



The euro after quarter of a century: a post-Keynesian perspective

Philip Arestis¹ · Malcolm Sawyer²

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Abstract

The paper starts by reviewing the post-Keynesian analysis of the formation of the euro, indicating the concerns over the imposition of common fiscal policies across the Economic and Monetary Union (EMU) countries, the likely deflationary effects, and constraints on counter-cyclical fiscal policy. Scepticism was expressed over the role of the European Central Bank (ECB) and its relationships with national governments in terms of the financing of government expenditure and its abilities to achieve a harmonised inflation target across all countries. It is argued that the issues identified by post-Keynesian (and other) authors have haunted the governance of the euro area and in a number of cases and that corresponding policy shifts have intensified these problems. The developments over budget deficits and national debt in the EMU are mapped out. It broadly suggests a tightening of the deflationary nature of the rules, particularly regarding the excessive deficit procedures, and the shift of emphasis from deficit to debt. The adoption of the ‘structural budget’ and its reliance on ‘potential output’ raise further problematics. Section 5 relates to the role of the ECB and monetary policy, and the relationship between ECB and national governments. Section 6 explores the responses of the authorities to the euro and other crises. Section 7 is a concluding section in which we discuss how far our fears on the euro were realised, and the struggles to address issues.

Keywords Euro · Fiscal policy · Monetary policy · Post-Keynesian economics

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✉ Malcolm Sawyer
m.c.sawyer@lubs.leeds.ac.uk

Philip Arestis
pa267@cam.ac.uk

¹ University of Cambridge, Cambridge, United Kingdom

² University of Leeds, Leeds, United Kingdom

1 Introduction

The ‘convergence criteria’ under the Maastricht Treaty for a European Union (EU) country’s adoption of the euro required interest and inflation rates close to benchmark figures, ‘independent’ central banks, and stable exchange rates, and imposed requirements in terms of the size of the budget deficit and national debt. The Stability and Growth Pact (SGP) hardened the budget deficit and debt requirements (for example, the requirement of a national budget deficit limited to 3% of GDP rather than a deficit figure achieved at a point in time) and confirmed the idea of the ‘independence’ of the European Central Bank (ECB). Many of those writing on the euro utilising post-Keynesian analysis were concerned over the possible implications of the ‘one size fits all’ approach to fiscal policy, the likely deflationary effects of the deficit and debt limits, and constraints on counter-cyclical fiscal policy. Scepticism was expressed over the role of the ECB and its relationships with national governments in terms of the financing of government expenditure and its abilities to achieve a harmonised inflation target across all countries. In the next section, we briefly outline the thrust of what we will term a post-Keynesian analysis of the formation of the euro and the accompanying fiscal and monetary policies. This section shows that the issues identified by the post-Keynesian (and others) have haunted the governance of the euro area since its inception, and in a number of cases, the policy shifts have intensified the problems.

Section 3 provides a brief discussion of economic growth of the euro area countries and, relatedly, budget deficits and public debt. This is background to consideration of the degree to which deficit and debt limits have been achieved in practice as well as the impacts of the general deflationary environment of the euro area.

Section 4 indicates significant developments regarding budget deficits and national debt within the governance of the EMU. It broadly suggests a tightening of the deflationary nature of the rules, particularly with respect to the excessive deficit procedures, and the shift of emphasis from deficit to debt. The adoption of a ‘structural budget’ and its reliance on ‘potential output’ raise further problematics.

In Sect. 5, the role of the ECB and its relationships between ECB and national governments are briefly discussed. Section 6 explores some of the ways in which the European authorities responded to crises and the strains which were placed on the euro area. Section 7 is the concluding section in which we discuss how far post-Keynesian concerns regarding the euro have materialised and the struggles that emerged from addressing these issues.

2 Post-Keynesian analysis of prospects for euro

We begin by summarising the main thrusts of post-Keynesian analysis, on the prospects for the euro in the years before its launch as a virtual currency in 1999 and a circulating currency on 1 January 2002. The analysis focused on the budget

deficit and debt ratio rules, and the possible deflationary aspects of the implementation of those rules within a multi-national framework with a small federal balanced budget. It also focused on the role of the ECB, and its relationships with national governments and its prescribed role in addressing inflation. Other issues raised, which were not confined to post-Keynesian analysis, included whether the euro area could in any sense be regarded as an 'optimal currency area', and hence the difficulties which could arise from differential economic conditions and performance between euro member countries in the framework of common monetary and fiscal policies: in particular, the issues of using a single policy instrument (interest rate) to address inflation which was expected to vary across countries in terms of overall intensity as well as with respect to the relevant generative and transmission mechanisms.

The criteria for a country to join the euro (under the Maastricht Treaty) were as follows:

1. Average exchange rate not to deviate by more than 2.25% from its central rate for the 2 years prior to membership.
2. Inflation rate was not to exceed the average rate of inflation of the three community nations with the lowest inflation rate by 1.5%.
3. Long-term interest rates not to exceed the average interest rate of the three countries with the lowest inflation rate by 2%.
4. Budget deficit not to exceed 3% of its GDP.
5. Overall government debt not to exceed 60% of its GDP.

Hence, the main emphasis of these criteria was on nominal convergence without reference to real convergence, and to the deficit and debt rules. The numbers chosen as ceilings for deficits and public debt (3% and 60%) were arbitrary and only internally consistent with a nominal growth rate of 5% per annum.¹

In addition, the Stability and Growth Pact alongside the Maastricht Treaty created four rules for economic policy. The four rules are that the ECB was granted independence from political influence; the rule of no-bail out of national government deficits was introduced; the monetary financing of government deficits was prohibited; and Member States must avoid 'excessive' deficits (defined as more than 3% of GDP).

