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Debate

The Mythology of European Monetary Union[1]

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The global economic crisis that began in 2008 with the failure of American financial institutions has appeared in Europe as a crisis of Economic and Monetary Union (EMU) which poses the most profound challenges the European Union (EU) has faced since its founding in 1958. People are asking: how did the EU get itself into this situation and why it is having so much trouble getting out of it? Although many factors converged to produce this perfect storm, at the heart of the crisis is a persistent failure to recognize that there are durable differences in the institutional structures of the European political economies, which cannot readily be erased and offer comparative institutional advantages that national governments often exploit (Hall and Soskice 2001; Amable 2003). Economic prosperity in Europe has long depended on the operation of these national varieties of capitalism (Hall 2001a).

From its inception, however, EMU has been built on the assumption that such institutional differences are transient deviations from neo-classical economic models, which should be corrected rather than accommodated. Of course, officials engaged in day-to-day policy-making have a more nuanced understanding of how their economies operate, but the major policy initiatives associated with the Euro have been justified in terms of this view. As a result, the Euro operates on a distinctive mythology.

Mythologies have their uses, especially in politics, as Machiavelli (1984) noted; and this one was instrumental to securing agreement to the establishment of a monetary union with a particular institutional form in 1992. This was the high water mark of a rational expectations economics whose doctrines left a distinctive imprint on the new union. In contrast to preceding Keynesian views, which saw active macroeconomic management as the key to stable growth, the new classical economics held that fiscal policy was rarely stabilizing and monetary policy largely without lasting effects on the real economy. Prosperity was said to depend, not on demand management, but on supply-side measures to make markets in labor and goods more competitive (Crystal 1979; Cuthbertson 1979).

Since active fiscal policy was deemed counterproductive, no effort was made to give the new monetary union capacities for coordinating its member states' fiscal policies over the medium term. A Stability and Growth Pact (SGP) placing crude limits on national deficits and debt was considered sufficient. Since monetary policy was said to be of value only for controlling inflation, and best done through monetary rules, the new union was endowed with a European central bank (ECB) entirely independent of political control, with circumscribed powers that kept it focused on inflation and unable to purchase sovereign debt directly. EMU acquired these features ultimately because this is what the member states, who were interested in EMU for political as well as economic reasons, could agree on; but images of the economy purveyed by

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rational expectations economics were crucial to making this design seem practicable (Dyson and Featherstone 1997; McNamara 1998; Hall 2012).

As one country after another, led by Germany and France, broke the rules of the Stability and Growth Pact, it became apparent that the emperor had no clothes. But the full limitations of the institutional design were revealed only in the wake of the Euro crisis. The crisis manifested itself in 2009, initially as a crisis of confidence in sovereign debt on the periphery of the Eurozone, which lent the crisis emergency dimensions that might have been avoided if the ECB had been able to threaten to purchase unlimited quantities of sovereign debt, as most central banks can. Revealing how inadequate the union's institutional capacities for fiscal coordination were, the crisis also gave rise to a new 'fiscal compact' designed to strengthen them, albeit without the capacity for coordinated reflation over the medium-term likely crucial to the continent's long-run prosperity.

In short, EMU was founded on a set of myths that presented the European economies as sets of classically competitive markets operated by highly-informed actors, whose management required only the minimal institutions with which the new union was endowed. An important element of prophecy was built into this mythology. Although observers recognized that many of the European economies did not conform to this image in the early 1990s, the widespread expectation was that they would soon be forced to do so, by the intense competitive pressure of operating under fixed exchange rates in a more open continental market. The idea was that the single market and the criteria for entry into EMU would enforce institutional convergence on national varieties of capitalism, setting off in effect a round of 'modernization from above' (cf. Hall 2001b).

Of course, like previous convergence theories, this one proved overly optimistic (cf. Piore and Sabel 1984). The need to compete within EMU inspired some significant structural reforms in southern Europe (Hall 2012). But, even when augmented by the Lisbon process and open methods of coordination, entry into monetary union was not enough to erase the longstanding institutional differences among European political economies. And many of the problems encountered by the monetary union have roots in those differences.

When the prospect of a monetary union was being debated, some skeptics worried that the union would be plagued by asymmetrical economic shocks in its member states. As it turned out, institutional asymmetries across the member states have been a more important source of problems (Boltho and Carlin 2012). Joined together in the new monetary union were countries and political economies organized very differently. To stylize slightly, on one side was a set of coordinated market economies in 'northern' Europe, operating export-led growth models built on high levels of wage coordination, sophisticated systems of vocational training, the inter-firm relations necessary to operate collaborative schemes for research and development, and intra-firm relationships that promoted continuous innovation and quality control. These included: Germany, the Netherlands, Belgium, Denmark, Finland and Austria (Hall and Soskice 2001).

