The Eurozone's 'Winner-Take-All' Political Economy:

Institutional Incentives, Inequality, and the Return of the North-South Gap

Matthias Matthijs
Johns Hopkins University – SAIS
matthijs@jhu.edu

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Abstract:

This paper offers an institutional explanation for the conflicting trends in income inequality across the Eurozone since the late 1990s, by arguing that the introduction of the single currency created radically different incentives for the 'peripheral' (or 'deficit') countries in the South (and West) and the 'core' (or 'surplus') countries in the North of Europe. Between 1998 and 2008, low interest rates due to capital inflows in the poorer Southern periphery fueled faster growth, increasing wages and lowering returns to capital, which resulted in falling income inequality in the South. On the other hand, the only way for the richer Northern core to remain competitive within the Economic and Monetary Union (EMU) was to practice relative wage restraint and enact structural reforms, initially decreasing the return to labor and increasing the return to capital, leading to rising income inequality during that time period in the North. The natural result during these 'normal' times was relative economic convergence between the member states of the Eurozone – both in GDP per capita, and in overall levels of income inequality.

Between 2008 and 2013, however, the Eurozone functioned in a fashion not unlike the interwar gold exchange standard. The deficit countries in the periphery had to sacrifice their internal domestic economic equilibrium in order to restore their external competitiveness, and therefore *had no choice* but to respond to a balance of payments crisis by a series of deflationary spending, price and wage cuts. These policies resulted in deep and long recessions, as well as widening income inequality. The euro periphery needed to practice austerity 'by institutional design.' The surplus countries on the other hand *had the choice* to respond to the crisis by instituting moderately inflationary policies domestically, which led to increasing wages and a lower return to capital, causing declining levels in inequality. Unlike the periphery, the core had the option to enact demand stimulus 'by discretion,' even though the stimulus was modest at best, especially at the onset of the crisis. The logical outcome of the euro crisis was to bring about renewed divergence between its member states, both in GDP per capita, and in national levels of inequality. To some extent, the crisis has catapulted Europe back to the early 1990s, when the absolute income gap between North and South on the continent was substantial and domestic income inequality in the countries of peripheral Europe was a lot higher compared to the countries of the core.

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1. Introduction: The Euro Crisis and Its Effects on Inequality in Europe

The euro crisis, the most significant aftershock of the global financial crisis of 2008, has wreaked havoc on the process of European integration. First, what soon mistakenly came to be known as the European "sovereign debt crisis,"[1] and the public policy response to it, has brought an abrupt end to the ongoing process of economic convergence between the Eurozone's 'Northern' core and 'Southern' periphery member states.[2] More disturbing for the European Union (EU) as a whole, the crisis has in fact reversed much of the progress made in the 1990s and 2000s in reducing national income differences between EU members. For example, while the ratio of per capita income (in constant prices) of relatively affluent Germany vis-à-vis much poorer Greece had been steadily improving since the early 1990s to a low of 1.53 in 2007, it worsened again to 2.12 by 2013, a number much higher than the prevailing ratio in the early 1990s. And it is not just a Greek tragedy: the corresponding ratios for Germany's per capita income vis-à-vis Italy's and Spain's were 1.15 and 1.20 in 2007, and 1.36 and 1.38 in 2013, respectively.[3] This adverse evolution has made a travesty of the old EU mantra of 'ever closer union.'

Second, the crisis and the multiple social movements it spawned all over Europe in 2011, from *Occupy London* in Britain to the *Indignados* in Portugal and Spain, have also led to a renewed focus by both academics and policy makers on the substantial widening in income inequality within Europe's national contexts. This trend is particularly striking in traditionally more 'egalitarian' societies such as Germany, Denmark and Sweden – all of which have experienced a marked increase in their national levels of inequality since the early 1990s – but also in already unequal economies such as Britain, where inequality has only risen further since the crisis hit in 2008. The higher levels of inequality foster the perception both at home and abroad of dwindling European solidarity and a continent adrift and in decline.[4] This new situation calls into question the future of Europe's much-vaunted social model and celebrated universal welfare state, which are central to the EU's 'soft power' projection to the wider world.

There exists broad consensus in both the academic literature and the economic policy world that income inequality has been systematically rising in most Anglo-Saxon economies starting in the late 1970s, while most other OECD countries – with a few

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[1] The euro crisis was in many ways the direct consequence of the US financial crisis, i.e. "a private sector banking crisis that necessitated a public sector bailout, which left sovereigns, especially in Europe's periphery, mired in debt." (Quoted from Matthias Matthijs and Mark Blyth (eds.), *The Future of the Euro*, chapter 1 (forthcoming 2014).

[2] Note that I will refer to the countries of Germany, Finland, Luxembourg, and the Netherlands as either "the North," "the core countries," or the "surplus" countries. And instead of using the popular acronym the "PIIGS," I will refer to the countries of Greece, Spain, Ireland, Italy and Portugal as "the South," "the periphery," or the "deficit" countries (even though Ireland, obviously, is not a part of Southern Europe). The other original Eurozone members, such as France, Belgium, and Austria, are not included because they have elements of both North and South. The countries that have joined the EMU since 2002, including Slovenia, Slovakia, Malta, Cyprus, Estonia, and Latvia, are not included in this analysis.

[3] IMF (2013), *World Economic Outlook Database* (Washington, DC). Online available at: http://www.imf.org/external/pubs/ft/weo/2013/02/weodata/index.aspx

[4] Erik Jones (2012), "European Crisis, European Solidarity," *Journal of Common Market Studies: Annual Review* 50, August, pp. 53-67

exceptions such as France and Belgium – followed suit in the late 1980s.[5] While average real household incomes for the whole OECD population rose by 1.7 percent annually between the mid-1980s and late 2000s, the top decile of the income distribution saw its average household income grow by 2.0 percent year-on-year, while the bottom decile only saw an increase of 1.4 percent year-on-year.[6] However, these averages mask significant national differences. Not all OECD members experienced widening inequality within that time period. Some saw the top decile's share of the pie expand much faster than others. Furthermore, 'single number' measures of inequality – such as the widely used GINI coefficient – have significant shortcomings: they generally lack important information about the actual concentration of income within the overall distribution.

The paper will proceed in six sections. Section two will lay out the Eurozone's inequality puzzle in greater detail. Section three will define exactly what we mean by income inequality and will briefly review the existing academic literature, both in economics and political science, that has delved into the various causes of widening inequality in the West since the 1980s. Section four will develop a theoretical framework to help us understand the underlying incentive structure of Europe's multi-state currency union, including a new typology combining method and burden of adjustment, and explain the differing institutional incentives member states face during 'normal' and 'crisis' times. Section five will analyze the empirical evidence on both intra- and inter-European inequality, contrasting the experience of the Northern core with the Southern periphery. Section six will discuss the institutional path dependence and ideational change of the Eurozone's monetary and fiscal policy response to its sovereign debt crisis. The final section will draw the main conclusions.

2. Introduction: Europe's Inequality Puzzle

Upon closer inspection of the national inequality data provided by Eurostat, however, there appears to be a more sinister inequality puzzle that has arisen within the context of the Eurozone. Rather than an overall increase in income inequality, the peculiar pattern within the Eurozone has been a tale of two very different 'Europes.' During the period starting with the establishment of the European Central Bank (ECB) in 1998 and the onset of the global financial crisis in 2008, the Northern Eurozone core member states of Germany, Finland, the Netherlands, and Luxembourg saw rising income inequality, as measured by their countries' GINI coefficients. The Southern and peripheral Eurozone members, including Ireland, Spain, Greece, Italy, and Portugal actually saw falling (or constant) levels of income inequality.[7]

Between 2008 and 2012, on the other hand, the situation went into reverse. The core Eurozone members saw their levels of income inequality fall, with the exception of Luxembourg, which experienced a small increase of just over one percent. The periphery

[5] OECD (2011), *Divided We Stand: Why Inequality Keeps Rising*, OECD Publishing, p. 22. Online available at: http://dx.doi.org/10.1787/9789264119536-en
[6] OECD (2011), "Growing Income Inequality in OECD countries: What Drives it and How Can Policy Tackle it?" (Paris: OECD), Monday May 2, 2011. Online available at: www.oecd.org/els/social/inequality
[7] Italy's GINI coefficient between 1998 and 2008 remained constant at 0.31 (Eurostat, 2014)

countries, with the exception of Portugal, all reported significant increases in their GINI coefficients since the crisis. The exact figures are summarized in table 1. So far, this empirical puzzle has been largely ignored in the academic literature, and is therefore in need of further exploration.

