Chap 6: Amplification mechanisms during the crisis

Key issue: The banks' balance sheet has been a key channel of contagion and amplification during the crisis. The nexus between banks and sovereigns is coined the doom-loop.

- Lane, P. "The Irish Crisis," CEPR DP N. 8287, 2011 (Sections 1 to 3).
- Reinhard and Rogoff, “This Time is Different.” Eight Centuries of Financial Folly, Chapter 14.
- De Grauwe, P., "Why the ECB refuses to be a Lender of Last Resort", 28 November 2011, VoxEu.
The Irish Crisis*

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Abstract
This paper has three goals. First, it seeks to explain the origins of the Irish crisis. Second, it provides an interim assessment of the Irish government’s management of the crisis. Third, it evaluates the lessons from Ireland for the macroeconomics of monetary unions.

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1 Introduction

Ireland is in the midst of a severe crisis. While the global financial crisis has affected all economies to varying degrees, it has been especially severe in Ireland with a cumulative nominal GDP decline of 21 percent from Q4 2007 to Q3 2010. This ranks Ireland among the worst-affected countries in terms of output performance during this period (Lane and Milesi-Ferretti 2010).

Allied to this economic shock, Ireland has also experienced a severe fiscal deterioration. After a long period of running surpluses, the fiscal balance shifted from positive territory in 2007 to baseline deficits of 11-12 percent of GDP in 2009 and 2010. Much of this fiscal deficit is structural in nature, such that the resumption of economic growth on its own is not sufficient to restore fiscal sustainability. In addition, the one-off cost of recapitalising the banking system pushed the overall general government deficit to 14.5 percent of GDP in 2009 and 32 percent of GDP in 2010, leading to rapid growth in the overall level of public debt.

The main factor behind these developments has been the devastating boom-bust cycle in the Irish property market. Since the property boom was financed through aggressive lending by the Irish banking system, the decline in property prices and the collapse in construction activity has resulted in severe losses in the Irish banking system. In turn, this has contributed to the economic crisis through a credit squeeze
and the fiscal crisis, both directly through the costs of recapitalising the banking system and indirectly through the loss of asset-driven revenues.

The scale of these problems meant that the sovereign spread on Irish debt rose sharply in 2010, with doubts concerning whether the government could achieve the triple play of restoring economic growth, fiscal sustainability and a healthy banking system. In the end, this resulted in a shift to official sources of funding in November 2010, with a three-year deal agreed with the IMF and the European Union.

The primary goal of this paper is to describe what went wrong in Ireland, which is covered in Section 2. In addition, I review the Irish government’s management of the crisis since 2007 in Section 3. Next, I reflect on the role of Ireland’s membership of EMU during this episode in Section 4. Section 5 concludes.

2 The boom and bust in Ireland

It is important to appreciate that there was a genuine Irish economic miracle, with very rapid output, employment and productivity growth during the 1994-2000 period. This period can be interpreted as an accelerated convergence phase, with Ireland catching up with the European frontier after a long period of underperformance (Honohan and Walsh 2002). In particular, major policy mistakes in the late 1970s had led to an unstable macroeconomic situation that resulted in a sustained phase of economic stagnation.

This period of stagnation came to an end with a sharp fiscal correction which was launched in 1987 with the agreement of the main political parties and accompanied by
a new social partnership approach that provided a strong social consensus behind a cooperative approach to rebuilding the economy on a pro-business platform (see also Lane 2000). While the economy performed well in the late 1980s (supported by the boom in major export markets such as the UK and the US), this was temporarily halted by the 1992-1993 European recession and currency crisis. Accordingly, the sustained period of uninterrupted economic growth really only began in 1994.

The remarkable economic performance during the 1990s was underpinned by multiple factors. The 1987 fiscal adjustment had delivered a stable fiscal situation, while the stagnation during the mid-1980s had eliminated the high inflation that had plagued Ireland in the late 1970s and early 1980s. Participation rates in second-level and third-level education had sharply increased throughout the 1970s and 1980s, such that new entrants into the labour force had far higher human capital levels than those leaving the labour force through retirement.

These positive domestic trends were accompanied by a favourable shift in the nature of world production and world trade. In particular, the rise of the ‘weightless’ economy, in which ‘high-value, low-weight’ sectors such as computers and pharmaceuticals were increasingly important, meant that Ireland’s peripheral geographic status became less of a barrier to export-oriented production. The result was a boom in inward foreign direct investment, primarily from American multinational firms. In part, these firms selected Ireland as a platform for exporting to the newly-unified European single market. However, a substantial proportion of the exports were also directed towards other regions, including exports back to the US home market.
With FDI providing an engine for productivity growth, domestic components of domestic demand also picked up, such that the economic expansion was very broad in its nature. Employment grew quickly with little pressure on wage rates, since there was an overhang of high unemployment, a very low initial level of female participation in the labour force and a large stock of Irish workers overseas that were ready to return home.

While house prices began to grow strongly from around 1994, much of the initial growth in house prices could be justified by low initial property values (in the wake of the 1992/1993 currency crisis) and the rapid growth in income levels. Moreover, credit expansion during the 1990s was also relatively restrained (Kelly 2010).

The rapid pace of economic growth was reinforced during 1999-2000 by the sharp devaluation of the euro against the dollar, which boosted Irish exports. In addition, interest rates fell in Ireland once entry into EMU was confirmed in 1997. While Ireland undertook a revaluation in spring 1998 prior to the formation of EMU, this was very small in scale. Moreover, Ireland had attained full employment by this stage and strong upward pressure on wage rates became evident.

There was also substantial fiscal expansion during 2000-2001, with a rapid increase in public spending and substantial cuts in taxation. While the ratio of public spending to GDP declined considerably during the rapid growth of the late 1980s, the timing of the fiscal expansion was procyclical. Accordingly, the initial years of EMU saw rapid growth but also a big surge in inflation, with Ireland appreciating against its fellow
The international recession in 2001 marked a turning point for the Irish economy. The expectation at the time was that Ireland would return to a more ‘normal’ European growth path, since the spare capacity in the labour force had been eliminated and the real appreciation meant that the marginal gains to foreign investors were diminishing (at least in labour-intensive sectors such as assembly or call centres).

This projection was wrong. Rapid economic growth resumed in 2003 and was maintained through 2007. However, the flavour of this boom was very different to the ‘Celtic Tiger’ years. In particular, it was dominated by a surge in construction activity, with the economy driven by a boom in investment in housing and commercial property. In turn, the positive wealth effect from rising property prices fed into strong growth in private consumption. With tax revenues from asset-related sources very strong, the government was also able to fund a strong pace of public expenditure growth, while maintaining a budget surplus and enjoying a rapid decline in the debt/GDP ratio.

The result was strong growth in employment but with little productivity growth. While FDI still grew, it was increasingly targeted at higher-value activities that required relatively little by way of unskilled labour, even if this sector was an important source of demand for higher-skilled workers.
The expansion in property investment was fuelled by rapid credit expansion, with the ratio of private credit to GDP sharply increasing during 2003-2007 (see also Kelly 2010). Figure 1 shows the acceleration in credit expansion during this period.

This expansion encompassed an increase in credit provision to the household sector but also to a small group of property developers. These property magnates acquired large and complex portfolios that included the building of new housing estates, retail outlets and office buildings. There was also intense competition to redevelop prime sites in Dublin, looking to replace existing structures with higher-density complexes. At the peak of the boom, such sites were acquired at astronomical values.
In addition to these domestic activities, many of these developers were also aggressive in international acquisitions, in the London prime real estate sector, the United States and emerging Europe. (Irish households were also highly active in foreign property purchases, both holiday homes and buy-to-let properties.)

Much of the credit growth was provided by local banks. In turn, these banks relied increasingly on international wholesale markets for funding, with a mix of short-term interbank funds and international bond issues. However, there was also significant expansion by the local affiliates of UK-headquartered funds. The increased competition in the market contributed to very low loan spreads and a loosening of loan documentation standards. Figure 2 illustrates the extraordinary expansion in the

Figure 2. Net Foreign Liabilities of Irish Banking System

Note: Net foreign liabilities of domestic banking sector, expressed as a ratio to GDP. Source: Author’s calculations, based on data from Central Bank of Ireland.
net foreign liabilities of the core Irish banks during this period.

Figure 3 Current Account Balance

![Chart showing current account balance from 1998 to 2010.](chart)

Note: Ratio of current account to GDP. Source: Author’s calculations based on data from Ireland’s Central Statistics Office.

Some standard feedback mechanisms amplified the boom. The collateral cycle played an important role with rising property prices improving the net worth of domestic investors, which in turn enabled extra leverage and a further impetus to the property market. In related fashion, the high profitability of the domestic banking system enabled an expansion in the balance sheets of these institutions, with a major increase in net external liabilities. The overall current account balance shifted from near zero in 2003 to a deficit close to 6 percent of GDP in 2007, as is shown in Figure 3.

The boost to tax revenues from asset-related sources enabled the government to add to domestic demand, including via a heavy programme of public investment. A new
twist was the role played by inward migration from the new member states from 2004 onwards. Inward migration helped to limit labour cost pressures in the construction sector, while the boost to population growth also added to investor confidence that the underlying demand for housing would continue to grow.

Finally, the demand-led nature of the boom also contributed to a high rate of domestic inflation. Since this meant that the short-term real interest rate was low, it boosted borrowing and investment demand. In addition, it also boosted tax revenues due to the non-indexation of the tax system.

There were clear signs that the property sector had passed its peak by autumn 2006. However, the hope was that there would be a soft landing by which the decline in property prices and construction-related activity would be gradual in nature and could be offset by expansion in other areas. Indeed, economic activity continued to be strong during 2007 such that the risk of a sharp crash did not seem immediate, even if the historical cross-country evidence signalled that the likelihood of a large decline in house prices was substantial (Kelly 2007).

As it turned out, the final trigger for the economic collapse was the shift in international financial markets during 2007 and 2008. By early 2008, the Irish banks found it more difficult to maintain funding in the international wholesale markets and, at the same time, there was a more rapid pull back by domestic investors from the property market. This period of stress culminated in a full-scale crisis in September 2008, with commercial funding for the Irish banks drying up in the wake of the disruption of international credit markets after the collapse of Lehman Brothers. Since
then, Ireland has grappled with a triple crisis, with a severe decline in economic activity, massive losses in the banking system and rapid deterioration in the fiscal position. We turn to the management of the crisis in the next section.

3 Crisis management

The economic crisis

In relation to the real economy, the recession in Ireland in 2008-2009 was driven by a dramatic decline in construction investment, with the sudden reversal in Ireland’s fortunes also inducing a pull back in domestic consumption. In contrast to many other advanced economies, the export sector was a stabilising factor, with the decline in output concentrated in the domestically-oriented sectors of the economy. In a mirror image to the boom period, negative feedback mechanisms kicked in. Banks pulled in lending, which in turn amplified the downturn in the property sector. The increase in bad loans further curtailed the supply of credit by Irish banks.

The decline in domestic demand also put downward pressure on the price level, with deflation contributing to the decline in tax revenues and an increase in the real burden of debt. Deflation was also partly driven by the sharp depreciation of sterling against the euro, in view of the importance of imports from the UK in Irish consumption, which constituted a terms of trade gain for Ireland. Between September 2008 and November 2010, the cumulative decline in the CPI was 6.2 percent. Figure 4 charts the dynamics of real GDP and nominal GDP over 1998.4 to 2010.3, expressed relative to aggregate EMU-16 performance. The data clearly show illustrates the greater amplitude of nominal GDP relative to real GDP, with strong relative output growth in the first decade of EMU accompanied by above-average relative inflation and the
subsequent relative decline in output matched by a strong relative decline in inflation.

Figure 1. Real GDP and Nominal GDP, 1998.4 to 2010.3.

Note: Real GDP and Nominal GDP each expressed relative to aggregate EMU16 values, normalised to 100 in 1998.4. Source: Author’s calculations based on data from Ireland’s Central Statistics Office and European Central Bank.

The recession has led to a sharp increase in unemployment, which climbed from 4.6 percent in 2007 to 13.3 percent in 2010. In addition, participation rates dropped and net emigration resumed, so that the total fall in employment was about 12 percent. With the decline in domestic demand, the current account has sharply improved, from 5.6 percent of GDP in 2008 to 2.4 percent of GDP in 2010.

The fiscal crisis

The downturn in domestic spending and the decline in transactions in the property market meant that tax revenues fell very quickly, to the extent that the government had to introduce a series of measures to obtain other sources of tax revenue and limit public expenditure growth.
This included the introduction of graduated income levies, which had the effect of sharply increasing the marginal income tax rate for middle and high earners. For public sector workers, pay levels were de facto reduced by the introduction of a public sector pension levy, while a recruitment freeze was also implemented. Further measures were taken in the 2010 budget (announced in December 2009), including further sizeable reductions in public sector pay levels, a reduction in social benefit levels and a contraction in spending commitments.

These measures limited the scale of the decline in the fiscal situation. Even so, the underlying weak state of the economy and the collapse of the tax base meant that the baseline fiscal deficits in 2009 and 2010 were still extraordinarily large at 11-12 percent of GDP, even before taking into account the one-off costs of recapitalising the banking system.

A sizeable proportion of the deficit is structural in nature. A key problem is that elevated revenues from asset-related sources during the boom were in part deployed to reduce more stable types of tax revenue (see also Lane 2007). In particular, the direct tax burden on low and middle earners was significantly reduced during this period. In addition, the Irish tax base is quite narrow, with no significant role for sources such as annual property taxes or local-level taxes. Accordingly, a major challenge is to expand the tax base.

On the spending side, public pay levels and social benefit payments had been increased quite sharply during the good years. The initial phase of fiscal adjustment
has already rolled back some of these gains. However, a 2010 agreement with public sector unions means that nominal levels of public sector pay will not be further reduced (barring exceptional circumstances), with savings to be obtained from a combination of a recruitment freeze and productivity reforms in the delivery of public services. A saving grace is that the decline in the construction sector means that the cost of public investment projects has greatly declined, allowing cuts in nominal investment spending far in excess of the decline in real spending.

The fiscal tightening measures are certainly a procyclical force that has contributed to the scale of the recession. It would have been better to have run larger surpluses during the good years and even accumulated a liquid rainy-day fund that might have been deployed as a buffer against the impact of the severe negative economic shock (Lane 1997, Lane 1998a, Lane 2010).

Taken together, the cumulative size of the discretionary fiscal tightening over 2008-2010 amounts to €14.6 billion, which is 9.3 percent of 2010 GDP. In November 2010, the government announced a four-year fiscal plan for 2011-2014 which would involve a further €15 billion in discretionary fiscal tightening. In turn, this four-year plan forms the basis for the fiscal component of the EU/IMF deal, which is further discussed below. Under current IMF forecasts, this fiscal austerity package is projected to stabilise the debt/GDP ratio by 2014 at 124 percent of GDP.

