax rates differ not only between but also within countries.

would work and it would be perceived like an insurance mechanism, where many States pool their resources in order to offset the adverse effect of *random* events. It is indeed unpleasant to pay for an insurance, but when you do it, you always think that sooner or later you could benefit from it.<sup>27</sup>

But does the “every-dog-has-his-day” model conform to reality? No. As Boltho and Carlin (2013) have made clear to the economic profession, the problem with Europe – both between and within member countries – is not asymmetric “shocks”: it is asymmetric “structures”. The need for transfers from Northern to Southern Italy was not the consequence of a “temporary” fall in the world demand for Sicilian oranges. The reason why Northern Italy had to subsidize Southern Italy lies in a complex mixture of difference in institutions (both formal and informal), in human and physical capital endowments, and in cultural heritages, determined by their respective historical paths. This is precisely why fiscal integration is politically unfeasible. Because everybody knows that the direction of transfers will not be randomly determined by the flighty international consumer: it will only go one way, in a direction determined by the respective historical paths of the member countries. Unless an extremely strong sense of (supra)national cohesion and identity exists and it is reasonable to expect that the structural gap between countries will be filled over time, such a one-way flow of transfers will not be accepted for a long time. In the same way as it is increasingly not tolerated *within* Italy, Germany, and Spain (just to quote a few examples), it will not be tolerated *among* them.<sup>28</sup> Is this selfish? Perhaps. But before engaging in a sentimental deprecation of this attitude, one should reckon with the facts. Was fiscal integration of any use in bridging the gap between different regions of Italy? The best that can be said is that the views on this point are mixed (Travaglini, 2010; Boltho and Carlin, 2013). The same applies to Germany. Let me be clear: I am not advocating “fiscal balkanization”. I am rather asking for a deeper understanding of what fiscal integration can and cannot do to promote a balanced growth of the regions within an integrated area, before its management is moved to a supranational level. Should this analysis be skipped, the suspicion would remain that the proponents of a “federal” Europe are keener to move fiscal policy farther away from the democratic control of national constituencies, than they are to see the supposedly beneficial effects of fiscal integration at work. By the way, it is no wonder why labour mobility was proposed as a solution by an economist living in a fictional “union” like the United States. The US is actually a huge nation State, where all people share the same language, have a strong sense of belonging to the same national identity, share the same cultural heritage and informal institutions. Moving from New York to Los Angeles may seem extremely painful to Woody Allen (who expresses this opinion in some of his movies), but it is pretty much the same thing as moving from Milan to Naples, which in turn is not the same thing as moving from Turku to Sintra. It may take centuries before the European States achieve the same level of cultural homogeneity. Exactly the same criticism applies to the political viability of fiscal integration. How many people, how much cultural richness will have to die before this is achieved? Would the sacrifice be worth it? Those who say it would be, probably believe that they will not be among the casualties. And perhaps they are wrong.

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27 As a passing remark, let me observe that in the “every-dog-has-his-day” model it would be silly to take labour mobility into account as a sensible adjustment mechanism. Who would ever move from Coimbra to Tromsø in response to a temporary, idiosyncratic shock?

28 Jacques Sapir (2012) has estimated the costs of a *bona fide* transfer policy addressed at bridging the infrastructural gap between Northern and Southern countries. This policy would cost the German taxpayer some 9% of German GDP. Even if one was to believe to the fairy tale of the core imperialist power that helps the peripheral countries in becoming dangerous competitors, these figures show clearly that such a policy is unfeasible.

Let us come back to positive theory, to the world as it is, not as it should be. Why was a regime adopted where wage repression is the only response available to macroeconomic shocks? Well, the answer is not that difficult. Do you remember Luciano Barca? “Deflazione e recessione antioperaia”: it was deliberately and openly adopted in order to repress wages. The same answer can be found in widespread economic policy textbooks (Acocella, 2005), as well as in the scientific literature (Featherstone, 2001). The economic rationale of the single currency was wage repression (or, in textbook parlance, “trade union discipline”, or “wage moderation”, or “sound money, sound finance”).

I am not claiming that wage repression was the sole rationale for the single currency. There were many other (pretended) economic and non-economic reasons for adopting a single currency. If we just look at economic arguments, we were told many things: the single currency would make us wealthier; it would shield us from crises; it would make us more competitive... Surprisingly enough, these arguments still sound appealing to the “ordinary educated person”. However, the logical nexus underlying these populist claims is never set out in full and it is often inconsistent. For instance, the argument was that the single currency would protect us because it would be strong. But how could a strong currency (as such, expensive for foreigners) help us compete (i.e., make our goods cheaper in international markets)? This argument was clearly populist. The proof is in the fact that today, stuck in the deepest crisis of the last two centuries, we are trying to *weaken* the euro in order to become more competitive. Apparently, something went wrong. This evidence reminds me of Giandomenico Majone’s (2014) wise remark:

generally speaking, a mismatch between process and outcome provides a *prima facie* evidence that the particular model of regional integration has been chosen for purposes other than the stated goal(s).

