

# Crisis, Profit Rate and the Political Economy of the Eurozone<sup>1</sup>

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Artigo submetido ao 42º Encontro Nacional de Economia - ANPEC

**Área 2 – Economia Política**

## **Abstract**

This paper aims to analyze the roots of the sovereign debt crisis around the Eurozone countries. Furthermore, it seeks to deconstruct the orthodox argument which states the crisis is caused by fiscal indiscipline of some of its members. In doing so, the article bears on the political economy tradition, integrating the elements of hierarchy and asymmetry among the various actors, and poses the hypothesis that the crisis in the Eurozone is due to three highly correlated causes: (i) the unfolding of the 2007 crisis that originated in the USA; (ii) the *financialization* of the global economy, and (iii) the intra-eurozone imbalances, a legacy of the neoliberal institutional framework of the last decades. In order to associate the Euro crisis with this neoliberal architecture, moreover, the main tendencies of contemporary capitalism are described, pointing to the theoretical contribution of Marx, particularly regarding his hypothesis of a tendential fall of the profit rate and the development of fictitious capital. Finally, some concluding remarks are considered, stressing alternatives to the budget austerity measures and to the necessary ruptures.

**Keywords:** Crisis in the Eurozone; Political Economy; Neoliberal Capitalism.

**JEL Classification:** B51; P16; H63; N14.

## **Resumo**

Este artigo tem por objetivo analisar as raízes da crise da dívida soberana nos países da zona do euro. Em adição, procura-se desconstruir o argumento ortodoxo o qual afirma ser a crise decorrente da indisciplina fiscal de alguns de seus membros. Para tanto, o texto faz uso da tradição da economia política, que procura integrar os aspectos de hierarquia e assimetria de poder entre os mais variados agentes, e levanta a hipótese de que a crise na zona do Euro decorre de três causas extremamente correlacionadas: (i) o desdobramento da crise de 2007 originada nos Estados Unidos; (ii) a *financeirização* da economia global e (iii) os desequilíbrios *intra-eurozone*, baseados no arcabouço institucional neoliberal das últimas décadas. Com o intuito de associar a crise do Euro a esta arquitetura neoliberal, ademais, são descritas as principais tendências do capitalismo contemporâneo, buscando o aporte teórico de Marx, particularmente em relação à sua lei de queda tendencial da taxa de lucro e do desenvolvimento do capital fictício. Por fim, algumas considerações finais são ponderadas, dando ênfase em alternativas à austeridade orçamentária e nas rupturas necessárias.

**Palavras chave:** Crise na zona do Euro; Economia Política; Capitalismo neoliberal.

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<sup>1</sup> The author would like to thank Tiago Appel and Yongjoon Park for their very valuable comments.

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## 1. Introduction

Throughout the nineties, the European integration process was deeply intensified and in 1999, with the introduction of a common currency, the Euro, had a benchmark in its trajectory. This integration process of the ‘old continent’ was supported by neoliberal political reforms, either institutional or ideological, which proclaimed the liberalization and the deregulation of markets as the most efficient way to allocate resources. The application of these rules, following their advocates, would result in high growth rates, economic development and wellbeing for the countries. The current European scenario, nevertheless, is characterized by insignificant growth (if not negative), very high levels of unemployment and intense social tensions that undermine and contradict these prerogatives, whose academic foundation is the aforementioned neoclassical theory.

Having said this, the paper has as its main purpose to analyze the roots of the sovereign debt crisis in the Eurozone countries, with the additional intention of deconstructing the orthodox reasoning that the current crisis comes from the fiscal indiscipline of some of its members. In doing this, the article bears on the political economy tradition, which aims to integrate the aspects of hierarchy and power asymmetry among all type of agents, and seeks to sustain the hypothesis that the crisis in the Eurozone is due to three highly correlated causes: (i) the unfolding of the 2007 crisis that originated in the USA; (ii) the *financialization* of the global economy, and (iii) the intra-eurozone imbalances, a legacy, as mentioned above, of the neoliberal institutional framework of the last decades.

Besides this introduction, the article is divided into four parts, as follows: in the first (section two), we aim to describe the institutional framework that preceded the Euro’s introduction and that had as its pivot the Maastricht Treaty, approved in February 1992. After that, in section three, we investigate the trends in neoliberal capitalism, which began at the end of the seventies, bearing on the theoretical contribution of Marx. Particular attention is given to the development of fictitious capital in contemporaneous capitalism, as well as the law of tendential fall of profit rate – the most important law in modern political economy according to this author. Part four, in sequence, talks about the imbalances between the Euro countries. Imbalances that are at the root of Europe’s crisis and that reveal, in reality, the limitations and failures of the institutional architecture presented in sections two and three. While section four is exposed, we must say, two groups of countries can be clearly distinguished. The southern (peripheral) countries comprising Portugal, Ireland, Italy, Greece and Spain and the Northern, or core countries, composed by Germany, Austria, Belgium, Finland and the Netherlands. We chose to exclude France from the sample (unless stated), for frequently taking an intermediate position on the variables under concern, as well as Luxembourg and some other countries which joined the Eurozone later as in the case of Slovenia (2007), Cyprus (2008), Malta (2008), Slovakia (2009) Estonia (2011) and Latvia (2014)<sup>3</sup>. In the last section, some final remarks are considered, stressing alternatives to the austerity measures and to the necessary ruptures.

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<sup>3</sup> In 2014, the southern countries accounted for 34% of the GDP of the 18 Eurozone countries, while the Northern countries accounted for 43.13%. Luxembourg, Slovenia, Cyprus, Malta, Slovakia, Estonia and Latvia, on the other hand, sum up, between them, no more than 3% of the GDP of the Eurozone countries.

## 2. The institutional framework preceding the introduction of the Euro

The Euro model, based on a Monetary Union with the adoption of a single currency, the Euro, brings us to the European Union Treaty, also known as Maastricht Treaty. In this treaty, approved in February 1992 by the 12 members of the European Community<sup>4</sup>, three stages for the implementation of the European Monetary Union were agreed upon. During stage I, the signatory countries agreed to eliminate capital controls and to strengthen the independence of their Central Banks, in this way aiming to make their internal laws compatible with the Treaty. In stage II, developed between January 1994 and December 1998, the member countries were expected to coordinate their economic and monetary policies in order to achieve quantitative targets set for the reduction of inflation, interest and exchange fluctuations between national European currencies, besides the control of the deficit and the public debt (UE, 1992). In 1997, particularly, the Stability and Growth Pact (SGP) was approved. According to this pact, the so-called convergence criteria to be met by the entering countries would be: (i) inflation in the last preceding twelve months should not have exceeded by more than 1.5% the lowest inflation rate of the member countries; (ii) public deficit should have been kept to a maximum of 3% of GDP; (iii) public debt no higher than 60% of GDP and (iv) long-term interest rates, in the preceding year, should not have exceeded more than 2% the rates of the three member countries with the “best performance” in terms of inflation. Stage III, in turn, beginning in January 1999, had as a milestone the inauguration of the European Central Bank (ECB) and the Euro’s introduction as a unity of account for all financial assets in 11 out of 15 member countries of the European Community<sup>5</sup>.

Therefore, since 1999 one of the key institutional pillars of the European Monetary Union (EMU) has become the European Central Bank (ECB) whose board is responsible for issuing the Euro and for the formulation and implementation of the common monetary policy of the Euro member countries. To put it in other words, with the monetary union the national central banks have lost the capability to formulate and execute monetary policy, function that is now undertaken solely by the board of the ECB, which defines the common basic interest rate to all countries of the Euro area. With the Euro’s introduction, consequently, those national central banks have lost the ability to implement domestic exchange policies.