The banking crisis

In addition to the baseline fiscal problem, the sovereign balance sheet in Ireland has been further strained by the government’s role in resolving the crisis in the banking
sector. At the end of September 2008, the most immediate concern was to stabilise the banking system. At the time, the belief was that the main problem was the loss of market liquidity. Accordingly, the Irish government sought to improve the funding situation by guaranteeing the vast bulk of its liabilities for a two-year period (deposits, senior debt and dated subordinated debt). This was followed later in 2008 by the provision of extra capital for the banking system, as it became clear that losses on property-related loans would be greater than previously calculated. (However, these initial capital injections would prove small relative to subsequent estimates of the underlying scale of potential losses.) In April 2009, the Irish government also established the National Asset Management Agency (NAMA), with the mandate to purchase the universe of development-related loans (above a certain value) from the banks.

This triple-track strategy had an internal coherence, even if the execution of the strategy turned out to be quite problematic in several respects.\(^2\) One basic problem was that the initial guarantee of liabilities was too broad (Honohan 2010a). By guaranteeing existing senior bonds and some types of subordinated debt, the capacity to allocate some part of the ultimate loan losses to bondholders was compromised, raising the taxpayer cost of resolving the banking crisis.

In relation to asset transfers, the aim was to cleanse bank balance sheets by transferring development-related loans to NAMA, since this category was the main source of uncertainty concerning total loan losses. During 2009-2010, NAMA purchased most of these loans at a steep average discount, such that the transfer also forced the banks to crystallise the losses on these loans. Under the guidance of EU
rules, the discount has been applied on a loan-by-loan basis. Accordingly, there were substantial transaction costs involved, since each individual loan had to be individually assessed. Moreover, the cumbersome nature of this approach meant that the transfer of loans took place slowly, which inhibited the goal of a rapid cleansing of bank balance sheets. (Under the EU/IMF deal, the remaining transfers to NAMA do not require loan-by-loan appraisal.)

While the asset transfer approach had the virtue of transparency, it also meant that the banks required substantial upfront recapitalisation programmes. Only one bank (Bank of Ireland) was able to raise significant new private capital, such that the State has ended up with extensive control of the Irish banking system. In turn, the high recapitalisation costs led to a sharp increase in gross government debt and increased the riskiness of the sovereign debt profile, in view of the ongoing uncertainties regarding ultimate losses in the banking sector.

While all banks have suffered considerable losses, the most extreme losses (relative to the size of loan books) were incurred by two marginal banks that have been revealed to have had very weak corporate governance. The biggest offender has been Anglo-Irish Bank, which was nationalised in early 2009. While it had little presence in the retail deposit market, this bank had grown very rapidly through aggressive property-related lending which was largely funded on wholesale markets. The losses at this bank have been by far the largest contributor to the overall losses in the Irish banking system. In addition, a smaller mutual bank (Irish Nationwide Building Society or INBS) has also incurred catastrophic property-related losses. However, the losses at the two main commercial banks (Bank of Ireland and AIB) and the tail-risk exposures
of these banks to further deterioration in the economy has meant that the entire banking system has been compromised.

While the public capital injections into Bank of Ireland and AIB may be viewed as financial investments that may ultimately yield a return, the capital poured into Anglo-Irish Bank and INBS is effectively a write-off. The capital transfers to Anglo-Irish Bank and INBS pushed the overall 2009 general government balance to 14.5 percent of GDP and the 2010 balance to 32 percent of GDP.

The EU/IMF deal

The Irish government ultimately requested assistance from the EU and IMF in November 2010. There were several triggers for this decision. In relation to the banking system, the expiry of the State guarantee in September 2010 led to an exit of private-sector funders that had committed funding under the guarantee. In turn, this resulted in a marked increase in the reliance of the Irish banks on liquidity support from the ECB and the extraordinary liquidity assistance facility of the Irish central bank. Apparently, the view from the ECB was that this liquidity support could only be maintained if the process of downsizing the Irish banking system were accelerated and the capital ratios of the Irish banks further improved as a buffer against tail-risk losses.

In addition, the projected level of property-related losses had increased over summer 2010, with the discounts on the second tranche of loan transfers to NAMA greater than expected. In addition, the new management team at Anglo-Irish Bank decided to make extra provisions on non-NAMA loans, requiring further capital injections into
These extra capital requirements contributed to increased market concerns about the sustainability of the fiscal position. More generally, the surprise nature of the extra provisions underlined the extent of the uncertainty surrounding estimates of total loan losses in the Irish banking system and this tail risk pushed up the spread on Irish sovereign debt (Figure 5).

Furthermore, a downward revision to the 2009 GDP data was announced in June 2010 and the publication of lower growth forecasts in the IMF Article IV report in July 2010 led to a re-assessment of the scale of the adjustment that would be needed to achieve a sustainable fiscal position. In part, these lower GDP forecasts related to a more pessimistic view of the impact of the financial crisis on the medium-term trend
growth rate for the economy. However, an additional factor was a greater recognition that the adjustment process would involve a sustained real depreciation, in which the growth in the GDP deflator would be negative in the short-term and only increase slowly over the medium term, such that the five-year projection for nominal GDP was much lower than previously estimated.

The total financial package under the EU-IMF deal is valued at €85 billion, which is about 54 percent of 2010 GDP for Ireland. However, €17.5 billion of the total is domestically sourced, from the assets held by Ireland’s sovereign wealth fund (the National Pension Reserve Fund) and the cash balances held by the agency responsible for managing the national debt (the National Treasury Management Agency). The external component of €67.5 billion is evenly split with €22.5 billion from the European Commission’s European Financial Stability Mechanism (EFSM); €22.5 billion from the International Monetary Fund (IMF); and €22.5 billion from the European Financial Stability Fund (EFSF) and bilateral loans (from the UK, Sweden and Denmark).

In terms of composition, the intention is that €50 billion can provide funding to the Irish State, such that Ireland need not primarily rely on the bond markets to fund its fiscal deficit or roll over existing debt over the next three years. (Although the programme does require Ireland to have partial access to market funding from 2012 onwards.) In relation to the banking system, €10 billion is to be drawn down to provide extra capital to the Irish banking system (€8 billion) and fund credit enhancements that are intended to allow the Irish banks to sell packages of risky loans to private investors (€2 billion). The final €25 billion is contingent funding that can be
drawn down if it turns out that the Irish banking system requires yet further capital in the coming years.

The agreed programme involves discretionary fiscal tightening of €15 billion over 2011-2014, with €6 billion of this total to take place in 2011. Under an optimistic growth scenario, this might deliver a budget deficit to GDP ratio in 2014 that is just under the 3 percent limit. However, the programme recognises that a lower growth path would not see the 3 percent target achieved by 2014. Under that scenario, the programme envisages that further tightening will be required in 2015, in order to achieve the 3 percent target.

The combined interest rate across the different funding lines is of the order of 5.8 percent per annum for a 7.5 year loan. While this is in line with standard IMF funding conditions, it is arguable that the European component of the funds could have been priced at a lower rate. While it is certainly important that such official funding contains a premium to discourage moral hazard, the 300 basis point premium built into this funding rate makes it more difficult to achieve fiscal sustainability. This limits the degree of solidarity across EU partners, while also increasing the risk facing other European governments in view of the potential contagion from doubts about the sustainability of the Irish sovereign position.

Although the context is quite different, it is striking that the December 2010 agreement between Iceland and the UK and Dutch governments on the Icesave debt specifies an interest rate of 3.2 percent over a long repayment period, with the interest rate calculated to approximate the cost of funds for the creditor governments.
Similarly, the balance of payments support provided by the European Commission to EU member countries outside the euro area (Hungary, Latvia) does not carry a similar penalty premium.

In terms of structural reforms, the main objective under the deal is to de-risk the banking system (see also Honohan 2010c, Honohan 2011). This involves several elements. First, the extra capital injections are intended to increase in core Tier 1 capital ratios to 12 percent. Second, the level of risky loans held by the banks are to be reduced through the transfer of extra property loan tranches to NAMA and the sale of loan packages to private investors. (As indicated above, the sale of loan packages to private investors will be supported by €2 billion in credit enhancements to limit the risk exposure that would otherwise deter private investors.) Third, the banks will be further downsized through the disposal of affiliates and other non-core assets. Fourth, the winding down of the main disaster banks (Anglo-Irish Bank and Irish Nationwide Building Society) will be accelerated. Fifth, the €25 billion in contingent funding provides an additional buffer in the event of extra loan losses.

Finally, these financial measures will be accompanied by a more extensive third-party assessment of the quality of the loan books. While the Irish central bank published a prudential capital assessment review (PCAR) in March 2010 that set out conservative provisions for loan losses (this was updated in September 2010), the level of uncertainty about loan quality means that further information disclosure is necessary in order to improve market understanding of the likely distribution of loan losses. Furthermore, the role of third-party assessors in examination of the loan books is seen as important in guaranteeing the rigour of the 2011 PCAR exercise. If it turns out that
the review signals that extra bank capital is advisable, this is allowed for under the terms of the EU/IMF funding.

Taken together, the goal is that these banking sector reforms will result in a smaller, less-risky and better-capitalised banking system. In turn, these changes improve the sustainability of the ECB liquidity provisions and also increase the likelihood that the Irish banks can return to the private wholesale funding markets.

An important issue in the negotiation of the deal was the appropriate scale of burden sharing by bank bondholders in the recapitalisation of the Irish banking system. If the holders of bonds issued by the Irish banks absorbed some of the losses, the fiscal burden would be lightened. It seems that there were about €32 billion of non-guaranteed bank bonds outstanding at the time of the EU-IMF deal, consisting of €12 billion of subordinated debt and €20 billion of senior debt. These are bonds that were issued before the introduction of the September 2008 guarantee (which has now expired) but have not yet reached their maturity dates. In addition, about €25 billion of guaranteed senior bonds have been issued under the 2009 Eligible Liabilities Guarantee scheme for new debt issuance.\(^3\) (A small amount of new non-guaranteed bonds has also been issued.)

The EU-IMF deal envisages that holders of subordinated debt will not be repaid in full. There is currently a bond exchange programme for the Anglo-Irish subordinated debt which offers the bond holders 20 cents on the euro. Over the last two years, there have been other voluntary exchange programmes for subordinated debt holders in several banks, with an estimated €7 billion obtained in discounts. (It is arguable that
these earlier exchange programmes were premature in that the appropriate level of
discount could not be properly determined before the full systemic evaluation of
prospective loan losses had taken place.)

However, it also seems that there was serious discussion of writing down the value of
some non-guaranteed senior bonds as part of the IMF/EU negotiations. While the
legal tradition in Ireland has been to view senior bonds as pari passu with depositors,
it seems that there may be legal options to break that link. For instance, in situations
in which the scale of State capital injections exceeds the pre-crisis level of capital, it
may be possible to argue that senior bondholders should have no legitimate
expectation of full repayment.

However, no agreement was reached for restructuring the non-guaranteed senior
bonds. Media reports indicate that European policymakers took the view that the
restructuring of senior debt would create a new precedent in European banking that
could severely disrupt bank funding markets. However, the counter-argument is that a
set of objective criteria could be developed that would clearly delimit the scenarios
under which some types of senior debt should be written down, thereby limiting the
scope for contagion.

Indeed, the working document of European Commission (2011) identifies a range of
possible criteria, even if the scope of the European Commission report is restricted to
the design of future bank bond contracts, rather than to altering the payoffs on
existing bank debt. Moreover, to the extent that the restructuring of senior bank
bonds improves the sovereign fiscal position, it might even be a calming influence on
sovereign debt markets. The ultimate treatment of the non-guaranteed senior bank bonds remains an unresolved issue and is set to feature in the political debate surrounding the upcoming general election in Ireland.

In terms of other structural reforms, the main priority is to improve the operation of the labour market in order to facilitate a reversal in the sharp increase in unemployment (much of it now long-term) since the onset of the crisis. The minimum wage (set at the peak of the boom) has been reduced by 12 percent, while there has been a further 4 percent decline in unemployment benefits. In addition, more vigorous labour market activation policies are envisaged under the plan and other types of rigidities in the wage setting system will be targeted. In relation to product markets, there are aspirations to reduce monopoly rents in sheltered sectors (such as the legal and medical professions) and boost productivity in the public sector.

However, the growth payoff from such reforms may occur with a long lag and cannot be relied on to improve growth substantially within the period of the deal. Similarly, public sector reform has the potential to boost efficiency considerably, but the overall growth payoff will only occur over a long period. Accordingly, it is not realistic to expect a sizeable direct short-term growth payoff.

Overall, the EU/IMF deal provides an environment in which Ireland can make progress in resolving its crisis. However, there are considerable implementation challenges in delivering the planned fiscal adjustment (see also Beetsma et al 2009). In addition, the cost of restructuring the banking system remains uncertain and depends on the ability to sell bank assets at prices above fire sale values.
Both the debt dynamics and the health of the banking sector are dependent on the rate of nominal GDP growth in the coming years. In this regard, there is considerable uncertainty about the path for GDP. The Irish finance ministry and the main local economic forecaster (the ESRI) are relatively optimistic about the speed of output growth, pointing to the capacity for a small open economy to rely on export-driven growth and the high current levels of precautionary savings that should decline once uncertainty declines and consumer confidence recovers. Against that view, the cross-country historical evidence is that output growth is typically very slow after major banking crises, even if these historical examples do not precisely match the current Irish conditions (Reinhart and Reinhart 2010).

Having reviewed the course of events in Ireland, we now turn to asking some general questions about the lessons to be drawn from the Irish experience in relation to the impact of EMU on member countries.

4 Ireland and EMU

At a surface level, it is possible to argue that membership of EMU has directly contributed to the boom-bust cycle in Ireland. First, Ireland entered EMU at the peak of the Celtic Tiger output boom, with full employment only recently achieved and the emergence of shortages in the labour market. Accordingly, the initial conditions for Ireland were quite different than for the aggregate euro area economy.

A standard prescription in this case is to revalue the exchange rate prior to entering the monetary union, such that price level pressures in the economy are diverted into
THE AFTERMATH OF FINANCIAL CRISSES

In the preceding chapter we presented a historical analysis comparing the run-up to the 2007 U.S. subprime financial crisis with the antecedents of other banking crises in advanced economies since World War II. We showed that standard indicators for the United States, such as asset price inflation, rising leverage, large sustained current account deficits, and a slowing trajectory of economic growth, exhibited virtually all the signs of a country on the verge of a financial crisis—indeed, a severe one. In this chapter we engage in a similar comparative historical analysis focused on the aftermath of systemic banking crises. Obviously, as events unfold, the aftermath of the U.S. financial crisis may prove better or worse than the benchmarks laid out here. Nevertheless, the approach is valuable in itself, because in analyzing extreme shocks such as those affecting the U.S. economy and the world economy at the time of this writing, standard macroeconomic models calibrated to statistically “normal” growth periods may be of little use.

