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# Current Account Imbalances in the EMU: An Assessment of Official Policy Responses

**Summary:** To handle the sovereign debt crisis in general and macroeconomic imbalances in particular the leading EU institutions and the Troika (European Central Bank, European Commission and International Monetary Fund) adopted two broad approaches: The short-term approach is based on enhancing the Stability and Growth Pact and to impose fiscal austerity on crisis countries. The medium- to long-term strategy consists of internal devaluation via reducing wage costs. Both approaches were combined with structural adjustment programs in the spirit of the Washington Consensus. The Troika's policy implies an asymmetric adjustment process burdening only crisis countries. It led to the shrinking of demand and output in crisis countries comparable to the Great Depression and brought the European Monetary Union to the edge of deflation. These policies must be judged as mislead increasing the risk of Japanese disease with more than one lost decade.

**Key words:** Current account imbalances, Euro area economic policies, Internal devaluation, Austerity.

**JEL:** E60, E62, F41.

This paper has the purpose to discuss how the European Union (EU) handled the deep crisis of the European Monetary Union (EMU), focusing in particular on the policies dealing with macroeconomic imbalances, especially budget deficits and current account deficits. The EU policy package to solve the sovereign debt crisis and increase the lost competitiveness of crisis countries and to stimulate growth, at least in the medium term, consisted in the following: (i) Fiscal consolidation with the aim of restoring investors' confidence became paramount and various austerity measures were endorsed by and/or imposed upon debtor-deficit countries. This can be considered a short-term policy, however, with the aim of a long term balanced public budget; (ii) Internal devaluation was considered the key point to restore competitiveness. This included nominal wage cuts as a key element. This can be considered a more medium- and long-term policy; (iii) Structural reforms like liberalisation, privatisation and deregulation should bring back long-term economic growth and are partly included in the two policies mentioned above.

All these policies are based in the heart of neoclassical thinking and very close to what became known as Washington Consensus in the late 1980s (see John Williamson 1990 for a summary of these policies). Paul Krugman (1995) called this pol-

icy a combination of sound money (restrictive fiscal and monetary policy) and free markets (radical reforms in the spirit that free markets would always be the best solution). The medicine the EMU crisis countries received or, better yet, had to follow, was more or less the same medicine that international institutions used to overcome crises in developing countries. The economic and social costs of these policies were enormous. It is fair to say that these policies pushed some of the EMU countries towards crises comparable with the Great Depression in the 1930s. As of the date of this paper (early 2015), these countries seem to be on a road of long-term low growth or even stagnation producing more than one lost decade. And worse, the danger of a deflationary spiral in some countries cannot be excluded as well. Such concerns have already been voiced by several authors (see, for instance, Hansjörg Herr 2009a; Jörg Bibow 2012; Observatoire Français des Conjonctures Économiques (OFCE), Institut für Makroökonomie und Konjunkturforschung (IMK) and the Economic Council of the Labour Movement (ECLM) 2013). In what follows, we analyse more in detail the policies followed by the EU to solve the crisis and deal with the problem of imbalances, and explain why the whole policy design was misleading. Our focus in this paper is on intra-euro area imbalances, that is, we take into account specifically the flows of imports and exports internal to the EMU. Section 1 describes the developments leading up to the crisis. Section 2 then describes the recent reforms in the EU governance which took shape since the outbreak of the crisis, with a particular focus on the Macroeconomic Imbalance Procedure (MIP). Policies of fiscal austerity as a short-term strategy (Section 3) and policies to enforce internal devaluation and structural reforms (Section 4) follow, along with a discussion of the costs of these methods of dealing with the EMU crisis. Here Greece, Spain, and Ireland are given special attention. The role of the European Central Bank (ECB) in correcting the imbalances is discussed in Section 5, before concluding.

## 1. Developments in the Years Leading Up to the Crisis

From the beginning of the EMU in 1999 until the outbreak of the Subprime Crisis in the United States in 2007, Southern European countries and Ireland manoeuvred themselves in a constellation of high current account deficits. Countries like Netherlands and Austria, but most notably Germany, realised current account surpluses with the result of increasing current account imbalances within the EMU. Imbalances developed as current account deficit countries saw unit labour costs increases outstrip those in surplus countries *and* deficit countries realised higher GDP growth rates (with the exception of Portugal) than surplus countries. High GDP growth in the deficit countries was to a large extent driven by real estate bubbles, which were allowed to develop alongside credit driven consumption. Budget deficits in these countries were often low (with the exception of Greece) or the countries even realised budget surpluses.

The widening of current account imbalances in the years leading up to the Great Recession in 2009 and the sovereign debt crisis in the EMU also had to do with the institutional architecture of a monetary union. As Paul de Grauwe (2013) pointed out, in a monetary union the booms and the busts at the national level are exacerbated because, given the differences in the economic development of individual countries,

a single interest rate for the currency union leads to a comparatively stronger boom in the booming countries and a stronger recession in crisis countries. In the EMU therefore, the common monetary policy meant that the boom in high-growth and high-inflation countries of Southern Europe and Ireland was amplified by relatively low real interest rates. Insufficiently regulated financial markets and low real interest rates stimulated unsustainable real estate bubbles in some of these countries. The boost of domestic demand in booming countries pushed up both prices and wages. The combination of relatively high growth and erosion of price competitiveness increased imports and led to rising current account deficits. At the same time, elsewhere in the euro area, low-growth and low-inflation countries for which the real interest rate was relatively high saw a stagnation of domestic demand accompanied by low growth and low wage and price increases (see also Jorge Uxó, Jesús Paúl, and Eladio Febrero 2011). Germany in particular experienced below average growth performance in the EMU and stagnating nominal wages throughout most of the 2000s, meaning that its unit labour costs grew much below the euro area average. Relatively low GDP growth and increasing price competitiveness led to high German current account surpluses which were not kept in check by an appreciation of the domestic currency, as the D-Mark no longer existed. In the EMU both the real interest rate channel and competitiveness channel contributed in widening the gap between these two groups of countries. These developments were symmetrical and were sustained over several years.

Current account imbalances are only possible when corresponding capital flows exist. Current account deficits in the EMU could be easily financed by deficit countries as investors in surplus countries obviously expected that, within a monetary union, regional indebtedness would not pose a problem. Capital imports were financed *via* the EMU money market, direct loans to the enterprise sector or government bonds issued in current account deficit countries. The stock of debt was building up in domestic currency, however the debtor countries' governments had no control over their central bank as governments usually do. There was no lender of last resort, as for instance in normal nation states as the United States, United Kingdom or Japan, in case it was needed to save public households from liquidity and solvency crises.

Before the Great Recession, the build-up of current account imbalances was not considered a problem by the key European institutions and mainstream economists. On the one hand, economists were influenced by the standard neoclassical argument that current account deficits were an element of countries quickly catching-up. On the other hand, European institutions seem not to have understood that the EMU is a monetary union without sufficient institutional integration and therefore not comparable to a nation-state with a national currency. In the case of the EMU, the absence of the central bank's explicit commitment that it will function also as a lender of last resort for public households undermined the credibility in the liquidity and solvency of individual nation-states within the EMU. This made the deficit countries vulnerable to sudden stops of capital inflows and panic in financial markets.

When the Great Recession hit Europe all countries initially followed an expansionary fiscal policy. Fiscal stimulus, together with costly bailout-packages of

banks and other financial institutions, increased budget deficits considerably in 2009 and 2010. In early 2010 and later in all Southern European countries and Ireland interest rates for public debt started to increase to unsustainable levels. In addition, a general change in fiscal policy was introduced, led by Germany and the EU Commission. Budget consolidation, rather than fiscal stimulus, became the policy priority. Under the Stability and Growth Pact (SGP) fiscal policy became pro-cyclical, thereby exacerbating the recession in crisis countries.

Private capital inflows to later crisis countries stopped when investors became uncertain whether public households in these countries could serve their debt obligations. The sovereign debt crisis broke out in Greece in early 2010, triggering panic in financial markets and spread to other countries. In 2010 spreads of deficit countries' 10-year government bonds relative to Germany's "safe" 10-year bonds exploded and even the promises of high yields did not stop the outflow of private capital.