Table 1: Selected Eurozone Countries Change in Income Inequality (GINI Coefficient)[8]

		% Change (1998-2008)	% Change (2008-2012)
"NORTH" (Core)	Germany	+20.80	–6.29
	Finland	+19.55	–1.52
	Netherlands	+10.40	–7.97
	Luxembourg	+6.54	1.08
"SOUTH" (Periphery)	Ireland	–12.06	+2.51
	Spain	–6.18	+9.72
	Greece	–4.57	+2.69
	Italy	0.00	+2.90
	Portugal	–3.24	–3.63

Further evidence of these opposing trends in income inequality between the Eurozone's core and periphery comes from the OECD. Table 2 shows the average annual percentage increase in real household income for the total population, and compares and contrasts it to the income trends for the bottom decile and the top decile between the mid-1980s and the late 2000s.

Table 2: Trends in Real Household Income by Income Group (mid-1980s to late 2000s)[9]

		Total Population	Bottom 10%	Top 10%	Difference b/w Top and Bottom 10%
NORTH	Germany	0.9	0.1	1.6	**+1.5**
	Finland	1.7	1.2	2.5	**+1.3**
	Netherlands	1.4	0.5	1.6	**+1.1**
	Luxembourg	2.2	1.5	2.9	**+1.4**
SOUTH	Ireland	3.6	3.9	2.5	**–1.4**
	Spain	3.1	3.9	2.5	**–1.4**
	Greece	2.1	3.4	1.8	**–1.6**
	Portugal	2.0	3.6	1.1	**–2.5**
	Italy	0.8	0.2	1.1	**+0.9**

[8] All data are taken from Eurostat (2014) and the calculations are my own. Note that the 2012 GINI Coefficient for Ireland was missing, so I used the 2010 measure instead of the 2012 one.
[9] Data also from OECD (2011), *Divided We Stand*, p. 23

The bottom 10 percent of households in Germany, Finland, Luxembourg, and the Netherlands all saw their incomes grow by a lot less than the top 10 percent, while the reverse was true for Ireland, Greece, Spain, and Portugal. Italy seems to be the exception to the North-South divide as it behaved more like a "Northern" country in that the bottom decile there did also much worse than the top decile.[10]

In other words, after a period of broad convergence between North and South – both in GDP per capita and in overall levels of inequality – the onset of the global financial crisis has triggered a severe regression back to the levels of the early 1990s. The logical question to ask is: what can explain these diverging tendencies in income per capita and the reversal of the converging trend in national levels of inequality since 2008? In this paper, I offer an institutional explanation for the conflicting movements in income inequality across the Eurozone since the late 1990s, by arguing that the introduction of the single currency, the euro, in 1999, created radically different policy incentives for peripheral countries on the one hand and core countries on the other.

Between 1998 and 2008, lower interest rates due to massive capital inflows in the poorer Southern periphery fueled faster growth and consumption, increasing wages and lowering overall returns to capital, which resulted in falling income inequality in the South. By contrast, the only way for the richer Northern core to remain competitive within the Economic and Monetary Union (EMU) was to practice relative wage restraint and enact structural reforms, initially decreasing the return to labor and increasing the return to capital, leading to widening income inequality in the North during the same time period. The expected result during these 'normal' times was relative economic convergence between the member states of the Eurozone – both in GDP per capita, and in overall levels of income inequality, as measured by the GINI coefficient for disposable household income (i.e. after taxes and transfers). In other words, during the first decade of its existence, the European single currency seemed to deliver on its lofty goal of bringing about convergence between richer and poorer member states.

Between 2008 and 2013, however, the Eurozone functioned in a fashion not unlike the interwar gold exchange standard. Just like during the 1930s, the 'deficit' countries in the periphery had to sacrifice their internal domestic economic equilibrium in order to restore their external competitiveness, and therefore *had no choice* but to respond to a balance of payments crisis by a series of deflationary spending, price and wage cuts. These resulted in deep and long recessions, and led to widening income inequality. The Eurozone periphery needed to practice austerity 'by institutional design,' having given up devaluation and inflation as possible shock absorbers by adopting a common currency.

Unlike the periphery, the surplus countries did not face the same pressure as the deficit countries and actually *had the choice* to respond to the crisis by instituting inflationary policies domestically. These mild responses, as well as the capital flight to safety from South to North, led to moderately increasing wages and a lower overall return to capital, causing falling levels of inequality. The core had the option to enact demand stimulus 'by discretion,' even though the stimulus was modest at best. The logical outcome of the euro

[10] OECD (2011), *Divided We Stand*, p. 23

crisis was thus to cause broad divergence between the Eurozone member states, both in GDP per capita and national levels of inequality. To some extent, the crisis has catapulted Europe back to the early 1990s, when the North-South income gap on the continent was significant and domestic income inequality in peripheral Europe a lot higher compared to the countries of the core.

3. Inequality in Europe: Definition and Brief Review of the Literature

Any paper or treatise dealing with inequality needs to start by carefully defining what is meant by it. There are significant differences between individual labor income inequality, household income inequality (which include capital income and returns from savings), and wealth inequality (which include the total stock of assets). For example, wealth inequality in Germany is substantially higher than the rest of Europe, as opposed to household income inequality, where Germany scores well below the average.[11] It is also important to distinguish between mean and median income levels, as they could be very different and lead policy makers to opposite conclusions. The landmark 2011 OECD study *Divided We Stand: Why Inequality Keeps Rising* highlights the differences between wage dispersion among salaried employees (where gender differences could play a big role), individual earnings inequality among all workers (which includes the self-employed) versus the entire working-age population (including those who are inactive or unemployed), household pre-tax 'market' income inequality versus household post-tax 'disposable' income inequality, and household 'adjusted disposable' income inequality (taking into account the actual value of public services like education and health).[12]

In this paper, I will mainly focus on *disposable household inequality*, which adjusts overall market incomes for taxes and transfers, and is corrected for household size and deflated by the consumer price index. The advantage of using this measure is that there are plenty of standardized comparative data available across Europe either through the databases of Eurostat or the OECD. The measure also focuses on actual 'outcomes,' as it takes into account most government policies enacted to decrease market inequality, such as progressive income taxation, real estate taxes, and taxes on capital gains, even though it omits the value of publicly provided services, which could be very important for the lower end of the income distribution. It is however very hard to find consistent data on this measure which are fit for comparison. As the OECD itself notes, increases in inequality have been largely driven by changes in the overall distribution of wages and salaries, which account for about three quarters of all household incomes.[13] At the higher end of the distribution, however, especially at the very top, returns to capital such as overall appreciation of their existing capital stock, dividends, and interest payments on savings, account for a much higher (and growing) share of household income than at the bottom.

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[11] See Paul De Grauwe and Yumei Ji (2013), "Are Germans really poorer than Spaniards, Italians, and Greeks?" *Vox*, 16 April. Online available at: http://www.voxeu.org/article/are-germans-really-poorer-spaniards-italians-and-greeks

[12] OECD, *Divided We Stand*, p. 26

[13] Ibid., p. 22

a. Economic Accounts

Standard explanations in the economics literature for the increase in the overall level of inequality in most OECD countries tend to emphasize, in order of importance, the role of skill-biased technological change (SBTC), the effects of increased international trade and globalization, the impact of immigration, and the growing returns to higher education.[14]

The most influential explanation in the economics literature, as put forward by Katz and Murphy in the early 1990s, remains that widening inequality across the OECD has been driven by an increase in the relative demand for skills, which is caused by exogenous and skill-biased technological change.[15] Acemoglu and Autor refined this view in 2010, making a crucial distinction between tasks and skills.[16] What became known as the 'routinization hypothesis' posited that computerization mainly affected people with so-called 'medium' skills – like accountants, legal clerks, administrative assistants, and medical laboratory technicians – who were more likely to move downward rather than upward in the task distribution after losing their job. This put greater downward pressure on low-skilled workers' wages compared to the wages of high-skilled workers and hence induced a polarization in the overall income distribution. The routinization hypothesis also explains the 'missing middle' or squeezed middle class, which was a central theme of many protest movements after the 2009 global financial crisis.