The Maastricht Treaty, it is noteworthy to mention, institutionalizes, due to Germany’s demand, price stability as the main objective of the ECB, subordinating all its other duties to this one point. Thus, the full and complete independence of the ECB against any agency or entity of the European Community and national governments is stated. In respect to fiscal policy, by the way, the Maastricht Treaty and the main agreements of the EMU imprison the National States insofar as they prohibit the ECB to fund, as lender of last resort, governments of the Euro area. That is, the fiscal policy of these National States must be subjected to the equilibrium requirements established by the SGP.

The Stability and Growth Pact, in turn, approved with the purpose of restraining “irresponsible” fiscal behavior by the European Union member countries, has seen since its birth, however, a loosening of its rules. It is interesting to note that in 1999 Belgium and Italy, for example, with public debts higher than 110% of GDP, were in clear breach of the Maastricht rules. These countries, which should have supposedly suffered financial penalties for disrespecting the rules, ended up not being penalized, as well as France and Germany, countries that in the following years to the Euro’s introduction disobeyed the Maastricht rules in relation to imbalances in public budgeting.

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<sup>4</sup> The European Community at that time consisted of Germany, Belgium, France, Netherlands, Luxembourg, Denmark, Ireland, UK, Portugal, Spain and Greece. Later, in 1995, Austria, Finland and Sweden joined the Maastricht Treaty. The adherence to the Treaty, however, did not mean the adoption of the Euro as a single currency. That is why UK, Denmark and Sweden opted to stay out of the Eurozone.

<sup>5</sup> These countries were Germany, Finland, Belgium, Netherlands, Austria, France, Portugal, Ireland, Italy, Spain and Luxembourg. The entry of Greece to the Eurozone was approved only in June 2000.

By and large, one can say that the integration process of the European Monetary Union transcends the economical aspect and reports us to the end of World War II. And although for reasons of space and focus, we will not trace the comings and goings of this integration for over 60 years, we shall only point out that in the view of its formulators this should be the *grand finale* for the unification of a continent scarred by centuries of intense rivalry and ongoing wars. And, in this sense, the introduction of a currency independent of any particular State would perhaps help to overcome the notion of national sovereignty. From a political standpoint, nevertheless, the dogma that pictures capitalism as a system best managed by market forces, i.e. without the National State, lacks all and any serious understanding of the real history and origin of the capitalist interstate system. The European liberal cosmopolitanism, in addition, presupposes a political unity on the continent that, at least to these days, still does not exist, given the heterogeneity of these European national states – featured by strong cultural, linguistic and, above all, capitalist economic development differences (FIORI, 2007, 2011; AMIN, 2012).

From the economic perspective, on the other hand, the ease with which trade transactions could be dealt with in any member country, alongside with the reduction in the degree of contractual uncertainty of exporters and importers, certainly contributed to popularize the advantages of a single currency. But that does not mean the process of Monetary Union did not suffer technical criticism since its conception, criticism based largely on the so-called theory of optimum currency areas, originally posited by Mundell (1961), McKinnon (1963) and Kenen (1969) and later on developed through the contribution of Tavlas (1993), among others<sup>6</sup>.

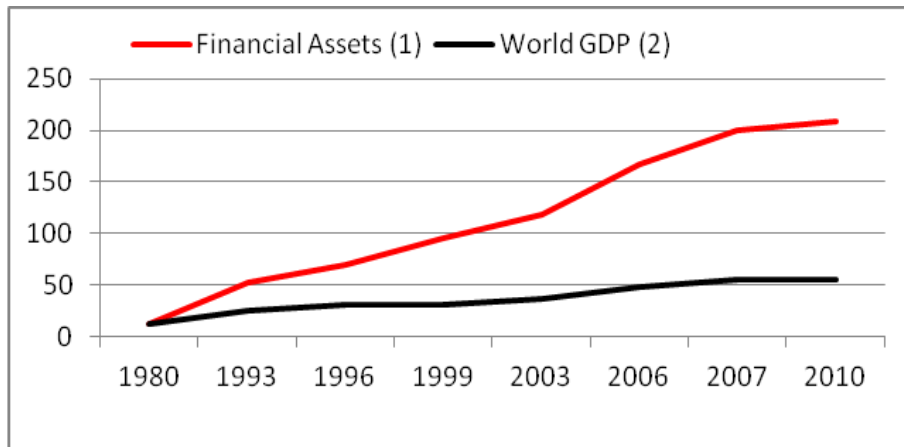
Actually, in the field of *heterodox political economy* – the area in which this paper fits in – the criticisms to the institutional architecture of the Monetary Union stem from its political and ideological neoliberal nature (HUSSON, 2012; LAPAVITSAS, 2012; STOCKHAMMER & ONARAN, 2012; ARESTIS & SAYER, 2011). This neoliberal project is based on the assumption that the liberalization of capital flows (trade and financial deregulation), budgetary discipline and the flexibility in the labour market would ensure the income per capita convergence of the economies that entered the Eurozone. For these reasons, before we proceed to the chain of events that led to the crisis in the Eurozone and the specific internal imbalances between those countries, we are going to describe, in the next section, the major tendencies of neoliberal capitalism with recourse to Marx's theory.

### 3. Trends of neoliberal capitalism in the light of Marxian theory

Since the mid-1980s, contemporaneous capitalism presents as a stylized fact the decoupling of the financial capital from the productive capital.

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<sup>6</sup> We cannot deny the reductionism and limitation, since its formulation, of these criticisms as a result of their neoclassical theoretical foundations that are hard to support vis-a-vis the formal inconsistencies of the law of diminishing returns, as exposed by the capital controversy. Furthermore, according to this literature, ultimately, a monetary zone would only be optimum in the case of one country, and yet under the assumption that its regions were “symmetrically affected by disturbances”, which makes that theory useless in practice. In this sense see: JONUNG & DREA (2009) and EICHENGREEN (1997).



**Figure 1 – Real and fictitious wealth (US\$ trillions)**

Source: McKinseys Global Institute

(1) Includes stocks and debentures, government bonds, private debt securities and banking applications; does not include derivatives.

(2) Instruments, machines, equipments, facilities, buildings, civil works, technology and anything else that allows future production of an increased flow of goods and services.

This financialization of the global economy is closely related to the concept of fictitious capital developed by Marx. To the latter, both government bonds as well as bills of exchange and stocks would represent as a matter of fact only accumulated rights, legal bonds on future production whose monetary value or capital-value either would not represent any kind of capital, as the case of public debt, or would be regulated independently from the value of the real capital they would represent (MARX, 1909, p.552). In Marx's words:

The greater portion of the banking capital is, therefore, purely fictitious and consists of certificates of indebtedness (bills of exchange), government securities (which represent spent capital), and stocks (claims on future yields of production). And it should not be forgotten, that the money-value of capital represented by these papers in the strongboxes of the banker is itself fictitious, even of those which are checks for guaranteed incomes, such as public bonds, or titles on actual capital, like industrial stocks, and that this value is regulated differently than that of the actual capital, which they represent at least in part; or, when they stand for mere claims on the output of production, and not for capital, that the claim on the same amount is expressed in a continually changing fictitious money-capital (MARX, 1909, p.552).

Taking into account, however, the pursuit of profit as the driving force of capitalism, it is interesting to notice this financialization of the economy from behind the movement of profit rate. This, in turn, can be described as follows:

$$r = s / (c + v) \quad (1)$$

Each capitalist realizes its profit rate by the ratio of its profits (surplus-value,  $s$ ) to the investment made, that is to say, the expenditure on machinery, equipment and raw materials ( $c$ , constant capital) plus the amount spent in labour-power ( $v$ , variable capital). Dividing both parts by  $v$ , Marx obtains:

$$r = (s / v) / ((c / v) + 1) \quad (2)$$

$s/v$  is the rate of surplus-value, which means the degree of exploitation of workers, and  $c/v$  represents the organic composition of capital<sup>7</sup>. For Marx, in the capitalist mode of production there would be a progressive tendency for the rate of profit to fall, due to the progressive development of the social productive power of labour. I.e. each capitalist's search for cost-reducing technical innovations (or profit-increasing product innovations), at prevailing prices and wages, that provide a super-profit (a higher-than average initial profit rate), would determine technical progress as labour-saving (and capital intensive) as an endogenous dynamics force of the system, as the result of the persistent increase of the organic composition of capital.