The crisis countries found themselves in a very difficult constellation. Price competitiveness *vis-à-vis* Germany and other surplus countries in the EMU was lost, real estate bubbles had collapsed, all private demand elements shrank and expansionary fiscal policy was no longer possible as financial markets restricted any fiscal expansion or even threatened the liquidity of governments. In such a situation, the crisis countries had to ask for external help, which was organised by EMU surplus countries and the IMF and executed by the Troika (European Central Bank, European Commission and International Monetary Fund).

## 2. Recent Reforms in the EU Governance

### 2.1 Overview of New Governance Institutions

The official aim of the new European economic governance, developed through various new regulations since the outbreak of the sovereign debt crisis, is to achieve a stronger and more binding coordination of economic policies among Member States and prevent a sovereign debt crisis in the future. In 2010, with the adoption of the "Europe 2020" strategy, a yearly cycle of European economic policy coordination was established – the so-called "European Semester" – where the European Commission issues recommendations for individual Member States which should then be translated into national reform programmes. More concretely, legislative reforms consist of the so-called "Six-Pack" which refers to all EU Member States, and the "Two-Pack" which is binding for the euro zone countries only. The "Fiscal Compact", on the other hand, is not yet European law, but is agreed upon by 26 Member States.

The **Six-Pack**, a nickname for 5 regulations and 1 directive concluded in November 2011, was designed to provide for tighter discipline on public finances. It basically recasts the rules of the Stability and Growth Pact, with the aim of making it more binding for Member States. Two of the 5 regulations deal specifically with macroeconomic imbalances, namely the Macroeconomic Imbalances Procedure and the Excessive Imbalance Procedure. These two are discussed more in detail below. The remaining 3 regulations consist of a so-called preventive arm, namely the "binding medium-term budgetary objectives" and an "expenditure benchmark", and a correc-

tive arm which consist of the “Excessive Deficit Procedure” (EDP) which entails financial sanctions of up to 0.2% of GDP in case of non-compliance. Finally, the directive specifies the accounting and other rules for the Member States for setting medium-term budgetary frameworks.

The **Two-Pack**, concluded in May 2013, refers to the euro area only and sets the stage for a strict regular close oversight of public finances of each Member State.

Within the Six-Pack Reversed Qualified Majority Voting became the rule. This means that if a sanction is proposed by the European Commission for a non-compliant country, it will take a majority vote by Member States to overturn the proposal. Basically, it becomes harder to disagree with Commission’s decisions.

The **Fiscal Compact** is incorporated in the Treaty on Stability, Coordination and Governance. 26 member countries signed (UK and Czech Republic refused) and committed themselves to a lower limit for a structural budget deficit of 0.5% of GDP. The Fiscal Compact is essentially a restatement of the Stability and Growth Pact and the Six-Pack.

Amidst these, an open-initiative **Euro Plus Pact** was advocated by Germany and France in February/March 2011. Also known as the “Competitiveness Pact”, it refers to wages explicitly as the key adjustment variable in order to deal with current account imbalances and increase competitiveness.

## 2.2 Macroeconomic Imbalance Procedure (MIP)

The MIP was adopted in 2011 with the *EU Regulation No 1176/2011* on the prevention and corrections of macroeconomic imbalances and *EU Regulation No 1174/2011* on enforcement measures to correct excessive macroeconomic imbalances in the euro area. It is embedded in the European Semester *via* the “Six Pack” and should form a coherent framework with other economic surveillance tools (European Commission (EC) 2013a). According to official EU documents the external and internal imbalances of EU countries – primarily abundant credit expansion and excessive debt accumulation, large and persistent current account deficits and surpluses, and losses in competitiveness – were significant contributors to the recent crisis (see for instance EC 2013a and EC 2014). Before discussing more in detail the MIP, a definition of what constitutes an imbalance – as seen by the official institutions – should be given:

*“‘imbalances’ means any trend giving rise to macroeconomic developments which are adversely affecting, or have the potential adversely to affect, the proper functioning of the economy of a Member State or of the economic and monetary union, or of the Union as a whole.”* (European Parliament 2011, p. 28)

And furthermore:

*“‘excessive imbalances’ means severe imbalances, including imbalances that jeopardise or risks jeopardising the proper functioning of the economic and monetary union.”* (ibid.)

In theory, any deviation from a desirable level can constitute an imbalance. In practice, those imbalances that raise concern are the ones reflecting unsustainable dynamics such as a real estate boom, or very high levels of debt or threats of “sudden stops” (EC 2013b).

In the framework of the MIP, the European Commission publishes annually the **Alert Mechanism Report (AMR)** the scope of which is to identify those member countries with possible macro-economic imbalances and recommend them for further analysis. The AMR is not made for the countries that at the time receive official financial assistance, as their situation is already examined under respective economic adjustment programmes (EC 2013b). Further analysis is made in the so-called **“In-Depth Reviews” (IDRs)** and here the Commission determines whether imbalances exist.

To assess whether or not a country should be subjected to an IDR, the AMR relies on an indicator-based **scoreboard**. Threshold values are assigned to each of the indicators and serve as alert levels, thus any breach of threshold values becomes the first indication of concern. The MIP scoreboard initially comprised 10 indicators, but in late 2012 an indicator detecting vulnerabilities of the financial sector was added. As of 2013, the AMR is complemented with a set of auxiliary social indicators (for instance, rate of people at poverty risk) that are used for better interpretation of the scoreboard results (EC 2013b). The indicators refer either to external imbalances and competitiveness (current account balance, net international investment position, real effective exchange rate, export market share, and nominal unit labour cost developments), or to internal imbalances (changes in house prices, private sector debt and credit flow, general government gross debt, unemployment rate, and financial sector liabilities). One of the indicators is the 3 year backward moving average of the current account balance as a percentage of GDP. Here the European institutions are more concerned with current account deficits than with surpluses: the threshold for current account surpluses is 6 per cent of GDP, while for deficits it is 4 per cent of GDP. It is visible here that John Maynard Keynes’s (1942) ideas of an symmetric adjustment process of current account deficit and surplus countries as expressed in his recommendation for the Bretton Woods System are not being followed.

The indicator for unit labour cost developments, furthermore, has an upper limit only; as it appears, there is no lower bound for excessively low wage increases or even drops in wages that could be considered alarming. This means, in other words, that no mechanism is put in place to prevent wage dumping strategies of countries or an eventual deflationary spiral.

Once a country is suggested for an IDR, the European Commission undertakes a country-specific analysis and ultimately assesses whether macroeconomic imbalances exist, and if they do, whether they are excessive or not (EC 2013b). The finding that imbalances do exist but are not excessive results in a preventative Country Specific Recommendation (CSR) addressed to the state in question by the European Council. Excessive imbalances, on the other hand, result in a corrective action plan – the **Excessive Imbalance Procedure (EIP)**. In this case the member country needs to draft its plan of action, and its compliance is subsequently monitored by the Council. If the country in question fails to “correct itself” a financial sanction of 0.1 per cent of GDP can be demanded (European Parliament 2013). In practice, no country has yet reached that stage, although – interestingly – most of the EU countries are on the list as experiencing imbalances.

The Alert Mechanism Reports and In-Depth Reviews have thus been published since February 2012, but it was only in November 2013 that the Alert Mechanism Report put two surplus countries on the list – Germany and Luxemburg. In the report on Germany published in March 2014 the Commission did underline the need to strengthen domestic demand in Germany and stimulate growth by means other than exports. It suggested a couple of ways to do so: by reducing income tax especially in the low-wage sector, diminish the burden of social contributions, and increase the incentives for working more hours by making the conditions of mini-jobs more favorable, implement a more business-friendly corporate taxation to stimulate investment, etc. An increase in the German wage level as a policy to support the internal devaluation of other EMU countries was not included in the recommendations.

