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# **The Brussels-Frankfurt-Washington Consensus**

## **Old and New Tradeoffs in Economics**

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## 1. Introduction

The application of the policies prescribed by the Washington Consensus in developing countries are the subject of a vast literature. What is much less widely recognized is that there really exists only one pure laboratory experiment implementing the Washington Consensus in the western world: Europe. The aim of this paper is to show that Europe has gone very far in the internalisation of the Washington Consensus; in fact, it has devised constitutionally a form of government that has no choice but to implement it. We argue below that until now this experiment has not been a success story.

The expression "Washington Consensus", first introduced by Williamson (1990), may look fuzzy. We use it to label any set of policies that follow three basic principles: First, the search for macroeconomic stability (balanced budgets, price stability, and for developing countries exchange rate stability). Second, structural reforms aimed at increasing competition and openness. Third, the neglect of any possible tradeoff between present and future growth. The most important problem with the Washington Consensus is that it loses of sight what should represent the ultimate objective of economic policy (growth, full employment), in favour of intermediate goals like macroeconomic stability.

The creation of a unique economic zone is one of the areas in which the slow and sometimes painful construction of an integrated Europe has progressed more. Member states have transferred sovereignty to the supranational level in the areas of monetary, trade, and competition policies. Fiscal policy, while still in the hands of governments, is subject to the provisions of the Stability and Growth pact. The institutional setup designed in the 1990s is rather complex. Supranational and national competencies intersect and interact, sometimes in odd ways. Competition policy is completely delegated to the European level, and the Competition Commissioner has legislative, executive and judicial powers. For macroeconomic policies, on the other side, the assignment of tasks and objectives is more vague. Monetary policy is in the hands of a technical body, the European Central Bank (ECB), which is given by treaty independence of targets and instruments (within the broad objective of price stabilization); furthermore, the ECB is not directly accountable to any political authority, which makes its degree of independence rather uncommon. Fiscal policy, the only instrument left in the hands of governments, is subject to the constraints of the Stability pact. The Commissioner for Economic and Financial Affairs is formally limited to a monitoring task, but has very considerable political influence magnified by the publicity given to its recommendations, and their effects on the reputation of governments. To further add to the complexity of the institutional setup, the treaties do not provide for a coordination mechanism or authority (a "prime minister") between the different actors; this gives even more power to

the strongest actors (the ECB, the Competition Commissioner). In other words, while on one side, competition policy is conducted at the European level, with the unambiguous task of promoting free trade and minimising monopolistic distortions, fiscal policies are carried on by a number of relatively weak and uncoordinated actors.

This setup is no accident. It reflects the neo-liberal doctrine that prevailed in the early 1990s according to which the areas of competition and macroeconomic policies have to be seen largely as substitutes, with the former being superior in terms of efficiency. The tasks for policy are then well defined: First, reduce the distortionary presence of the government in the economy, which can be done by reducing its size, by balancing the budgets, and by fighting inflation; and then use the freed resources to increase competition by means of structural reforms aimed at the smooth working of markets. No surprise then that macroeconomic policy in the European institutional setting is not at the centre of the stage; furthermore, it is in the hands of technical bodies like the ECB or even worse constrained within the limits of inflexible rules like the Stability pact. This crystallization of a particular doctrine within economic institutions is a peculiar feature of today's Europe, and is unprecedented on such a scale.

The European "ideological bias" is further aggravated by the objective difficulties of a currency area that is far from optimal. The low labour mobility creates a rigidity in the system for which the solution would be price and wage flexibility, that in the form required by the theory has not been experienced anywhere, as it would be socially unbearable. The only way out from this *impasse*, consistent with the neo-liberal doctrine that permeates the European institutions, is a form of indirect "flexibilization": Cost reduction through fiscal competition and the progressive dismantlement of the welfare state (social competition), on one side are the only form of policy available to national governments for reacting to idiosyncratic shocks; and on the other, respond to the more general objective of reducing the weight of the state in the economy, a pillar of the Washington Consensus.

The obvious question that arises then is: Were these policies successful in attaining the objectives of growth, prosperity and low unemployment? Macroeconomic policy was characterized by substantial inertia, at least in the past two decades. Was this choice rewarding? We claim in this paper that the answer is no, as the comparison with the growth performance of the United States indicates. We claim that the root of the inferior performance of the European economy is to be found in the adherence to the neo-liberal doctrine as outlined above, and to the substantial neglect of the growth objective in policy choices. We also try to argue why this result should not be surprising, as the doctrine has both theoretical and empirical weaknesses.

This brings to the more general issue of the identification of capitalism with the free market paradigm. By looking at the past, we quickly realize that ranking different institutional settings in the attempt to find the "best" one is a vain exercise; in fact, different models proved successful in assuring prosperity at different points in time, depending on the conditions of the moment. In fact, the strength of capitalism resides precisely in the capacity to adapt and to accommodate different institutional setups and to deal with the complexity of the world.

Further broadening the perspective one must ask first why should efficiency be the sole objective of a modern society<sup>1</sup>; and then, whether excluding ethical considerations from the policy maker's objectives is necessarily the best way to assure prosperity. As recent experiences in the developing and transition economies have painfully reminded us, the issues of wealth creation and distribution are inextricably linked. This calls for a complex and delicate role for policy. Policy choice is a problem of arbitrage between conflicting objectives, rather than, as implied by the neo-liberal doctrine, the simple search for a first best outcome. Tradeoffs, often ignored by mainstream economics, are at the centre of the stage, and have to be faced in making policy choices.

The paper is structured as follows. The next section will present a few stylized facts comparing the growth performance of the US and of the largest European countries. The following section will describe the mainstream explanation for the European "growth deficit". In section 4 we will challenge this explanation, highlighting empirical and theoretical weaknesses alike. Then, in sections 6 and 7 we will argue that tradeoffs, and hence a scope for policy action, characterize modern economies. We will also show, by means of a simple *ad hoc* model, how the problem of arbitrating between structural reforms and stabilization policies may stem from commonsensical assumptions. Sections 8 and 9 will briefly deal with monetary and fiscal policy in Europe, and finally section 10 concludes.