In the previous chapter we deliberately excluded emerging market countries from the comparison set in order not to appear to engage in hyperbole. After all, the United States is a highly sophisticated global financial center. What can advanced economies possibly have in common with emerging markets when it comes to banking crises? In fact, as we showed in chapter 10, the antecedents and aftermath of banking crises in rich countries and in emerging markets have a surprising amount in common. They share broadly similar patterns in housing and equity prices, unemployment, government revenues, and debt. Furthermore, the frequency or incidence of crises does not differ much historically, even if comparisons are limited to the post–World War II period (provided that the ongoing global financial crisis of the late 2000s is taken into account). Thus, in this
chapter, as we turn to characterizing the aftermath of severe financial
crises, we include a number of recent emerging market cases so as to
expand the relevant set of comparators.¹

Broadly speaking, financial crises are protracted affairs. More
often than not, the aftermath of severe financial crises share three
characteristics:

• First, asset market collapses are deep and prolonged. Declines in
  real housing prices average 35 percent stretched out over six years,
  whereas equity price collapses average 56 percent over a downturn
  of about three and a half years.

• Second, the aftermath of banking crises is associated with profound
  declines in output and employment. The unemployment rate rises
  an average of 7 percentage points during the down phase of the
  cycle, which lasts on average more than four years. Output falls
  (from peak to trough) more than 9 percent on average, although
  the duration of the downturn, averaging roughly two years, is con-
  siderably shorter than that of unemployment.²

• Third, as noted earlier, the value of government debt tends to ex-
  plode; it rose an average of 86 percent (in real terms, relative to
  precrisis debt) in the major post–World War II episodes. As dis-
  cussed in chapter 10 (and as we reiterate here), the main cause
  of debt explosions is not the widely cited costs of bailing out and
  recapitalizing the banking system. Admittedly, bailout costs are dif-
  ficult to measure, and the divergence among estimates from com-
  peting studies is considerable. But even upper-bound estimates pale
  next to actual measured increases in public debt. In fact, the biggest
  driver of debt increases is the inevitable collapse in tax revenues
  that governments suffer in the wake of deep and prolonged output
  contractions. Many countries also suffer from a spike in the inter-
  est burden on debt, for interest rates soar, and in a few cases (most
  notably that of Japan in the 1990s), countercyclical fiscal policy ef-
  forts contribute to the debt buildup. (We note that calibrating dif-
  ferences in countercyclical fiscal policy across countries can be
difficult because some countries, such as the Nordic countries, have
powerful built-in fiscal stabilizers through high marginal tax rates and generous unemployment benefits, whereas other countries, such as the United States and Japan, have automatic stabilizers that are far weaker.

In the last part of the chapter, we will look at quantitative benchmarks from the period of the Great Depression, the last deep global financial crisis prior to the recent one. The depth and duration of the decline in economic activity were breathtaking, even by comparison with severe postwar crises. Countries took an average of ten years to reach the same level of per capita output as they enjoyed in 1929. In the first three years of the Depression, unemployment rose an average of 16.9 percentage points across the fifteen major countries in our comparison set.

Historical Episodes Revisited

The preceding chapter included all the major postwar banking crises in the developed world (a total of eighteen) and put particular emphasis on the ones dubbed the “Big Five” (those in Spain, 1977; Norway, 1987; Finland, 1991; Sweden, 1991; and Japan, 1992). It is quite clear from that chapter, as well as from the subsequent evolution of the 2007 U.S. financial crisis, that the crisis of the late 2000s must be considered a severe Big Five-type crisis by any metric. As a result, in this chapter we will focus on severe systemic financial crises only, including the Big Five crises in developed economies plus a number of famous episodes in emerging markets: the 1997-1998 Asian crises (in Hong Kong, Indonesia, Korea, Malaysia, the Philippines, and Thailand); that in Colombia in 1998; and Argentina’s 2001 collapse. These are cases for which we have all or most of the relevant data to allow for meaningful quantitative comparisons across key indicator variables, such as equity markets, housing markets, unemployment, growth, and so on. Central to the analysis are historical housing price data, which can be difficult to obtain and are critical for assessing the
V. THE U.S. SUBPRIME MELTDOWN

recent episode. We also include two earlier historical cases for which we have housing prices: those of Norway in 1899 and the United States in 1929.

The Downturn after a Crisis: Depth and Duration

In figure 14.1, based on the same data as table 10.8, we again look at the bust phase of housing price cycles surrounding banking crises in the expanded data set. We include a number of countries that experienced crises from 2007 on. The latest crises are represented by bars in dark shading, past crises by bars in light shading. The cumulative decline in real housing prices from peak to trough averages 35.5 percent. The most severe real housing price declines were experienced by Finland, Colombia, the Philippines, and Hong Kong. Their crashes amounted to 50 to 60 percent, measured from peak to trough. The housing price decline experienced by the United States during the latest episode at the time of this writing (almost 28 percent in real terms through late 2008 according to the Case-Shiller index) is already more than twice that registered in the United States during the Great Depression.

Notably, the duration of housing price declines has been quite long lived, averaging roughly six years. Even excluding the extraordinary experience of Japan (with its seventeen consecutive years of real housing price declines), the average remains more than five years. As figure 14.2 illustrates, the equity price declines that accompany banking crises are far steeper than are housing price declines, albeit shorter lived. The shorter duration of a downturn compared with real estate prices is perhaps unsurprising given that equity prices are far less inertial. The average historical decline in equity prices has been 55.9 percent, with the downturn phase of the cycle lasting 3.4 years. As of the end of 2008, Iceland and Austria had already experienced peak-to-trough equity price declines far exceeding the average of the historical comparison group.
In figure 14.3 we look at increases in unemployment rates across the historical comparison group. (Because the unemployment rate is classified as a lagging indicator, we do not include the most recent crisis, although we note that the U.S. unemployment rate has already risen by 5 percentage points from its bottom value of near 4 percent.) On average, unemployment rises for almost five years, with an increase in the unemployment rate of about 7 percentage points. Although none of the postwar episodes has rivaled the rise in un-
employment of more than 20 percentage points experienced by the United States during the Great Depression, the employment consequences of financial crises are nevertheless strikingly large in many cases. For emerging markets the official statistics likely underestimate true unemployment.

Interestingly, figure 14.3 reveals that when it comes to banking crises, the emerging markets, particularly those in Asia, seem to do better in terms of unemployment than the advanced economies. (An exception was seen in the deep recession experienced by Colombia in 1998.) Although there are well-known data issues involved in
comparing unemployment rates across countries, the relatively poor performance in advanced countries suggests the possibility that greater (downward) wage flexibility in emerging markets may help cushion employment during periods of severe economic distress. The gaps in the social safety net in emerging market economies, compared to industrial ones, presumably also make workers more anxious to avoid becoming unemployed.

In figure 14.4 we look at the cycles in real per capita GDP around severe banking crises. The average magnitude of declines, at 9.3 percent, is stunning. Admittedly, as we noted earlier, for the post–World War II period, the declines in real GDP have been smaller for advanced economies than for emerging market economies. A probable explanation for the more severe contractions in emerging market economies is that they are prone to abrupt reversals in the availability of foreign credit. When foreign capital comes to a
“sudden stop,” to use the phrase popularized by Rudiger Dornbusch and Guillermo Calvo, economic activity heads into a tailspin.6

Compared to unemployment, the cycle from peak to trough in GDP is much shorter, only two years. Presumably this is partly because potential GDP growth is positive and we are measuring only absolute changes in income, not gaps relative to potential output. Even so, the recessions surrounding financial crises are unusually long compared to normal recessions, which typically last less than a year.7 Indeed, multiyear recessions usually occur only in economies that require deep restructuring, such as that of Britain in the 1970s (prior to the advent of Prime Minister Margaret Thatcher), Switzerland in the 1990s, and Japan after 1992 (the last due not only to its financial collapse but also to the need to reorient its economy in light of China’s rise). Banking crises, of course, usually require painful restructuring of the financial system and so are an important example of this general principle.
The Fiscal Legacy of Crises

Declining revenues and higher expenditures, owing to a combination of bailout costs and higher transfer payments and debt servicing costs, lead to a rapid and marked worsening in the fiscal balance. The episodes of Finland and Sweden stand out in this regard; the latter went from a precrisis surplus of nearly 4 percent of GDP to a whopping 15 percent deficit-to-GDP ratio. See table 14.1.

Figure 14.5 shows the increase in real government debt in the three years following a banking crisis. The deterioration in government finances is striking, with an average debt increase of more than 86 percent. The calculation here is based on relatively recent data from the past few decades, but recall that in chapter 10 of this book we take advantage of our newly unearthed historical data on domestic debt to show that a buildup in government debt has been a defining characteristic of the aftermath of banking crises for over a century. We look at the percentage increase in debt rather than in

<table>
<thead>
<tr>
<th>Country, crisis year</th>
<th>Year before the crisis</th>
<th>Peak deficit (year)</th>
<th>Increase or decrease (–) in the fiscal deficit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Argentina, 2001</td>
<td>–2.4</td>
<td>–11.9 (2002)</td>
<td>9.5</td>
</tr>
<tr>
<td>Chile, 1980</td>
<td>4.8</td>
<td>–3.2 (1985)</td>
<td>8.0</td>
</tr>
<tr>
<td>Colombia, 1998</td>
<td>–3.6</td>
<td>–7.4 (1999)</td>
<td>3.8</td>
</tr>
<tr>
<td>Finland, 1991</td>
<td>1.0</td>
<td>–10.8 (1994)</td>
<td>11.8</td>
</tr>
<tr>
<td>Indonesia, 1997</td>
<td>2.1</td>
<td>–3.7 (2001)</td>
<td>5.8</td>
</tr>
<tr>
<td>Japan, 1992</td>
<td>–0.7</td>
<td>–8.7 (1999)</td>
<td>9.4</td>
</tr>
<tr>
<td>Korea, 1997</td>
<td>0.0</td>
<td>–4.8 (1998)</td>
<td>4.8</td>
</tr>
<tr>
<td>Malaysia, 1997</td>
<td>0.7</td>
<td>–5.8 (2000)</td>
<td>6.5</td>
</tr>
<tr>
<td>Mexico, 1994</td>
<td>0.3</td>
<td>–2.3 (1998)</td>
<td>2.6</td>
</tr>
<tr>
<td>Norway, 1987</td>
<td>5.7</td>
<td>–2.5 (1992)</td>
<td>7.9</td>
</tr>
<tr>
<td>Spain, 1977*</td>
<td>–3.9</td>
<td>–3.1 (1977)</td>
<td>–0.8</td>
</tr>
<tr>
<td>Sweden, 1991</td>
<td>3.8</td>
<td>–11.6 (1993)</td>
<td>15.4</td>
</tr>
<tr>
<td>Thailand, 1997</td>
<td>2.3</td>
<td>–3.5 (1999)</td>
<td>5.8</td>
</tr>
</tbody>
</table>

Sources: International Monetary Fund (various years), Government Financial Statistics and World Economic Outlook, and the authors’ calculations.

*As shown in figure 14.4, Spain was the only country in our sample to show a (modest) increase in per capita GDP growth during the postcrisis period.
Figure 14.5. The cumulative increase in real public debt in the three years following past banking crises.

Sources: Appendixes A.1 and A.2 and sources cited therein.
Notes: Each banking crisis episode is identified by country and the beginning year of the crisis. Only major (systemic) banking crisis episodes are included, subject to data limitations. The historical average reported does not include ongoing crisis episodes, which are omitted altogether, because these crises began in 2007 or later, and the debt stock comparison here is with three years after the beginning of the banking crisis. Public debt is indexed to equal 100 in the year of the crisis.

debt relative to GDP because sometimes steep output drops complicate the interpretation of debt-to-GDP ratios. We have already emphasized but it bears being stated again, the characteristically huge buildup in government debt is driven mainly by a sharp falloff in tax revenue due to the deep recessions that accompany most severe financial crises. The much-ballyhooed bank bailout costs have been, in several cases, only a relatively minor contributor to the postcrisis increase in debt burdens.

Sovereign Risk

As shown in figure 14.6, sovereign default, debt restructuring, and/or near default (avoided by international bailout packages) have been a part of the experience of financial crises in many emerging markets; therefore, a decline in a country’s credit rating during a crisis hardly

232
comes as a surprise. Advanced economies, however, do not go unscathed. Finland’s sovereign risk rating score went from 79 to 69 in the space of three years, leaving it with a score close to those of some emerging markets! Japan suffered several downgrades from the more famous rating agencies as well.

Comparisons with Experiences from the First Great Contraction in the 1930s

Until now, our comparison benchmark has consisted of postwar financial crises. The quantitative similarities of those crises with the recent crisis in the United States, at least for the run-up and early trajectory, have been striking. Yet, in many ways this “Second Great Contraction” is a far deeper crisis than others in the comparison set, because it is global in scope, whereas the other severe post–World War II crises were either country-specific or at worst regional. Of course, as we will discuss in more detail in chapter 17, policy authorities reacted somewhat hesitantly in the 1930s, which may also
explain the duration and severity of the crisis. Nevertheless, given the lingering uncertainty over the future evolution of the crisis of the late 2000s (the Second Great Contraction), it is useful to look at evidence from the 1930s, the First Great Contraction.

Figure 14.7 compares the crises of the 1930s with the deep post-World War II crises in terms of the number of years over which

![Diagram of Peak-to-Trough Duration (Years) for post-World War II crises and Great Depression crises]

**Figure 14.7.** The duration of major financial crises: Fourteen Great Depression episodes versus fourteen post–World War II episodes (duration of the fall in output per capita).

**Sources:** Appendix A.3 and the authors' calculations.

**Notes:** The fourteen postwar episodes were those in Spain, 1977; Norway, 1987; Finland, 1991; Sweden, 1991; Japan, 1992; Mexico, 1994; Indonesia, Thailand, and (grouped as Asia-4 in the figure) Hong Kong, Korea, Malaysia, and Philippines, all 1997; Colombia, 1998; and Argentina, 2001. The fourteen Great Depression episodes were comprised of eleven banking crisis episodes and three less systemic but equally devastating economic contractions in Canada, Chile, and Indonesia during the 1930s. The banking crises were those in Japan, 1927; Brazil, Mexico, and the United States, all 1929; France and Italy, 1930; and Austria, Germany, Poland, and Romania, 1931.
output fell from peak to trough. The upper panel shows postwar crises including those in Colombia, Argentina, Thailand, Indonesia, Sweden, Norway, Mexico, the Philippines, Malaysia, Japan, Finland, Spain, Hong Kong, and Korea—fourteen in all. The lower panel shows fourteen Great Depression crises, including those in Argentina, Chile, Mexico, Canada, Austria, France, the United States, Indonesia, Poland, Brazil, Germany, Romania, Italy, and Japan.

