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# *Document de travail*

## **EUROPEAN ECONOMIC GOVERNANCE: THE BERLIN-WASHINGTON CONSENSUS**

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# European Economic Governance: The Berlin-Washington Consensus

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## Abstract

This paper argues that the European Union has gone farther than any other country or institution in internalizing the prescriptions of the Washington Consensus. Embedding neo-liberal principles in the treaties defining its governance, the EU has enshrined a peculiar doctrine within its constitution. We further argue that this “Berlin-Washington Consensus” has serious empirical and theoretical flaws, as its reliance on Pareto optimality leads to neglect the crucial links between current and potential growth. We show by means of a simple model that the call for structural reforms as an engine for growth may be controversial, once current and potential output are related.

We claim that adherence to the Consensus may go a long way in explaining the poor growth performance of the European economy in the past two decades, because of the constraints that it imposed on fiscal and monetary policies. The same constraints have deepened the eurozone crisis that started in 2007, putting unwarranted emphasis on austerity and reform. Challenging the Consensus becomes a precondition for avoiding the implosion of the euro, and recovering growth.

*Keywords:* Washington Consensus, Neoclassical Theory, Austerity, Structural Reforms, Fiscal Policy, Monetary Policy, EU Governance, ECB, Stability and Growth Pact, Fiscal Compact

*JEL-Codes:* E02, E32, E58, E62, E63

The expression "Washington Consensus," first introduced by Williamson (1990), has been the subject of a vast literature, mainly related to developing countries. We use it in a sense close to its original meaning, to identify any set of policies with three basic characteristics: first, the search for macroeconomic stability (balanced budgets, price stability); second, structural reforms aimed at increasing competition and openness; third, clear distinction between a short term in which demand has possibly a role, and a long term "natural" position of the economy in which only supply factors matter.

This paper argues that the European Union has gone very far in the internalization of the original Washington Consensus prescriptions; since the Maastricht treaty of 1992, the institutions for economic governance of the EU embed and give constitutional strength to that doctrine. The latest treaty (known as the 'fiscal compact'), signed in March 2012 and not yet ratified, goes even more backward in history, rejuvenating the Treasury view of the "Memorandum on Certain Proposals Relating to Unemployment" by the British government of 1929.

The main flaw of the Washington Consensus is that it loses sight of what should be the ultimate objectives of economic policy, growth and full employment, in favour of intermediate goals such as a short-sighted definition of macroeconomic stability. In this paper we will argue that this flaw translates into the current European debate. In particular, the excessive focus on debts and deficits can explain the dismal performance of the past, and may prove disastrous in the future.

After introducing (section 1), the European institutional framework, section 2 presents a few stylized facts comparing the growth performances of the United States and the largest European countries. Section 3 will review the consensus explanation for Europe's "growth deficit." In section 4, we will challenge this explanation, highlighting both empirical and theoretical weaknesses of the consensus. In sections 6 and 7, we will argue that tradeoffs and therefore a broad range of policy choices characterize modern economies. By means of a simple *ad hoc* model, we will also show how simple commonsense assumptions introduce a tradeoff between structural reforms and stabilization policies that is absent in mainstream reasoning. Sections 8 and 9 will deal briefly with monetary and fiscal policy in Europe. Section 10 concludes.

# 1. The European Macroeconomic Policy Framework

Creating a unified economic zone has been a great achievement of the European construction. Member states have transferred sovereignty to the supranational level in the areas of monetary, trade, and competition policies. Concerning macroeconomic policies, there is today a strong asymmetry: Fiscal policy, still in the hands of national governments, is strictly framed by the Stability and Growth Pact (SGP) that the fiscal compact will make tighter. Monetary policy is managed by the European Central Bank (ECB), to which the treaties give strong independence with respect to targets and instruments, but within a strict and exclusive mandate for price stability. Unlike sister institutions like the Fed or the Bank of England, the ECB is not directly accountable to any political authority. This design makes it impossible to even conceive a policy mix. The fiscal policy of national governments is under close surveillance of the EU Commissioner for Economic and Financial Affairs, who is explicitly forbidden by the treaties to coordinate with the ECB, and has considerable influence because of the effect of Commission's recommendations on the reputation of national governments (Fitoussi and Saraceno, 2008). Furthermore, the treaties do not provide for a coordinating mechanism (such as an EU treasury or prime minister). Fiscal policies are coordinated from the bottom by the adherence to the SGP rules.

The EU institutional setup is no accident. It reflects the neo-liberal doctrine that prevailed in the early 1990s, that assumed competition to be superior in terms of efficiency. The policy prescriptions are coherent with the objective of minimizing obstacles to aggregate supply growth: increasing competition through deregulation and privatization; price stability; budget balance. Each objective has to be pursued independently from the others, as if the model of the economy were linear.

The consolidation of a particular doctrine within economic institutions, that require unanimity of member States to be modified, is a peculiar feature of today's Europe, and is unique in history. This "doctrinal bias" is compounded by the difficulties of governing a currency zone that is far from optimal. In a low labour mobility context, the neo-liberal doctrine calls for price and wage flexibility. Nevertheless, because it cannot be accompanied by exchange rate devaluation, flexibility implies wage deflation, with socially unbearable costs, in countries hit by idiosyncratic shocks. The only way out of this impasse is a form of indirect "flexibilization": cost reduction through tax competition and the progressive dismantling of the welfare state (Fitoussi, 2005). This improves competitiveness, and is consistent with the more general objective of reducing government size, a buttress of the Washington Consensus.