The Stability and Growth Pact can be aligned with a general theoretical framework, which finds its expression in the 'new consensus macroeconomics'² (NCM). Then—and now—the key features were as follows (Arestis and Sawyer 2003, 2004):

¹ The relationship between a sustained budget deficit (relative to GDP) d and debt ratio b is given by $b = d/g$, and hence a deficit ratio of 3% and debt ratio of 60% would be consistent with nominal growth rate of 5%.

² The NCM framework, and its implications for monetary policy, was suggested initially by Goodfriend and King (1997), and Clarida, Gali and Gertler (1999). For an extensive theoretical treatment, see Woodford (2003). For a critique, see Arestis (2007) and Arestis and Sawyer (2003, 2008).

- (i) Politicians in particular and the democratic process in general cannot be trusted with economic policy formulation because of their tendency to make decisions which have stimulating short-term effects (reducing unemployment) but are detrimental in the longer term (notably a rise in inflation).
- (ii) Inflation is a monetary phenomenon and can be controlled through the monetary policy in the form of interest rate, rather than the money supply. This formed the basis of the policies of the ECB though the ECB did make some reference to growth of money stock M3.
- (iii) The level of unemployment fluctuates around a supply side determined equilibrium rate of unemployment, generally labelled the non-accelerating inflation rate of unemployment (NAIRU). The level of the NAIRU may be favourably affected by a 'flexible' labour market but is unaffected by the level of aggregate demand or by productive capacity. The supply-side equilibrium is now represented in terms of potential output which, as indicated below, has been a central and problematic feature of the fiscal rules of EMU.
- (iv) Fiscal policy is impotent in terms of its impact on real variables and as such it should be subordinate to monetary policy in controlling inflation. The government budget position will fluctuate during the course of business cycles but in the context of an essentially passive fiscal policy. Constraints on budget deficit and debt are seen to be required to constrain government profligacy.

2.1 Fiscal and budgetary policies

From a post-Keynesian perspective (though often shared with others), the approach of the SGP and successors to national government budgets and fiscal policy raised a range of issues (as discussed, for example, in Arestis et al. 2001 and Arestis et al. 2001). First, it limited the role of fiscal policy in dampening economic instability. The operation of 'automatic stabilisers' with budget deficits rising during economic downturn, thereby limiting the degree of the downturn and the use of discretionary fiscal stimulus in response to downturn, could bump against the upper limits placed on the scale of deficits. This issue was exacerbated by the absence of fiscal policy at the EU level due to a relatively small EU budget (order of 1% of GDP) and the requirement that it is in balance. A range of economists, post-Keynesian and others, recommended the development of a substantial EU budget which could involve deficits and thereby enhance the stabilising features of fiscal policy (Arestis and Sawyer 2013).

Second, it brought a 'one size fits all' perspective on national fiscal policies combined with a lack of concern as to whether the target budget deficit was compatible with sustainable employment levels (which could be interpreted as full employment or a level of unemployment consistent with low inflation).

The national accounts identity of government budget deficit = private savings minus private investment + current account deficit (capital account inflow) reveals that the imposition of a common target or limit for the government budget deficit implies the imposition of a common limit on the right-hand side of the equation. A country with a buoyant current account surplus and/or buoyant private investment

relative to private savings finds a budget in balance or small surplus easier to achieve than others. There is little reason to think that current account positions are or could become similar across countries of the euro area.

The limitations on budget deficit did not make any distinction between current expenditure and capital expenditure, and did not make any reference to a ‘golden rule’ whereby capital expenditure is met by borrowing and current budget would be in balance. There were moves later to make some allowance for public investment requirements. But the imposition of common budgetary rules made no allowance for heterogeneous public investment requirements, and at the same time contributed to austerity pressures. Countries differ in their requirements for public investment, and these rules place unnecessary constraints on those with large public investment requirements.

An important feature for the workings of the euro area and economic policy which were not fully appreciated outside of Germany came from *ordo-liberalism* and the constraints imposed by the *ordo-liberal* agenda include the rule of law in respect of economic policies. *Ordo-liberalism* is an influential doctrine in economic policy-making in Germany in recent decades and its macroeconomic policies with many aspects of that doctrine having wide political acceptance in Germany (Kapeller et al 2022; Young 2014). With *ordo-liberalism*, economic policies are embedded into law, and even more into a constitution which limits the ability to change those policies. The major examples relevant here come from placing fiscal and monetary policy into a constitutional framework which thereby shifts policy from discretionary to rule-based decisions. The placing of rules into a constitution (or equivalent) makes them difficult to change. If the chosen rule had universal validity, this would not constitute a problem. *Ordo-liberalism* places constraints on changing the policy agenda with the constitutional law-based approach to economic policy, and particularly with regard to fiscal and monetary policy. It limits ability to ‘update’ policy, e.g. by incorporating financial stability as objective of ECB.

2.2 Monetary policy

The ‘independent’ European Central Bank raised a range of issues referring to the institutional arrangements and the policy agenda. The following lines of argument were highlighted.³ An ‘independent’ Central Bank is a non-democratic organisation, and yet is the only one implementing EMU level macroeconomic decisions. It pursued its own, generally neo-liberal, agenda (as is briefly illustrated below). In terms of its policy objective, it was assigned the pursuit of price stability. But as a central bank it was inevitably involved in issues of the financing and funding of national government’s expenditure and budget deficits. This leads to the relationships between the ECB and the national fiscal authorities, which do not parallel the relationships between a national central bank and a national fiscal authority, even under the arrangements of national independent central. The ECB may, but does not

³ This draws heavily on Arestis et al. (2012).

have to, operate as lender of last resort. The ECB cannot directly monetize budget deficits but in this regard does not operate differently from many other central banks (e.g. Bank of England). However, it can determine which national government bonds it would accept in its open market operations. The underpinning of the debt of a national government comes from a combination of its tax raising abilities, the willingness by its central bank to purchase national government debt, and, as a final resort, its willingness to create money. These underpinnings are reliant on the government debt being denominated in the national currency, which cannot be the case within a single currency area (Arestis et al. 2012).