Each half of the diagram forms a vertical histogram. The number of years each country or several countries were in crisis is measured on the vertical axis. The number of countries experiencing a crisis of any given length is measured on the horizontal axis. One sees clearly from the diagram that the recessions accompanying the Great Depression were of much longer duration than the postwar crises. After the war, output typically fell from peak to trough for an average of 1.7 years, with the longest downturn of four years experienced by Argentina and Finland. But in the Depression, many countries, including the United States and Canada, experienced a downturn of four years or longer, with Mexico and Romania experiencing a decrease in output for six years. Indeed, the average length of time over which output fell was 4.1 years in the Great Depression.8

It is important to recognize that standard measures of the depth and duration of recessions are not particularly suitable for capturing the epic decline in output that often accompanies deep financial crises. One factor is the depth of the decline, and another is that growth is sometimes quite modest in the aftermath as the financial system resets. An alternative perspective is provided in figure 14.8, which measures the number of years it took for a country’s output to reach its precrisis level. Of course, after a steep fall in output, just getting back to the starting point can take a long period of growth. Both halves of the figure are stunning. For the postwar episodes, it took an average of 4.4 years for output to claw its way back to precrisis levels. Japan and Korea were able to do this relatively quickly, at only 2 years, whereas Colombia and Argentina took 8 years. But things were much worse in the Depression, and countries took an average of 10 years to increase their output back to precrisis levels, in part because no country was in a position to “export its way to re-
Figure 14.8. The duration of major financial crises: Fourteen Great Depression episodes versus fourteen post–World War II episodes (number of years for output per capita to return to its precrisis level).

Sources: Appendix A.3 and the authors’ calculations.

Notes: The fourteen postwar episodes were those in Spain, 1977; Norway, 1987; Finland, 1991; Sweden, 1991; Japan, 1992; Mexico, 1994; Hong Kong, Indonesia, Korea, Malaysia, the Philippines, and Thailand, all 1997; Colombia, 1998; and Argentina, 2001. The fourteen Great Depression episodes were comprised of eleven banking crisis episodes and three less systemic but equally devastating economic contractions in Canada, Chile, and Indonesia. The banking crises were those in Japan, 1927; Brazil, Mexico, and the United States, all 1929; France and Italy, 1930; and Austria, Germany, Poland, and Romania, 1931. The precrisis level for the Great Depression was that of 1929.
covery” as world aggregate demand imploded. The figure shows, for example, that the United States, France, and Austria took 10 years to rebuild their output to its initial pre-Depression level, whereas Canada, Mexico, Chile, and Argentina took 12. Thus, the Great Depression era sets far more daunting benchmarks for the potential trajectory of the financial crisis of the late 2000s than do the main comparisons we have been making to severe postwar crises.

As we will show in chapter 16, the unemployment increases in the Great Depression were also far greater than those in the severe post–World War II financial crises. The average rate of unemployment increase was about 16.8 percent. In the United States, unemployment rose from 3.2 percent to 24.9 percent.

Finally, in figure 14.9 we look at the evolution of real public debt during the crises of the Great Depression era. Interestingly, public debt grew more slowly in the aftermath of these crises than it did.

![Diagram showing cumulative increase in real public debt three and six years following the onset of the Great Depression in 1929. Selected countries. Sources: Reinhart and Rogoff (2008b) and sources cited therein. Notes: The beginning years of the banking crises range from 1929 to 1931. Australia and Canada did not have a systemic banking crisis but are included for comparison purposes, because both also suffered severe and protracted economic contractions. The year 1929 marks the peak in world output and hence is used as the marker for the beginning of the Depression episode.](image-url)
in the severe postwar crises. In the Depression, it took six years for real public debt to grow by 84 percent (versus half that time in the postwar crises). Some of this difference reflects the very slow policy response that occurred in the Great Depression. It is also noteworthy that public debt in emerging markets did not increase in the later stages (three to six years) following the crises. Some of these emerging markets had already drifted into default (on both domestic and external debts); others may have faced the kind of external constraints that we discussed in connection with debt intolerance and, as such, had little capacity to finance budget deficits.

Concluding Remarks

An examination of the aftermath of severe postwar financial crises shows that these crises have had a deep and lasting effect on asset prices, output, and employment. Unemployment increases and housing price declines have extended for five and six years, respectively. Real government debt has increased by an average of 86 percent after three years.

How relevant are historical benchmarks in assessing the trajectory of a crisis such as the global financial crisis of the late 2000s, the Second Great Contraction? On the one hand, authorities now have arguably more flexible monetary policy frameworks, thanks particularly to a less rigid global exchange rate regime. And some central banks showed an aggressiveness early on by acting in a way that was notably absent in the 1930s or in the latter-day Japanese experience. On the other hand, we would be wise not to push too far the conceit that we are smarter than our predecessors. A few years back, many people would have said that improvements in financial engineering had done much to tame the business cycle and limit the risk of financial contagion. And as we saw in the final section of this chapter, the Great Depression crises were far more traumatic events than even the more severe of the post–World War II crises. In the Depression, it took countries in crisis an average of ten years for real per capita GDP to reach its precrisis level. Still, in the postwar crises
it has taken almost four and a half years for output to reach its pre-crisis level (though growth has resumed much more quickly, it has still taken time for the economy to return to its starting point).

What we do know is that after the start of the recent crisis in 2007, asset prices and other standard crisis indicator variables tumbled in the United States and elsewhere along the tracks laid down by historical precedent. It is true that equity markets have since recovered some ground, but by and large this is not out of line with the historical experience (already emphasized in chapter 10) that V-shaped recoveries in equity prices are far more common than V-shaped recoveries in real housing prices or employment. Overall, this chapter’s analysis of the postcrisis outcomes for unemployment, output, and government debt provides sobering benchmark numbers for how deep financial crises can unfold. Indeed, our post–World War II historical comparisons were largely based on episodes that were individual or regional in nature. The global nature of the recent crisis has made it far more difficult, and contentious, for individual countries to grow their way out through higher exports or to smooth the consumption effects through foreign borrowing. As noted in chapter 10, historical experience suggests that the brief post-2002 lull in sovereign defaults is at risk of coming to an abrupt end. True, the planned quadrupling of International Monetary Fund (IMF) resources, along with the apparent softening of IMF loan conditions, could have the effect of causing the next round of defaults to play out in slow motion, albeit with a bigger bang at the end if the IMF itself runs into broad repayment problems. Otherwise, as we have mentioned repeatedly, defaults in emerging market economies tend to rise sharply when many countries are simultaneously experiencing domestic banking crises.
There will probably be big action in the euro zone tomorrow; so, some quick analytical notes.

The big question, I believe, is whether the Italian and maybe Spanish crises are the kind of thing that might be brought under control by ECB bond purchases. This is often phrased in terms of whether they are facing liquidity or solvency problems; but I think it’s better phrased in terms of the possibility of self-fulfilling crises, a la Obstfeld. (Obstfeld was thinking of devaluations in a fixed-exchange-rate system, but the logic also applies to default within a single currency).

In the case of Greece and probably also Ireland and Portugal, I’d argue that we’re looking at fundamental insolvency. The debts are just too big, the required fiscal adjustment just too large even if interest rates were low, to make full payment plausible.

In the Italian case, you have big debt but also a primary budget surplus. So if interest rates stayed low, as they would if no default were expected, it wouldn’t be hard to service the debt with only modest further fiscal adjustment.

But if people expect a default – and also if they believe that once a country takes on the fixed cost of default, it might as well impose a big haircut on creditors – then you could see interest costs rising to a point where default indeed becomes the preferred option.

So there is a reasonable case that what we’re seeing in Italy is a self-fulfilling crisis trying to happen, in which fear of default is precisely what leads to default. And that’s exactly the kind of case in which intervention could short-circuit the crisis. Let the ECB buy lots of Italian bonds, in effect guaranteeing a low interest rate, and the possibility of default fades – which in turn means that further intervention isn’t
needed. It’s certainly worth a try.

While I’m at it, a further note: a country with the same level of debt as Italy, but with its own currency – and with debt in its own currency – would not face the same kind of crisis. The temptation, after all, would be to inflate rather than to default – and inflation does not have the same kind of “first bite of the cherry” aspect that default has, in which once you’ve decided to move you might as well impose a 50 percent haircut or thereabouts on creditors. What this means, I believe, is that a country with its own currency would not be subject to the kind of self-fulfilling panic that is now arguably hitting Italy. I leave the relevance of this observation to other parties as an exercise for readers.

**Update:** Via Calculated Risk, here it comes. I think this is confirmation, although the Eurospeak is so thick I’m not entirely sure what they said. But as you may have gathered from the discussion above — or am I equally incomprehensible? — I’m for it. It’s risky, but not acting would be fatal for sure.
The Eurozone debt crisis: Why the IMF’s proposal is flawed | VOX, CE...

Jordi Gual 13 September 2011

The IMF has recently suggested the recapitalisation of Europe’s banks as the most prudent way out of the continent’s economic crisis. This column argues that such thinking is based on a flawed analysis of the problem and is an unhelpful distraction at best. Europe is facing a crisis of government debt. The true problem of the Eurozone is not its banking system.

The recent calls by the IMF for a recapitalisation of European banks are, to say the least, disconcerting. A few weeks after the European Banking Authority (EBA) stress tests highlighted the resilience of European banks, it is discouraging that IMF officials (see Lagarde 2011) keep coming up with an argument that should have been settled months ago. This debate diverts attention from the real policy decisions that can deal with the dire predicament of the Eurozone economy.

This policy proposal is the result, I believe, of a flawed analysis of the current stage of the financial crisis. At present, we are fundamentally facing a government debt crisis and not a banking crisis. Of course, banks face challenges, since they are in the midst of a broad deleveraging process affecting both private and public debts. But banks will be sound if government debt is sound, since the process of gradual deleveraging of the private sector is well underway in most countries and, as shown by the EBA tests, the banking system is already sufficiently capitalised to absorb any potential losses from the completion of this process.

According to the Institute of International Finance (IIF 2011), European banks have raised $414 billion in capital since 2008, compared to the $314 billion raised by US banks. The perception of problems arises from the fact that, relative to their asset base, European banks hold much more public debt than US banks.

It is important to have a correct diagnosis of the reasons why this mountain of debt, private and public, has accumulated. It is clear that between 1999 and 2007 the gradually enlarging external imbalances within the Eurozone were an unintended and harmful byproduct of the introduction of the euro. Absurdly, the markets priced all debts issued by Eurozone private and public agents at levels close to Eurozone reference rates. This market failure, coupled with an era of low interest rates, led to extremely benign financial conditions. The consequence was a dramatic underestimation of risks, wrong investment choices, and a misallocation of capital. The anticipated
The flow of capital from North to South happened with a vengeance, with incorrect market signals triggering mistaken decisions from both savers and investors.

A second part of the accumulated debt, mostly public, comes to some extent from the policy reaction to the global financial crisis, which led to the worsening of the public finances of many Eurozone states, as they attempted, more or less successfully, to cushion the effect of the global contraction on their economies. In some countries, however, profligate fiscal policies over many years were also responsible.

The current proposal of bank recapitalisation arises from a focus on the potential losses in the banking book of government debt. It has been argued that this debt should be marked to market, like the trading book, with substantial haircuts applied to sovereign holdings, at least of those countries under rescue programmes.

This is, of course, one possible approach to the crisis. It is based on the idea that the fundamental problem lies in the banks, and that it is investors that should pay for the wrong investment decisions that they took. If this recapitalisation is to come from the private sector, it is not clear what it will mean for the broader economy in terms of credit availability. If it is forced by the public sector (see Hau 2011 on this site), it will involve a further deterioration of the finances of many, if not all, members of the Eurozone, thus reinforcing the current vicious circle.

However, if we accept that the root cause of the current stage of the crisis is the excessive public debt overhang within the Eurozone, and the absence of clear mechanisms of burden sharing when countries face difficulties servicing their debt, then the nature of the solution is altogether different.

The solution must involve a Eurozone arrangement that facilitates the gradual deleveraging of the countries that built up excessive debts. This is in the interest of both creditor and debtor countries. It must be implemented by a combination of financial support instruments which are flexible enough to allow growth recovery in indebted countries, and monitored fiscal adjustment and structural reforms that ensure the long-run fiscal viability and competitiveness of these economies. This is the burden sharing that is needed: creditor countries providing the funding or insurance at reasonable costs, and debtor countries undergoing the short term costs of fiscal retrenchment and reform.

If this programme is successfully completed – and indeed the EU appears to be taking steps in this direction – then the overall solvency of the banking system need not suffer. After all, the real problems of the European banking systems have had quite different roots all along the financial crisis. Some banks have failed or been rescued due to their exposure to subprime toxic assets and derivatives. Others, due to their holdings of real estate assets in the context of property bubbles. Still others, due to maturity mismatch and poor management.

It is quite absurd to argue that banks should fail due to their exposure to sovereign debt. After all, this debt was characterised by the regulator itself as safe debt, with a zero weight in terms of capital allocation. How ironic that banks are deemed to have insufficient capital due to their exposure to an asset class that according to the official rules of the game, old and new, requires no capital.

Obviously, banks will have to take a hit for their holdings of Greek debt subject to restructuring, but it has been made clear that such restructuring is exceptional. The principle should be that sovereign debt in the Eurozone is indeed a safe asset.

There is much that has not worked well in Europe during the financial crisis. The rules that govern
asset allocation by banks may be faulty and this is important in the wake of Basel III, which essentially endorses them (Gual 2011). But the true problem of the Eurozone is not its banking system. The true problem lies elsewhere, in the fact that Europe has built a monetary union with an inherent flaw – the absence of a sovereign safety net, since the debts accumulated by member states have been incurred in a currency that none controls. This issue, and not banking capitalisation, should be the focus of the policy debate.

The views expressed in this column are those of the author.

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A tale of two overhangs: the nexus of financial sector and sovereign credit risks

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There has emerged in the Western economies a strong nexus between the credit risks of financial sectors and their sovereigns. We argue that this phenomenon can be understood in the context of two debt overhang problems: one affecting the financial sector due to its under-capitalisation following the crisis of 2007-08; the second, affecting the non-financial sector, whose incentives are crowded out by high sovereign debt and anticipated future taxes. While the desire to resolve the financial sector overhang may make bailouts tempting, they raise the risk of exacerbating the overhang related to sovereign debt. Conversely, reduction of growth prospects due to sovereign debt overhang can make the financial sector riskier as it is highly exposed to sovereign debt both through direct holdings and indirectly through implicit government guarantees. We provide evidence on this important nexus, based on our ongoing research that exploits data on European bank and sovereign credit risks.
From 2007 to 2010, the public debt to gross domestic product (GDP) ratio of the Irish government increased roughly at 20% per annum, from one of the most prudent in 2007, at 25%, to among the highest in 2010, at 96%. Irish banks had looked increasingly vulnerable in the Fall of 2008 with their credit default swap (CDS) spreads – the cost of buying protection against default on their unsecured bonds – having reached a peak (on average across the four largest banks) of over 400 basis points (bps) in September 2008. While Irish bank CDS stabilised to 150 bps following the Irish government’s announcement of a blanket guarantee of all creditors of Irish banks on 30th September 2008, the post-bailout period saw Irish sovereign and bank CDS co-move strongly, with both increasing to over 600 bps by the start of 2011.