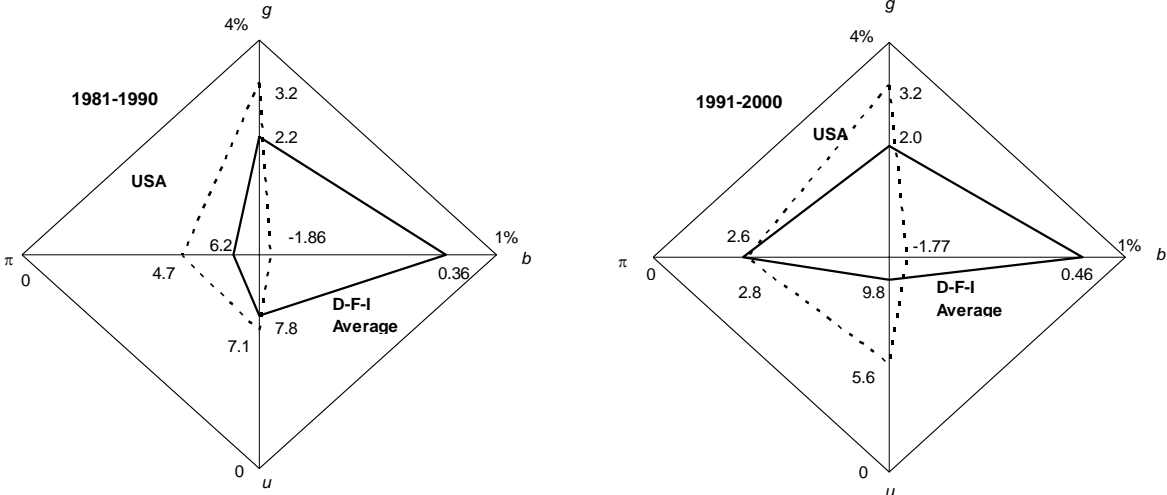
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<sup>1</sup> In his Keynes Lecture Solow (1998) remarks that: "If pure unadulterated labour-market reform is unlikely to create a substantial increase in employment, then the main reason for doing it is anticipated gain in productive efficiency, however large that may be. But if we respect the wage earner's desire for job security, and it seems at least as respectable as anyone's desire for fast cars or fat-free desserts, then an improvement in productive efficiency gained that way is not a Pareto-improvement".

## 2. The Facts: Us Growth vs. European Stagnation

The different growth and unemployment performances of the United States and the largest countries of the Euro area over the past two decades have generated a huge literature. We can try to look into these performances by means of Kaldor's (1971) "magic square", as reported in figure 1.

On each of the axes we represent one of the four main objectives of economic policy: Growth of real GDP ( $g$ , north), external balance (current account surplus over GDP,  $b$ , east), unemployment ( $u$ , south), and inflation ( $\pi$ , west).



**Figure 1.** The Magic Square for the USA and for the three largest European countries (Germany, France, Italy). Average yearly values for each decade. Source: OECD and IMF. Authors' calculations.

The figure offers a good snapshot of the difference in performance of the two areas. In the 1980s, the US had an average growth of 3.2% per year, a full point above the average of Germany, France and Italy. Furthermore, inflation and unemployment were lower, albeit at fairly high levels. In the 1990s the US was able to make a considerable improvement in its performance in terms of inflation without giving up growth. Furthermore, unemployment fell significantly over the decade. The European countries on the other hand, had to trade their much improved record on inflation with a further worsening of their unemployment situation that over the decade averaged nearly 10% (whilst growth stagnated at a mere 2%).

To summarize, we can say that the US reached three out of the four objectives, especially in the 1990s, while Europe was only able to master inflation and to keep the external balance.

Why is it so? Is the external imbalance of the US, which accumulated for more than two decades, the price that had to be paid to reach a high growth – low inflation path? And was the European emphasis on external (and internal) balance, together with the fight against inflation, detrimental for growth? In other words, is figure 1 showing us a trade-off between policy objectives that was (more or less deliberately) resolved in different directions by policy makers on the two sides of the Atlantic? Or was the uneven performance, especially in Europe, the effect of policy (and institutional) mistakes, that prevented the economy from reaching *all* the objectives?

### **3. The Brussels-Frankfurt-Washington Consensus.**

The general consensus on the above questions emphasizes the latter approach: The different position of Europe and the US on the magic square is explained not by different policy choices in the past three decades, but rather by the different structure of the economy. The US has a more flexible, market oriented economy, whereas European countries have to carry the burden of an inefficient welfare state that forces their economy on a low growth – high inflation path. This consensus, that we label as the "Brussels-Frankfurt-Washington (BFW) Consensus" has academic and institutional supporters alike. Thus, for example, Prescott (2003) argues that the differences in hours worked in the US and in Europe are almost entirely attributable to an excessive tax burden in the latter, and hence that reducing government size would yield higher growth. In a similar vein, Lucas (2003), while conceding that in the past Keynesian stabilization policies played an important role in reducing income fluctuations, claims that there is no further role for stabilization, while a lot can be gained in terms of welfare from structural reforms. We limited ourselves to the some of the more recent and prestigious examples, but the list could include hundreds of citations.

The BFW Consensus has also permeated policy making, and the institutions in charge of economic governance at the global or regional level. The International Monetary Fund and the World Bank, backed and inspired by the richest countries, have proposed a development model based on essentially three elements: First, a reduced role of macroeconomic policy; second,, an increased role for market mechanisms (privatization, deregulation, and in general structural reforms); and third, full integration with the global economy (openness to trade and

free financial flows). The model did not prove as successful as its proponents had hoped<sup>2</sup>, but this has not substantially altered the reference framework of development policy.

In Europe adherence to the BFW Consensus has been pushed to the point that its prescriptions were embedded into the constitution, represented by the Maastricht and Amsterdam treaties (signed in 1992 and 1997 respectively). The European institutional setup, *de facto*, gives up discretionary economic policy. Monetary policy is delegated to an independent monetary authority, the European Central Bank, which is not accountable in front of any political body. And fiscal policy is strongly constrained by the Stability and Growth pact, which barely leaves space for automatic stabilizers to play. Recently, this setup has been criticized by a variety of sources, as being too rigid and unfit to promote growth. But in fact, most criticisms are 'internal' and only call for minor adjustments<sup>3</sup>. With a few exceptions (Fitoussi, 2002; Arestis and Sawyer, 2003) nobody has challenged the underlying framework that limits the role of government to the removal of obstacles preventing the smooth working of markets. As proof, it is perhaps enough to consider that the Constitutional treaty, submitted to the Inter-Governmental Conference in view of enlargement, as it pertains to economic matters simply crystallized the existing setting without any modification.