Even the moderate and in its spirit neoclassical recommendations for a more symmetric adjustment process by the Commission led to harsh opposition in Germany. The president of the Deutsche Bundesbank, Jens Weidmann, made his view clear in a speech shortly after the review of Germany was published. Among other things, he stated that “stimulating German demand cannot be a substitute for removing rigidities in the deficit countries” and that Germany’s current account surpluses stem from an interplay of various factors, most importantly “fundamentals” such as demographics and Germany’s stage of development, and are therefore not likely to change any time soon (Jens Weidmann 2014).

In sum, the Six Pack and the Two Pack as well as the Euro Plus Pact highlight the overarching concern with budget consolidation. The problem of macroeconomic external imbalances is seen by the European institutions to come about mainly as a result of “downward wage rigidities” (ECB 2012, p. 9) which prevent the restoration of competitiveness in current account deficit countries. In addition, the new European system of economic governance introduced mechanisms and tools for intervening into national wage policies and collective bargaining agreements – for the first time in the history of the European Union (Thorsten Schulten and Torsten Müller 2013).

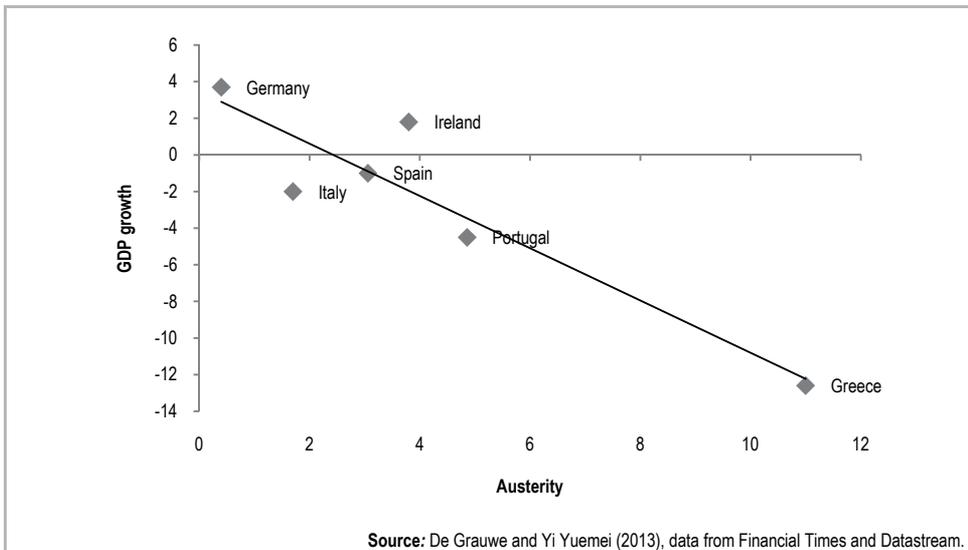
### **3. Short-Term Approach: Fiscal Austerity and Effects on Public Budgets**

The EU policy of fiscal austerity and internal devaluation has two levels of enforcement. The first one takes the form of recommendations and, to a degree, other subtle ways on applying pressure on countries to conform to EU-specified targets. These country-specific recommendations are not legally binding, but with the introduction of the European Semester have definitely gained in importance by strengthening the authority of the EU institutions.

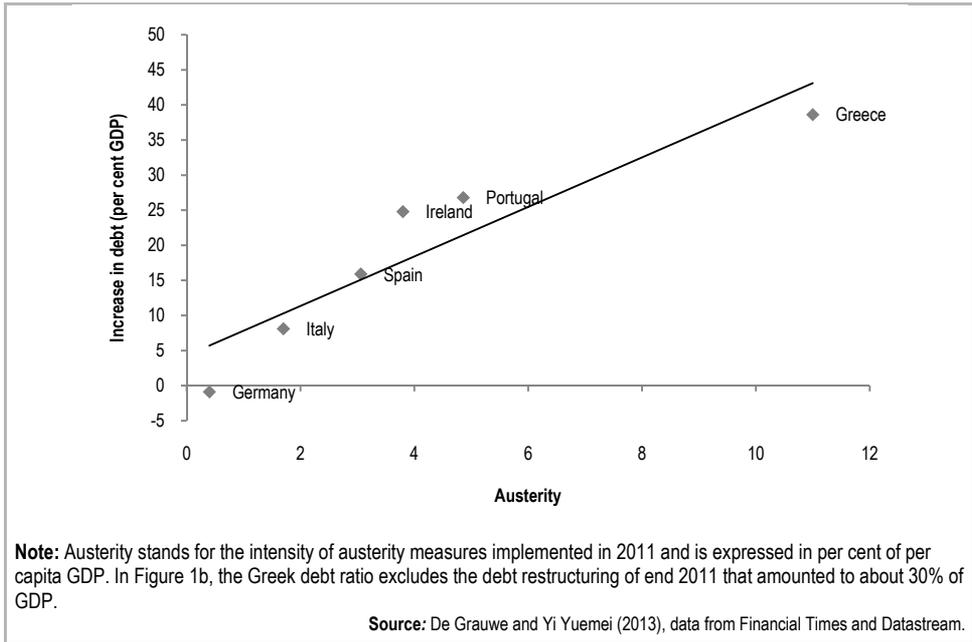
The second form is much more straightforward, as well as legally binding. The countries affected here are those benefitting from financial assistance from the Troika. Countries under such programmes are obliged to conform to a set of policies required by the Troika. The conditionality imposed by the Troika when supporting countries affected by the sovereign debt crisis consist of fiscal, financial, and labour

market reforms. The typical demands are: fiscal consolidation *via* current expenditure reduction, cuts in unemployment benefits and family allowances and a decrease in health spending and public investment; privatisation of the transport, energy, communication and the insurance sector; a push for firm-based wage negotiations; reducing the role of legal extension mechanisms of wage bargaining; no increase or cut in statutory minimum wages; relax dismissal protection, etc.; a general reduction of state participation in industries; reforms of public administration and reductions in public employment; increases in personal income tax and so on (Christoph Hermann 2013; Daniel Vaughan-Whitehead 2014).

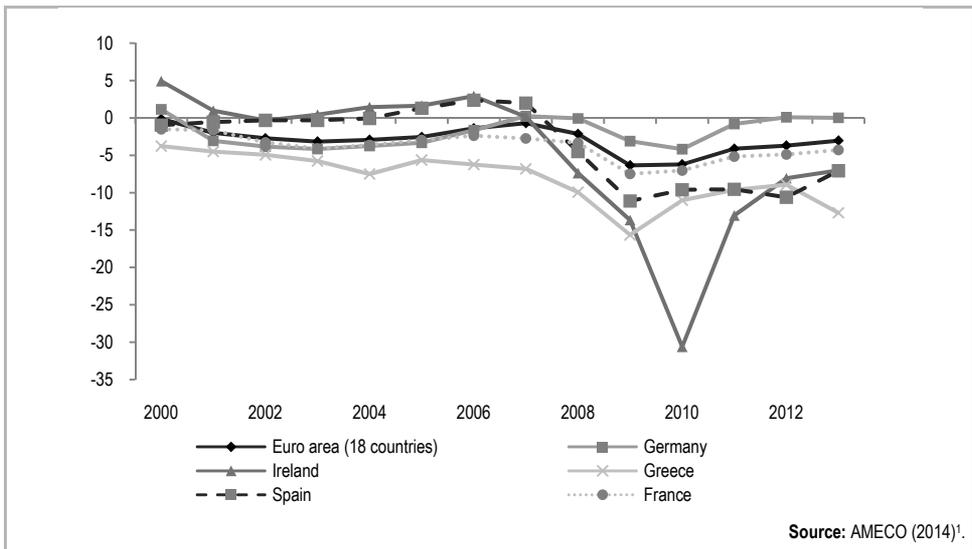
Greece, Ireland and Portugal were the most affected countries by these policies because they needed help from the Troika. In these countries the GDP sharply contracted; in fact, the stricter the austerity measures implemented, the greater the contraction of GDP (see Figure 1a). Figure 1b furthermore shows that, if the aim of cutting public expenditures was to improve the debt-to-GDP ratios, the strategy did not work. Budget deficits in spite of strict austerity measures did not improve as hoped (see Figure 2). In Greece in fact, budget deficits as percentage of GDP increased again after 2012. Even worse, debt-to-GDP ratios strongly increased in the countries that endorsed austerity policies (see Figure 3).