At the other end of Europe, the Italian government had maintained a debt to GDP ratio of close to 100% even before 2007. While the Italian banks were stable at CDS spreads of close to 100 bps in 2007, the Italian sovereign CDS widened steadily from 2007 to 2010, reaching nearly 600 bps in 2011. By this time, the Italian banks were also assessed in credit markets at a significantly higher risk of over 600 bps. The situation in Greece was similar, indeed worse, with Spain and Portugal sitting somewhere in between the case of Ireland and the cases of Greece and Italy. All of these countries experienced severe growth contractions during 2007-2011.

The pan-European patterns were similar: the average pre-bailout quality of the banking sector and the size of government debt predict future sovereign risk. We illustrate these relationships by examining empirical proxies for the quality of the banking sector and the size of the government debt before the bank bailouts and their association with the change in sovereign credit risk after the bailouts.

Chart 1 pertains to the quality of the banking sector. We measure the quality of the banking sector as the average bank CDS as of September 26th, 2008. We choose this date because it is immediately prior to the first announcement of bank bailouts in Europe and the United States. We thus interpret our measure as a proxy for the quality of the bank sector if investors do not necessarily expect bank bailouts. Consistent with this interpretation, we generally observe a large decline in average bank CDS after the announcement of a bailout. We use sovereign CDS to measure sovereign risk and we analyse the change in sovereign CDS over a short and a long horizon. The short horizon is September 26th until October 21st, 2008, the period when a large group of

![Chart 1: Average bank CDS before bailouts predicts sovereign CDS after bailouts](image)

**Chart 1**

Average bank CDS before bailouts predicts sovereign CDS after bailouts

*(in basis points, x axis: average bank CDS before bailouts, y axis: change in sovereign CDS during bailouts)*

**a) Short-run**

**b) Long-run**

Note: This Chart shows the relation between average bank CDS by country before the bank bailouts (as of September 26th, 2008) and the increase in sovereign CDS after the bank bailouts (from September 26th, 2008 to October 21st, 2008). We include all European countries with available data on sovereign CDS and bank CDS.

Sources: Datastream (bank and sovereign CDS data) and Acharya, Drechsler, Schnabl (calculations).

Note: This Chart shows the relation between average bank CDS by country before the bank bailouts (as of September 26th, 2008) and the increase in sovereign CDS after the bank bailouts (from September 26th, 2008 to the European bank stress tests on March 31st, 2010). We include all European countries with available data on sovereign CDS and bank CDS.

Sources: Datastream (bank and sovereign CDS data) and Acharya, Drechsler, Schnabl (calculations).
Western governments announced their bank bailouts. For the long horizon, we extend this period until the 2010 European bank stress tests (September 26th to March 31st, 2010). The 2010 European bank stress test is a natural cutoff for the long-term measure, but our results are robust to other cutoff dates.

As shown in Chart 1a, there is a positive relationship between the quality of the banking sector and the short-term change in the sovereign CDS. Countries with risky banking sectors, such as Spain and Ireland, had an increase in sovereign CDS of up to 50 bps, whereas countries with safe banking sectors, such as Norway or Sweden, experienced an increase of less than 20 bps. As shown in Chart 1b, the positive relationship survives if we examine the long-term change in sovereign CDS. The fit is quite remarkable given that the 2010 bank stress test were conducted more than 2 years after the Lehman bankruptcy.

Chart 2 pertains to the size of government debt. We measure government debt as the debt-to-GDP ratio before the Lehman bankruptcy (as of June 2008). As shown in Chart 2a, there is a positive relationship between the pre-bailouts size of debt-to-GDP and the short-term change in the sovereign CDS. Countries with a high debt-to-GDP ratio, such as Italy and Greece, experienced an increase in bank CDS of up to 50 bps, whereas countries with a low debt-to-GDP ratio, such as Finland and Germany, experienced an increase of less than 20 bps. As shown in Chart 2b, the positive relationship survives if we examine the long-term change in sovereign CDS.

Charts 1 and 2 suggest that is important to examine both the quality of the banking sector and the size of government debt. For example, Ireland is prominent in the banking sector chart (Chart 1) but an outlier with regard to the debt-to-GDP ratio (Chart 2). In contrast, Italy is prominent in the debt-to-GDP (Chart 2) but an outlier with regard to the banking sector (Chart 1). Taken together, our analysis shows that some countries, such as Ireland, entered distress due to significant debt overhang in the financial sector, whereas others, such as Italy, entered distress due to sovereign debt overhang.

We therefore argue in Acharya, Drechsler and Schnabl that these relationships between financial and sovereign credit risks, and economic growth, are not accidents, but in fact represent a tale of two debt overhang problems. When financial sectors

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A tale of two overhangs: the nexus of financial sector and sovereign credit risks

Viral V. Acharya, Itamar Drechsler and Philipp Schnabl

are under-capitalised, as after the losses suffered during the 2007-08 financial crisis, economic growth can collapse as financial intermediaries engage in de-leveraging and a credit crunch ensues. In other words, the resulting debt overhang in the financial sector reduces banks’ incentives to provide credit to the real economy. To avoid such a credit crunch and loss of real sector output, governments engage in large-scale, often blanket, financial sector bailouts.

Such bailouts, however, are costly and run the risk of amounting to a “Pyrrhic victory” for the sovereigns. First, bailouts require immediate issuance of additional debt by the sovereign in order to backstop the creditors of distressed or insolvent financial firms. This leads to an immediate increase in the sovereign’s credit risk through the liability side of its balance-sheet. Second, and perhaps even more importantly, the sovereign runs the risk of becoming indebted to the point where another debt overhang can take hold in its economy. The private sector – households and corporations – anticipate that the sovereign’s additional debt will require higher taxes in the future. This dilutes long-run returns on real-sector and human-capital investments. The resulting under-investment in the economy can cause growth and productivity in the sovereign to slow down, affecting the sovereign’s credit risk through the asset-side of its balance-sheet. There is therefore a tradeoff between the two overhangs, and the sovereign many need to “sacrifice” its own creditworthiness in order to alleviate the financial sector’s overhang. The resulting rise in sovereign credit spreads induced by this “sacrifice” is consistent with the patterns in Chart 1 and 2, as are downwards revisions in expectations of growth in the Fall 2008.

Chart 3
Home bias in Government debt
(y axis: home share, x axis: country)

AT = Austria; BE = Belgium; DE = Germany; DK = Denmark; ES = Spain; FI = Finland; FR = France; GB = United Kingdom; GR = Greece; IE = Ireland; IT = Italy; LU = Luxembourg; NL = Netherlands; NO = Norway; PT = Portugal; SE = Sweden.

This Chart shows the average holdings of home sovereign debt as a share of total sovereign debt by country as of the European bank stress tests on March 31st, 2010.
Sources: 2010 European bank stress tests (home share and Acharya, Drechsler, Schnabl (calculations))

Chart 4
Home bias in Government debt and bank credit risk
(y axis: log [Bank CDS], x axis: home share, %)

This figure shows a positive association between home bias in government debt and bank credit risk (proxied for by the natural logarithm of a bank’s credit default swap) as of the European bank stress tests on March 31st, 2010. Home bias in government debt is total home sovereign debt as a share of total sovereign debt. We include all banks that are included in the 200 bank stress tests and that have bank CDS data.
Sources: Datastream (bank CDS data), 2010 European bank stress tests (home share) and Acharya, Drechsler, Schnabl (calculations)
Perversely, the deterioration in the sovereign’s creditworthiness introduces the risk that its credit problems will feed back adversely onto its financial sector. One channel through which this occurs is the significant direct holdings of government debt by the financial sector. The stress test data revealed by the European regulators in June 2010 (on positions as of 31st March 2010) show that for every six euros of risk-weighted assets, the 91 stress-tested European banks held on average one euro of sovereign bonds. Further, Chart 3 shows the extent of “home bias”, the proportion of the sovereign debt that was held by banks in a given country in the form of the country’s own bonds. The home bias in government bond holdings is on average close to 60%, and is particularly strong for banks of troubled sovereigns (Greece, Ireland, Portugal, Spain and Italy). This home bias creates one form of reverse feedback from sovereign to the financial sector.

The second form of reverse feedback arises due to the fact that the financial sector – with or without bailouts – is perceived to have creditor guarantees provided by the sovereign. As the sovereign’s creditworthiness declines, the value of these explicit and implicit government guarantees also declines, and this adversely impacts the financial sector’s credit quality.

The case of the Spanish Bank Santander provides an example of the increased borrowing costs paid by a bank as the value of its sovereign’s implicit guarantees deteriorates. Despite being the most profitable bank in the Euro region since 2007, Santander was in October 2010 paying more to borrow than some of its weaker counterparts in Germany. In particular, on June 1st 2010, Santander had a long-term bond rating of “AA” and was trading at a CDS fee of 207 bps. Its sovereign, Spain, had a sovereign CDS fee of 247 bps. On the same day, the German Bank WestLB had a long-term bond rating of “BBB+” and traded at a CDS fee of 158 bps. Its sovereign, Germany, had a sovereign CDS fee of 43 bps.

Chart 5 shows that this pattern holds across Europe. We assign each bank the sovereign CDS of the country where the bank is headquartered and groups countries in five quintiles using sovereign CDS.

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2 In another example, Santander sold in September 2010 1 billion euro (USD 1.4 billion) of 4.125 percent, seven-year senior bonds with a AA rating that yielded 156 basis points more than average market rates. In contrast, Germany’s Commerzbank AG, which required a government rescue in 2008, issued 1 billion euros of 4 percent, 10-year senior debt with an A rating that yielded 126 basis points more than the benchmark.
Next, we compute average banks CDS by credit ratings and by country quintile. The chart shows that keeping credit ratings constant, bank CDS monotonically increase in country quintiles, weakly so in the left panel which is before the bank bailouts (second quarter of 2008), and strongly so after the 2010 European bank stress (second quarter of 2010). In particular, banks with credit ratings of “AA” and “A” in the highest country quintile (e.g., Spain in June 2010) had on average higher CDS prices than banks with credit ratings of “BBB” in the lowest four country quintiles.

Alternatively, we can test the strength of the association between sovereign and bank CDS as a function of a bank’s credit rating. Specifically, we use daily bank-level data to estimate

\[
\log(\text{Bank CDS}_{it}) = \sum_k \alpha_k \text{Rating}_{ikt} + \delta_t \sum_k (\delta_k \text{Rating}_{ikt}) + \log(\text{Sov CDS}_{it}) + \epsilon_{it}
\]

where \(\log(\text{Bank CDS}_{it})\) is the natural logarithm of the CDS of bank \(i\) at time \(t\), \(\text{Rating}_{ikt}\) is an indicator variable for the S&P Rating \(k\) of bank \(i\) at time \(t\), \(\log(\text{Sov CDS}_{it})\) is the natural logarithm of the CDS of the country in which bank \(i\) is based, and \(\delta_t\) are time fixed effects. We focus our analysis on banks that are based in Europe and the United States with more than USD 50 billion in assets (according to Bankscope) and that have traded bank CDS and sovereign CDS (according to Datastream). We restrict our sample to the period after the bank bailouts and we focus on banks with S&P investment grade ratings (according to S&P RatingsXpress).

Table 1 presents the result. As shown in Column (1), bank CDS is larger for banks with lower ratings. This result is not surprising and suggests that credit ratings are informative about a bank’s financial distress. More importantly, Column (2) shows that the relationship between bank and sovereign CDS is positive for all banks and statistically significant for banks with lower ratings such as banks with A or BBB ratings. For banks with a credit rating of AA or higher, a 10% increase in sovereign CDS is associated with a 1.2% increase in bank CDS. For banks with a credit rating of A or BBB the effect increases to 3.1% and 2.6% respectively. Hence, the strength of the association is larger for banks with lower ratings. In short, these results suggest that an increase in sovereign CDS increases bank credit risk even after controlling for bank credit ratings and that the impact of sovereign CDS is larger for bank with lower credit ratings.

<table>
<thead>
<tr>
<th>Dependant variable</th>
<th>Log(Bank CDS)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(1)</td>
</tr>
<tr>
<td>Rating A</td>
<td>0.454**</td>
</tr>
<tr>
<td></td>
<td>(0.098)</td>
</tr>
<tr>
<td>Rating BBB</td>
<td>0.724**</td>
</tr>
<tr>
<td></td>
<td>(0.148)</td>
</tr>
<tr>
<td>Rating (AAA or AA) + Log(Sovereign CDS)</td>
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</tr>
<tr>
<td>Rating A + Log(Sovereign CDS)</td>
<td>0.307**</td>
</tr>
<tr>
<td>Rating BBB + Log(Sovereign CDS)</td>
<td>0.265*</td>
</tr>
<tr>
<td>Constant</td>
<td>4.530**</td>
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<tr>
<td></td>
<td>(0.072)</td>
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<tr>
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<tr>
<td>Banks</td>
<td>83</td>
</tr>
<tr>
<td>R-squared</td>
<td>0.180</td>
</tr>
</tbody>
</table>

Both of these reverse feedbacks – the first due to direct holdings of government bonds by financial firms, and the second due to implicit guarantees of the financial sector by governments – would further result in withdrawal of intermediation by banks, exacerbating sovereign credit risks, and giving rise to severe downward spirals of growth.

The nexus of debt overhangs and credit risks between the sovereign and the financial sectors that we have highlighted has an important policy implication. Sovereign bonds are accorded minimal, often zero, risk-weights in capital requirements for banks as long as sovereigns are well-rated. However, through the nexus of debt overhangs, even small deteriorations in the credit quality of sovereigns can precipitate financial and economic crises. It may therefore be prudent in good times, even when sovereigns are well-rated, to entertain the “stress test” possibility of future credit deterioration, e.g., through non-zero risk weights on sovereign bonds, and to require banks to fund sovereign bond holdings with reasonable quantities of capital. Not doing so can result in excessive funding of sovereigns by banks in good times, but with sharp reversals in bad times, as is being witnessed currently in the euro zone.

