

## **The European crisis: political and institutional failures or method in the madness?**

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In a recent contribution to the understanding of the origin of the European Monetary Union (EMU) crisis, Paul Krugman (2011) argues that this has been due to the choice made by the European politicians of putting the reasons of politics that called for a closer union, presumably after the German reunification, before those of economics. Since political union was not yet in sight, a shortcut to an irreversible path has been found in a monetary union. In another contribution, Carlo Panico (2010) found the origins of the crisis in an institutional failure. Both arguments are fine as far as they go. However, both the political choice made by the European politicians and the institutional framework they selected are more calculated than it would appear from the interpretations considered here. Let us begin with the second argument.

1. The failure of the League of Nations to deal with the aggressiveness of the fascist powers and the subsequent second world conflict sparked off a reaction against what was defined as Utopian liberalism, the idea that conflict was an irrational way to solve international controversies and that, by rational design on international settlement institutions, the mutual advantages of peace would be obtained (a magisterial example of this reaction is Carr 1939). Behind the liberal idea of the potential harmony among nations were the Ricardian and marginalist theorems showing the mutual advantages of international trade. The alternative view that emerged, political realism, recovered the old realist view of Thucydides, Machiavelli and Hobbes, of history as guided by the individual's (or State's) search of wealth and power, not necessarily out of greed but also out of reciprocal diffidence and fear. Political realism has also been an influential approach with International Political Economy (Cohen 2008). Political realists within this field, such as Robert Gilpin (1987) also traced their intellectual roots in the State-centred conflict views of the mercantilist and later authors such as Friedrich List and Gustav Schmoller. Particularly relevant to recall is the sceptical view of international institutions we derive from Hobbes. While a social contract attributing a superior power to a sovereign would solve the conflict latent in a national civil society, no sovereign state would accept - if not

for convenience over a short span of time - a super-national authority bringing order to the international conflict.<sup>1</sup>

2. This premise is useful to appraise Panico's argument that regards the EMU institutional failures as the cause of the European crisis and, more specifically, for the 'speculative attacks' to the European peripheral, in-debt countries. That the blame of the crisis should be attributed to those 'attacks' is disputable, since they take advantage of a crisis that has older and more profound causes.<sup>2</sup> Nonetheless, the reference by Panico to the institutional weakness of the European economic governance is useful and relevant. No doubt that the absence of a respected European economic authority on the one hand and the prevalence of political dithering especially by the main regional power on the other, has favoured the speculative activities that have worsened an already serious situation. Panico (2010: 4) points out, in particular, the lack of an official status of the *Eurogroup*, the committee composed of the EMU finance ministers (with the participation of the President of the ECB). Having said so, the question that Panico does not discuss is why Europe has not endowed itself with a more authoritative economic governance.<sup>3</sup>

International institutions do not fail because they are badly designed, as Panico seems to suggest, but because, as political realism taught us, States quite rarely surrender their sovereignty – certainly only weak or defeated powers accept to relinquish it, or perhaps national elites that are

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<sup>1</sup> Some decades later, liberals pretended that the mutual advantages of trade, both at the national and international level, undermined the premises of the Hobbesian (and Mercantilist) disharmonic views (Hirschman 1997), by showing the latent potential harmony of the civil society in situations where *laissez-faire* prevails. The validity of the economic theories liberals refer to is discussed in Cesaratto (2010) where I dwell on the harmonic and disharmonic views of the international economic relations.

<sup>2</sup> In his incipit Panico (2010: 1) attributes all the adversities of peripheral Europe to the 'speculative attacks', including 'a sharp decline in the rate of growth, higher unemployment, economic and social instability, changes in economic and social policies'. For a nice account of the origins of the crisis we may refer the reader to the essay by Krugman (also reviewed here) and, *si parva licet*, to Cesaratto (2011a). Panico (2010: 3) seems indeed to downplay the rather standard reference to the EMU as the origin of the European imbalances.

