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The Lessons of the Crisis for EU Policy Making

The article details the dominant narrative on the EMU crisis, the so-called "Berlin View", centered around the macroeconomic Consensus that emerged in the 1990s. This Consensus rules out discretionary policy (in particular fiscal policy) as a tool for policy makers, that should let market adjustments take care of macroeconomic shocks. The Consensus not only shaped the response to the crisis, but it is also the foundation of the Maastricht institutions (ECB mandate and fiscal rule). The article contrasts this narrative with a more structural one, highlighting the non-optimality of the EMU. If this second narrative were correct, much more than austerity and fiscal consolidation were needed. Institutions mimicking the functioning of a federal state would be needed to avoid divergence and further crises.

Les leçons de la crise pour le système politique européen

L'article examine la vision dominante de la crise de l'UEM, souvent attribuée à Berlin, et exprimant un consensus macroéconomique qui émergea dans les années 1990. Ce consensus se fonde sur le refus des politiques discrétionnaires, particulièrement en matière fiscale, laissant au jeu du marché le soin de répondre aux choses macroéconomiques. Ce consensus constitua non seulement la réponse à la crise mais il fut à la base de la fondation de certaines institutions par le traité de Maastricht (mandat de la BCE et règles fiscales). Le papier met en avant les limites de cette approche. Des institutions s'inspirant du fonctionnement d'une fédération seraient nécessaires pour réduire les disparités et répondre aux crises économiques à venir.

The Lessons of the Crisis for EU Policy Making

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The global financial crisis had a profound impact on the academic and policy debate. Three decades of "great moderation", stable growth with low inflation, had created the widespread sentiment that a consensus had been reached in particular in the field of macroeconomics (see e.g. Blanchard, 2000). This consensus was based on three pillars: (a) markets are efficient, so that the key for macroeconomic growth is in supply side factors; (b) aggregate demand plays a role only in determining short term fluctuations; (c) macroeconomic policy should be predictable in order not to tamper with market functioning.

This consensus constitutes the intellectual foundation of the institutions that, starting with the Maastricht Treaty, were designed to implement the macroeconomic governance of the EMU. This paper will argue that the poor management of the crisis stems from the application of this "Berlin-Brussels-Frankfurt" (BBF, see for details Fitoussi and Saraceno, 2013), to a currency area that proved to be far from optimal according to the traditional criteria.

I will then argue that the EMU is an interesting laboratory for the debate on economic policy coordination, and ask the question whether "surrogates" to a fully federal structure may be enough to reabsorb the imbalances.

The Crisis and the Prevailing Narrative: The Berlin View

The Maastricht Treaty, centered European economic governance on the rejection of active macroeconomic policies: the ECB only has a mandate for price stability, and has considerable autonomy in pursuing it. Furthermore, the Stability and Growth Pact (SGP), introduced with the Amsterdam Treaty (1997), forces countries to rely solely on automatic stabilizers to cushion economic fluctuations. This Berlin-Brussels-Frankfurt is an evolution of the original Washington Consensus (Williamson, 1990), a fuzzy concept that here

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I use to label any set of policies that follow three basic principles: First, the quest for macroeconomic stability (balanced budgets, price stability, and, for developing countries, exchange rate stability). Second, supply-side structural reforms aimed at increasing competition and openness. Third, the neglect of any possible tradeoff between present and future growth.

The Consensus has its theoretical foundations in the neoclassical Walrasian theory. In a nutshell, the theory postulates the centrality of markets populated by rational agents who, if left free to operate without distortions, tend to spontaneously converge to "optimal" equilibria, characterized by full employment of resources and the maximization of a representative agent's welfare (the so-called Pareto efficiency). Price and wage flexibility, then, ensures that demand adapts to full-employment supply (a principle known as Say's Law). The emphasis of the theory is then on supply-side measures capable of increasing the capacity of the economy to produce. Barring exceptional circumstances, this view considers aggregate demand management useless, if not harmful. Credible reforms would boost profits and productivity expectations, thus leading to increased demand and growth. And even if supply side policies, reducing wages and social protection were to have a negative impact on private demand, this would be more than compensated for by the export-led growth induced by gains in competitiveness.

A crucial corollary of the Walrasian framework is that money, whose intrinsic utility is zero, is only demanded for transaction motives. It stems from this corollary that, at least in the long run, money is neutral, i.e. that it has no impact on the real sector, and only affects prices and inflation. Long run neutrality dictates that even in these cases, the best central banks can do is to keep strict inflation targets, thus anchoring private sector expectations and minimizing deviations from the optimal path of the economy. Rules (be they fiscal or monetary) are justified by the same token: they avoid policy-induced uncertainty, minimize the risk of biases in government action, and provide a stable environment for investment and growth.