Other economic accounts of rising inequality in the developed world have focused on the effects of international trade and factor movements, starting with the Stolper-Samuelson theorem that builds on the trade theory of Eli Heckscher and Bertil Ohlin. This account predicts decreasing returns on low-skill labor and increasing returns on high-skill labor; developed countries specialize in and export goods that require a high proportion of skilled labor, and import goods that require a high proportion of low skilled labor in production. However, this theory generally has not been confirmed empirically, as doubts have been raised about whether the overall volume of trade between developed and developing economies really is large enough to explain the large increases in inequality.[17] The current consensus seems to be that only about 10 to 15 percent of the rise in income inequality across the OECD can be explained by the effects of growing international trade.[18] "Offshoring" or outsourcing of services abroad has also been found to reinforce labor market polarization, as in general mainly routinized tasks can be outsourced to low-

[14] For a comprehensive review of the economics literature, see Rafal Kierzenkowski and Isabell Koske (2013), "The Drivers of Labor Income Inequality – A Literature Review," *Journal of International Commerce, Economics and Policy* 4 (1).
[15] Lawrence Katz and Kevin Murphy (1992), "Changes in Relative Wages, 1963-1987: Supply and Demand Factors," *Quarterly Journal of Economics* 107 (1), pp. 35-78
[16] Daron Acemoglu and David Autor (2010), "Skills, Tasks, and Technologies: Implications for Employment and Earnings," *NBER Working Paper* 16082, Cambridge, MA
[17] IMF (2007), *World Economic Outlook – Globalization and Inequality*. Washington, DC
[18] Paul Krugman (2008), "Trade and Wages, Reconsidered," *Brookings Papers on Economic Activity*, 39, pp. 103-154

wage, low-skill countries.[19] Immigration overall is found to have a rather small impact on native workers.[20]

The average level of educational attainment is found to be negatively correlated with wage inequality, with the college wage premium in the United States for example, having grown dramatically since the early 1980s. According to the Council on Foreign Relations, the median earnings of a worker with a bachelor's degree were 65 percent higher than the earnings of a high school graduate's, with workers with professional degrees such as law, medicine and business enjoying a 161 percent wage premium.[21]

b. Political Accounts

While the economic literature does a remarkably good job at explaining overall upward trends in income inequality in the developed world, it often falls short in addressing why certain economies have seen much larger increases than others, or why the income gains in some countries tend to be more heavily concentrated at the very top of the distribution. After all, skill-biased technological change and increasing trade flows are 'global' phenomena, which for the most part impact all advanced industrial countries.

The political science literature is much thinner than the economics literature on the subject of inequality, and differs substantially based on the country that is being studied. General large-N studies focusing on labor market policies and institutions have found that the impact of declining unionization and a lower relative minimum wage mainly affects the lower end of the income distribution, while government employment can be a mitigating factor and lead to reduced inequality.[22] The OECD study *Divided We Stand* confirmed that product and labor market regulations and institutions have become weaker over time.[23] The study finds that weaker employment protection legislation, a less progressive income tax with fewer tax wedges, and declining unemployment benefit replacement rates are the most significant in influencing inequality levels, together with 'upskilling' or increased education levels. What is even more important, the same study finds that these factors are more important than trade integration, the deregulation of foreign direct investment, or technological progress.

Michael Wallerstein considered institutional and political determinants of pay inequality in 16 countries from 1980 and 1992, and found that the most important factor in explaining pay dispersion was the level of wage setting.[24] The more wage coordination is

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[19] Robert Feenstra and Gordon Hanson (1996), "Foreign Investment, Outsourcing, and Relative Wages," *NBER Working Paper* 5121, Cambridge, MA
[20] Kierzenkowski and Koske, pp. 13-14
[21] Steven Markovich (2014), "The Income Inequality Debate," *Council on Foreign Relations*. Online available at: http://www.cfr.org/united-states/income-inequality-debate/p29052
[22] Jonas Pontussen, David Rueda and Christopher Way (2002), "Comparative political economy of wage distribution: The role of partisanship and labor market institutions," *British Journal of Political Science* 32 (2), pp. 281-308
[23] OECD, *Divided We Stand*, p. 30
[24] Michael Wallerstein (1999), "Wage-Setting Institutions and Pay Inequality in Advanced Industrial Societies," *American Journal of Political Science* 43 (3), pp. 649-680

achieved collectively, the more egalitarian will be the overall distribution of pay. Wallerstein also stressed the importance of trade unions and the share of the labor force that is covered by collective bargaining agreements for achieving more equitable distributions of income. Other political accounts, many of them exclusively looking at income trends in the United States, have focused on median voter preferences ("politics as electoral spectacle") or the role of organized interests and policy drift ("politics as organized combat").[25] Paul Pierson and Jacob Hacker, who emphasize the central role of special interests in influencing legislation that systematically skews the income distribution in favor of the top 1 percent in the United States, deserve much credit for their efforts to bring politics back into the conversation.[26]

Of course, while all of the above political explanations are convincing in either explaining specific trends in individual cases, or can account for the differences in magnitude of increases in overall levels of inequality between countries based on labor union strength or centralized wage bargaining, none of these accounts can do justice to the peculiar evolution in income inequality in the Eurozone since the late 1990s as described in the introduction to this paper. How can we explain the marked difference in both between-country and within-country income inequality across the Eurozone, as well as the stark reversal in trends in the North and South after the 2008 financial crisis?

4. Theoretical Framework: Method versus Burden of Adjustment and Incentive Structure in a Multi-State Currency Union

While this paper fully agrees with Hacker and Pierson's observation that most political accounts overemphasize the median voter, have too thin a conception of policy, and ignore organized interests, their warnings need to be considered within the overall institutional framework of Europe's Economic and Monetary Union. For us to understand the opposing trends in inequality in the Eurozone's Northern core and Southern periphery states, we need to focus on the institutional incentives and constraints on conducting economic, i.e. monetary and fiscal poly. Hacker and Pierson's account of inequality in the U.S. correctly assumes significant levels of agency on the part of different U.S. administrations when it comes to implementing policies, which is not the case in Europe.

Europe's bold decision at Maastricht in December 1991 to embark on the uncertain road of monetary integration had profound consequences for national economic policymaking, not least by taking the option of external currency realignment off the table. Furthermore, by delegating the authority over monetary policy to an independent central bank with a strong bias towards very low inflation (often bordering deflation), and fiscal policy discretion hemmed in by the signing of the Stability and Growth Pact (SGP) in July 1997, joining the euro severely limited a member state's options in managing their economy. As all economic policy decisions are by nature fundamentally 'political' and 'distributive,' joining the euro was never a decision free of ideology or politics.

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[25] Jacob Hacker and Paul Pierson (2010), "Winner-Take-All Politics: Public Policy, Political Organization, and the Precipitous Rise of Top Incomes in the United States," *Politics & Society* 38 (2), pp. 152-204
[26] Ibid.

a. Method versus Burden of Adjustment

A useful way to approach the political problem of economic adjustment is to differentiate between the 'method of adjustment' a government will embrace in the face of economic difficulties, and which socio-economic groups – either domestic or international – will suffer the disproportionate 'burden of adjustment.'[27] Figure 1 proposes a typology of how to think about the four main possible policy options or 'shock absorbers' in an economy. The method of adjustment can either be mostly via 'internal' (austerity or demand stimulus) or via 'external' channels (currency devaluation or debt default). The main burden of adjustment can be borne by either debtors or creditors (national or foreign), or additionally, by either domestic workers or capital owners (even though, many workers are owners of capital, and plenty of capital owners receive a significant portion of their income from wages).

