OVERCOMING THE INSTITUTIONAL MISMATCH OF THE EURO-ZONE:
Undetected by conventional economics,
Favoured by nationally focused politics,
Fuelled and then revealed by global finance.

Robert BOYER, Institute of the America

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Abstract

The article proposes a common interpretation of the initial success of the launching of the euro and of the painful muddling through since the bursting out of the Greek sovereign debt crisis. At odds with mono causal analysis, it is argued that three interrelated processes interact and deliver a quite complex idiosyncratic systemic crisis. First of all, the victory of new classical macroeconomics has diffused the belief that market economies are structurally stable, money is neutral, financial markets are efficient. Thus private and public actors would cope with the Euro, provided it generates more symmetric shocks than asymmetric ones. The experts involved in the assessment of the Euro superbly ignored an elementary teaching from Tinbergen about the viability of any policy mix regime, the analyses from economic geography, the core truth of Keynesian economics and the consequences the heterogeneity of European capitalisms and their regulation modes.

The second perverse process takes place in the political arena. National politicians and elites were happy to invoke the functional necessity to defend the Single market by a definite step towards monetary integration: they could present as an external constraint coming from Brussels the liberalisation reforms that were opposed by various social groups within the domestic democratic arena. Furthermore the same European Treaty could be interpreted quite differently across the members of the Euro-zone according to their legal tradition, degree of acceptance of world competition, economic specialisation and political references and ideologies. Most governments were only defending their national interests and shrinking sovereignty, whereas a weaker European Commission and a rather modest European Parliament had lost most of their expertise and legitimacy in defending a community and supranational aggiornamento of European institutions in line with the ambition of the Euro.

Nevertheless, a third stream of causality has to be brought into the picture. The first years of the Euro would not have been so happy and then its crisis so severe, had not financial innovation and globalisation provided the anaesthesia of experts, politicians and public opinion. An easy access to credit for homeowners, households, governments generated a boom for any member States, even for those economies less and less competitive. With the collapse of Lehman Brothers, the musical chair game stops and after a lag the Euro-zone becomes the weakest link of the international economy and focuses the impatience and anxiety of finance. All the previously neglected unbalances and political oppositions about the best way out of the crisis pop out, not to forget that the time of supranational political deliberation cannot cope with the quasi instantaneity of finance.

The article builds upon this analysis in order to explain why the numerous European Councils, from March 2010 to June 2012, have been unable to simultaneously stop the contagion of the crisis on one side, restore the credibility of the Euro by announcing more and more ambitious plans to launch the federal institutions required for sustaining private and public financial stability on the other side. According to the entity that will take the lead -Central Bank, European Commission, European or national citizens, quite contrasted trajectories may emerge: complete renationalisation of the policy mix, split of the euro-zone according to a North/south divide, a pragmatic return to Jean Monnet’s method of common interest institution building, ECB initiated sequence of reforms, and finally return to the democratic foundations of any economic institution, supranational or national, including the Euro. Hence a prognosis: the Euro crisis is here to last and will probably bring many surprises.
INTRODUCTION

On January 2010, the tenth anniversary of the Euro was celebrated: after an uncertain start, had not the European Union benefited from the shield of the Euro in the context of an unprecedented severe world crisis since the 1930s? In the summer 2012, after a long series of European Councils that anticipated that the viability of the Euro had been restored, European authorities and leaders of the Euro-zone state that the Euro is an irreversible building block of half century of European integration. On the other side, in the US and UK, many anticipate the collapse not only of Greece but of the whole Euro-zone: any monetary union calls for a form or another of fiscal and hence political federalism, a bold step in the pooling of national sovereignty that most Europeans are not ready to surrender.

The present article aims at overcoming this rather simple dichotomy (full federalism or death of the Euro) and explain both the rise and fall in the hope generated by the common currency via a brief retrospective and institutional analysis of the events that lead to the present uncertainty If mainstream economists do like quite parsimonious, mono causal factors that explain crises – lax public spending and welfare in the context of global competition – here it is argued that the current turmoil is so deep with unpredictable outcomes because it is at the junction of different processes affecting the academic profession, the nature of the political game at the national European level and finally the inner forces that shape the international finance after its liberalisation and cross-border development.