Have these policies successfully met the objectives of prosperity and low unemployment? We claim that the answer is no. In the past two decades the EU growth performance has been

considerably lower than the US. We argue that the root cause of this dismal performance is a government by the rules, which leads to the substantial neglect of growth as a policy objective.

## 2. The Facts: US Growth vs. European quasi-Stagnation

The different macroeconomic performances of the United States and the largest countries of the eurozone over the past two decades can be summarized by means of Kaldor's (1971) "magic square" (figure 1).

On each of the axes we represent one of the four main objectives of economic policy: real GDP growth ( $g$ , north); external balance, that is, current account surplus over GDP ( $b$ , east); unemployment ( $u$ , south); inflation ( $\pi$ , west). We only included data until 2007, for the crisis not to alter the results.

The figure offers a good snapshot of the difference in performance between the two regions. In the 1980s, average annual growth in the United States was 3.2 percent, a full point above the average of Germany, France, and Italy. Furthermore, inflation and unemployment were lower in the United States, albeit they still hovered at fairly high levels. In the 1990s the United States was able to lower inflation considerably without giving up growth. In addition, unemployment fell significantly over the decade. The European countries, on the other hand, had to pay for their much improved record on inflation with an even worse unemployment situation: joblessness over the decade averaged nearly 10 percent while growth stagnated at a mere two percent.<sup>1</sup>

The years 2000s show the final conquest of inflation for the 4 countries, and a further divergence: while the three European countries (in particular Germany) kept their attention focused on external balance, the US was more concerned by unemployment and growth.

To summarize, we can say that the United States reached three out of the four objectives, especially in the 1990s; Europe was able only to master inflation and maintain external balance. Why is this so? Is the external imbalance of the United States, which increased for more than two decades, the price to be paid for a high growth/low inflation economy? And was the European emphasis on external (and internal) balance, together with the fight against inflation, detrimental to growth? In other words, does figure 1 reveal a trade-off between policy objectives that was (more or less deliberately) resolved differently by policy makers on

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<sup>1</sup> We do not enter, here, in the complex yet crucial issue of the distribution of gains from high growth. Even considering the important differences in average wages, social security, and the distribution of income, this would not change the fact that the macroeconomic environment in the US has been consistently more growth friendly than in Europe.

the two sides of the Atlantic? Or was uneven performance, especially in Europe, the effect of policy and institutional errors that prevented the economies from reaching all four objectives? The management of the eurozone crisis in late 2011 gives some insight. Domestic demand is not considered in Europe (especially by Germany) as an engine for growth. The fiscal compact only focuses on the sustainability of public finances. Meanwhile, the rare calls for more emphasis on growth envision structural reforms to boost the European economies through exports. If this “Berlin view” were to evolve into a “Berlin consensus” and become dominant in Europe, we would then have the paradox of the second largest economic block of the world relying only on foreign demand to ensure prosperity for its citizens.

### **3. The Berlin-Washington Consensus.**

The dominant view, that we label the Berlin-Washington (BW) Consensus<sup>2</sup>, explains the different profiles of the two regions on the magic square by the different structure of their economies. The US has a more flexible, market-oriented economy, whereas European countries carry the burden of an inefficient welfare state that keeps their economy on a low growth/low employment path. For example, Prescott (2003) argues that the much larger amount of hours worked in the United States is almost entirely attributable to Europe’s excessive tax burden. Therefore, reducing government size would yield higher growth. In a similar vein Lucas (2003), although he concedes that Keynesian policies played an important role in reducing income fluctuations in the past, claims that there is no further role for stabilization policies, and that much can be gained in terms of overall welfare from structural reforms. The literature offers hundreds of similar statements<sup>3</sup>.

The Washington Consensus has permeated the stance of institutions in charge of economic governance at the global level. The IMF and the World Bank, backed and shaped by the richest countries, proposed a development model based on essentially three elements: first, a reduced role for stabilization policy (macroeconomic policy should be limited to fighting inflation and keeping public finances under control); second, an increased role for market mechanisms (privatization, deregulation, and other structural reforms); and third, full integration into the global economy (openness to trade and free financial flows). The model did not prove as successful as its proponents had hoped,<sup>4</sup> and is today increasingly challenged.

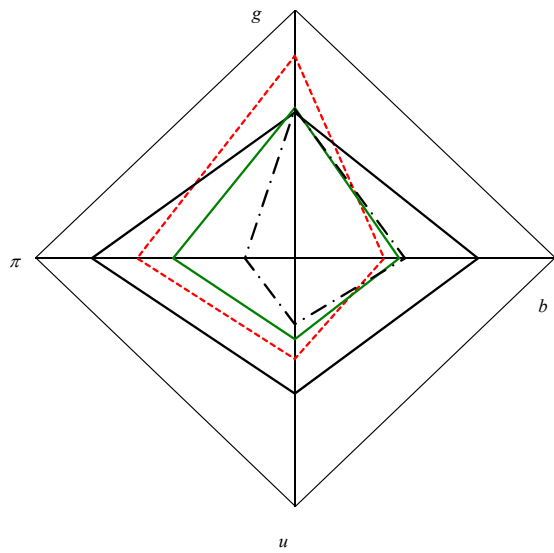
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<sup>2</sup> In previous work (Fitoussi and Saraceno, 2004) we coined the term Brussels-Frankfurt-Washington Consensus. The evolution into a Berlin-Washington consensus is an indicator of the slow but constant drifting of the EU towards more weight on its intergovernmental structure. It is a fact that today the Commission plays a lesser role than before the crisis.