The existence of a Pareto superior equilibrium to which the market economy spontaneously tends once the appropriate conditions are met has a very strong policy implication: the only role for economic policy is to make sure that barriers to free competition (monopolies, asymmetric information, rigidities) are removed through "structural reforms", so that markets are able to converge to the optimal equilibrium path. Policy is not supposed to make choices, but only to clear the ground of obstacles to the free unfolding

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of market forces, leading to a state that, by definition, represents the best of all possible worlds.

The BBF Consensus, embedded in European institutions and practices since the early 1990s, led European governments to give up active management of the business cycle, and to engage in a non-cooperative strategy through fiscal and social competition. Even before the global financial crisis hit the world economy, the inertia of European policy makers in comparison with their homologues across the ocean was striking. Fitoussi and Saraceno (2011) show that while in the pre-crisis period short term rates in the US and in the Eurozone have been on average very similar, the much higher variability of interest rates in the United States, denotes an activism of the Fed that is nowhere to be seen in ECB policies. Likewise, while sanctions for excessive deficits were never imposed, the SGP proved nevertheless to be effective in that it constrained fiscal policy that in EMU countries was significantly less reactive to the cycle than in the United States (Fitoussi and Saraceno, 2008).

The crisis that began in 2007 confronted policy makers with hard choices. European institutions, and in particular the ECB, were not adapted for the task. They had been designed, in fact, at a time of "Great Moderation", when it was believed that policy would at worst have to smooth the business cycle. The next section will show how this compounded structural flaws of the EMU, thus leading to tensions and inefficiencies in the management of the crisis, and explaining the persisting weakness of the European economy seven years into the crisis.

Optimal Currency Areas and the EMU Crisis

Mundell's (1961) seminal work states the criteria that countries should assess in determining whether to give up the management of their currency and join a monetary union. Roughly speaking, a monetary union would be optimal, and sovereign monetary policy could be abandoned, if other mechanisms could be relied upon to reabsorb macroeconomic shocks. This happens if shocks are symmetric across the union, so that the common monetary policy can react; or if fiscal transfers allow asymmetric shock to be reabsorbed with flows from booming to slumping economies; or, last but not least, if market flexibility makes policy, be it common or national, redundant: labour market flexibility, and production factors' mobility, would boost the slumping

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economies and cool down those booming, thus ensuring shock reabsorption and convergence.

While in the late 1980s the consensus among economists and policy makers was that the EMU was not an optimal currency area (De Grauwe, 2006), the choice was made to proceed with the single currency for two essentially opposed reasons[1]: The first, stemming from the BBF Consensus, saw monetary integration, together with the establishment of institutions limiting fiscal and monetary policy, as an incentive for pursuing structural reforms and converging towards market efficiency: if the role of macroeconomic management was believed to be limited, giving up monetary policy would impose negligible costs to countries, while forcing them, through competition, to remove the obstacles to markets that stifled growth.

Another group of academics and policy makers, while not necessarily subscribing to the Consensus, highlighted the political economy of the single currency: Adopting the euro in a non-optimal currency area would have created the incentives for completing it with a political union: a federation, endowed with a common fiscal policy and capable of implementing the fiscal transfers that are required to avoid divergence. In other words a non-optimal euro was seen as just an intermediate step towards a real United States of Europe. A key argument of the proponents of a federal Europe was, and still is, that fiscal transfers seem unavoidable to ensure economic convergence. A seminal paper by Sala-i-Martin and Sachs (1991) shows that even in the United States, where market flexibility is substantially larger than in the EMU, transfers from booming states to states in crisis account for almost 50 % of the reaction to asymmetric shocks.

It is interesting to notice how the hopes of both views were dashed by subsequent events. As the theory of optimal currency areas correctly predicted, the inception of the euro without sufficiently strong correction mechanisms, triggered a divergence between a core, characterized by excess savings and export-led growth, and a periphery that sustained the Eurozone growth through debt-driven consumption (public and private) and investment.

1 We do not focus here on the political reasons for the adoption of the euro, as a step towards deeper integration regardless of an assessment of costs and benefits. As it has been the case for the choice of the exchange rate between the eastern and the western mark, at the time of German unification, political considerations did have priority over economic considerations. And rightly so.