**Figure 1a** Austerity and GDP Growth 2011-2012

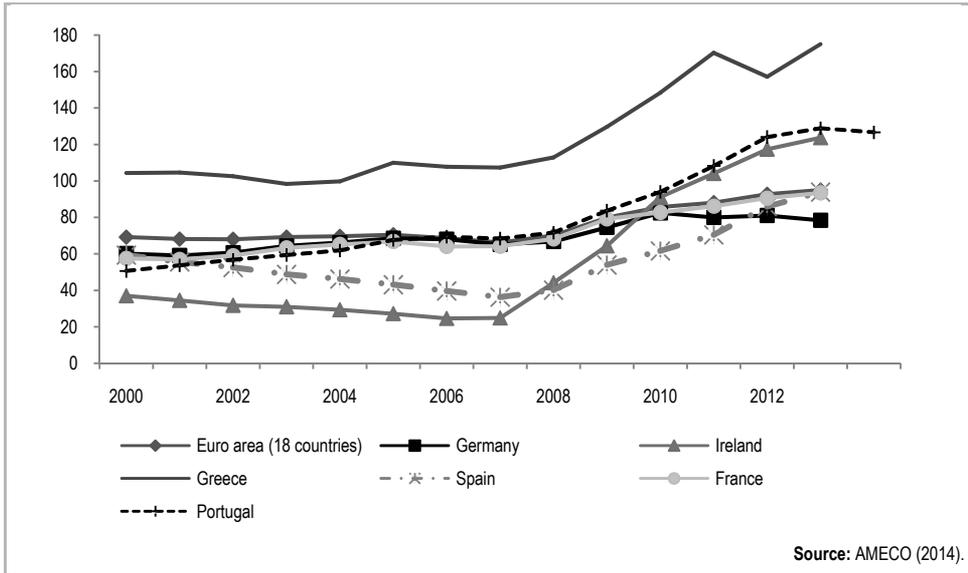


**Figure 1b** Austerity and Increases in Debt-to-GDP Ratios



**Figure 2** Budget Balances of Selected EU Governments, Incl. Euro Area Average, 2000-2013

<sup>1</sup> **European Commission (EC).** 2014. AMECO Database. [http://ec.europa.eu/economy\\_finance/db\\_indicators/ameco/index\\_en.htm](http://ec.europa.eu/economy_finance/db_indicators/ameco/index_en.htm) (accessed May 13, 2014).



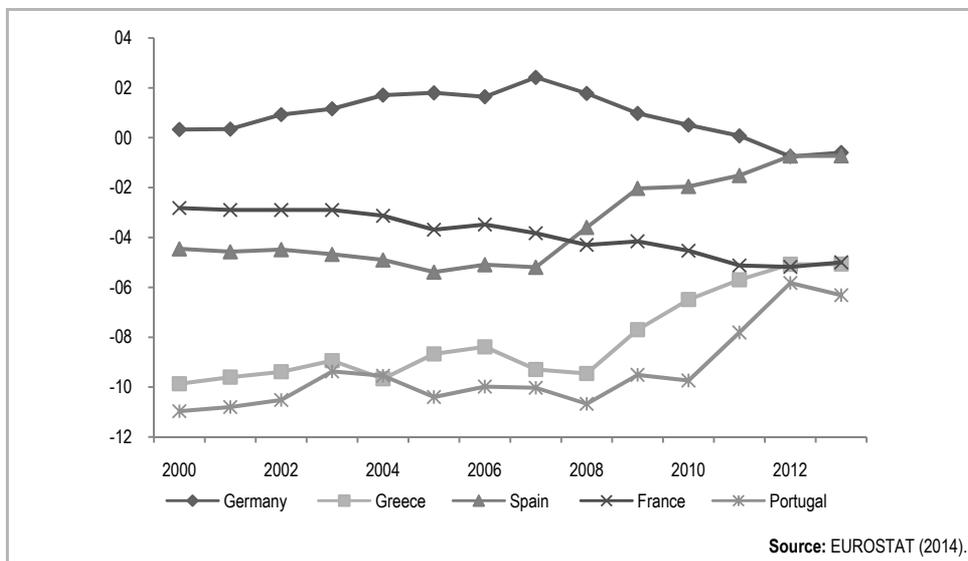
**Figure 3** Public Debt to GDP, Selected EU Countries and Euro Area Average, 2000-2013

Of course, this should hardly come as a surprise. Basic Keynesian economics teaches us that a further reduction of spending in times of crisis can result only in a deeper recession, due to a negative goods market multiplier. With the shrinking of domestic demand, investment drops even more because decreasing capacity utilization is poison for investment. Unemployment reaches ever-higher levels and, amidst depressed aggregate demand, government receives less tax revenues and is at the same time confronted with increasing social expenditures. Any round of austerity measures leads to a further downward spiral. One explanation for this completely dysfunctional restrictive fiscal policy in a constellation of current account deficits (negative contributions of the external sector for aggregate demand), collapsing investment demand and shrinking consumption demand is the belief in neoclassical arguments such as, for example, the argument of “crowding in” of fiscal contraction or that structural reform spontaneously triggers growth processes. Another plausible explanation is that the panic in financial markets in 2010 following the “sudden stop” of capital inflows into crisis-hit countries, exploding interest rate spreads, also led politicians to panic and either themselves opted for, or immediately agreed to, austerity measures. Thus, pressure from financial markets when the central bank could not or would not act as lender of last resort for governments enforced austerity measures (de Grauwe 2013). Another explanation is that politicians, especially in the surplus countries, saw their chance to enforce neoliberal reforms in Europe which before could not be realized.

## 4. Medium- to Long-Term Approach: Internal Devaluation and Effects on External Imbalances

### 4.1 Policies to Cut Wages

The backbone of the more long-term adjustment process was the enforcement of an internal devaluation in the crisis countries. Indeed, as can be seen in Figure 4 the later crisis countries had build-up substantial current account deficits with other EMU trade partners. In particular Greece and Portugal showed very high deficits, while in the cases of France and Spain current account deficits were increasing in the years leading up to the crisis. Germany, on the other hand, realised one record in its export surpluses after the other. Ireland (not present on the graph), despite experiencing sharply increasing current account deficits *vis-à-vis* rest of the world from 2004 to 2008, had always maintained a surplus with other EMU countries. Nonetheless, these surpluses were reduced substantially, from 19.4 per cent of GDP in 2001 to 12.1 per cent of GDP in 2008 (EUROSTAT 2014<sup>2</sup>).



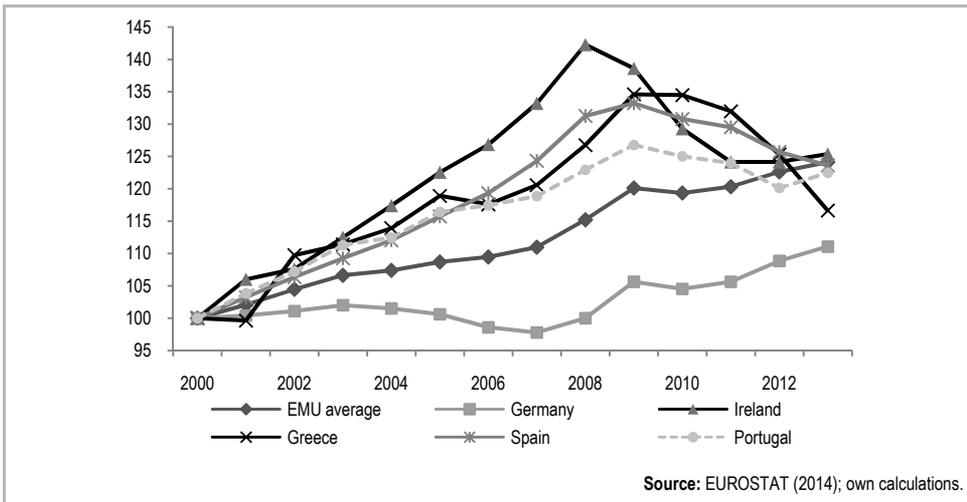
**Figure 4** Current Account Balance with EU17 in Per Cent of GDP, Selected Countries, 2000-2013

Figure 5 shows that before the Great Recession increases in unit labour costs in current account deficit and later crisis countries like Greece, Spain or Ireland were substantially above EMU average and in countries like Germany unit labour cost increases were below EMU average. These diverging developments in unit labour costs of EMU countries can be explained almost entirely by differentials in nominal wage developments, and not by productivity differentials (AMECO 2014).