<sup>3</sup> Panico (2010: 5) proposal of an independent authority, similar to the ECB, in charge of fiscal policy is also disputable, particularly from a Keynesian point of view, since it certainly reminds of a body whose mandate is just fiscal rigour. Moreover, an independent fiscal authority would only increase the lack of democratic accountability of economic decisions in Europe.

unable to pass some desired (for them, but unpleasant for the majority of the population) measures at the national level that are thus gladly delegated to a super-national authority. The existence of mutual economic advantages might, of course, also justify some devolution.

As a matter of fact, France has traditionally, and repeatedly from 2008, pressed Germany to accept a stronger European governance, in particular, a coordinated fiscal policy (Maes 2004; Cesaratto 2011a). The Germans have always firmly rejected these proposals since a higher status of the Eurogroup would have *de facto* weakened the authority and independence of the ECB. Clearly an authoritative political body charged with the coordination of economic policies would have a status higher than a technocratic body as the ECB. Going a step further, in summer 2009, a sentence of the German Constitutional Court ruled any hypothetical European federal economic governance as unconstitutional, thereby reaffirming the nature of the EU as a club of independent states.

3. As noted earlier, whenever convenient, States relinquish some sovereignty to a super-national body. So why has Germany surrendered her currency, but does not want to attribute fiscal policy coordination to a European political body? In my own work (Cesaratto 2011a, 2011b) I tried to explain this by looking at the German economic and social model that took shape in the post-World War-II period. We may call this model ‘ordo-mercantilismus’. The ordo-liberal school that dominated western Germany in the fifties (more famously and misleadingly known as ‘social market economy’) preached a free-market capitalism that, however, had to be free from the pressure of oligopolistic powers on the one hand, and (more importantly) of conflictive trade unions on the other. Price stability as the yardstick of economic discipline was the obsessive objective of the ordo-liberals, while Keynesianism was rejected for being associated with trade union power and inflation. According to historian Carl-Ludwig Holtfrerich (1999), Ludwig Erhard – the legendary guide of the German economic policy in the fifties – and Wilhelm Vocke, the President of the Bank Deutscher Lander (as the central bank was then called), deliberately decided to pursue a ‘monetary mercantilist’ model taking advantage of the Bretton Woods context: assure through internal price stability, or a lower inflation rate than the competitors, a competitive advantage. This model, by implying domestic labour discipline, involved the trade unions in the success of the model: “foreign trade is not a specialised activity for a few who

might engage in it, but the very core and even precondition of our economic and social order”, stated Erhard in 1953. The ‘independent’ Central Bank was anyway the watchdog of the last instance of wage discipline.<sup>4</sup> The great success of this model is widely known. Domestic fiscal rigour, sterilisation measures and capital exports (followed in the sixties by two revaluation of the DM) protected the country from what was at that time called ‘imported inflation’. Fiscal surpluses and wage growth moderation explain why the export-led model was accompanied by large trade surpluses.

This is not the place to illustrate the vicissitudes of this model in the period since World War-II. The natural impression arises that the recent policies pursued by Germany, after some fiscal profligacy that followed unification, were an attempt to reaffirm this model, particularly under the Gerhard Schroder’s Kanzleramt. This is not a model that Germany would give easily up. In this context, the surrender of the monetary sovereignty is not surprising, since it assured the working of the German ‘monetary mercantilism’ without the noise created by the competitive devaluations of weaker countries. Another story would be, of course, the devolution of macroeconomic policy- monetary and fiscal- to an external authority that had to also take care of the balance of payments disequilibria among member countries, possibly compelling the surplus