Similarly, from a Marxian perspective, it is possible to describe such profit rate in the following way (DUMÉNIL & LÉVY, 2003; FOLEY & MICHL, 1999):

$$r = (s/(v + s))/((c + v)/(v + s)) \quad (3)$$

Here,  $s/(v + s)$  is the share of profit in total income, and  $(c + v)/(v + s)$  is total capital per hour worked, which is another measure of the organic composition of capital (this ratio can also be read as the ratio of capital to output, since output is equal to total income, or equivalently the inverse of what is frequently loosely called 'capital productivity'). Then, decomposing the determinants of the profit rate from equation (3) we get a distributive effect – the capital-labour struggle in national income – and a technological effect, i.e. the productivity from sector I:

$$r = (s/(v + s)) * ((v + s)/(c + v)) \quad (4)$$

The tendency for the profit rate to fall has in Marx a fundamental feature. For him, this means nothing less than "*the most important law of modern political economy, and the most essential for understanding the most difficult relations. It is the most important law from the historical standpoint*" (MARX, 1993, p.748). The emphasis Marx gave to this question stirred, and still does nowadays, heated debates and controversies within the Marxist field.

For Paul Sweezy (1966, 1987), for instance, the tendency in the falling rate of profit would not be verified in the current stage of monopoly capitalism, but only in its competitive stage. In the competitive phase, period in which Marx purportedly made his analyses – this phase would date from the beginning of the eighteenth century to the mid-late nineteenth century –, there would have been, according to Sweezy, an increase in the organic composition of capital due to a shift from production based primarily on labour to production based on machines (the so-called industrial revolution), i.e. the replacement of living labour by dead labour. In the current monopoly stage of capitalism, however, technological progress would take shape through *capital-saving* techniques, curbing, consequently, the growth in  $c/v$  and the falling rate of profit tendency. For Sweezy, moreover, the ongoing increases in labour productivity in the monopoly capitalism would induce increases in the rate of surplus-value capable of eliminating the effects of likely increments in the organic composition of capital. Therefore, the author suggests replacing the law of a tendentially falling rate of profit by the law of rising surplus.

Joan Robinson (1942), in turn, criticizes Marx's scheme since it is based on a constant rate of exploitation. That is, with the rate of exploitation holding steady, the falling rate of profit would be a tautology, given the increment in capital per worker. For the English economist, such a hypothesis would reveal a contradiction within Marx's analysis, because it would imply that real wages should grow at the same rate as the continuous increase in labour productivity, i.e. Marx could only demonstrate the tendential fall in the profit rate giving up his usual argument for the tendency of real wages to remain constant, or, then, by presenting a theory of a rising trend in real

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<sup>7</sup> Besides the organic composition of capital (and the surplus-value) the average profit rate depends on the turnover time from the circulating capital. Since a diminishing turnover time from the circulating capital means an acceleration on the realization of the surplus-value, this leads to an increase in the average profit rate (MARX, 1909, V. III, Chapter XIII).

wages. The English author is aware that Marx takes into consideration the rise in the rate of surplus-value in the chapter about the “causes that counterbalance the law”, however, for her this increase has narrow effectiveness in Marx’s general explanation and thus would not be able to suppress the tendency for the rate of profit to fall. For Joan Robinson such a situation would be a mistake given that labour productivity can grow without limits, and if real wages remain constant, the rate of exploitation may also go up unrestrictedly<sup>8</sup>.

In this intricate debate, Yaffe (1972) seems to rescue a central element within Marx’s method to defend the law of a tendentially falling rate of profit: the contradiction of capital in its process of reproduction, insofar as, on the one hand, there is capital as value in course, value trying to expand itself without boundaries and, on the other, there is the working population (increasingly lower) imposing limits to this expansion. Schematically such an argument becomes clearer, since the numerator of the profit rate is the mass of surplus-value, and this is the result of the product of the rate of surplus-value times the number of employed workers at a given rate, i.e.:

If  $s$  grows and  $v$  tends to zero,  $\text{Lim. } s/v = + \text{infinity} (\infty)$ .

But, since  $S$  (mass of surplus-value) =  $(s/v) * V$ .

If  $s/v$  tends to infinity ( $\infty$ ) and  $V$  tends to zero,  $\text{Lim. } S = 0$ , because  $S = \infty * 0 = 0$

The very capital accumulation, therefore, imposes limits to the extraction of surplus-value. There are barriers beyond which it is impossible, for a given amount of labour-power, to either increase absolute labour time, or to reduce necessary labour time for the reproduction of the working class, in as much as each worker cannot work more than 24 hours per day and necessary labour time may not be less than zero. Here arise the natural limits to the extraction of surplus-value. To the extent that the rate of surplus value approaches these extremes, its neutralizing effect over the organic composition of capital is diminished and, consequently, the profit rate will tend to fall.

Marx associates his law of the falling rate of profit even with an increase in the rate of surplus-value, but as seen above, this rise has limitations. It is worth noting, however, that for Marx this law, although a characteristic feature of capitalist technical progress, denotes just a long-term tendency. In several passages of Chapter XIII and XIV from the third volume of "Capital", Marx claims it is quite possible for the profit rate to fall for other reasons and/or that this fall can be temporarily overcome. *This progressive tendency of the average rate of profit to fall is, therefore, but a peculiar expression of capitalist production for the fact that the social productivity of labor is progressively increasing. This is not saying that the rate of profit may not fall temporarily for other reasons.[...] There must be some counteracting influences at work, which thwart and annul the effects of this general law, leaving to it merely the character of a tendency. [...] The law therefore shows itself only as a tendency, whose effects become clearly marked only under certain conditions and in the course of long periods* (MARX, 1909, p.249-272-280).

The empirical analysis of the rate of profit, despite limitations surrounding the appropriate measurement of Marxist categories<sup>9</sup>, reveals that it reversed its downward picture in the neoliberal era (SHAIKH, 2010; MOSELEY, 2007; DUMÉNYL & LEVY, 2011; HUSSON, 2013, 2008; GLYN, 2006). And although there is still no consensus on the restoration of the profit rate to levels akin to those obtained prior to the “Fordism Keynesianism” crisis, the crucial question to know is:

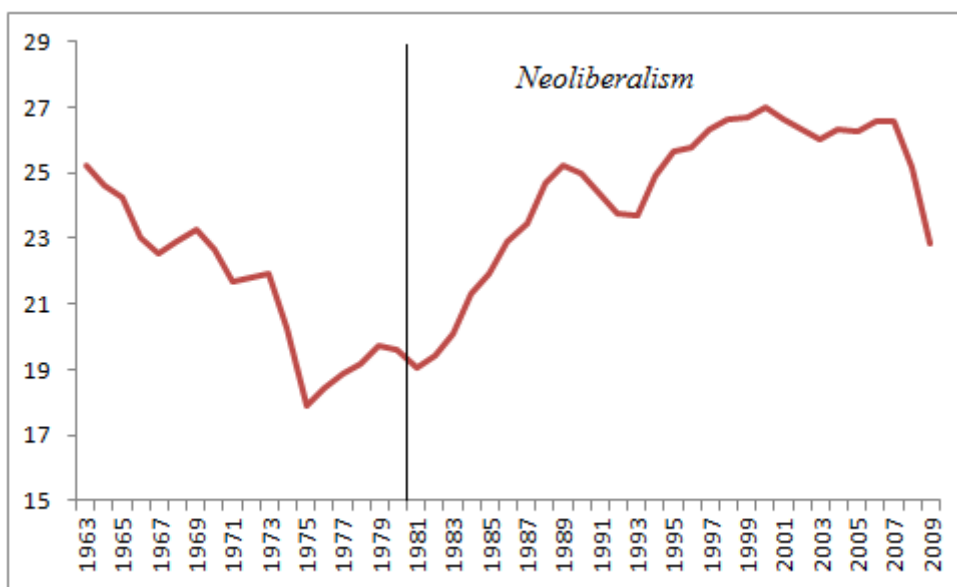
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<sup>8</sup> Josef Steindl (1952), in a similar manner, also points out as a failing of Marx about the law of the profit rate the limits to the growth of the rate of surplus-value. For the author, nonetheless, what inhibits the falling rate of profit tendency is the use of less capital in relation to a given output.