Figure 1: Typology: Method vs. Burden of Adjustment

		Burden of Adjustment	
		Debtors & Workers	Creditors & Capital Owners
Method of Adjustment	Internal	**AUSTERITY** *'Deflationary' Measures*	**DEMAND STIMULUS** *'Inflationary' Measures*
	External	**DEVALUATION** *Currency Realignment*	**DEFAULT** *Debt restructuring*

The first potential national policy choice – *austerity* – in the top-left quadrant, usually involves a combination of public spending cuts and tax increases on the fiscal side and interest rate increases on the monetary side. Austerity is transmitted into the macro economy mostly via internal channels, i.e. by affecting domestic economic activity in the short term and lowering wages and prices in the medium term. The adjustment burden in the case of austerity falls on both debtors, who see the real value of the debts they owe increase, and on domestic workers, who tend to have relatively little savings, and might suffer either through lower nominal wages (and fixed rent or mortgage payments, for example), lower benefits and less generous government services, or higher unemployment. Creditors and capital owners, on the other hand, will see the real value of their savings and outstanding loans increase, and will generally be better off. The expected result of austerity will be to widen income inequality between rich and poor, as the poor rely mainly on wages or government benefits for their income, and tend to have higher outstanding debts vis-à-vis their overall wealth, while the rich in general get a much higher percentage of their income from capital compared to the rest of society.

The second possible policy choice in the upper-right quadrant – *demand stimulus* – is the other 'internal' method of adjustment. Demand stimulus usually entails direct increases in

[27] For a seminal contribution on the domestic sources of foreign economic policy during the Great Depression, see Beth A. Simmons (1991), *Who Adjusts?* (Princeton: Princeton University Press)

government spending and cuts in taxes on the fiscal side, or interest rate cuts on the monetary side. Demand stimulus normally has the short-to-medium term effect of stimulating domestic economic activity by pushing up aggregate demand, and raising prices and real wages in the medium term. In this case, the burden of adjustment will fall disproportionately on creditors and capital owners, who will experience a drop in the real value of their capital and savings, and a lower nominal return. Debtors and workers are likely to benefit, either through a lowering of the real value of their outstanding loans, higher nominal wages, lower unemployment, or better future employment and promotion prospects. The expected result of demand stimulus is therefore lower income inequality between rich and poor, as the bottom of the income distribution sees its wages go up faster than the top of the distribution, which also sees a lower return to their capital.

The two other domestic policy choices in the bottom row of table 1 primarily affect economic activity through the balance of payments and during periods of serious economic difficulties. For that reason, I refer to these as the two 'external' methods of adjustment. In the bottom-left quadrant, a government can choose a policy of *devaluation*, i.e. to lower the value of its currency vis-à-vis its main trading partners. Devaluation boosts exports and makes domestic firms more competitive with foreign firms, but lowers the purchasing power parity of workers and pensioners, whose nominal incomes are fixed. The latter bear the brunt of the adjustment since devaluation usually goes hand in hand with higher prices of imported goods and services. Debtors who have outstanding loans in foreign currencies will also be significantly worse off. However, devaluation is a bit more complicated and does not so neatly fit into the quadrant, since workers in export industries will likely keep their jobs, and might even see wages increase, and therefore stand to benefit from devaluation. And obviously capital owners will also see their purchasing power damaged by devaluation, unless they have invested most of their capital abroad. So, devaluation tends to hit debtors and workers more, but also harms capital owners, depending on their consumption and investment patterns. It is probably the response that spreads the burden of adjustment the most equally across society, as it works indirectly through the balance of payments.

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

Between 1945 and the mid-1970s – a golden period of fast growth and shrinking income inequality all over the advanced industrial world – countries could utilize all four economic policy tools (or a combination thereof). What John Ruggie called the

"embedded liberal" compromise, which was struck in 1944 at Bretton Woods, had incorporated the main lessons from the Great Depression and allowed countries to combine internal (full employment) with external (balance of payments) equilibrium through a system of fixed exchange rates, capital controls and domestic discretion over monetary and fiscal policy.[28] Nixon's closure of the gold window in 1971 heralded the beginning of a new era of flexible exchange rates, deregulation, and rising international capital flows. As a result, most industrialized countries – including the U.S., Japan, Britain, Australia, and Canada, and later the emerging economies of China, India and Brazil – kept all four policy tools firmly on their menus. While everybody talked the talk of market discipline and strict economic policy rules during the early 1990s, in practice they were all careful enough to preserve their domestic fiscal and monetary policy levers with a variety of capital controls, exchange rate measures, and downright prohibitions.[29] In other words, they all firmly preserved the main tenets of the embedded liberal compromise.[30]

The exception was continental Europe, where France and Germany, along with other members of the then European Community (EC), gradually surrendered their national economic sovereignty and eventually agreed to tie their economic fate together by creating a single currency – the euro – in the early 1990s.[31] With the euro's adoption, EMU members put in place a forever-fixed exchange rate to supplant their national currencies, controlled by an independent central bank focused exclusively on price stability, but with no de facto lender of last resort functions or common debt instrument. By doing so, European leaders removed one policy tool, devaluation, from their menus of choice, and made the other, demand stimulus, a lot harder by signing onto a Stability Pact with strict fiscal rules. Given the growing importance of international financial markets, and the importance of sovereign credit ratings for the liquidity of most countries' bond markets, default also became a much less appealing option. In effect, this left austerity as the only realistic policy option. By constructing the euro, European elites 'disembedded' the Bretton Woods compromise from their national politics, but without putting in place any supranational fiscal transfer mechanisms to guarantee solidarity in times of stress. During a crisis, international commitments would take precedence over domestic concerns, just like they did during the interwar gold standard.[32]

Most advanced industrial countries – from the U.S. to Britain, and Japan to Brazil – could spread the burden of adjustment over their political economy's different constituencies, making the politics of adjustment during both good times and hard times a lot more sustainable and less overtly 'political.' In the Eurozone, on the other hand, as we will see

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[28] John Gerard Ruggie, "International Regimes, Transactions, and Change: Embedded Liberalism in the Postwar Economic Order," *International Organization* 36 (2), pp. 379-415

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

[30] Eric Helleiner (1994), *States and the Reemergence of Global Finance* (Ithaca: Cornell University Press)

[31] See Matthias Matthijs (2014), "Mediterranean Blues: The Crisis in Southern Europe," *Journal of Democracy* 25 (1), pp. 101-115

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

in the next subsection, there are two different institutional dynamics. The economic policy tool a country can wield depends on a country's 'structural' position in the currency union (core versus periphery) as well as the particular phase of the business cycle (i.e. expansionary or contractionary).

b. Different Institutional Incentives for Policy in Core and Periphery

While Eurozone members' hands have been tied a lot more severely than non-Eurozone members since the late 1990s, especially when it comes to 'external' adjustment, the institutional incentives are very different for Northern core and Southern periphery, as summarized in figure 2, where 'w' stands for the overall wage rate (or return to labor) and 'r' for the overall interest rate (or return to capital).

Figure 2: Economic Policy Incentive Structure in a Currency Union

		Phase in the Currency Union's Overall Business Cycle	
		Upturn/Boom	**Downturn/Recession**
Member State "Position" in the Currency Union	**"Core"** (e.g. Germany)	**'Deflationary Policy'** *(By institutional design)* W ↓ , R ↑ **Domestic Inequality ↑**	**'Inflationary Policy'** *(By choice/discretion)* W ↑ , R ↓ **Domestic Inequality ↓**
	"Periphery" (e.g. Spain)	**'Inflationary Policy'** *(By choice/discretion)* W ↑ , R ↓ **Domestic Inequality ↓**	**'Deflationary Policy'** *(By institutional design)* W ↓ , R ↑ **Domestic Inequality ↑**

In the early 1990s, wages were a lot higher in the North compared to the South, while interest rates were a lot higher in the South compared to the North. The formation of a currency union, and the preparations towards this end in the 1990s, led to large capital flows from North to South in search of higher yields, and in the secure knowledge that they no longer faced any exchange rate risk, as devaluation was now firmly off the table, and no rational investor truly believed the no-bailout clause.[33] Furthermore, as capital flows accelerated from North to South, the core countries realized that the only realistic way to compete in a currency union with the lower wage periphery members was to restrain growth in their overall wages and prices. So, due to the euro's institutional design, Northern countries saw their best option as pursuing broadly 'deflationary' policies, or austerity, which would lead to lower wages and higher domestic rates of

[33] Erik Jones (2011), "Europe and the Global Economic Crisis," in R. Tiersky and E. Jones (eds.), *Europe Today*, 4th edition (Lanham, MD: Rowman & Littlefield), pp. 327-350

return on capital, together with the already slightly higher returns on capital that had been parked in the Southern periphery. Not surprisingly, the outcome during 'normal' times in the North was widening income inequality.