As a matter of fact, only one thing went exactly as expected: wage repression or, more generally, the destruction of the European welfare state. And this outcome was expected, although politicians, for obvious reasons, preferred not stress it in the debate – yet they declared it quite often, as we shall see below.

The contrast between the single currency and the European model of welfare and labour market regulation has always been widely acknowledged in the literature. As Kevin Featherstone (2001) puts it:

Economic and Monetary Union (EMU), on the one hand, and existing models of labour market regulation and welfare provision within the European Union (EU), on the other, have been often assumed to stand in contradiction to one another. The re-appearance of EMU on the European agenda in the late 1980s, following the de-regulation paradigm of the single European market, raised widespread concern that it might serve as a ‘Trojan horse’ for a neo-liberal policy shift across EU States. The ‘sound money, sound finances’ principles underlying the particular design of EMU, strengthened in the Stability Pact of 1997, seemed to threaten traditional social models and the scope for national differentiation.

In order to fully appreciate the relevance of these words, you should consider that Featherstone is not only a prominent scholar, but also a strong supporter of “Europeanisation”. In other words, he is not supposed to disapprove the single currency, and he never questioned the monetarist “sound money, sound finances” principle on which it is based. Nevertheless, despite being a neoliberal “euro hawk”, he plainly admits that the

### 3.2 The positive theory of Optimum Currency Areas: the political economy of the “vincolo esterno”

“concern that it might serve as a ‘Trojan horse’ for a neo-liberal policy shift” was widespread, and the only thing he could say, in 2001, in order to refute this concern, was that the evidence so far was “limited and varied”.

After years of Troika regime in some Eurozone countries, the evidence is now abundant and univocal to say the least: we all see that the whole point in keeping the euro is to destroy the European welfare. This exactly the reason why a private finance crisis is systematically misrepresented by the media as a sovereign debt crisis: in order to strengthen this political aggression to the welfare state by gaining the consensus of its potential victims – mostly, civil servants and dependent workers at large.

“Progressive” euro advocates often object to this evidence with the usual patronizing calls for a wider perspective. The main objections are two: firstly, fixed exchange rates are not to blame, because the wage share had risen during the Bretton Woods regime – which was a global fixed exchange rate regime; secondly, the euro is not to blame, because starting in the Eighties the wage share has fallen throughout the world, even in countries outside the Eurozone.

Both these stylized facts are confirmed by the data, but their ideological interpretation misses some important points. The first objection does not take into account the fact that in the Bretton Woods regime, capital movements were regulated. Financial repression was an important (and often overlooked) part of the picture (Reinhart and Sbrancia, 2011), and it defused the attacks of financial capital to labour in at least two respects: firstly, by allowing the governments to regulate (up to a certain extent) the cost of borrowing. This protected the governments from the blackmailing of financial markets, which nowadays operates via the prohibition of deficit monetization. Secondly, by preventing private credit from financing and thereby fostering external imbalances. These two reasons concur to explain why competitive unemployment was *not* the rule within the Bretton Woods fixed exchange rates agreement. As for the second objection, it is true the fall in wage share starting in the Eighties was a global phenomenon, and as such it affects also countries that did not formally belong to any currency union or fixed exchange rate agreement. In fact, financial globalization operates by definition on a global scale, altering the balance of powers between capital and labour everywhere. But even in this case a detail is often overlooked: European countries were endowed with a strong welfare system, where the protection of labour and the commitment to equal opportunities were in some cases (such as in Italy) enshrined in the Constitution. In a sense, European countries could have been expected to be more resilient to the attacks of financial globalization. This is the reason why financial capital needed a stronger weapon: the euro, i.e. a fixed exchange regime whose rigidity has no historical precedents.<sup>29</sup>

With the benefit of hindsight it becomes more and more evident that the most devious (and effective) way to emasculate the social democrat constitutions of European countries, like Italy, was to override them with the prescriptions of European Treaties grounded in the neoliberal principle of “sound money, sound finances”, mentioned by Featherstone. This process was apparent to Italian jurists such as Salvatore Giachetti (1992) back in the Nineties, when he defined the European Treaties as “European community termites”, which were going to silently damage the structure of the Italian Constitution by corroding its first principles.<sup>30</sup> But there is more in the euro than the silent override of these principles. What the euro

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29 Catão and Solomou (2003) document the systematically overlooked fact that the euro is the most rigid monetary system ever, because even the gold standard, inappropriately quoted as its most close historical precedent, featured a large degree of nominal exchange rate flexibility between core and peripheral countries, which proved effective in addressing the external imbalances.

30 I would like to thank Luciano Barra Caracciolo for pointing out to me Giachetti's work.

necessarily brings about is a deep alteration of the rules in the democratic game, a point forcefully raised by Luciano Barra Caracciolo (2013).