<sup>9</sup> For a better measurement of the rate of profit, within Marxist vocabulary, it would be necessary to have information about the amount of productive and unproductive labour, as well as total capital advanced in production.

what actually happened so that there was this marked transformation in the behavior of the profit rate?

As it can be seen in Figure 2, the profit rate presents notably two distinct phases. The first phase corresponds to the period of the dismantling of the Fordist mode of accumulation and of its respective Keynesian policies. This phase, commonly referred to as the “stagflation crisis”, was associated with a sharp decrease in capital profitability. The second phase, beginning in the early 1980s, on the other hand, has as a hallmark some very specific reforms and policy measures such, as mentioned earlier, the deregulation and increased flexibility in labour market, the trade and financial liberalization, as well as privatizations and the rebirth of monetarism. At this second phase, named neoliberalism, there has been a recovery in profit levels.



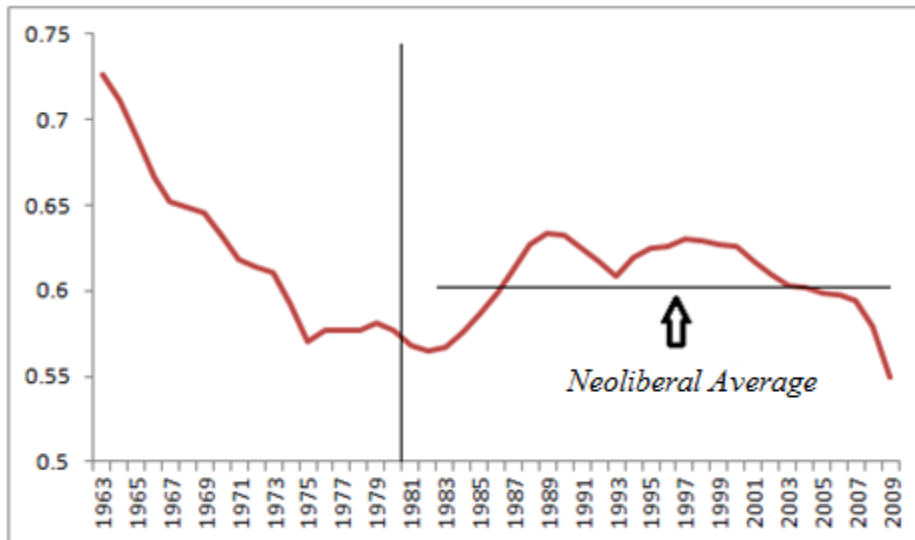
**Figure 2** – Profit rate in the Eurozone countries

Source: Author’s elaboration based on EPWT 4.0 and AMECO.

The investigation of the determinants of the profit rate, as it turns out, also reveal distinct patterns. The capital productivity evolution, for example, shows that during the period of the stagflation crisis this variable plummeted, which means that the organic composition of capital had an overwhelming impact on the fall of the rate of profit in this period (Figure 3). In the neoliberal years, in contrast, the organic composition of capital has had a much shyer and stagnant character. This phenomenon is more likely to be associated with two causes. In the first place, we can highlight the financial and macroeconomic instability of the post-Bretton Woods environment, leading this way to a sluggish Gross Capital Formation – this mismatch between capital accumulation and the profit rate is also set in the context of the dominance of shareholder value maximization, at the level of the firm, as the main corporate objective (GUTTMANN, 2008). Afterwards, it is reasonable to link this dormant organic composition of capital to a possible incorporation of technological innovations regarding the third industrial revolution<sup>10</sup>.

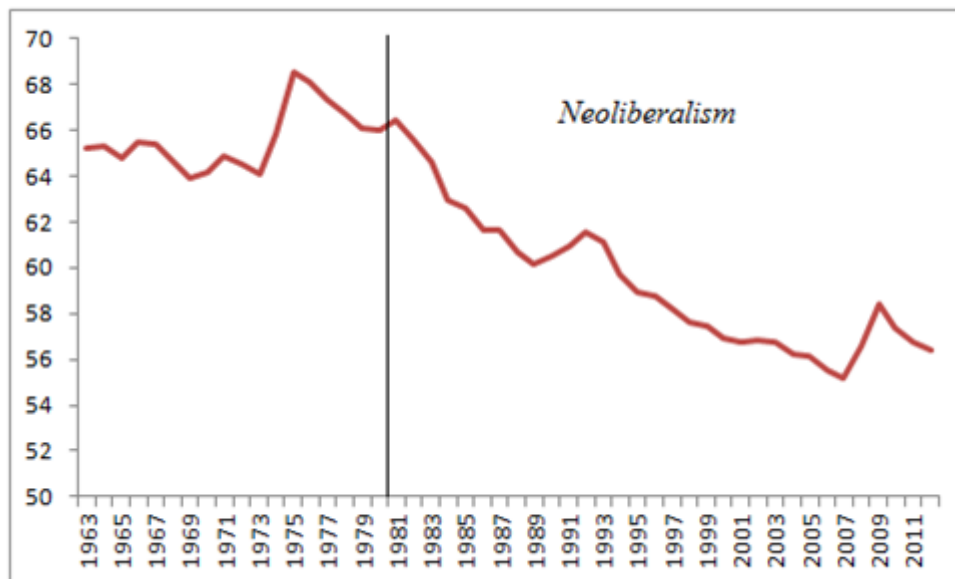
<sup>10</sup> For Marx, the cheapening of the elements of constant capital could be a counteracting cause for his law of the falling tendency of the rate of profit, i.e. although the mass of means of production did grow in relation to a given labour-power, the increase in value of constant capital relative to variable capital could not keep up with the respective increase in its mass. To put it in other words, the strong technological innovation since the 1980s, resulting from the new information and communication technologies, while devaluing the existing equipment at an accelerated pace, ended up weakening the rising trend in the organic composition of capital.





**Figure 3** – Capital productivity in the Eurozone countries.  
Source: EPWT 4.0

The examination of the influence of the distributive factor in the determination of the profit rate, as it should be, also seems peculiar. As can be seen in Figure 4, phase I, corresponding to the “stagflation crisis”, was associated with a reasonable increase in the workers’ share of national income. This event, by decreasing the degree of exploitation of labour-power, exacerbated the intrinsic tendency for the rate of profit to fall<sup>11</sup>.



**Figure 4** – Wage share of national income in the Eurozone countries  
Source: Annual Macro-Economic Database

<sup>11</sup> For some theorists, labeled profit squeeze theorists, the growing power of workers during this period was a key reason for the decline in the rate of profit. Glyn (2006), for example, by highlighting the strengthening of unionism and legislative changes that supported the bargaining position of workers, can be included in this school. According to the author’s calculations, by the way, the number of average hours annually worked in the OECD countries fell from 2000 in 1950 to 1750 in 1973, the equivalent to more than half of a working day less per week. Marx, from another angle, asserts: *Nothing is more absurd, for this reason, than to explain a fall in the rate of profit by a rise in the rate of wages, although there may be exceptional cases where this may apply* (MARX, 1909, p.281).