Within the now standard TBC and DGSE macroeconomic models and mathematical financial model the present double dip recession had an infinitely small probability to happen, given the past regularities embedded into the tools used by the Central Banks, Ministries of Finance and financiers. It is an invitation to survey the debates that took place in the preparatory phase of the Euro in the 90s (I).

Dissenting analyses have been developed that were able to anticipate some, if not all, of the possible unbalances generated by the shift from the European Monetary System to an irreversible Euro. Similarly, a survey of the origins of the Rome Treaty and subsequent development hints that new European public goods, such as financial stability, or a modicum of solidarity were necessary for the long run viability of the Euro. In a sense, many of the flaws in the Euro now apparent for any observer were pointed out by a minority of analysts (II).

Both the founding fathers of the European integration but also contemporary mainstream economists share a functionalist theory of economic institution building: politicians have a specific role: to help implementing the reforms required for generating a better efficiency. In the case of Europe, this means to correct, by new measures, the unbalances generated by the previous phase of European integration. This restricted economist’s vision of polity has hidden the complex web of social groups and national interests that sustain a limited, and if possible not too visible, transfer of sovereignty to supranational entities. A better understanding of the political logics at stake helps in analyzing the trajectory of the Euro since 2000 (III).

Mixing these processes, intellectual, political and financial makes clearer why high frequency meetings of the European Councils from March 2010 to June 2012 have been unable to find out a quick fix to such major unbalances. One of the key entities – Finance, ECB, European Commission…or citizens – have to take the lead to impose a form of coherence into a multifaceted and long term reconfiguration of the relationships between Member-States, the European Union and the world economies. There is not only a high road / low road bifurcation
since many other reconfigurations can be imagined and this history in the making will probably explore still different paths.

I. THE NEGLECTED INTELLECTUAL ORIGINS OF THE EURO-ZONE CRISIS

The first theoretical reference is of course the theory of Optimal Currency Areas (OCA) elaborated long ago (Mundell, 1961) and revisited during the phase of discussions about the benefits and constraints associated with the creation of a common European currency. Four features make more likely the viability of a currency union, defined as the ability to enjoy from an efficient economic policy in term of stabilization of economic activity: labour and capital mobility across the region, price and wage flexibility, automatic fiscal transfer mechanisms to regions, nations or sectors adversely affected, and relatively well synchronised business cycles. Clearly, all these requisites were not fulfilled in the European Union of the 60s: very low cross-national mobility of labour but increasing geographical diversification of capital portfolios, significant nominal wage rigidity and very limited redistributive impact of the European Structural Funds. Furthermore the UK and continental Europe do not display the same timing in their business cycles.

This might explain why the UK decided not to join the Euro, while most experts involved in the discussions about opportunity of the Euro recognized that in its current configuration the European Union was not an OCA, but that the launching of the Euro would trigger a wave of structural adjustments towards the fulfilment of most of its preconditions. The centre of the debate then moved from international monetary theory to the macroeconomics of activity stabilization.

1. New classical macroeconomics at odds with the major issues about the Euro

The launching of the Euro coincides with the loss of influence of the Keynesian paradigm and the rise of Real Business Cycles (RBC) models that assume that business cycles can be explained by exogenous shocks hitting a pure Walrasian economy. This academic school has progressively gained influence in economic policy discussions, especially when many influential Central Banks have been using this approach in the evaluation of their monetary policy. The European Central Bank has thus been developing the second generation of these models under the name of Stochastic Dynamic General Equilibrium Models (DSGE) (Smets and Wouters, 2002). This was presented as a definitive move towards a fully scientific approach to previously highly ideological discussions about monetary and fiscal policy.

Without overestimating the influence of macroeconomists upon the fate of the Euro, this conversion to pre-Keynesian conceptions has contributed to the misunderstanding of many issues at stake.

The contrast between the key features of the Euro-zone and the core hypotheses of the Dynamic Stochastic General Equilibrium models is striking.

First of all, the neutrality of money is central and does not help to explain the recurring bubbles generated by the low interest rates set by the Central Bank. Furthermore, the Central Bank is the only financial entity that issues fiat money, in the absence of any commercial bank or financial market. The control of money supply to maintain low inflation rate was supposed to capture the essence of monetary stability. By omission, financial stability was automatically fulfilled. One imagines the disarray of these experts facing the diffusion of the subprime crisis to Europe,
revealing the financial fragility of many banks. In this context, the monetary policy loses its efficiency because the channel of credit is broken (Draghi, 2012).

