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Governing by Panic: The Politics of the Eurozone Crisis

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Abstract

The Eurozone's reaction to the crisis beginning in late 2008 involved not only efforts to mitigate the arbitrarily destructive effects of markets but also vigorous pursuit of policies aimed at austerity and deflation. To explain this paradoxical outcome, this article builds on Karl Polanyi's account of a similar deadlock in the 1930s. Polanyi argued that a society-protecting response to malfunctioning markets was limited under the gold standard by the prospect of currency panic, which bankers used to push for austerity, deflationary policies, and labor's political marginalization. This article reconstructs Polanyi's theory of "governing by panic" and uses it to explain Eurozone policy during three key episodes of sovereign bond market panic in 2010-2012. By threatening to allow financial panics to continue, the European Central Bank promoted policies and institutional changes aimed at austerity and deflation, limiting the protective response. Germany's Ordoliberalism, and its weight in European affairs, contributed to the credibility of this threat.

Keywords

Karl Polanyi, Euro, Eurozone Crisis, Ordoliberalism, European Central Bank

Introduction

A fundamental, and quite puzzling, contradiction marked Eurozone leaders' efforts to deal with the effects of the world financial crisis that began in 2007-2008. On the one hand, both the Eurozone as a whole and individual European states sought to prevent the transformation of crisis into catastrophe by evading the onset of well-known vicious circles. To combat bank runs and the downward spiral of debt deflation, governments offered deposit guarantees and bailouts, while the European Central Bank (ECB) provided liquidity to the financial sector on an unprecedented scale.¹ To avoid a fall in consumer prices that would reduce incentives to spend and thus put further downward pressure on prices, the ECB sought to cut market interest rates and increase the money supply. Against the tendency of recession to breed more recession as spending and investment retrench in reaction to reduced demand, governments deployed expanded spending on unemployment support and other automatic stabilizers and—in 2009, at least—explicit demand stimulus. Later, Eurozone leaders did not simply stand aside in the face of an accelerating feedback loop between falling bond prices, higher government interest costs, and the prospects for budget balance. Instead, they worked to ease financing constraints for affected national governments. In short, national and international policy responses to the Eurozone crisis were replete with measures premised on the belief that it would be too costly to allow assets to find their own price on markets where pessimistic expectations could feed on themselves.

On the other hand, accompanying this impulse to reject the sovereignty of the price mechanism and to build bulwarks against price collapses was a contradictory impulse—

one that sought to *enforce* the sovereignty of the price mechanism and *dismantle* bulwarks against deflation. Above all, a number of governments, pushed by the ECB and other European institutions, made efforts to fight high levels of unemployment through promoting declines in wages—for instance, by reducing minimum wage rates, by decreasing public sector salaries, by reducing unemployment benefits, by weakening and decentralizing collective bargaining, and by forcing renegotiation of labor contracts in recessionary conditions.² Meanwhile, fiscal demand stimulus that would have moderated downward pressure on wages and other prices was short-lived, and from 2010 states across Europe pursued austerity, seeking to balance budgets through tax rises and spending cuts. Eurozone members also adopted new treaty obligations intended to make austerity in reaction to budget difficulties effectively mandatory.

Thus, Eurozone governments and institutions pursued policies designed at once to protect societies from markets and to subject them more fully to them. They used both fiscal and monetary policy instruments to ward off vicious circles of declining growth or financial implosion, yet did not turn these same instruments to promoting virtuous circles of expansion. Rather than a comprehensive victory for the point of view that prices cannot safely be left to find their own level, or for the rival claim that maximal price flexibility assures rapid adjustment and resumption of growth, one finds a deadlock between contradictory impulses.

This stalemate was not unprecedented. In his 1944 masterwork *The Great Transformation* (henceforth *TGT*), Karl Polanyi traced the interwar European catastrophe to a similar deadlock, one which likewise kept the widely shared impulse to protect the social fabric against arbitrarily destructive markets from growing into a

successful recovery program. Polanyi located the root of this deadlock in the use by bankers of the shadow of financial panic to keep democratic politicians in check. As he put it,

Under the gold standard the leaders of the financial market are entrusted, in the nature of things, with the safeguarding of stable exchanges and sound internal credit on which government finance largely depends. The banking organization is thus in the position to obstruct any domestic move in the economic sphere which it happens to dislike, whether its reasons are good or bad. In terms of politics, on currency and credit, governments must take the advice of the bankers, who alone can know whether any financial measure would or would not endanger the capital market and the exchanges. ... The financial market governs by panic.³

On Polanyi's argument, the gold standard endured as long as it did, despite the tremendous difficulties it entailed, because financial interests feared the political consequences of unorthodox policy by labor governments and wished to retain the potential to govern by panic. The end of the gold standard, by making a currency panic impossible, meant "the political dispossession of Wall Street." No longer constrained to heed the counsel of bankers, governments could launch innovative attacks on economic crisis, as the United States did in the New Deal. However, FDR's unilateral decision to take the dollar off gold was exceptional. Elsewhere, financial leaders retained their capacity for obstruction, and would only agree to abandon the gold standard when labor had been politically neutralized.⁴

Where the gold standard was still in force, and where a drain of gold arising from trade deficits and capital movements threatened convertibility, financial interests used

the prospect of panic to push for austerity and deflation. These policies aimed to achieve the adjustment of international relative prices, restoring trade balance. They were frustrated, however, by a "countermovement," animated by "the principle of social protection aiming at the conservation of man and nature as well as productive organization."⁵ Workers resisted decreases in wages, agriculturalists decreases in food prices, and enterprises the destructiveness of a general deflation. Therefore, "authoritarian interventionism" in service of "vain deflationary efforts" weakened democracy but did not achieve its aim.⁶ Economically, this led to an incoherent policy premised on deflationary aims that could not be attained (and were destructive to the limited extent they were). Politically, the direct opposition between economic and political power meant an undermining of democracy. Only the demise of the gold standard could break the stalemate between the popular principle of social protection and the political leverage of financial interests.

With appropriate but remarkably limited modifications, this article contends, Polanyi's arguments about the political and economic consequences of the gold standard can explain the puzzling contradictions of Eurozone policy diagnosed above.⁷ That this should be so might well have surprised Polanyi himself. After all, the euro was not linked to gold nor even fixed to any external currency. At no point in the crisis was there even a remote prospect of a generalized flight from the euro. Moreover, Polanyi's account of the agenda motivating the bankers of the Great Depression era to deploy the panic weapon was comprehensively archaic by the early 21st century: parties of the mainstream left with not the slightest inclination to set the foundation-stones of

capitalism a-tremble simply could not provoke the kinds of anxiety among capitalists he diagnosed.

Nonetheless, Polanyi's explanation of how "governing by panic" can limit efforts to defend society from market implosions remains highly pertinent to the Eurozone experience, for two reasons. First, even after the shift from gold-backed to inconvertible currencies, financial panic is an endemic possibility under capitalism. As Eurozone sovereign borrowers and their creditors had repeated occasion to observe in 2010-2012, any fungible, widely held asset such as a government bond is vulnerable to a panic if investors believe a general shift in expectations regarding its value is imminent. A currency panic is thus only one species of a more general phenomenon.

An inconvertible currency does, however, offer a central bank an almost invincible weapon against panic: the use of money creation to buy up assets and coordinate investor expectations about prices. Most students of central banking consider this "lender of last resort" role to be a fundamental advantage of the institution.⁸ But capacity to act as a lender of last resort does not entail a willingness to do so. The second reason Polanyi's theory proves relevant to the Eurozone crisis is that in its course politicians and technocrats could and did use the prospect of financial market panic for political leverage. The European Central Bank (ECB), as demonstrated below, repeatedly threatened to refuse to serve as a lender of last resort for government bonds unless certain policy prescriptions were met. These prescriptions aimed to promote the "Brussels-Frankfurt consensus," which substantially recapitulated the financial orthodoxy of the 1920s and 1930s in its support for austerity and promotion of the price

mechanism.⁹ Because with the move to the euro national governments had no capacity of their own to serve as lender of last resort, they acceded to these demands.

The result was a new deadlock between social protection and panic-enforced fiscal orthodoxy, one that had effects similar to its 1930s analogue. Economically, the Eurozone pursued an incoherent effort to at once induce deflation via austerity and to fend it off. Politically, what in Polanyi's case was a split between political power and economic power became, in the Eurozone case, a split between nationally organized political power and transnational economic power channeled by the ECB, again with severe consequences for democracy. Even the ECB's eventual acceptance of a lender-of-last-resort role (in mid-2012) paralleled one path to the demise of the gold standard Polanyi described: it happened only after opposition to austerity had been politically neutralized, in this case via the drastic curtailment of the budgetary autonomy of national states.

The balance of this paper is organized as follows. The first section reconstructs Polanyi's analysis of the economic background of the Great Depression, and of the role of "governing by panic" in the political deadlock that ensued, with a particular focus on the British case. The second section uses this same case to give Polanyi's argument more institutional specificity, focusing on the particular role of central bankers and the strategic difficulties they face in credibly threatening to let a market panic rage, and how the gold standard enabled such threats. The third section examines the Eurozone crisis, describing both a protective reaction and the emergence of an austerity agenda enforced through panic. It suggests that in the absence of a gold standard, the capacity of the ECB credibly to refuse to serve as lender of last resort depended crucially on the

influence of Ordoliberalism on German policy makers and institutions, and discusses the political circumstances under which the ECB came to accept a lender-of-last-resort role. The conclusion situates the Polanyian explanation in relation to other approaches.

The Deadlock of the 1930s

In Polanyi's interpretation, the political and economic disasters of the interwar period arose from the intersection between two causal processes. The first was his famous "double movement," "the clash of the organizing principles of economic liberalism and social protection."¹⁰ In practical terms, "economic liberalism" means here the gold-standard adjustment mechanism linking international trade, wages and other prices, and monetary policy, whereas "social protection" encompasses anything that interferes with this mechanism. The second causal process was the "conflict of classes," which blocked any coherent response to the depression that arose from the malfunctioning gold standard's baleful effects.¹¹ Working-class influence in a democratic political system blocked a deflationary response, but the strength of capitalists in the economy, and in particular the threat of market panic, forestalled a stimulationist one.¹² The resulting "deadlock" between democracy and markets led to fascism, which was avoided only if the gold standard was abandoned before the collapse of democracy. The remainder of this section offers a detailed reconstruction of Polanyi's argument.

The gold standard—the axis around which Polanyi's entire narrative turns—was described by Hume in the 18th century as an automatic equilibrating mechanism for international trade and prices: prices at an uncompetitive level lead to a trade deficit, which gives rise to gold outflows, a consequent decline in the money supply, and thence a fall in prices that restores competitiveness and the trade balance. Polanyi saw the

effects of allowing the mechanism to operate in this way as manifestly ruinous due to the deflation it would often imply. In a context of falling prices, sales may fail to cover costs (such as wages) fixed by contract, leaving enterprises "in danger of liquidation accompanied by the dissolution of productive organization and massive destruction of capital."¹³ According to *TGT*, two forms of social protection arose to ensure against this sort of arbitrary and unnecessary destruction.¹⁴ The first was central banking, which offered some flexibility on how, and how rapidly, trade deficits and associated gold outflows translated into contractions in the supply of paper currency created against gold reserves.¹⁵ The second form of social protection applied specifically to the price of labor, where "social legislation, factory laws, unemployment insurance, and, above all, trade unions ...[interfere] with the mobility of labor and the flexibility of wages."¹⁶

The potential deflationary implications of the restored gold standard of the interwar period, Polanyi implies, were much greater than those of the 19th century, for the relevant currency values required much larger price adjustments to balance trade.¹⁷ To the extent that central banking or wage-defense mechanisms blocked deflation, trade deficits and associated gold drains persisted.¹⁸ Polanyi notes two related responses. The first was trade protectionism, whether direct or via various forms of exchange restriction.¹⁹ Keynes, for instance, advocated a protective tariff to avoid abandoning the gold standard in the summer of 1931.²⁰ Thus, "the incubus of self-sufficiency haunted the steps taken in protection of the currency,"²¹ and this had cumulative effects in reducing international trade.²² The second response to blocked deflation Polanyi emphasizes was the spread of international credit, used to finance the balance of payments deficit.²³ The joint result of these two responses was a waxing of international

capital movements as international trade waned.²⁴ However, this "perpetual borrowing"²⁵ was doomed to be temporary. Internationalized finance transmitted the effects of the U.S. stock market crash to the rest of the world, and international credit dried up.²⁶ "The interdependent deficit economies went into an irreversible slide, and the whole stabilization structure collapsed."²⁷

Without credit available to cover the balance of payments deficits, national authorities faced a choice between two unappealing options: massive deflation or exit from the gold standard. Polanyi's explanation of why the gold standard was not simply abandoned to obviate deflation is of particular significance for understanding the politics of the interwar tragedy. In part, Polanyi contends, the gold standard's persistence stemmed from its role in international economic integration and from its powerful ideological sway.²⁸ But another important factor was class conflict, and in particular the way in which capitalists regarded the gold standard as a critical weapon in this conflict. The gold standard meant that any national currency was vulnerable to collapse in a panic: if a sufficient number of currency holders were to demand conversion of their notes into gold, convertibility would have to give way. This circumstance, as Polanyi argues in the passages quoted at the outset of this paper, gave capitalists substantial political influence. When labor parties were in power—as in Britain in 1929-1931 and France in 1936-1937—the prospect for capital flight (via conversion of currency) ensured capital-holders a veto over radical measures. As long as labor was politically potent, Polanyi maintains, capitalists insisted on the gold standard for political, not just economic reasons.