#### **4. The Theoretical Basis of the BFW Consensus**

The theoretical basis of the Consensus is a modern version of the neoclassical paradigm that has continuously been challenged since Keynes. After the crisis of Keynesian economics, in the 1970s, the neoclassical paradigm has become dominant again both in academic research and in economic policy making. Despite its endless variations, the scheme is quite similar to the old one: Once public intervention has coped with externalities, clearing and complete markets, populated by fully rational agents, usually yield the best possible outcome in terms of resource allocation and growth. And when that is not the case, it is because frictions and market failures prevent this from happening. The role for policy is then simply to remove or minimize these frictions on the supply side, i.e. to intervene on the structure of the economy to assure that it conforms as much as possible to the reference model.

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<sup>2</sup> For two recent accounts of the missed promises of globalisation the reader is referred to Stiglitz (2002) and Rodrik (2003). The first is aimed at a general public, while the second is more academic.

<sup>3</sup> Recent examples include Wyplosz (2002), Buiters (2003), Buti, Eijffinger and Franco (2003). These critiques came to the spotlight in October 2002, when the President of the European Commission, Romano Prodi, defined the Stability pact "stupid", as all rigid rules are.



In this perspective, any intervention on the demand side is useless, if not harmful. Once the conditions on the supply side are fulfilled, the economy attains the most efficient position, unless disturbed by distortionary public measures. This has important consequences in terms of policy: If tradeoffs do not exist, the policy maker is not confronted by choices, and there is no role for activist policies. Rules become the preferred method for conducting policy, as they prevent biases in policy makers' action, and constitute an anchor for private expectations.

The real business cycle literature is quite paradigmatic in this respect<sup>4</sup>. Fluctuations around the trend are simply the result of optimal responses of agents to shocks. As such they are optimal themselves, and any attempt to smoothen the cycle leads to welfare losses. Policy has a role only when frictions (for example price rigidity in the recent Neo-Keynesian literature: See Gali, Lopez-Salido and Valles, 2003) cause deviations from these optimal fluctuations. And even in this case, policy action is limited to (more or less) simple rules aimed at compensating the distortions/externalities.

A noteworthy feature of the paradigm is the claim of universality, which stems from its foundations in the "first principles" of rationality and maximization. As such, it proposes the same prescriptions in any situation: A developing country facing the risk of a currency crisis, or a mature European country affected by chronic low growth; an economy in transition, or an African country confronted with hunger and chronic diseases. This "simplicity" and universality of the theory probably contributes a great deal to explaining why, despite all its shortcomings (highlighted in the next section), the empirical weakness and the policy errors it induced, it is still dominant nowadays<sup>5</sup>.

## **5. Challenging the Consensus**

The BFW Consensus is widespread, and dominates both the academic debate and policy making. In spite of that, it has substantial weaknesses, both empirical and theoretical. In this section we will pinpoint some of these weaknesses, which may open the way for a challenge to the Consensus.

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<sup>4</sup> The two papers that initiated this stream of research are Kydland and Prescott (1982) and Long and Plosser (1983).

<sup>5</sup> The simplicity of the theory may not be the only reason for its dominance in policy making, especially in Europe. We argued elsewhere, in reference to the European Stability and Growth pact, that countries may be willing to accept potentially welfare reducing restrictions to their freedom of action, in order to acquire the reputation needed to access the "club" of virtuous countries (Fitoussi and Saraceno, 2002).

## *Do Data Support the BFW Consensus?*

The most surprising thing, about a Consensus so widespread in the academic and political community, is the scant evidence supporting it. The BFW Consensus has been internalized by European policy makers, who, as we noted above, embedded it into the institutional setup of the Union. The last serious demand management effort in Europe was carried out in France in 1981, to be quickly reversed in 1982. Since then, and especially since the Maastricht treaty, fiscal policy has been extremely passive, while monetary policy was almost exclusively focussed first on exchange rate stabilization and then, since the launching of the euro, on price stabilization. Nevertheless the growth performance of the area has been hardly impressive. The question then arises: where is the prosperity promised by the Consensus? In fact, if anything, the evidence goes against it: the only two episodes of relatively high growth in the past two decades, namely at the end of the 1980s and at the end of the 1990s, have both been preceded by a substantial loosening of monetary conditions. Monetary policy seems to be a major factor, though not the only one, behind recent European growth performance.

A follower of the BFW Consensus could say that the problem lies in the insufficient adherence to its prescriptions. Policy may have been virtuous, she would argue, but structural reforms have not progressed enough. However, in the light of the available evidence, this seems little more than a theological argument. Take the most paradigmatic structural reform, i.e. the reform of labour markets. Most economists<sup>6</sup> would point at the labour market as the main suspect in explaining the strikingly different growth performances of the US and Europe over the past two decades. A recent study representative of the Consensus is the one by Nickell *et al.* (2003), who argue that the equilibrium level of unemployment is affected by variables that either influence the ease with which unemployed individuals can be matched to available job vacancies, or directly prevent wage adjustment in spite of existing disequilibria in the labour market. These variables include the unemployment benefit system, the real interest rate, employment protection, active labour market policies, union structures, the extent of coordination in wage bargaining, labour taxes, and many others. The problem though, is that the impressive amount of work devoted to finding empirical support for this view has not yielded the expected results<sup>7</sup>: Evidence on institutions and labour market

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<sup>6</sup> The literature on the subject is vast. The ground has been laid by Layard, Nickell and Jackman (1991, 1994), using as a reference framework the job matching model developed in the early 1990s by Pissarides in the first edition of its celebrated book (2000), and by Mortensen and Pissarides (1994). More recent contributions include Siebert (1997), Elmeskov, Martin and Scarpetta (1998), and Saint-Paul (2000). On the institutional side, two good examples of how the Consensus has been embedded in policy making are the OECD employment outlooks (see in particular chapter two of OECD, 1999), and the recently released Sapir report (Sapir *et al.*, 2003).