In principle, since the vast majority of workers are employees (i.e., people who earn a wage) a wage repression policy goes against the economic interests of the majority and as such should not be politically viable in a democratic regime. But here the *vincolo esterno* (external constraint) determined by the single currency enters the picture. By adopting the single currency, the Southern elites “tied their hands” to the neoliberal principles of the European Treaties (to quote Giavazzi and Pagano, 1988). In particular, they surrendered their monetary policy to a supposedly “more credible” supranational bank, with supposed reputational gains. In fact, membership to the single currency embodies what Grande (1997) defined as the “paradox of weakness”: peripheral elites transfer some power to a supranational policy maker (thereby looking “weaker”), to allow themselves to withstand pressure from societal actors by testifying that “this is Europe’s will” (therefore becoming stronger). In the light of Featherstone’s analysis of the *vincolo esterno*, it would be misleading to read the European integration process as a tale of governments willing to *become* weaker by surrendering their powers in order to pursue a common supranational goal. A more plausible interpretation is that those governments preferred to *appear* weaker, in order to better fight on the national soil the battle of capital against labour. Wolves in Europe’s clothing  
As Featherstone puts it:

Binding EU commitments enable governments to implement unpopular reforms at home whilst engaging in ‘blameshift’ towards the ‘EU’, *even if they themselves had desired such policies.* [emphasis added]

In fact, most of Featherstone’s analysis of the steps European governments took towards Europeanisation of their countries revolves around the capability of the respective prime ministers to put the blame on the EU at the right moment, in order to escape their responsibility, hold the power, and force their constituencies to swallow the bitter pill (Alain Juppé being blamed for not having been able to do so in 1995). The single currency (and the need to preserve it through “reforms”, i.e., by enabling still greater downward wage flexibility) becomes therefore the main tool used by European governments in order to become more and more unaccountable. Another non negligible part of the picture was the way political elites appealed to the nationalist and populist sentiments of Southern country citizens, for whom the single currency was perceived as a status symbol, as the tangible demonstration that “Southerners” were not inferior to “Northerners”. Unaware people were trapped in this monetary flag-waving (Connolly, 1997; Belke and Verheyen, 2012). As a matter of fact, this is another paradox of the euro: purported to be a decisive step in overcoming nationalism, its very adoption by Southern countries was encouraged by promoting misled nationalism.<sup>31</sup>

The fact that the goal of the euro game was the dismantling of the European welfare state is not only an educated guess following from the implacable but allegedly narrow-minded economic logic (the one according to which it is “patently obvious” that if the exchange rates are fixed, then the wage must give). It is also the goal openly declared by some prominent

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<sup>31</sup> As every populist strategy, this “keep up with the Müller’s” approach is now backfiring, because Southern constituencies are eager to keep the status-symbol currency at all costs, and the strategy supposedly followed by leaders such as Tsipras (i.e., to force Germany to expel Greece from the Eurozone) would almost certainly be construed by Greek people as a national defeat, leading to potentially dangerous outbursts of resentment.



“founding fathers” of the euro, such as Tommaso Padoa Schioppa (2003), member of the Delors Committee, deputy governor of the Bank of Italy, member of the ECB board, Minister of Economics in the second Prodi government, who while serving at the ECB declared at the most authoritative Italian newspaper (*Il Corriere della Sera*) that:

Nell' Europa continentale, un programma completo di riforme strutturali deve oggi spaziare nei campi delle pensioni, della sanità, del mercato del lavoro, della scuola e in altri ancora. Ma dev'essere guidato da un unico principio: attenuare quel diaframma di protezioni che nel corso del Ventesimo secolo hanno progressivamente allontanato l' individuo dal contatto diretto con la durezza del vivere, con i rovesci della fortuna, con la sanzione o il premio ai suoi difetti o qualità.<sup>32</sup>

The idea that moving decisions to a supranational level was a mean to the end of reducing democratic accountability is not just the malicious hypothesis of some overly distrustful researcher. Mario Monti, former EU commissioner in the Santer commission, and Italian prime minister from 2011 to 2013, was formal on this point:

Perché, tutto sommato, alle istituzioni europee interessava che i Paesi facessero politiche di risanamento. E hanno accettato l'onere dell'impopolarità essendo più lontane, più al riparo, dal processo elettorale.<sup>33</sup>  
Rampini (1978)

Therefore, economic and political reasoning, as well as the confessions of prominent economists and politicians who played an important role in the building of the Eurozone, converge on a single point: the purpose of the euro is to annihilate the economic and political rights of the European working class, by dismantling the welfare state and sheltering decisions from the electoral process.

**4. A primer on European illogic** Building on the previous section, it will now be easier to analyze some inconsistencies in the “Europeanist” narrative. Sometimes, there is method in their apparent madness. In other cases, these inconsistencies point out the existence of fundamental paradoxes, where by “fundamental” I mean these contradictions endanger the foundations of the *current* European integration project, calling for a different approach.

**4.1 Market vs. plan** At present, despite its ambitious goals – frustrated so far as we all know – the European Union is basically an economic integration agreement. This is apparent from the list of its competences provided by Articles 3 and 4 of the Treaty on the Functioning of the European Union (TFEU), as well as from the fact that in every-day life the EU is mentioned mostly in relation to the economic issues of its member countries. As such, the European project must be evaluated first and foremost in terms of its economic logic. According to the Article 3 of the Treaty on European Union,

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<sup>32</sup> “In continental Europe a comprehensive program of structural reforms must encompass the fields of pensions, health, labour market, education, and many more. But it must be guided by a single principle: to weaken the system of protections that during the 20th century has separated the individual from the direct contact with the hardness of life, with the reversal of fortune, with the punishment or the prize to his weaknesses or qualities.”