Table 1 – The consequences of the new classical macroeconomics upon the assessment of the viability of the Euro

<table>
<thead>
<tr>
<th>HYPOTHESES</th>
<th>MECHANISMS INVOLVED</th>
<th>CONSEQUENCES OF EURO</th>
<th>DEGREE OF REALISM</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. EXOGENOUS MONEY CREATED BY CENTRAL BANK</td>
<td>• Typical monetarism</td>
<td>Price stability is the first objective of Central Bank</td>
<td>In modern financial system, endogenous money creation</td>
</tr>
<tr>
<td></td>
<td>• Neutrality of money in the long run</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2. FULL EMPLOYMENT EQUILIBRIUM</td>
<td>• Perfect adjustment by prices and wage flexibility</td>
<td>Basically no inflation / unemployment trade off</td>
<td>Large and steady involuntary unemployment in many EU economies</td>
</tr>
<tr>
<td></td>
<td>• Only voluntary unemployment</td>
<td></td>
<td></td>
</tr>
<tr>
<td>3. SYMMETRIC SHOCKS WILL PREVAIL OVER ASYMMETRIC, COUNTRY SPECIFIC SHOCKS</td>
<td>Thus a common monetary policy will fulfil the bulk of macroeconomic adjustments</td>
<td>Euro-zone can be viable even if it is not an optimum for monetary unification</td>
<td>Significant endogeneity of productivity at the national level</td>
</tr>
<tr>
<td>4. RATIONAL EXPECTATIONS FOR ALL ACTORS: - FIRMS, HOUSEHOLDS - GOVERNMENTS</td>
<td>The economic policy rule associated to the Euro will affect all private and public strategies</td>
<td>The irreversibility of Euro is crucial for its credibility</td>
<td>Adaptation of firms and banks... But governments play a domestic political games</td>
</tr>
<tr>
<td>5. THE SAME SIZE FOR ALL</td>
<td>Existence of generic economic adjustments common to all member-States</td>
<td>The Euro will speed up a nominal and possibly real convergence</td>
<td>The Single Market has generated a deeper division of labour, hence heterogeneity</td>
</tr>
</tbody>
</table>

Since wage and price are fully flexible, the unemployment is voluntary in the sense that it is the outcome of a trade off between work and leisure. Such a pattern is difficult to reconcile with the observation of millions of European willing to work for the ongoing wage but unable to have access to jobs, both in the epoch of introduction of the Euro and after 2010, the bursting out of sovereign debt crisis and its contagion to the banks. Clearly, the euro-zone is facing a wave of involuntary employment, in line with the gap between capacity of production and demand. If full-employment were prevailing, austerity policies would boost private demand...but the opposite has been observed since 2010. Nevertheless, surprisingly, leading economists and politicians continue to trust and follow a failed representation of the Euro-zone (Artus, 2012a). This does help in overcoming the euro crisis.
A third misrepresentation relates to the existence of generic mechanism: that are common to all
the members of the Euro-zone and this entitles to run a common monetary policy. In a sense,
this postulates the homogeneity of macroeconomic adjustments for each national economy.
Quite on the contrary since 2000, quite diverging evolutions have been observed and this has
enhanced the initial heterogeneity of national “regulation” modes. Therefore the EU level models
loose their relevance, including for the transmission of monetary policy: very low interest rate
does not convert into buoyant credit when the banks of some members of the Euro-zone are
near bankruptcy. More generally, the complementarity of an innovation and export led growth in
Northern Europe with a domestic demand led configuration in the South falsifies the hypothesis
of a common European model. Alas the diffusion of austerity policies (Boyer, 2012) prolongs the
“same size for all” illusion that has been so detrimental to past IMF programs in Asia and Latin
America.

