A tale of two cities: Exit policies in Washington and Frankfurt[1]

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Summary. In this paper we study policy reactions to the crisis across the Atlantic, with specific emphasis on its Eastern side. We want to explain the different attitude of European policymakers *vis-à-vis* their USA homologues and to this end we choose the perspective of the historical roots of European monetary union institutions.

1. Introduction.

As is well known, the current crisis was born in the USA in 2007 but soon spread to Europe. Its (proximate) roots were in the accumulation of private debt. In 2009 its pace began slowing down in the USA as an effect of public intervention while accelerating in Europe as a public debt crisis emerged here on the top of the private debt one and improper policies were adopted to face them.

In this paper we study policy reactions to the crisis across the Atlantic, with specific emphasis on its Eastern side. We want to explain the different attitude of European policymakers *vis-à-vis* their USA homologues and to this end we choose the perspective of the historical roots of European monetary union (EMU) institutions.

In the USA both fiscal and monetary policy were active in counteracting recessionary impulses, with a clear Keynesian inspiration. While having this imprint, monetary policy was also innovative, as it devised various types of unconventional measures that added to the traditional ones. Differently from policies in Washington, in the EMU, only the Frankfurt pole, i.e. monetary policy, was actively expansionary, even if with some hesitation, and to some extent innovative. Fiscal policy not only did not offer any expansionary impulse, but acted in the opposite direction.

This different reaction is consistent with the foundations of European monetary institutions, which were set up on a number of de facto circumstances, but drew theoretical support from the theories prevailing at the time. However, they seem to be no longer justified on these terms, i.e. with respect to current theories, which have countered almost all the conclusions of theories that were asserted since the end of the Sixties and widely applied in Anglo-Saxon countries in the Eighties and in Continental Europe in the Nineties. This raises the issue whether there are different explanations for the continuation of such out-dated policies, in terms, e.g., of the opposing interests of the member states and their relative bargaining power.

The rest of the paper is organized as follows. After having briefly described the evolution of the crisis, the next section deals with policy responses in Washington and Frankfurt. Section 3 tries to feature the impact of the EMU institutional architecture on the dynamics of the crisis with an implicit comparison with the role of the USA institutions. Section 4 sketches the historical roots of EMU institutions and the different interests and targets pursued by the participating countries. In section 5 we study the analytical foundations of the main building blocks of EMU institutions both at the time they were devised and in the light of current economic thought. In section 6 we suggest some possible explanations of the hysteresis shown by European institutions and policies and try to answer the issue why European policymakers seem to be still slaves of economic theories that were fashionable in the Seventies. Section 7 concludes.

2. Exit policies in Washington and Frankfurt

[1] I am grateful to Mario Tiberi for his remarks on a previous version of this paper.

2.1. The evolution of the crisis in the USA and Europe

The financial turmoil initiated in 2007 in the USA and turned into a deep crisis in terms of the main macroeconomic indicators. It soon hit Europe too and began to cause recession also here. In 2009 the GDP went down by 3.1 per cent in the USA and by 4.4 per cent in the Euro-area. In 2010, on the top of the private debt problem – and to a large extent as an outcome of public policy measures enacted to cope with it – a public debt issue arose in Europe. Sovereign debts in some countries – the so-called PIIGS countries, i.e., Portugal, Ireland, Italy, Greece and Spain – were hit by speculation and spreads between the interest rate paid on them and that of the German Bunds soared to unsustainable levels. Practically the whole EMU economy precipitated into recession, while the USA recovered to a large extent. In the four (seven) years after 2009 (2006), EMU GDP has risen at an annual pace of 0.6 (0.2) per cent, comparing with a 2.1 (0.9) per cent for the USA. American unemployment rate in 2013 will be 1.6 (3.1) p.p. higher than in 2009 (2006), whereas the EMU one has soared by 2.6 (3.7) p.p. in the same period. The inflation performance has been practically the same in the two regions: 2.2 (2.1) per cent in the USA vs. 2.1 (2.0) in the EMU in the four (seven) years (European Commission, 2013), even if fears could arise of a possibly higher inflationary bias for the USA, due to the relative interdependence between the Fed and the Government (Sims, 2008).

2.2. Policies in Washington

Expansionary monetary policy was soon enacted in the USA. It first tended to support ailing financial institutions, through ordinary operations (open market operations with broker-dealers) changing the aggregate quantity of reserve balances that banks held at the Federal Reserve, by lending directly to commercial banks and other depository institutions at the "discount window" (with its maximum maturity lengthened to 90 days) and by creating a range of emergency liquidity facilities to meet the funding needs of key nonbank market participants at interest rates close to zero. The main issue, however, was that of relieving various financial institutions from the risks and losses of securities markets, which had taken a dominant role. A joint action of the Federal Reserve with the Treasury of November 2008 tended to restart these markets, in establishing the Term Asset-Backed Securities Loan Facility (TALF), with the former supplying the liquid funding and the latter assuming the credit risk.