Table 1
Bank CDS and sovereign CDS by bank rating

The table shows regressions of bank CDS on bank credit ratings and sovereign CDS for the period from November 2008 to December 2010 using daily data. The sample includes all banks that have more than USD 50 billion in assets in Bankscope, have an investment grade rating from S&P in RatingsXpress, and have traded CDS in Datastream. The omitted category is Rating AAA and AA. The standard errors are clustered at the bank-level ** 1% significant and * 5% significant.

Source: Acharya, Drechsler, Schnabl.
Ok, who moved first?? Was it you, bond yield? Or was it you, CDS spread? It was you, wasn’t it.. Quick, shoot the messenger! Get him!!!

Maybe that’s not exactly what’s happening in the discussion of the transition mechanism between CDS spreads and bond yields. But the topic has become so politicised it can sometimes seem that the angry villagers are on a rampage.

It’s not that this hasn’t been looked into before. There was an EU Commission report, though it was only released when the Dutch paper Het Financieele Dagblad got all freedom-of-informationy about it.

That report concluded that sovereign CDS weren’t having an adverse effect on the bond markets, but rather the markets move contemporaneously. In other words, don’t blame CDS for sovereign funding troubles.

Not so fast though. In the last few months, a number of studies have come out saying that CDS do actually affect bond prices. Before getting into some of the detail, it’s instructive to take a step back to examine what’s actually being looked at here.

Imagine there is a race being run. It’s between Italian CDS and BTPs. The question is, if CDS jumps the gun, getting a head start (for whatever reason that may be, but pretend it’s something macro) then how fast does BTP run to catch up? Similarly, if BTP jumps the gun, how quickly does the CDS run? Or, if they were both already running the race, which one works harder to catch up with the other when he falls behind?
In these types of studies, if the bond runs faster, then clearly the CDS is leading. If the CDS runs faster, then the bond is leading. In the EU Commission study, they were found to be running together as a team.

According to a paper by Delatte, Gex, and Lopez-Villacencio that is forthcoming in the *Journal of International Money and Finance*, the answer to who runs faster actually depends on the race conditions and the general health of the runners, which is an interesting thought. In fact, their running speeds aren’t even constants, but more on that later.

The researchers take a sample of ten Western European sovereigns, which they further split into core countries and, politely, “high yield” countries. First, they replicate the linear methodology that earlier papers have used, i.e. the one where the race conditions and general health of the runners doesn’t matter.

In that set of results, they find that for the core countries, CDS and bonds are running as teammates, just like the EU Commission’s study.

For the high yield countries, though, the CDS lead the bond spread. For the avoidance of doubt, that’s the *ding, ding, ding!!* for politicians who want to ban CDS, either completely or at least just forbid naked shorts.

One of the things that the authors point out, however, is that some of the older studies were using older data. Obvious, but it has to be said. This study’s dataset goes to July 2010, so would certainly be worth a rerun.

Then onto the second part of the study, which is where the big payoff is. Here they also throw race conditions into the mix: namely, the levels for spreads and bonds, the variability in the market (again measured by spreads and bonds), and deviations from the long-run relationship between them.

Now, another thing that is important with this part of the study is that they make a methodological change. When assessing the relationship between the two types of financial instrument, most studies insist that the speed of catching up is constant for the entire dataset and that whoever is chasing whom also stays constant. In this second part, the speed and the identity of the chaser can change, making it much more dynamic.

The conclusion about core sovereigns in this second part is that the bond market leads when conditions are benign. **However, this flips around financial conditions deteriorate, and then CDS start leading bonds.** That is, bonds have to start running faster to catch-up.

For high-yield sovereigns, whose health was bad to begin with, **CDS spreads dominate across all race conditions.** Imagine the bonds flailing and struggling to keep up with the whipper-snapper CDS.

Before anyone cries foul on the reseachers* by pointing out how much smaller the CDS market is than the bond market, be aware that they do discuss this. Their point is that developed country
CDS are more active now than they used to be and they allow investors to easily take leveraged positions.

Also, although their results are statistically significant in all the right places, **this doesn’t establish causality or the nature of the transition mechanism.**

They don’t get into detail about technicals that can drive either financial instrument. Bonds, for example, can be influenced by flights-to-quality, ECB buying, auction calendars, repayment schedules, and repo markets, just to name a few things other than CDS.

Below are some basis charts courtesy of Markit, just to have a squint at what some of these series can look like relative to each other when such factors are in play.
Try looking at the above and making an intelligent statement about how CDS influenced Italian and Spanish bond yields in the face of the ECB’s bond buying. Frankly, the CDS were left in the dust, wondering if they were going to be banned from the race completely.

And before getting out pitchforks for CDS, go ask a few risk managers if they want to figure out what to use instead when it comes to hedging and modelling risk. Or ask newly minted macroprudential supervisors what early warning signs they want for financial distress. Just a thought.

* Please do not place any blame anywhere even vaguely near the researchers for the race analogy. Responsibility for that lies solely with FT Alphaville. Thank you.

**Related links:**
The benefits of naked CDS – FT Alphaville
CDS: modern day weapons of mass destruction – FT
A CDS basis “pain trade” – FT Alphaville

This entry was posted by Lisa Pollack on Thursday September 22nd, 2011 18:44. Tagged with Capital Markets, CDS, Credit Default Swaps, sovereign cds, Sovereign spreads.
The European ban on naked sovereign credit default swaps: A fake good idea

Anne-Laure Delatte 23 July 2012

Uncovered sovereign credit default swaps will be permanently prohibited in the EU by November 2012. While empirical evidence on their destabilising role is mounting, this column argues that the EU regulation will have only a limited effect, as a number of inconsistencies create regulatory arbitrage and opportunities to circumvent the ban.

The European debt crisis has raised concerns regarding the use of credit default swaps (CDSs). CDSs are a derivative financial product used to hedge against the default risk of any entity. From the outset, it has been suspected that the crisis has been exacerbated by a few investors driving up the prices in the CDS market. This issue has attracted much interest in policy circles and has led to the adoption of new European regulation, including the ban of naked sovereign CDSs.

There is already some empirical evidence that the CDS market can influence the price of the government bond market when the market is distressed (see Portes on 2012 for a recent contribution, and Delatte et al. 2012). But is this initial scientific evidence enough to justify setting a limit to speculative positions? Essentially, it suggests that CDSs provide a forum for establishing and disseminating price information¹. So the question is: Does financial speculation with CDSs play a positive disciplinary role by forcing governments to adjust their fiscal policies? Or have government bond spreads become sensitive to erratic speculative movements? This is still under debate (Duffie 2010 and De Grauwe and Ji 2012).

CDSs have served as a coordinating device for speculation

We address this issue in a recent working paper (Bruneau et al. 2012). A similar question about the disciplinary or destabilising role of financial speculation motivated the development of the ‘second generation’ approach to currency crises in the 1990s². It describes crises where the economic fundamentals are not the only determinants—a crisis can occur due to market expectations. In our paper, we transpose this approach to analyse the benefits and costs of defaulting for policymakers.

Drawing on Jeanne and Masson (2000), we model the probability of default in the context of the European sovereign crisis. If investors become pessimistic, they sell government bonds. This increases the interest rate and interest-rate payments and thus leads to the burden of public debt. The subsequent austerity efforts increase the probability of default because the government may receive less democratic support to increase taxes. In total, the authorities’ optimal policy may validate market expectations ex post; i.e. default if investors expect a default.

Some questions

How to bring the theory to the data? How to test the presence of self-fulfilling dynamics during the European crisis? Market expectations matter if, for the same level of fundamentals, investors require a different interest rate. When market participants are optimistic, the interest rate required is low and when expectations become pessimistic. The next question is obviously what drives
To answer, we take a sample of five peripheral European countries in which the sovereign yield has been most under pressure, i.e. Greece, Ireland, Italy, Spain and Portugal. We estimate a relationship between the government spread and the economic fundamentals of these countries (such as the ratio of public debt to GDP, the fiscal deficit, etc…). We then use an innovative estimation method that allows this relationship to be nonlinear, i.e. the relationship changes along observable variables. We test different market signals that may have coordinated the expectations of market participants during the crisis, i.e. financial variables that convey public information, both about the economy as well as the mood of market participants, such as CDS prices and interbank rates.

We find that the markets of sovereign and banking CDSs have played a dominant role in driving market sentiment. In fact, we find that for the same level of fundamentals, investors require a higher interest rate when CDSs premia are high. Within a market environment filled with uncertainty and imperfect information, the CDS market transmits a market signal that leads market participants to believe that other participants “know something”.

The rise in sovereign and banking CDSs premia changes the market’s expectations about the country’s default probability. Market participants sell bonds and banking stocks in the belief that default risk is greater. The market shifts to a pessimistic equilibrium and, in fact, sovereign default becomes more likely. Accounting for shifts in market sentiment explains the sudden eruption of the crisis in countries like Portugal or Spain, where the fundamentals have deteriorated only progressively.

In total we obtain empirical support of an intuition, often heard from market practitioners, that CDS prices affect market sentiment and serve as a coordinating device for speculation. Unfortunately, the regulation on CDSs that has just been adopted by the European Parliament suffers from several limits.

The European regulation on short selling and certain aspects of CDSs

As with most financial derivative products, transactions in the CDS market are traded “over-the-counter” as opposed to on a centralised exchange. A new regulation on short selling and naked CDSs will come into effect across the EU in November 2012. Investors willing to trade sovereign CDSs in an EU country must hold the underlying bond or a portfolio of assets correlated to the value of the sovereign debt (a similar ban proposal was debated in the US in 2009 but finally abandoned). The corporate CDSs are excluded from the ban – which is an inconsistency in light of our findings that CDS on banking assets drive market sentiment. The exclusion of banking CDSs clearly introduces a regulatory arbitrage.

More worrying though is an exemption for market makers, which casts serious doubt about the efficiency of the European regulation. In fact, a market participant is considered a market maker when her volume of transactions is sufficiently large and she commits to price any transactions an end-user may ask. In other words, large dealers in CDSs, like JP Morgan for example, are market makers. The point is that this market is highly concentrated, with 87.2% of the CDS trading activity coming from the top 15 dealers (SEC 2012). And the border between market makers and proprietary trading is usually fuzzy in investment banks. In practice, market makers have an overall view of the market, as they know volumes and price better than anyone else. They often reap the benefits of this competitive advantage in order to carry out proprietary trading activity. In sum, there is a realistic risk that the ban excludes market participants – an activity which is precisely the one that the regulation aims to limit.

Conclusions

Effectively, the advantage of this regulation is that it harmonises the regulation on short selling across the EU. Beyond that, its relevance is questionable in the context of the recently implemented European Market Infrastructures Regulation on over-the-counter derivatives. Indeed, the regulation aims to increase transparency in the opaque over-the-counter market along similar lines as the Dodd-Frank act in the US. While it covers all over-the-counter derivative markets, it has been inspired by the specific risk associated with CDSs. It introduces reporting and clearing obligations to
promote the standardisation of trades. In the case of a highly-concentrated market such as the CDS market, standardisation and clearing reduce opaqueness and avoid collusion. How then can we explain the adoption of a European ban on CDSs in parallel with the European Market Infrastructures Regulation? The answer may be that a ban draws more attention from the general public. Moreover, it illustrates the inconsistencies of the political process in financial regulation.

**References**


Securities and Exchange Commission (2012), “Information regarding activities and positions of participants in the single-name credit default swap market” Memorandum, Division of Risk, Strategy and Financial Innovation of the U.S


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1 As R. Pickel argued before the US House of Representatives in April 2010, “CDS have often been the best way to express a view on credit in troubled times when cash and securities market have seized up”.


3 Regulators can lift the prohibition temporary in case of market distress which makes the ban semi-permanent.
LENDER OF LAST RESORT: 
THE CONCEPT IN HISTORY

Thomas M. Humphrey*

Averting banking panics and crises is the job of the central bank. As lender of last resort (LLR), it has the responsibility of preventing panic-induced collapses of the money stock. Traditionally, it has discharged this responsibility by making emergency loans of high-powered money to sound but temporarily illiquid banks at penalty rates on good collateral. Ideally, the mere announcement of its commitment, by assuaging people's fears of inability to obtain cash, would be sufficient to still panics without the need for making loans.

Banking scholars agree that the Bank of England in the last third of the nineteenth century was the lender of last resort par excellence. More than any central bank before or since, it adhered to the strict classical or Thornton-Bagehot version of the LLR concept. That version, named for its principal framers Henry Thornton and Walter Bagehot, stressed (1) protecting the aggregate money stock, not individual institutions, (2) letting insolvent institutions fail, (3) accommodating sound institutions only, (4) charging penalty rates, (5) requiring good collateral, and (6) preannouncing these conditions well in advance of any crisis so that the market would know exactly what to expect. These precepts served the Bank well. So well, in fact, that the U.K. suffered no banking crises after 1866. Even today, the Thornton-Bagehot version of the LLR concept provides a useful benchmark or standard for central bank policy. It is time to document the evolution and logic of that concept in some detail.

Henry Thornton's Contribution

The term "lender of last resort" owes its origin to Sir Francis Baring, who in his Observations on the Establishment of the Bank of England (1797) referred to the Bank as "the dernier resort" from which all banks could obtain liquidity in times of crisis. But the concept itself received its first-and in many respects still its most rigorous, complete, and systematic—treatment in the hands of Henry Thornton. It was Thornton who, in his testimony before Parliament, in his speeches on the Bullion Report, and in his classic An Enquiry Into the Nature and Effects of the Paper Credit of Great Britain (1802), identified the Bank of England's distinguishing characteristics as an LLR. It was he who also specified the LLR's primary function, who distinguished between the micro and macroeconomic aspects of this function, and who analyzed the LLR's relationship with the monetary control function of the central bank. Finally, it was he who first enunciated the so-called "moral hazard" problem confronting the LLR.

Distinctive Features

Thornton identified three distinguishing characteristics of the LLR. First was its unique position as the ultimate source of liquidity for the financial system. The LLR, he pointed out, maintained and created a strategic stock of high-powered money (gold and Bank of England notes) that could be used to satisfy demands for liquidity at critical times. More precisely, it held the central gold reserve from which all banks could draw. Equally important, it supplied the non-gold component of the monetary base in the form of its own notes—notes which, by virtue of their unquestioned soundness and universal acceptability, were considered the equivalent of gold and therefore constituted money of ultimate redemption. The Bank's effective monopolistic power to issue these notes gave it sole control over an inexhaustible source of outside money—the first requisite of an LLR.