2. A polarization over the relative frequency of symmetric and asymmetric shocks

In the late 90s, the debates among leading experts have focused upon the fourth condition for an
OCA, i.e. the distribution of shocks between symmetric and asymmetric ones. If the
perturbations originate in the world economy and technology, the centralization of monetary
policy is justified, whereas the irreversibility of internal exchange rate prevents the repetition of
the previous European crises, such as the dramatic episode of 1993. On the contrary, if the
perturbations are mainly idiosyncratic – national public finance crisis, adverse evolution of
national competitiveness, major social conflict – the centralization of monetary policy will not
add more to the efficiency of the European policy mix or even worse will prevent the past
mobilisation of both national fiscal and monetary instruments.

The adoption of the new classical macroeconomic paradigm had two consequences that have
turned to be detrimental to the realism of the initial assessment of the viability of the Euro.
Firstly, the emphasis upon the primacy of rational expectations leads to the anticipation that the
irreversibility of the Euro will create a European business cycle, generated by the progressive
synchronization of national economic activity. This is a drastic simplification of the various and
scattered mechanisms that shape firms investment decisions, household consumption and credit
allocated by banks, not to mention the political processes that make possible…or not the
structural reforms in public spending, taxation and welfare. The primacy of symmetric shocks
was not an informed guess out of past observations but a bet about major transformations
triggered by the new epoch opened by the Euro.

The second and major failing of this polarization upon the exogeneity of shocks was precisely to
neglect the endogeneity of the economic transformations that make the members of the Euro-
zone more heterogeneous in terms of international specialization, labour market institutions,
welfare organization and financing, priorities in public spending, financial markets and so on.
Given these endogenous transformation of national “regulation” modes, the same monetary
policy might well have quite different impact. Just to give an example, according the national style
for financing housing, the same low interest rate may generate a dangerous speculative bubble in
Spain and Ireland, but not in Germany. When these bubbles burst out, the ECB is facing an
unexpected dilemma: continue to focus exclusively on a low inflation policy – as measured by the
aggregate European consumer price index – or address more directly the issue of financial
stability, thus adopting so-called unconventional monetary policy.

The intellectual framework based on the new macroeconomic orthodoxy appears today largely
obsolete… but it continues to inspire, by default, the current austerity policies.
3. Governments as servants of economic rationality: they had to comply with the reforms required by the irreversibility of Euro membership.

There is another consequence of Rational Expectations Hypothesis (REH): all actors, private and public, had to develop strategies coherent with the commitments formalized in the Amsterdam Treaty. This was not too problematic for large firms that deployed their activity in response to the removal of exchange rate risk within the Euro-zone. Similarly, the banks have extended their branches across the members of the Euro and diversified their portfolio buying foreign public bonds and securities, they would not have acquired before the launching the Euro. These two moves were in conformity with the prognosis based on REH.

It is not so for households living in economies that had weak currencies: the brutal decline of nominal and ultimately real interest rates induced many of them to buy houses and durable goods on an unprecedented scale. The rapid increase in housing price was fuelled by this easy access to credit and it started speculative bubbles that were welcome since they fed the profit of banks, created jobs in the construction sector and even filled the coffers of the State, some of them experiencing public finance surplus (Spain) at the eve of the world crisis. Convinced that the financial markets were efficient and that no public authority was able to detect a speculative bubble in real time, leading analysts and economists praised these national experiences as a promising evidence of the benefits of the Euro. This hype was general, as evidenced by the reference to the Irish trigger or Iceland’s miracle (Mishkin and Ebbertsson, 2006; Portes and Baldinsson, 2007).

But the more severe flaw was the rationality attributed to public authorities: having accepted the pooling of monetary sovereignty, they had to undertake all the reforms necessary to workout a viable policy mix and foster a more or less ambitious reform in their national growth regime. This meant that politicians had to take all the decisions required in the light a pure economic rationality, with the hope that a better efficiency could generate the resources to satisfy all other demands from citizens about taxation, public goods, welfare and fight against unemployment. In other words, the political domain had to become mainly the locus where the policies necessary to the success of the Euro are implemented.

This complete determination of the polity by the economy does not fit with the observation that the political arena deals with the accumulation of power over a given territory, whereas in the economy, it is a matter of wealth permanent enlargement, and this process tends to cross national political borders (Théret, 1992). If so, the adhesion to the Euro makes apparent major differences in national political alliances and styles. In societies where an industrial compromise prevails, the European treaties push forward the existing public policies centred upon competitiveness. In other societies, the European integration might well help a “clientelist” strategy of politicians, quite alien to the concern for the long term viability of the national style of development. If Northern Europe explores the first path, Southern Europe the second, this makes intelligible the oppositions and misunderstandings that permeate during the numerous European Summit and Councils that took place since the Greek crisis.