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Even before the crisis the federal project failed to make it into the political agenda. The euro came to be seen by the political elites not, as the federalists hoped, as an intermediate step towards closer integration, but rather as the endpoint of the process initiated by Jean Monnet and Robert Schuman in 1950. The crisis further deepened economic divergence and recrimination, highlighting national self-interest as the driving force of policy makers, and making solidarity an empty word. As we write, the Greek crisis management, the refugee emergency, the centrifugal forces shaking Europe, are seen as a potential threat to the Union, rather than a push for further integration as it happened in the past (Rachman, 2015).

The Consensus partisans won the policy debate. The EMU institutions as we said reflect their intellectual framework, and the policies followed by EMU countries (more or less willingly) especially since the crisis, are the logical consequences of the consensus: austerity and structural reforms aimed at increasing competitiveness and reducing the weight of the State in the economy. But while they can rejoice of their victory, BBF Consensus proponents have to deal with the failure of their policies: five years of Consensus therapy has nearly killed the patient. Peripheral countries' debt is still unsustainable, growth is nowhere to be seen (including in successful Germany), and social hardship is reaching unbearable levels (Kentikelenis et al., 2014). Coupling austerity with reforms proved to be self-defeating, as the short term impact on the economy was much larger than expected (Blanchard and Leigh, 2013), and as a consequence their long run benefits failed to materialize (Eggertsson *et al.*, 2014). It is then no surprise that in spite of austerity and reforms divergence between the core and the periphery of the Eurozone is even larger today than it was in 2007 (Saraceno, 2013).

The dire state of the Eurozone economy is in some sense the revenge of optimal currency areas theory, with a twist. It appears evident today, as it was clear two decades ago thanks to the already quoted work by Sala-i-Martin and Sachs (1991), that market flexibility alone would never suffice to ensure convergence (rather the opposite), so that the Consensus faces a potentially fatal challenge. On the other hand, the federalist project, that was already faltering before the crisis, seems to have received a fatal blow.

What is the possible way out? Barring a dissolution of the euro, whose consequences are virtually impossible to assess, it seems necessary to take stock from the crisis, and from what we know about monetary unions, to devise a working monetary union.

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Policy Solutions. Are Surrogates of Fiscal Federalism Enough?

A politically feasible strategy for exiting Eurozone woes requires two pillars. The first pillar consists in putting in place a number of surrogates of a federal government that, while politically feasible, may play the role that federal taxes and transfers would play in limiting divergence. A number of policies or institutions, that are currently being implemented or discussed, may be appropriate:

1) The implementation of a European unemployment benefit scheme funded by a part of social contributions, may play an important countercyclical role. Countries temporarily experiencing higher-than-normal unemployment would draw from the scheme, while those experiencing a boom would chip into it. Such a proposal already exists (European Commission, 2013), and it would need to be better designed so that the national preferences concerning the welfare state are preserved.
2) A properly designed banking union, associating to common supervision (already implemented) also some form of common deposit insurance (which instead is being blocked by some countries, fearful of a mutualization of debt) could also play a role. Countries experiencing a financial crisis could rely on a pool of common resources, and therefore avoid the vicious circle between private and public debt that sank the Eurozone peripheral economies in 2010-2012.
3) A partial mutualization of public debt (Eurobonds) would allow the financing of Pan European investment projects that could be used in the same spirit as the Juncker plan, but on a larger and more efficient way, for crowding-in private investment and fostering long term convergence (taking the place of structural funds); but, more importantly for the purpose of income stabilization, it could also finance investment projects to sustain regions or countries experiencing temporary slumps.

All of these instruments, alongside with others responding to the same need, would need to be constructed in such a way that each country's net contribution is zero along the business cycle. To be surrogates of federal transfers, they should not take the form of permanent transfers between countries. In addition, this would remove at least some of the objections currently aired by the core European countries. Furthermore, they should be managed by the European Commission, under the control of the European parliament, in order to minimize the risk of abuse and free riding.