The periphery, on the other hand, initially saw falling interest rates, thanks to the capital inflows from the North, where returns were lower due to the diminishing returns of a much higher capital stock. Lower interest rates fueled investment and consumption, and allowed the periphery to pursue 'inflationary' policies by discretion during normal economic times, resulting in higher wages. The combination of higher wages and lower returns to capital in the periphery during a normal period of upturn in the business cycle logically led to falling levels of inequality in the poorer periphery. Higher rates of growth in the South and lower rates of growth in the North also had the overall effect of broad convergence in absolute levels of GDP per capita.

The story is reversed during 'downturns' or recessions, however. The periphery now has no choice but to follow broadly deflationary policies – by institutional design as we have seen earlier. This lowers wages and increases returns to capital through higher interest rates on the countries' sovereign bonds. Spending cuts and tax increases mainly hurt wage earners and workers who rely on government services much more than rich capital owners. In addition, structural reforms initially have the effect of increasing the level of unemployment, especially for the young and the least skilled who are concentrated at the bottom of the income distribution. The outcome of these policies is to make the recession worse, resulting in higher levels of inequality.

The core of a currency union during a downturn has more discretion, thanks to falling interest rates due to capital flight to safety from the South, which gives them a little more room to maneuver. They can choose to let their automatic stabilizers kick in, and even enact some stimulus and mildly inflationary policies, which will have the effect of increasing wages. Of course, they do not have to follow this path, but at least both firms and governments have the agency to do so if that is what they choose. The main point is that falling rates of return to capital and higher wages in the core during downturns in the currency union will actually lead to falling levels of inequality. Positive rates of growth in the North and negative growth rates in the South lead to renewed economic divergence.

The main point of figure 2 is to make the distinction between deflationary policies – which are not chosen by the national government in question, but have to be implemented quasi-automatically and by institutional design – and inflationary policies – which governments can enact by discretion if they choose to do so. Whether the inflationary path is actually taken by the core countries will depend on the economic ideas held by the elites in charge of those economies and on how much fiscal room for maneuver there is.

5. North versus South: From Convergence to Divergence (1990 – 2013)

Let me summarize the previous section in concise terms. When the currency union is in its overall phase of economic expansion, there will be convergence in standards of living

and inequality levels between core and periphery, with the periphery gaining mostly at the expense of the core. During periods of economic downturn, there will be divergence in standards of living and inequality levels between core and periphery, with the core gaining at the expense of the periphery. The theoretical framework of figure 2 broadly corresponds to the empirical findings of table 1 in the introduction. In this next section, I will provide further evidence and put some more empirical flesh on the theoretical bones.

a. Eurozone: Between-Country Economic Convergence and Divergence

From the mid-1990s onwards, after the 1992-93 EMS crises, it became clear to financial market participants that the European Union was serious about introducing its common currency by the end of the decade. In anticipation of further economic convergence, and with all future EMU members implementing austerity measures to bring their economies into line with the Maastricht Treaty's 'convergence criteria,' Northern capital – ever in search of higher yields – started to flow into Southern Europe, taking advantage of the pending evaporation of any future exchange rate risk and acting on the assumption that the fiscal and structural reforms underway in the 1990s would be consolidated by the euro's launch. From a financial markets point of view, this resulted in yield convergence of 10-year sovereign bonds, which held until well after the global financial crisis hit in 2008. Yields only started to diverge in late 2009 and early 2010, with the onset of the euro crisis (figure 3).

Figure 3: Interest Rate Convergence and Divergence (1990-2013)[34]

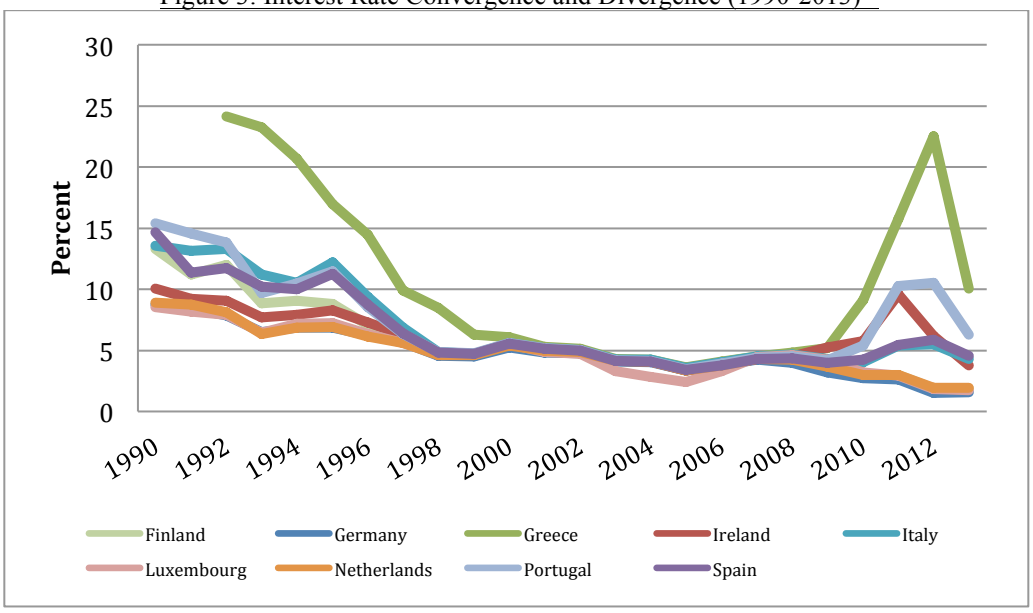


Figure 4 shows the evolution in real GDP per capita in the Eurozone starting in 1990 (in 2005 US dollars) for three 'Northern' and five 'Southern' member states. Let us compare Spain and Germany for example, as they are both in the 'middle' of their respective groups when it comes to living standards. While the gap in income per capita between

[34] Eurostat (2014)

Germany and Spain in 1990 was $6,150, it had fallen to $4,970 by 2007. But due to the global financial crisis and the euro crisis, the gap had widened again in just six years to $8,020. The gap between the Netherlands and Greece – the North's best and the South's worst performer respectively – was $11,180 in 1990, $14,790 in 2007, and $17,840 in 2013.

Figure 4: Evolution in Real GDP per capita in 2005 US dollars (1990 – 2013)[35]