Polanyi suggests that the gold standard as a source of political leverage was so fundamentally important to capitalists because they feared that labor's political power represented an existential threat. This was not because a repetition of the Bolshevik revolution in Europe was in any regard likely.²⁹ Instead, capitalists feared that labor "might disregard the rules of the market which established freedom of contract and the sanctity of private property as absolutes." The consequences of this lack of what nowadays would be termed credible commitment to capitalism Polanyi describes in dire terms that would do any market liberal proud: moves along these lines "must have the most deleterious effects on society, discouraging investments, preventing the accumulation of capital, keeping wages on an unremunerative level, endangering the currency, undermining foreign credit, weakening confidence and paralyzing enterprise." This was the source of "latent fear which, at a crucial juncture, burst forth in the fascist panic."³⁰

How the gold standard was made to serve the purpose of limiting labor's freedom of political action comes through more clearly when Polanyi's compact discussion of relevant cases is fleshed out with further contextual details. In 1936, Polanyi writes, the socialist Blum took power in France "on condition that no embargo on gold exports be imposed," leaving the panic weapon available.³¹ Although Blum did devalue the currency after coming into office, it remained tied to gold via a specified trading band. However, even this was abandoned shortly after Blum resigned in the summer of 1937 and a new government formed by the middle-class Radicals took power.³² This is the background to Polanyi's claim that "once labor had been made innocuous, the middle-class parties gave up the defense of the gold standard without further ado."³³

Polanyi asserts that this last statement applies to Britain as well, where he has in mind the fall of the Labour government (in August 1931) and the subsequent abandonment of sterling's tie to gold (in September). The proximate cause of the fall of the Labour government was negotiations over balancing the budget deficit, which had been swollen by unemployment support expenditures.³⁴ Trade unions and many members of the government wished to accomplish this by raising taxes. Prime Minister MacDonald, as well as the Bank of England and the opposition parties, wanted to cut unemployment payments (the dole) instead. These discussions took place on the backdrop of strong speculation against sterling that left Britain in urgent need of international loans, which were solicited from New York bankers Morgan Grenfell on the basis of MacDonald's proposal. The bank replied that it could arrange a short-term loan only if the budget-cutting proposal could be expected to pass Parliament, and if its announcement would reassure the City and the Bank of England. Told of this, Labour ministers who opposed MacDonald's proposal resigned, claiming that the government was cutting unemployment benefits at the insistence of bankers. MacDonald formed a new "national government" with the opposition and pushed cuts in the dole through Parliament. The incident became known as the "bankers' ramp" (with ramp being used in the obsolete sense of a market manipulation).³⁵

In *TGT*, Polanyi pointedly affirms the existence of the "ramp," but focuses on Labour's effort to maintain incompatible commitments to high social spending and the gold standard.³⁶ An analytically parallel but much fuller account can be found in the journalism he wrote as these events were unfolding, in which he argued that "no immediate danger threatened the pound in August,"³⁷ and traced the financial panic

almost entirely to politics.³⁸ The purpose of the political deployment of market panic was to enforce the deflationary solution to the problem of international adjustment under the gold standard:

[Chancellor of the Exchequer] Snowden and the City had resolved to reduce unemployment support and to improve the English balance of trade through a general reduction in wages and increased export. This was their long-range program for defending the pound's gold parity. In order to carry it through, the dangers threatening the pound needed to be painted on the wall as luridly as possible, in order that the stabilization of state finances—including, to be sure, curtailed unemployment support—appeared as the only path to salvation. To impose this path on the country under the *diktat* of foreign bankers was the dominant political idea of the August situation.³⁹

That the conflict over the terms of the Morgan Grenfell loan brought down the Labour government illustrated, for Polanyi, the fundamental conflict between government by panic and democracy. Alternative measures to address the crisis acceptable to Labour's political base—maintaining unemployment payments while balancing the budget by higher taxes—were unacceptable to financiers, and the threat of capital flight gave the latter's preferences political weight. "The removal of the Labour Party from office was meant, like that of the French Cartel in 1926, to lend the pound new stability as guarantee against a capital flight driven by tax policy, which would have been a completely new phenomenon for England."⁴⁰

If in Britain and France financial markets dictated the scope of democratic governance, the U.S. case showed the opposite pattern. Polanyi argues that

Roosevelt's decision to abandon the gold standard—which he appears to link to FDR's idiosyncratic economic views—was a crucial precondition for the success of the New Deal, as it accomplished "the political dispossession of Wall Street"⁴¹ insofar as Wall Street's power rested on the possibility of politically motivated capital flight.

Thus, Polanyi discusses two paths to the preservation of democracy in the interwar period, both of which required exit from the gold standard but relied on distinct political formulas. In one, exemplified by the British and French cases, the political power of labor was broken via successful financial market pressure on elected officials, giving capitalists the political comfort they needed to allow the surrender of the gold standard and with it the powerful threat of capital flight. (Polanyi doesn't rate the "democratic" character of the resulting system very highly, but formal democracy was preserved.) The other possibility was the pre-emptive abandonment of the gold standard by democratic politicians, as accomplished in the United States. Democracy and the market economy were rendered compatible a radical reduction in the influence of either labor or capital.

When both labor and capital retained power, however, the result was "deadlock" and "a social catastrophe of the Continental type."⁴² Polanyi describes this catastrophe only in relatively general terms, with little discussion of concrete cases. However, he includes Brüning (German chancellor 1930-1932) among politicians who pursued a deflationary policy to protect the gold standard,⁴³ and the German case clearly lies behind many of his more general descriptions. As Polanyi summarized, "in the course of these vain deflationary efforts free markets [were] not restored though free governments [were] sacrificed."⁴⁴ Brüning's use of Presidential decree power to back deflationary

policies would, for Polanyi, have been a clear instance of the "authoritarian interventionism" that "resulted in a decisive weakening of the democratic forces which might otherwise have averted the fascist catastrophe."⁴⁵

To sum up, then, Polanyi's view of the gold standard crisis: given the downward rigidity of prices, the gold standard ensured persistent trade imbalances, which could endure so long as international credit was available. But once credit became scarcer after the collapse of the U.S. stock-market boom, either the gold standard itself had to give way or prices in trade-deficit countries had to fall. The gold standard, though, was strong, for reasons both political—by amplifying the danger of financial panic, it served as a bulwark against socialist policies—and economic, as the basis of international economic integration. When for these political or economic reasons the gold standard endured, the austerity agenda needed to push down prices could only happen if the vociferous objections of labor were suppressed. This undermined democracy and paved the way for fascist coups.

Political Use of Market Panic: Some Preconditions

Polanyi's insights into the way the prospect of market panic can become a political weapon, I will argue below, shed a great deal of light on the course of the Eurozone crisis. Before turning to this argument, however, it is worth exploring in greater depth the preconditions for the 'weaponizing' of market panic and the circumstances in which these preconditions are likely to obtain.

Financial panic is often straightforwardly and convincingly described as a coordination dilemma between owners of some liquid asset.⁴⁶ If the asset owners

maintain their holdings, the value of the asset remains stable. If they all try to sell it, the value sinks sharply. An asset holder that fears a general sell-off ought to try to sell first, but if all act on this logic they produce a price collapse as a self-fulfilling prophecy. As long as some sort of binding general agreement between asset-holders is not possible, each asset holder must regard apprehensively any information that could induce other asset holders to sell.⁴⁷

That the prospect of financial panic stems from a lack of coordination among financial market participants indicates an ambiguity in Polanyi's claim that "the financial market governs by panic." Who, exactly, does the governing? An authoritative representative of asset holders tasked with ensuring their interests could presumably try to brake panic dynamics rather than pursue any sort of broader political agenda. There are two paths out of this analytical difficulty. One, on which Polanyi implicitly relies, is to suggest that asset holders have shared aversions to particular economic policies (such as taxation of the wealthy to fund unemployment insurance). Even without explicit coordination, they can be expected react in parallel ways to the prospect of the introduction of such policies, creating the preconditions for panic, which thereby becomes an effective political constraint.⁴⁸ Whether this causal mechanism is plausible depends on concrete circumstances, but certainly it is not always the case that policy preferences among asset holders are of a sufficiently general, coherent, and absolutist character for it to operate.⁴⁹

There is, however, a second means of political instrumentalization of market panic. An actor (such as a central bank) with the capacity to coordinate expectations—to fuel or calm panic fears—may also attempt to derive political leverage from this fact. This

possibility is indeed illustrated by the British case that Polanyi analyzed. As the sustainability of sterling's peg to gold came into question in the summer of 1931, the Bank of England had the task of calming market fears by selling gold reserves, and arranging international lending to supplement these reserves. However, Bank leaders, especially Deputy Governor Ernest Harvey (who ran Bank policy during much of the period), were not reticent in impressing on politicians a particular interpretation of what would calm the markets or make foreign credit available, stressing budget balance above all.⁵⁰ Eventually, Harvey shut down intra-Labour bargaining over how to deal with budget deficits by warning of an imminent exhaustion of gold reserves (while ruling out raising interest rates as an alternate way of preserving them), apparently deliberately seeking to bring about a government collapse.⁵¹ This had the effect of strengthening the hand of those who favored spending cuts rather than progressive tax rises as a means to balancing the budget.⁵² Even Harvey's final decision to abandon the gold standard was an effort to force the government to cancel an impending election he feared (incorrectly) that Labour would win.⁵³ This was very much an effort to "govern by panic," but an effort mediated through the specific institutional agency of the central bank.

Understanding the important co-ordinating role of a lender of last resort in facilitating "governing by panic" weakens Polanyi's case that the abandonment of the gold standard should eliminate the phenomenon. *For a currency panic is not the only sort of panic in which the threat to withhold last-resort lending might become politically relevant.* As Minsky has convincingly argued, capitalism will continually create the preconditions for panics that operate analogously to bank runs, ensuring the permanent relevance of the lender-of-last-resort role.⁵⁴ Polanyi, however, has very little to say on

the subject of bank runs and other financial crises not linked to gold convertibility. He merely notes the danger that the gold standard might mandate "fatal monetary stringency in a panic."⁵⁵ This remark suggests that Polanyi may have discounted financial panic's continued political relevance because he had no particular reason to expect that a central bank, absent a gold constraint, would refuse to calm the waters when necessary. The rise of central banking reflected, after all, part of society's self-defense against the self-regulating market's arbitrary destructiveness.

Although Polanyi did not bolster this position by analyzing the strategic interactions of central bankers and politicians, such an analysis might appear to reinforce his case.⁵⁶ A central bank can use the prospect of market panic as a tool of political influence only if it can make a credible threat to allow the panic to happen.⁵⁷ Under the gold standard, the credibility of this threat comes from the fact that the central bank can in fact lose a battle to avoid a flight from the currency when gold reserves are exhausted (though even in these circumstances shrewd central bankers may seek to maximize their influence by concealing the panic-fighting capacities they do have available, as Harvey probably did).⁵⁸ Without the gold standard, allowing a panic when fiat money could prevent it would seem to have consequences too extreme to make it a credible threat.

There are thus two reasons one might contend that the demise of the gold standard would eliminate the use of looming market implosion to impose political decisions: one could share Polanyi's optimism that it would free central bankers to defend society against the arbitrary destructiveness sown by panic, or one could suggest that absent an inflexible gold constraint no threat to permit a panic would be believed. As the next section shows, the re-emergence of governing by panic in the course of the Eurozone

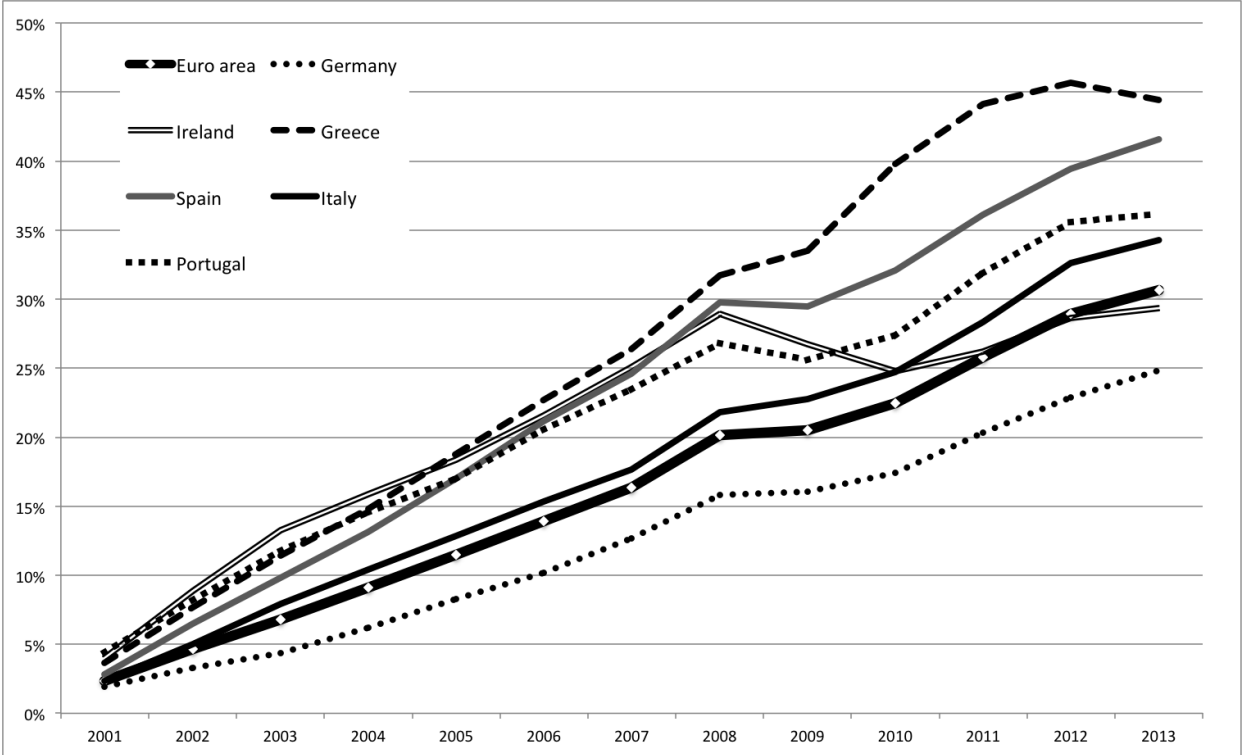
crisis demonstrated that both contentions are misleading: Central bankers proved to have a political agenda distinct from Polanyi's societal self-protection, and inflexible ideas about rule-governed action served as a strategic substitute for the inflexibility of the gold standard.