<sup>7</sup> A first reason is the difficulty of constructing meaningful indicators of variables like wage rigidity, employment protection, and so on (see Addison and Teixeira, 2003).

performance is weak, and often contradictory<sup>8</sup>, so that the most cautious authors studying the subject have to conclude that "the broad-brush analysis that says that European unemployment is high because European labor markets are 'rigid' is too vague and probably misleading" (Nickell, 1997; p. 73); or again that "we feel that we probably deserve a B grade" (Nickell *et al.*, 2003; p. 396). The reason for this cautiousness has to be traced to a few related facts: First, as shown by Fitoussi (2003), the negative effects of various rigidity measures on employment performance are often of second order, and not robust. In fact in unemployment regressions, at least for OECD countries, nation specific factors often become non significant once we control for common shocks. Second, Fitoussi *et al.* (2000) show that structural reforms have not always yielded, where implemented, the expected results on labour market performance. In general, they find that different degrees of labour market rigidity across OECD countries may help to explain the reaction of unemployment to shocks, but reforms *per se* may not be seen as determining variables for medium-to-long unemployment reduction.

Finally, an important and often overlooked factor is the endogeneity of institutions. The well known results by Greenwald and Stiglitz (1986) and others, show how incomplete information, leading to moral hazard and incompleteness of markets, prevents the first theorem of welfare economics from working, as the market allocation is not (constrained) Pareto optimal. Greenwald and Stiglitz show that a government facing the same information constraints can act to improve efficiency. But their results also have the less emphasized consequence that institutions themselves emerge to compensate for market inefficiencies and incompleteness. Once imperfect information prevents contracts, for example, in the labour market from yielding the efficient outcome, norms guaranteeing labour protection may prevent excessive fluctuations of employment. How can we be sure, then, that labour protection legislation is an obstacle to full employment? Could it rather be that it emerged precisely in response to persistently high levels of unemployment?<sup>9</sup> Paradoxically, the only robust result emerging from the wide array of works devoted to the subject is that no single labour market institutional setting proves to be superior to the others, and that success is determined by the interaction of institutions with country specific factors (on this, see the excellent work by Freeman, 2000). This is exactly the opposite of what the BFW Consensus holds.

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<sup>8</sup> For an extensive and critical review on empirical evidence on labour market institutions and unemployment, the reader is referred to Baker *et al.* (2002).

<sup>9</sup> Baker *et al.* (2002) show that in the paper by Elmeskov, Martin and Scarpetta (1998) it is impossible to reject the hypothesis that higher unemployment Granger-causes higher unemployment benefits for important countries like the United States, France, Italy and the United Kingdom. They conclude that "While clearly not universal, this evidence of reverse causation provides serious grounds for viewing test results showing a correlation between high unemployment and long benefit duration with caution." Baker *et al.* (2002, p. 28).

In the field of development as well, the BFW Consensus has substantially failed the empirical test. The last decades witnessed some incredibly successful stories, and some tragic failures. All of them had complex reasons, and all of them proved wrong the notion that one institutional model, based on deregulated markets and a small government, is always superior to the others: One size does not fit all. And by looking backwards, of one thing we can be assured: Capitalism is sufficiently robust to accommodate rather different institutional settings, and results vary according to the period, the objectives, the external conditions and so on. Attempting to exemplify the best institutional arrangement, we would have recommended the French institutional model in the 1960s; we would then have turned to Japan in the 1970s, to the German experience in the 1980s, and finally to the US model in the 1990s. The nationality of the best institutional setting for the present decade is still unclear. Can we be sure that, in the future, historians will not point at the Chinese model as the uniquely superior model for the decade of 2000?

### *The Theoretical Flaws of the Consensus*

The lack of robust empirical evidence is only one of the problems of the BFW Consensus. As we mentioned above, the reference is an economy with clearing and complete markets, perfect competition and rational expectations. In such a model full employment is always assured, and policy is ineffective. This framework emphasizes the role of institutions in economic performances, especially labour market institutions: Any rigidity leads to departures from the reference model and hence to bad economic outcomes.

The main theoretical flaw of this framework is that it is based on a simplistic application of the welfare theorems, according to which a perfectly competitive market, absent distortions, will always reach the most efficient price/quantity allocation. It is simplistic because the step from the theoretical result to the policy prescription is trickier and has to be taken cautiously (as was done by the founders of general equilibrium theory). In fact, the efficiency of the market outcome strongly depends on a number of assumptions that are rarely observed in the real world, from perfect competition to complete markets and information. But once we admit, because of "market failures", the impossibility of attaining the first best equilibrium, the theory is incapable of establishing a unique ranking of alternative institutional arrangements. In other words, it has still to be proven that efficiency is monotonically related to price and wage flexibility, so that the closer we get to the benchmark, the better; and unless this is proven, the statement "more reforms are good" can not be unconditionally true.

If we broaden the perspective, things become even more complex. One of us has argued

elsewhere (Fitoussi, 2002) that democracy and political adhesion of the population to the economic governance of a society can actually enhance efficiency, guaranteeing the flexibility, transparency and consensus for policy actions that would be missing when ruling according to the strict application of a doctrine.

To conclude this section, it is useful to highlight some paradoxes that characterize the Consensus. The first is that its policy prescriptions are in one sense, more interventionist than the traditional Keynesian stabilization policies, because they require a deep modification of the economic and social structure through structural reforms. Hence, on one side mainstream economists ask the government to reduce its presence in the economy, and on the other they pretend that it can reach into relationships and customs that are rooted in society (often as the result of long term complex evolutions), to substitute them with the free market paradigm.

The other paradox linked to the Consensus is its different impact on different layers of the world economy. According to many commentators (e.g. Blinder and Yellen, 2001), the positive performance of the US in the past two decades may largely be attributed to their activist policy, and to the good coordination of monetary and fiscal policy. On the other hand, the Consensus is mainly a product of the academic community of the US. It looks as if the United States produced a good, the Consensus, that has not been marketed at home but rather exported, the greatest consumers being abroad. This consumption can be voluntary as in Europe, where policy makers have decided to embed the Consensus' prescriptions into the treaties; or it can be the result of a bargaining/bullying process, as was often the case for developing countries that were forced to adopt structural adjustment programs in order to gain access to international aid (Stiglitz, 2002).