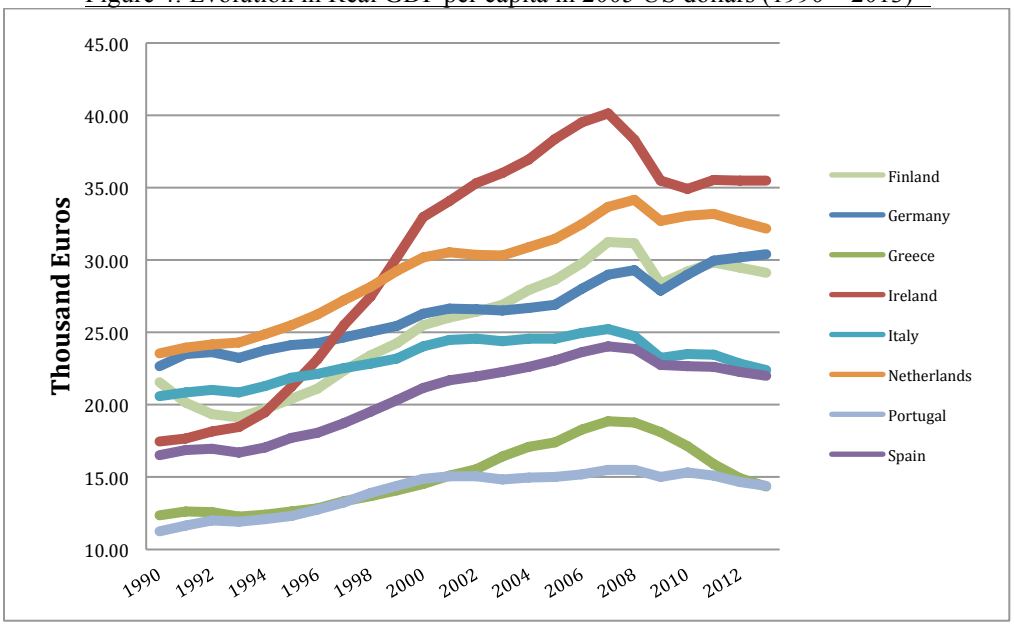
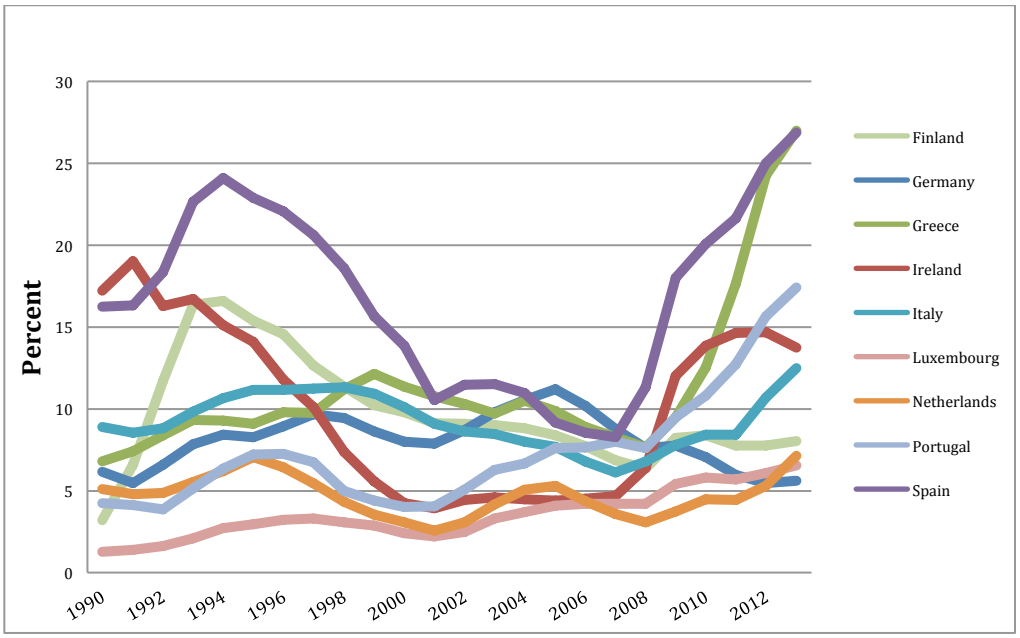


Figure 5: Evolution of the Unemployment Rate (1990-2013)[36]



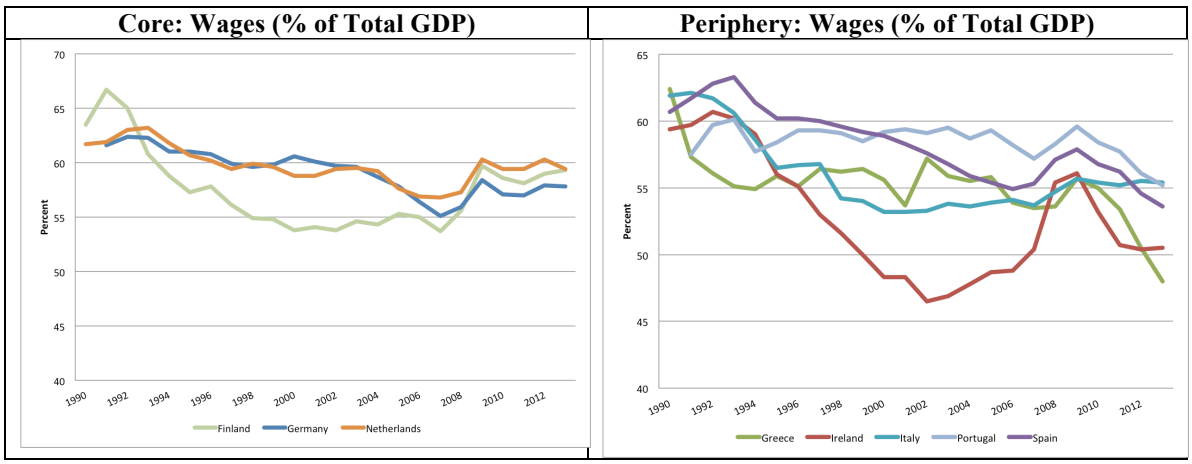
[35] IMF (2013), *World Economic Outlook Database* (Washington, DC), October
[36] Ibid.

Figure 5 underscores the convergence and divergence between North and South when it comes to unemployment. Ireland, with an unemployment rate of 19 percent in 1991, and Spain, with an unemployment rate of over 24 percent in 1994, saw their respective rates gradually fall to around 4.5 percent and 8.2 percent by 2007, when their unemployment situation went into stark reverse, back to highs of 14.7 percent in Ireland in 2012 and 26.9 percent in Spain in 2013. In 2007, all eight countries (both core and periphery) in figure 5 had an unemployment rate somewhere between a low of 3.5 percent (the Netherlands) and a high of 8.7 percent (Germany). By 2013, the North-South gap was there for everyone to see in unemployment. The four Northern countries all had unemployment rates of 8 percent or below, with Germany at 5.6 percent, Luxembourg at 6.5 percent, the Netherlands at 7.1 percent and Finland at 8 percent. The five Southern states saw their unemployment situation worsen dramatically to a low of 12.5 percent in Italy, 13.7 percent in Ireland, 17.4 percent in Portugal, Spain at 26.9 percent, and Greece at 27 percent.

b. Eurozone: Within-Country Inequality Convergence and Divergence

On the issue of inequality within countries, figure 6 shows the evolution of the adjusted wage share as a percent of the total economy for both core and periphery Europe, based on data from the European Commission. The left hand panel has the data of three EMU core countries (Finland, Germany, and the Netherlands). One can observe a fall of the overall wage share from well above 60 percent in all three countries in the early to mid 1990s to a low of around 55 percent in 2007. Since the crisis, remarkably, wage shares as a percentage of total GDP have recovered to close to 60 percent again in the North. The right hand panel showing the periphery is a bit more mixed. Ireland, Italy, Spain and Greece all see their wage share decline starting in the early 1990s, bottom out in the early 2000s (mid 2000s for Spain), and then peak between 55 and 60 percent in 2007. With the exception of Italy, all see the overall wage share fall quite steeply after 2008. Greece is the most extreme case, with a wage to GDP share of 62.4 percent in 1990, down to 48 percent in 2013, with Ireland dropping from above 60 percent in the early 1990s to just above 50 percent in 2013.