<sup>33</sup> “After all, the European institution were interested in consolidation policies. And they accepted the burden of unpopularity because they were farther away, they were sheltered from the electoral process.”



The Union shall establish an internal market. It shall work for the sustainable development of Europe based on balanced economic growth and price stability, a highly competitive social market economy, aiming at full employment and social progress, and a high level of protection and improvement of the quality of the environment.

Many things could be discussed about this article, but we shall limit ourselves to two. Firstly, the aim to establish a “highly competitive” economy. The question arises: “highly competitive” with whom? Later on, the same article mentions the fact that the Union “shall promote economic, social and territorial cohesion, and solidarity among Member States.” However, I suppose everybody has noticed that the whole narrative on the current crisis revolves around Southern EU members not being competitive enough with respect to Northern EU members. Since the crisis erupted, the competitiveness of the EU as a whole towards third parties was rarely or never mentioned. The lack of cohesion and solidarity is often blamed, but it is rarely stressed how this goes against the letters of the Treaties (not to mention their spirit). No matters what it should be in theory, in practice the “highly competitive” part of the story has been interpreted as a *bellum omnium contra omnes* within the Union’s borders. One may wonder whether it is really necessary to sign a Treaty in order to fight each other. Moreover, since this fight contradicts the letter of the Treaties, one may wonder whether changing the Treaties in any way would really be worth the trouble. Who or what guarantees that the new Treaty would be respected?

Secondly, the reference to a “market economy” is also puzzling. The European Treaties put “market” and “competition” among their founding principles. Yet, the main goal of the Union, and the only one fully achieved so far, has been the suppression of the foreign exchange market through the adoption of the euro. If the competitive market mechanism is so reliable and its effects so beneficial that they need to be enshrined within the first few articles of the Treaty, why not trust them in relation to national currencies?

There are two answers to this question.

The official one is that the single currency abates transaction costs and is therefore essential for the development of the single market. Like in a Greek tragedy, the sacrifice of the FOREX is required by some divinity, in order to assure a smooth functioning of the remaining markets. But this answer is futile. The transaction costs are negligible, even according to the EC propaganda study *One market, one money*, where it was estimated that the adoption of the single currency would bring about a one-shot windfall gain of about 0.4% to European GDP. As Eichengreen (1993) aptly noticed, “this hardly seems an adequate return on a project riven with uncertainties and risks”. Moreover, as Feldstein (2012) points out,

There is, of course, nothing in economic logic or experience that implies that free trade requires a single currency. The North American Free Trade Agreement, for example, has stimulated increased trade without anyone thinking that the United States, Canada, and Mexico should have a single currency.

Furthermore, Meade (1957) has forcefully argued, in the heyday of the Bretton Woods fixed exchange rate system, that successful commercial integration in Europe would require *flexible* exchange rates in order to allow member countries to pursue domestic stabilization goals.<sup>34</sup>

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<sup>34</sup> I allow myself to point out again to the reader the remarkable detail that Meade’s insightful plea in favor of flexible exchange rates was written when fixed exchange rates were the dominant paradigm worldwide. Moreover, I remind the reader that Meade was a progressive economist, whose main concern was full employment and decent

Besides these theoretical arguments, there is plenty of historical evidence: here in Europe the European Free Trade Association (EFTA) is still alive and well without adopting a single currency; moreover, many countries belong to the European Union – and hence to the single market – without belonging to the monetary union; finally, each and every Eurozone member country does trade not only with other Eurozone member countries, but also with third countries, mostly in a regime of flexible exchange rates, and data show that international trade with those third countries is more flourishing than intra-zone trade despite the supposed hindrance of exchange rate uncertainty. Transaction costs are really not an issue. We have already mentioned the fact that their removal did not promote intra-Eurozone trade, but simply re-oriented it to the benefit of core countries.

The unofficial answer to the question “why do the European Treaties distrust the FOREX market only?” is the *vincolo esterno* story. The single currency was needed to curb income distribution and benefit the rich through the two concurring mechanisms of trade union discipline and capital market indiscipline. This unofficial answer finds a lot more support in the data. The “social market economy” has worked as it was supposed to work – as Featherstone, Monti, Padoa Schioppa and many others assumed it would work: as a weapon of mass destruction for workers’ rights. There is no paradox in praising the market forces while abolishing the FOREX market: the rationale of this decision is to skew the labour market in favor of financial capitalism.