The paradox is even more striking if we look at the progress of economic theorising on market failures and on policy making. Contrary to what happened in the 1970s, a large portion of economists nowadays believe that regulation and government intervention are key factors in guaranteeing durable, equitable and robust growth. But with a few exceptions (the most noticeable, as we said, being the US), policy makers still refer to the model of the 1970s.

## **6. Old and New Tradeoffs**

The model on which the Consensus builds contemplates no tradeoffs. Once the conditions for an optimal working of the economy are assured, it will attain the most efficient position by itself, and tampering with it by policy will be harmful. In such a framework there is never a

problem of choice. But this problem appeared clearly in the late 1960s, when the well known debate on the Phillips curve started. With rational expectations, only surprise inflation could (temporarily) move the economy away from its natural unemployment rate. On the other hand, Keynesians would argue that as soon as we departed from the benchmark model, policy makers could trade inflation for unemployment reduction, and hence would be able to "choose" a point on the negatively sloped Phillips curve<sup>10</sup>.

Today's debate, *mutatis mutandis*, replicates the old one. The trade-off about which economists argue in this case is between current and future growth. The vast literature in favour of structural reforms argues that those would enhance the growth potential of the economy, without hampering its short term performance; in fact market forces would be able to immediately absorb the structural changes. The argument has even been pushed as far as saying that this capacity of adaptation by the market could result in higher future *and* present growth<sup>11</sup>. In the worst case there could (temporarily) be losers that would have to be compensated by transfers. Absent (or negligible) short term costs, the policy prescriptions are straightforward: the prescribed reforms should be implemented without hesitation by any country wishing to increase its growth potential<sup>12</sup>. As we said before, this view stems from the confidence in the self regulating properties of the market, which in the mainstream has substantially the same foundations since the pre-Keynesians.

In such a framework activist macroeconomic policies are useless, if not harmful. They are useless because they do not affect the growth potential of the economy; and they may be harmful if they distract resources needed for implementing structural reforms. But a stronger link between present and future growth may emerge, once we depart from the benchmark model. It is easy to imagine situations in which active policies may improve welfare, for example by stabilizing income. On the other hand, structural reforms, in a non idealized world, would need time to have their positive effects, and short term costs for the society as a whole could appear. Job losses due to restructuring, or the slashing of pension benefits would both result in reduced purchasing power, with negative short term (in the best case scenario) effects

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<sup>10</sup> The rational expectations revolution, and the policy errors that followed the oil shocks of the 1970s settled the debate in favour of the New Classical school. Only recently we witness a "return of the Phillips curve" both in empirical and theoretical works.

<sup>11</sup> This is the case, for example, of the literature on the non-Keynesian effects of deficit reduction, initiated by Giavazzi and Pagano (1990); deficit reduction would, if perceived as credible by markets, have a positive effect on expectations and hence on private expenditure; these could more than compensate the restrictive effects of reduced deficits on current income.

<sup>12</sup> In fact there is a case for gradualism, when vested interests are strong enough to block the implementation of the reform. In the labour market, for example, insiders would resist liberalization (Saint-Paul, 2000). In this case, a gradual implementation of the reform would allow to initially exclude the insiders from it, and thus to weaken their resistance. The case for gradualism, hence, is not made based on general interest and on the costs of reforms for society as a whole.

on consumption and aggregate demand. Reforms seem then to be conceptually analogous to investment, that needs to be financed out of present resources, but whose product will only be available in the longer run. When endowed with scarce resources, then, the government would be confronted with the choice of using them for stabilization, i.e. for sustaining current growth, or in the alternative of implementing reforms thus focussing on future growth.

Things may become even more complicated if we consider the link between current and future growth. In fact, long periods of depressed activity may have long lasting effects by throwing the economy out of balance. For example, firm bankruptcies can spread to the financial sector, resulting in a credit crunch that may cause a shortage of working capital for the production sector, and have heavy negative effects on investment and the capital stock. Another example is the potential effect of prolonged unemployment on “deskilling” of the labour force. The growth potential of the economy would then be reduced. In other words, if current and future growth are complementary, exclusive or excessive focus on structural reforms may even prove to be harmful for potential growth, as the positive effects could be more than compensated by the underinvestment caused by the poor current performance<sup>13</sup>.

The stylised facts about Europe that we reported at the outset are a good case in point. It is clear by now that in our opinion the different performances of the US and Europe do reflect different policy choices and consequently a ranking of objectives. In the US growth and employment were a priority of economic policy, so that inflation and external balance were sacrificed to it. On the contrary, in Europe adherence to the Consensus has implied the choice of an institutional setting completely oriented towards long term growth. The Stability pact was designed in order to constrain short term discretionary policy, with the idea that sound public finances would improve the prospects for future growth. Similarly, by limiting the statutory task assigned to the European Central Bank to containing inflation, the treaties proved to be written caring more about the long term effects of inflation on potential income than about the need for short term output stabilization. In other words, as figure 1 clearly shows, the intermediate objectives of low inflation and external balance were predominant with respect to the final objectives of growth and unemployment<sup>14</sup>.

But in fact, it may well be that it is not in spite of, but rather *because* of this strong policy bias towards future growth, that the potential growth rate of the European economy has

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<sup>13</sup> We might even observe a direct negative effect linked to incentives. Reforms alter the balance of power between workers and firm owners in favour of the latter. Once their life is made easier, entrepreneurs may lose the incentive to innovate and to risk. On the aggregate this could result in lower dynamism of the economy, and hence in reduced growth potential.

remained disappointingly low. The case of the United Kingdom in this respect may be instructive. The common wisdom maintains that the reforms of the 1980s have reduced the role of the government in the economy and the associated distortions, thus increasing actual and potential growth rates with respect to the other European countries. But on one side, we already remarked how evidence on the effect of structural reforms is inconclusive; and on the other we notice how another distinguishing feature of the UK institutional setting, namely an active and pro-growth macroeconomic policy has gone unnoticed. While monetary policy in the Euro area focussed on price stability, the Bank of England had an active stance. Similarly, a wise application of the golden rule prevented the excessive reduction of public investment that has been observed in European countries trying to fulfil the Maastricht criteria.

We claim that the lack of interest of European authorities in current growth, rather more than structural rigidities, is at the root of Continental Europe's poor economic performance, and of its even weaker potential for future growth. We will come back to these issues in sections 8 and 9, when discussing the action of the ECB and the working of the Stability pact. The next section will develop a simple model in which these tradeoffs are considered.