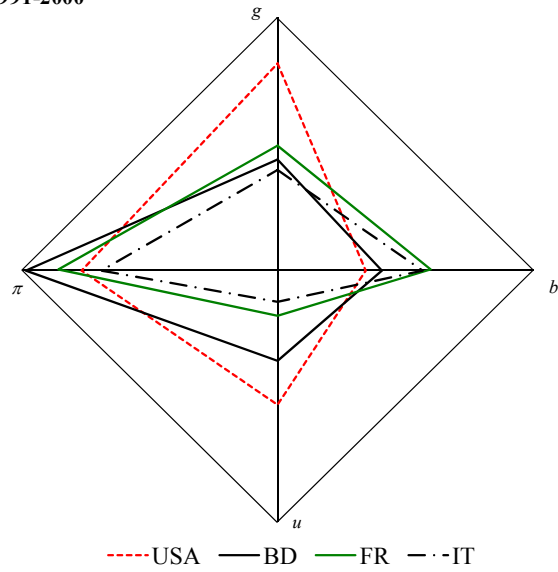
<sup>3</sup> In particular, the EMU has fostered a relevant literature calling for structural reforms. For recent examples and surveys, look at Leiner-Killinger *et al.* (2007), Allard and Everaert (2010), Beetsma and Giuliodori (2010).

<sup>4</sup> For recent general audience accounts of the missed promises of globalisation, see Stiglitz (2002), and Rodrik (2011); a more technical account can be found in Rodrik (2007).

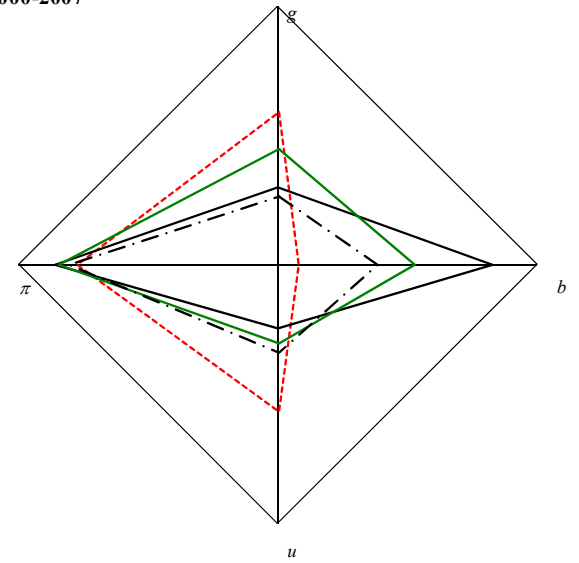
1981-1990



1991-2000



2000-2007





Policy makers in Europe, on the contrary, progressively but surely embedded the Consensus prescriptions into the fundamental structure of the EU (established by the Maastricht Treaty of 1992 and completed, waiting for the ratification of the fiscal compact, by the Treaties of Amsterdam, 1997, and Lisbon, 2009). The European institutional setup, *de facto*, gives up discretionary economic policy, by limiting monetary policy to inflation targeting, and fiscal policy to automatic stabilization (up to a point). This framework was subject to criticisms, but most of them were internal to the mainstream as they called for only minor adjustments.<sup>5</sup> With a few exceptions (Fitoussi, 2002; Arestis and Sawyer, 2003), no one has challenged the underlying framework that limits the role of government to removing obstacles that prevent the smooth working of markets. Furthermore, and somewhat paradoxically, the build-up of public debt that followed the successful effort to save the world financial sector and the economy from collapse in 2007-2009, led to a renewed emphasis on the need to constrain fiscal policy. Reversing causality, Germany and EU institutions blamed the crisis on public finances excesses, imposing austerity and the signature of the fiscal compact to introduce in member countries' constitutions the balanced budget requirement.

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

The theoretical basis of the Consensus is a modern version of the neoclassical theory. After the crisis of Keynesian policies in the 1970s, the neoclassical paradigm became dominant again, both in academic research and in economic policy making. Despite its endless variations, the new version is quite similar to the old one: Markets are populated by fully rational agents so that, once public intervention has coped with externalities, informational asymmetries and excessive market power, they usually yield the best possible outcome in terms of resource allocation and growth. Only frictions and market failures may prevent this from happening. The role of economic policy is then simply to remove or minimize these frictions on the supply side, that is, to change the structure of the economy to insure make sure that it conforms as much as possible to the reference model.