Arresting Internal Drains

The second hallmark of the LLR was its special responsibilities as custodian of the central gold reserve. It must hold sufficient reserves to inspire full confidence in their ready availability in times of stress. Also it must rely on its own resources (since as the last resort, it can turn to no other source) to protect the reserve from gold-depleting specie drains. Specifically, it must stand ready to freely issue its own paper to stem the panics that produce internal drains as cashholders seek to

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switch from country bank notes to gold or its equivalent. And, while relying on the Bank's monetary control function to prevent external drains caused by persistent inflationary overissue of paper, it must hold so large a gold reserve as to withstand those temporary and self-reversing external drains caused by real shocks to the balance of payments. Should the Bank nevertheless find its gold reserve depleted by an extraordinary succession of such shocks (Thornton mentions three successive crop failures), it must take steps to ensure that the eventual return flow of gold is not delayed by domestic monetary contractions that depress aggregate production and reduce output available for export. For, according to Thornton (1939, p. 118), given downward inflexibility of wages and prices in the face of a money-stock collapse:

the manufacturer, on account of the unusual scarcity of money, may even . . . be absolutely compelled by necessity to slacken, if not suspend, his operations. To induct such a pressure on the mercantile world as necessarily causes an intermission of manufacturing labor, is obviously not the way to increase that exportable produce, by the excess of which, above the imported articles, gold is to be brought into the country.

In short, the central bank must ensure that secondary monetary shocks do not prolong temporary external drains originating in real disturbances. To do so, it must sterilize or neutralize those drains with temporary increases in its own note issue. In so doing, it maintains the base of high-powered money and prevents sharp contractions in the money stock, contractions which, by depressing manufacturing activity and thus reducing output available for export, would prolong the trade deficit and hinder the return flow of gold. By judicious expansion of its own paper, the Bank of England arrests and reverses these specific drains that imperil its gold reserve.

Public Duties The third characteristic of the LLR was that it was not just like any other bank; it had public responsibilities. Unlike an ordinary commercial banker, whose responsibilities extend only to his stockholders, an LLR's responsibility extends to the entire economy. The LLR's duties include preserving the aggregate quantity and hence purchasing power of the circulating medium during bank runs and panics, and assisting the entire financial system in times of crisis. This responsibility, Thornton argued, dictates that the LLR behave precisely the opposite of a commercial banker in times of general distress, expanding its note issue and loans at the very time the banker is contracting his. For whereas the individual banker can justify his loan and note contraction on the grounds that it will enhance his own liquidity and safety while not materially worsening that of the whole economy, the LLR can make no such assumption. On the contrary, the LLR must assume that, because of its influence over the total money supply, any contractionary policy on its part would adversely affect the economy. Consequently, the LLR must expand its note issue and loans at a time when the prudent commercial banker is contracting his.

Policy Issues Having outlined the distinctive features of the LLR, Thornton next expounded on four policy issues pertaining to the LLR. The first concerns a possible conflict between the central bank's responsibility as controller of the paper component of the monetary stock and its function as lender of last resort. Since the central bank bears the responsibility for providing a stable framework of monetary growth, it must exercise a moderate and continued restraint on the rate of expansion of its own note issue. It must do so either to protect its gold reserves from displacement by excess paper so that it can maintain the convertibility of its currency under fixed exchange rates or to prevent domestic inflation under floating exchange rates. But coping with unusual liquidity strains or panics through exercise of the LLR function calls for abandonment of this restraint and relinquishing control over the growth rate of the Bank note component of the monetary base. Hence, some banking specialists have noted an apparent conflict between these two central banking objectives.

Monetary Control and the LLR Thornton, however, saw no inconsistency between a policy of stable monetary growth and the actions required to deal with liquidity crises. In the following passage, which Joseph Schumpeter called the "Magna Carta of central banking," Thornton distinguishes between the long-run target growth path of paper money and temporary emergency deviations from the path. The proper policy of the Bank of England, Thornton (1939, p. 259) said, is

[To limit the total amount of paper issued, and to resort for this purpose, whenever the temptation to borrow is strong, to some effectual principle of restriction; in no case, however, materially to diminish the sum in circulation, but to let it vibrate only within certain limits; to afford a slow and cautious extension of it, as the general trade of the kingdom enlarges itself; to allow of some special, though temporary, increase in the event of any extraordinary alarm or difficulty, as the best means of preventing a great demand at home for guineas;1 and to lean

1 Thornton is here referring to the public's demand for gold coin, the guinea being the name of a standard gold coin in use in England at the time.

FEDERAL RESERVE BANK OF RICHMOND
to the side of diminution, in the case of gold going abroad, and of the general exchanges continuing long unfavourable; this seems to be the true policy of the directors of an institution circumstanced like that of the Bank of England. To suffer either the solicitations of merchants, or the wishes of government, to determine the measure of the bank issues, is unquestionably to adopt a very false principle of conduct.

**Remedies for External Drains** Thus, to Thornton, the main responsibility of the central bank was to regulate paper money so that it expands at a steady noninflationary pace roughly comparable to the long-term growth rate of output. The bank must also counter those specie drains that periodically threaten to deplete its gold reserve and force suspension of convertibility. As previously mentioned, these drains were of two types: external (or foreign), composed of exports of gold to cover an adverse balance of payments, and internal, consisting of panic-induced increases in the quantity of gold held by domestic residents. Now temporary (self-reversing) external drains arising from transitory real shocks to the balance of payments can normally be met from the large buffer stock of gold reserves held precisely for that purpose, the temporary runoff of gold being offset by a reverse flow later on. But an extraordinary succession of such drains, if sufficient to exhaust the metallic reserve and deplete the gold in circulation, may require expansionary policy. Such policy, Thornton argued, would neutralize (sterilize) the gold outflow, prevent needless monetary contraction and the resulting disruption of the export industries ("those sources of our returning wealth"), and thereby contribute to the prompt correction of the trade deficit and the speedy return of gold. By contrast, persistent external drains arising from inflationary overissue of paper money call for restrictive policy. Either by reducing inflated British prices relative to foreign prices or by creating an excess demand for money which domestic residents attempt to satisfy by selling more goods and buying less, such restrictive policy spurs exports, checks imports, eliminates the trade-balance deficit, and halts the outflow of gold. Clearly monetary contraction, he thought, is the correct remedy for persistent external drains.

**LLR and Internal Drains** In the case of a panic and internal drain, however, the Bank should be prepared temporarily to expand sharply both its note issue and its loans to satisfy the public's demand for high-powered money. This means that the Bank must step off its path of stable note growth to prevent the money stock from shrinking. Indeed, Thornton argued that emergency expansions of Bank of England notes were required to keep the entire stock of paper money (Bank notes plus notes issued by country banks) on path in the face of panic-induced demands to switch out of country notes. There need be no conflict between the functions of money control and lender of last resort, however, since the first refers to the long run and the second to temporary periods of emergency that may last for only a few days. If the LLR responds promptly and vigorously to the threat of a liquidity crisis, the panic will be averted quickly. Indeed, Thornton held that the mere expectation of such a response may be sufficient to stop the panic before additional notes are issued. Thus, the deviation of the paper component of the monetary base from its long-run target path will be small, both in magnitude and duration.

**Macro vs. Micro Responsibilities** The second issue considered by Thornton concerns the extent of the lender of last resort's responsibility to individual banks as opposed to the banking system as a whole. Suppose these individual banks are unsound. Must the LLR act to prevent their failure; that is, are bailout operations necessary to preserve the stability of the payments mechanism? Thornton (1939, p. 188) answered in the negative.

It is by no means intended to imply, that it would become the Bank of England to relieve every distress which the rashness of country banks may bring upon them; the bank, by doing this, might encourage their improvidence. There seems to be a medium at which a public bank should aim in granting aid to inferior establishments, and which it must often find very difficult to be observed. The relief should neither be so prompt and liberal as to exempt those who misconduct their business from all the natural consequences of their fault, nor so scanty and slow as deeply to involve the general interests. These interests, nevertheless, are sure to be pleaded by every distressed person whose affairs are large, however indifferent or even ruinous may be their state.

Thornton made four key points in this passage. First, the lender of last resort's primary responsibility is to the market ("the general interests") and not to the individual bank. The central bank has no duty to sustain particular institutions. Second, the LLR must take account of the moral hazard problem. That is, it must recognize that when it makes liberal accommodation available, it may create incentives that encourage laxity and recklessness in the lending practice of individual banks. Thornton's solution to this problem was to advise against bailout operations for banks whose distress arises from "rashness," "improvidence," or "misconduct." By subsidizing the risk-bearing function of poorly managed banks, such rescue operations, he asserts, would encourage other banks to take excessive speculative risks without fear of the consequences. In short, individual imprudence...
should be punished by losses. Only if the financial repercussions of such punishment threaten to become widespread should the lender of last resort intervene. His third point, however, was that even in this latter case, aid should be extended sparingly and on relatively unfavorable terms. Finally, he was skeptical of the claim that economic welfare is inevitably harmed when a bank fails. This argument, he noted, would provide every large bank, no matter how poorly run, with an automatic justification for aid. He was aware that the public interest may be better served by the demise of inefficient banks, because the resulting improvements in resource allocation may well outweigh any adverse spillover side effects of the failure.

**Containing Contagion** The third issue addressed by Thornton was whether the lender of last resort should try to prevent shocks to the financial system. Here Thornton answered in the negative. The lender of last resort exists, he said, not to prevent shocks but to neutralize their secondary repercussions. He argued that a panic could be triggered by any kind of “alarm”; for example, rumors of a foreign invasion, an initial bank failure, and so on. The central bank has no responsibility for stopping these triggering events, but it does have a responsibility for arresting the panic, stopping it from spreading throughout the system. “If any one bank fails,” said Thornton (1939, p. 180), “a general run on the neighboring ones is apt to take place, which if not checked at the beginning by a pouring into the circulation a large quantity of gold, leads to very extensive mischief.”

The proper response, according to Thornton, is not to stop the initial failure, but to pump liquidity into the market. In Thornton’s view, the actual occurrence of a widespread panic would be properly attributable not to the initial bank failure, but to the central bank’s failure to insulate the economy from the impact of that event. He distinguished between the effect of closing an individual bank and the policy errors of the lender of last resort. Closing an individual bank, he said, contributes very little to “general distress” or “general commercial difficulty.” By contrast, policy errors of the lender of last resort create a “general shock to credit” that “produces Distress throughout the whole Kingdom” (Thornton, pp. 287 88, 304 5).

**Protecting the Money Stock** Finally, Thornton identified the paramount objective or primary purpose of the lender of last resort. That objective he specified as the prevention of panic-induced declines in the money stock, declines that could produce depressions in the level of economic activity. That is, he viewed the LLR as essentially a monetary rather than a banking function. While recognizing that the LLR also functions to forestall bank runs and avert credit crises, he insisted that these functions, although undeniably important, were nevertheless ancillary and incidental to the LLR’s main task of protecting the money supply. In other words, the LLR’s crisis-averting and run-arresting duties were simply the means (albeit the most efficient and expeditious ones) through which it pursued its ultimate objective of preserving the quantity, and hence the purchasing power, of the money stock. The important point was to prevent sharp short-run shrinkages in the quantity of money, since hardship ensued from these rather than from bank runs or credit crises per se.

In this connection, he drew a sharp distinction between bank credit (loans and discounts) on the one hand and the stock of money on the other. He then argued that, while the two aggregates tend to rise and fall together, it is the fall of the money stock that does the damage to the real economy. More precisely, he asserted that, while credit indeed finances and supports business activity, such credit arises from money rather than vice versa. Since credit springs from money and not money from credit, it follows that monetary contractions rather than credit collapses per se are the root cause of lapses in economic activity. Regarding this point, Thornton (1939, p. 307) asserted that a run-induced contraction in bank credit is not as harmful as the corresponding decline in the money stock: “It is not the limitation of Discounts or Loans, but ... the limitation of Bank Notes or the Means of Circulation that produces the Mischiefs [of unemployment and lost output].”

To show how such monetary contraction and the resulting fall in output and employment would occur in the absence of an LLR, Thornton traced a chain of causation running from an alarm or rumor to financial panic to the demand for high-powered money to the money stock itself and thence to aggregate spending and the level of real economic activity. Panics, he noted, trigger doubts about the solvency of country banks and the safety of their note and deposit liabilities. As a result, moneyholders seek to convert these assets into money of unquestioned soundness, namely gold or Bank of England notes. These two items, he noted, comprise the base of high-powered money, an unaccommodated increase in the demand for which in a fractional reserve banking system is capable of causing a multiple contraction of the money stock. The demand for base money, he said, is doubly augmented during panics. For at the same time that moneyholders are attempting to convert suspect country bank notes and
deposits into gold or its equivalent, country banks are seeking to augment their reserves of these high-powered monetary assets, both to meet anticipated cash withdrawals and to allay public suspicion of financial weakness. The result is a massive rise in the demand for base money—a rise that, if not satisfied by increased issues, produces sharp contractions in the money stock and equally sharp contractions in spending. Since Thornton contended that wages and prices were downwardly sticky and therefore responded sluggishly to declines in spending, he thought that output and employment would bear most of the burden of adjustment; that is, the monetary contraction would fall most heavily on real activity.

To prevent this sequence of events, the LLR must stand ready to accommodate all panic-induced increases in the demand for high-powered money. And this it can readily do since it has a monopoly over its own Bank note component of the monetary base. Expressed in modern terminology, Thornton’s argument was essentially this: The LLR must be prepared to offset falls in the money multiplier arising from panic-induced rises in currency and reserve ratios with compensating rises in the monetary base. By so doing, it maintains the quantity of money intact and therefore also the level of economic activity.

Walter Bagehot’s Contribution

After Thornton, LLR theory received its strongest and most influential exposition in the writings of Walter Bagehot. In his seminal 1873 volume, _Lombard Street_, Bagehot revived and restated many of the points made earlier by Thornton. For example, he emphasized the Bank of England’s special position as the holder of the ultimate reserve. This position, he noted, rendered the central bank different from ordinary commercial banks. It also gave the Bank the power as well as the duty to lend to all solvent institutions offering good collateral in a crisis, the very time when other bankers would be contracting their loans. He also followed Thornton in advocating that the Bank of England hold large buffer stocks of gold reserves from which periodic drains could be met without adversely affecting the quantity of money in circulation. Finally, like Thornton, he distinguished between the appropriate response to internal versus external cash drains. An internal drain, he said, should be countered by a policy of lending freely and vigorously to erase all doubt about the availability of bank accommodation. An external drain, however, should be met by a sharp rise in the central bank’s lending rate, the high interest rate serving to attract foreign gold and encouraging the retention of domestic gold. This rate increase, Bagehot thought, was necessary to protect the metallic component of the monetary base. According to Bagehot (1962, p. 155), “the first duty of the Bank of England was to protect the ultimate cash of the country, and to raise the rate of interest so as to protect it.”

A sufficient gold reserve, of course, was necessary both for the preservation of the gold standard and for the maintenance of public confidence in the convertibility of paper currency into gold. On the potential fragility of public confidence, Bagehot (1962, pp. 156-57) argued that “a panic is sure to be caused” if the gold reserve falls below “a certain minimum which I will call the ‘apprehension minimum.’” It follows that the lender of last resort should strive to keep its gold reserves above this critical threshold.