The Deadlock of the 2010s

The early 21st century plight of the Eurozone displays resonant parallels with Polanyi's description of the deadlock of the 1930s, but there are also significant differences. The economic prelude to the Eurozone crisis was a period of large intra-European trade imbalances. As in the 1920s, ample credit made these trade imbalances easy to fund. The analogy is not exact, though. Polanyi viewed international credit as disrupting the self-adjusting mechanism the gold standard was designed to enable, slowing down relative price adjustment. In the Eurozone, international credit did not merely slow price adjustment, but actually exacerbated price disparities. The introduction of the Euro meant that the European Central Bank set a single interest rate for all Eurozone countries. However, cross-country distinctions in inflation rates did not disappear. This meant that real interest rates were different in different Eurozone countries. In low-inflation countries real interest rates were high, while in high-inflation countries real interest rates were low. Thus, the Eurozone's single interest rate had a pro-cyclical character—delivering monetary stimulus to the higher inflation countries, and monetary restriction to the lower inflation in countries.⁵⁹ Cross-country financial flows were one way these monetary effects worked themselves out. Credit flows thus

not only compensated for trade imbalances, but actually drove relative price movements in a way that intensified, rather than relieving, these imbalances (see Figure 1).⁶⁰

Figure 1: Cumulative consumer price level (HICP) change since 2000



Source: ECB

Germany was central to these developments. For low-inflation Germany, the Euro's introduction was recessionary, exacerbating an already difficult unemployment situation. Germany did not react to the recession by seeking to launch a program of domestic fiscal demand stimulus. This was more or less out of the question under the Maastricht criteria: even the action of automatic stabilizers meant that Germany was breaching these criteria by 2003.⁶¹ Instead, Germany initiated labor-market reforms (the Hartz IV and Agenda 2010 initiatives) that facilitated the creation of low-wage jobs. At the same time, those parts of German industry subject to collective bargaining began a long period of wage restraint. In a closed economy, policies to hold wages down have

limitations as a growth strategy, insofar as wages are also the source of demand. But in an open economy, wage restraint's damping effect on domestic demand may be compensated for by export demand—assuming export markets are growing.⁶² But this was just the situation the pro-cyclical character of Eurozone monetary policy created: Germany's Eurozone trading partners were benefiting from substantial monetary stimulus, the magnitude of which grew with their inflation rates. Rising wages in some Eurozone countries made the citizens more able to buy German exports, and at the same time made wage-earners less competitive compared to German ones. It is no surprise, then, that German exports surged and trade balances on the Eurozone periphery went sharply negative. Trade deficits were funded by lending from German banks recycling export earnings.⁶³

This pattern of international financing came to an abrupt halt in the autumn of 2008, but it was to have an important legacy thereafter. The run-up to the Eurozone crisis saw the accumulation of multiple forms of what Minsky termed "financial fragility," fueled by international credit.⁶⁴ Borrowers in trade-deficit countries, including the governments of those countries, came to rely on the continued availability of incoming financial flows. Banks on the other side of these transactions could thus only be assured of receiving expected repayments as long as general credit conditions remained easy. Meanwhile, in two Eurozone countries, Ireland and Spain, a boom emerged in housing markets. Low Eurozone interest rates were probably a facilitating condition in kicking off the booms, though not a sole explanation (Portugal and Italy did not see similar booms). They were fueled by the classic Minskyian collateral appreciation-credit easing cycle, backstopped by the recycling of German export receipts. The resulting economic growth

swelled tax revenues, and the fiscal position of the two countries became much stronger—but also more fragile, in that the positive fiscal balance implicitly relied on the speculative finance that was fueling the housing booms.⁶⁵

From the Crisis to a New Deadlock

Thus when the "elastic band snapped,"⁶⁶ and international credit conditions tightened overnight, the financial fragility that had emerged over the course of the euro's first decade meant that the conditions for debt deflation and financial panic were very much in place. The effects of the financial crisis hit Europe in two stages. In the first, which began as early as 2007 but intensified massively after the failure of Lehman Brothers in September 2008, the crucial issue was financial fragility in the banking sector. Some European banks had become heavily reliant on the US financial system both for liabilities and for assets, and the implosion of the markets for short-term credit and securitized sub-prime mortgages pressured both sides of their balance sheets and threatened their imminent financial ruin, which might well have led to a general collapse of the European financial system.⁶⁷ There was no "fatal monetary stringency" in the face of this panic, though. The ECB made ample credit available.⁶⁸ However, this dealt primarily with the liabilities side of balance sheets and had only a limited effect in stopping the collapse of asset values, whether of exotic mortgage-backed securities from the US or simply of housing prices in Ireland and Spain. On this background, national governments across Europe took steps to bail out their banking sectors, such as Ireland's decision to offer a state guarantee of its banks' liabilities.⁶⁹

Despite these measures, and parallel ones in other large markets like the US and UK, this first phase of the financial crisis was also accompanied by a huge fall-off in

demand. Here, too, European governments were not passive. Late 2008 and early 2009 saw a significant expansion in deficit spending, including the operation of automatic stabilizers and some explicit demand stimulus; Germany's demand stimulus package was the most significant, though perhaps the least advertised.⁷⁰

In broad, then, the Eurozone's initial reaction to the crisis was the sort of protective countermove that Polanyi would have expected. Rather than accepting the catastrophic consequences of letting labor, money, or risk find their price on an imploding market, fiscal and monetary policy sought to modify or reverse price pressures. Nonetheless, a second phase of the financial crisis began after the revelation of the extent of Greece's debt problem in late 2009. The hallmark of this new phase was a sudden and large jump in interest-rate differentials between Eurozone sovereign borrowers, with the so-called periphery (Greece, Portugal, Ireland, Spain, and Italy) paying dramatically higher rates.⁷¹ The financial fragility facing fiscal authorities became manifest as refinancing of sovereign debt in the market on acceptable terms became difficult or even impossible. Because interest payments were an important component of government spending, the danger of self-fulfilling market predictions of debt unsustainability (pessimism breeding higher interest rates breeding deeper pessimism) became significant.⁷² Meanwhile, weak sovereign debt prices created additional dangers for the financial system; holdings of peripheral debt were heavily concentrated in Germany and especially France.⁷³

Again, Eurozone authorities did not simply step aside and watch asset prices reach levels that would have bred financial collapse via rapid debt deflation and sovereign defaults in the face of market panic. From May 2010, the ECB expanded lending to banks and began intervening in sovereign debt markets to hold down interest rates.⁷⁴

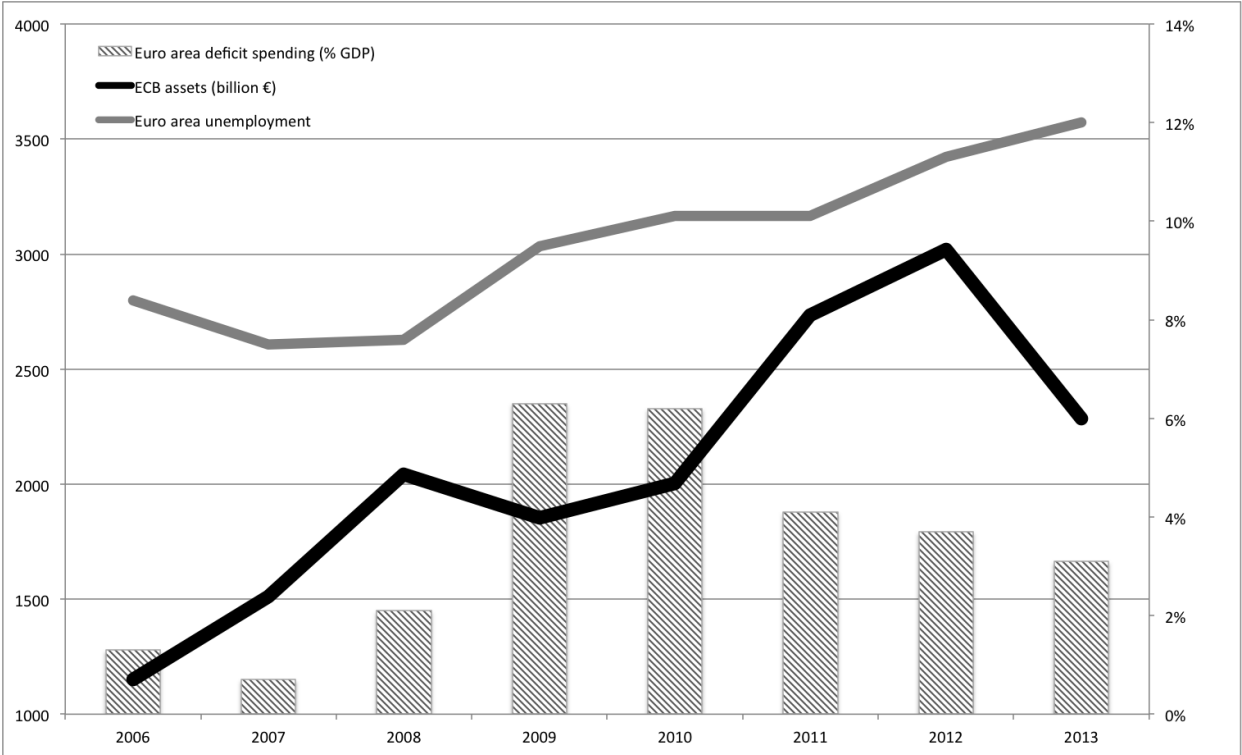
Concentrated in the peripheral countries where banks were facing the greatest difficulties, ECB lending served as an alternative source of financing for these countries' trade deficits, compensating for the "sudden stop" of private financing.⁷⁵ Multilateral arrangements, worked out in a large number of Eurozone or broader EU summit meetings, provided fiscal support, including for banking rescues, in Portugal, Ireland, and Greece.⁷⁶ This international response greatly exceeded the limited multilateral interventions that had sought to shore up the gold-standard system, and provided forms of support that had been all but absent in the earlier period.⁷⁷

The post-crisis protective response from the Eurozone thus in many ways outstripped its interwar predecessor in vigor. But this response was nonetheless limited and riven with contradictions in ways remarkably analogous to those Polanyi describes. As domestic demand in the peripheral countries shrank or stagnated, reducing trade deficits via increased exports was a requisite of growth. But such an expansion was difficult to achieve. Like the gold standard, the euro had no adjustment mechanism for international trade imbalances other than deflation—the very deflation protective measures worked against. If trade deficit countries could not regain competitiveness via downward price adjustment, then the only way their price levels could sink relative to those of the trade surplus states was if the latter's prices rose more quickly. However, there were no policies in place to promote this. ECB policy pushed against outright deflation, but remained very far from promoting a level of inflation that would facilitate the emergence of substantial cross-country differentials in inflation rates (see Figure 1). Indeed, the leaders of Germany, with by far the largest intra-European trade surplus,

explicitly and repeatedly rejected this route to rebalancing.⁷⁸ By early 2014, only Ireland had seen any substantial adjustment of prices against the German benchmark.

The protective countermove was also limited by intensive efforts—described further below—to ensure that assistance of all sorts was conditional on implementation of liberalization and austerity measures intended to promote competitiveness by increasing price flexibility, especially for wages.⁷⁹ Anti-deflationary monetary policy was thus combined with pro-deflationary fiscal and reform policy. The broad pattern can be seen in Figure 2. While the trends vary somewhat by country, a turn from fiscal stimulus to austerity was taking place as early as 2010, somewhat compensated by expansive monetary policy.

Figure 2: Evolution of Eurozone Budgets, Money Creation, and Unemployment



Source: ECB

The Strategic Power of Neoliberal Ideas: the Brussels-Frankfurt Consensus and Ordoliberalism

The Eurozone, in sum, was experiencing a deadlock between deflationary and protective impulses analogous to the one Polanyi described—and with analogous political origins, as this section demonstrates. The political parallels between the two periods arose because the key elements of Polanyi's causal mechanism found functional substitutes in the 2010s. The role of capitalist fear of labor radicalism was played by the neoliberal "Brussels-Frankfurt consensus,"⁸⁰ strongly entrenched in the European Central Bank. ECB pursued this neoliberal agenda by threatening to allow a self-sustaining market panic unless their conditions were met. As for the role of the gold standard in making such threats credible, here the functional substitute stemmed in part from the institutional structure of the Eurozone, which gave Germany an effective veto over many of the measures needed to promote the protective reaction. The thorough embedding of Ordoliberalism, the particular German variant of neoliberalism, in Germany's institutions and policy-making culture made the prospect that this veto would be used credible.⁸¹ The strategic power of Ordoliberalism derived from the central role of rule-bound action in this policy approach.⁸² Because Ordoliberalism offered resources to justify even catastrophic consequences in an individual case by citing the broader benefits of rules, actors with a commitment to Ordoliberalism could credibly threaten to veto policies required to ward off market panic. Both the Brussels-Frankfurt consensus and Ordoliberalism have loomed large in a number of previous explanations of Eurozone crisis-fighting policy⁸³ The distinctive contribution of a Polanyian interpretation is to show how the prospect of market panic was crucial to establishing the influence of these two closely related sets of ideas.