Rescuing the Euro is not a pure technocratic game played in Brussels, but the outcome of specific political struggles in each member-State of the Euro-zone.
4. The benign neglect for dissenting but probably more relevant theories and analyses

The rather wide consensus over the viability of the Euro-zone has been reached by excluding alternative approaches that, in retrospect, had pointed quite rightly some, but of course not all, of the structural weaknesses of the Amsterdam and subsequent treaties (table 2).

<table>
<thead>
<tr>
<th>APPROACH</th>
<th>CORE MECHANISMS</th>
<th>CONSEQUENCES FOR EU</th>
<th>DEGREE OF REALISM</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. KEYNESIAN THEORY</td>
<td>Generally effective demand is the key determinant of employment</td>
<td>Orthodox restrictive monetary policy and limits to public deficit will imply high unemployment</td>
<td>Realist for the period 1993-1999, but not from 2000 to 2008</td>
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<td>2. NEO-SCHUMPETERTIAN THEORY</td>
<td>• Innovation is the engine of growth</td>
<td>• Speed up innovation via RD and structural reforms</td>
<td>• Germany and Northern Europe, good pupils of the Euro</td>
</tr>
<tr>
<td></td>
<td>• The knowledge based economy is the new paradigm</td>
<td>• Growth is the condition for the success of the Euro</td>
<td>• Lagging Southern Europe</td>
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<td>3. NEW ECONOMIC GEOGRAPHY</td>
<td>Increasing returns imply geographical polarization</td>
<td>The Euro triggers a deeper division of labour among regions and countries, hence larger national heterogeneity</td>
<td>The productive unbalances put the Euro at risk, in absence of fiscal federalism / large labour mobility</td>
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<td>4. POST KEYNESIAN THEORIES</td>
<td>Built in instability of finance in the context of liberalisation, innovation and globalisation</td>
<td>Need to build the credibility of the Euro with respect to international finance, at the cost of lower growth</td>
<td>A typical sequence of optimism (2002-2007) and recurring pessimism (2008-2012)</td>
</tr>
</tbody>
</table>

• Imagining that the Euro-zone would constitute a Walrasian economy where adjustments take place via a complete flexibility of price and wage ignore that oligopolistic pricing is the rule in leading final goods production and that nominal wage rigidity is a common feature. Similarly, households can optimize over time their consumption only if they have access to a perfect credit market. Therefore the Ricardian equivalence principle, that states that private agents will counterbalance any public finance decision, is not an accurate representation of the majority of European economies. This brings back the Keynesian argument: all the European Treaties have a structural bias towards lower growth than under the previous European Monetary System regime. Somehow the most recent DGSE models for the Euro-zone recognize that their simulations become more accurate if “non-Ricardian households in the form of rule-of-thumb consumers” are introduced (Coenen & Al., 2012). This is a hidden tribute to the Keynesian consumption function, where current income is the key factor.
Nevertheless the prognosis derived from the textbook Keynesian model concerning the negative impact of the Euro and the Stability and Growth Pact (SGP) on economic activity has turned out as erroneous for the period 2000 to 2008. This period is better captured by post-Keynesian analyses about the impact of financial liberalisation and innovation upon the recurrence of financial bubbles (Minsky, 1986). Clearly the Euro was a major financial innovation with few precedents to compare with. Nevertheless, the typical pattern of liberalized markets has been observed once more: after an wait-and-see period, the Euro has been perceived as successful since the control of inflation at a low level has allowed a decline in interest rates. The dynamism of consumption and housing market has fuelled a wave of optimism and generated a bubble in a significant part of the Euro-zone. The subsequent period 2008-2012 follows the pattern of the previous bubbles: the loss of confidence of financiers and the poor reactivity of European authorities trigger a double dip recession. After all, Keynes and Minsky were right: the credit money is not neutral and by changing the domestic financial systems, the Euro has shown the irrelevance of the Walrasian approach to macroeconomics.