The crisis of capital profitability during this period, known by many just as “stagflation crisis”, by exposing the limits of Keynesian policies in the face of capitalism’s contradictions, as Desai (2004, p.254-255) points out, clarifies, in addition, a huge theoretical gap:

Government expenditure had gone up to finance public-sector jobs. These jobs replaced the lost jobs in the private sector. But public-sector jobs - unlike private-sector ones - generated no surplus-value and no profits. Marx had labelled such jobs unproductive. Productive jobs were those where the workers were employed by capitalists in order to make profit. Unproductive workers were hired for consumption services, not for profit. They were paid out of income, not capital, as productive workers were. Productive workers aided accumulation by generating profits for the capitalists. Unproductive workers were an expenditure, a diversion of savings. [...] Teachers, social workers, prison officers, police, civil servants and, in the UK, all those employed in the National Health Service - all these workers were unproductive in Marx's sense. They were not useless in terms of people's well-being, but they were paid out of taxation which diverted savings away from accumulation. For Keynesians this distinction is irrelevant, since what concerns them is the contribution of employment in keeping up effective demand (DESAI, 2004, p.254-255).

Bearing in mind the crisis of capital profitability of the 1970s, therefore, it becomes easier to interpret the subsequent expansion of finance capital seen in Figure 1. Nevertheless, one cannot lose sight of the fact that the respective profitability standards imposed by financiers in the neoliberal period were only made possible by an increase in the level of exploitation of labour-power; i.e. the wage rigidity and the employment flexibility, as well as the systematic recourse for cheap and poorly protected labour, through international outsourcing and offshoring, allowed this action<sup>12</sup> (CHESNAIS, 2004). As can be seen in Figure 4, the wage share of national income in the Eurozone countries during neoliberalism suffered a sharp decline. This phenomenon, along with the innocuous increase in the organic composition of capital, triggered the reversal on the pattern of the profit rate in contemporaneous capitalism.

#### 4. The crisis and the imbalances in the Eurozone countries

After the disclosure of fraud in Greece’s public accounts and its excessive indebtedness, it became conventional, within mainstream literature, to attribute the crisis in the Eurozone to the irresponsible behavior of the governments of the peripheral economies of the Euro<sup>13</sup>. For some authors, within this theoretical school, the Southern countries would have embraced populist policies, during the “fat years of Maastricht”, which would now be compromising them. To others, the crisis would be the result of the Welfare State, and of excessive labour costs in these countries, which would have made them non-competitive due to high unemployment benefits, early retirement, few hours worked and so on. Throughout this section, however, we will try to refute those interpretations, since we assume this is a capitalist crisis engendered by the neoliberal institutional arrangement presented previously, which reinforces the imbalances between the Northern and Southern countries. And that therefore the sovereign debt crisis is just a manifestation

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<sup>12</sup> In global terms, China, and in a lower degree India, have a prominent role in this scenario. The wage rate of an average worker in China, for example, is about one-twentieth of that in the USA, 1/16 of that in South Korea, ¼ of that in Eastern Europe and half of that in Mexico or Brazil (LI, 2008). That is to say, the Chinese labour-power, huge in quantity, productive and extremely cheap, allows the Chinese and foreign capitalists to make profits through its intense exploitation – in light of this, it is not surprising that China receives large amounts of Foreign Investments.

<sup>13</sup> By peripheral economies of the Euro, we are referring to Portugal, Ireland, Italy, Greece and Spain. By core countries of the Eurozone, in contrast, we bear in mind Germany, Austria, Belgium, Finland and Netherlands. From now on, by the way, we will follow Artus’s (2011) and Husson’s (2012) hypothesis of a two tier Europe, labeling the peripheral countries as the “South” and the core countries as the “North”.

or rather a consequence arising mainly of the measures taken to bail out the private banks since the 2008 recession<sup>14</sup>.

As a starting point, we must remember that the purpose of an economic union between countries with different levels of development is to generate some form of harmonization and convergence. This implies that the less developed countries should grow faster. From Table 1, we note that this process, in a way, actually did happen, since those countries, which in 1990 presented the lowest levels of GDP per capita, were, in the period 1990-2008, the ones that recorded the highest rates of growth.

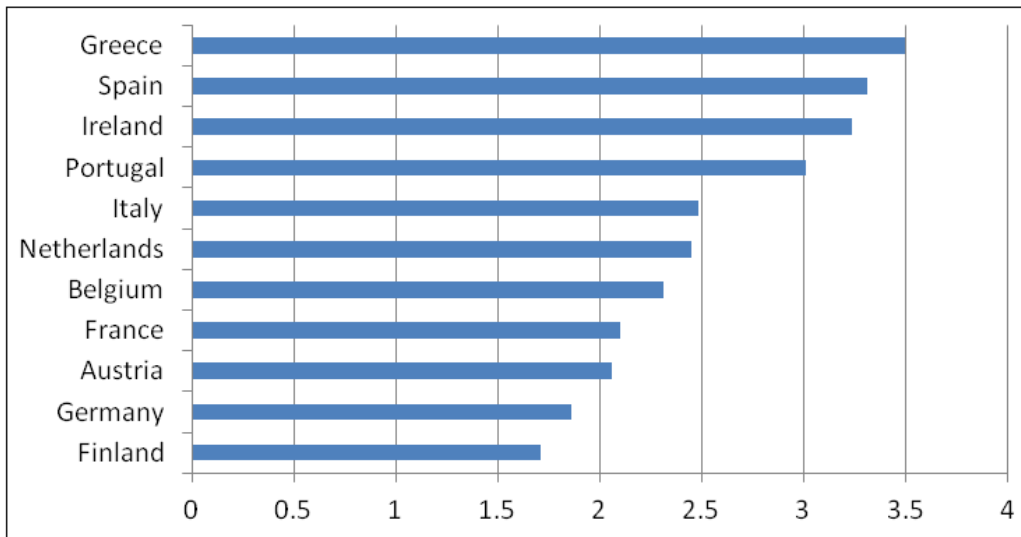
**Table 1** – Growth rate of GDP and GDP per capita

Countries	Average growth rate of GDP		Index of GDP per capita (Euro = 100)	
	1990-2008	1999-2008	1990	1999
Ireland	5.86	6.04	76.2	117.8
Spain	2.98	3.74	75.1	71.0
Greece	2.77	4.13	51.5	56.1
Netherlands	2.71	2.50	110.5	119.4
Austria	2.55	2.55	120.2	121.9
Finland	2.37	3.57	156.0	115.7
Portugal	2.20	1.77	43.6	57.0
Belgium	2.10	2.30	114.0	114.2
Germany	1.88	1.65	120.9	119.1
France	1.85	2.19	119.6	110.4
Italy	1.36	1.54	112.4	97.4
Euro	2.60	2.91	100.0	100.0
South	3.03	3.44	71.8	79.9
North	2.32	2.51	124.3	118.0