Another delicate issue was that of the final impact of monetary action on the real economy, which mainly depended on the level of the long-term interest rate. Arbitrage is supposed to operate the transmission mechanism from short-term to long-term rates. However, it tends to work in an imperfect way, depending on expectations on future rates as well as on the preference for very short-term assets, which is very high in times of financial panic. In order to influence expectations the Federal Reserve made it clear that the duration of the almost zero interest rates would last for "an extended period" (Kohn, 2010). In addition, in order to have a direct impact on longer-term rates, it inaugurated various rounds of unconventional measures having the purpose of buying longer-term securities and making use of 'forward guidance' (i.e., working directly on markets' expectations, through explicit announcements and communication about future trends in policy). These lowered yields and pushed up asset prices, inducing positive wealth effects. The first such measures (usually referred to as Quantitative easing 1, QE1) - addressed to large-scale asset purchases (LSAP) of GSE debt, agency debt, mortgage-backed securities (MBS) and Treasury securities - began towards the end of 2008. The second type of unconventional measures (QE2) started in the second half of 2010 and concentrated on purchases of US Treasury securities. In September 2011, the Federal Reserve rediscovered "Operation Twist", a commitment to extend the maturity of securities held on its balance sheet, already experienced

in 1961. In September 2012 a third round of QE was inaugurated, focusing on the purchase of MBS.

In May 2013 an announcement by President Bernanke of the possibility of a future exit action from the expansionary stance negatively hit financial markets which jumped the gun on the recovery. He had to but had to correct the announcement[2] to signify that the current stance would not be abandoned until the Fed's targets (in terms of either unemployment and growth or inflation) would not be hit.

Unconventional operations have been very effective in lowering sovereign yields and raising equity markets, not only in the US, but also in other countries, as an effect of portfolio re-allocation and re-pricing of the risk in global financial markets (Fratzscher, Lo Duca and Straub, 2013). They also contributed to lower bank funding volatility and increased loan supply (Carpenter, Demilrap and Eisenschmidt, 2013).

Fiscal policy too has always been expansionary in the USA. Conspicuous discretionary measures were taken, beginning with G. W. Bush's October 2008 Troubled Asset Relief Program (TARP) (implying a $700 bn. purchase of nonperforming financial assets from the balance sheet of private banks, infusion of funds into GM, Citigroup and AIG), continuing with President Obama's American Recovery and Reinvestment Act (ARRA) in 2009, which led to an additional expenditure (and tax cuts and transfers) of $787 bn[3].

It is true that part of this huge discretionary impulse[4] could be simply explained by a structural feature of that country, i.e. paucity of automatic stabilizers (Dolls et al., 2012b), and that its net effect on GDP growth and employment was rather small for a number of reasons[5]. However, it testifies the will of the American administration to counter the recession, even at the cost of public debt accumulation. A struggle has then emerged towards the end of 2012 between the Obama administration and the opposition as to the way to cope with the 'fiscal cliff'. A debt ceiling has limited the possibility of prolonging the fiscal expansionary stance and the discretionary impulse will be (moderately) negative in next years.

2.3. Policies in Frankfurt

Practically all the Euro-area countries, Germany included, have responded to the crisis with a moderately expansionary fiscal stance, up to 2010. This has been followed by a contractionary orientation after the emergence of a public debt issue. A strengthening of the Stability and growth pact (SGP) has then been decided, by inaugurating a fiscal compact.[6] This has failed to pursue its claimed target, i.e. a fall in deficit/GDP and debt/GDP ratios in order to tame the speculation. In

[2] Finally, in July 2013 President Bernanke made it clear before the Congress that, first, no exit policy will be adopted 'at least as long as the unemployment rate remains above 6-1/2 percent and inflation and inflation expectations remain well behaved in the sense described in the FOMC's statement' (implying that long-term inflation is below 2 per cent) and, in addition that 'the specific numbers for unemployment and inflation in the guidance are thresholds, not triggers. Reaching one of the thresholds would not automatically result in an increase in the federal funds rate target' (Bernanke, 2013).

[3] This included $288 billion in tax cuts and benefits to individuals and firms; $275 billion in contracts, grants, and loans; and $224 billion in entitlements.

[4] The budgets for TARP and ARRA constituted approximately 10 per cent of US GDP.

[5] The TARP was intended to relieve financial institutions from the burden of non-performing assets; tax reliefs from ARRA were largely used for deleveraging; effects on unemployment lacked because of firms' restructuring (Tcherneva, 2011).

[6] For an inquiry on the size of both automatic stabilizers effects and the discretionary fiscal stance of European countries see Dolls et al. (2012a). As said, an inverse relationship between the two components of fiscal policy is found by Dolls et al. (2012b). In March 2011 the Pact was toughened, requiring drastic action to reduce the debt/GDP ratio and instituting ex ante surveillance of national budgets and in December 2011 the fiscal compact was agreed on.

fact, the recession has lowered the denominator of these ratios and conjured up the spectre of a future crisis of confidence. In the last five years to 2013 the debt/GDP ratio has soared by almost 25 p.p. to 95.5 per cent.

Monetary policy response had been expansionary until April 2011 through the usual open market operations. The European Central Bank also used 12-month and 36-month Long Term Refinancing Operations (LTRO) (a form of non-standard measures) since 2009. These operations have continued in 2011 and 2012. In addition, the ECB instituted a Securities Markets Programme (SMP) running since May 2010,[7] by which it purchased bonds issued by the countries under speculative attack to the tune of several hundred billion euros[8]. In this sense European monetary policy shared some features with the Federal Reserve's policy of quantitative easing, but we show later that the analogy is only apparent.