The Brussels-Frankfurt consensus can be compactly identified with attachment to stable money, sound finances, and efficient local-factor markets, especially labor markets.⁸⁴ Ordoliberalism, while it encompasses these three elements, has additional commitments that require somewhat longer description. Ordoliberalism is a specific variant of neo-liberalism that emerged in Germany in the inter-war period and received canonical formulation in the post-WWII era, especially in the works of Walter Eucken and Franz Böhm.⁸⁵ Like other market liberals, Ordoliberals extolled the role of the price system in coordinating economic action. To make the price system work they advocated market competition: businesses and individuals struggling against one another to make sales to sovereign consumers. However—and the point is crucial to the entire Ordoliberal project—the economic system cannot be counted on spontaneously to evolve to ensure this outcome. Only state action will bring it about.⁸⁶ Thus, compared to the Austro-American version of neoliberalism more familiar outside of Germany, Ordoliberalism offers a much more unambiguous and less conflicted embrace of the role of the state in giving order to a market economy.⁸⁷

Nonetheless, Ordoliberals, like other market liberals, sought to ensure that state powers necessary to underpin markets were not turned to purposes of which they did not approve. To this end, the economy should be governed by an "economic constitution" which should ensure that the state's actions are constrained to take the form of general rules, an *Ordnungspolitik* or ordering policy.⁸⁸ In this, the spirit of Ordoliberalism partakes of the continental or Roman approach to law (also known as civil law), which emphasizes the role of exhaustively codified rules and rejects the situational judgment characteristic of the common law approach.⁸⁹ The mandate for

Ordnungspolitik and pre-codified rules, like the proscription of case-by-case decision, were intended to limit the scope of action available to democratic governments, complicating efforts at rent-seeking by ruling out exceptions for particular situations, industries, or professions.⁹⁰

Ordoliberalism's legal philosophy did not enjoy unchallenged sway in post-war West Germany. Ordoliberal theory had to compromise with a corporatist praxis it could not fully encompass nor defeat, a compromise encapsulated by the well-known "social market economy" formula.⁹¹ Nonetheless, its influence was far from negligible. For instance, a constitutional change was required before West Germany could begin a brief and limited experiment with contextually responsive demand stimulus in the late 1960s.⁹² Ordoliberal ideas had particular (though not exclusive) influence in shaping West Germany's negotiating approach to European Monetary Union, and had much to do with the rule-based character of the resulting Maastricht treaty.⁹³ In 1993, a decision by the German Constitutional Court (*Bundesverfassungsgericht*) on a challenge to the Maastricht treaty had the effect of entrenching an Ordoliberal interpretation of its meaning.⁹⁴ The decision defended the treaty against the claim that by denuding German voters of sovereignty it violated democratic principles by arguing, in the spirit of Ordoliberalism, that constraints on democratic governments could promote good economic governance.⁹⁵

The court further argued that the provisions of the treaty were sufficiently well specified to grant European institutions determinate authority, any exceeding of which would require treaty modification and thus a new democratic imprimatur. In the

meantime, the court declared, European decisions found to supersede treaty authorizations would not be binding on German institutions.⁹⁶

After the financial crisis, rules and institutions inspired by Ordoliberalism became entangled in a well-known dilemma: strictly rule-bound behavior runs the risk of producing perverse consequences in an individual case for which the rules are poorly suited. Ordoliberals do not seem to have grappled with the dilemma on this level of abstraction, but their texts suggest they were "rule consequentialists."⁹⁷ Rule consequentialists resolve the perverse consequences dilemma by arguing that the consistent operation of properly chosen rules will have beneficial consequences that outweigh any undesirable outcomes arising from the application of rules to a particular case. In a political economy context, such reasoning is regularly encountered in the discussion of soft budget constraints and moral hazard, discussed in Ordoliberalism as the problem of proper assignment of liability to market actors. Such arguments generally contend that the attractions of mitigating some particular economic disaster must be resisted due to the broader consequences of allowing market participants to expect such mitigation, which can promote profligacy and excessive risk-taking.⁹⁸ In the same vein, Eucken also makes a more general argument for "constancy in economic policy" to avoid discouraging long-term investment.⁹⁹ The beneficial consequences of rule-bound action are asserted and the possible situational advantages of policy change (for instance, preserving existing long-term investments, as Polanyi suggests) are not discussed.

Carried to an extreme, a consequentialist defense of a rule based on its general effect might be able to justify disregarding the unpleasant consequences of almost any

individual application whatsoever.¹⁰⁰ But this is not the only way a rule consequentialist might react to a difficult case. Another possibility is to combine an exception in the individual case with an effort to craft a system of rules ensuring that such difficult cases do not arise in the future. Foucault ascribes to Ordoliberalism two key elements, the first being its attachment to the rule of law. The second element is its "policy of society," which Foucault portrays as an effort to diffuse the capacity to compete in markets through society, ensuring that society will not generate demands to restrict market competition.¹⁰¹ Conceiving of Ordoliberalism as a rule-consequentialist approach helps to understand the relationship between these two elements. The "policy of society" helps to ensure that that rigid rules implied by the Ordoliberal vision of the rule of law subordinated to markets will not give rise to intolerable consequences in practice.

A brief consideration of Germany's domestic policy response to the financial crisis in 2007-2009 can illustrate the insights made possible by understanding Ordoliberalism as involving an ambition to a form of market-promoting governance bound by rules but that avoids disasters. Germany faced both a demand crisis and a financial crisis. It reacted to the first with extensive demand stimulus, and the second by a mixture of guarantees, subventions, and nationalizations. These reactions did not in the least reflect the application of pre-existing policy rules, but were rather extemporized and legitimated by highly context-specific legislation.¹⁰² In this light, it is tempting to see a gulf between Ordoliberal rhetoric and practical policies, with invocations of the former little more than a public-relations dodge.¹⁰³ This position, however, overlooks substantial changes in forward-looking rules that were bundled with contextual crisis-fighting measures. The most important of these was a constitutional "debt brake," sharply limiting federal

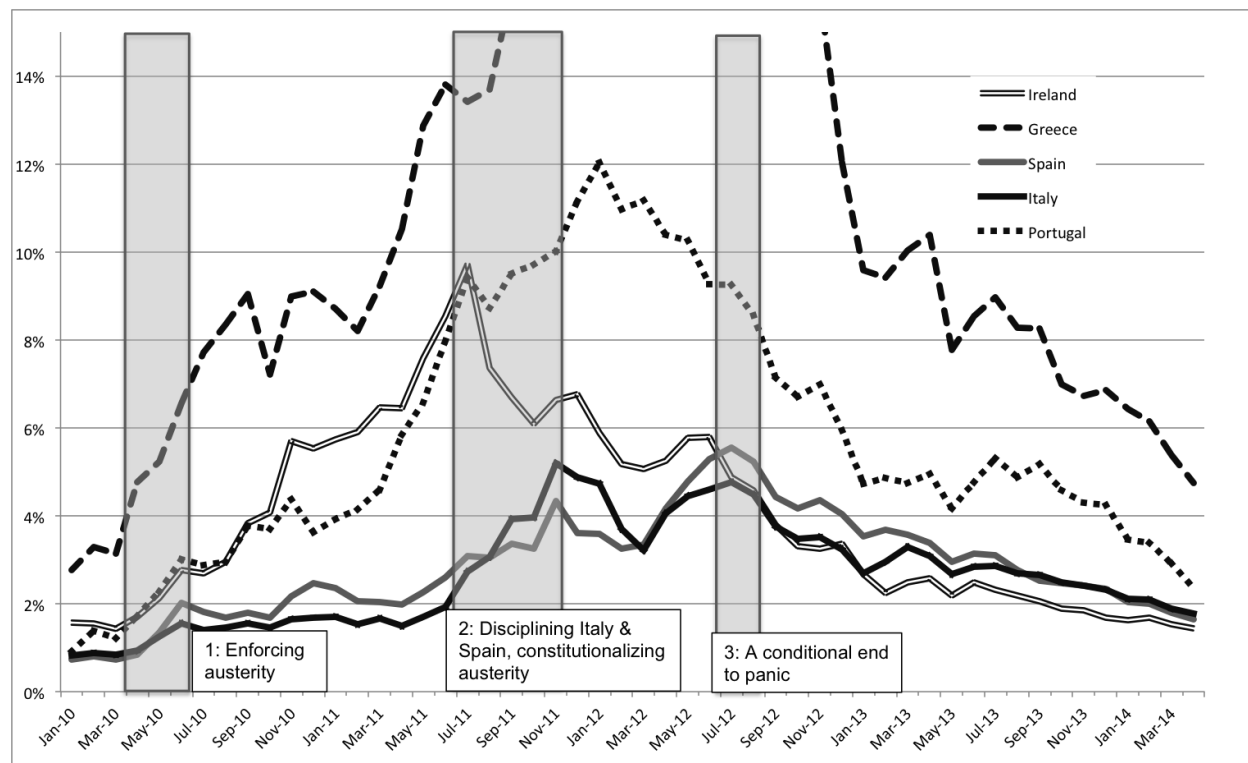
budget deficits and banning provincial (*Länder*) governments from running deficits altogether.¹⁰⁴ This constitutional change eliminated the reference to "overall economic equilibrium" as an aim of budget policy that had been introduced in the 1960s to authorize Keynesian policies.¹⁰⁵ It ensured that demand stimulus would be limited in time, while also complicating explicit or implicit backstopping of the regional public banks (*Landesbanken*) by *Länder* governments. At the same time, aid to *Landesbanken* was conditioned on major restructuring.¹⁰⁶ These institutional changes were, then, entirely in the spirit of Ordoliberalism, restructuring rules and the actors subject to them in ways designed to facilitate the operation of a market economy and make further discretionary interventions both unnecessary and unavailable.¹⁰⁷

The Political Use of Bond-Market Panic

It's now possible to analyze how Ordoliberalism intersected with European institutions and the prospect of market panic may to produce a deadlock between the protective countermove and austerity. Three crucial decision episodes—in April-May 2010, late summer through autumn 2011, and summer 2012—illustrate the relevant dynamic (see Figure 3). In each case, spiking interest rates on sovereign bond markets prompted a sense of crisis among European political leaders, who were well aware of the potentially disastrous impact on the banking system.¹⁰⁸ And in each case, the ECB eventually used its power to create money to help calm markets. First, however, the ECB leadership implicitly or explicitly threatened to withhold its help unless policy or institutional changes implementing Brussels-Frankfurt priorities (especially labor market liberalization and fiscal austerity) were adopted. These threats were made credible by

the rigid rules on the ECB's independence and mandate, and the prospect of vigorous German political and legal opposition to exceeding that mandate.¹⁰⁹

Figure 3: Rates on 10-year Government Bonds (monthly averages)



Source: ECB

Episode 1: Enforcing austerity, April-May 2010. After the revelation of the depth of Greece's budget problems in late 2009, European leaders debated whether and how to support the country throughout the spring of 2010. In the last week of April, with these discussions still uncompleted, a panic broke out on European sovereign bond markets in the aftermath of rating agency downgrades, with very large spikes in interest rates on Irish, Portuguese, and especially Greek debt, and noticeable spikes in rates for Spain and Italy. Falling bond prices raised major difficulties not only for the governments most directly affected, but also for banks, many of them French and German, which held these bonds as assets.¹¹⁰ Given the serious prospect of a broader financial panic, in

early May the leadership of the ECB took a contentious internal decision to use purchases of sovereign bonds to calm the markets. A second, simultaneous decision, though, was less contentious: to postpone announcement of the market intervention until after European leaders had created their own plan to address the bond crisis. The rationale for the delay, which was very explicitly advanced in the ECB's internal deliberations, was that were the ECB to act immediately it would remove the panic's pressure on Europe's leaders to come to an agreement on crisis measures of their own.¹¹¹

At a meeting with European heads of state on May 7, 2010, ECB President Jean-Claude Trichet described the bond-market panic in dire terms, advocating a rescue fund financed by European governments and a program of budget austerity.¹¹² He also communicated that adoption of these measures was a precondition for ECB market intervention.¹¹³ The credibility of the implied threat that the ECB would sit on its hands if it did not get its way, despite a market situation Trichet had portrayed as desperate, was clearly tested during the ensuing discussion. Trichet flatly rejected the insistence of French president Nicolas Sarkozy and others that ECB begin intervention, affirming the bank's absolute independence of action.¹¹⁴ The evidence strongly suggests that institutionalized Ordoliberalism was an important reason that this intransigence could seem more than bluff. German Prime Minister Angela Merkel invoked the Maastricht treaty in Trichet's defense, and (albeit apparently in another context) mentioned the possibility that the Bundesverfassungsgericht would reject any actions inconsistent with the treaty.¹¹⁵ Two subsequent events illustrate how institutionalized Ordoliberalism—in particular, the shadow of the Bundesverfassungsgericht's Maastricht decision—meant

the threat of ECB inaction might well have been viewed credibly. First, when the ECB did subsequently begin sovereign bond purchases the Bundesbank seriously considered refusing to implement the program on the grounds that it was not authorised by the relevant treaties.¹¹⁶ Second, in 2014 the Bundesverfassungsgericht did indeed declare a later bond-market intervention program not authorised by treaty and thus at variance with the German constitution.¹¹⁷ At a minimum, Trichet's interlocutors in May 2010 would have had every reason to suppose that he would face a severe challenge in winning internal ECB agreement to bond purchases, and that achieving policy changes congenial to the Brussels-Frankfurt consensus that dominated within the Bank were necessary to overcome this challenge.