From this perspective, discretionary interventions on the demand side are useless, if not harmful. True, the new neoclassical synthesis, using Dynamic Stochastic General Equilibrium models, introduces some short term effects of monetary policy. But the conclusion is mild enough not to disturb the consensus: *cherchez* the lowest possible inflation rate, and rules are always to be preferred to discretion to avoid the time inconsistency problem. The European constitution fits very well this theoretical framework as it enshrines both a monetary policy rule and a fiscal rule.

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<sup>5</sup> Examples of "internal critiques" include Buitert (2003) and Buti, Eijffinger and Franco (2003). These critiques came under the spotlight in October 2002 when the then President of the European Commission, Romano Prodi, called the Stability Pact "stupid," as all rigid rules are.

The real business cycle literature is quite emblematic in this respect.<sup>6</sup> Fluctuations within the overall trend are simply the result of optimal responses by agents to shocks. Given this, therefore, the fluctuations themselves are optimal, and any attempt to smooth out the cycle leads to welfare losses in general. Policy has a role only when frictions cause deviations from these optimal fluctuations for example, in the recent Neo-Keynesian literature (Gali, Lopez-Salido and Valles, 2003). But even in this case, policy action is limited to following (more or less) simple rules aimed at compensating for the distortions or externalities.

The "simplicity" and universality of the theory probably contributes a great deal to explaining why it is still dominant today despite all its shortcomings, empirical weaknesses, and the policy errors that it has induced.<sup>7</sup> And why, above all, it is surviving the 2007-2008 financial crisis (Quiggin, 2010).

## 5. Challenging the BW Consensus

### *Do Data Support the Consensus?*

Since the 1992 Maastricht treaty, fiscal policy has been extremely passive. Before the launching of the euro, monetary policy focused almost exclusively on exchange rate stabilization; since then, it has focused on price stabilization at the point that a threat of imported inflation in July 2008 triggered an interest rate increase a few weeks before the collapse of Lehman Brothers. Nevertheless, the EU's growth performance has hardly been impressive. The question then arises: where is the prosperity promised by the Consensus? The only two episodes of relatively high growth in the past two decades—at the end of the 1980s and at the end of the 1990s—were both preceded by a substantial loosening of monetary conditions. In contrast, relatively tight monetary policy seems to be a major factor, although not the only one, behind the unimpressive European growth performance in the last decade. If we also look at the experience of structural adjustment programs, the most surprising thing about a Consensus so widespread in the academic and political communities is the scant evidence to support it.

A follower of the BW Consensus might object that the problem lies in insufficient adherence to its prescriptions. Macroeconomic policy may have been virtuous, the follower would argue, but structural reforms have not progressed enough. In light of the available evidence, however, this seems little more than a theological argument. Take the reform of

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<sup>6</sup> The two references are Kydland and Prescott (1982), and Long and Plosser (1983).

<sup>7</sup> The simplicity of the theory may not be the only reason for its dominance in policy making, especially in Europe. We argued elsewhere (Fitoussi and Saraceno, 2008), in reference to the 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

labour markets, the most paradigmatic of structural reforms. Most economists<sup>8</sup> would point to labour markets as the main suspect in explaining the strikingly different growth performances of the United States and Europe. For example, Nickell *et al.* (2003) argue that the equilibrium level of unemployment is affected by variables that influence either the matching of unemployed individuals with job vacancies or wage adjustment in case of disequilibrium.. These include the unemployment benefit system, the real interest rate, employment protection, active labour market policies, labour union structures, coordination in wage bargaining, labour taxes. Yet, the impressive amount of work devoted to validate this view has not yielded the expected results. Evidence on institutions and labour market performance is weak and often contradictory. This is not really surprising, as the negative effects of rigidity measures on employment are often of second order and not particularly robust. In fact, in unemployment regressions, at least for OECD countries, nation-specific factors often become non-significant once we control for common shocks (Fitoussi, 2003). Fitoussi *et al.* (2000) further show that structural reforms, where implemented, have not always yielded the expected results on labour market performance.

Finally, an important and often overlooked factor is the endogeneity of institutions. Well-known results by Greenwald and Stiglitz (1986) and others show how incomplete information, leading to moral hazard and incompleteness of markets, prevents the working of the first theorem of welfare economics, because market allocation is not (constrained) Pareto optimal, so that government intervention may enhance welfare. But their research also has the less emphasized consequence that institutions themselves emerge to compensate for market inefficiencies and incompleteness. For example, once imperfect information prevents efficient contracts in the labour market, norms guaranteeing labour protection may prevent excessive fluctuations in employment. How can we be sure, then, that labour protection is an obstacle to full employment? Could it rather be that norms emerged precisely in response to persistent unemployment? Paradoxically, the only convincing conclusion to emerge from the wide array of studies devoted to labour market reform is that no single institutional setting proves to be superior to others, and that success is determined by the interaction of institutions with country-specific factors (Freeman, 2000). This is exactly the opposite of the BW Consensus one size fits all philosophy.

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<sup>8</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 (Pissarides, 2000), and by Mortensen and Pissarides (1994). Other often cited 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, more recently, their *Going for Growth Series* (see e.g. the latest issue OECD, 2012).