<sup>2</sup> EUROSTAT. 2014. Statistical Database.

[http://epp.eurostat.ec.europa.eu/portal/page/portal/statistics/search\\_database](http://epp.eurostat.ec.europa.eu/portal/page/portal/statistics/search_database) (accessed May 05, 2014).

As a norm, to realise the EMU inflation target (which is slightly below two per cent) and not to change regional price competitiveness in the EMU, wages should increase according to the inflation target of the ECB plus the regional medium-term change of productivity. Taking this norm, before 2007 wage increases in Germany and in later crises countries missed the ideal wage norm by largely the same extent. Wage increases in Germany were much too low and in Greece, Spain, etc. much too high (Herr and Gustav Horn 2012). After the outbreak of the crisis, unit labour costs in Germany, the most important current account surplus country by far, increased slightly, whereas unit labour costs have fallen sharply in Ireland, Greece and Spain. What we see here is an overall asymmetric adjustment process focusing on wage cuts in crises countries.



**Figure 5** Developments in Nominal Unit Labour Costs, 2000-2013, 2000=100, Selected Countries

As a devaluation of the exchange rate is not possible in a monetary union, the increase of price competitiveness according to the Troika should take place *via* a reduction of nominal costs, especially nominal wages. The EU institutions used three main arguments to legitimise its intervention in wage policies. The first one has to do with the debt crisis and the need for substantial cuts in public expenditures in order to improve governments' fiscal positions. This directly affects wages of public sector workers. In fact, austerity-marked national reform programs all contained demands for wage cuts and/or wage freezes in the public sector. The second argument is, as outlined throughout this paper, the view that macroeconomic imbalances are partly a result of differences in competitiveness among states and thus require correction of unit labour cost developments. Based on a lack of comprehensive thinking about the functioning of a currency union and/or political pressure from surplus countries, changes of relative price competitiveness should in the eyes of the Troika only be achieved by nominal cost cuts in deficit countries and not by symmetric adjustments in deficit and surplus countries. The third is a more micro-oriented argument and comes from the neoclassical view that involuntary unemployment is due to institutional rigidities in the labour market.

With these underlying premises, policies enforced by the Troika and forcefully recommended to countries not directly depending on the Troika *via* the new EU governance institutions selected labour market reforms as one of the key reform areas (Olivier Blanchard, Florence Jaumotte, and Prakash Loungani 2013). Policies consisted of labour market deregulation and direct intervention in wage policy – for instance *via* cuts or freezes of public sector wages as well as statutory minimum wages. Greece, Ireland and Portugal which were the recipients of official bail-out programmes had to sign “Memorandums of Understanding” with the Troika. Hungary, Latvia and Romania were subject to “Stand-By Agreements” with the IMF. In all these cases labour market reforms and wage policy recommendations were legally binding. In Ireland minimum wages have been frozen since 2008, as well as in Portugal since 2012. Spain was obliged to commit to extensive reforms in labour market regulation. In Greece minimum wages were cut and there were either cuts or freezes in both public and private sector wages. Greece also had to agree to further decentralise collective bargaining and apply stricter rules for the extension of collective agreements (Hermann 2013; Schulten and Müller 2013; European Trade Union Institute (ETUI) 2014). Italy, to give an example from a country not under the dictate of the Troika, was subject to covert pressures to radically decentralise its collective bargaining system<sup>3</sup>. As a result of these policies, together with a substantial weakening of trade unions by high unemployment and external political pressure, nominal unit labour costs have seen an asymmetric adjustment.

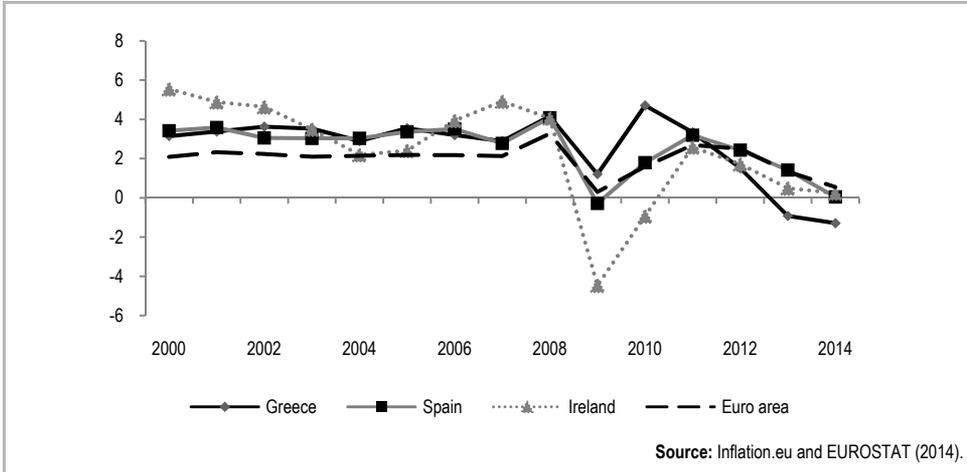
Before the Great Recession, average unit labour costs in the EMU were close to the wage norm and the ECB more or less achieved its inflation target. After the Great Recession, average unit labour cost increases in the EMU became very low. As unit labour costs are the most important medium-term factor to determine the price level (Keynes 1930; Herr 2009b) it is not a surprise that the EMU experienced very low inflation rates the years after the outbreak of the sovereign debt crisis. Ireland experienced a short deflation in 2009 and 2010 which was mainly caused by a sharp cut in unit labour costs and flexible prices. In following years deflation in Ireland came to an end. However, Ireland seems to fall back in deflation. Greece suffered from deflation in 2013, and Spain and Ireland stand on the edge of deflation (see Figure 6). In 2014 a deflationary development in the whole euro area became a real danger. This was also understood by the ECB when it cut its main refinancing rate in September 2014 to 0.05%.

Deflation, in combination with high indebtedness – a constellation existing in the EMU – bears the threat of getting out of hand (see the seminal paper by Irving Fisher 1933 explaining the Great Recession, see also Nina Dodig and Herr 2014). Deflationary expectations reduce consumption and investment demand. Consumers shift the purchase of consumer durables into the future and companies do not want to compete with companies that buy capital goods for a cheaper price in the future. Even more importantly, deflation increases the real debt burden. It becomes nearly impossible to successfully restructure financial markets in countries suffering from

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<sup>3</sup> This was exposed in autumn 2011 when a confidential letter from the ECB to the Italian government was leaked, containing requests for various far-reaching labour market reforms (Schulten and Müller 2013).

deflation. The Troika shot itself in the foot when it forced countries like Greece or Spain to do everything to cut wages and create a deflation when, at the same time, this policy led to a further permanent creation of new non-performing loans and the erosion of financial markets, and eroded demand and confidence in these countries.



**Figure 6** Average Inflation Rate (CPI), by Year, Greece, Spain, Ireland, EMU Average, 2000 - May 2014

## 4.2 Did Internal Devaluation Work?

Despite the improvement of the current accounts in EMU crisis countries (see Figure 4), these adjustments were one-sided and came at a great cost to the crisis countries. It is worthwhile mentioning that the build-up of imbalances in the pre-crisis period was relatively symmetric in the euro area whereas the rebalancing is not (Stefan Ederer and Peter Reschenhofer 2013; Carlos Carrasco and Patricia Peinado 2014). The reduction of current account deficits was combined with a substantial reduction of output and employment. The main factor leading to reduced deficits was the shrinking income in the crisis countries, which reduced imports. The fall of output was much larger than what would have been needed to reduce deficits if the adjustment process would have been more symmetric (OFCE, IMK, and ECLM 2013).