In the event, Eurozone leaders categorically affirmed their commitment to budget austerity, and pledged to create (with help from the IMF) a rescue fund, the European Financial Stability Facility (EFSF), to aid Greece and other distressed sovereign borrowers (with austerity conditionality a given). The ECB, in turn, launched direct bond market purchases to support prices and lower interest rates, and greatly widened its liquidity provision to the financial system in ways that served to ameliorate banks' losses on sovereign debt.¹¹⁸ It bears noting that there is no plausible chain of reasoning under which the effectiveness of either of these monetary policy interventions depended on austerity. Their bundling with austerity was the result of a deliberate political decision on the part of the ECB leadership. Trichet was not the only actor pushing for this result; this was also the preferred approach of the German and some other governments. Nonetheless, the negotiating history sketched above strongly suggests that the ECB played a pivotal role in bringing about this outcome. The ECB's monopoly on money

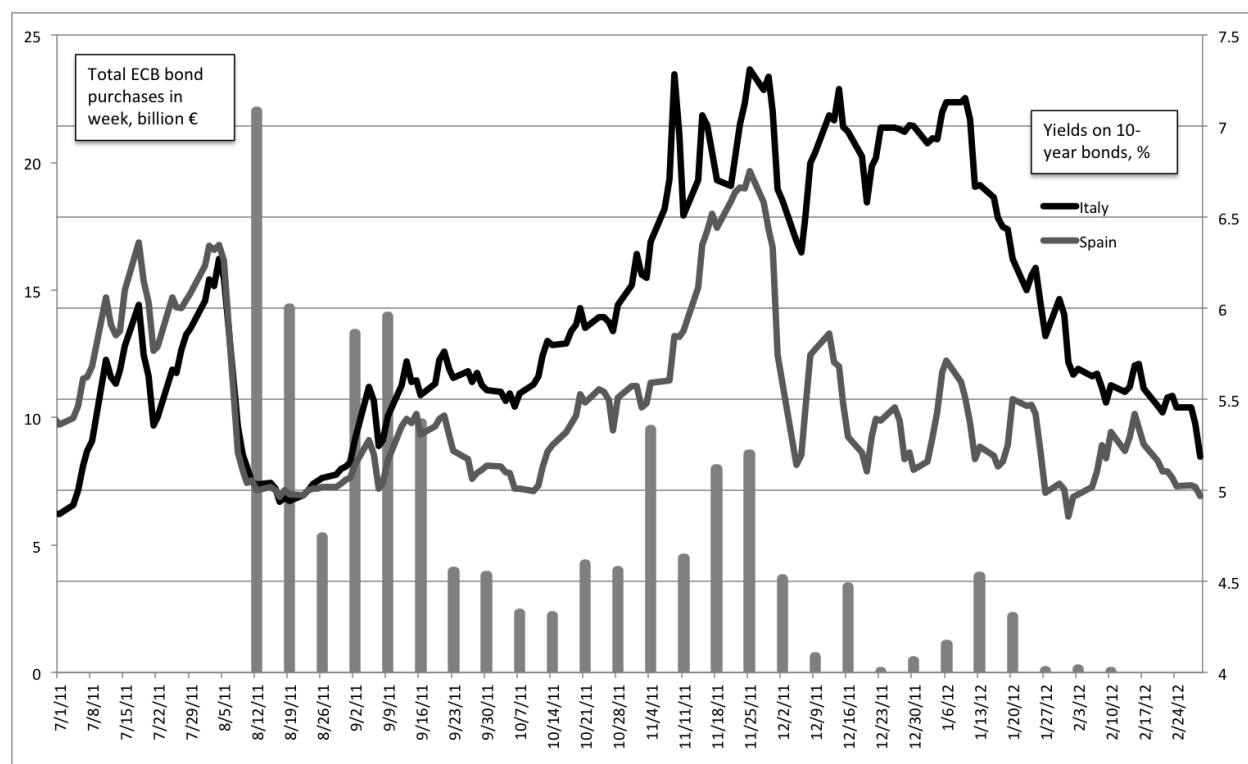
creation meant it was able to offer something that the governments participating in the negotiations could not.

Thus, in this episode, as in Britain in 1931, market panic facilitated central bank pressure on politicians for austerity policies. The most immediate effect was in Spain, where Prime Minister Jose Rodriguez Zapatero returned from the Brussels summit to announce sweeping new austerity measures, reversing a prior commitment to Keynesian stimulus.¹¹⁹ For Greece, Portugal, and Ireland market panic abated only briefly after the ECB's May intervention. The restrictive rules under which the EFSF was created meant that the EU, ECB, and IMF "Troika" administering its programs had an even more manifest capacity to credibly threaten to abandon countries to the market maelstrom unless its demands were accepted. The contradiction of this form of policy-making with democracy was pronounced.¹²⁰ Both in Greece and in Portugal, EFSF programs were made conditional on pledges from parties not in government, to ensure that they could not be overturned by elections.¹²¹ In Ireland, the government party that agreed to the ESFS package was all but destroyed in a subsequent election, but absent alternative sources of funding the new government found itself equally constrained.¹²²

Episode 2: disciplining Spain and Italy and constitutionalizing austerity, August-December 2011. The pattern set by the Eurozone's responses of 2010 was reiterated in the latter half of 2011. The evidence indicates that ECB leaders not only threatened to allow bond market panic to rage if their preferred policies were not adopted, but also in fact did carry out this threat.

Disciplining Spain and Italy. From the summer of 2011, Spain and Italy began to experience spiking interest rates (see Figure 4). On August 5, Trichet sent letters to the Italian and Spanish governments describing what was needed to "restore the confidence of investors."¹²³ Both letters called for intensified austerity, labor market reforms, and a liberalizing reorganization of collective bargaining. Although neither letter mentioned the prospect of further bond-market intervention from the ECB, it was clear even from immediate press reports that the letters were widely being understood as setting out preconditions for such intervention.¹²⁴ In both cases, the governments responded with alacrity to the suggestions, quickly announcing efforts to implement the recommendations in their entirety, though without specifying their origins in detail.

Figure 4: Bond Prices and ECB Intervention, 2011-2012



Source: 10-year benchmark bond prices from Datastream; SMP purchases from ECB

Intervention in the market for Spanish and Italian bonds began on Monday August 8. Although the ECB clearly intended to calm the markets, it was pursuing two contradictory goals. For investors seeking a new focal point, the predictability of ECB bond purchases would have facilitated coordination. However, predictable purchases—for instance, committing to a target interest rate for bonds by analogy with successful interventions into currency markets—would have made modulating interventions to discourage unwelcome policy developments impossible.¹²⁵ In the event, the ECB did not take even minimal steps to offer a credible commitment to support bond prices.¹²⁶ Facing a choice between mollifying markets and intimidating politicians, the ECB opted for the latter.¹²⁷ This conclusion is supported not only by the ECB's public statements, but also by patterns of its bond purchases. (Figure 4 shows the volume of ECB purchases, which are available only as weekly totals and are not broken down by country.) For three weeks through October, the bank did little intervention, despite a sustained run-up in prices, during a period when Berlusconi's government was having trouble winning parliamentary accession to the measures announced in August.¹²⁸ When prices jumped in early November, interventions intensified but remained well below the volumes that had proved effective in the summer. It may be, as one observer believes, that the dip in purchases in the second week of November was intended to allow bond prices to reach levels ensuring Berlusconi's resignation, first promised on November 8.¹²⁹ In any event, evidence is strong that domestic politicians who wished to install a technocrat congenial to the Brussels-Frankfurt consensus arranged Berlusconi's defenestration.¹³⁰ And it is unarguably the case that the ECB leadership did not pursue bond market intervention aggressively when bond prices were at their

highest level, and made clear its desire to deploy its resources only to support those governments that adopted its desired policies. Meanwhile, the resignation of another German ECB representative in September highlighted political conflict over even the limited bond-buying that was done, reinforcing the prospect that the ECB would indeed stand aside despite market panic if its demands were not meant.¹³¹

Constitutionalizing austerity. Through the same period, Eurozone leaders debated other issues as well, including how to reform and expand the EFSF. Germany's institutionalized Ordoliberalism again played an important role, especially in a struggle between France and Germany over potential alternate means by which the power of money creation could be harnessed to tame market panic. Sarkozy suggested that the European Stabilization Mechanism (ESM) that was to succeed the EFSF be given a bank license; this would allow it to borrow from the ECB. Germany resisted the proposal on the grounds that it would amount to monetary financing of governments. In September, the German Constitutional Court ruled that while German participation in the EFSF was legal, any further extension of German commitments required parliamentary approval.¹³² By late October, Sarkozy abandoned the bank license plan, ending his insistence the measure be included in an agreement that Merkel would have to take to the Bundestag.¹³³ Sarkozy tried a different approach in early November, proposing with US backing that the IMF use its money-creation powers to create Special Drawing Rights, some of which could be contributed to the EFSF via European countries. Again Germany objected; Merkel cited Germany's constitution in refusing to overrule the Bundesbank's objection to the plan.¹³⁴

Thus, the ECB maintained its autonomy to decide when and whether newly created money could be used against market panic. Mario Draghi, who took over as head of the ECB from November, publicly specified a precondition for intervention: adoption of a "fiscal compact" proposed by France and Germany.¹³⁵ This would tighten budget deficit targets, and also require governments to give these targets a maximally constitutional character involving automatic correction, on the model of the German "debt brake." For the Germans, it represented "the extension of the ordoliberal paradigm ... across the EU."¹³⁶ Heads of government agreed on the outlines of the compact at a summit on 8-9 December. The compact itself made use of the threat of market panic as a disciplinary mechanism, since countries that did not ratify it would not be eligible for ESM support.¹³⁷ As the leaders were meeting, Draghi announced plans for a massive expansion of cheap long-term loans to EU banks on 8 December. Banks could pledge sovereign bonds as collateral for these loans, of which nearly €500 billion were made at the end of December, allowing them to serve as an alternative to direct ECB bond purchases.

Episode 3: a conditional end to panic. As noted above, Polanyi argued that when the political leverage afforded by panic was no longer necessary, financiers and their political allies could abandon the gold standard. By the summer of 2012, advocates of the Brussels-Frankfurt consensus had reached an analogous situation. The fiscal compact and other changes in European arrangements had sharply limited the autonomy of governments. Meanwhile, indirect support via lending to banks had proved insufficient to restrain a new spike in interest rates on Italian and Spanish bonds (see

Figure 3). It was at this point that Draghi positioned the ECB to become a true lender of last resort for the sovereign bond market, pledging to deploy unlimited resources against speculators betting on the exit of any country from the Euro.

The political context and significance of this decision are clearly revealed by the history of its development.¹³⁸ Although the Open Monetary Transactions (OMT) program allowed for unlimited bond market intervention, this could only be done on behalf of countries that had agreed to a rescue program under the ESM and accepted the associated conditions. Defending the OMT proposal to a German audience, ECB director Jorg Asmussen promised that it would involve more effective conditioning of bond purchases on reforms than had been achieved in the case of Italy.¹³⁹ This conditionality was key in winning the backing of German leaders for the plan.¹⁴⁰ At the same time, Draghi noted that the plan was directed "a 'bad equilibrium,' namely an equilibrium where you may have self-fulfilling expectations that feed upon themselves and generate very adverse scenarios."¹⁴¹ Thus, OMT embodied a contradiction between creating certainty for markets (by promising unlimited intervention to prevent self-fulfilling expectations) and uncertainty for governments (by threatening that intervention would end if conditions were not met). Nonetheless, the potentially unlimited character of OMT and Draghi's statement that bond markets could be driven not only by expected fiscal and economic developments but also "fear and irrationality" amounted to a significant new commitment to combat market panic.¹⁴² The introduction of the OMT was the moral equivalent of the end of the gold standard: an explicit rejection of the sovereignty of financial markets. The dramatic subsequent decline in Eurozone bond

prices (see Figure 2) strongly suggests that bond purchasers themselves welcomed this rejection.

Conclusion

At the end of 2014, economic output in the Eurozone was still 1% below its level in 2007, and was only expected to equal the 2007 level at the end of 2015. These lost eight years compared unfavorably even with the Great Depression. During this period, policy-makers used both fiscal and monetary policy instruments to ward off vicious circles of declining growth or financial implosion, yet did not turn these same instruments to promoting virtuous circles of expansion and avoid austerity. As late as 2014, Draghi found himself at once announcing deflation-fighting measures and defending deflation's necessity for adjustment.¹⁴³ In short, there was a very deep intellectual incoherence at the core of the Eurozone's reaction to the crisis.

The virtue of a Polanyian analysis is that it accounts for this paradoxical outcome, illuminating its political roots in the use of market panic as a tool to eliminate the space for democratic choice about economic policy. Despite the operation of institutions and attitudes reflective of Polanyi's protective countermove, the joint effect of the Brussels-Frankfurt consensus and German Ordoliberalism, politically empowered by the irreplaceable role of the central bank as a tool against market panic, was to push austerity and deflationary adjustment. "The market" did not demand these policies. (A particularly revealing incident in this regard occurred in early 2012, when the credit rating agency Standard & Poor's downgraded the bonds of a number of European states because of fears that austerity could become counterproductive due to the contraction of demand.)¹⁴⁴ The collapse in Eurozone interest rates after the introduction

of OMT decisively illustrated once again what had long been obvious: there was no direct connection between data on budget deficits and growth prospects and the mood of the markets. Eurozone debt as a share of GDP continued to grow even as interest rates plummeted. There is no sense in which the austerity agenda was imposed by market forces; it was a political choice that governing by panic was used to implement.

Of the traditional explanatory triumvirate of ideas, and institutions, interests, this explanation emphasizes the first.¹⁴⁵ If the thinking behind the Brussels-Frankfurt consensus had been less deeply embedded in European institutions, if Ordoliberalism's rule-consequential style of thinking were less prevalent in Germany, a deadlock could have been avoided and breakthrough to sustained stimulus would have been possible.¹⁴⁶

Institutions were not irrelevant. Treaty provisions and the veto power Germany held over many potential actions at the European or Eurozone level contributed to the credibility of the ECB threat to stand aside in the face of market panic. However, these institutions only facilitated the pursuit of particular aims; they did not specify these aims. Flexibility was possible. The extensive creation of new treaty arrangements (such as the fiscal compact) in the course of the crisis, as well as the ECB mission creep involved in its detailed policy recommendations and adoption of a lender-of-last resort role, illustrate the potential flexibility of the rules. The possibilities for approving more extensive deficit spending created by treaty references to "structural" deficits could have been exploited to a much greater extent than they were.¹⁴⁷ There is no sense in which the austerity agenda was imposed by European or Eurozone institutions; it was a political choice.