### 4.2 Convergence vs. integration

The “solidarity and cohesion” mentioned in Article 3 of the TFEU raise another question. As mentioned above, the economic literature made it clear since Kenen (1969) and Kaldor (1971) that fiscal integration (i.e., a mechanism of automatic compensation of idiosyncratic shocks operated through a federal budget) was needed in order to alleviate the damages created by fixed exchange rates. The Maastricht Treaty completely misses this point for the obvious political reasons set out above: since the costs of monetary unification stem from “structural” differences rather than from “random” shocks, the certitude that there will be unidirectional and massive transfers of resources makes “integration” politically unfeasible. However, the Maastricht Treaty goes a long way in the opposite direction when it imposes the so-called “convergence” requirement – expressed by the infamous Maastricht parameters. I won’t get into the technical discussion about why these parameters make no sense (Buiter *et al.*, 1992). I just want to stress the faulty logic of the whole approach. While the European Union motto is “United in diversity”, you cannot belong to the Union unless you are equal to the incumbent countries. This does not make a lot of sense, especially if you consider how “convergence” is imposed only in public finance by setting limits to the government’s deficit and debt. Nothing is said about other structural features of the economy, including the one that proved to be more disruptive: unregulated private finance.

Despite the widespread claims that the Maastricht Treaty is “only” an economic project, whose failures depend on the lack of political underpinning, the contradiction we are stressing here suggests a different interpretation: the single currency should rather be considered as a successful neoliberal political project, in which the European federalist method of “political creative destruction” (i.e., the advocacy of economic crises as political “window of opportunities”) was used for the dismantlement of the welfare state, rather than for the

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labour standards in a commercially integrated area. Therefore, I would advise progressive intellectuals not to use the objection that flexible exchange rates are right-wing because Milton Friedman (1953) had advocated them four years before Meade! As I observed above, progressive intellectuals who are so uncomfortable with an exchange rate regime supported *also* by a neoliberal economist, should ask themselves why they are so keen to live in the ECB’s *k%* rule world, supported *only* by a neoliberal economist: Friedman (1960).

advancement of the federal project. In fact, while “integration” would attribute an active role to the State in the management of the economy, “convergence” was designed in order to repress the role of the State. This simple remark shows how deeply the fixed-rules/fixed-parameters approach of Maastricht was influenced by neoliberal Chicago-school thinking. At a less deep level, the alleged justification of the “convergence” approach was the need to “ring-fence” the supposedly undisciplined Southern States (Italy, above all). While this sounds as a wise precaution, at least from the point of view of Northern taxpayers, it is nevertheless logically inconsistent with any principle of solidarity. As mentioned before, the management of the crisis has clearly shown that in the single currency world public debt cannot be mutualized, while private debt can, but to the expenses of Southern countries’ taxpayers. This double standard will prove unsustainable over time, and call for the reintroduction of exchange rate flexibility, insofar as it forces imprudent creditors to bear the risks of their decisions.

The *vincolo esterno* logic moves from the assumption that the single currency (more generally, financial integration) will force member States to abide by the “sound money, sound finance” principle. We have already elaborated on the adverse consequences for democracy of this approach.<sup>35</sup> Let us now consider its economic logic. It is “patently obvious” (to use Mundell’s words) that you cannot ask someone to make a better use of a resource if you give it for free – or at an artificially low price. Yet, this is exactly what the Europeanist narrative has told us for years: that the main benefit of the single currency was to provide low interest rates to investment-thirsty Southern countries, *and* that the single currency would have disciplined them. Unfortunately, those two things “passen nicht zusammen” (to use the Mr. Schäuble’s words, Brost and Schieritz, 2015): they do not stick together, they are internally inconsistent, much in the same way it is internally inconsistent the wish to keep the euro (i.e., to abolish external devaluation) while avoiding austerity (i.e., internal devaluation). Once more, the economic literature has already pointed this out well before the disaster.

Since the purpose of the European Union is to stay “united in diversity”, it is really difficult to understand how the equalization of interest rates across countries could be seen as a sensible goal. Nevertheless, in the public debate one frequently meets experts that simply *assume* that a single currency *implies* a single interest rate, or even worse, that a single currency is successful, or makes sense, only insofar as it brings a single interest rate. We also often hear the converse statement: whenever interest rates differ among member countries, one cannot sensibly speak of single currency anymore. But this does not make sense. Italy formed a monetary union one and a half centuries ago. Yet, interest rates on similar financial market instruments still differ from one region to the next, being typically higher in the Mezzogiorno, as many economic theories would predict.<sup>36</sup> Have you ever heard someone in the decades before the onset of the euro complain that the Italian lira was not a true Italian single currency because there was a spread between loans in Calabria and Piemonte?

Here we face again the Europeanist market schizophrenia. In principle, the market fundamentalism of European Treaties would suggest that it would be unwise to interfere with the “natural” mechanism of interest rate determination (no matter what it is). A less fundamentalist view would suggest that markets need to be regulated. Progressive thinking

#### **4.3 Financial discipline vs. financial integration**

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<sup>35</sup> The non-existence of an univocally determined “technical” optimum in economics makes it suspect any attempt to entrust “technical” bodies with economic decisions.