The neo-Schumpeterian approach, too, has not been taken seriously in the launching and management of the Euro. First, it shows that productivity increases are not exogenous since they derive from the explicit strategy of firms in order to capture more profits. Furthermore product and organisational innovations are also key ingredients in the search for oligopolistic rents. Second, neo-Schumpeterian economists have argued that Europe was affected not only by exchange rate and financial volatility but suffered from lagging in adopting the principle of a Knowledge Based Economy (KBE). This explained the slow growth of the old continent and made the sustainability of generous welfare systems problematic (Rodrigues, 2002). The Lisbon agenda intended to correct this weakness in European Systems of Research and Innovation. By the way, the Keynesian and neo-Schumpeterian diagnoses of the impact of the Euro are more complementary than contradictory: their time or horizon is different and they agree that RD expenditures are pro-cyclical, hence reactive to the nature of macroeconomic stabilization policy. Thus a long lasting conservative monetary and fiscal policy reduces productive capacity formation, innovation, in such a way that the long term growth is lower (Dosi, 2011).

This synthesis becomes more and more pertinent as the muddling through the Euro-zone crisis lasts. On one side, the perseverance in maintaining austerity policies depress demand and this falsifies the crowding out effect typical of public spending put forward by new classical theory (Boyer, 2012). On the other side, a depressed productive investment does reduce potential growth and makes the sustainability of public finance of the weakest economies more uncertain. This vicious circle cannot find any easy and convincing explanation within the on going macroeconomic paradigm.

Finally, the new economic geography (Krugman & al., 1999) was able to provide an interesting prognosis, against the convergence hypothesis implicit too most European strategies and the new classical macroeconomics. Given the importance of increasing returns to scale, typical in most contemporary sectors, and the agglomeration effects that foster innovation, the stabilization of internal exchange rates had the likely consequences of polarizing economic activity around the already competitive regions, the more so, the more overvalued had been the domestic currency when it was converted into Euros. This is precisely that the evolutions from 2000 to 2012 have pointed out: the North of Europe has maintained a strong manufacturing export basis, whereas the South has specialized in domestic services (Artus, 2011a). The common currency has created the polarization of trade surplus in the North versus trade deficit in the South and such unbalances cannot be corrected by a purely financial strategy.
To summarize, the turmoil in the Euro-zone is also a matter of inadequate economic theorizing.

5. Early warnings about the difficulties in implementing the Excessive Deficit Procedure

Under the pressure of Germany, the negotiators of the Amsterdam Treaty (1997) were highly conscious that the shield provided by the Euro could induce a free rider strategy in terms of national public finance. The articles 99 and 104 institute a 3 % limit for the public deficit / GDP and a maximum total debt / GDP of 60 %. The related SGP is the basis for a multilateral surveillance mechanism and a special. Excessive Deficit Procedure to enforce it via the payment of penalties for Member-States that do not comply.

Was the precise formulation of the SGP the more relevant? A lively debate took place but, finally, it did not change the content of the initial formulation. The opponents to SGP had many arguments and most of them turned out to be right and justify the successive reforms decided in the direction of a softening of the interpretation of the rules on march 2005, and then on the contrary, strengthening them and taking into account other macroeconomic structural macroeconomic disequilibria, such as loss of competitiveness or excess credit, on October 2011.

Table 3 – The drift of public finance could be (and has been) anticipated

<table>
<thead>
<tr>
<th>APPROACH</th>
<th>CORE MECHANISM</th>
<th>CONSEQUENCE FOR EURO</th>
<th>DEGREE OF REALISM</th>
</tr>
</thead>
</table>
| PUBLIC FINANCE | Theoretical conditions for public finance sustainability | The criteria selected by the Stability and Growth Pact extrapolate past growth patterns | • Any growth slowdown implies a frequent violation  
• Better rules are available | |
| ECONOMETRIC ANALYSES | The rules of SGP have been frequently violated in the past | It will be difficult to enforce | Actually many countries have been unable to stick to the rule since 2003, including France and Germany |
| POLITICAL ECONOMY | Politicians respond to domestic social demands | Public deficits will expand in economies with major adjustment problems to the Euro | Virtuous competitive Northern Europe versus lagging Southern economies |