As for interests, this was certainly a case where they did not "come with an instruction sheet."¹⁴⁸ Consider two of the relevant interests often cited. The politicians of creditor countries, such as Germany, could have focused on the benefits of stimulating demand for exports rather than on the costs of bailouts. And the taming of the bond market panic after 2012 suggests that the options for addressing financial-sector difficulties were certainly not limited to austerity.

Despite the disasters it chronicles, it is possible to read *TGT* in an optimistic vein: the spastic crisis-fighting innovations of the interwar period could be the harbingers of a new form of enlightened economic management; the demise of financial panic as an *ultima ratio* in class conflict would reveal that tensions between markets and democracy were not inherent to these two institutions. As Polanyi put it elsewhere, "as soon as the credit system is based no longer on 'confidence' but on administration, finance, which rules by panic, is deposed, and sanity can prevail."¹⁴⁹ But elimination of the gold standard proved very far from eliminating the importance of confidence to the financial system, and very often what counted as sanity to those in charge of administering monetary policy embodied many of the market liberal ideas Polanyi had criticized.¹⁵⁰ The Eurozone crisis was only one of many episodes since the second world war demonstrating the continuing relevance of the political dynamic Polanyi so astutely diagnosed, in which the agencies with the capacity to stem financial panic took advantage of desperate circumstances to push a neoliberal agenda.¹⁵¹ This history fails to bear out Polanyi's post-war optimism, but it does confirm again the enduring genius of *The Great Transformation*—a fact that would be cold comfort to Polanyi, as it should be to those who share his values.

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Notes

¹ In a "debt deflation," debtors liquidate assets to cover their debts; this drives asset prices down and tightens credit availability for other debtors, who must then liquidate their assets, etc. Irving Fisher, "The Debt-Deflation Theory of Great Depressions," *Econometrica* 1 (1933): 337-357.

² OECD, *Economic Policy Reforms 2014: Going for Growth Interim Report* (Paris: OECD Publishing, 2014); André Sapir and others, "The Troika and Financial

Assistance in the Euro Area: Successes and Failures" (Study on the request of the Economic and Monetary Affairs Committee, European Parliament Directorate General for Internal Policies, Economic Governance Support Unit, February, 2014), online at

[http://www.europarl.europa.eu/RegData/etudes/etudes/join/2014/497764/IPOL-ECON_ET\(2014\)497764_EN.pdf](http://www.europarl.europa.eu/RegData/etudes/etudes/join/2014/497764/IPOL-ECON_ET(2014)497764_EN.pdf).

³ Karl Polanyi, *The Great Transformation* (Boston,: Beacon Press, 1957), 229.

⁴ *Ibid.*, 228-229.

⁵ *Ibid.*, 130, 132.

⁶ *Ibid.*, 233-234.

⁷ For an alternative application of Polanyi's analysis to the Eurozone crisis, see Christopher Holmes, "Whatever It Takes': Polanyian Perspectives on the Eurozone Crisis and the Gold Standard," *Economy and Society* 43, no. 4 (2014): 582-602.

⁸ Paul De Grauwe, "Design Failures in the Eurozone: Can They Be Fixed?," LSE 'Europe in Question' Discussion Paper Series 57/2013 (February 2013), online at <http://www.lse.ac.uk/europeanInstitute/LEQS/LEQSPaper57.pdf>.

⁹ For a description, see Erik Jones, "The Collapse of the Brussels-Frankfurt Consensus and the Future of the Euro," in V. A. Schmidt and M. Thatcher, eds., *Resilient Liberalism in Europe's Political Economy* (Cambridge University Press, 2013), 145-170 and below.

¹⁰ Polanyi, *The Great Transformation*, 134.

¹¹ *Ibid.*, 134.

¹² I am grouping under the term "capitalists" what Polanyi refers to as "trading classes," "employers," and the "financial market" more or less interchangeably.

¹³ *Ibid.*, 192; cf. John Maynard Keynes, *A Tract on Monetary Reform* (Amherst, NY: Prometheus Books, 2000), 36.

¹⁴ Polanyi is especially concerned to show that the relevant destruction would not be creative, but indiscriminate, even if the necessity of deflation is conceded. For deflation could affect not only exporters and potential exporters, whose cost competitiveness determines the balance of trade, but also other firms "according to their fortuitous business dealings." Polanyi, *The Great Transformation*, 194.

¹⁵ *Ibid.*, 194-195.

¹⁶ *Ibid.*, 177.

¹⁷ *Ibid.*, 197. Cf. Kevin O'Rourke and Alan Taylor, "Cross of Euros," *Journal of Economic Perspectives* 27, no. 3 (2013): 172-174.

¹⁸ For reasoning along these lines, see Polanyi, *The Great Transformation*, 197, 210, 217; Karl Polanyi, "Demokratie und Wahrung in England," in M. Cangiani and C. Thomasberger, eds., *Chronik der Grossen Transformation: Artikel und Aufsatze (1920-1945)*, vol. 1 (Marburg: Metropolis, 2002), 124.

¹⁹ Polanyi, *The Great Transformation*, 27, 214.

²⁰ Robert Skidelsky, *Politicians and the Slump: The Labour Government of 1929-1931* (London: Papermac, 1994), 293.

²¹ Polanyi, *The Great Transformation*, 27.

- ²² For a similar contemporary position, see Barry Eichengreen and Douglas Irwin, "The Slide to Protectionism in the Great Depression: Who Succumbed and Why?," *The Journal of Economic History* 70, no. 04 (2010): 871-897.
- ²³ Polanyi, *The Great Transformation*, 206, 232; Karl Polanyi, "Mechanisms of the World Economic Crisis, 1931-1933," in K. McRobbie and K. Levitt, eds., *Karl Polanyi in Vienna: The Contemporary Significance of the Great Transformation* (Black Rose Books Ltd, 2005), 351.
- ²⁴ Polanyi, *The Great Transformation*, 206.
- ²⁵ Polanyi, "Mechanisms of the World Economic Crisis," 351.
- ²⁶ Polanyi, *The Great Transformation*, 233. For a recent account of this "sudden stop" see Olivier Accominotti and Barry Eichengreen, "The Mother of All Sudden Stops: Capital Flows and Reversals in Europe, 1919-1932," NBER Working Paper 19580 (October, 2013), online at <http://www.nber.org/papers/w19580>.
- ²⁷ Polanyi, "Mechanisms of the World Economic Crisis," 351.
- ²⁸ Polanyi, *The Great Transformation*, 230, 232, 234, 25.
- ²⁹ *Ibid.*, 190.
- ³⁰ *Ibid.*, 190. Compare also *ibid.*, 234-236.
- ³¹ *Ibid.*, 229. Blum's premiership relied on a coalition that also included the middle-class Radicals, who were opposed to capital controls. Peter Gourevitch, "Breaking with Orthodoxy: The Politics of Economic Policy Responses to the Depression of the 1930s," *International Organization* 38, no. 1 (1984): 95-129.
- ³² Kenneth Mouré, *The Gold Standard Illusion: France, the Bank of France, and the International Gold Standard, 1914-1939* (Oxford: Oxford University Press, 2002), 235.
- ³³ Polanyi, *The Great Transformation*, 229.
- ³⁴ For two detailed and careful histories on which I rely, see Philip Williamson, "A 'Bankers' Ramp'? Financiers and the British Political Crisis of August 1931," *The English Historical Review* 99, no. 393 (1984): 770-806; James Morrison, "Shocking Intellectual Austerity: The Role of Ideas in the Demise of the Gold Standard in Britain," *International Organization* (forthcoming).
- ³⁵ Liaquat Ahamed, *Lords of Finance: The Bankers Who Broke the World* (London: William Heinemann, 2009), 428.
- ³⁶ Polanyi, *The Great Transformation*, 228.
- ³⁷ Polanyi, "Demokratie und Währung in England," 125. This was a plausible conclusion from publicly available data, although policymakers had a different attitude; see Williamson, "A 'Bankers' Ramp'," 786. Nonetheless, different reactions to market difficulties were still possible, and in illuminating the path chosen Polanyi's analysis retains its force.
- ³⁸ Polanyi, "Demokratie und Währung in England;" Karl Polanyi, "England auf der Waage," in Cangiani and Thomasberger, eds., *Chronik der Grossen Transformation* vol. 1, 131-141.
- ³⁹ Karl Polanyi, "England auf der Waage," 137. For a somewhat less categorical version of the argument, see Polanyi, "Demokratie und Währung in England," 124.
- ⁴⁰ Polanyi, "Demokratie und Währung in England," 126. This new stability was, of course, short-lived. In his journalism, Polanyi argued that Britain's leadership

chose to break the tie to gold in September because they were reluctant to bear the costs of higher interest rates to the budget and private finance Polanyi, "England auf der Waage," 138. This is consistent with the position in *TGT* that Labour's political marginalization allowed capitalists to stop retaining the gold standard as a political weapon. For an account of the gold standard exit decision that stresses the political motivations of the Bank of England's leadership, see Morrison, "Shocking Intellectual Austerity."

⁴¹ Polanyi, *The Great Transformation*, 229.

⁴² *Ibid.*, 229.

⁴³ *Ibid.*, 228-229.

⁴⁴ *Ibid.*, 233.

⁴⁵ *Ibid.*, 234; William Patch, *Heinrich Brüning and the Dissolution of the Weimar Republic* (Cambridge: Cambridge University Press, 1998), 181, 201-213.

⁴⁶ For an example with currency as the relevant asset, see Kenneth Oye, "The Sterling-Dollar-Franc Triangle: Monetary Diplomacy 1929-1937," *World Politics* 38, no. 1 (1985): 173-199.

⁴⁷ John Maynard Keynes, *The General Theory of Employment, Interest and Money* (London; New York: Macmillan; Cambridge University Press: For the Royal Economic Society, 1974), 155-156.

⁴⁸ For a discussion of the political power of businesses' non-coordinated action, though not in the context of panic, see Claus Offe and Helmut Wiesenthal, "Two Logics of Collective Action," in J. Keane, ed., *Disorganized Capitalism* (Cambridge, MA: MIT Press, 1985), 79.

⁴⁹ To take a pertinent example, financial markets have not displayed a consistent attitude to austerity in the course of the Eurozone crisis; Mark Blyth, *Austerity: The History of a Dangerous Idea* (Oxford: Oxford University Press, 2013), 3.

⁵⁰ Morrison, "Shocking Intellectual Austerity;" Williamson, "A 'Bankers' Ramp'."

⁵¹ Morrison, "Shocking Intellectual Austerity."

⁵² On the struggle between these approaches, see Williamson, "A 'Bankers' Ramp'," 796-797. Williamson downplays Harvey's political maneuvering, arguing that although Harvey did tell MacDonald that unemployment insurance cuts were crucial to reassure markets, "MacDonald simply obtained the advice he wanted" (*ibid.*, 797). Yet even providing this advice formed a way of mobilizing the threat of panic to promote a particular political outcome. Morrison's evidence on Harvey's activities tends to contradict Williamson's view that Harvey held himself outside the political process.

⁵³ Morrison, "Shocking Intellectual Austerity."

⁵⁴ Hyman Minsky, "The Financial Instability Hypothesis: An Interpretation of Keynes and an Alternative to 'Standard' Theory," *Challenge* (1977): 20-27. Minsky provides a crucial supplement to Polanyi because of his much deeper exploration of the implications of the financial character of capitalism, emphasizing that capitalist economies are composed of entities with balance sheets, and that their ability to manage the relationship between assets and liabilities is crucial to their survival. While Polanyi demonstrates a clear understanding of this point in his

account of the devastating implications of deflation for going concerns, he does not otherwise investigate it. Polanyi, *The Great Transformation*, 192-193.

⁵⁵ *Ibid.*, 138.

⁵⁶ For discussion of the interaction between independent central banks and politicians in a strategic context (though one where only the bank's own policy is the subject of contention), see Philip Keefer and David Stasavage, "The Limits of Delegation: Veto Players, Central Bank Independence, and the Credibility of Monetary Policy," *American Political Science Review* 97, no. 3 (2003): 407-423.

⁵⁷ On credible threats, Thomas Schelling, *The Strategy of Conflict* (Cambridge: Harvard University Press, 1960), 35-43 remains indispensable.

⁵⁸ Morrison, "Shocking Intellectual Austerity."

⁵⁹ Bob Hancké, "The Missing Link. Labour Unions, Central Banks and Monetary Integration in Europe," *Transfer: European Review of Labour and Research* 19, no. 1 (2013): 89-101.

⁶⁰ Jonathan Hopkin, "The Trouble with Economic Reform: Understanding the Debt Crisis in Spain and Italy," in F. Panizza and G. Philip, eds., *Moments of Truth: The Politics of Financial Crises in Comparative Perspective* (Routledge, 2013), 141-142.

⁶¹ Fritz Scharpf, "Monetary Union, Fiscal Crisis and the Disabling of Democratic Accountability," in A. Schäfer and W. Streeck, eds., *Politics in the Age of Austerity* (Cambridge, UK: Polity, 2013), Kindle edition, 2301.

⁶² *Ibid.*, 2304-2321. On the roots of wage restraint see Christian Dustmann and others, "From Sick Man of Europe to Economic Superstar: Germany's Resurgent Economy," *Journal of Economic Perspectives* 28, no. 1 (2014): 167-188 and *passim*.

⁶³ Paul De Grauwe and Yuemei Ji, "TARGET2 As a Scapegoat for German Errors," *Vox* (2 November 2012) <http://www.voxeu.org/article/target2-scapegoat-german-errors>; De Grauwe, "Design failures in the Eurozone: can they be fixed?," 6-8.

⁶⁴ Minsky, "The Financial Instability Hypothesis." For a convincing, clear, and concise statement of the intersection of the Eurozone's design with boom-bust cycles, see De Grauwe, "Design failures in the Eurozone: can they be fixed?," 6-11.