<sup>36</sup> According to Banca d’Italia (2014) the spread on bank loans to manufacturing firms between Southern and Northern regions in Italy is still around 200 basis points.

would probably agree with the latter view. However, as was already pointed out, it is one thing to regulate markets, and another, completely different, thing to systematically alter their functioning, to possibly the benefit of the stronger<sup>37</sup>. By bringing financial integration without market regulation, “Europe” fostered financial indiscipline through three distinct channels. Firstly, since the (artificially induced) single interest rate was too low in Southern countries, it made credit too cheap for private and public agents in those countries, thereby encouraging a massive rise in their indebtedness. Secondly, the credibility gained through Eurozone membership, as well as the abolition of the exchange rate risk (determined by the adoption of a single currency), altered the markets’ perception of risk. Thirdly, financial integration by definition made the cross-border transfer of funds easier.

As a consequence, private agents used credit to frontload expenses and public agents used credit to postpone reforms.<sup>38</sup> Can we really believe that these were only unexpected side-effects? Not really, and if they were they would demonstrate a dangerous level of incompetence in the European elites. Both basic economic reasoning (if a resource is cheap, you are going to care less about how you use or misuse it) and the empirical literature (in particular, the studies on currency unions in emerging countries; Tornell and Velasco, 2000) had warned that the adoption of a single currency would lead to less “discipline” in weaker countries. It should be clear that I am not an advocate of “discipline” *per se* (nor of the use of any other moralistic category in economics). However, I am an advocate of consistent thinking. Fiscal convergence, as embodied in Maastricht parameters, is logically inconsistent with a single currency insofar as the latter will promote both private and public indebtedness in weaker countries. In other words, financial integration – insofar as it makes money artificially cheaper in weaker countries – is inconsistent with financial discipline (both public and private). An increasing number of economists are now sharing this view with respect to the Eurozone crisis (Granville, 2013; Fernandez-Villaverde et al., 2013; Ciżkowicz *et al.*, 2015).

**4.4  
Single currency  
vs. single market**

As we have seen above, Feldstein (2012) argues that there is no logical necessity to adopt a single currency in order to ensure the functioning of a single market. Many free trade areas exist across the world – think for instance of the EFTA and the North American Free Trade Agreement (NAFTA) – and none of them adopts a single currency, or have even thought of adopting one. The same point is forcefully made by Majone (2014), who also quotes the example of the Australia New Zealand Closer Economic Agreement (ANZCERTA) and of the Mercado Común del Sur (MERCOSUR).<sup>39</sup> In fact, Feldstein’s argument can be pushed a bit further: a single market does not imply a single currency and in top of that a single currency is

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37 This point is missed by the median progressive intellectual, whose instinctive aversion for market fundamentalism, which I share, becomes very often an acritical support to each and every measure that somehow “punish”, “represses”, “hinders”, “cancels” the market functioning. A collateral, and misguided, implication of this view is that we need a “big” European State, and hence a “big” European money, to fight the “big” global market. As I show in this paper, the big European money so far was successful only in repressing national democracies.

38 I do not enter here in the debate as to whether “reforms” (of whatever kind) were actually needed. I expressed my view on this topic in Bagnai (2014). I am just trying to show to the reader the internal inconsistency of the reform worshippers’ reasoning, within the logical framework used by the worshippers themselves (namely, the absolute faith in the market mechanism).

39 Many other examples of economic integration could be made where the issue of a single currency was never discussed. Among them, the Association of South-East Asian Nations (ASEAN) and the Common Market for Eastern and Southern Africa (COMESA). On the contrary, the two most important regional integration agreements that adopted a single currency are the Central African Economic and Monetary Community (CAEMC) and the West African Economic and Monetary Union (WAEMU) in Sub-Saharan Africa. Those two institutions involve former French colonies, and as such they inherited their single currency (the CFA franc), rather than adopting it. This a telling and absolutely *not* coincidental detail.

logically inconsistent with a single market, insofar as it eliminates the main benefit of pooling national markets into a single one.

A good starting point is Alberto Alesina's (1997) reflection on the size of the State. Alesina frames this reflection in terms of two trade-offs, one in terms of governability, and the other in terms of resilience to external economic shocks. Small countries are easier to rule, but are more vulnerable to global economic shocks. On the contrary, large countries are less vulnerable to global economic shocks because they benefit from a larger internal market (one that can sustain the economic activity even if exports fall), but are more difficult to rule because of their intrinsic complexity and inhomogeneity. Alesina's argument is that the general trend towards globalization and freedom of international trade makes flexibility more important than size:

Why would a country want to lock itself in a political union when it could be small, enjoy freedom of political choice, and trade peacefully with the rest of the world? There is no need for political integration when there is economic integration.

This argument, though openly neoliberal, has some truth in it. Post-Keynesian economists, including myself, could question the underlying assumption that free trade will always lead to an optimum allocation of resources. Nevertheless, the hypothesis that once "the world becomes the market" you do not really need to become "larger" in political terms fits the fact that since the end of WWII we have witnessed both an increase in political fragmentation (the number of sovereign States having increased from 74 to more than 200) and an increased resort to flexible exchange rates (Ghosh et al., 2014).<sup>40</sup> At the very least, the European "imperial" project leans against the wind of history in these two important dimensions.<sup>41</sup> The point I made in Bagnai (2014) is that once an economic union is supplemented with a monetary union, its main advantage disappears. Once an external shock arrives, the Union becomes a *shock amplifier* instead of a shock absorber, since member countries are forced to engage in competitive unemployment ("internal devaluation"). In other words, instead of insulating member countries from foreign shocks through its large internal market, an economic *and monetary* union crushes its member countries under the need to compete with each other by repressing internal demand – and it is the single currency that implies the need to resort to internal devaluation. As such, the single currency is logically inconsistent with a single market. Once more, economic facts are consistent with economic logic: the more or less "successful" experiences with free trade areas (EFTA, NAFTA, ASEAN, ANZCERTA, COMESA, MERCOSUR, and so on) *never* featured a monetary union.