After April 2011, despite the feebleness of the economic recovery in that year, the ECB prematurely initiated an exit strategy and insisted on this course for some months. Finally, in November 2011 this stance was abandoned and substituted again by an expansionary one.[9] In July-September 2012 monetary authorities decided to undertake a new program. Differently from the SMP, which was temporary, this measure - Outright Monetary Transactions (OMT) – has no *ex-ante* time limit and is geared to support sovereign bonds' demand in the euro area in secondary markets to an unlimited extent. This again is not true unconventional monetary policy similar to the American or British-style QE for three reasons: first, because the program is limited to a subset of European countries (those having an 'appropriate' EFSF/ESM programme designed to reduce the deficit and debt/GDP ratios)[10], whereas QE in the US and UK has targeted those countries' entire debt; second, because the impact of the interventions of the OMT should be sterilised in order to re-absorb the liquidity injected. Finally, even if the immediate targets of the ECB interventions resemble those of the Federal Reserve, i.e. driving down the interest rate on government bonds, the final objectives differ. For the Fed the fundamental aim is to lower long-term interest rates by forward guidance[11] and large scale asset purchases so as to foster private investment, whereas the ECB is basically seeking to make up for the EMU's lack of consistent and credible institutional architecture and, ultimately, to ensure the survival of the euro, which has

[7] According to the ECB "the design and implementation of such measures remains focused on the ECB's primary objective", namely price stability. Ostensibly, they will only "remove the major roadblocks" to the effectiveness of standard policies and "by their nature are temporary to the extent that they have to be strictly commensurate to the degree of dysfunctionality of markets that is hampering the transmission mechanism. The central bank must guard against the danger that the necessary measures in a crisis period would evolve into a dependency as conditions normalize" (Trichet, 2010; ECB, 2010a). The main preoccupation of the ECB has been to ensure that the Programme can avoid having an impact on monetary conditions. Such an impact has been repeatedly denied, even if some analysts doubt that (Henderson Global Investors, 2010).

[8] The Programme involved buying a little more than €200 billion bonds. After it had been terminated in September 2012, bonds held by the ECB were still €218 billion at the end of February, 2013.

[9] The ECB increased the main refinancing operations rate by a quarter of a point twice in April and July 2011 to lower it in four legs, in November, December 2011, July 2012 and May 2013.

[10] A European Financial Stability Facility (EFSF) was first established in 2010, that has been later substituted by a European Stability Mechanism (ESM), which began operating in 2012.

[11] In August 2013 also the new governor of the Bank of England, Mark Carney, who had already adopted 'forward guidance' at the Bank of Canada, formally introduced this new policy tool at the Bank of England, targeting a reduction in the unemployment rate down to 7 per cent from its present level of 7.8 per cent.

emerged in the course of the crisis as the true issue at stake.[12] Notwithstanding this profound differences there were beneficial effects of the unconventional monetary measures adopted by the ECB, which contributed to lower bank funding volatility and increase loan supply, similarly to what non-standard measures did for the USA, even if to a lower extent (Giannone, Lenza, Pill and Reichlin, 2011, 2012; Carpenter, Demilrap and Eisenschmidt, 2013). In addition, at least until now (August 2013), OMT have been able to stop the speculative component of spreads between PIIGS countries and the German Bunds[13]. Had the ECB decided to commit earlier to unlimited support of sovereign debt, the crisis in the Eurozone might have followed a different course.

2.4. Why so much difference?

As we have seen, in the USA steady expansionary policies were adopted with no hesitation. In the EMU only monetary policy has been – all in all – expansionary, but premature exit policies have been adopted for a certain time, whereas fiscal policy has always been contractionary since 2010. The outcomes in macroeconomic terms are clearly in favour of the USA.

Striking the proper balance between restoring normality and avoiding a protracted depression is the crux of the matter of exit policies. This has proved to be all the harder in a currency union like the EMU, which is not a federal state and has no common fiscal policy. In the current institutional setting the exit strategies adopted within the EMU derive from a bias towards being premature and so tend to aggravate the risk of prolonged depression. The bias stems from some deficiencies in the institutional architecture of the EMU (mainly, absence of common active fiscal policy), which has acted to nourish crisis factors first and has then made the pressure of markets and impatience to prevail and to impose premature adoption of exit strategies. In addition, excessive concern for the impact of expansionary fiscal policy on debt which also derives from undervaluation of multipliers. We will deal with the deficiencies in the institutions in the next section. The issue of the excessive preoccupation with the impact on debt of expansionary fiscal policy will be dealt with in section 5.

3. The institutional architecture and the dynamics of the crisis in the EMU [14]

3.1. Introduction

The Euro-area crisis is usually described as characterized by the dynamics of the public debt in specific countries, in particular the PIIGS countries. This characterization raises a number of questions, as public and private debt (more generally, the various sections of a financial market) are linked and there are usually spillovers from one to the other. These spillovers can degenerate into contagion when they are excessive (Allen and Gale, 2000). Our interpretation of the Euro-area

[12] Our interpretation is different from that appearing in ECB publications. Cour-Thimann, Winkler (2013) make use of a flow of fund analysis that highlights the financial structure of the euro area economy – where financing is mostly bank-based rather than market-based. They emphasise the nature of ECB unconventional measures as a complement to, rather than a substitute for, standard interest rate decisions, as the non-standard measures are aimed at supporting the effective transmission of monetary policy to the economy rather than at delivering additional direct monetary stimulus. They interpret the ECB response to the crisis as a way of fulfilling the traditional role of a central bank 'as a lender of last resort to the banking system and, more broadly, reflecting (its) … capacity to act as the "ultimate sector" that can take on leverage when other sectors are under pressure to deleverage' (Cour-Thimann, Winkler, 2013: 2). This interpretation, which reflects Trichet (2010) and ECB (2010a) for the SMP, may well be correct, but in our opinion much more has been at stake when the ECB has adopted unconventional measures. Otherwise, it would be difficult to understand the ferocious opposition of one of the German representatives in the ECB Governing Council, first, and the Bundesbank's President, later, to the ECB decisions, before and after introduction of OMT.