Source: World Bank Database

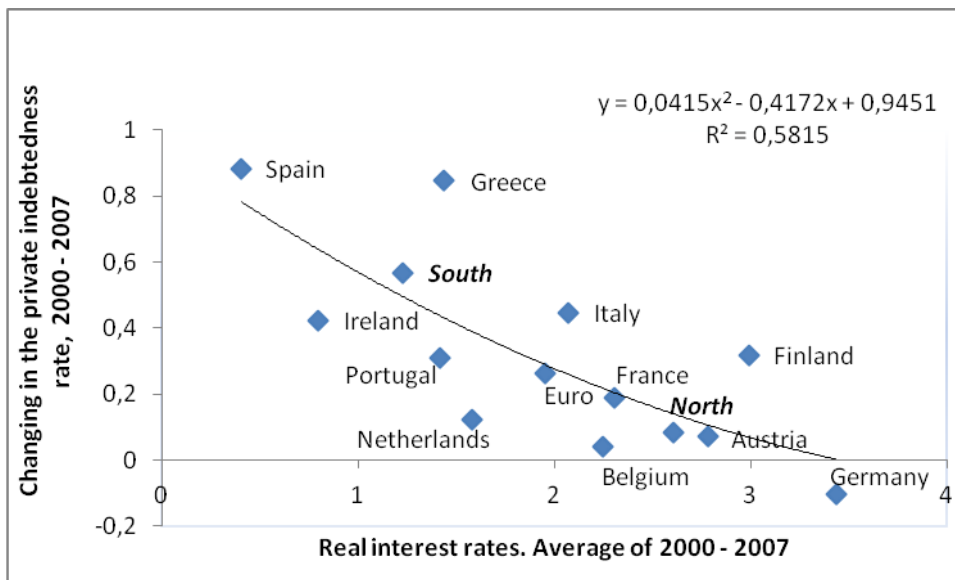
It so happens that this type of convergence was followed by higher inflation. As one can see in Figure 5, the peripheral countries were the ones that had the highest inflation rates during the period. It is worth noting, moreover, that these higher rates of inflation did not come about only due to their higher economic growth, insofar as less developed countries structurally present higher rates of inflation, either by reason of bottlenecks, lack of infrastructure and economies of scale, or also because of a greater distributive conflict. In other words, this means that even in the absence of asymmetric shocks, the acquiescence to the same monetary policy thwarts the convergence of inflation levels in different national economies (MATHIEU & STERDYNIAK, 2007).

<sup>14</sup> This does not disqualify that accounting fraud and excessive indebtedness did in fact occur in Greece, but the same does not apply to Spain and Ireland, countries that until the outbreak of the 2008 crisis recorded fiscal surpluses. In relation to Greece, already in 2004, with the change of government, the European commission was informed of the accounting manipulation that allowed the entry of this country into the Eurozone. Then, the fraud was denounced by the new government, which later, with the help of the U.S investment bank Goldman Sachs enacted new manipulations, discovered only in late 2009 with the return to power of the Labour Party.



**Figure 5** – Average annual rate of Inflation 2001-2008  
Source: Eurostat

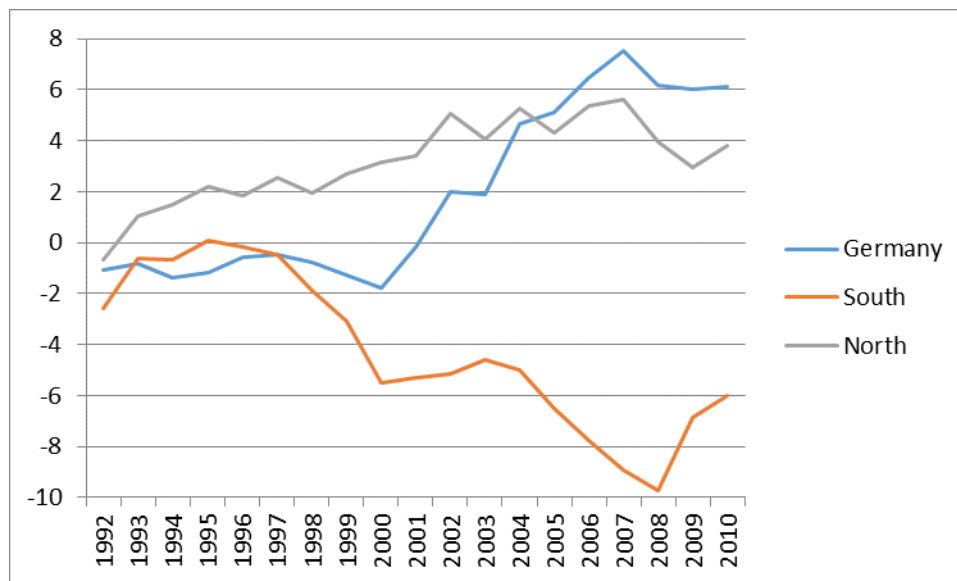
These higher inflation rates in the peripheral countries of the Euro have contributed to two events. In the first place, they collaborated to the divergence in real interest rates between the Eurozone countries. Between 2000 and 2007, for example, the real interest rate in the Northern countries was in average 2.7% and in the Southern countries only 1.2%. These low interest rates, in turn, led to a substantial increase in private debt, a 36% increase in the South versus only a 4% in the Northern countries. As shown in Figure 6, there is a link between the average level of interest rates and the growth in household indebtedness. The great economic growth in the countries of the South was therefore partly underpinned by a debt-led regime, which has fueled housing bubbles, notably in Spain.



**Figure 6** – Real interest rates and private indebtedness  
Source: Author's elaboration based on Annual Macro-Economic Database

On the other hand, the higher inflation rate in the Southern countries, given the impossibility of nominal exchange rate devaluation, has made the exports of these peripheral countries of the Eurozone more expensive, and their imports, in contrast, cheaper [ $E = e(p^{international} / p^{domestic})$ ]. Having the opposite movement taken place in the Northern countries, it has contributed to further asymmetries in the intra-zone competitiveness. Hence, since the Euro's introduction, as the Figure

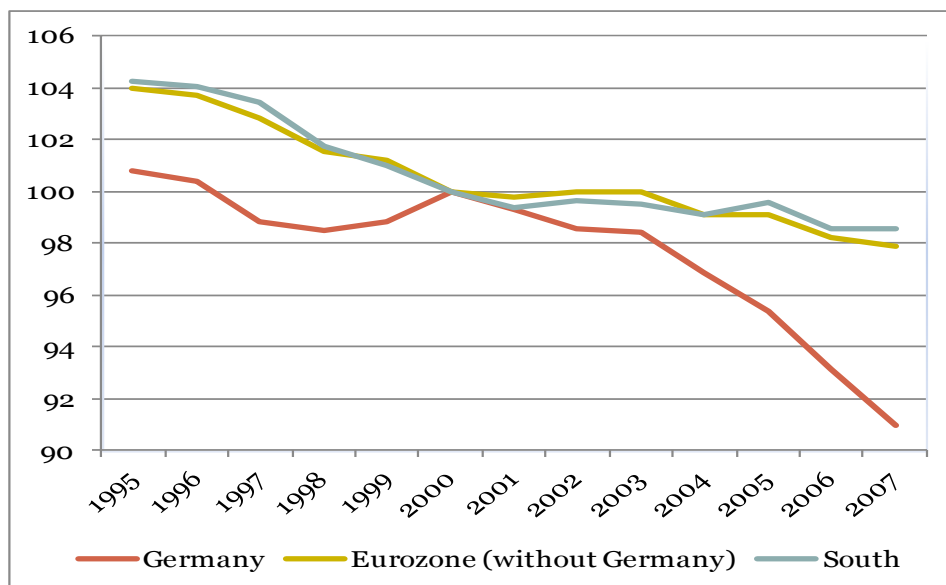
below shows, there has been a tendency for the Northern countries to present surpluses in their current accounts whereas the Southern countries present deficits.



**Figure 7** – Current Account balance in % of GDP, 1992-2010  
Source: Annual Macro-Economic Database

This disequilibrium in the balances of current account between the Eurozone countries, however, cannot be explained only by the rate of inflation. It must be said that, in a neoliberal world, the flexibility in labour markets, or, to be more accurate, the reduction of labour costs, also brings competitive advantages<sup>15</sup>. From Figure 8 we can notice, as a general framework, a decline in real unit labour costs for the whole Eurozone. Until the introduction of the single currency in 1999, in fact, most of the Eurozone countries made a huge effort towards convergence in the sense of lowering these costs. And this competition towards lowering labour costs was later on won by Germany which, first under Gerhard Schroeder's administration and afterwards under Angela Merkel's tutelage, performed a wage freeze without precedents throughout this period, along with pressures to weaken labour unions and to cut back on the value of workers' pensions.