The BW Consensus has substantially failed the empirical test in the field of development as well. The last decades witnessed some extraordinarily successful stories and some tragic failures. All of them had complex causes, proving wrong the notion that the institutional model based on deregulated markets and small government is always superior to other models. It took many years, but it is nowadays clear that one size does not fit all (Rodrik, 2007). By looking back, we learnt that capitalism is sufficiently robust to accommodate rather different institutional settings, but often not enough to dispense from government intervention.

### *The Theoretical Flaws of the Consensus*

The lack of robust empirical evidence is only one of the problems of the BW Consensus. The main theoretical flaw of this framework is its reliance on a simplistic application of the welfare theorems, according to which complete and perfectly competitive market, absent distortions, will always reach the most efficient price/quantity allocation. It is simplistic because the move from the theoretical result to the policy prescription is tricky and requires caution (as was clear to the founders of general equilibrium theory). In fact, once we admit the existence of "market failures" and therefore the impossibility of attaining the first best equilibrium, the theory is incapable of ranking alternative institutional arrangements according to their effectiveness. 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. Unless this is proven, the statement "more structural reforms are good" cannot be unconditionally true.

To conclude, 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 structures through structural reforms, i.e. a modification of the social contract itself. So, on the one hand, Consensus economists ask the government to conduce hands-off policies, and on the other, they pretend that it can reach into relationships and customs that are rooted in society (the result of long-term complex evolutions) and substitute them with the free market paradigm. The other paradox of 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 United States from the early 1980s to the late 2000s is largely due to efficient coordination of activist monetary and fiscal policies (and to ...financial bubbles). The Consensus, however, is mainly a product of the US academic community. It appears that the United States produced a commodity, the Consensus, which has not been marketed at home but rather exported, given that the largest number of

consumers is abroad. This "consumption" can be voluntary, as in Europe where policy makers have decided to embed the Consensus' prescriptions into EU treaties. Or it can also be the result of bullying, as developing countries were often forced to adopt structural adjustment programs in order to gain access to international aid (Stiglitz, 2002). We have to recognize that a pillar of the consensus, the efficient market hypothesis, was indeed also consumed in the US; but this led to the financial crisis, thus reinforcing our point. The paradox is even more striking if we consider the progress of economic theorizing on market failures that led a growing number of economists to believe that regulation and government intervention are key factors in guaranteeing durable and robust growth. But with just a few exceptions, policy makers still refer to the BW Consensus model. In this respect, it is striking how European policy makers largely ignore the call from many academic quarters and opinion makers (e.g. the *Financial Times* or *The Economist*) for a more meaningful articulation between short term support to global demand and long term consolidation of public finances.

## 6. The choiceless government

According to the Consensus, governments have no choice but to comply with the doctrine. In a way, they are governments without a people. The argument in favour of structural reforms argues that they allow market convergence to the first best. At worst there might be losers in the short-term, who could be compensated through transfers. With negligible short-term costs, reforms should be implemented without hesitation to increase the growth potential of the economy.<sup>9</sup> The argument has even been pushed as far as to claim that the market's capacity to adapt to reform could result in higher future *and* present growth<sup>10</sup>. Thus governments face no real choice: with limited resources, and as demand management policies are useless, they will logically choose to implement reforms. Never, according to the Consensus, a government would face a choice between future and present growth.

If we do not live in a first best world, convergence to the first best optimal allocation may be slow or uncertain, and it would take time before reforms have the desired effect, if any. In the meanwhile, society would have to bear the cost of reforms. Job losses due to restructuring, or the slashing of pension benefits would both result in reduced purchasing

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<sup>9</sup> Even in this approach, there may be a case for gradualism when vested interests are strong enough to block reforms. In the labor market, for example, insiders would resist liberalization (Saint-Paul, 2000); gradual implementation would initially exclude insiders and thus weaken their resistance. Thus the case for gradualism is not made based on the general interest and on the costs of reforms for society as a whole.

<sup>10</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 current private expenditure.

power, with negative effects on consumption and aggregate demand. Active policies may then improve current welfare, for example, by stabilizing employment.

Furthermore, a modicum of historical sensitivity suffices to understand that long spells of depressed economy may have long-lasting effects on the growth potential of the economy. For example, firm bankruptcies can spread to the financial sector, resulting in a credit crunch that causes a shortage of working capital for the production sector and serious negative effects on investment and the capital stock. Hysteresis effects of unemployment may further worsen the picture. (DeLong and Summers, *forthcoming*). In other words, if current and future growth are related, excessive focus on structural reforms may hamper the future, especially if we are far from the optimal equilibrium.

Adherence to the Consensus in Europe has led to institutions completely geared towards structural reforms. The intermediate objectives of low inflation and external balance were preferred to the final objectives of growth and employment (figure 1), that were supposed to be reached through structural reforms<sup>11</sup>.

The case of the United Kingdom is often invoked to make the point: the reforms of the 1980s have reduced the government's role in the economy, allowing for a higher path of potential growth. But a distinguishing feature of the UK institutional setting —namely an active pro-growth macroeconomic policy— has gone unnoticed. While monetary policy in the euro area focused on price stability, the Bank of England had an active stance. Similarly, a wise application of the golden rule setting limits to deficit net of public investment (see Creel, Monperrus-Veroni and Saraceno, 2009) prevented the excessive reduction of public investment which has characterized European countries trying to fulfill the Maastricht criteria.