• First of all, public finance specialists and macroeconomists pointed out the ad hoc selection of the threshold of 3 % and 60 % respectively for public deficit and total public debt. This was built upon a specification and extrapolation of the general formula formalizing all the parameters that enter into the assessment of a public finance program: interest rate, growth rates and initial stock of debt / GDP. Similarly, the criteria was too generous in good times but too severe in case of a severe recession: a better criteria would have been the structural deficit, corrected of cyclical fluctuations., and this would imply a clear counter-cyclical public finance management, at odds with the excessive permissive nature of SGP in boom periods if only the current public deficit is taken into account. If the objective was to prevent the
default on public debt, then only the total debt criteria is relevant and the rise of the interest on the refinancing of the State could be an early indicator for unsustainable public finance. Last but not least, economic rationality would imply too forbid to finance by credit current expenditures but to allow a deficit equivalent to public investment, analyzed as a contribution to future growth.

- On their side, statisticians have measured the frequency in the breaking of the 3% and 60% threshold before the march to the Euro and they found them rather frequent. Therefore the compliance with the SGP implied a significant alteration in the handling of public finance, and such an adaptation was up to the strategy of national States in response to their acceptance of the European treaties.

- Precisely political economy approaches stresses that politicians respond to the demands of various social groups and the conjunction of these pressures over the direction of public spending and the distribution of the tax burden sets the position of national public finance along with the level of economic activity. By nature, these expenditures display a lot of inertia since they result from past institutional compromises (Delorme, André, 1983) and the activation of a series of entitlements is the legacy of these past social and political compromises. Some societies have developed a political organisation that allows the renegotiation of these institutional compromises, when the economy is facing major unbalances, such as unemployment, external and/or public deficits: Nordic countries and Germany belong to this category and thus their adaptation to the Euro is a priori easier since quite all private organisations and national institutions take into account the preservation of the competitiveness of the economy. By contrast, other member-States used to be less involved in world trade and to be more conflict prone; in such a configuration, public spending and tax concessions might become the typical method for softening distributional struggles and postponing the solution to macroeconomic unbalances to better times, via an increase of public debt. Greece, Italy and France belong to this second category. The danger for European stability that represents a large heterogeneity in levels of development and socio-economic regimes was expressed quite early, at the end of the 90s.

Nevertheless geopolitical concerns about the need of an inclusive Europe and political hype won over the warning of cold analysts.

II. AN INSTITUTIONAL AND HISTORICAL ANALYSIS ALLOWED TO ANTICIPATE THE CURRENT EURO-ZONE CRISIS

It is time to propose an approach which takes on board the mechanisms basically neglected by the conventional theorizing of the Euro within RCB and DSGE models. It is thus possible to correct two of its basic failings.

Firstly the European integration is a program of supranational institutions building in charge of monitoring competition, European public goods provision, and since 2000 monetary policy. But this form of constructivism is a priori rejected by the general vision embedded in new classical macroeconomics: only private actors are able to get the information relevant for their strategy, efficient markets socialize this information and they deliver a stable, and under some condition, an efficient, equilibrium. Any active rule, either by the Central Bank or Ministry of Finance, is pernicious since the private sectors know the relation between monetary supply and inflation and anticipate that any today public deficit spending will need tomorrow more taxation: the Ricardian equivalence means the structural inability of public authorities to influence the level of activity.
The alternative is thus to consider that markets operate within a given set of institutional forms and thus their coherence and quality contribute to macroeconomic short term adjustment - a regulation mode-, but also long trends - a growth regime.

Secondly, the European integration is a long run historical process aiming at the transformation of national economies by the rearrangement of their relations. This is a permanently unbalanced process, since the institutional advances in one area reveal some emerging inconsistency with the prevailing configuration. This cannot be analyzed as a shift from a stable equilibrium to another, for instance from a regime of internal flexible exchange rate to the Euro since this would mean that the historical process would stop and converge to a stationary state.