## **7. A Stylized Model**

This simple, *ad hoc* model, has the scope to show how a trade-off between present and future growth could appear in an economy. We are not interested, here, in deriving it from microfoundations. We only want to show that, once reasonable assumptions on the aggregate effects of structural reforms are taken into account, a trade-off, and hence a problem of choice for the policy maker appears. In such a case, that we claim to be the general one, constraining policy by means of rigid rules may not be the wisest thing to do, even when we take a long run perspective.

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<sup>14</sup> Notice that it is not just a question of higher weight given to inflation reduction in the policy maker's objective function; growth becomes a concern and hence an objective *only once* inflation is checked. This lexicographic ordering has its *raison d'être* in the fallacious idea that future and current growth are unrelated.



### *The Economy.*

Consider a two period economy, whose aggregate behaviour is described by the following two equations:

$$\begin{aligned}y_1 - \bar{y}_1 &= \varepsilon_1 + g_1 - \gamma r_1 \\ \bar{y}_2 - \bar{y}_1 &= \alpha(y_1 - \bar{y}_1) + \rho r_1\end{aligned}\tag{1}$$

The first equation describes the current output gap, that depends on  $\varepsilon_1$ , a zero mean symmetric shock to income, and on the two policy variables: The first,  $g_1$ , is deficit or surplus (if negative) that in this stylized model directly affects income; the second,  $r_1$ , denotes reforms of period one; these reforms have short run costs  $\gamma$ , which also affect income (for example through reduced consumption). Reforms also have long run benefits  $\rho$  on potential income, whose evolution is described by the second equation. The current output gap influences future potential income as well; we can imagine both effects to operate through investment, either by improvements of productive capacity (the effect of reforms) or by an accelerator mechanism (the effect of current output gap). We assume that  $\alpha$  is small (as the effect of current income on permanent income is low). Finally, we normalize  $\bar{y}_1 = 0$ .

### *The Government's Choice*

The government is the only decision maker in this *ad hoc* economy. In fact, the private sector only acts as a feedback device, reacting mechanically to policy choices. The policy maker maximizes a simple welfare function:

$$\begin{aligned}\max_{r_1, g_1} & \ln(y_1 - \bar{y}_1) + \beta \ln(\bar{y}_2) \\ \text{s.t.} & \quad g_1 + r_1 = d\end{aligned}\tag{2}$$

In words, the government has a deficit bias in the current period, as it values positive deviations from current potential output; but it also cares for the long run growth potential of the economy. The tools that the government can use to maximize its objective function are reforms and countercyclical deficits. The two are substitutes, because we assume that the government is constrained by a total deficit cap  $d$ .<sup>15</sup>

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<sup>15</sup> In a multi period economy, this deficit cap could be made to depend on previous income.

### *The Optimal Level of Reforms*

Substituting the budget constraint into equation (1), and then substituting back in (2), we obtain an unconstrained maximization problem (notice that the policy maker acts after observing the realization of the shock  $\varepsilon$ ):

$$\max_{r_1} [\ln(\varepsilon_1 + d - (\gamma + 1)r_1) + \beta \ln(\alpha(\varepsilon_1 + d) + (\rho - \alpha(\gamma + 1))r_1)] \quad (3)$$

Call  $A \equiv \rho - \alpha(\gamma + 1)$ , and assume  $A > 0$  (which if  $\alpha$  is small is not too unrealistic); broadly speaking,  $A$  represents the net long run effect of reforms. We assume it is positive, because if the long term effects of reforms were negative, the problem would trivially yield  $r_1 = 0$ . Notice that we argued in the preceding sections that the positive long term effects of reforms may not be warranted (i.e. it may be the case that  $\rho \leq 0$ ), or that they can simply be more than compensated by short term effects (i.e.  $\rho < \alpha(\gamma + 1)$ ). In other words, by assuming  $A > 0$  we have decided to put ourselves in the most favourable case for reforms. Finally, define  $B \equiv \varepsilon_1 + d$ .  $B$  can be interpreted as the total budget constraint. In fact, the shock  $\varepsilon_1$  may either release (if positive) or tighten (if negative) the budget constraint. The solution to problem (3), if we take into account the nonnegativity constraint, is

$$r_1 = \max \left( 0, B \frac{\beta A - (\gamma + 1)\alpha}{(\gamma + 1)A(1 + \beta)} \right)$$

Thus, we have a positive level of reforms only if the weight given to the future, and the net benefit of reforms, are higher than the short term loss and long run effects of current growth losses (given by  $\alpha$ ).

The sign of the derivatives with respect to the constraints is intuitive:

$$\frac{\partial r_1}{\partial \beta} = \frac{B\rho}{(\gamma + 1)(\rho - \alpha(\gamma + 1))(1 + \beta)^2} > 0$$

$$\frac{\partial r_1}{\partial (\gamma + 1)} = -B \frac{(\rho - \alpha(\gamma + 1))^2 \beta + \alpha^2 (\gamma + 1)^2}{(\gamma + 1)^2 (\rho - \alpha(\gamma + 1))^2 (1 + \beta)} < 0$$

$$\frac{\partial r_1}{\partial B} = \frac{\beta(\rho - \alpha(\gamma + 1)) - \alpha(\gamma + 1)}{(\gamma + 1)(\rho - \alpha(\gamma + 1))(1 + \beta)} > 0 \Leftrightarrow r_1 > 0$$

$$\frac{\partial r_1}{\partial \rho} = \frac{\alpha B}{(\rho - \alpha(\gamma + 1))^2 (1 + \beta)} > 0$$

Thus, *caeteris paribus*, the level of reforms chosen will be higher if the government cares more about the future ( $\beta$  large), if the short run cost is lower ( $\gamma$  small), if the budget constraint is less binding ( $B$  large), and if the long run benefits of reforms are larger ( $\rho$  large).

The third condition, in particular is interesting. It says that reforms should be implemented in good times (when the budget constraint is less binding) rather than in bad times.

But what is, in fact, important is that we can easily set up a simple model, based on commonsensical hypotheses, in which the desirability of reforms, and their "depth", depend on a series of parameters like costs and benefits, the degree of preference for the future, the strength of feedback effects from actual to potential income, and so on. Thus, the mix between the implementation of structural reforms and active macroeconomic policies becomes a problem of choice. Only in very particular cases, when the links are all broken (i.e. when  $\alpha = \gamma = 0$ ) and when the budget constraint for the government is not binding, the trade-off disappears.