<sup>15</sup> It is worth noting that this mechanism is not always valid, but strictly so in neoliberal capitalism. I.e., the current pattern of incentives nowadays stimulates a race to the bottom in which countries, taken individually, try to reduce their labour costs and flexibilize labour markets. Palley (2004), for instance, makes an analogy with the prisoners' dilemma: given that each country has an incentive to gain a marginal competitive advantage by reducing its labour cost, if one country reduces its cost and the other does not, the former has a larger payoff. The greatest overall payoff, nevertheless, would happen when no country decreased its labour costs and the lowest overall payoff when both had done so. Thus, due to the pattern of private incentives, in the absence of compulsory labour standards, the global (or regional) economy would bear only an equilibrium in which both countries reduce their labour standards (sub-optimal). For the author, in this sense, the only way to stop this process would be through cooperative measures that, by changing the pattern of incentives to governments and entrepreneurs, would carry the economy into a superior equilibrium with higher wages and output.



**Figure 8** – Real Unit Labour Costs (2000 = 100)

Source: Annual Macro-Economic Database

The low rate of inflation in conjunction with reduced labour cost, therefore, were the variables that artificially triggered the rise in competitiveness in Germany and which explain its remarkable surplus in the current account, as already shown in Figure 7<sup>16</sup>.

In general, the depth of the Euro crisis can be better grasped by highlighting the existing link between the budget deficit and the trade deficit in each country. From the accounting equality, we know that:

$$\text{Need for public financing} = \text{private savings} + \text{capital inflows}$$

This equation says that ultimately the public deficit is covered by two feasible sources, i.e. private savings (households and firms) and/or the influx of capital, corresponding to the deficit in the current account. This relationship, moreover, despite not saying much about the self-adjusting mechanism, provides an analytical tool that allows us to clearly distinguish between the Northern and the Southern countries.

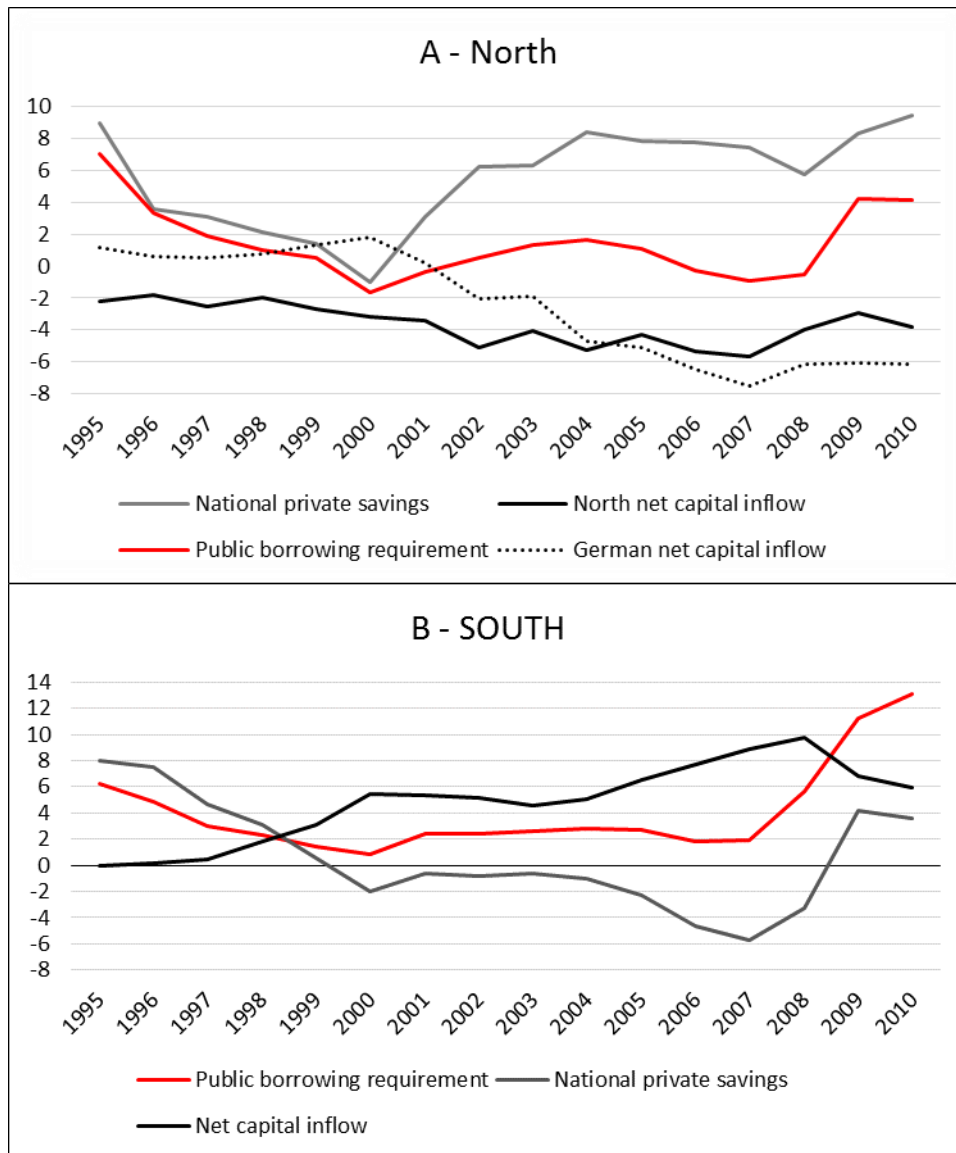
Until the crisis, in fact, the need for public financing evolved, relatively, in a similar manner in both groups of countries. In the North, however, after the introduction of the Euro the national savings rate increased substantially, as well as the exports of capital (above all in Germany) – a counterpart of the trade surplus – represented by the negative influx of capital in Figure 9A<sup>17</sup>.

In the South, on the other hand, the scenario was the opposite and very well periodized. Before the introduction of the Euro, these peripheral countries reduced their budget deficits to comply with the Stability and Growth Pact, having as a counterpart a fall in private savings that were offset by capital inflows. Until the crisis, public deficits did not rise, but from the mid-2000s the imbalances sharpened, because trade deficits deepened, leading to massive capital inflows offset by a decline in private savings. The current account deficit of these countries in the South, it is

<sup>16</sup> A third element may be considered here: the weak growth of domestic demand, and in particular of consumption, because between 1997 and 2007, for example, the consumption, in volume, increased 28% in the Eurozone, 30% in the South, but only 9% in Germany. Anyway, what should be clear is that Germany's competitive gains have nothing to do with increases in productivity induced by Investment. In this sense see RMF Report, 2011 chapter one, p.16.

<sup>17</sup> As we can assume from Figure 9A, the bulk of German surpluses have not derived only, or even mostly, from the periphery, but from across the Eurozone.

worth noting, was – with the free movement of capital established by the Maastricht Treaty, – financed through increasing external banking indebtedness, both public and private, as well as inflows of foreign portfolio investment arising from the surplus countries, which, as a matter of fact, have fed upward spirals of asset prices, spurring, as stated before, housing bubbles in Spain, Ireland and Greece. The outbreak of the crisis, last but not least, manifested itself as a large increase in these countries’ public deficit. At the same time, there was capital flight followed by a big increment in the rate of private savings (Figure 9B).