The purpose of this paper was to remind the "ordinary uninstructed reader", i.e., educated people lacking specific economic knowledge yet endowed with some intellectual curiosity, of the basic economic logic of currency unions. Our aim was to explore from a progressive point of view the implications of this simple logic for the political evolution of the Eurozone. This led us to restate some simple truths, still taught in entry-level textbooks, yet apparently unlearned from the Eighties onwards by most progressive intellectuals. In section 2 we are reminded that fixed exchange rates (and hence single currencies) come at a cost. This cost is

## 5. Conclusions

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40 A concurrent reflection on the optimal size of regional organization is developed by Majone (2014), who points out that small organizations (i.e., organizations with a smaller number of members) economize on transaction costs and facilitate the development of an enforcement system based on mutual trust.

41 In order to conceal this bare fact of life, in 1991 EU consultants joined the IMF in opposing the dismantlement of the rouble zone; Granville (2002) describes this troika *ante litteram*.

likely to be shared in an asymmetric way, with weaker classes and weaker countries suffering heavier burdens. In section 3 we addressed OCA theory, which is used as economic rationale by the advocates of the “more Europe” solutions to the crisis (i.e., to a more and more unlikely shift towards a “federal” European Union). We showed that this theory rests on a shaky neoliberal foundation – an ominous feature for a project so keenly endorsed by the European left-wing – and it also lacks any political realism, because it ignores the size of transfers needed in order to ensure the viability of any federal project. In section 4 we explored some paradoxes of the European narrative and of the Eurozone structure. The crucial result is that a monetary union, by implying the need to resort to internal devaluation, destroys the benefit of an economic union, i.e., the presence of a large internal market working as a buffer in case of external shocks. The basic logic of currency unions dooms an economic *and monetary* union to become a shock amplifier in case of a major global shock. The performance of the Eurozone from 2008 onwards provides strong evidence for this hypothesis.

Despite my effort to simplify their presentation, without sacrificing rigor, I understand some of these arguments may seem too technical – and perhaps they are. However, in my view, the rather self-defeating worship of the single currency by most progressive intellectuals cannot be excused by their lack of technical skills. One does not need a PhD in economics in order to appreciate Majone’s (2014) argument that the “mismatch between process and outcome” suggests that some choices – including the choice of a single currency – were made for “purposes other than the stated goal(s)”. And one does not need a PhD in political science to smell a rat when wealthy central bankers, often coming from the private financial institutions, show such a compassionate attitude towards the lower classes. Price stability is purported to protect the purchasing power of wages. However, its most immediate effect is to preserve the nominal value of financial wealth. This, as well as the fact that price and wage stability is regulated by the industrial reserve army, has sadly been forgotten by most left-wing politicians and intellectuals.

This apparently inexplicable oblivion led the European left-wing to betray the economic interest of the lower classes and to witness passively an unprecedented increase in income inequality and social injustice. This betrayal is likely to depend on a number of reasons. As I argued above, an important reason is the neoliberal revolution was successful in spreading the deceitful idea that a purely “technical” – and hence apolitical – economic optimum exists. This conviction is apparent in the attitude of most trade union leaders in Italy (and perhaps also elsewhere). In the public debate they simply assume that since “money creates inflation”, and “inflation is a tax on the poor”, you’d better entrust a “technician” with the management of the economy. Oddly enough, these leaders seem to overlook the fact that, should the world really work like this, they would become useless. In the neoliberal world there is no room for trade unions, there is no room for any left-wing party, there is no room for politics, and there is no room for the State. The market rules. Why on Earth should a progressive intellectual defend such a *Weltanschauung* will, I think, remain a mystery – like cetacean stranding.

What complicates things is the fact that in Southern countries the political support for a project meant to overcome the dangers of nationalism was sought mostly by resorting to nationalism. Monetary flag-waving (i.e., the nationalist aspiration to share the same money with Northerners), and what we could call “supranationalism”, are an important part of this story. By “supranationalism” I mean the pursuit of a regional integration model that mimics at the supranational level the “legal centralism” prevailing at the national level (Majone, 2014). This approach is allegedly justified by the supposed need to create a “bigger” nation, the European nation, in a world where “the players are getting bigger”. As we have shown above, the claim that we can survive only by getting bigger has no economic rationale and is refuted by a lot of historical evidence. Yet, it sounds plausible and appealing to “ordinary



uninstructed” constituencies. There must be some archetypal, deep, unconscious feeling that brings men (and women) to prefer “rigid” exchange rates, “strong” currencies, “big” players, and so on. That said, politics is also a matter of symbols. However, unfortunately, economics is mostly a matter of figures.