⁶⁵ Minsky, "The Financial Instability Hypothesis;" Colin Hay, "Good Inflation, Bad Inflation: The Housing Boom, Economic Growth and the Disaggregation of Inflationary Preferences in the UK and Ireland," *British Journal of Politics & International Relations* 11, no. 3 (2009): 461-478; Hopkin, "The trouble with economic reform," 149-150; Blyth, *Austerity*, 64-68.

⁶⁶ This is Polanyi's phrase to describe the sudden stop of international credit flows in 1929. Polanyi, "Mechanisms of the World Economic Crisis," 351.

⁶⁷ Blyth, *Austerity*, 84-85

⁶⁸ See Neil Irwin, *The Alchemists: Inside the Secret World of Central Bankers* (London: Headline Publishing Group, 2013), Kindle edition, 280 for the beginning of this policy.

⁶⁹ Emiliano Grossman and Cornelia Woll, "Saving the Banks: The Political Economy of Bailouts," *Comparative Political Studies* 47, no. 4 (2014): 573-600; Hubert

Zimmermann, "No Country for the Market: The Regulation of Finance in Germany After the Crisis," *German Politics* 21, no. 4 (2012): 484-501; Reimut Zohlnhöfer, "Between a Rock and a Hard Place: The Grand Coalition's Response to the Economic Crisis," *German Politics* 20, no. 2 (2011): 227-242.

⁷⁰ David Cameron, "European Fiscal Responses to the Great Recession," in N. G. Bermeo and J. Pontusson, eds., *Coping with Crisis: Government Reactions to the Great Recession* (New York: Russell Sage Foundation, 2012), Kindle edition, 2004-2638; Waltraud Schelkle, "Policymaking in Hard Times: French and German Responses to the Eurozone Crisis," in Bermeo and Pontusson, eds., *Coping with Crisis*, 2645-3281; Mark M. I. Vail, "Varieties of Liberalism: Keynesian Responses to the Great Recession in France and Germany," *Governance* 27, no. 1 (2014): 63-85.

⁷¹ Paul De Grauwe and Yuemei Ji, "Mispricing of Sovereign Risk and Macroeconomic Stability in the Eurozone," *JCMS: Journal of Common Market Studies* 50, no. 6 (2012): 866-880.

⁷² *Ibid.*, 877-878.

⁷³ Helen Thompson, "The Crisis of the Euro: The Problem of German Power Revisited" SPERI Paper 8 (December, 2013), online at <http://speri.dept.shef.ac.uk/wp-content/uploads/2013/01/SPERI-Paper-NO.8-The-Crisis-of-the-Euro-The-Problem-of-German-Power-Revisited-PDF-536KB.pdf>.

⁷⁴ *ECB Decides on Measures to Address Severe Tensions in Financial Markets*, <https://www.ecb.europa.eu/press/pr/date/2010/html/pr100510.en.html> (accessed April 7, 2014).

⁷⁵ Accominotti and Eichengreen, "The Mother of All Sudden Stops."

⁷⁶ See Jean Pisani-Ferry, André Sapir and Guntram Wolff, *EU-IMF Assistance to Euro-area Countries: An Early Assessment* (Brussels: Bruegel, 2013) for a survey.

⁷⁷ Accominotti and Eichengreen, "The Mother of All Sudden Stops."

⁷⁸ For instance, *Rede von Bundeskanzlerin Angela Merkel beim BDI-Tag der deutschen Industrie*, <http://www.bundesregierung.de/ContentArchiv/DE/Archiv17/Reden/2012/09/2012-09-25-bkin-bdi.html> (accessed April 7, 2014).

⁷⁹ Klaus Armingeon and Lucio Baccaro, "The Sorrows of Young Euro: The Sovereign Debt Crises of Ireland and Southern Europe," in Bermeo and Pontusson, eds., *Coping with Crisis*, 3285-4092; Blyth, *Austerity*.

⁸⁰ Jones, "The Collapse of the Brussels-Frankfurt Consensus."

⁸¹ On the relationship between Ordoliberalism and the creation of veto points see Brigitte Young, "The Battle of Ideas in Eurozone Crisis Management: German Ordoliberalism Versus Post-Keynesianism," in S. Fadda, and P. Tridico, eds., *The Economic Crisis in Social and Institutional Context: Theories, Policies and Exit Strategies* (Abingdon: Routledge, 2015)..

⁸² On limiting discretion as a way of gaining a bargaining advantage, see Schelling, *The Strategy of Conflict*, 22-43. For a discussion of Eurozone reform as a chicken game in which inflexibility offers bargaining advantage, see Frank Schimmelfennig,

"European Integration in the Euro Crisis: The Limits of Postfunctionalism," *Journal of European Integration* 36, no. 3 (2014): 1-17.

- ⁸³ Eg. Jones, "The Collapse of the Brussels-Frankfurt Consensus;" Sebastian Dullien and Ulrike Guérot, "The Long Shadow of Ordoliberalism: Germany's Approach to the Euro Crisis," ECFR Policy Brief 49 (2012), online at http://www.ecfr.eu/page/-/ECFR49_GERMANY_BRIEF.pdf; Blyth, *Austerity*, 140-141.
- ⁸⁴ This follows Jones, "The Collapse of the Brussels-Frankfurt Consensus," who perceptively analyzes these elements, as well as their ambiguity.
- ⁸⁵ David Gerber, "Constitutionalizing the Economy: German Neo-Liberalism, Competition Law and the 'New' Europe," *The American Journal of Comparative Law* 42, no. 1 (1994): 25; Viktor Vanberg, *The Constitution of Markets: Essays in Political Economy* (London; New York: Routledge, 2001), 37; Ralf Ptak, "Neoliberalism in Germany: Revisiting the Ordoliberal Foundations of the Social Market Economy," in P. Mirowski and D. Plehwe, eds., *The Road From Mont Pèlerin: The Making of the Neoliberal Thought Collective* (Cambridge, Mass.: Harvard University Press, 2009), Kindle edition, 1278-1809.
- ⁸⁶ Walter Eucken, "The Social Question (1948)," in H. F. Wünsche, ed., *Standard Texts on the Social Market Economy: Two Centuries of Discussion*, trans. Derek Rutter (Stuttgart; New York: Gustav Fischer, 1982), 270.
- ⁸⁷ Blyth, *Austerity*, 57, 151; Michel Foucault, *The Birth of Biopolitics: Lectures at the Collège de France, 1978-1979* (Basingstoke: Palgrave Macmillan, 2008), 133; Ptak, "Neoliberalism in Germany," 1319.
- ⁸⁸ Blyth, *Austerity*, 140; Gerber, "Constitutionalizing the Economy," 46; Vanberg, *The Constitution of Markets*, 39-42. Compare also Foucault's discussion of the importance of the "rule of law" to Ordoliberalism, Foucault, *The Birth of Biopolitics*, 171.
- ⁸⁹ Cf. Gerber, "Constitutionalizing the Economy," 47. For an outstanding discussion of the differences between civil law and common law, see Vivian V. G. Curran, "Rethinking Hermann Kantorowicz: Free Law, American Legal Realism and the Legacy of Anti-formalism," in A. Riles, ed., *Rethinking the Masters of Comparative Law* (Oxford-Portland: Hart Publishing, 2001), 75.
- ⁹⁰ Vanberg, *The Constitution of Markets*, 51; Ptak, "Neoliberalism in Germany," 1446-1469.
- ⁹¹ Christian Joerges, "Unity in Diversity As Europe's Vocation and Conflicts Law As Europe's Constitutional Form," LSE 'Europe in Question' Discussion Paper Series 28/2010 (April 2013); Christian Joerges, "Europa nach dem Ordoliberalismus: eine Philippika," *Kritische Justiz* 43, no. 4 (2010): 394-406; Ptak, "Neoliberalism in Germany," 1340-1343; Philip Manow, "Ordoliberalismus als Ökonomische Ordnungstheologie," *Leviathan* 29, no. 2 (2001): 179-198; Kenneth Dyson, "The German Model Revisited: From Schmidt to Schroder," *German Politics* 10, no. 2 (2001): 135-154.
- ⁹² *Grundgesetz für die Bundesrepublik Deutschland (Geschichte, Hinweise und Verweise zu Artikel 109)*, <http://www.verfassungen.de/de/gg/gg-a109.htm> (accessed May 29, 2014); Egon Tuchtfeldt, "Social Market Economy and Demand

Management," in H. F. Wünsche, ed., *Standard Texts on the Social Market Economy*, 68; Christopher Allen, "The Underdevelopment of Keynesianism in the Federal Republic of Germany," in P. A. Hall, ed., *The Political Power of Economic Ideas: Keynesianism Across Nations* (Princeton, N.J.: Princeton University Press, 1989), 276-279; Kenneth Dyson, "In the Shifting Shadows of Crisis: Pivot Points, Crisis Attribution, and Macro-Economic Policies Under Grand Coalition," *German Politics* 19, no. 3-4 (2010): 393-415. It has been argued, however, that Ordoliberalism's strength in general lay more in West German private law than in public and constitutional law, the latter being more congenial to corporatism and the welfare state. Joerges, "Europa nach dem Ordoliberalismus," 397-398.

⁹³ Kenneth Dyson and Kevin Featherstone, *The Road to Maastricht: Negotiating Economic and Monetary Union* (Oxford; New York: Oxford University Press, 1999), 263, 274-285 and *passim*. It bears noting, however, that some Ordoliberals felt that the treaty still left too much room for discretionary economic policy. For a summary, see Wolf Sauter, "The Economic Constitution of the European Union," *Columbia Journal of European Law* 4, no. 1 (1998): 27-68.

⁹⁴ Joerges, "Europa nach dem Ordoliberalismus," 403.

⁹⁵ Thus, in defending the creation of an independent European central bank, the court stated that such a measure

takes account of the special characteristic (tested and proven--in scientific terms as well--in the German legal system) that an independent central bank is a better guarantee of the value of the currency, and thus of a generally sound economic basis for the state's budgetary policies and for private planning and transactions in the exercise of rights of economic freedom, than state bodies, which as regards their opportunities and means for action are essentially dependent on the supply and value of the currency, and rely on the short-term consent of political forces. To that extent the placing of monetary policy on an independent footing within the sovereign jurisdiction of an independent European Central Bank ... satisfies the constitutional requirements under which a modification may be made to the principle of democracy. Bundesverfassungsgericht 2. Senat, "Manfred Brunner and Others v. The European Union Treaty," *Common Market Law Reports* 1 (1994): 57.

⁹⁶ Steve Boom, "The European Union After the Maastricht Decision: Will Germany Be the "Virginia of Europe?," *The American Journal of Comparative Law* 43, no. 2 (1995): 177-226.

⁹⁷ Brad Hooker, "Rule Consequentialism," in *The Stanford Encyclopedia of Philosophy* (2011), online at

<http://plato.stanford.edu/archives/spr2011/entries/consequentialism-rule/>.

⁹⁸ Walter Eucken, "A Policy for Establishing a System of Free Enterprise (1952)," in H. F. Wünsche, ed., *Standard Texts on the Social Market Economy*, 126-127; Walter Eucken, *Grundsätze der Wirtschaftspolitik* (Tübingen: J.C.B. Mohr, 2004), 280-285; Janos Kornai, "The Soft Budget Constraint," *Kyklos* 39, no. 1 (1986): 3-30; Finn F. E. Kydland and Edward E. C. Prescott, "Rules Rather Than Discretion: The Inconsistency of Optimal Plans," *The Journal of Political Economy* 83, no. 3 (1977): 473-492.

⁹⁹ Eucken, "A policy for establishing a system of free enterprise (1952)," 126-127. I have retranslated 'Konstanz' as 'constancy' rather than 'consistency' given the flavor of the argument; Eucken, *Grundsätze der Wirtschaftspolitik*, 285-289.

¹⁰⁰ Hooker, "Rule Consequentialism," explains how rule consequentialists have addressed this issue by introducing a higher-order "prevent disaster" rule that overrides any other rule, while conceding vagueness in what counts as a disaster.

¹⁰¹ From the German *Gesellschaftspolitik*. It appears that the term was not necessarily generally employed in the sense that Foucault uses it, but I believe his argument is insightful nonetheless. Foucault, *The Birth of Biopolitics*, 146, 156n52, 160. In a similar vein, Blyth, *Austerity*, 57 suggests that Ordoliberalism promotes "extra-economic institutions to allow labor to adjust skills to match market needs."

¹⁰² Dyson, "In the Shifting Shadows of Crisis;" Zimmermann, "No Country for the Market;" Schelkle, "Policymaking in Hard Times;" Vail, "Varieties of Liberalism.;" Zohlnhöfer, "Between a Rock and a Hard Place;" Walter Kickert, "How the German Government Responded to the Financial, Economic and Fiscal Crises," *Public Money & Management* 33, no. 4 (2013): 291-296. For instance, when a voluntary nationalization of a large troubled bank proved impossible, a new law was passed to permit expropriation in a very limited time window; Zohlnhöfer, "Between a Rock and a Hard Place," 232. On the long-standing Ordoliberal hostility to discretionary demand stimulus (though not welfare-state "automatic stabilizers") see Allen, "The Underdevelopment of Keynesianism in the Federal Republic of Germany;" Egon Tuchtfeldt, "Social Market Economy and Demand Management," in H. F. Wünsche, ed., *Standard Texts on the Social Market Economy*, 65-80.

¹⁰³ Schelkle, "Policymaking in Hard Times" makes a strong case for this position. Adalbert Winkler, "Warum kriegt Europa die Eurokrise nicht in den Griff?," *Wirtschaftsdienst* 92, no. 7 (2012): 449-456 argues that Germany's successful fight with the financial crisis in 2009 ignored Ordoliberal principles, while they dominate in German discussions of European problems. Vail, "Varieties of Liberalism" also implicitly supports this case. He sees highly stimulative German domestic economic policy in this period as consistent with a tradition of "corporate liberalism" aimed at supporting favored social groups, but does not discuss the Ordoliberalism side of the social market compromise.