**Figure 9** – Public borrowing requirement, Net capital inflow and National private savings  
Source: AMECO & HUSSON (2012)

In fact, in 2007, i.e. on the eve of the subprime crisis, nothing could indicate the imminence of a crisis with major dimensions involving the European sovereign debt. The housing crisis in the United States, nonetheless, has become a crisis of the global banking system from the very moment that those toxic securities tied to mortgages were sold as legitimate. Thereby, we came upon a global recession: global banks got weak in terms of liquidity and solvency, including the European banks<sup>18</sup>. The global recession, particularly in 2008 and 2009, meant that National Governments had

<sup>18</sup> It is worth remembering that with the introduction of the single currency, and the consequent elimination of exchange risk, governments of several member countries from Eurozone came into debt, in Euros, on the international market, which resulted in the expansion of indebtedness to investors not residents, leaving these countries potentially exposed to the volatile mood of financial markets.

to intervene in order to support their domestic economies (obviously the capacity to collect taxes and the yield of National Governments were reduced, insofar as their domestic economies shrank). The Northern countries were then better able to sustain their economic activity by raising their public deficit, but the Southern countries, already constrained by current account deficits, had to increase their public debt to exorbitant levels – at least in the view of market players. At the same time, we must bear in mind that the fiscal stimulus measures adopted by these countries in the South to combat the economic downturn were frowned upon by the international agencies of credit rating – that since 2008, with the default episode of Iceland, were on alert over the high level of indebtedness of some European countries. For these reasons, already at the beginning of 2009, with the lowering of the rating of credit risk of these peripheral countries of the Euro area, fears coming from some investors that these countries could not pay their debts were triggered – having as a catalyst the manipulation of public accounts in Greece at the end of 2009. In the last instance, therefore, with the solvency of these countries also in concern, the confidence of investors dropped even more, intensifying the sale of public securities arising from peripheral countries in exchange for German bonds (KRUGMAN, 2011). And it was precisely because of the desperate attempt to sell the bonds of the peripheral countries – generating a fall in their prices and, consequently, an increase in their interest rates (to compensate for the risk) –, that the European financial crisis became a crisis of sovereign debt. The Greek imbroglio, in addition, unambiguously makes clear, due to the intricate and complex financial relationships among banks, governments and companies in a context of globalized and deregulated finance, how severe and contagious the collapse of a small Southern country may be to the soundness of the economies of the North and the Euro itself.

In this sense, the austerity policies embraced since 2010 in a context of low economic growth, as shown in Table 2, have exacerbated the negative impact of the crisis and stopped to contributing even with the decline in the debt to GDP ratio. Thanks to the massive dismissal of civil servants (along with growing private unemployment), budgeting cuts, cuts in salaries and pensions, and liberalizing reforms in health and social security, we are witnessing a true offensive against labour and what is even worse: the dismantling of the European Welfare State for the sake of banks and the interest of finance.

**Table 2 – GDP Growth, Unemployment and Public Debt**

Countries	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
<b>GDP growth rate (percentage change on previous year)</b>											
Ireland	3.7	4.2	6.1	5.5	5.0	-2.2	-6.4	-1.1	2.2	0.2	-0.3
Greece	5.9	4.4	2.3	5.5	3.5	-0.2	-3.1	-4.9	-7.1	-7.0	-3.9
Spain	3.1	3.3	3.6	4.1	3.5	0.9	-3.8	-0.2	0.1	-1.6	-1.2
Italy	0.0	1.7	0.9	2.2	1.7	-1.2	-5.5	1.7	0.4	-2.4	-1.9
Portugal	-0.9	1.6	0.8	1.4	2.4	0.0	-2.9	1.9	-1.3	-3.2	-1.4
<b>Unemployment rate (% labour-power)</b>											
Ireland	4.6	4.5	4.4	4.5	4.7	6.4	12.0	13.9	14.7	14.7	13.1
Greece	9.7	10.5	9.9	8.9	8.3	7.7	9.5	12.7	17.9	24.5	27.5
Spain	11.4	10.9	9.2	8.5	8.3	11.3	18.0	20.1	21.7	25.0	26.4
Italy	8.4	8.0	7.7	6.8	6.1	6.7	7.8	8.4	8.4	10.7	12.2
Portugal	7.1	7.5	8.6	8.6	8.9	8.5	10.6	12.0	12.9	15.8	16.4
<b>Public Debt / GDP</b>											
Ireland	30.7	29.5	27.3	24.6	25.1	44.5	64.8	92.1	106.4	117.6	122.8
Greece	97.4	98.6	100.0	106.1	107.4	112.9	129.7	148.3	170.3	156.9	173.8
Spain	48.8	46.3	43.2	39.7	36.3	40.2	53.9	61.5	69.3	84.2	93.9
Italy	104.1	103.7	105.7	106.3	103.3	106.1	116.4	119.3	120.8	127.0	132.5
Portugal	59.4	61.9	67.7	69.4	68.4	71.7	83.7	94.0	108.3	123.6	128.8

Source: Eurostat and IMF



## 5. Final remarks

Throughout this paper we have argued that the current fiscal crisis of many Euro countries stems not from the fiscal profligacy they supposedly display, as suggested by economic orthodoxy, but rather from the bailout policies and the socialization of private losses, exacerbated by the decline in economic activity and in tax revenues arising from the global recession of 2008. The resulting augmentation of the level of indebtedness, in conjunction with the reversal of the general state of expectations and, as a consequence, of liquidity conditions, led to a rise in risk premiums demanded by creditors, establishing, in this way, a vicious circle of growing levels of public debt in these countries. The solutions to this European crisis, however, are multidimensional and would require another article in itself. Yet, we must highlight some final comments on the subject.

First of all, it is urgently necessary to discard, from the range of alternatives, the austerity policies, which have caused the collapse in demand, the absence of growth, a shortage of private domestic credit (due to liquidity retention of banks) and full social regression around the old continent.

Regarding the possibility of exit from the Euro, in particular of Greece, one should be cautious. In general, it is argued that the exit of a specific country from the zone would allow the return of its exchange policy, which would be able, then, to foster its external competitiveness. Nonetheless, such a measure in itself would not solve the problem of the already accumulated debt and, it would likely lead the country into hyperinflation, as a result of excessive capital flight. The exchange devaluation, furthermore, could even raise the cost of debt. On the other hand, a generalized exit of countries, i.e. an overall fragmentation of the zone, would give rise to a currency war between National States and could drive the resulting dead-lock into exaggerated nationalism – what history has shown to be extremely dangerous. Greece's choice to withdraw from the Euro, in any case, should be subjected ultimately to public scrutiny so that only its society, in a democratic manner, can decide its path.

The maintenance of the 'Euro project', in turn, should be guided by radical changes in its construction. In this sense, a fundamental goal has to be the absorption of the weight of accumulated debt, which, as a matter of fact, makes the restoration of economic activity in the peripheral countries more difficult. A brutal restructuring of this debt, or its cancellation, associated with the socialization of banks would be necessary steps on this new road. The socialization of banks would be, indeed, the only way to untangle the web of debts, given that sovereign debt is, mostly, in charge of banks. The proof for this is the example of *Bankia* in Spain, *Crédit agricole* in France and the greatest absurdity according to which the European Central Bank pours billions of Euros into banks instead of helping the National States directly. The possibility for the ECB to fund the States directly, by the way, could be fruitful, in that it would act as a fiscal transfer mechanism, as likely fruitful would be the injection of capital in the European Investment Bank, the tax on large fortunes, capital controls, the issue of Eurobonds and so on.

The necessary European rebuilding, in short, can only be forwarded through principles of political and economic cooperation that reject inadequate rules as the ones set by the Maastricht Treaty. It is noteworthy that, by determining a fiscal deficit-ceiling without setting a limit to surpluses, these rules forge asymmetries in deflationary conditions and just reinforce the gap between the Eurozone countries. The sovereign debt crisis, as stated in the paper, reveals a deep crisis within the Euro system that requires the rebalancing of the German economy – towards a more inward orientation and increases in the wage share – and, above all, a rupture with the neoliberal institutional framework. This framework, which was brought to light here, has provided excessive wage restraints and undesired flexibility of European labour markets besides triggering a process of ideological homogeneity surrounding the celebration of individualism. In this process, the ethics of solidarity is replaced by the ethics of efficiency and thus the programs of income redistribution and/or that try to reduce regional imbalances find strong resistance within societies. The solution to this crisis, therefore, rests on a paradox, because the principles of economic cooperation and of a Europe based on solidarity among Nations – elements urged when the

integration took shape – are incompatible with the very capitalist logic. This contradiction, notwithstanding, makes the future an uncertain and challenging period.

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