Another was a set of mixed market economies predominantly in 'southern' Europe, where wage bargaining was difficult to coordinate, apart from periodic 'social pacts', because trade unions were relatively strong but often lacked a monopoly over labor representation and competed with one another for the allegiance of the workforce or the right to negotiate wage bargains. Employer associations were more coordinated but less deeply institutionalized than their northern European counterparts, so that collaborative vocational training schemes were harder to operate. Partly for this reason, the workforce in these countries was less skilled and continuous innovation more difficult to achieve. Firms were correspondingly more inclined to build their competitive advantages on low-cost labor. With some variation across sectors, the political economies of Greece, Italy, Spain and Portugal shared these general features (Hall and Gingerich 2009).

These features of the political economy are neither superficial nor ephemeral. They develop over long periods of time, out of myriad political struggles, and become fundamental to how firms organize their endeavors (Thelen 2004; Streeck and Yamamura 2001). While subject to incremental reform at the margins, they are established facts, to which governments have to adjust their economic strategies in order to seek prosperity and comparative advantage in international markets; and historically that is what governments have done.

In northern Europe, governments have typically taken advantage of the institutional capacities for wage coordination embedded in their political economies to pursue strategies of export-led growth, i.e. growth in which the expansion of exports is prominent relative to the growth of domestic demand. Wage coordination has been used to hold the rate of growth of unit labor costs down, while para-public systems of skill formation have supported high value-added production and the incremental innovation that allows firms to compete on quality as well as price. For the most part, this strategy dictates a restrained macroeconomic stance, lest expansionary policy set off a wage spiral, and the effectiveness of counter-cyclical policy is inhibited by the high savings rates of work forces equipped with significant levels of specific skills (Katzenstein 1985; Carlin and Soskice 2009).

By contrast, the governments of southern Europe have been unable to contain wage costs via coordinated bargaining and so historically more inclined to pursue demand-led growth, i.e. economic strategies based on the expansion of domestic demand. These entail more expansionary macroeconomic policies, a focus on job creation in the service sectors, and, in some cases, employment subsidies designed to incorporate low-skilled workers into the workforce. To offset the inflationary effects that often accompany such policies, these governments have devalued their exchange rates periodically, lowering relative unit labor costs and reducing the prices of exports relative to imports.

It should be apparent that entry into EMU had very different implications for these two types of political economies. Membership in the new monetary union was highly advantageous for the countries of northern Europe. The export-led growth strategies on which they had long relied continued to serve them well. Firms were able to use the capacities for strategic coordination embedded in the institutions of these political economies to restrain wages and restructure to remain competitive within the new union and with the emerging economies. The Union itself provided them with large export markets in European countries that could no longer devalue to make their own products more competitive against those exports; and the Eurozone offered lower external exchange rates than they were likely to achieve on their own, thereby sustaining the competitiveness of their exports elsewhere in the world. Not surprisingly, in the wake of strenuous German efforts to hold down wages in order to ensure the country's competitiveness, domestic demand stagnated and Germany built up large balance of payments surpluses.

For the political economies of southern Europe, however, entry into EMU posed more serious challenges. It called into question the viability of their demand-led growth strategies, because they could no longer devalue against their principal trading partners to offset the inflationary effects of such policies. Should they abandon those strategies? And, if so. in favor of what? In the event, the decision was largely made for them by the effect monetary union had on the cost of credit in the south. The confidence effects of membership in the new union improved the access of southern Europe to low-cost capital; and European banks, eager to invest the surplus balances of the north, sent large new flows of credit to southern Europe. Thus, even without an expansionary macroeconomic stance, domestic demand grew rapidly in southern Europe, fueled by the borrowing of firms and consumers.

The effects were predictable. With expansion came inflation, which took relative prices and unit labor costs in the south to new heights. Unable to devalue to offset the effects of this inflation on exports, these countries saw their current account balances deteriorate, as their products became less competitive on world markets. In principle, the ECB could have used its monetary instruments to reduce rates of inflation in southern Europe, but only at the cost of contraction in the north, whose rates of inflation were lower and hence real interest rates higher. Instead, in line with its mandate, the ECB targeted the average rate of inflation in the Eurozone.