## 8. Monetary Policy and the European Policy Mix

The theory of currency unions (Mundell, 1961) assigns to monetary and fiscal policy well defined tasks. The first is supposed to react to common shocks, by means of changes in the common interest rate. The latter, on the other hand, is decentralized and has to take care of asymmetric shocks. The monetary authorities of a currency union set monetary policy in order to maximize some sort of union-wide objective function (that in the literature is often obtained by averaging the objective functions of national monetary authorities). In such a framework, the optimal monetary policy response to idiosyncratic shocks is to "do nothing" (Lane, 2000). For them it is fiscal policy at the national level that has to avoid inefficiently large fluctuations in output. On the other hand, when dealing with common disturbances, national fiscal policies would be ineffective, and possibly harmful, unless perfectly coordinated. It is in this situation that the common monetary policy has to take care of stabilisation. Furthermore, once fiscal policy is restricted to country specific shocks, it is hard

to argue in favour of pure inflation targeting on the part of monetary authorities. There would be no tool and/or institution in charge of demand management in the face of aggregate shocks.

And yet, this is what the Maastricht treaty has put in place. Contrary to what happens for other important central banks (for example the US Federal Reserve), the treaty gives the ECB the task of conducting "a single monetary policy and exchange rate policy the *primary objective of both of which shall be to maintain price stability* and, without prejudice to this objective, to support the general economic policies in the Community" (Art. 3a, emphasis added).

In fact, by looking at ECB behaviour in the first few years of its existence, we can conclude that the mandate was closely followed, and the emphasis on price stability was predominant<sup>16</sup>. After managing quite skilfully the late consequences of the East Asian crisis, the ECB began in November 1999 to raise rates in response to increasing inflation. In fact, the Bank reacted to actual, rather than core inflation (the latter was in fact quite stable), which seems to indicate that the risks of overheating of the economy were overstated. At any rate, all along the year 2000 we could observe a monetary tightening in spite of weakening demand and basically stable (core) inflation. Since then, the stance remained substantially restrictive until at least early 2003. The consequence is that monetary policy was in fact procyclical, at least over the years 2000-2002, strengthening the slowdown. True, the ECB considerably lowered its rates in fall 2001, following the September 11 events. At the same time, though, the Fed acted more rapidly and aggressively, inducing many commentators to accuse the ECB of excessive inertia. This was even more evident as the European slowdown persisted, and it became apparent that growth, rather than inflation was (is) the problem of the early years 2000s. In spite of this, in virtually all of its official documents, the ECB kept referring to the price stability objective. Even over the year 2003, when monetary policy became slightly more expansionary, low growth was never cited as a determinant of the Bank's actions.

To conclude, we can say that the ECB seldom pursued the growth objective; and when it did so, that was never done explicitly, often at the price of a baroque and opaque communication strategy.

If growth is not an objective of the common monetary policy, and fiscal policy at the national level is constrained and confined to country specific shocks, there arises the problem of a missing actor in charge of income stabilization at the Union level. This has been solved by invoking a sort of "coordination from the bottom", as growth would have to be assured by structural reforms at the national level: Balance the budget, reduce the role of the state in the

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<sup>16</sup> For a detailed account of the first four years of the Euro, see Fitoussi and Creel (2002).

economy by cutting public expenditures; increase the flexibility of labour markets by shrinking the welfare state, and increase competition in both product and labour markets (particularly the latter, as we discussed above). The adherence of the ECB to the BFW Consensus explains the emphasis on reforms that recurs in all of its documents (the most recent example is the editorial of the November 2003 bulletin). We saw that according to the Consensus such a comprehensive policy framework will lead to an increase in workers' incentives, higher growth and lower inflationary pressures (through the increase in the intensity of competition). These reforms, by making national economies more flexible, would put them in a position to better absorb *all* shocks including the common ones. This is why they are often considered substitutes for active monetary policy.

The conceptual framework behind the Consensus is obviously shared by most central bankers in the industrialised countries. In spite of that, almost invariably, this theoretical orthodoxy is coupled with a much more pragmatic attitude in actual behaviour. The most striking case is the US Federal Reserve, which continuously manoeuvred its interest rates to try to influence markets with the objective of keeping the economy on a low inflation-high growth path. Why is it so, then, that the ECB seems to be practically the only central bank that acts in accordance with monetary (and fiscal) orthodoxy?

This points to a specific characteristic of the ECB, namely its need, as a young institution, to establish a reputation. Credibility is an invaluable asset for an institution that deals with (financial) markets in which expectations have an essential role to play. A young central bank has to convince markets that it is serious about reaching its objectives, and that it has the means and the skill to do it. Taking this into consideration, the restrictiveness of monetary policy, and the inertia that has characterised the ECB attitude facing the economic slowdown may be seen as signs that the Bank is focussing on its main objective, and that it does take the time to accumulate information in order to act efficiently.

While believing that these credibility considerations are important, we do not share the opinion that they would be sufficient to justify the course of action the ECB chose, particularly since early 2001. In fact, if a restrictive policy was the price to pay in order to acquire credibility, then that price was largely paid in vain, as toughness has not been identified by the markets with credibility<sup>17</sup>.

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<sup>17</sup> Artus and Wyplosz (2002) have shown that if we take a standard measure of the influence of a central bank on agents expectations, namely the responsiveness of market-determined long term rates to changes in the Central bank rates, the ECB has been much less effective than the Fed and the Bundesbank.

There are various reasons why the ECB did not fully convince markets: The most widely discussed (Artus and Wyplosz, 2002) are, on one side, the excessively ambitious inflation objective it chose (even in a period of low growth, inflation was above the 2% threshold for all years except 1999); and on the other, the systematic lack of transparency of its decisions, as the "two pillars" were in fact one: the first, money growth, was systematically overlooked, while the second, the composite indicator of inflationary pressures, was in fact kept as vague as possible to hide the ambiguity between the strategy the Bank was supposed to follow and the one it actually implemented. Of course it is not beneficial to the reputation of a central bank to miss almost systematically its target; similarly, the lack of transparency harmed the effectiveness of the communication strategy, and finally damaged the ECB in its quest for credibility.