Figure 6: Evolution of Adjusted Wage Share (% of Total Economy): Core vs. Periphery (1990-2013)



Source: European Commission (2014)

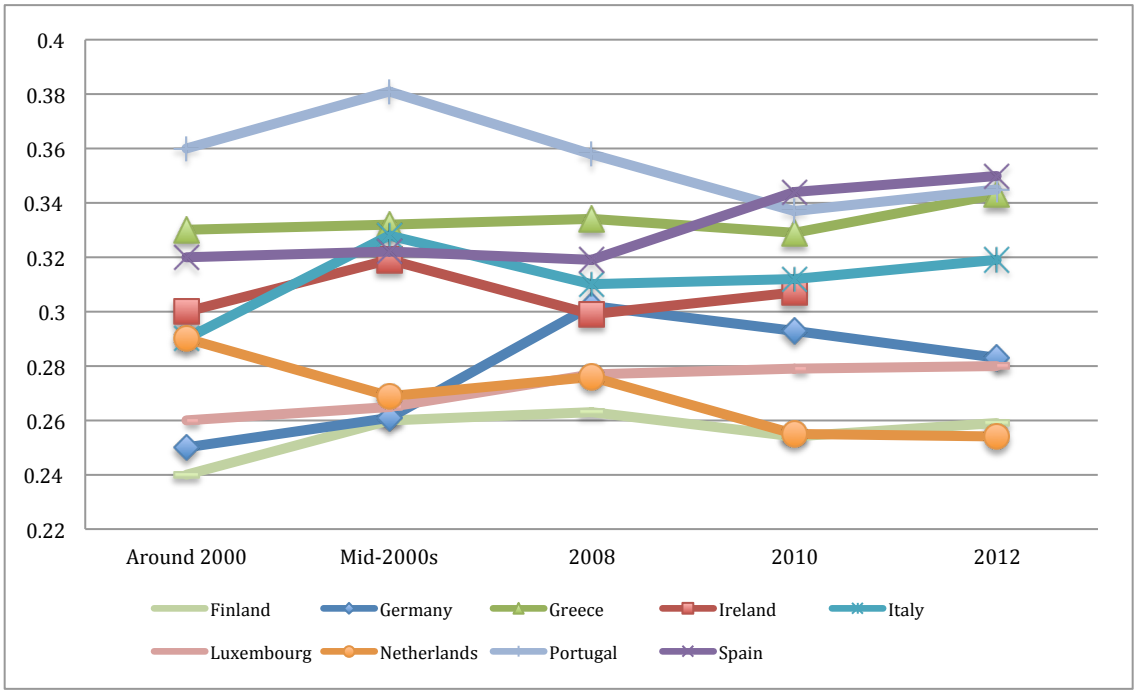
While the falling overall share of wages in the overall economy can explain the widening levels of income inequality in most European countries during the 1990s, the trend is in opposing directions during the 2000s, with further decreasing wage shares in the North deepening inequality until 2008 and improving wage shares in the South lowering inequality. After 2008, the reverse is true. Table 3 shows the changes in nominal and real unit labor costs for 2000-2007 and 2008-2012. The numbers are especially striking for the evolution in nominal wages, with very large increases in the periphery and much smaller increases in the core (even negative for Germany). When it comes to real wages, all core countries see significant increases from 2008 to 2012, while periphery countries see sharp decrease in real wages (with the exception of Italy, which experienced a very small increase).

Table 3: Change in Nominal and Real Unit Labor Costs in the Eurozone

	NOMINAL		**REAL**	
	2000-2007	**2008-2012**	**2000-2007**	**2008-2012**
Germany	-2.2%	+8.9%	−9.0%	+3.6%
Finland	+8.5%	+14.1%	−0.2%	+6.2%
Netherlands	+15.2%	+8.7%	−3.4%	+5.2%
Italy	+19.8%	+7.2%	+0.8%	+1.5%
Spain	+24.3%	−4.2%	−6.0%	−4.4%
Greece	+20.6%	−2.3%	−1.8%	−5.9%
Ireland	+33.2%	−12.7%	+4.2%	−9.1%
Portugal	+18.9%	−2.3%	−3.3%	−3.8%

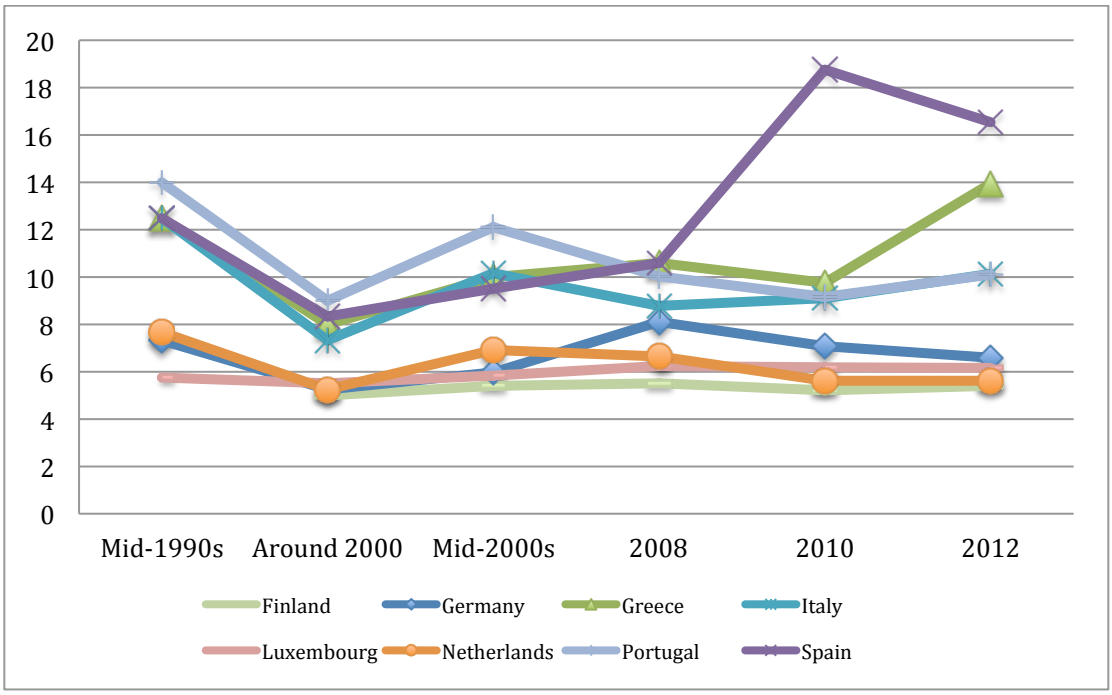
Figures 7 and 8 give further evidence of the evolution in national levels of inequality. Note in figure 7 how Germany, Greece, Italy, Spain and Ireland are all close together in 2008 with GINI coefficients between 0.30 and 0.33, while the range significantly widens again by 2012, with 0.28 for Germany and 0.35 for Spain. Figure 8 then gives us another measure of inequality, by looking at the P90/P10 ratio, which compares the average income of the 10 percent with the highest income to the average income of the 10 percent with the lowest income. In 2008, the range within EMU was from a low of 5.5 (Finland) to a high of 10.5 (Spain). By 2012, this had changed to a low of 5.4 (Finland) and a high of 16.5 (Spain).

Figure 7: Gini Coefficient (2000-2012)



Source: Eurostat (2014)

Figure 8: P90/P10 Ratio, 1995-2012



Source: Eurostat (2014)

6. The Euro's Monetary and Fiscal Design: Ideational Stickiness versus Institutional Flexibility

One of the fundamental tensions in the previous five sections is the question of structure versus agency. On the one hand, the institutional design of the euro was such that core and periphery countries in the Eurozone faced different incentives during different phases of the business cycle. And while 'inflationary' policies are politically much easier to implement, 'austerity' is not. Why did countries in the core (especially Germany) not choose laxer policies during the good times? Why did the periphery countries (especially Greece) not question more openly the deflationary logic of the Eurozone during bad times? Not only did the economic and political elites in the periphery countries broadly accept the consensus around austerity, they also failed to act collectively to form a counterweight to the demands of the Troika (including the ECB, the Commission, and the IMF).

On the other hand, the ideational consensus vis-à-vis monetary and fiscal policy gradually changed during the life of the euro, making fiscal discretion even harder starting in 2010. This change in ideas on discretion versus rules when it comes to the conduct of monetary and fiscal policy, can explain part of the puzzle why it was easier for the periphery to pursue 'inflationary' policies between 2003 and 2010, but not after. The relatively short history of EMU, however, has shown remarkably little institutional flexibility.