[13] On this see also De Grauwe, Ji (2013a).

[14] This section partly draws on Acocella (2011).

crisis is that the specific dynamics of private debt in the EMU – in addition to (or in conjunction with) the financial crisis erupting in the USA - nourished by inappropriate EMU institutions is at the origin of the EMU crisis. This tended to degenerate into a public debt crisis, because of improper policy conduct by the national policymakers of PIIGS countries as well as European policymakers and, again, an inappropriate EMU institutional setting.

In the next subsection we explain how a private debt crisis arose. In subsection 3.3 we show how the public debt crisis emerged to a large extent as a consequence of the private debt crisis, EMU institutions helping the public debt crisis precipitate into a depression. In the last subsection we point to the main shortcomings of the EMU institutions *vis-à-vis* those of USA.

3.2. The trend in private debt

The accumulation of private debt in some countries (not only the PIIGS) was built into the way the Euro-area institutions were (and are) shaped, which caused macroeconomic imbalances to arise. In fact, differences in real interest rates derive from virtually equal nominal rates throughout the area but different inflation rates[15]. Such differences tended to stimulate borrowing and speculative operations in the real estate and stock markets in the less advanced member states (De Grauwe, 2010a). Expectations of high real growth convinced people of the sustainability of debt (EEAG, 2011).[16] Free capital movements and a common monetary policy that was expansionary until 2006 actually fuelled this process. Again, absence of any common financial supervisor, regulator or rescue body made it possible for the bubble to grow and burst as soon as the financial crisis imported from the USA erupted. To save financial intermediaries required the intervention of national governments and an increase in public deficits, thus threatening the whole European financial system, as we will see in the next subsection.

Contrary to the conclusions of Blanchard and Giavazzi (2002),[17] the Union should not have adopted a position of benign neglect with respect to the impact on current account imbalances, as these are a potential source of problems and disruption. To be sure, a more active attitude by European policymakers faced real difficulties. For one thing, imbalances could not be properly dealt with under the Euro-area's institutional arrangements (see in particular De Grauwe, 2009 and Harashima, 2011). Sticking to these, i.e., with no innovation introduced in the institutional architecture of EMU, each country should undertake policies to resolve the imbalances on its own, and the deflationary effects could snowball. In fact, different countries tried to cope in different ways. Some took a contractionary budget stance; others did not, preferring higher employment in the short run, and instead enacted labour market reform to remedy the deterioration in the real exchange rate. Labour market flexibility has thus increased substantially in a number of EMU countries (see, e.g., Damiani et al., 2011). Contrary to the opinion of some authors (Zemanek et al., 2010, and references therein), this has not significantly reduced inflation differentials, first of all because Germany reacted by further trimming wage increases (De Grauwe, 2009). Moreover, the reforms were not really effective when the crisis erupted; in some countries (such as Spain) they had created an army of temporary workers that compounded the recession. Some countries,

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[15] The macroeconomic imbalances within the Euro-area depend on a number of circumstances. Here, we concentrate on the differing wage and price trends. These, in turn, are to some extent tied to untackled structural factors, as underlined by Balassa (1964) and Samuelson (1964). Moreover, the degree of competition in labour and goods markets is different as an effect of the historical, structural and policy factors that influence price competition and wage bargaining. There is in fact no simple way of explaining why the rate of increase in wages declined in Germany and Austria after the advent of EMU and rose in other countries, creating new inflation differentials or widening existing ones.

[16] See Blanchard, Giavazzi (2002) on the sustainability of current account deficits.

[17] For a recent reappraisal of the relevance of the issue, see Giavazzi, Spaventa (2010).

such as Greece, neither shrank their budget nor enacted labour market reform in the last decade,[18] which might help to explain the strength of the tensions accumulated.

In any case we can conclude this sub-section by saying that either European policymakers have not been up to the needs deriving from the crisis or that there have been profound contrasts among them that have prevented adoption of a more innovative action, mainly directed to removal of holes in the EMU institutional architecture.

3.3. The public debt

Unlike the private sector debt, before the crisis the public debt had been reduced in all the Euro-area countries, except Germany and Portugal only. In the area as a whole it fell from 69 per cent of GDP in 2000 to 66 per cent in 2007 (Eurostat, 2011). As to the peripheral countries, their past histories are quite varied.[19] So there is little basis for the analysis of the EEAG (2011) according to which these countries were marked by excessive public spending and borrowing. In practice, the only such country was Greece. And, all in all, there was no sign of significant public debt tensions *before the crisis*, with the exception of Greece, whose difficulties were disclosed in the course of the crisis but actually stemmed from previous conduct. The EEAG report is thus mistaken in attributing the crisis to moral hazard,[20] i.e. a lax attitude on the part of the PIIGS governments owing to the expectation of being bailed out by other European countries.[21]

When it comes to the management of the crisis, matters stand somewhat differently. Initially, many countries *had to expand their budget deficits greatly to cope with the financial crisis*[22]. But in the process, the size of the deficit/GDP ratio depended on the EMU governments' responses, specifically on the deflationary fiscal policies initiated in 2010 *by all the EMU countries* as each government sought to ward off insolvency, which tended to contain the numerator of that ratio, but eventually reduced the denominator too. Tensions within the EMU exploded almost by chance – in the case of Greece, when the new government disclosed its predecessor's misconduct – or as a direct consequence of the crisis and the need for government intervention, as in Ireland. Expectations of insolvency then arose.