We believe that the benign neglect of European authorities vis à vis current growth is at the root of continental Europe's poor economic performance, and its even weaker potential for future growth. This was true before the crisis hit the world economy, and is even truer now that the debate turns around fiscal consolidation and little else.

## 7. A Stylized Model

This section presents a simple *ad hoc* model (microfoundations are beyond the scope of this paper) to demonstrate how a trade-off between present and future growth appears once reasonable assumptions about the effects of structural reforms are taken into account. In this

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<sup>11</sup> It is not just a question of higher weight given to inflation reduction in the policy maker 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.

case, which we believe to be general, constraining policy by means of rigid rules may not be optimal, even when taking a long-run perspective.

### *The Economy*

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

$$y_1 - \bar{y}_1 = \varepsilon_1 + g_1 - \gamma r_1 \tag{1}$$

$$\bar{y}_2 - \bar{y}_1 = \alpha(y_1 - \bar{y}_1) + \rho r_1$$

The first equation describes the current output gap that depends on  $\varepsilon_1$ , a zero-mean symmetric shock to income, and on two policy variables: The first,  $g_1$ , is public balance (deficit if positive)) 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. Potential output is also affected by the current output gap, through hysteresis and investment. We can safely assume that the effect of current income on the potential is small (small  $\alpha$ ). Finally, we normalize  $\bar{y}_1 = 0$ .

### *The Government's Choice*

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

$$\max_{r_1, g_1} \ln(y_1 - \bar{y}_1) + \beta \ln(\bar{y}_2) \tag{2}$$

$$s.t. \quad g_1 + r_1 = d$$

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, as we assume that the government is constrained by a total deficit cap  $d$ . Notice that we abstract from “free lunch” reforms, which improve the potential growth rate at no costs. If they are not implemented it is not for economic reasons, but for the opposition of vested interests.

### *The Optimal Level of Reforms*

With appropriate substitution 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  $r_1 = 0$ . We argued above that the positive long term effects of reforms may not be warranted (i.e.  $\rho \leq 0$ ), or that they can be more than compensated by short term effects (i.e.  $\rho < \alpha(\gamma + 1)$ ). By assuming  $A > 0$  we put ourselves in the most favorable case for reforms. Finally, define  $B \equiv \varepsilon_1 + d$ .  $B$  can be interpreted as the total budget constraint. 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 non-negativity constraint, is

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

Thus, we have a positive level of reforms only if the weight given to the future, and the net benefit of reforms, are larger 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 parameters is intuitive:

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

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

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

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



The quantity of reforms 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 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). This runs counter the common argument that governments should take advantage of crises to implement painful reforms. According to the model it makes more sense the long term plan presented in September 2011 by the Obama administration (400 US\$ billions of extra expenditures for the “Jobs Act”, matched by 3000 billions of deficit reduction over the following ten years). On the contrary, it is hard to support the sequence of austerity plans imposed by fellow European countries and the IMF to Greece, Spain and Italy, requiring hasty implementation of reforms with uncertain long-run benefits, and inevitable short-run costs.

This model is by no means realistic, and its results should be interpreted accordingly. The important message is that we can easily set up a simple model, based on commonsensical hypotheses, in which the desirability and "depth" of reforms depend on a series of parameters like 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 all links between periods are broken (i.e. when  $\alpha = \gamma = 0$ ) and when the budget constraint for the government is not binding, the trade-off disappears. Only in such a situation, the call for austerity in recession times could make sense.

## **8. Monetary Policy and the European Policy Mix**

The theory of currency unions (Mundell, 1961) assigns well defined tasks to monetary and fiscal policy. Monetary authorities react to common shocks setting the interest rate in order to maximize some union-wide objective function (usually obtained by averaging the national objective functions). The optimal monetary policy response to idiosyncratic shocks is to "do nothing" (Lane, 2000), leaving the task to national fiscal policies, that remains decentralized.

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 to deal with demand management in the face of aggregate shocks. Yet, this is what the economic governance of the EU looks like. Unlike charters for other important central banks (e.g., the US Federal Reserve), the EU treaty gives the ECB the task of conducting monetary policy “the *primary objective* of which shall be to *maintain price stability and, without prejudice to this objective*, to support the general economic policies in the

Community" (Art. 105.1; emphasis added). The problem of income stabilization at the EU level has been solved by invoking a sort of "coordination from the bottom" through limits to deficit and structural reforms at the national level. By making national economies more flexible, these reforms would put them in a position to absorb *all* shocks better, including their common ones. This explains the recurring ECB emphasis on structural reforms (the most recent example is the editorial in the June 2012 ECB bulletin, but there are no significant differences with the ones written before the crisis). ). By making national economies more flexible, these reforms would put them in a position to absorb *all* shocks better, including their common ones. This is why the reforms are often considered substitutes for active monetary policy, even if experience almost invariably proves this belief to be wrong (Ffrench-Davis, 2002).