1. Back to the basic principles about the viability of any economic policy regime

How should a rational economic policy be decided? A school in macroeconomic modelling has proposed a useful framework (Tinbergen, 1952). Basically, macroeconomic activity is largely endogenous, because consumption, investment, exports and imports are related to wages, profits, effective demand, relative prices, i.e. variables set by private agents. But generally, involuntary unemployment is observed or an inflationary boom may imperil financial and even social stability. The policy makers may correct these evolutions since they master some instruments such as the taxation rates, public spending, wage norms for the public sector, interest rates and exchange rate. By an adequate move of these instruments, a better macroeconomic equilibrium can be reached. Then the policy maker may try to decide its economic policy according to target variables concerning inflation, unemployment or external trade equilibrium and growth. Here comes the “Tinbergen’s rule”: the number of instruments must be equal at least to the number of objectives.

In the Golden Age, the national State could use rather freely at least four instruments to fulfil these objectives: monetary policy, budget and tax, exchange rate, industrial / innovation policy with the possible complement of tentative income policies (table 4). With the adoption of flexible exchange rate and the trans-nationalisation of finance, the autonomy of the monetary policy has been limited by the will to monitor somehow the exchange rate and public deficits have been put under the scrutiny of financial markets. Frequently, the unemployment rate has been the variable of adjustment and full employment has become more and more difficult to reach, in particular because public authorities had largely lost the full control over exchange rates.

But with the adoption of the Euro, national authorities lose a second tool: a monetary policy adequate to the national needs. The situation created by the Euro is radically new. It is neither the full autonomy of independent national States, nor is it a typically federalist configuration (Dehove, 1997). The responsibility of economic policy is now shared at two levels and nested in the sense that neither the supranational rules nor the subsidiarity principle exert a dominant role. Clearly the monetary policy is the full responsibility of the ECB, in charge of maintaining price stability in Europe as a whole. But the credibility of the Euro and especially its exchange rate with respect to the Dollar is significantly affected by the conduct of national budgetary policies. Given the fixed exchange rate system which is irrevocably installed by the Euro between the eleven first members, the Mundell-Fleming’s model implies that the budgetary policy becomes the only efficient instrument left to national governments in order to control the domestic level of activity (Wyplosz, 1997). Therefore each national State may have an incentive to “free ride” upon the collective good produced by the wise budgetary policy followed by other Nation-States. This is the justification for the SGP. But this introduces still another limit in the use of the traditional tools to stabilize each national economy.
Table 4 – J. Tinbergen’s analysis of economic policy: the Euro means the loss of two key instruments and the ability to refinance public debt via the Central Bank

<table>
<thead>
<tr>
<th>INSTRUMENTS</th>
<th>THE GOLDEN AGE</th>
<th>THE ROUTE TOWARDS THE EURO</th>
<th>AFTER THE EURO</th>
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<tr>
<td>OBJECTIVES</td>
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</table>
| 1. Inflation | Autonomous monetary policy | Restriction upon monetary policy (defence of exchange rate) | • Mainly the objective of the European Central Bank  
• Interdiction of the refinancing of national public debts |
|             | Eventually income policy |                           |               |
| 2. Full employment | Mainly Budgetary policy | Restriction upon budgetary policy (lower public deficit) | • Budgetary policy restricted by the Stability and Growth Pact  
• Structural reforms (competition, labour market) |
|             | Sometimes Social Pacts |                           |               |
| 3. External equilibrium | Adjustment by political decisions upon the exchange rate | Exchange rates become financial market variables, tentatively controlled by the Central Bank | • No more formal external constraint for Member States  
• The Euro/$/Yen exchange rates as pure market variables |
| 4. Growth | Innovation and industrial policy | Primacy of macroeconomic approach | • Enforcement of competition, as alternative of industrial policy  
• Complemented by the Lisbon Agenda |

Last but not least, there a third loss concerning the autonomy of national policy: on top of the monetary policy and exchange rate, the European Treaty forbids the monetisation of public debt, which was a device quite central during the Golden Age. Consequently, only the private credit channel is open at the ECB, contrary to the status of other central banks, such as the FED, Bank of England, or Japan. In a sense, Euro-zone member-States emit debts in a currency they can no more create at the national level. Here is a parallel with emerging countries that have to float their public debt in dollars or other international currency; consequently some Latin-American economists compare the Argentina crisis from 1997-2001 to the evolution of Greece since 2009…There are significant differences in the two crisis. Among them, European authorities have perceived the danger of contagion to larger economies: in violation with the letter of treaties, the ECB has transitorily accepted buy directly Italian and Spanish Treasury bonds.