Some analysts (EEAG, 2011, for one) hold that the shocks would have been avoided simply by enacting a stiffer SGP and a credible no-bailout clause. However, this would not have worked with Greece, which could still have violated it, not reporting the true state of its public finances. In the case of Ireland, this would simply have made it harder to rescue the banks. And the measures proposed would have had an extra deflationary effect, causing additional difficulties for other

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[18] By contrast, the proportion of temporary jobs actually decreased from 1999 to 2006 (see Lampousaki, 2008).

[19] Spain had a low debt/GDP ratio before EMU and halved it to 36 per cent in 2007. After 1999 Portugal ran deficits larger than those of Germany and France (3.6 per cent against 2.1 and 2.6 per cent, respectively, in 1999-2007), but smaller than those of a number of other EMU countries. As for Ireland, it had a high debt ratio until 1985 but succeeded in reducing it to a record low of 25 per cent in 2007 thanks to rapid GDP growth. Greece, then, is the only case of high and rising debt since the formation of the EMU. Italy also lowered the debt/GDP ratio until 2008, but it then turned sharply upwards as an effect of the crisis. The poor prospects for reasonably high growth in the medium run then fuelled speculation.

[20] The underlying idea is in Sinn (2010).

[21] According to De Grauwe (2011) the thesis that the crisis was ultimately determined by moral hazard at banks is also untenable. In fact, it is hard to imagine that the root cause of excessive risk-taking by private banks was some expectation of being bailed out by the governments, in Europe or elsewhere.

[22] Generally speaking, an increase in private debt should trigger a build-up in government debt, according to the debt deflation dynamics analyzed by Fisher (1933) and Minsky (1982). As De Grauwe (2010b: 3) notes, this occurs through two channels: first, governments relieve banks of their debt; and second, the public deficit increases by reason of automatic stabilizers and Keynesian discretionary policies. Alter, Beyer (2013) construct contagion indices based on measures for aggregated spillover effects. Results of their empirical estimates show growing interdependencies between banks and sovereigns, which represents a potential source of systemic risk.

countries. In fact, the burden of the bank rescue was aggravated by the bad design of the euro area's first bailout fund, the European Financial Stability Facility, which charged high interest rates and sent a negative signal (of significant default risk) to the markets (De Grauwe, 2011)[23]. Finally, making the SGP more rigid would have aggravated the deflationary effects.

3.4. The role of institutions

In this subsection we point out the specific EMU institutional features that explain the different steps of the EMU crisis, having an eye to USA institutions.

Generally speaking and apart from fiscal policy, absence or weakness of a number of common institutions in the EMU didn't help prevent the private debt crisis to arise. We refer to common policies in fields such as financial regulation, wage policy, regional and industrial policy[24]. As seen in the previous sub-sections, the accumulation of private debt by some EMU countries derived from structural imbalances. Failing an adequately high labour mobility[25], imbalances should have been prevented by an appropriate wage policy, under the form of price and incomes policy, and/or by a proper regional and industrial policy. The former could have set a dynamics of wages related to that of productivity and an appropriate price regulation. The latter should have pointed to the growth of 'peripheral' economies, to an extent much higher than the actual one, thus requiring a more significant EU budget. Thus absence of a common and active government in the monetary union explains current account deficits, speculative bubbles and the accumulation of private debt in PIIGS countries.

The SGP – i.e., again, a passive rather than active fiscal policy – contributed too to the accumulation of public debt in most PIIGS countries and the ensuing speculative operations that aggravated it. A limited but timely intervention by a federal government such as the USA one would have avoided precipitating the financial position of those countries. To some extent, wrong estimation of the value of policy multipliers (which were deemed to be rather low) and of the negative impact on growth of a high public debt might have influenced the decision to choose the route of reducing government deficit and debt rather than adopting a general fiscal expansionary stance in the EMU countries as a way to cope with the crisis and excessive public debt[26].

Moreover, the conservative nature of the ECB contributed to the late and insufficient rescue interventions. Operating in the primary market of government bonds would have been more effective for the ECB not only in limiting speculative operations but also in promoting the real economy recovery.[27] Had a federal government and a non-conservative central bank been in place, the Greek and Irish shocks might have occurred, but they could have been smoothly absorbed, with no domino effect.

In addition to formal institutions and specific policies we should finally mention the value judgments underlying them, as these have certainly concurred to the actual attitudes of European policymakers *vis-à-vis* the crisis. Relying on punishment by markets in order to reduce moral hazard has been at the heart of the interventions to cope with the public debt crisis and the route actually followed for fixing EMU institutions, in particular for stiffening the mechanism of the SGP

[23] However, according to Alter, Beyer (2013) the setup of the EFSF (and the decision of the two LTROs in December 2011) had a mitigating impact contagion indices.

[24] To be sure, in this case the USA is not a good reference point. In fact, as to regulation, it had abundantly deregulated financial markets in the Eighties. As for wage policy, apart from a few attempts many decades ago, the USA has never adopted such policy. Finally, the USA regional and industrial policies have always been very weak too.

[25] Different languages and historical factors explain to a large extent the lower mobility in Europe as compared to that in the USA.

[26] We will expand on this in Section 5.