Throughout its existence, the ECB emphasis on price stability was predominant. After managing the late consequences of the East Asian crisis quite skilfully, the ECB reverted, to a rather restrictive monetary policy stance, in spite of weakening demand and stable core inflation. As a consequence, monetary policy was pro-cyclical, at least during the 2000-2003 period. It is true that the ECB lowered rates considerably following the September 11 events. The US Fed however, acted more rapidly and aggressively which prompted many commentators to accuse the ECB of excessive inertia. Overall we can say that in the years prior to the crisis, the ECB rarely pursued growth, and when it did, never explicitly, sometimes with the consequence of an often baroque and opaque communication strategy. The same pattern can be observed during the crisis that began in 2007. The subprime crisis represents a typical case in which solvency and liquidity problems are difficult to disentangle. Nevertheless, in August 2007 the crisis hit the credit sector with no regard to the actual solvency of individual institutions, dramatically increasing systemic risk. In this context, monetary policy has been correctly praised as effective and timely in preventing a meltdown of the banking sector. Nevertheless, in what concerns macroeconomic stabilization, while the Fed put in place all the instruments, conventional and unconventional, to circumvent the liquidity trap in which the world economy had sank, the ECB was more timid, and quickly reverted to its customary call for attention to inflationary pressure. Even during what could be called the "phase two", the eurozone sovereign debt crisis, the ECB remained attested to its mantra (fiscal consolidation and structural reforms). It refused to address the issue of acting (through appropriate treaty changes) as a buyer/lender of last resort for governments, thus making eurozone sovereign debt analogous to any other major economy, and shielding it from speculation. The arguments were that treaty provisions would forbid it, and that this would increase the risk of moral hazard. Yet, even constitutions, especially ineffective ones, may be changed. More importantly, the moral hazard argument did not prevent the ECB from injecting large amounts of liquidity in the system to save financial institutions. (e.g., with the

two Long Term Refinancing Operations -LTRO- of the winter 2011). These are less effective (there is no guarantee as of how much of the liquidity pumped in the system will actually be used to buy sovereign bonds), and fail to address a major objective of the lender of last resort, which is to anchor expectations, defusing speculation and hence making actual intervention unnecessary. The strategy chosen by the ECB has actually been the opposite: massive purchases on secondary markets, and liquidity injections in the financial sector, coupled with a communication strategy emphasizing that this intervention would be limited in size and in time. This is unfortunate, because if the liquidity injections are used by the banks to buy public bonds, an increase of the spread would make both governments and the banks worse off. On the contrary, direct purchases by the ECB on primary markets would reduce the spreads and improve the banks' balance sheets.

Some justify the strict adherence of the ECB to the consensus to its need, as a young institution, to establish a reputation. We refer the reader to Artus and Wyplosz (2002) and to our previous work (Fitoussi and Saraceno, 2004) for an extensive discussion of why being tough does not necessarily means being credible, and why an excessively ambitious inflation target may actually have hampered the ECB credibility. Here it suffices to remark that it is impossible for a central bank to acquire credibility if it imposes excessive costs on society when trying to reach its goal. How credible can a central bank be if it refuses to lower rates because of a largely undemonstrated inflationary threat when the euro-zone economy is on the brink of a recession? This is precisely what happened in 2008 when, a few weeks before the Lehman collapse the ECB increased its main rates.

## **9. The Fiscal Governance of the Eurozone**

The Amsterdam Council of 1997 put in place the Stability and Growth Pact which coordinates fiscal policy in the euro zone "from the bottom", and is designed with the explicit objective to ban discretionary fiscal policy, and to lay the burden of adjustment on the operation of automatic stabilizers (Buti and Giudice, 2002). According to its provisions, each member country has to achieve the objective of a medium-term balanced budget, while the deficit in any given year needs not to be above the 3% Maastricht threshold. The requirement to attain a position of close to balance or surplus in the medium term is an important innovation of the SGP with respect to the Maastricht Treaty. In fact, it implies the strong consequence that public debt as a ratio to GDP should tend asymptotically to zero, a position hard to justify *per se*. The Amsterdam Treaty also defines an "excessive deficit procedure" which gives the Commission the power to propose sanctions against any country that exceeds the limit. The Pact and the sanctioning procedure received a severe blow in 2003 when the EU's Council did not follow the Commission's recommendation to impose fines on France

and Germany. This led to a reform (in 2005) that softened its requirements, notably allowing deviations for countries with low debt and/or that were trying to implement costly structural reforms.

The sovereign debt crisis revived the discussion on the Pact. Germany and other core eurozone countries conditioned their help to countries in trouble to the implementation of strict austerity measures. Furthermore, Germany and the European institutions (in particular the ECB) pushed for giving constitutional strength to the requirement of a balanced budget. This resulted in the “fiscal compact” (formally, the *Treaty on Stability, Coordination and Governance in the Economic and Monetary Union*), signed by 25 European member states in March 2012. The fiscal compact states that the government structural deficit must not exceed 0.5% of nominal GDP. Furthermore, countries with debt exceeding the 60% reference level should reduce it at the rate of one twentieth of the difference per year. The main innovation of the fiscal compact is that the balanced budget rule will have to be introduced in member states' national legal systems at constitutional or equivalent level.