During the mid-1990s, the overriding consensus in Europe was for a politically independent central bank, with a narrow mandate to focus on price stability, and the need for economic convergence. At the insistence of the German finance ministry and the powerful *Bundesbank*, the Maastricht Treaty established a series of convergence criteria on budget deficits, levels of inflation, long-term interest rates, and overall levels of debt, which formed the foundation for the Stability and Growth Pact that was agreed upon by Europe's leaders in 1997. At the heart of the SGP was the 3 percent deficit-to-GDP rule, and an 'excessive deficit procedure,' since many European countries, most notably Italy and Belgium, had overall debt levels well in excess of the maximum 60 percent of GDP as determined by the SGP. Limiting member countries' annual fiscal deficits was seen as the most crucial step for the launch of the euro in 1999, and afterwards, for the Eurozone's stability.[37]

As has been well documented by now, both central founding members – France and Germany – were actually the first two countries to break the 3 percent rule in 2003, triggering an excess deficit procedure by the European Commission in Brussels, which was blocked by the European Council, made up of heads of state. Romano Prodi, the President of the Commission at the time, famously called the Stability Pact "stupid," in

[37] David Marsh (2011), *The Euro: The Battle for the New Global Currency* (New Haven: Yale University Press), pp. 202-11

reference to its rigidity in applying the deficit rule, and pointed out that more flexibility would be needed to interpret the rules going forward.[38]

Figure 9: Changing Consensus on Economic Policy in the Eurozone (2003-2013)

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

The fiscal transgressions of both Berlin and Paris led the European Council to relax the SGP in 2005, by allowing more political discretion in deciding whether a breach of the 3 percent rule was truly a violation of the spirit of the Pact. The 3 percent and 60 percent rules were maintained, but the decision to start an excessive deficit procedure against a member country now relied on a set of predetermined parameters. These included the exact moment in the business cycle, the overall level of debt, the duration of a period of slow growth, or whether the deficit was mainly the result of structural reforms that had been enacted and would lower the deficit permanently over the longer term, as had been the case of Germany in the early 2000s. So, from 2003 onwards, there was a new reigning consensus on the use of fiscal and monetary policy in the Eurozone. Monetary policy remained under the technocratic control of the ECB, and was conducted 'by rule.' The ECB's only mission was to maintain price stability as measured by an inflation rate of "close to but below 2 percent." On the fiscal side, the reforms of the SGP in March 2005 allowed for considerably more political discretion over levels of domestic spending and taxation, even though member states promised to remain faithful to the 3 percent norm. From 2005 onwards, fiscal policy was firmly under the political control of the national governments. This consensus is summed up in the top row of figure 9.

With the onset of the European sovereign debt crisis in 2010, there has been a marked shift in the consensus on monetary and fiscal policy in the Eurozone. With Greece's admission in the fall of 2009 that its deficits were a lot higher than earlier reported, the main cause of the crisis was believed to be 'fiscal' and the 2005 reforms of the SGP was seen as one of the main culprits for letting the proverbial fiscal cat out of the bag. The argument went that as soon as France and Germany, the two founding members of EMU, broke the rules, and were let off without punishment by the European Commission, this

[38] Honor Mahoney (2002), "Prodi calls stability pact 'stupid'" *EU Observer*, October 17. Online available at: http://euobserver.com/economic/8008

opened the door to other countries – who were not in the midst of deep structural reforms to their labor and product markets (as in the case of Germany) – to start running excessive deficits. Even though this argument only really holds for Greece – and most notably not in the cases of Ireland and Spain, who were both deeply affected by the crisis – the obsession with fiscal policy changed the consensus from 'discretion' to 'balanced budget' rules. This formed one of the main principles of the new Fiscal Compact that was agreed upon by 25 of 27 member states in December 2011, and signed in March 2012, which considerably limited temporary deviations due to exceptional circumstances and put in place an automatic correction mechanism.[39]

Furthermore, since 2010, the policies of the European Central Bank in Frankfurt, which had enjoyed independence just like its German predecessor, the *Bundesbank*, in whose image it was built, have become a lot more 'politicized' given that the ECB has started to interpret its mandate a lot more broadly than had originally been envisaged.[40] Given that the impact of its market interventions – from two rounds of Long Term Repurchasing Operations (LTROs) in late 2011 and early 2012, to ECB President Mario Draghi's statement that he would do 'whatever it takes' to save the euro, to the announcement of Outright Monetary Transactions (OMTs) in early September 2012 – have been crucial for the survival of the Eurozone, the ECB has gained remarkable political clout in fighting the crisis. Indeed, many financial market participants see it as the only institution capable of effectively taking control of the crisis.

Many voices in Europe now claim that the ECB should go even further and outright buy the bonds of the countries under stress in the periphery, which would lower their sovereign debt yields, and jumpstart economic recovery. Even though the ECB has so far stopped short of outright interventions, but clearly holds the key to taming the crisis, most analysts applaud its new discretion and policy flexibility. However, more discretion on the part of the ECB brings up the question of political legitimacy. If it is the only actor that is capable of doing something in the short term, and does not suffer from the Olsonian logic of collective action as do Eurozone finance ministers, should its decisions not be subject to some democratic control? This changed consensus in economic policy in the Eurozone since 2010 is summed up in the bottom row of figure 9.

The shift in the economic policy consensus in Europe from monetary rule to monetary discretion, and from fiscal discretion to fiscal rule, makes the deflationary 'austerity' box of figure 2 in which most countries of the periphery find themselves all the more cumbersome. In the past, even though they had no influence over the monetary policies of the ECB, they at least had some short-term discretion to stimulate their economies by fiscal means, either by cutting taxes or increasing spending. Since 2010, with the fiscal consensus in Brussels and Frankfurt shifted to balanced budgets, with strict supranational control of national budgets, those countries are even firmer stuck with austerity and deflationary policies. Even though the ECB could do more to fight the crisis, given its newfound policy discretion, there is nothing individual member states can do to control

[39] The exact name of the "Fiscal Compact" is the Treaty for Stability, Coordination, and Governance

[40] See Dorothee Heisenberg (1999), *The Mark of the Bundesbank: Germany's Role in European Monetary Cooperation*, (Boulder, Col.: Lynne Riener).

or influence those policies. And given that the ECB has thus far stopped short of outright buying bonds of countries in distress, out of fear that that would dampen the enthusiasm for fiscal and structural reforms, Frankfurt has become part of the deflationary problem.

All this does not bode well for the diverging trends within the Eurozone. The main outcome of the shift in consensus from fiscal discretion towards balanced budget rules has been to solidify the widening trends in income inequality in the Eurozone. The danger remains that at some point, the countries of the periphery may decide that the euro game is no longer worth the austerity candle.

7. Conclusion: Winner-Take-All, Loser-Pay-All?

This paper has proposed an institutional explanation for the contradictory trends in income inequality in the Eurozone since the late 1990s: while inequality further widened in the North of Europe, following the lead of the United States and the United Kingdom, inequality actually started to decline in EMU's periphery in the early 2000s, with both trends reversing after 2008. Going beyond the 'standard' explanations in economics and political science, this paper has argued that the particular institutional design of the euro gave different incentives for economic policymaking in both core and periphery, with significant consequences for overall standards of living and national levels of inequality. During the upward phase of the currency union's business cycle, this led to broad convergence in the Eurozone, with faster growth in the periphery, and slower growth in the core. Wage suppression and higher returns to capital in the North led to widening inequality, while wage increases and lower returns to capital in the South resulted in falling levels of inequality.

During an economic downturn, the story goes in reverse. The "winner-take-all" surplus countries of Germany, Luxembourg, Finland and the Netherlands have benefited from the euro crisis through lower interest rates, faster growth, and relatively mild austerity measures and reforms, with some maneuvering room for modest wage increases. Not only is growth faster in the North, inequality levels also improved. The "loser-pay-all" deficit countries of Greece, Italy, Spain, Portugal and Ireland have suffered from higher debt-to-GDP ratios, much higher interest rates, negative growth, and Brussels-imposed austerity measures and structural reforms. Not only have standards of living fallen for everyone, inequality has also gotten worse in the periphery.

The irony is that the creation of the euro in 1991 at Maastricht was meant to further unite Europe by bringing about economic convergence, thereby preserving the European social model. The first decade of the euro seemed to deliver the goods. However, with the onset of the euro crisis, the Eurozone has experienced renewed economic divergence, questioning not only the sustainability of the European social model, but also the future viability of Economic and Monetary Union itself.

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