The rest, as they say, is history. When the American bubble burst, shaking confidence in world financial markets, investors in European bonds became alarmed at the levels of debt found in southern Europe and more reluctant to fund governments there, even when their primary deficits or levels of debt were lower than those of apparently creditworthy neighbors. The European Union is still trying to find a way to restore the confidence of the bond markets and a route out of the recessionary conditions that followed the imposition of austerity programs in the periphery. The fate of the Euro hangs in the balance.

My point is not to suggest that institutional asymmetries in the European political economies are entirely responsible for the Euro crisis. Plenty of mistakes made both before and after the onset of the crisis have fueled it. Greek governments took the country's deficits and debt to unsustainable levels. The Irish and Spanish governments failed to dampen down housing booms that put their banking systems at risk, as in the U.S., and the Irish banks were allowed to vastly overextend their operations. In many respects, this is a classic debt crisis: over-exuberant lending and borrowing built on unrealistic expectations about the trajectory of asset prices have given way to a recession, whose self-fulfilling prophecy is that much of that debt will have to be written off, even if the EU has yet to come to grips with that fact (Reinhart and Rogoff 2009).

From the outset, however, EMU has been haunted by an absence of realistic thinking about how the institutional structures of the political economy bear on economic growth and the viability of strategies for securing it. Any notion that the southern European economies could prosper inside monetary union by emulating the policies of northern Europe was always unrealistic. They lack the institutional infrastructure required to operate such strategies successfully, and acquiring such an infrastructure is a matter of decades, if not centuries.

The alternative view that these economies could secure prosperity by intensifying competition in their markets for goods and labor is more plausible; steps in this direction are likely to improve the efficiency with which various kinds of goods are produced, especially in the most protected sectors of any economy. But this is not a panacea. In Spain, a large expansion in temporary employment and short-term contracts has brought limited benefits; and it is notable that the liberal market economies of the U.S. and U.K., whose efficiency is often taken as a model to be emulated, also tend to rely on demand-led growth strategies, rendered feasible by flexible exchange rates – under the umbrella of a reserve currency in the American case. Thus, some of the difficulties afflicting southern Europe, and the Eurozone as a whole, were built into EMU from the start but ignored under the influence of economic models that assume there is only one route to economic success.

Unfortunately, such myths die hard and the EU is still in the grip of them. They are most visible in the proposals recently advanced to strengthen the institutional capacities of the EU for fiscal coordination and to restore growth in Europe. As I have noted, the former center on a fiscal compact aimed at producing balanced budgets, and the latter focuses on 'structural reform' – generally a synonym for making competition in markets for labor and goods more intensive. If this analysis is correct, neither of these steps will be sufficient. To avoid a decade of deflation, the EU needs institutional capacities for coordinating reflation across northern and southern Europe. Imposing balanced budgets as a substitute for that is to assume that policies appropriate for the political economies of northern Europe will also work in the very different institutional settings of the south, where balanced growth is likely to depend more on the periodic expansion of domestic demand.

Similarly, what the EU currently sees as its 'growth strategy' is essentially a mirage. In the long run, structural reforms may improve the efficiency of an economy, but they are not going to generate economic growth over the short-to-medium term. Of course, European policy-makers realize that; but many cling to this myth because they have to have a growth strategy and this is the only one on which the member states can currently agree. Perhaps that is because, after a decade of sacrifices to improve their own competitiveness, many in the north do not see why they should now have to revive growth in the south. Or they may now be so mistrustful of their neighbors that they are no longer willing to accept the risks of trying to coordinate on more flexible macroeconomic policies. But the popularity of this mythical growth strategy is also surely influenced by the view that one set of best practices will work everywhere.

Until policy-makers and political economists shake off such myths, they are unlikely to find viable growth strategies for Europe as a whole. At this point, it is far from clear that the southern European economies can prosper within monetary union. However, if successful growth strategies are to be found, they will have to exploit, rather than ignore, the institutional differences between Europe's political economies. That entails finding forms of transnational fiscal coordination, backed up, if necessary, by intra-state flows of funds, which reduce the levels of austerity currently imposed on the south and allow for a coordinated expansion over the long run in both the north and south that accommodates appropriate differences in the national macroeconomic stance. Only then will firms and governments in the southern European economies have a fighting chance of securing the 'social pacts' that limit the pace of wage growth and of moving toward the higher value-added production crucial to long-term living standards there (Avdagic *et al*. 2011). On this depends, not only the economic outlook for the south, but the future of a European Union whose appeal has always turned on its capacity to ensure a prosperous future for all its members.

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