Coordination and cooperation over macroeconomic policies become much more difficult with these institutional arrangements. The ECB is charged with general support of EU economic policies. It is though left to the ECB to decide how that should be and does not insist on coordination. A particular example has arisen in respect of environmental and climate change policies. It should be noted in relation to coordination and cooperation of policies that a serious problem is the lack of banking unions and fiscal union, and both should be introduced. According to Wallace (2016), 'Creating monetary union without corresponding fiscal and political union amounted to political misspelling' (p. 12).

The continuing lack of a fiscal union in the EMU is a real and serious problem in terms of policy. A fiscal union is needed to produce financial and economic integration and stability. Banking union, which is also required, would not be enough. The EMU needs fiscal union to ensure proper tackling of business cycle risks. It would also help to improve coordination of monetary and fiscal policies, as well as financial stability policies (see Arestis and Karagiannis 2025; also, Mackowiak and Schmidt 2023; and Acocella et al. 2016).

3 Economic performance of the eurozone

The economic record of the countries of the euro area is briefly summarised in Figs. 1 to and 2, and Table 1.

A brief indication of the growth of GDP (per capita) is given in Fig. 1 (annual for Germany, France, Italy, and Spain as well as the euro area on average) and Table 1 (annual average for all 27 EU member countries over the period 2001–2023). For the euro area as a whole, per capita GDP grew at an annual average rate of 0.81%, with almost all countries recording average per capita growth of less than 1% per annum. These growth rates are substantially below those previously recorded, leaving open the obvious question as to whether the formation of the euro and particularly the nature of the monetary and fiscal policies contributed.

Unemployment in Germany has trended downwards in the past 15 years. France, Italy, and Spain have trended downwards in recent years, albeit with rates of unemployment much higher than Germany. This is clearly shown in Fig. 2.

Figure 3 illustrates that the budget deficit position (average for euro 20) gradually declined during the 2010s and then rose with COVID. Some discussion of the effects follows. Over the period 2001–2024 (using forecast figures for 2024), budget deficit for the euro area countries averaged 3.22% with figures of 3.03% for

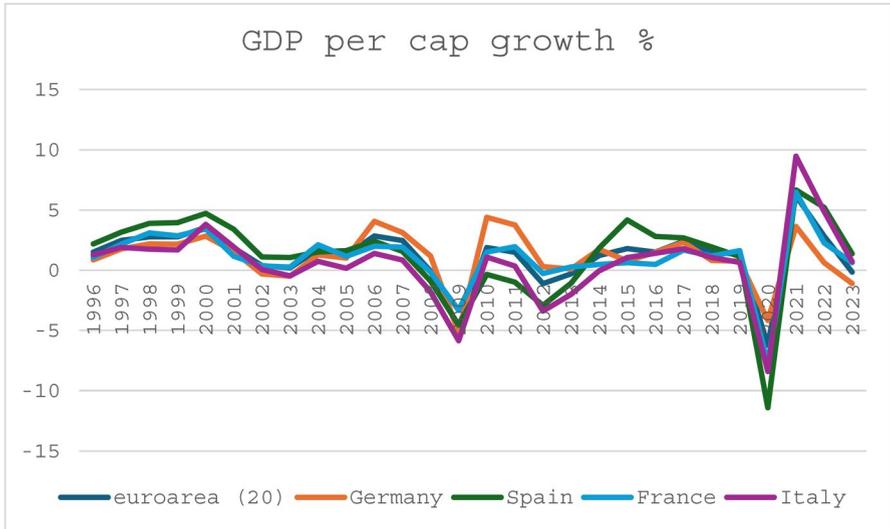


Fig. 1 GDP per cap.: average and some illustrations (Germany, France, Italy, Spain) Source: Calculated from OECD Economic Outlook database

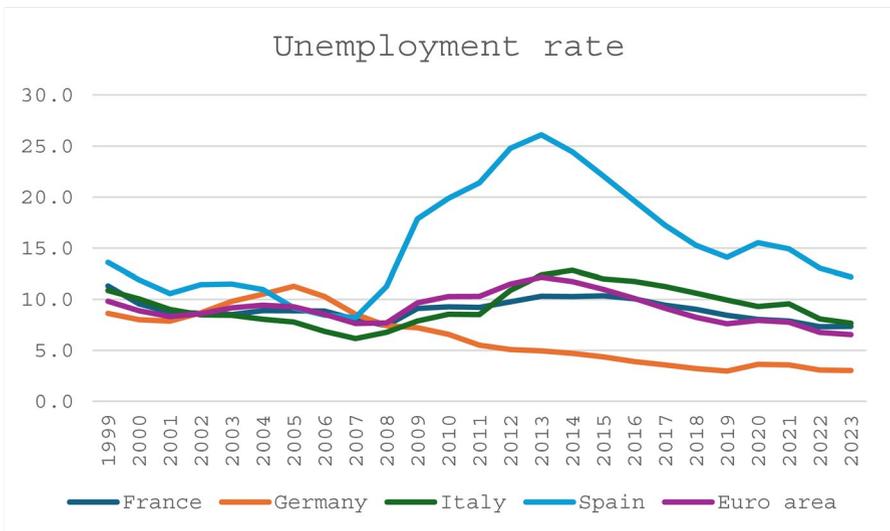


Fig. 2 Unemployment Source: Calculated from OECD Economic Outlook database

2001–2008 and 3.41% for 2009–2024. Germany’s budget deficit in the earlier period averaged 2.89%, falling to 0.93% in the latter period. Most other countries recorded higher deficits in the second period as compared with the first period.

The debt ratio statistics (summarised in Fig. 4) tell a similar story of debt ratios often (but by no means always) rising and generally being well more than 60%.