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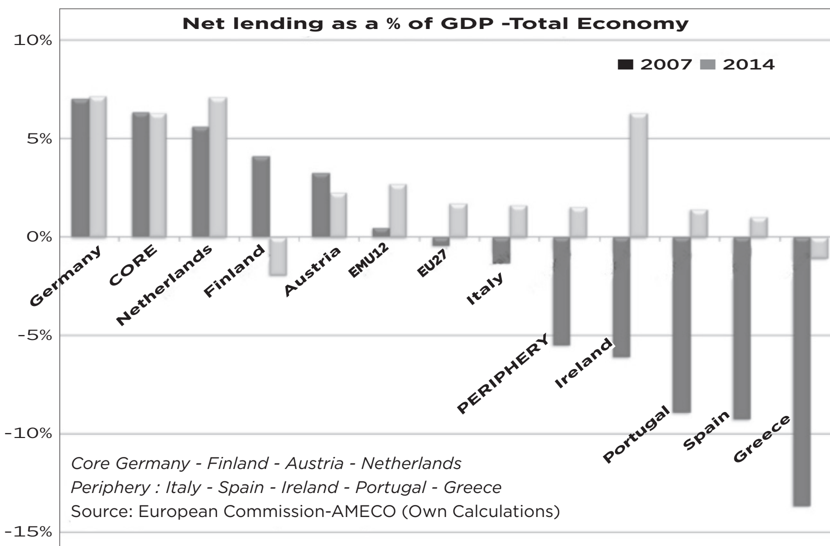
It is of course unlikely that these surrogates of countercyclical fiscal transfers may suffice to absorb asymmetric shocks, especially when they are of the size of the current crisis. This is why a second pillar is necessary: The Berlin view blames the crisis on peripheral countries alone, as these failed to conform to the prescription of the Consensus. The burden of adjustment hence was asymmetric, and peripheral countries were asked to reduce their excess demand. The problem is nevertheless that while these countries were doing their homework, Germany and the core did not reduce their excess savings (i.e. their current account surplus), the other side of the Eurozone problem. The result is that, if we compare 2007 to 2014, external imbalances of the periphery were greatly reduced or reversed, while with the exception of Finland the core did not do its homework:



In some sense, the victory of the BBF Consensus is exemplified by the fact that the EMU as a whole became a large Germany, running a current account surplus (it was more or less in balance in 2007), and relying on its exports for growth. This is a very dubious strategy in the long run, as the German model cannot work for two reasons. The first is a fallacy of composition: not everybody can export at the same time, and for each current account surplus there needs to be a corresponding current account deficit. The second, more political, is that by betting on an export-led growth model Germany and Europe will be forced to rely on somebody else's growth (and imports from the Eurozone) to ensure their prosperity. This is of course a source of economic fragility, but also of irrelevance on the political arena, where influence goes hand in hand with economic power.

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Thus the second pillar would require abandoning the Consensus, and heading towards a real coordination of European macroeconomic policies: Instead of the same restrictive policies followed by all countries regardless of their fiscal situation, the Eurozone would have needed differentiated policies, coordinated to maximize the common Eurozone welfare. The inevitable fiscal consolidation in the peripheral countries should have been accompanied by a corresponding expansion of domestic demand in the core, most notably in Germany. Fiscal space should have been used to increase public expenditure and reduce taxes on wages, so as to boost domestic (private and public) demand, thereby supporting growth in the countries undergoing painful economic adjustment. While the Eurozone economy is slowly emerging from deflation, this lesson remains valid. The ECB effort is at full steam, and it is doubtful that peripheral countries will be able to endure further austerity and social hardship. It is hard to imagine how the crisis could be definitely put behind us, without a change of policies in the core Eurozone countries.

Conclusion

The current paper tried to draw lessons from the current crisis, that is political, economic, and institutional. The crisis highlighted flaws in the institutional design of the Eurozone, showing that properly considering the theory of optimal currency areas would allow us to put in place instruments (political surrogates of fiscal federalism) to reduce divergence both in good and in bad times. I also argued that this would probably not be enough, and that a change of paradigm would be needed. The consensus has failed to deliver the institutions, and the policy response, adapted to the crisis. In Europe, as well as in the rest of the world, the old doctrine based on market efficiency proved to be unfit to deal with a massive market failure. The conclusion is unequivocal: the BBF Consensus should be dropped, and fiscal policy should go back to being a tool for macroeconomic stabilization. In the current situation this means that without expansionary policies and inflation in the core, adjustment and recovery will be too slow. So slow, that the breakdown of the euro could happen before the crisis is over.

But the Consensus should be scrapped beyond the current crisis. The Eurozone experience since 1992 teaches us that relying on the efficient markets hypothesis as a guide for policy is not a good idea. We should learn from the United States that growth (or the lack of it) comes from the complex

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interaction of imperfect institutions like markets and governments. This calls for abandoning a government by the rules, and adopting a flexible approach to policy based on coordination among the different actors involved. Lacking a federal government, the Council is the place where this coordination should happen.

The crisis imposes exceptional hardship on the European people. It is to be hoped that studying it and understanding how to manage a non-optimal currency area, will allow us not to repeat the same mistakes over and over again.

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