We witness here two paradoxes: the left wing endorsing, through the euro, pro-capital policies, and the attempt to overcome nationalism through (supra)nationalism. These paradoxes are extremely likely to prevent a democratic solution to the Eurozone crisis and an orderly transition towards a more reasonable model of European integration.<sup>42</sup>

As in any other fixed exchange rate agreement, the euro implies the need to use internal devaluation as the main adjustment mechanism. However, this sets off a vicious circle. Internal devaluation destroys internal demand, and hence makes the country even more dependent on external demand, and hence calls for further internal devaluation. In other words, basic economic reasoning implies that by backing the euro left-wing parties endorse mercantilist policies – which in turn fly in the face of any wage-led model of economic growth (Lavoie and Stockhammer, 2014). Consequently, in order to survive progressive parties must insist on an ultimately self-defeating strategy: the claim that “another euro is possible”, or, better yet, that it *would* be possible, if only creditor countries would not be so selfish. With the “another-euro-is-possible” mantra the rules of the “blameshift” game change from one where Southern and Northern elites jointly put the blame on Europe for their anti-labour policies, to one where Southern elites deprecate Northern elites for their resistance to the concessions that would supposedly make the euro viable. However, while providing Southern elites with a convenient escape strategy from their historical responsibilities, this mantra makes the euro politically unsustainable by fostering the Southerners’ resentment towards the (supposedly) greedy and selfish Northerners. Kaldor’s (1971) prevision in this respect has already been largely realized. This is especially evident in Italy, where the euro’s founding fathers like Romano Prodi (2012, 2015) censure Frau Merkel, claiming she is the only one responsible for the failure of the European project. On top of that, the idea is sometimes expressed that mobilizing anti-German resentment at a national or international level, aimed at threatening Germany to do “the right thing” (i.e., to make concessions to the debtors), could be a viable strategy. Besides its evident dangers, this strategy ignores the fact that it is extremely difficult to do “the right thing” when the rules are wrong. As argued above, the purpose of adopting a fixed exchange rate is to put all of the burden on the shoulders of the debtors. Once you grant this power to the creditor, it would be a utopian fantasy to expect them do anything to meet the debtors halfway.

I am afraid I must end this paper on a very pessimistic note.

The political viability of the euro has so far been assured by two conflicting populist lies. The populist lie of the Southern elites was that the euro would shelter weak countries from major crises, would make people richer, and would help countries to reform themselves. None of these promises were supported by economic rationality (as we have shown in this paper), and all of them failed. The populist lie of the Northern elites is that the failure of the euro is the fault of lazy, unproductive, and corrupted citizens of peripheral countries, because they ruined the sacrifice that had been offered by Northern countries when they gave up their strong currencies in order to create a peaceful Europe. It is quite evident that those who have proposed the euro as an absolute value cannot easily renege on their populist claims. The best

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42 Such as the Functional Overlapping Competing Jurisdictions (FOCJ) model developed by Frey and Eichenberger (1999), the inter-jurisdictional competition mode advocated by Majone (2014), and the “polyphonic” model of integration proposed by Zielonka (2014).



they can do is to adopt a lie equal and opposite to that of the Northerners, putting the blame on the latter's greed. On the other hand, Northern elites cannot renege on their simplistic "blameshift". In other words, while Southern elites are stuck to the euro, Northern elites are forced to manage it in an extremely uncooperative way. Every German politician (of whatever color) that is willing to endorse a more cooperative attitude would immediately lose support in favor of "euro hawks" (of whatever color). The Greek crisis has provided many examples of this rather obvious political dynamics (anticipated by Kaldor, 1971 and Feldstein, 1997). In principle, it would be easy to find simple arguments for a thorough revision of the whole project – while also avoiding that this revision be perceived as a defeat or a step backward. The most compelling, in my view, is the idea that a project started when the main economic problem was inflation and the main political problem was the Cold War (the Werner report was issued in 1971) is not suitable for a world where deflation is the new main economic problem and the "Empire of evil" does not exist anymore. Many other arguments can be put forward, and are set out in this paper. That said, any politician willing to endorse the need of such a revision of the European integration process would be likely to suffer short-term political costs, and politics is an intrinsically short-sighted activity. Likewise, the construction of a new Europeanist narrative would require mutual trust and cooperation among the European elites: precisely what the Eurozone crisis has destroyed. The "political market" failure is evident: each and every politician is waiting for an exogenous event that would save him the need to explain why the Eurozone project is doomed to fail and why it would be better to manage this default, rather than to suffer it. This leaves me with the unpleasant feeling that the end of the Eurozone will necessarily be traumatic – and managed by right-wing parties. The euro flag-waving so keenly advocated by our progressive elites, with the ultimate aim to dissolve national identities (assumed to be the causes of all political evils), will backfire. It is not unlikely that deflation will once more be dealt with in the usual way: through a major conflict, as it was in 1939. An apparently paradoxical but indeed quite natural outcome for a project that pretended to foster peace, while actually being nothing else than class conflict in disguise.

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