Table 1 Average annual growth rate of GDP p.c. 2001–2023

European Union—27 countries (from 2020)	1.09
Euro area—20 countries (from 2023)	0.81
Belgium	0.98
Bulgaria	4.15
Czechia	2.04
Denmark	0.97
Germany	0.89
Estonia	2.96
Ireland	3.38
Greece	0.27
Spain	0.62
France	0.67
Croatia	n.a.
Italy	0.11
Cyprus	1.34
Latvia	4.13
Lithuania	4.66
Luxembourg	0.54
Hungary	2.57
Malta	3.08
Netherlands	0.99
Austria	0.80
Poland	3.77
Portugal	0.72
Romania	4.39
Slovenia	2.01
Slovakia	3.31
Finland	0.74
Sweden	1.16

Source: Calculated from OECD Economic Outlook database

The debt to GDP ratio for the euro area in 2001 averaged 68%, though amongst the big four only Italy at 109% exceeded the 60% target. By 2024, the average had risen to 91%, and amongst the big four only Germany came close (at 64%) to the target. There was near doubling of the debt ratio in a number of countries including France and Spain.

These statistics strongly suggest that in spite of (or perhaps because of) the relentless pressures to meet fiscal rules, there has been a tendency for the debt ratios to rise and for the deficits not to conform to the fiscal rules. To some degree, attempts to scale back budget deficit through a combination of expenditure cuts and tax increases can be self-defeating. A study covering the 1990s and the early years of the euro had similar findings. The Stability and Growth Pact ‘has been unsuccessful in fulfilling its goals, fiscal sustainability and supporting

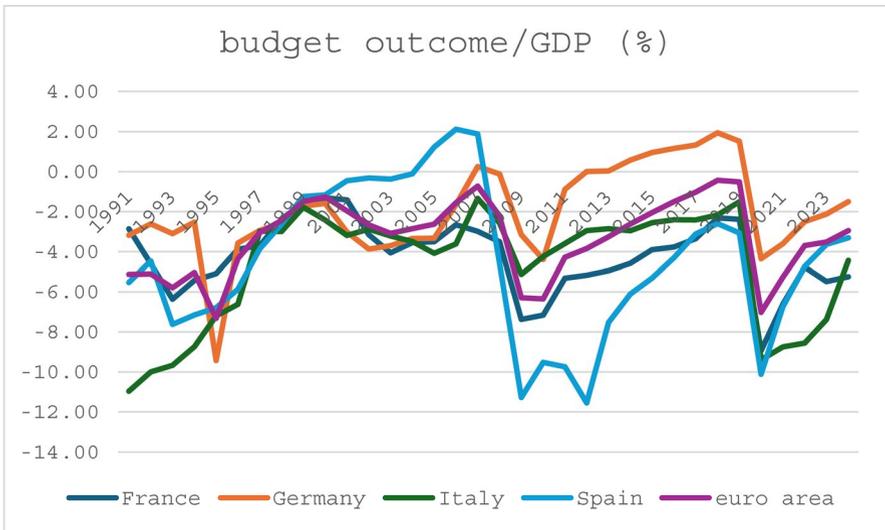


Fig. 3 Budget position/GDP 1990–2024 Source: Calculated from OECD Economic Outlook database

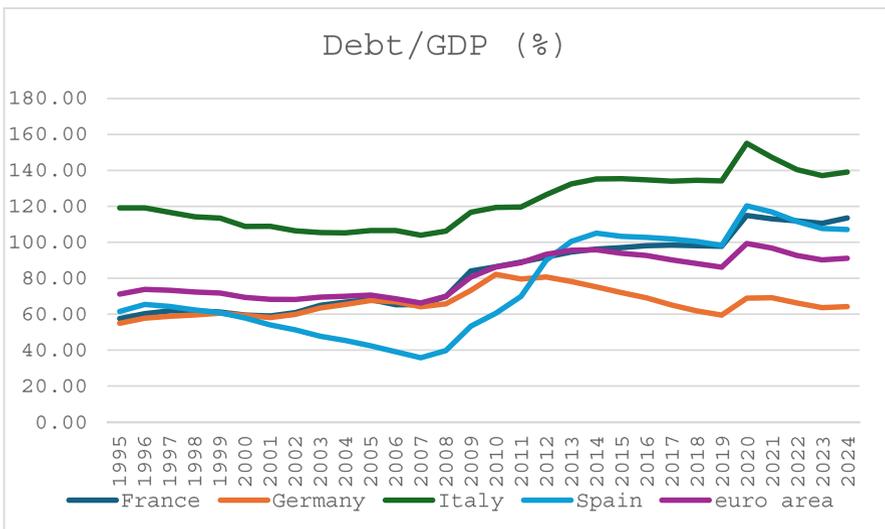


Fig. 4 Public debt/GDP Source: Calculated from OECD Economic Outlook database

economic growth. More and more countries have exceeded the 3 per cent of GDP limit for the budget deficit and the public debt-to-GDP ratios have been growing while at the same time macroeconomic performance has been unsatisfactory. In the Euro area fiscal policy has been much more restrictive [as compared with USA] and has had pro-cyclical and therefore destabilizing effects for many countries' (Hein and Truger 2007, p. 179).

We would though suggest that at least some of the difficulties have come from the inappropriateness of a balanced budget in the face of significant imbalances between savings and investment and the current account. A country which has a large current account surplus finds it relatively easy to secure a balanced budget.