[27] Remember the final objectives of the ECB (see sub-section 2.3) as opposed to those of the Federal Reserve.

and devising the bailout mechanism. This not only is a partial and highly expensive remedy to the crisis, but can even be a further factor of systemic crisis: in fact, bondholders will run for cover every time they fear the likelihood of a default, with the possibility of creating a self-fulfilling mechanism of crisis. A system of stick and carrot would have been more effective (De Grauwe, 2010b, 2011; De Grauwe and Ji, 2013b).

In a nutshell, responsibility for the crisis is to a large extent attributable to the unsuitable institutions for an area too heterogeneous in terms of economic growth and inflation, in addition to different orientation and interests among member countries. An area whose only common policy is that of a conservative central bank can face shocks of the kind and size that have hit Europe only at the cost of depression. The difficulty of facing the crisis in a unified monetary policy having no other common policies, notably federal fiscal policy, has been recognized by the then President of the ECB himself. In fact, he said: 'We must remain mindful that the Euro-area consists of 16 sovereign states. It is not a fully-fledged political union or a fiscal federation, within a unified government bond market' (Trichet, 2010).

4. The historical roots of European institutions

As is well known, European institutions after 1957 were little more than a customs union. In 1992 the Maastricht accords introduced an important innovation, by establishing the creation of the EMU. In some sense this was the prosecution of an old idea dating back to the Werner plan of 1969. However, this was amended of all the institutions and macroeconomic policies which had been foreseen in that plan. Further decisions established an independent central bank having price stability as its pre-eminent target.

The EMU construction was heavily influenced both by some practical circumstances that had matured in the previous two decades and by some developments of economic theory since the late sixties[28].

From the former point of view notable is the rising weight and bargaining power of Germany among European countries (Gros, Thygesen, 1992: chap. 1), due to its rapid growth and the unification with Eastern *lander*. This country was thus able to pursue its scarce interests in implementing appropriate policies to close long-run divergences in economic performance (Gros, Thygesen, 1992: 318) while having institutions that tended primarily to price stability and avoided re-alignments of nominal exchange rates by 'deficit' countries (particularly in the aftermath of its re-unification). In the most indulgent interpretation of the German 'vision' underlying the EMU construction, in due time a common currency could integrate European economies and make them converge: monetary unification could ensure the structural changes necessary for creating a stable macroeconomic context (in particular, uniform wage and price dynamics). A unique currency ruled by a conservative central bank would impose the virtues of automatic rules and external constraints, leading not only to nominal, but also to real convergence. From this perspective, the Eurozone has been referred to as an updated – even if geographically reduced - version of Gold standard. The financial crisis that hit Europe was initiated by the Greek shock in

[28] See, e.g., Lambertini, Rovelli (2004).

The pre-dominant theoretical influence was that of optimal currency areas (Mundell, 1961), even if many economists had manifested their reserves and critiques (Cesarano, 1997, 2006). The antecedents of the Single Act are well represented by Gros, Thygesen (1992). A French and Italian memorandum had criticized the European Monetary System bias against 'deficit' countries as well absence of mechanisms designed to achieve structural change and growth. The German answer was of a monetarist kind, in asking for monetary unification and the institution of a central bank capable of acting as "catalysts in the efforts to achieve the necessary convergence of economic policies in the member states" (Gros, Thygesen (1992: 313-4). German reply, anticipating real developments in the European institutional architecture, is thus closely linked to theoretical innovations since the end of the 1960s as well as to the traditional stance of Bundesbank, fully accepted by the German government.

2009. However, about 20 years after Maastricht, persistence of structural imbalances implies that any adverse shock hitting a peripheral country would have led to similar consequences.

5. The role of the history of economic thought: The theoretical innovations of the 1970s and their recent mise-en-question

5.1. Theoretical foundations of EMU institutions

The theoretical foundations of EMU institutions can be traced back to a number of analytical contributions dating back the second half of the 1960s up to mid-1980s: critique of the existence of long-run trade-off between inflation and unemployment (Friedman,1968) [29]; optimality of a negative inflation rate (Friedman, 1969); ineffectiveness of monetary policy on the real economy and the need for a central bank to build reputation and to commit to low inflation (Kydland, Prescott, 1977; Barro, Gordon, 1983); Lucas critique of economic policy effectiveness when the private sector has rational expectations (Lucas, 1976); the capacity of a conservative central banker to reduce inflation and the need for political independence of monetary authorities in order to discipline public spending decisions and get lower inflation, with no negative impact on unemployment and growth, thus ensuring constraints on lax fiscal policies and preventing harmful time inconsistency and accumulation of public debt[30], the more so in the presence of coordination between national fiscal authorities[31]; fiscal policy ineffectiveness on the real economy as an effect of ultra-rationality (Barro, 1974); existence of negative interest rate spillovers from public deficits in one country to other countries (Buiter and Kletzer 1990)

In this perspective it is not strange that: active fiscal policy has been put in plaster by the SGP and the fiscal compact; until recently, the only common institution in the EMU has been a conservative central bank[32]; the idea of alternative institutions to preside over price stability has been given up even if they had produced positive outcomes in some EMU countries, not least Germany (Acocella, Leoni, 2007).

Only a few economists and observers[33] warned at the time – or have pointed out later – about the fragility of this project. Almost a decade ago Alan Blinder claimed that 'a sharp revision of the naively optimistic views (about the capacity of economic policy to control the economy) held by some economists circa 1966 was called for. But … the pendulum may have swung just a bit too far' (Blinder, 2004a: 26), producing a similar naively optimistic views about the virtues of markets and the central bank conservativeness.

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[29] See, e.g., European Commission (1990: 22), Goodhart (1994).