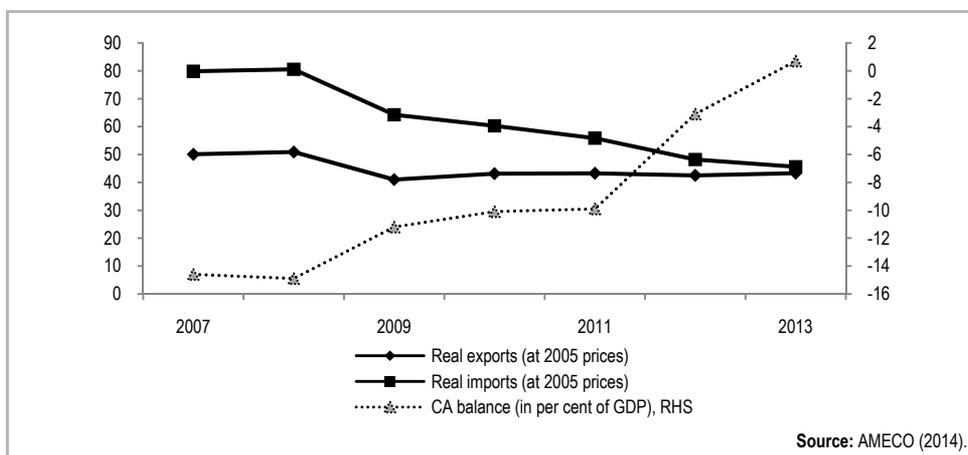
The downward adjustment of current accounts in surplus countries was minimal. Germany and Netherlands, in fact, have seen their surpluses increase since 2010. Given the developments in (former high) current account deficit countries, this means that the euro area as a whole has become a surplus region. Germany and other surplus countries managed to shift from shrinking exports to EMU crisis countries to the rest of the world. Germany, for example, was extremely successful to export cars and machinery to the rest of the world and in this way stabilised domestic output and employment. The high surpluses of Germany and other surplus countries with the rest of the world were a double-edged sword for the deficit countries. On the one hand, the surpluses added to the relative strength of the euro *vis-à-vis* other currencies. This undermined the efforts of the EMU's deficit countries to increase their price competi-

tiveness as their position relative to non-euro area markets has weakened. On the other hand the relatively good economic performance in Germany increase imports from the crises countries. However, higher wage increases and a domestically based economic growth stimulus in surplus countries as part of a symmetric adjustment process of current account imbalances would have been much less harmful for the deficit countries.

Cutting costs and prices improves price competitiveness as long as other countries do not the same. However, price elasticities of imports and export may be low in a number of crises countries. This means that even if the Marshall-Lerner condition holds, big changes in real exchange rates may be needed to improve the current account as a result of increasing price competitiveness.

We take a closer look at the developments in Greece, Spain and Ireland since the Great Recession to find out whether increased price competitiveness or the shrinking GDP caused the reductions of current account deficits.

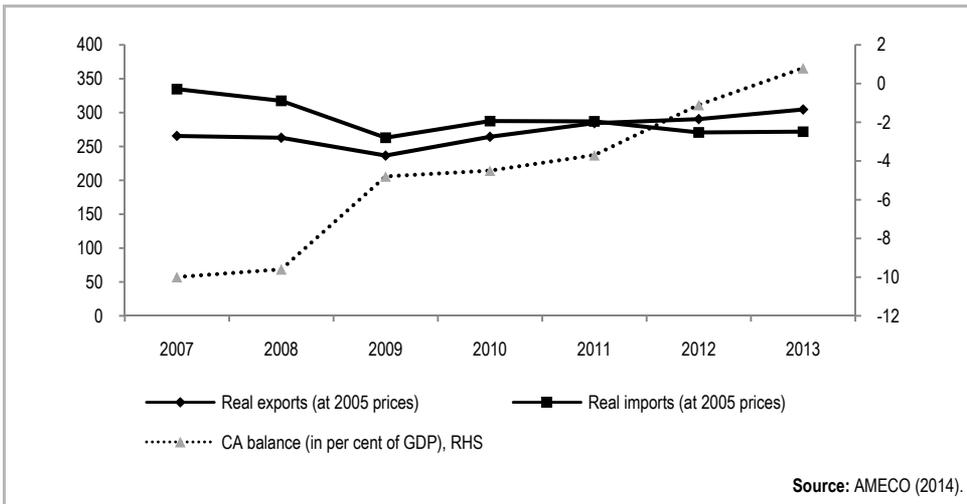
As can be seen in Figure 7, Greece is, unfortunately, not only a very good example of the negative economic effects of austerity; it is also an example of the difficulties of internal devaluation. Despite substantial wage cuts (see Figure 5) and other labour market reforms, Greek exports actually declined in real terms by 14 per cent between 2007 and 2013. The major current account adjustment came from a sharp drop in imports. Real imports almost halved in Greece in between 2007-2013. Thus, in the Greek case, it seems safe to conclude that the fiscal austerity and a related dramatic drop in domestic demand were the major contributors in bring the Greek current account slightly over zero in 2013. Furthermore, the Greek example highlights the difficulties of internal devaluation. Price elasticities may be so low that extreme nominal wage cuts, and such losses of terms of trade and reduction of living standard is needed that the process is socially and politically difficult to imagine in a monetary union. In extreme cases, the Marshall-Lerner condition might not be ful-



**Figure 7** Greece, Real Exports and Real Imports (in Billions of Euros) (Left Hand Side), and Current Account (CA) Balance (in Per Cent of GDP) (Right Hand Side, RHS), 2007-2013

filled and a real depreciation increases the current account. Bringing a country into a recession with austerity policies will surely result in shrinking imports. An increase in competitiveness is much more difficult to achieve.

Between 2007-2013 real exports increased in Spain by almost 15 per cent, however real imports shrank by about 19 per cent at the same period (Figure 8). Both developments brought the Spanish current account into surplus in 2013, but, even in this case, it is visible that policies depressing Spanish aggregate demand had a much larger effect than increasing competitiveness. It should also be pointed out that, despite an impressive export performance by Spain, it still – as do the other EMU countries – lags behind Germany. German real exports increased by close to 16 per cent between 2007 and 2013.

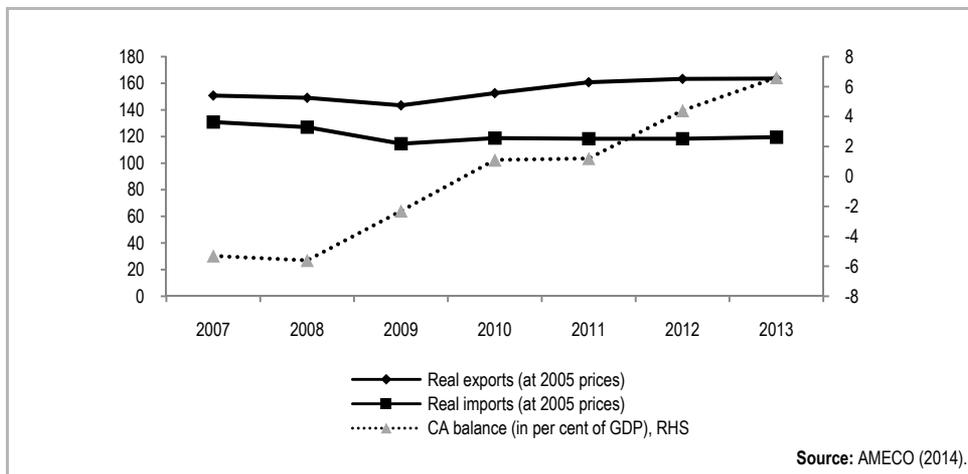


**Figure 8** Spain, Real Exports and Imports (in Billions of Euros) (Left Hand Side), and Current Account (CA) Balance (in Per Cent of GDP) (Right Hand Side, RHS), 2007-2013

Looking at the situation in Ireland (Figure 9), we can see an improvement in exports in real terms by about 9 per cent between 2007 and 2013. Real imports declined by approximately the same percentage. This was enough for Ireland to bring its current account to a surplus of 6.6 per cent of its GDP in 2013 – with a lot of praise by EU institutions. But to decide which country, if any, deserves praise, one needs to look deeper into economic development.