The record on budget deficits and public debt is generally one of not meeting the rules and constraints of the fiscal rules. It can also be asked how far this was for want of trying. And the record here appears to be that fiscal consolidation through raising tax rates and reducing public expenditure was often pursued. Deveries et al. (2011) and Adler et al. (2024) provide a history of fiscal consolidations in a range of countries including most of the euro area countries. They reveal substantial fiscal consolidations within the euro area, though how far those fiscal consolidations can be assigned to the operation of the Stability and Growth Pact and its successors is difficult to ascertain. And, of course, countries outside the euro area also have undertaken fiscal consolidation. Ideas of expansionary fiscal consolidation (i.e. that fiscal consolidation promotes higher economic activity) were often politically influential but the evidence has tended to point in the other direction. There are inevitable difficulties in constructing the counterfactual to an episode of fiscal consolidation. Heimberger (2017) analyses the short-run effects of fiscal consolidation measures on economic activity in the euro area in the years 2011–2013 covering the euro crisis. His main empirical finding is that a reasonable approximation (depending on the size of the multiplier used in the range 1.4 to 2.1) of the output losses due to fiscal austerity in the euro area in this period was in the range of 5.5% to 8.4% of GDP.

Gechert et al. (2019, p. 664) find that ‘fiscal policy [in the euro area] seems to have had a permanent effect in the 2010–11 period and beyond. ... Interestingly, it turns out that the effects weaken for measures in late crisis years after 2013 and when including very small very open economies. ... For our European sample, we find evidence for strong hysteresis effects as opposed to the short-run pain, long-term gain consensus that emerged after the early crisis years’.

Liotti et al. (2025) investigate the 12 initial eurozone countries over the period 1999–2019 and the effects of cyclically adjusted primary balance on public debt. The results indicate ‘that the implementation of discretionary fiscal austerity has contributed to the rise of public debt, regardless of the economic structures within Eurozone countries. This effect likely occurs because discretionary fiscal austerity reduces aggregate demand, particularly consumption and investment, thereby slowing economic development and negatively impacting growth, which ultimately leads to an increase in public debt’.

Heimberger (2025) analyses the growth effects of fiscal adjustments and their implications for debt sustainability. Three periods of fiscal consolidation in the euro area are identified: the period leading up to the formation of the euro area with governments facing the Maastricht criteria for joining the monetary union (1992–1998); the decade before the global financial crisis (1999–2009); and the euro crisis (with a specific focus on the 2011–2013 period). He finds that ‘the empirical evidence on the growth effects of fiscal consolidation shows that while fiscal adjustments are contractionary, the negative growth effects were particularly strong and persistent during the euro crisis’ (p. 1).

4 Deficits and debt policies under the euro

The governance of the euro has involved postulated limits on budget deficit and public debts which are intended to be enforced through sanctions and fines. However, early on, France and Germany (amongst others) did not meet the deficit requirements, but no sanctions were applied. There have, though, been moves in the direction of tighter limits on deficits and debts, though with suspension of those limits at times and often failure to meet the limits.

An important development came in 2009 when the ‘debt brake’ (formally the balanced budget amendment to the German constitution) was approved and then gradually introduced thereafter, requiring that at the federal level the budget deficit was legally limited to 0.35% of the GDP beginning in 2016, and German states that approved the law were prohibited from taking on debt after 2020. Its operation has been subsequently suspended at times of crisis. The ‘debt brake’ was not only a significant tightening of the constraints on budget deficit in Germany, but was something of a forerunner for the fiscal compact (as discussed below). It further embedded rules for economic policy into law and thereby opened further potential involvement of the courts in ruling on economic policies.

The Treaty on Stability, Coordination and Governance (TSCG) in the Economic and Monetary Union of which the ‘fiscal compact’ was the central part was agreed by most EU countries as an inter-governmental agreement (in face of perceived difficulties of amendment of the European Treaty). The essential features of the ‘fiscal compact’ and the Treaty are as follows:

The imposition of the ‘structural budget deficit’ rule that the structural deficit may not exceed 0.5% of GDP. A rapid convergence towards their respective medium-term objective and within a time frame proposed by the European Commission is also required.

A stricter policy imposed on countries with a debt ratio exceeding 60% of GDP. The Treaty made it possible to open an ‘excessive deficit procedure’ (EDP). Member States with government debt ratios in excess of 60% of GDP should reduce this ratio in line with a numerical benchmark, which implies a decline of the amount by which their debt exceeds the threshold at a rate in the order of 1/20th per year over 3 years.

The deficit requirement had to be written into a country’s national constitution or equivalent (Article 3 (2) TSCG). These developments introduced an undemocratic element in that it would appear to limit any aspiring government from advocating a higher budget deficit. It embeds economic policy into the constitution whereas ideas on appropriate economic policy are not unchanging over time. It seems a folly to incorporate ideas what some, but no means all, think are appropriate policies into a document which is difficult to change, especially when those ideas are mistaken. It can also be seen as an attempt to tie the hands of the electorate and future governments on economic policies.

Through the excessive deficit procedure, further constraints on deficit were imposed. The intention to balance the budget deficit over the cycle is superseded by a balanced structural deficit rule, such that the structural budget deficit does not exceed 0.5% of GDP.

The implementation of a balanced structural budget requirement is made difficult by disputes over the measurement of the structural budget position. The implementation of a requirement that there be a balanced annual budget does not face such difficulty as the annual budget outcome can be readily measured (though it is the *ex post* annual budget, which can be measured but not the *ex ante* budget). The structural budget is 'structural' public expenditure (that is some 'normal' level of expenditure excluding any one-off forms of expenditure) less the tax revenues, which would be generated from the 'normal' set of tax rates when the economy operates at some 'average' level (which will be described as 'potential output' in line with the literature). Each of the elements of the structural budget is a matter of estimates and dispute, and notably what constitutes 'potential output'. The degree to which the interpretation of whether a country meets its structural deficit requirements is in effect left in the hands of economic forecasters. A structurally balanced budget may be impossible to achieve, as not only does it require that the budget would be balanced at a high level of employment but also that there would be equality between investment and savings (including foreign savings) which can be seen from the national accounts relationship as above: if the right-hand side equals zero for a high level of economic activity (e.g. when the output gap is zero), then the left-hand side would also have to equal zero at the same level of economic activity.