[30] Reference is to arguments by Rogoff in favour of a conservative central banker (Rogoff, 1985) as well as to *political economy* ones (see, e.g., Bade, Parkin, 1978; Alesina, Tabellini, 1990; Alesina, Perotti, 1995b). These are recalled, e.g., by De Haan, Sturm (1992), Cukierman (1994), Akhtar (1995). The influence of these ideas should be compared to that of the Keynesian thought on the statute of the Fed, though the amendments of the 1970s, which required the Board and the FOMC 'to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates'.

[31] In monetary unions time inconsistency justifies a conservative central bank and absence of coordination between fiscal policies (Beetsma, Bovenberg, 1998).

[32] Common financial regulatory bodies were set in 2009-2010, but are to a large extent still to take off.

[33] See Eichengreen, Frieden (2000). For the practical absence of anti-cyclical policies and the limitation of the European budget see Buiter, Corsetti, Roubini (1993). For perverse incentives leading to self-realizing speculative attack created by the Treaty see Eichengreen, Wyplosz (1993); on the compromises between different positions leading to the Treaty see Bini Smaghi, Padoa Schioppa, Papadia (1994); on the issue of coordination between monetary and fiscal policy see also Bryson (1994), Dixit, Lambertini (2001), Leitemo (2004), Onorante (2006).

5.2. The rebuttal of theoretical convictions of the 1970's and 1990's

Blinder's words are even more actual nowadays as economic theory has further questioned the credo that had emerged in the two decades after 1966. Thirty years later Rip van Winkle's[34] faith in this credo would again be crowded out by the analytical developments of the following years. Think of: the limited practical relevance of surprise effects, recognized by Lucas (1996: 679) himself; the irrelevance of many critiques to the 'classical' theory of economic policy (in particular, Tinbergen's 'golden rule' about controlling the economy) based on rational expectations (Blinder, 1998: 8; Acocella, Di Bartolomeo, Hughes Hallett, 2012[35]); the theoretical and practical limits to time inconsistency and thus to related prescriptions of monetary policy rules that should replace discretionary action (Blinder, 1998: 56); existence of a long-run non vertical Phillips curve (Hughes Hallett, 2000; Graham and Snower, 2008; Benigno and Ricci, 2011; Acocella, Di Bartolomeo, Tirelli, 2013); the need for more active fiscal policy and regulation (especially of financial markets and institutions[36]) once some unrealistic assumptions of current models are ruled out[37]; critique of the arguments put forward by Rogoff (1985) and Bade, Parkin (1978) and others (Posen, 1994, and Hayo, 1998, who highlight that both political independence and inflation are the outcome of structural economic and social factors that make the central bank statutes have no impact on inflation); sub-optimality of a conservative central bank in a monetary union with active trade unions (Acocella, Di Bartolomeo and Tirelli, 2007a; 2007b) [38]; critique of the Friedman rule and the need for an inflation target well above zero (Tirelli, Di Bartolomeo and Acocella, 2010)[39].

Of special interest are two myths of the literature that have inspired the European construction first and its policy to combat the crisis: the idea of a limit beyond which an increase in public debt would have negative consequences on growth (Reinhart, Rogoff, 2010; Kumar, Woo, 2010); the assertion of very low spending and tax multipliers. The former has recently been demolished almost by chance as a consequence of a Ph.D. investigation. The latter has passed through a long process of both theoretical refinements and empirical evaluations.

IMF (2010) has provided a complete and detailed empirical analysis of the effects of fiscal consolidation, which takes into account a number of aspects of the effects of fiscal consolidation

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[34] Rip van Winkle is the character created by Washington Irvin and evoked by Gordon (1976) who made a terrible 'environmental' mistake awaking up in the republican America after sleeping for twenty-years by declaring himself a devote subject of King George III.

[35] Public action can be facilitated by rational expectations. In what circumstances this can happen depends on the number of targets and that of the instruments available to the government and the private sector (Acocella, Di Bartolomeo and Hughes Hallett, 2012). When the *policymaker* has a sufficient number of instruments available he can make use of appropriate announcements of future policies (to exercise what the Federal Reserve calls 'forward guidance': see Woodford, 2007, 2008; and Williams, 2011).

[36] Europe and the USA have slowly moved to introduce tough regulation in this field. Remarkable is the new position of the IMF, which now advocates exceptional and limited direct controls of capital movements, reversing the pro free market position adopted in the previous 40 years (IMF, 2012).

[37] In a few lines we will deal with the introduction of assumptions that moderate inter-temporal consumption smoothing and limit effectiveness of fiscal policy. As to the possible negative impact on real activity of imperfections in financial markets, see Bernanke, Gertler (1989, 1990); Greenwald, Stiglitz (1988, 1990, 1993), Kiyotaki, Moore (1997, 2002); Bernanke, Gertler and Gilchrist (1999) and a lot more recent contributions.

[38] The validity of Beetsma, Bovenberg (1998) conclusions strictly depends on their assumption of absence of labour markets distortions (Acocella, Di Bartolomeo and Tirelli, 2007b). More specifically, when trade unions operate fiscal coordination ensures better outcomes with a conservative central bank, while being detrimental with a populist one (Acocella, Di Bartolomeo and Tirelli, 2007a), which is paradoxical with respect to the institutional arrangements of the EMU.