Two related issues are interesting. Firstly, prices of export goods in crisis countries increased in recent years much more than import prices. In Greece, export prices increased by 15 per cent from 2007 to 2013, in Ireland, Spain and Portugal by 7-8 per cent in the same period. Germany saw a roughly 4 per cent increase in export prices in the same period, thereby gaining relatively in competitiveness with respect to the three countries. In the face of declining unit labour costs in all three countries, this means that firms at least in the export sector did not cut prices according to cuts in wage costs but increased the share of profits in value-added (see OFCE, IMK, and ECLM 2013, p. 83). The most plausible explanation seems to be that due to competi-

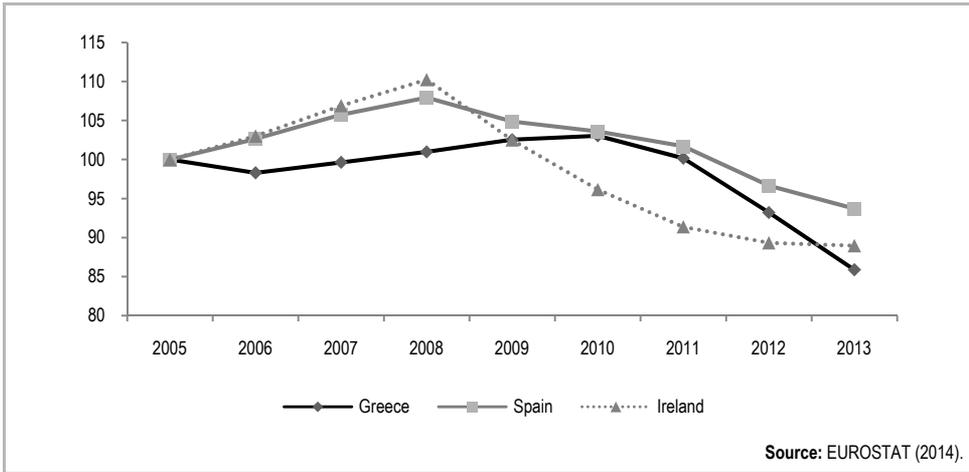
tion, profits of the export sector in these countries had been squeezed during the period before 2007 when wage costs in these countries increased substantially and that firms opted to regain their profitability. In addition it may need some time until the process of competition brings prices down when costs decrease. An upward turning wage-price spiral may be faster than a downward turning.



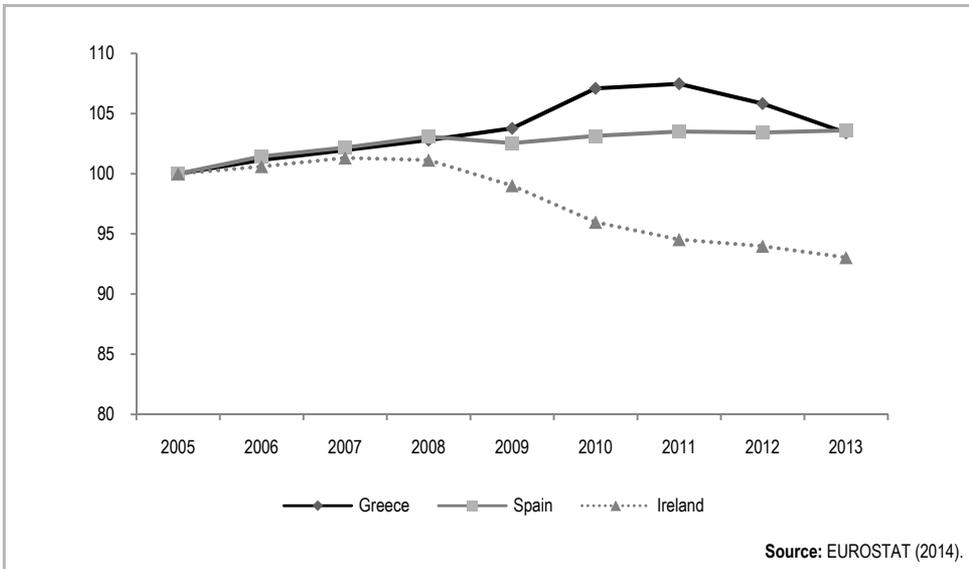
**Figure 9** Ireland, Real Exports and Imports (in Billions of Euros) (Left Hand Side), and Current Account (CA) Balance (in Per Cent of GDP) (Right Hand Side, RHS), 2007-2013

Secondly, Figure 10 shows the real effective exchange rate deflated with nominal unit-labour costs of the three countries under discussion. It can be seen that in all three countries there has been a substantial depreciation of the real effective exchange rate reflecting the development of unit labour costs in these countries. Looking at the real effective exchange rate deflated with the (consumer) price index (see Figure 11) it becomes clear that Greece and Spain did not gain much price competitiveness because prices did not much decrease. The situation is different in Ireland which increased its price competitiveness substantially. Figure 11 also explains why Ireland quickly reduced current account deficits and achieved current account surpluses. This analysis supports the argument that for many countries it is an illusion to reach international price competitiveness with moderate wage cuts.

GDP growth in Spain and Ireland seems to be on a rebound since the first quarter of 2013 – despite fiscal austerity. As was seen in this section, the recovery of GDP in these two countries has been completely reliant on increasing exports – a mercantilist strategy of which Germany has been a strong advocate. But it is in particular from the German case that we can learn the limits of a mercantilist strategy. Germany itself is stagnating throughout 2014 simply because exports did not grow sufficiently and domestic demand is weak. Not all countries can follow a successful mercantilist strategy within the EMU – at least as long as EMU surpluses do not become a disturbing factor for the world economy.



**Figure 10** Real Effective Exchange Rate (Deflator: Unit Labour Cost in the Total Economy), Greece, Spain and Ireland, 2005-2013 (2005=100)



**Figure 11** Real Effective Exchange Rate (Deflator: Consumer Price Index), Greece, Spain and Ireland, 2005-2013 (2005=100)

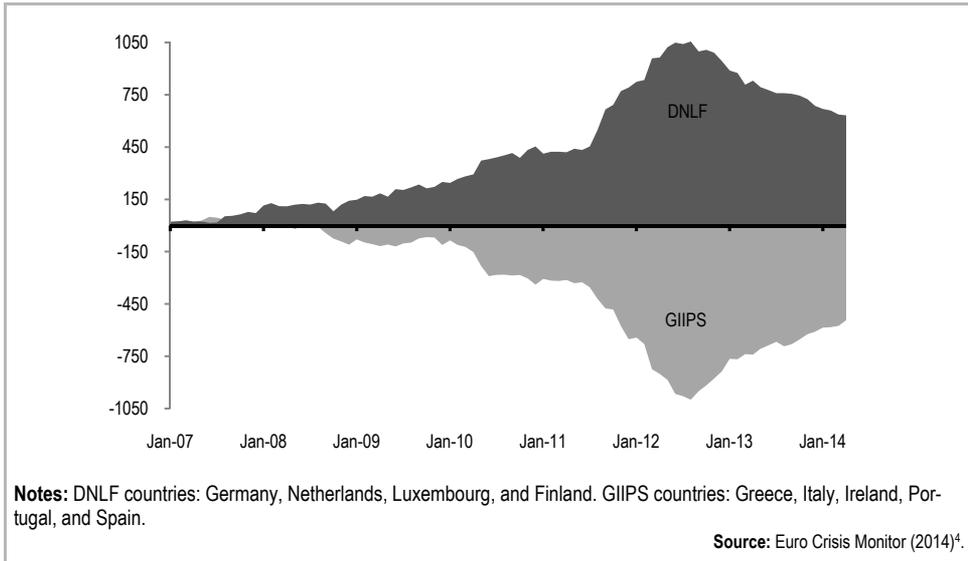
## 5. The Role of the ECB

The central bank is the only institution that can, by stepping into the role of a comprehensive lender of last resort, prevent a panic in sovereign bond markets. It also can curb the power of financial markets, including rating agencies, to threaten whole countries. Central banks can buy government bonds infinitely and prevent a default of public households indebted in domestic currency and high interest rates for public debt. In a crisis with deflationary tendencies, such a policy does not lead to inflation.