The stability programmes and convergence programmes, introduced in 2016, included a Medium-Term Objective as a budgetary target set by each Member State, defined in structural terms, and Member States had to set out yearly targets on the way towards the MTO and forecast the expected path of their debt-to-GDP ratios. A description and an assessment of policy measures to achieve the programme objectives were required. Stability Programmes submitted by Member States had to be based on macroeconomic forecasts produced or endorsed by independent bodies which were assessed by the European Commission and, when appropriate. The convergence programmes had to be based on what were termed sound fiscal scenarios. The Commission assessed stability programmes and convergence programmes both before and after implementation which allowed the Commission to identify and discuss any risks of non-compliance with the Stability and Growth Pact before they occur, and to identify any actual instances of non-compliance that could ultimately warrant sanctions.⁴

A new economic governance framework⁵ came in 2024 with the objectives of strengthening Member States' debt sustainability, and the promotion of sustainable

⁴ See stability and convergence programmes prior to 2024 - European Commission at ec.europa.eu/economic-and-fiscal-governance/stability-and-growth-pact/preventive-arm/preventive-arm-prior-2024/stability-and-convergence-programmes-prior-2024_en.

⁵ See Commission welcomes political agreement on a new economic governance framework fit for the future at ec.europa.eu/commission/press-corner/detail/en/ip_24_711.

and inclusive growth in all Member States. It seeks a simpler framework that is more transparent and effective with greater national ownership and better enforcement. There is the hope that public debt levels can be reduced in a realistic, gradual, and sustained manner. Significantly, ‘medium-term fiscal structural plans are at the centre of the new framework. Member States will design and present plans setting out their fiscal targets, priority reforms and investments, and measures to address any possible macroeconomic imbalances during a fiscal adjustment period. ... These plans will then be assessed by the Commission and endorsed by the Council, based on common EU criteria’.⁶ The assessment of an ‘excessive deficit’ is to take into account a range of relevant factors which could include the public debt situation, economic and budgetary developments, and the implementation of reforms and investment and defence expenditure.

New fiscal rules came into force 30 April 2024 including debt sustainability analysis (DSA) (see Heimberger et al 2024; Heimberger 2025). DSA plays a key role in reformed EU fiscal rules, which came into force on 30 April 2024. For EU member countries with a fiscal deficit above 3% of GDP or a public debt ratio above 60%, the European Commission (EC) put forward a DSA-based ‘reference trajectory’. This is supposed to ensure that, by the end of a multi-year fiscal adjustment period, the public debt ratio ‘is on a plausibly downward trajectory or stays at prudent levels, even under adverse scenarios’ (Regulation (EU) 2024/1263) (Heimberger et al. 2024).

These developments in policy have tended to shift attention towards the debt ratio rather than the budget deficit, though obviously there are clear implications for the budget deficit from the debt ratio. The monitoring by the European Commission intensifies though the degree of flexibility of the application of the fiscal rules and the allowance for national differences.

5 Monetary policy under the ECB

The ECB was established as an ‘independent’ central bank along the lines of the Bundesbank. Independence implies that instructions cannot be taken from political authorities; also, it is not sanctioned if it fails to meet the objective of ‘price stability’ which ECB interpreted as CPI inflation of less than 2% per annum. The operations of the ECB can be examined in respect of its price stability mandate. The first relates to issues of differential rates of inflation between euro member nations. The second relates to the ability to control the average rate of CPI inflation. The time path of that average rate is portrayed in Fig. 5.

However, the period through the 2010s has been one of low and then very low interest rates in the face of inflation at or around the target level. But the inflation rate rose towards the end of the period in the face of global energy price pressures, and geopolitics problems, to well above the 2% target. Monetary policy is impotent in the face of global inflation, and any measures to address

⁶ See Commission welcomes political agreement on a new economic governance framework fit for the future at ec.europa.eu/commission/press-corner/detail/en/ip_24_711.

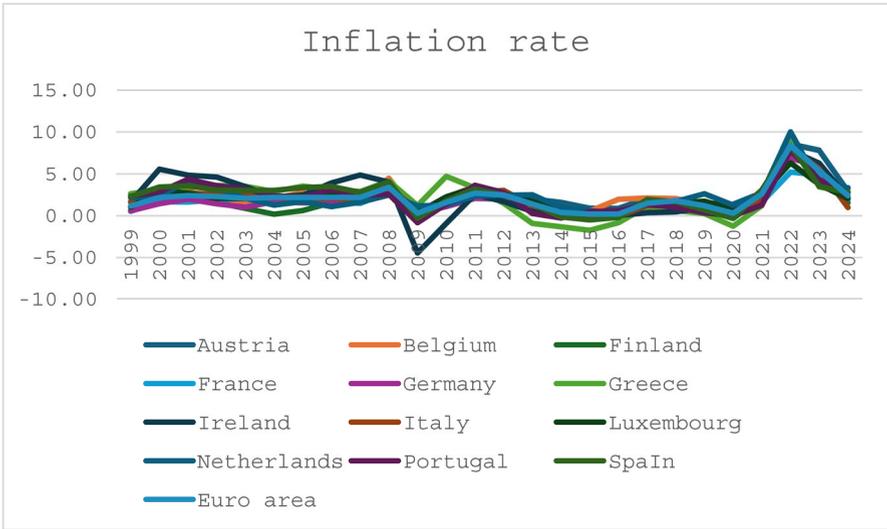


Fig. 5 Inflation rates amongst the original 12 Source: Calculated from OECD Economic Outlook database

such inflation through control/subsidy of energy prices (in this instance) must be taken by the national authorities.