The main theoretical foundation of the Stability Pact is an externality argument: a government running a budget deficit must borrow; in a monetary union, this raises the common interest rate, which may affect negatively other countries. But the argument could actually be reversed. On the one hand, if the fiscal expansion were unjustified, in the resulting inflationary pressure would reduce competitiveness. On the other hand, if the deficit responded to a slump, it would sustain demand and hence imports. In both cases, demand for the other countries' goods would increase, and their deficits would be reduced thanks to increased fiscal revenues. The externality argument is also hard to hold if the financial market is capable of valuating the sustainability of the fiscal stance of different countries. In that case it will increase the risk premium paid by countries which are following “bad policies” and reduce it for the other countries, which will, in this way, benefit from the behaviour of “bad” countries.

Supporters of the Stability Pact make a second argument in its favour: excessive deficits could lead to insolvency which would force the ECB to intervene (against its statute) to bail out the floundering country. Excessive deficits could thus undermine the ECB's credibility in the fight against inflation. While it is true that excessive deficits in Greece raised the pressure on the ECB, it is also true that in other countries (Spain or Ireland) the public debt build-up followed the crisis, and was due to problems originating in the private sector. Thus, limits to public debt, *per se*, would not reduce the risk of ECB involvement. Eichengreen and Wyplosz (1998) argued that the risk of default (that at the time appeared remote) would be better dealt with through better public debt management and bank regulation.

The Pact was designed assuming that governments would accumulate surpluses in good times, thus allowing the operation of automatic stabilizers in bad times. This ideal scenario, however, ignored the fact that such balance would be attained only after a long transition that for many countries was not completed at the outset of the crisis. This led to the adoption of procyclical restrictive policies, and to the hasty reversal of the stimulus plans that had been put in place in 2009. As of today, most eurozone countries do not even have room for automatic stabilizers to work. The situation is socially unsustainable and results in creative accounting, increasing pressure to soften or simply ignore the rules, and pressure on the ECB for a more expansionary monetary stance. All this looks far more threatening for the credibility of the European institutional system than giving member countries the possibility to conduct discretionary policies.

Supporters of the pact also invoke the literature that flourished in the 1990s on the non-Keynesian effects of budget deficit reductions (see footnote 10). If the budget deficit reduction is credible and significant, it may trigger (via lower expected taxes) an upward revision of permanent income, and thus of private expenditure. This literature has been challenged mainly because non-Keynesian effects require a capacity of the private sector to spend that is usually hampered by fiscal consolidation (e.g. in Greece, Spain or Italy). Recent research confirmed that past expansionary fiscal consolidations were triggered by an increase of exports rather than domestic demand (Perotti, 2012).

Finally, Fitoussi (2005) and Creel and Saraceno (2009) notice how the EMU is evolving towards an inconsistent institutional setting. The European treaties are consistent with a society that gives importance to the insurance role of the government through the welfare state; a system in other words, where automatic stabilization plays an important role. In the US, on the contrary the social contract gives a low weight to the insurance role of the government. Coherently with this democratic choice, discretionary macroeconomic policies need to be active to smooth income fluctuations. In other words, two equally legitimate and consistent systems can be designed: one in which a marginal role for the welfare state is compensated by active discretionary fiscal and monetary policies (the US); or a European treaty-consistent one in which constraints to discretionary policy go hand in hand with a role for automatic stabilization. Creel and Saraceno (2009) show nevertheless that the EMU is gradually evolving towards an inconsistent framework, dismantling its social insurance system, while it tightens the constraints to macroeconomic policies. This could lead, in the medium run, to extreme instability and dangerous social consequences.

## 10. And Now?

We have shown that the constitution of Europe makes Europe a strange political construct: a set of quasi-nation-states orphan of a federation. This leads to chronic instability. The combination of a monetary federation with a fiscal confederation can't be stable. The attempt to impose coordination through rules believing that discretion would lead to an even greater instability, did more harm than good.

But in abnormal times like the one we are living in today, an instable construction is threatened to break. An (un?)intended consequence of the treaties is that members of the euro area have lost the protection of their national central banks, while the ECB is forbidden to act as a lender of last resort. Hence in the eurozone debts are sovereign but money is without a sovereign. This immanent contradiction is leading to an unsustainable situation. To abide by the rules, governments are forced to deleverage through austerity policies at the very moment when the private sector, in the midst of a balance-sheet recession, has to do the same. That worsens the crisis, as each sector is trying to increase its saving. Even unconventional monetary policies are showing their limits, as people have lost faith in the European construction and in the very future of the single currency. This distrust is feeding capital flights from peripheral countries today, and maybe from the eurozone in the future. In short, the euro area is dangerously approaching the abyss. Will it explode?

It all depends on whether we will be able to free ourselves from the BW Consensus, and to recognize that government intervention (in particular, as is always the case in balance sheet recessions) is today key to put the economy back on a sustainable growth path. This brings us to the more general issue of identifying capitalism with the free market paradigm. History tells us that ranking different institutional settings so as to find the "best" one is a vain exercise. Different models have proved successful at different points in time, depending on the conditions of the moment. The strength of capitalism resides precisely in its capacity to adapt and to accommodate different institutional setups and to deal with the complexity of the world.

From an even broader perspective, we must ask, first, why efficiency should be the sole objective of a modern society<sup>12</sup> and, second, whether excluding ethical considerations from the policy maker's objectives is necessarily the best way to assure prosperity. As the crisis painfully reminded us, the issues of wealth creation and distribution are inextricably linked.

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<sup>12</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".

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