In case an inflationary development is triggered the central bank has all the instruments left to fight against it. The ECB did not take over the function of a lender of last resort for governments early enough (de Grauwe 2011). It intervened only in phases of great instability in capital markets when the EMU was in danger to break down. The ECB's purchase of government bonds from crisis countries in secondary markets began in 2011 *via* the **Securities Markets Program**. However, it was announced that the program would be limited in volume and in time. It was essentially a half-hearted attempt by the ECB to solve the sovereign debt crisis (Herr 2014).

Things changed in July 2012, when it became clear that there would be no quick economic recovery in the EMU. At the same time the instability of EMU capital markets exploded again, shown in increasing interest rate spreads for government bonds in EMU crisis countries compared to German government bonds. Even spreads of EMU countries not under the umbrella of the Troika increased sharply. Mario Draghi, President of the ECB since November 2011, realized that only an unconditional commitment by the ECB could prevent the breakdown of the euro area. At that time, Germany, which was always against such a promise, gave up its resistance against such a policy. At the Global Investment Conference in London on July 26<sup>th</sup>, Draghi famously declared he will do "whatever it takes" (Mario Draghi 2012) to save the euro. The ECB finally stated that it would purchase unlimited amounts of national debt on secondary markets – however, provided that the countries in question agree to reform programs negotiated with the Troika. EMU capital market calmed down after this promise.

One of the most important policies of the ECB dealing with the crisis in the EMU has been **TARGET 2** financing. Monetary transfers between EMU banks are carried out *via* the Trans-European Automated Real-Time Gross Settlement Express Transfer System (TARGET 2). For example, a Spanish bank has to balance its financial obligation daily, *vis-à-vis* a German bank. When, for example, deposits are shifted from a Spanish bank to a German bank, the Spanish bank has to transfer money to the German bank. With the outbreak of the sovereign debt crisis, capital flows to crisis countries stopped and capital flight from crises countries to stable countries in the EMU started. The boom phase of capital inflows, which financed the high current account deficits, turned into a bust phase with net capital outflows. As Spanish, Greek, Portuguese banks etc. were cut off from the EMU money market, the only possibility left for these banks was to ask for refinancing from their national central banks. The national branches of the ECB refinanced their banking systems without limit as part of their lender of last resort function. To legally allow the refinancing, the quality of collateral for the refinancing process was reduced in such a way that banks in crises countries always had sufficient collateral for refinancing. This process eventually caused an explosion of TARGET 2 imbalances shown in Figure 12. Imbalances in regional refinancing operations are normally not even mentioned by central banks. However, in the European System of Central Banks regional surplus and deficits in central bank money creation are booked as surpluses or deficits of member central banks of the euro area.



**Figure 12** TARGET 2 Balances, 2007-2014

In absolute values, Germany is by far biggest surplus country, followed by the Netherlands and Luxembourg, whereas the biggest deficit countries are Spain and Italy. In short, after the outbreak of the sovereign debt crises cash-flow imbalances within the EMU have not been financed by private capital flows. Instead, imbalances have been financed by increasing refinancing through the central banks in crisis countries (Ulrich Bindseil and Philipp J. König 2012). In substance, the ECB finances *via* TARGET 2 transfers the capital flight from EMU crises countries *and* their current account deficits. If the ECB would not have financed the banking systems in crises countries, the financial system would have broken down in the EMU. Improvement of TARGET 2 balances the last years reflect first of all the improvement of current account balances in the crises countries. Central bank money created by this process flooded banks in surplus countries, which had no need for it, as they did not want to expand credits sufficiently and/or there was a lack of credit demand from good debtors. Banks in surplus countries kept the created central bank money as excess reserves with the central bank.

The ECB's policy of low interest rates and several Lender of Last Resort measures undertaken since 2009, including TARGET 2 financing managed to offset, to a certain degree, the crisis intensifying effects of Troika policies. It was the ECB which prevented the collapse of the euro. The role of Mario Draghi as President of the ECB has arguably been very important in these developments, as he appears to be more aware of the need of a comprehensive Lender of Last Resort and the danger of deflation in the EMU than other representatives of EU institutions (Financial Times 2013; Draghi 2014).

<sup>4</sup> **Euro Crisis Monitor.** 2014. Institute of Empirical Economic Research Database, Osnabrück University. <http://www.eurocrisismonitor.com/Data.htm> (accessed June 03, 2014).

## 6. Conclusions

There were two fundamental misconceptions in the handling of the crisis in the EMU. Crisis countries were forced to follow an asymmetric adjustment process. Sharing the burden with current account surplus countries and countries with no refinancing problems would have been necessary to prevent the deep crisis in the EMU. Keynes's (1942) ideas as expressed in his recommendation for the Bretton Woods System were completely forgotten and EMU countries followed their short-sighted individual interests without thinking about the EMU as a whole. Such a policy was, in the end, also harmful for the surplus countries, which also do not show a convincing sustainable growth performance.

The second fundamental mistake was to believe that fiscal consolidation may slightly reduce growth in the short-term but structural reforms will unfold market forces spontaneously and will lead to a recovery and full employment. This policy, which is based on the Washington Consensus, does not care for any demand stimulation (Herr and Jan Prieue 2005). There was no element of demand creation in the Troika's recommendations; there was a lack of demand, a lack of production and a lack of employment.

As a result, in spite of fiscal austerity, budget deficits in the crisis countries could not be reduced as planned as fiscal austerity reduced the tax base *via* a shrinking GDP and increased the social costs of the crisis. Public debt in per cent of GDP increased in spite of austerity. In the end, only the late promise by the ECB in 2012 to guarantee for public debt ended the sovereign debt crisis – not austerity policy. The ECB could have given such a promise already in 2010. Or, either the surplus countries or the EMU countries together should have guaranteed for public debt in crisis countries. Had the ECB, together with the European Commission and EMU surplus countries like Germany, guaranteed the Greek public debt and at the same time enforced needed structural reforms in Greece – structural reforms not in a neoclassical spirit – the European debt crisis likely never would have happened.

The way the internal devaluation in current account deficit countries was enforced was a disaster as well. It is not understandable to force countries to create a deflation when these countries suffer from high stock of debt. It should have been clear that such a policy reproduces non-performing loans and represses investment and consumption demand even further. This policy, together with fiscal consolidation in a situation of shrinking private demand, pushed the EMU to the edge of a deflation – a danger that should have been seen at the beginning of the Great Recession (see for example Herr 2009a). In summer 2014 the ECB started to warn about the serious danger of a deflation in the EMU – a paradox given that the ECB also sits in the Troika.

What would have been needed is a symmetric process to overcome the crisis. This would have meant, without going into details, higher wage increases and fiscal stimulus after the Great Recession in surplus countries like Germany as well as a European wide program of demand stimulation, for example in the framework of a green new deal. Needed would have been a cautious consolidation of public finances after the end of the crisis and no wage cuts in crisis countries. The guarantee of public debt in crisis countries at the beginning of the sovereign debt crisis would have

largely prevented the sovereign debt crisis (also see the contribution by Detzer and Hein in this issue). In addition, a quick further integration of the EMU would have been needed, which goes beyond mechanisms to control public sector balances and warn for macroeconomic imbalances. For example, an EMU fiscal centre with own taxes and active fiscal policy is needed alongside new institutions to coordinate wage development in the EMU (for example European minimum wages regionally differentiated) or elements of an EMU social safety net (for example an EMU unemployment insurance starting on a low level).

All this was not done. In early 2015, it looks that the EMU as whole is not only heading for one lost decade, but for even longer stagnation. A Japanese deflationary scenario cannot be excluded with huge regional differences within the EMU and further eroding social standards.

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