The inflation rates in Fig. 5 give some impression of the differences between the euro area founder member countries. It can be seen that countries often experienced inflation above the 2% target level, albeit usually by less than 1 percentage point. The (unweighted) average rate for the 12 countries was between 2% and 3% every year from 2000 to 2008. There were significant shifts in relative prices between countries. The statistics in Fig. 5 refer to consumer prices (which is the target for monetary policy). But the development of measures of competitiveness and prices of tradeable goods is more significant for trade. Over the period 2000–2009, the annual average rise in unit labour costs was 0.6% for Germany through to 3.9% for Ireland and 4.5% for Greece, with an average (across the 12 countries) of 2.4%. There were then implications for the real exchange rates between the member countries when the nominal exchange rate is constant.

‘Independence’ of central banks involves much more than inflation targeting though the two have often been associated. The ‘independence’ also refers to the relationship between the central bank and government, and to what degree central bank operates ‘independently’ of central government. In the case of inflation targeting the ‘independence’ refers to central government setting target for rate of inflation with the central bank charged with aiming to reach the target set through monetary policy, notably the use of the policy interest rate.

6 Euro crises

What has often been termed the euro area crisis (or European sovereign debt crisis) started in 2009 following the global financial crisis (GFC). It took many dimensions, and a number of Member States, often given the derogatory label of Portugal, Ireland, Italy, Greece, Spain (PIIGS), encountered difficulties in financing and refinancing their national government debt. Governments sought to bail out those fragile banks and financial institutions in difficulties following the GFC. Substantial differences in the current account positions of the Member States (with Northern European countries generally in surplus and Southern European in deficit) had tended to grow. These differences clearly could not be removed by a depreciation of the currency value of the deficit countries. The corresponding different position of the capital account meant patterns of lending (current account surplus countries) and borrowing (deficit countries). There were differences in the government budget positions (to some degree related to differences in current account positions).

Vigny (2022) reviews a range of explanations of the Greek crisis which are refuted in the paper. An alternative interpretation 'of the Greek macroeconomic trajectory before the sovereign debt crisis is provided'. From the perspective of this paper, the significant aspect of Vigny's argument is that 'the rise of private debt explains Greek stylized facts before the crisis but is not sufficient to cause the sovereign debt crisis. As post-Keynesian authors already pointed out, the absence of ECB interventions led to the crisis. The EMU political governance was the cause of the crisis. It brought Greece close to default. The Greek government had to implement the so-called Memorandum of Understanding to receive financial assistance from other European states. The imposed austerity led to a never-ending crisis, which lasted a bit less than a decade. In the EMU, Greece is a non-sovereign country. The EMU political decisions are shaped by the largest Member States, which enjoy a more favourable status'.

Flassbeck and Spiecker (2011) take a different position relating to the causes of the euro crisis. Wage and price divergences as already mentioned above induced external imbalances, which are then viewed as a central issue. 'The core of a monetary union is the agreement of all Member States on a target inflation rate and nothing else. A monetary union is not a union of harmonised public budget targets or of harmonised holiday entitlements. But unfortunately, many of those who were in favour of the monetary union had, and still have, an unbalanced view of the constitutional elements of a currency union. The focus of the EC and the Member States on government deficits and public debt was driven by the overwhelming neoliberal agenda to minimise government and replace it with the private sector wherever possible. Instead of being alerted by the dramatically divergent development of prices, wages and unit labour costs, they fine-tuned the rules for budgetary discipline time and again' (p. 180). In the aftermath of the 2007–2009 global financial crisis, the European Semester was established in 2010, which was intended to address the need for stronger EU socio-economic governance and better coordination between national economic and fiscal policies. EU Member States initiated a broad reform of EU policies which included

new tools to handle Member States facing financial distress, including the European Stability Mechanism, stronger fiscal surveillance of national budgets through the reformed Stability and Growth Pact, and new instruments to prevent and correct risky macroeconomic developments with the Macroeconomic Imbalance Procedure.

The European Stability Mechanism (ESM) is part of the EU strategy designed to safeguard financial stability in the euro area. Like its predecessor, the temporary European Financial Stability Facility (EFSF), the ESM provides financial assistance to euro area countries experiencing or threatened by financing difficulties.

A Recovery and Facility entered into force on 19 February 2021, and finances reforms and investments in EU Member States, made from the start of the pandemic in February 2020 until 31 December 2026. Countries can receive financing up to a previously agreed maximum amount. To benefit from support under the Facility, EU governments have submitted national recovery and resilience plans, outlining the reforms and investments they will implement by end-2026, with clear milestones and targets. The plans had to allocate at least 37% of their budget to green measures and 20% to digital measures.

The ECB and the national member central banks have been barred from the direct monetisation of national government expenditure and deficits though it has always performed indirect monetisation through open market operations and the willingness to purchase bonds of the member governments. The budget deficit limits were often not met by euro area member governments in the first years of the euro, including Germany, though little action was taken against the governments concerned. The global financial crises of 2007/2009 (and the associated recession) brought major upswings in budget deficits and increased debt ratios well beyond any 60% limit. The first years of the euro had a tendency for an increasing divergence between member countries in respect of current account positions. Countries, notably Germany and the Netherlands, had large and growing current account surpluses, whereas others (mainly Southern European) large and growing deficits.

One intention behind the various convergence criteria along with the common policy interest rate across member countries was that the rates of interest at which governments could borrow were close. Furthermore, the credit ratings of government bonds would be similar. The European banking crisis and other factors put pressures on the euro area as a monetary bloc. Notions that lending to one euro area country was essentially the same as lending to another disappeared. In particular, each government needed to keep the 'spread' between the rate at which it could borrow and the rate at which Germany could borrow as low as possible. There was an asymmetry within the ERM, and the fault lines were revealed in the course of the European sovereign debt crisis. National central banks could not undertake any decisions or operations themselves to address the bond market pressures. The Maastricht Treaty forbade the ECB from directly purchasing the debt issued by Member States; the ECB could not readily act as a guarantor of any sovereign bonds either. The lack of lender-of-last resort capacity (whether at ECB or a national level) differential borrowing costs could not be stopped. Some governments were at various times during 2010–2011 shut out from capital markets (Greece, Ireland, and Portugal) —then needed bailouts, even though the Maastricht Treaty also forbade bailouts.