In addition to these obvious reasons, there is a third one, subtler but more important, that has to do with our previous discussion. It is impossible for a central bank to acquire credibility if, while attaining its objective, it imposes excessive costs on society. Most theories advocating the sole objective of price stability rely on the hypothesis of rational expectations, which in turn implies an absence of social costs: Private agents correctly anticipate the bank's action, and their behaviour is modified accordingly with no effects on employment or growth. In these conditions price stability comes for free, and a central bank that does not pursue it acquires a negative reputation. But reality is another thing, and the low inflation objective often comes at the cost of reduced investment and growth, as may have been the case in Europe in recent years. How credible can a central bank be, if in the middle of a general slowdown on both sides of the Atlantic, with the Euro zone economy on the brink of a recession, it refuses to lower rates because of a largely undemonstrated inflationary threat?

Thus policy making involves tradeoffs and hence choices. Only in the special case of a simplified world of "first bests", the tradeoffs disappear.

## **9. The Stability and Growth Pact**

The Amsterdam treaty of 1997 has put in place the Stability and Growth pact, that acts as a coordination device "from the bottom" for fiscal policy in the euro area. According to its provisions, member countries have to present a yearly "Stability and Convergence Program", stating a medium-term objective for the budgetary position of close to balance or in surplus, and a description of budgetary and other economic policy measures being taken to achieve the objectives.

The plans are examined by the European Council, which may subsequently issue 'recommendations', in case the country deviates from the objectives stated in the program. The Maastricht and Amsterdam treaties also define an 'Excessive deficit procedure', that gives the Commission the power to propose sanctions for countries deviating from the 3% limit; the Council then has the possibility (by qualified majority) to impose sanctions on the country not respecting the limit. The pact and the sanctioning procedure received a severe blow in November 2003, when the Council did not follow the Commission recommendation to impose fines on France and Germany.

The main theoretical foundation of the Stability pact is an externality argument: A government running a budget deficit has to borrow; in a monetary union this is supposed to raise the common interest rate, with restrictive effects on aggregate demand in the other countries. This negative externality would induce national governments to run excessive budget deficits, making the other countries pay part of the bill.

But the argument could actually be reversed. If the fiscal expansion occurring in a country were unjustified, it would result in inflationary pressure, and hence in reduced competitiveness. . On the other hand, if the deficit responded to a slump in production it would sustain demand and hence income and imports. In both cases, demand for the other countries' production would increase, and their deficit (thanks to increased fiscal revenues) would be reduced.

A second argument in favour of the Stability pact is credibility: Excessive deficits may end up in insolvency, forcing the ECB to intervene (against its own statute) to bail out the country involved; otherwise, banks owning the debt would see their financial soundness undermined , and face the risk of depositors' runs. The moral hazard aspect of excessive deficits could hence undermine the Central Bank credibility in its commitment to fight inflation.

This argument may be dismissed on several grounds. The first is the scarce plausibility of a debt crisis in the present context<sup>18</sup>. As for credibility, it is far from obvious that it would be enhanced. The pact was designed assuming that governments would accumulate surpluses in good times to allow the operation of automatic stabilizers in bad times. This ideal scenario though, did not take into account the fact that this symmetry would only be attained after a

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<sup>18</sup> Eichengreen and Wyplosz (1998) notice that the European banking system exposure and the term structure of public debt are more solid than those of Mexico and East Asia during the crises of the 1990s, so that the bailout risk is not particularly relevant. And at any rate, they argue that such a risk would be better dealt with by improving public debt management and bank regulation.

long transition. In the meantime, governments are being forced to adopt restrictive fiscal policies irrespective of the business cycle phase. The consequence is that the euro area economy has experienced an explosive combination of depressed growth and (procyclical) restrictive fiscal policy. The three largest countries, Germany, France and Italy do not even have room for the automatic stabilizers to play. The situation is unbearable, and results in creative accounting, in increasing pressure to revise, soften, or simply ignore the pact, and on pressure on the ECB for a more expansionary monetary stance. These phenomena seem far more threatening, for the credibility of the European institutional system as a whole, than the bailout risk.

Another common argument in favour of the pact builds on the above mentioned literature that flourished in the 1990s on the Non-Keynesian effects of budget deficit reductions. Broadly speaking, the argument goes as follows: If the budget deficit reduction is credible and significant, it may trigger the expectation of a permanently lower share of government spending in GDP. The consequent upwards revision of permanent income, will cause private expenditure increases, and hence be expansionary. This will in turn reinforce the initial debt consolidation. Again, the argument is not convincing. First, the empirical support for these effects refers to extreme cases, when public finances are in distress. Now, the state of European countries' public finances hardly qualifies as unsustainable. Furthermore, the perverse effects of the pact on budget transparency, the attempts to find loopholes and shortcuts to meet the requirements, will hardly have a positive effect on private expectations.

## **10. Conclusion**

The adherence to the BFW Consensus has permeated the European Union in the past decade, and has created an institutional set up that is ineffective: Discretionary policy is severely constrained by the treaties through the Stability pact and the statute of the ECB. Price stability is the only policy objective that has to be actively pursued at the Union level, while automatic stabilizers are supposed to offset country specific shocks. The Stability pact, and the objective of a zero structural deficit, rule out any active fiscal policy at the national level. No actor is supposed to take care of common real shocks, as the ECB only has to deal with inflation. Consistent with the Consensus, the main policy recommendation is to pursue structural reforms, which are supposed to be the cure for all European sicknesses, and to imply no short run costs. In short, the economic governance of Europe ties the hands of policy makers, with strong negative effects on current economic conditions, based on the unwarranted assumption that this would increase the potential for future growth. The rationale behind this institutional construction and the policy prescription that it yields is that policy



faces no trade-off, as its only role is to accommodate and smoothen the working of efficient markets.

The facts reported in section 2 contradict this vision. Two decades of policy inertia in our continent have not given the expected results. The poor growth performance has built tensions that are finally calling into question the institutional set up. The US Fed model is being increasingly invoked for the ECB; and the Stability pact is probably going to be substantially ignored. We may be approaching an economic governance of Europe that is less ideological, and in which rules and credibility coexist with political choices and discretionary policies. If this happens, it will most probably result in more balanced and effective policy making.

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