[39] To be sure there are analysts thinking that after thirty years of successful anti-inflationary action by central banks, the advantages of anchoring businesses and households' expectations at price stability should not be lost (Kohn, 2010). Our position is that a moderately higher inflation rate target could be chosen without impairing expectations anchoring, but with a significant positive impact on unemployment and growth, especially in the EMU.

policies: in particular, their timing (i.e., whether they are short- or long-term), the monetary policy stance, the expansionary or contractionary nature of budget policies of other countries. Its conclusion is that, first, 'the idea that fiscal austerity triggers faster growth in the short term finds little support in the data. Fiscal retrenchment typically has contractionary short-term effects on economic activity, with lower output and higher unemployment…, (but) fiscal consolidation is likely to be beneficial over the long term'. In addition, a budget cut is less expansionary the lower the interest rate (as monetary policy has little room for partially accommodating their deflationary effects), the lower the possibility of a currency depreciation and the less expansionary are the policies of other countries, which gives little scope for raising net export.

Of a similar nature is the result of more recent theoretical and empirical research. Some point out that smoother fiscal consolidations are more successful than stiffer ones (Batini, Callegari and Melina, 2012). Other studies stress the efficacy of fiscal policy in severely depressed economies when central banks do not offset its effects (DeLong, Summers, 2012). More generally, fiscal multipliers are shown to be asymmetric and regime-dependent, 'being stronger in recessions than in expansions, in particular in presence of financial market stress, so that contractionary effects can become very severe when fiscal consolidations are pursued' (Semmler, Semmler, 2013: 2)[40], either because of some economies are locked in a bad equilibrium (De Grauwe, 2011) or as an effect of macroeconomic non-linearities (Semmler, Semmler, 2013). Similar conclusions raise doubts on the validity of the EMU prescription tending to contract public debt burdens by reducing fiscal deficits *and opens the way for co-ordinated expansionary fiscal policies in order to deflate the debt/GDP ratio*[41]. By paraphrasing Auerbach, Gorodnichenko's (2012: 17) words, coordinated 'fiscal activism may be more valuable than previously thought'.

6. Why European policymakers are still slaves of economic theories fashionable in the Seventies? Physiological lags and perverse ties.

After more than twenty years of implementation of dated theories and its certainly not superb outcomes, it seems difficult to begin re-thinking of policies in Europe. Differently from the United States, neither theoretical progress of the Ninenties and the following decade nor the depth of the crisis that has hit the EMU countries have produced a substantial change in the institutional architecture of EMU and current policy attitudes. The former has even stressed its deflationary bias by introducing the 'fiscal compact'. [42]

Policy actions always depend on both economic theory and practical political orientations and interests. The latter partly reflect the former, but are to some extent independent of them, and there are a number of factors explaining this diversity (see, e.g., Galbraith, 1987).

Among the latter we would like to underline the still opposing interests of different EMU countries, at least according to the views prevailing in political circles. Germany and some other countries have created a system powerful enough not to suffer from the deflationary bias of the EMU institutions, because of their ability to successfully compete in Europe (and to some extent outside the area). By contrast, peripheral countries (most of the PIIGS) still think that they may draw profit from the external constrain of fixed exchange rates and other EMU institutions. They

[40] See also Auerbach, Gorodnichenko (2012), which documents the strength of output multipliers in recessions and the relevance of cross-country spillovers.

[41] According to Nickel, Tudyka (2013), however, while the overall cumulative effects of spending shocks on GDP are positive and significant when the debt-to-GDP ratios are moderate, the effects turn negative as the ratios increase.

[42] From this point of view Rip van Winkle would certainly not be hit by the institutional changes introduced in the EMU. He could still declare himself a convinced supporter of the theories asserted by Friedman, Sargent and Wallace, Barro or Lucas, without repeating an 'environmental' mistake.

might like changing these institutions but are not powerful enough to counter German opposition. Fragmentation between the different European countries is rising.

By looking at the performance of EMU countries since the institution of the euro, one can detect that it has been worse than that of European non-Emu countries at a comparable stage of development (i.e., Denmark, Sweden and UK) in terms not only of unemployment and the GDP rate of growth, but also of inflation. To be fair, this was already true before 1999, but the EMU has only succeeded in reducing the gap in terms of price stability, at the expenses of larger growth- and unemployment-rate gaps (see table 1).

Table 1. A comparison of growth, unemployment and inflation rates, EMU and European non-EMU countries, 1991-2012

GDP % growth rates at constant prices	1991-98	1999-2012
EMU	1.8	1.3
DK, SW, UK	1.9	1.7
Unemployment rates (%)		
EMU	10.4	8.9
DK, SW, UK	7.9	6.0
Inflation rates (Consumer price index, %)		
EMU	3.1	2.1
DK, SW, UK	2.6	2.0
Source: European Commission (2013 and various years)		

However, the most recent economic evolution and the depth of the crisis seem to have an influence on political attitudes. The level of unemployment is still climbing everywhere in Europe. France, the Netherlands and other formerly virtuous countries are facing rather serious difficulties that have led also to a deterioration of the deficit/GDP ratio. A very dangerous situation is thus emerging that might be a prelude to a vast authoritarian attitude throughout Europe. This might help explain why Germany could accept some attenuation of its tough stance. Then positions are slowly changing.

7. Conclusions

The evolution of economic thought can contribute to explain differences only in so far as EMU institutions were built at a time when the state of economic analysis seemed to justify them. Time has passed which should have led to a radical change of most of the still current institutional architecture, but a sort of hysteresis is in place. This has a number of possible explanations, as those underlined by Galbraith (1987). However, in order to explain it one should refer not only to normal and physiological lags, but also the opposing interests and visions among European countries and the dominant role of Germany.

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