There were a range of responses to seek to overcome these limitations. In May 2010, ECB established Securities Market Programme to buy sovereign bonds indirectly in secondary markets though ‘no one could seriously pretend this purchasing was compatible with the intent behind the Maastricht Treaty’ (Thompson, 2022, p. 149; see also Scicluna 2018).

During the summer of 2011, Italy and Spain were in similar positions as Greece, Ireland, and Portugal had been. But they were much larger economies, and the bailout framework established for Greece was inadequate for larger economies. Further, French and German banks were heavily exposed to Italy and Spain. The responses led by the ECB illustrate the leading role of the central bank as the key Federal-level macroeconomic institution. Further, the conditions which come with the ECB in acting as lender of last resort, but which would not be tolerated in the national context. There was a combination of the ECB imposing conditions on elected governments in a neo-liberal direction. In August 2011, Trichet governor of ECB wrote to Berlusconi (Italian Prime Minister) to demand policy changes, which eventually led to the Italian president appointing Mario Monti’s cabinet of technocrats. Trichet and the governor of the Bank of Spain wrote to Spanish prime minister Zapatero requesting various policy measures including on labour market reforms before the end of August 2011, which were eventually imposed by decree. The Troika (EC, ECB, IMF) loans ‘came with German-driven conditions that forced these governments into public expenditure cuts, tax increases, and labour and welfare reforms in the name of replicating the German trade surplus’ (Thompson 2022, p. 148). Thompson remarks that the euro area in 2011 could not function as it was constitutionally supposed to under the Maastricht Treaty. The ECB was going well beyond its mandate and intervening in the fiscal policies of Member States. Draghi as governor of ECB noted that a number of EU and euro area countries have requested financial assistance in the aftermath of the crisis ‘because of their challenged access to capital markets’. But those countries had to commit ‘to implementing the reforms necessary to secure full market access in the future. Since financial assistance can only be temporary, the quality of the reforms and their implementation are absolutely essential. It is this quality that ultimately determines the success of a programme’ (Draghi 2012a).

On the 2nd of August 2012, the Governing Council of the European Central Bank (ECB) announced that it would undertake outright transactions in secondary, sovereign bond markets (OMT operations), aimed ‘at safeguarding an appropriate monetary policy transmission and the singleness of the monetary policy’. The Outright Monetary Transactions (OMT) is considered by the European Central Bank when an euro-area government seeks for financial assistance through the European Stability Mechanism and the European Financial Stability Facility funds. The ECB can buy government-issued bonds of 1 to 3 years’ maturity, provided the bond-issuing countries agree to certain domestic economic measures. The aim of the programme is to prevent divergence in short-term bond yields. The central bank notes that the OMT is meant as a means to ‘safeguard an appropriate monetary policy transmission and the singleness of the monetary policy’. Interventions through the programme are stipulated to be potentially limitless. The technical framework of these operations was formulated on 6 September 2012. The programme was adopted with near

unanimity: the President of the Bundesbank being the sole vote against. The OMT decision was challenged in the German Federal Constitutional Court by members of the German Bundestag. It was referred to the European Court of Justice (ECJ) which ruled the conditional OMT programme to be legal, as due to its attached conditions it did not exceed the powers of the ECB with regard to monetary policy and did not contravene the prohibition of monetary financing of EU nations. Under this programme, the ECB makes purchases ('outright transactions') in secondary, sovereign bond markets of bonds issued by Eurozone Member States, under a number of conditions. The programme was viewed as key aspect of Draghi's (July 2012) commitment that 'Within our mandate, the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough' (Draghi 2012b).⁷

For the OMT to be activated towards a certain euro area state, a total of four conditions needed to be fully met including receipt of financial sovereign support from the bailout funds EFSF/ESM, and signed conditioned Memorandum of Understanding attached to the EFSF/ESM sovereign support programme shall be complied with at the time of OMT purchases (see Altavilla et al. 2014).

Along with many other central banks, ECB undertook Quantitative Easing (in two major phases). Its intention was to underpin low interest rates, and QE involved purchase of national government bonds and its implications.

A major focus here is on the nature of the relationship between the central bank and the national governments, and in whose interests the ECB has operated.

7 Concluding comments

There were many problematic features surrounding the launch and subsequent development of the euro area. There are two which we highlight here. The first relates to seeking to impose common fiscal rules relating to the size of budget deficits and national debt across all member countries. The rules tended to be deflationary in nature, at least for some member countries, and to limit the role of fiscal policy acting as an automatic stabiliser. The differing current account and savings/investment positions in member countries pointed to the need for differing budget deficit positions. Throughout the quarter of a century, the fiscal rules have tended to tighten and yet at the same time a continuing failure to meet the deficit and debt limits.

The second relates to the operations of the ECB and its relationships with member governments. The ECB was precluded from the direct financing of national deficits, and did not have to act as lender of last resort. The complications which flowed from this became apparent during the euro crisis of the 2010s.

The fiscal union and banking union are not complete in the European Monetary Union, which are needed to support investment and growth. As Berger et al. (2018) suggest, the EMU needs a fiscal union 'to preserve financial and economic integration and stability' (p. 1).

⁷ See for example, [www.europarl.europa.eu/RegData/etudes/ATAG/2015/519231/IPOL_ATA\(2015\)519231_EN.pdf](http://www.europarl.europa.eu/RegData/etudes/ATAG/2015/519231/IPOL_ATA(2015)519231_EN.pdf)

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