¹⁰⁴ Wolfgang Renzsch, "Federal Reform Under the Grand Coalition," *German Politics* 19, no. 3-4 (2010): 382-392; Ed Turner and Carolyn Rowe, "Party

- Servants, Ideologues or Regional Representatives? The German Länder and the Reform of Federalism," *West European Politics* 36, no. 2 (2013): 382-404.
- ¹⁰⁵ *Grundgesetz für die Bundesrepublik Deutschland (Geschichte, Hinweise und Verweise zu Artikel 109)*; Tuchtfeldt, "Social market economy and demand management," 68.
- ¹⁰⁶ Dyson, "In the Shifting Shadows of Crisis," 403; Kickert, "How the German government responded to the financial, economic and fiscal crises," 292.
- ¹⁰⁷ Compare Dyson, "In the Shifting Shadows of Crisis," 413. There is no space here to make a detailed case for the influence of Ordoliberalism on the decisions discussed; my purpose has been to show that these decisions do not offer a *prima facie* case for the irrelevance of Ordoliberalism.
- ¹⁰⁸ Thompson, "The Crisis of the Euro."
- ¹⁰⁹ In what follows, I do not offer references for facts easily verified from multiple public sources, but do seek to include detailed references for all potentially controversial assertions about empirical developments.
- ¹¹⁰ Anonymous, "The Euro Zone's Debt Crisis: The Cracks Spread and Widen," *The Economist* (2010) <http://www.economist.com/node/16009119> (accessed June 6, 2014); Thompson, "The Crisis of the Euro."
- ¹¹¹ Irwin, *The Alchemists*, 3957-3959, 4082-4093; Carlo Bastasin, *Saving Europe: How National Politics Nearly Destroyed the Euro* (Washington, D.C.: Brookings Institution Press, 2012), 200, 202-203.
- ¹¹² Tony Barber, "Saving the Euro: Dinner on the Edge of the Abyss," *FT.com* (2010) <http://www.ft.com/cms/s/0/190b32ae-d49a-11df-b230-00144feabdc0.html?siteedition=uk>; Irwin, *The Alchemists*, 3967-3971
- ¹¹³ This wasn't done in so many words but the message was clear. Irwin, *The Alchemists*, 3976-3978; Bastasin, *Saving Europe*, 208-209.
- ¹¹⁴ Barber, "Saving the Euro: Dinner on the Edge of the Abyss;" Bastasin, *Saving Europe*, 208; Irwin, *The Alchemists*, 3983.
- ¹¹⁵ Barber, "Saving the Euro: Dinner on the Edge of the Abyss;" Bastasin, *Saving Europe*, 208.
- ¹¹⁶ Irwin, *The Alchemists*, 4124-4128. Recall that the Bunderverfassungsgericht had stated that decisions not authorized by the treaty would not be binding on German institutions.
- ¹¹⁷ Peter Lindseth, "Barking Vs. Biting: Understanding the German Constitutional Court's OMT Reference ... and Its Implications for EU Reform," *eutopialaw* (10 February 2014), <http://eutopialaw.com/2014/02/10/barking-vs-biting-understanding-the-german-constitutional-courts-omt-reference-and-its-implications-for-eu-reform/> (accessed June 6, 2014).
- ¹¹⁸ Thompson, "The Crisis of the Euro."
- ¹¹⁹ Luis Aizpeolea, "The Perfect Storm That Saw Zapatero Sacrifice His Sacred Social Agenda," *El Pais - English Edition* (14 May 2010), 3; Niamh Hardiman and Sebastian Dellepiane, "The New Politics of Austerity: Fiscal Responses to Crisis in Ireland and Spain," UCD Geary Institute Discussion Paper Series (February 2012), online at <http://ssrn.com/paper=2013238>. While the background to this decision is

not described in a detailed way in the sources I have examined, it seems quite likely that had Zapatero not done this, he would have faced a slew of negative commentary from the Commission representatives and perhaps other leaders, which would have roiled the market further; instead, he won broad praise. In any event, it had become in Brussels clear that the powers of the ECB to tame panic would not be put at the service of any government eschewing consolidation. Sebastian Dellepiane-Avellaneda, "The Political Power of Economic Ideas: The Case of 'Expansionary Fiscal Contractions'," *The British Journal of Politics & International Relations* (2014): 391-418 concludes that Spain's shift to austerity was not due to ideological conversion, which is consistent with the idea that it resulted from coercion.

¹²⁰ Armingeon and Baccaro, "The sorrows of young Euro," 3789.

¹²¹ *Ibid.*, 3475, 3564.

¹²² Hardiman and Dellepiane, "The New Politics of Austerity," 16-17.

¹²³ Jean-Claude Trichet and Mario Draghi, "Un'azione Pressante Per Ristabilire La Fiducia Degli Investitori," *Corriere della Sera* http://www.corriere.it/economia/11_settembre_29/trichet_draghi_inglese_304a5f1e-ea59-11e0-ae06-4da866778017.shtml (accessed June 20, 2014); José Zapatero, *El Dilema: 600 Días de Vértigo* (Barcelona: Editorial Planeta, 2013), 405-408. The letters were co-signed in both cases by the ECB representative from the country in question. Their exact content was not immediately made public.

¹²⁴ Brian Blackstone, "Europe Central Bank Signals Wider Bond Purchases," *The Wall Street Journal Online* (6 August 2011) <http://www.wsj.com/articles/SB10001424053111903366504576490662869530734>; Irwin, *The Alchemists*, 5657; Bastasin, *Saving Europe*, 299.

¹²⁵ Bastasin, *Saving Europe*, 328.

¹²⁶ Paul De Grauwe, "Europe Needs the ECB to Step Up to the Plate," *FT.com* (19 October 2011) <http://www.ft.com/cms/s/0/955dcf18-fa57-11e0-b70d-00144feab49a.html#axzz35M9MoNsS>.

¹²⁷ See Trichet's response to a question on the ECB's potential role as a lender of last resort on bond markets in Lionel Barber and Ralph Atkins, "FT Interview Transcript: Jean-Claude Trichet," *FT.com* (13 October 2011) <http://www.ft.com/cms/s/0/75c4d508-f5b5-11e0-bcc2-00144feab49a.html#axzz35M9MoNsS>, and a report of a recognition of the contradiction in letters to Sarkozy and Merkel in July 2011: Bastasin, *Saving Europe*, 292.

¹²⁸ Bastasin, *Saving Europe*, 318-319.

¹²⁹ Irwin, *The Alchemists*, 6174. In the immediate aftermath of Berlusconi's resignation, ECB board member Jens Weidmann claimed that bond buying was not intended to aid or punish Italy. However, he added that it was important that bond buying not "mute the incentives that come from the market." Citing Italy in particular, he added: "Recent experience has shown that market interest rates do play a role in pushing governments towards reforms." Ralph Atkins and Martin Sandbu, "FT Interview Transcript: Jens Weidmann," *FT.com* (13 November 2011)

- <http://www.ft.com/cms/s/0/b3a2d19e-0de4-11e1-9d40-00144feabdc0.html?siteedition=uk> (accessed June 23, 2014).
- ¹³⁰ Alan Friedman, "Italy: Monti's Secret Summer," *FT.com* (10 February 2014) <http://www.ft.com/cms/s/0/b9474c88-8e98-11e3-b6f1-00144feab7de.html?siteedition=uk> (accessed June 30, 2014); Perry Anderson, "The Italian Disaster," *London Review of Books* 36, no. 10 (2014): 3-16 <http://www.lrb.co.uk/v36/n10/perry-anderson/the-italian-disaster>.
- ¹³¹ Bastasin, *Saving Europe*, 310.
- ¹³² *Ibid.*, 308-310.
- ¹³³ Details of the arguments presented in the October negotiations are scarce, but the timing is suggestive; *ibid.*, 326-334. Joachim Schild, "Leadership in Hard Times: Germany, France, and the Management of the Eurozone Crisis," *German Politics & Society* 31, no. 1 (2013): 24-47 suggests that Sarkozy's successor should not expect to achieve revision of the fiscal compact or other priorities because "Berlin can very credibly play two-level games, as the odds of getting domestic support in Germany for the French wish list are very low." Note that European leaders in the course of the crisis have taken decisions without domestic support; the credibility here is at least in part tied to institutional factors.
- ¹³⁴ Peter Spiegel, "How the Euro Was Saved - FT Series," *FT.com* (11 May 2014) <http://www.ft.com/cms/s/0/f6f4d6b4-ca2e-11e3-ac05-00144feabdc0.html>.
- ¹³⁵ Irwin, *The Alchemists*, 6222-6232. For some evidence that the French and German governments conceived the fiscal compact as a way to convince the ECB to intervene more aggressively see Jan Dams and Jan Hildebrand, "Geheimverhandlung : Merkel und Sarkozy gründen Klub der Super-Europäer," *Die Welt* (27 November 2011) <http://www.welt.de/politik/ausland/article13737213/Merkel-und-Sarkozy-gruenden-Klub-der-Super-Europaeer.html>.
- ¹³⁶ Amandine Crespy and Vivien Schmidt, "The Clash of Titans: France, Germany and the Discursive Double Game of EMU Reform," *Journal of European Public Policy* 21, no. 8 (2014): 1085-1101.
- ¹³⁷ Sergio Fabbrini, "Intergovernmentalism and its Limits: Assessing the European Union's Answer to the Euro Crisis," *Comparative Political Studies* 46, no. 9 (2013): 1003-1029.
- ¹³⁸ Paul Carrel, Noah Barkin and Annika Breidthardt, "Special Report: Inside Mario Draghi's Euro Rescue Plan," *reuters.com* (25 September 2012) <http://www.reuters.com/article/2012/09/25/us-ecb-draghi-plan-idUSBRE88O09A20120925>; Brian Blackstone and Marcus Walker, "How ECB Chief Outflanked German Foe in Fight for Euro," *Wall Street Journal* (2 October 2012) <http://online.wsj.com/news/articles/SB10000872396390443507204578020323544183926>.
- ¹³⁹ Robert von Heusinger and Markus Sievers, "EZB-Direktor Asmussen: Krisen-Länder Müssen Probleme Angehen," *Frankfurter Rundschau* (20 August 2012)

<http://www.fr-online.de/wirtschaft/ezb-direktor-asmussen-krisen-laender-muessen-probleme-angehen,1472780,16920556.html>.

¹⁴⁰ Carrel, Barkin and Breidhardt, "Special Report;" Blackstone and Walker, "How ECB Chief Outflanked German Foe."

¹⁴¹ Mario Draghi, "ECB: Introductory Statement to the Press Conference (with Q&A)," *European Central Bank* (September 6, 2012), <http://www.ecb.europa.eu/press/pressconf/2012/html/is120906.en.html> (accessed June 27, 2014).

¹⁴² Mario Draghi, "So Bleibt der Euro Stabil!," *Die Zeit* (30 August 2012) <http://www.zeit.de/2012/36/01-Euro-Krise-Europaeische-Zentralbank/komplettansicht> (accessed June 27, 2014).

¹⁴³ Mario Draghi, "ECB: Introductory Statement to the Press Conference (with Q&A)" *European Central Bank* (June 5, 2014), <https://www.ecb.europa.eu/press/pressconf/2014/html/is140605.en.html> (accessed June 30, 2014).

¹⁴⁴ *Standard & Poor's Takes Various Rating Actions on 16 Eurozone Sovereign Governments* (13 January 2012)

<http://www.standardandpoors.com/ratings/articles/en/us/?articleType=HTML&asetID=1245327294763> (accessed April 24, 2014).

¹⁴⁵ Thus showing the imprint of Blyth, *Austerity*. On the triumvirate, see Peter Hall, "The Role of Interests, Institutions, and Ideas in the Comparative Political Economy of the Industrialized Nations," in M. I. Lichbach and A. S. Zuckerman, eds., *Comparative Politics: Rationality, Culture, and Structure* (Cambridge University Press Cambridge, 1997).

¹⁴⁶ Another ideational factor sometimes ascribed an important role is a moralistic German public opinion linking Southern Europe's economic difficulties to laziness or profligacy. However, such opinions militated against even the conditional support that was provided (Crespy and Schmidt, "The clash of Titans," 1092), and provided neither a specific blueprint for policy nor a specific justification for catastrophic outcomes. On the ways in which Ordoliberalism served to channel moralistic views of the economy see Matthias Matthijs and Kathleen McNamara, "The Euro Crisis' Theory Effect: Northern Saints, Southern Sinners, and the Demise of the Eurobond," *Journal of European Integration* 37, no. 2 (2015): 229-245.

¹⁴⁷ Jeremie Cohen-Setton, "How Important Was the "Structural Balance" Screw-up in Driving European Austerity?," *Noahpinion* (2013) <http://noahpinionblog.blogspot.co.uk/2013/10/how-important-was-structural-balance.html> (accessed January 23, 2014).

¹⁴⁸ Cf. Mark Blyth, "Structures Do Not Come with an Instruction Sheet: Interests, Ideas, and Progress in Political Science," *Perspectives on Politics* 1, no. 4 (2003): 695-706.

¹⁴⁹ Karl Polanyi, "Universal Capitalism or Regional Planning?," *London Quarterly of World Affairs* 10, no. 3 (1945): 86-91. The context is a discussion of Soviet-bloc

international trade, but it does not seem unreasonable a summary of his broader perspective.

¹⁵⁰ For evidence that Polanyi feared the continued influence of these ideas in the post-war world, see *ibid.*; Karl Polanyi, "Our Obsolete Market Mentality: Civilization Must Find a New Thought Pattern," *Commentary* 3 (1947): 109-117.

¹⁵¹ Cf. Aaron Major, *Architects of Austerity: International Finance and the Politics of Growth* (Stanford: Stanford University Press, 2014)

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