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<sup>4</sup> For reasons not yet well assessed (Giersch et al. 1992) the German trade unions opted for co-determination, favouring the model without conflict. Franzese and Hall (2000: 182-83) point out that the specificity of the wage bargaining in Germany, led by the IG-Metall, made a peculiar interaction between the German CB and the trade unions possible: ‘The highly public pas de deux between the Bundesbank and the principal wage bargainers, which occurs at the time of every wage round in Germany, is a prominent feature of politics. The bank often issues pointed comments on the initial wage demands made by the union involved in the leading settlement, accompanied by detailed commentary about the state of the economy and warnings about the policy consequences of overly inflationary wage settlements. ... this kind of dialogue between wage bargainers and the central bank is completely absent from the U.S. economic politics. ... The Federal Reserve and the Bundesbank speak differently because they have audiences with different institutional structures.’ Interestingly, the Bundesbank’s credibility was reinforced by the export-led model, given the concentration of the strongest trade unions in the export sectors: ‘The metalworking sector, which produces the lead bargain in most years, has a high export concentration. In itself, this induces lower settlements because wage bargainers in export sectors are especially concerned with maintaining unit labor costs at internationally competitive levels. Actors in such sectors are also especially sensitive to signals from the central bank, however, because the restrictive monetary policies that the bank wields not only depress the level of economic activity but also tend to appreciate the exchange rate, thereby threatening export sectors especially severely by rendering their products more expensive in world markets.’

countries to reduce their trade surplus – by imposing a laxer fiscal and wage policy on them (Williamson 2011), or by enforcing compensatory fiscal transfer to deficit countries, the ‘transfer union’ so-feared by the German public opinion. The German total closure towards anything vaguely close to these stances explains why France, after some grumbling, has always ended up backing Berlin views.

Of course, the crisis has shown the short-sightedness of the German views of a non-cooperative international capitalism, given that as a credit country it is would be fully involved in a possible bankruptcy of the indebted countries. The hope that worse scenarios will not materialise, and the progressive projection of this country in the extra-European markets – particularly in the Chinese – may explain Germany’s relatively little interest in more stable inter-European solutions that might jeopardize her economic model. It is also possible, however, that the materialisation of the worse scenarios will impose on her some previously unthinkable solution. Anyway, the question is not of institutional design, but of convergence or lack of it, of national interests.

4. American economists have always been skeptical about the EMU. Krugman’s explanation of the decision by the European powers to endeavour such a risky enterprise (from the point of view of economic analysis) refer to the widespread argument that the European politicians put the cart before the horse, the political design of a closer Europe ignoring ‘the warnings, which were issued right from the beginning.’ The standard account of this forcing is usually found in the French will of rendering the German western European ties irreversible after the unification and the collapse of eastern Europe real socialism, moderating the natural tendency of Germany to re-establish her old eastern ties. This argument is fine as far as it goes. It does not, however, satisfactorily explain why peripheral European countries – including Italy - strived to obtain the EMU membership. The ambition to import the German discipline was likely the main motivation for these countries, although hidden behind the pro-European rhetoric. This is another case in which a national elite regards it convenient to release national sovereignty to a super-national authority. The point is that Germany will always be the best player at its own game, so that the price paid by the European periphery to ‘import discipline’ has been progressive trade imbalances vis-à-vis Germany. On the other hand, had the European periphery being better at the German game – for instance by avoiding an economic growth fed by cheap capital inflows,

keeping wages and prices more competitive -, Europe would have anyway died of a competitive deflation spiral. 'Profligate' PIGS countries, sustained by capital flows from core European countries, gave the illusion that the EMU was working and a catching up taking place, while avoiding Germany's fall into a recession given its renewed restrictive wage and fiscal policy stance. Germany could thus also celebrate the full recovery of her export-led model.

5. To sum up, both the policy and the institutional options taken by core and peripheral European countries do not appear as the result of too haste political decisions or ill institutional design, but as deliberate choices, method in the madness. A better designed Europe could, of course, be possible with fiscal and monetary coordination, and internationally planned national wage and fiscal policies aimed to correct the infra-European imbalances. The only problem is that this does sound like an unpleasant joke to German ears.

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