**Bagehot’s Rule** Bagehot (1962, pp. 27-28) thought that a persistent external drain would trigger an internal drain as the public, observing the diminution of the gold stock and fearing a suspension of convertibility, sought to convert deposits and country bank notes into gold. “Unless you can stop the foreign export,” he said, “you cannot allay the domestic alarm.” In this case, in which “periods of internal panic and external demand for bullion commonly occur together,” the lender of the last resort must “treat two opposite maladies at once—one requiring stringent remedies, and especially a rapid rise in the rate of interest; and the other, an alleviative treatment with large and ready loans.” Therefore, “the best remedy...when a foreign drain is added to a domestic drain” is the provision of “very large loans at very high rates.” Here is the origin of the famous Bagehot Rule: “lend freely at a high rate.”

Like Thornton, Bagehot stressed that last-resort lending should not be a continuous practice but rather a temporary emergency measure applicable only in times of banking panics. Like Thornton, he argued that if the central bank responded promptly and vigorously, the panic would be ended in a few days, by implication an interval not long enough for the paper component of the monetary base to depart significantly from its appropriate long-run growth track.

**Responsibility to the Market** Bagehot also viewed the role of the lender of last resort as primarily macroeconomic. The central bank, he said, bears the responsibility of guaranteeing the liquidity of the whole economy but not that of particular institutions. He prescribed last-resort lending as a remedy for
emergencies affecting the entire banking system, not for isolated emergency situations affecting an individual bank or a few specific banks. Nor did he intend it to be used to prevent very large or key banks from failing as a consequence of poor management and inefficiency. As shown below, he did not think that support of such distressed key banks was necessary to forestall panics. Like Thornton, he emphasized that the task of the central bank was not to prevent initial failures of unsound institutions but rather to prevent a subsequent wave of failures spreading through the sound banks of the system.

More generally, he believed with Thornton that the lender of last resort exists not to prevent shocks but to minimize their secondary repercussions. His views on this point are contained in his analysis of panics. Panics, said Bagehot (1962, p. 61), can be triggered by a variety of exogenous events—a bad harvest, an apprehension of foreign invasions, a sudden failure of a great firm which everybody trusted.” But “no cause is more capable of producing a panic, perhaps none is so capable, as the failure of a first-rate joint stock bank in London” (Bagehot 1962, p. 29). The shock of this initial failure must be contained before it gets out of hand, for “in wild periods of alarm, one failure makes many.” The problem is how to “arrest the primary failure” that causes “the derivative failures.” Bagehot’s solution, quoted below (1962, p. 25), stresses the liberal provisions of liquidity to the whole system rather than loans to the distressed bank:

A panic, in a word, is a species of neuralgia, and according to the rules of science you must not starve it. The holders of the cash reserve must be ready not only to keep it for their own liabilities, but to advance it most freely for the liabilities of others. They must lend to merchants, to minor bankers, to ‘this man and that man,’ whenever the security is good . . . The way in which the panic of 1825 was stopped by advancing money has been described in so broad and graphic a way that the passage has become classical. ‘We lent it,’ said Mr. Harmon, on behalf of the Bank of England, ‘by every possible means and in modes we had never adopted before; we took in stock on security, we purchased Exchequer bills, we made advances on Exchequer bills, we not only discounted outright but we made advances on the deposit of bills of exchange to an immense amount, in short, by every possible means consistent with the safety of the bank, and we were not on some occasions over nice. Seeing the dreadful state in which the public were, we rendered every assistance in our power.’ After a day or two of this treatment, the entire panic subsided, and the ‘City’ was quite calm.

Conspicuously absent is any mention of the need to channel aid to specific institutions, as would be implied by bailout operations. Bagehot’s emphasis is clearly on aid to the market rather than to the initially distressed bank. He obviously did not think it necessary to prevent the initial failure at all costs.

Up to this point, Bagehot has been depicted largely as a follower or disciple of Thornton. But Bagehot did more than just elaborate, refine, and coordinate Thornton’s analysis. He also contributed several original points that added substance to the lender-of-last-resort doctrine and advanced it beyond Thornton’s formulation. At least five of these points deserve mention.

Preannounced Assurance First, Bagehot distinguished between the central bank’s extending support to the market after a crisis began, and its giving assurance of support in advance of an impending crisis. He argued that the lender of last resort’s duty did not stop with the actual provision of liquidity in times of crisis, but also involved making it clear in advance that it would lend freely in all future crises. As Bagehot (1962, p. 85) put it, “the public have a right to know whether [the central bank] -the holders of our ultimate bank reserve -acknowledge this duty, and are ready to perform it.” This assurance alone, he thought, would dispel uncertainty about and promote confidence in the central bank’s willingness to act, thus generating a pattern of stabilizing expectations that would help avert future panics.

Penalty Rate Second, he advocated that last-resort accommodation be made at a penalty rate. Borrowers should have relief in times of crises, but they should be prepared to pay a price that implied a stiff penalty. The central bank has a duty to lend, but it should extract a high price for its loans, a price that would ration scarce liquidity to its highest-valued uses just as a high price rations any scarce commodity in a free market. Moreover, a penalty rate also had the appeal of distributional equity, it being only fair that borrowers should pay handsomely for the protection and security afforded by the lender of last resort. Allocative efficiency and distributive justice aside, the penalty rate, Bagehot claimed, would produce at least four additional beneficial results. First, it would encourage the importation and prevent the exportation of specie, thus protecting the nation’s gold reserve. It would achieve this result by attracting short-term capital from abroad and by exerting a deflationary influence on spending and domestic prices, thereby improving the external balance of trade by spurring exports and reducing imports. Second, consistent with the objective of maintaining stable growth of the note component of the money stock, a penalty rate would ensure the quick retirement of emergency expansions of the Bank note issue once the emergency ends. The very unprofitability of bor-
rowing at the above-market rate would encourage the prompt repayment of loans when the panic subsides, and the resulting loan repayment would extinguish the emergency issue so that the Bank note component of the money stock would return to its noninflationary path. Third, the high rate of interest would reduce the quantity of precautionary cash balances that overcautious wealth-holders would want to hold. Without the high rate to deter them, these cashholders might deplete the central gold reserve. As Bagehot put it, the penalty rate would serve as “a heavy fine on unreasonable timidity,” prompting potential cashholders to economize on the nation’s scarce gold reserve. In this connection, he advocated that the penalty rate be established “early in the panic, so that the fine may be paid early; that no one may borrow out of idle precaution without paying well for it; that the Banking reserve may be protected as far as possible” (Bagehot 1962, p. 97).

Last and most important, the penalty rate would, in addition to rationing the scarce gold reserve, provide an incentive for banks to exhaust all market sources of liquidity and even develop new sources before coming to the central bank. By encouraging individual banks to develop better techniques of money management and the capital market to develop new channels to mobilize existing liquidity, the penalty rate would promote allocative efficiency in the financial system. In short, the penalty rate would protect the gold reserve, minimize deviations of the Bank note component of the money stock from its stable path, allocate resources by market price, discourage reliance on the central bank, and ensure that recourse to the latter’s lending facilities was truly a last resort.

Bagehot’s analysis, it should be noted, implies still another use for the penalty rate: providing a test of the soundness of distressed borrowers. A penalty rate set a couple of percentage points above the market rate on alternative sources of funds would encourage illiquid banks to turn to the market first. Success in obtaining accommodation at the market rate—defined here as the going rate on default-free short-term credit instruments—would indicate that lenders judge these borrowers to be sound risks, for the borrowers and their assets would pass the market test. On the other hand, resort to the central bank at the penalty rate would tend to indicate weakness in the borrowing institutions, suggesting that they may be unable to borrow in the market at the lower rate. Fearing default, private lenders may demand a risk premium in excess of the differential between the risk-free market rate and the penalty rate, forcing the banks to resort to the central bank’s lending facility. Thus, the penalty rate will have provided a test of the banks’ soundness.

Eligible Borrowers and Collateral  Bagehot’s third contribution was his specification of the types of borrowers the lender of last resort should accommodate, the kinds of assets it should lend on, and the criteria it should use to determine the acceptability of those assets. Regarding the types of borrowers, he stated that the Bank of England should be willing to accommodate anyone with good security. Last-resort loans, said Bagehot (1962, p. 25), should be available “to merchants, to minor bankers, to this man and that man.” The objective of the central bank in time of panic is to satisfy the market’s demand for liquidity. It makes little difference, he said, whether this objective is accomplished via loans to merchants, to bankers, or to any other sound borrowers.

Concerning the type of collateral on which the central bank should lend, Bagehot’s answer was clear. The bank should stand ready to lend on any and all sound assets, or, as he put it, “on every kind of current security, or every sort on which money is ordinarily and usually lent” (Bagehot 1962, p. 97). Besides the conventionally eligible bills and government securities, acceptable collateral should include “all good banking securities,” and perhaps even “railway debenture stock” (pp. 97, 101). In another passage he makes the point that the “amount of the advance is the main consideration . . . not the nature of the security on which the advance is made, always assuming the security to be good” (p. 101). The basic criterion was that the paper be indisputably good in ordinary or normal times. The latter qualification is important. It implies that the lender of last resort should not be afraid to extend loans on normally sound assets whose current market value is temporarily below book value owing to depression in the securities market.

To summarize, Bagehot felt that few restrictions should be placed on the types of assets on which the central bank might lend, or the kinds of borrowers it might accommodate. This position was consistent with his advocacy of price as opposed to non-price rationing mechanisms. He recommended that the central bank eschew qualitative restraints—eligibility rules, moral suasion, administrative discretion and the like—and instead rely on the penalty rate to ration borrowing.

Unsound Institutions  Fourth, Bagehot delineated the extent of the lender of last resort’s responsibility to individual banks as distinguished from the banking system as a whole. Concerning the question of
whether this responsibility included assistance to insolvent banks, Bagehot's answer was an unequivocal no. The central bank's duty, he said, is not to rescue "the 'unsound' people" who constitute "a feeble minority." Such businesses, he said, "are afraid even to look frightened for fear their unsoundness may be detected" (Bagehot 1962, p. 97). In short, the job of the central bank is not to prevent failure at all costs but rather to confine the impact of such failure to the unsound institutions.

Bagehot meant for his strictures to apply even to those key banks whose failure, in the absence of central bank action, could shatter public confidence and start a falling-dominoes chain-reaction sequence of financial collapse. Thus, Bagehot (1962, p. 129) acknowledged that if:

owing to the defects in its government, one even of the greater London joint stock banks failed, there would be an instant suspicion of the whole system. One terra incognita being seen to be faulty, every other terra incognita would be suspected. If the real government of these banks had for years been known, and if the subsisting banks had been known not to be ruled by the bad mode of government which had ruined the bank that had fallen, then the ruin of that bank would not be hurtful. The other banks would be seen to be exempt from the cause which had destroyed it. But at present the ruin of one of these great banks would greatly impair the credit of all. Scaircly any one knows the precise government of any one; in no case has that government been described on authority; and the fall of one by grave misgovernment would be taken to show that the others might easily be misgoverned also. And a tardy disclosure even of an admirable constitution would not much help the surviving banks; as it was extracted by necessity, it would be received with suspicion. A skeptical world would say 'of course they say they are all perfect now; it would not do for them to say anything else.'

Even in this case, however, Bagehot did not think it appropriate for the central bank to extend aid to poorly managed key banks. It is, instead, "the 'sound' people, the people who have good security to offer" who constitute "the majority to be protected." The lender-of-last-resort function should not be interpreted to mean that unsound banks should not be permitted to fail. Instead it implies that the failure should not be allowed to spread to sound institutions. To Bagehot, the distinction is crucial. In his words, "no advances indeed need be made" on assets on "which the [central] Bank will ultimately lose." Again, in another passage, he offers assurance that if the lender of last resort "should refuse bad bills or bad securities" it "will not make the panic really worse." To arrest a panic, he says, it is sufficient that the bank guarantee to provide liquidity to the "solvent merchants and bankers" who comprise the "great majority" of the market. This policy ensures that the alarm of the solvent merchants and bankers will be stayed" (Bagehot 1962, p. 97).

Strengthening Self-Reliance Finally, Bagehot warned against undue reliance on the lender of last resort and stressed the need to strengthen individual banks. The lender of last resort, he pointed out, was not meant to be a substitute for prudent bank practices. Consistent with his laissez-faire, free-market philosophy, he argued that the basic strength of the banking system should rest not on the availability of last-resort accommodation, but rather on the resources and soundness of the individual banks. According to Bagehot (1962, p. 36):

[We should look at the rest of our banking system, and try to reduce the demands on the Bank [of England] as much as we can. The central machinery being inevitably frail, we should carefully and as much as possible diminish the strain upon it.

Bagehot (1962, p. 60) described in glowing terms the self-reliant character of a hypothetical decentralized "natural system of banking," composed "of many banks keeping their own cash reserve, with the penalty of failure before them if they neglect it." Elsewhere he pointed out that "under a good system of banking . . . a large number of banks, each feeling that their credit was at stake in keeping a good reserve, probably would keep one; if any one did not, it would be criticized constantly, and would soon lose its standing, and in the end disappear" (Bagehot 1962, p. 52). In relying on its own soundness rather than the resources of the central bank, such a system, he noted, "reduces to a minimum the risk that is caused by the deposit. If the national money can safely be deposited in banks in any way. This is the way to make it safe" (p. 53).

Providing Liquidity via Open Market Operations One final observation should be made concerning Bagehot's views on the central bank's most appropriate instrument to combat panics. Today many banking experts regard open market operations, rather than discount window accommodation, as the most effective way to deal with systemic liquidity crises. Bagehot likely would have agreed. Although he consistently prescribed loans, rather than open market purchases of assets, to stop panics, this was mainly because the latter weapon was not widely used in his day. Had the technique of open market operations been highly developed at that time, he probably would have approved of its use, at least in those cases where there was no danger of the gold stock being depleted by a foreign drain. On these occasions, Bagehot favored resorting to the most expeditious means of stopping an internal cash drain. Open
market operations are quite consistent with his dictum “that in time of panic” the central bank “must advance freely and vigorously to the public . . . on all good banking securities” (Bagehot 1962, pp. 96-97). Moreover, open market operations would have appealed to his preference for market-oriented allocation mechanisms. He would have approved of this particular policy instrument, which regulates the total amount of money but not its allocation among users or uses.²

Conclusion

Thornton and Bagehot believed the LLR had the duty (1) to protect the money stock, (2) to support the whole financial system rather than individual institutions, (3) to behave consistently with the longer-run objective of stable money growth, and (4) to preannounce its policy in advance of crises so as to remove uncertainty. They also advised the LLR to let insolvent institutions fail, to lend to creditworthy institutions only, to charge penalty rates, and to require good collateral. Such rules they thought would minimize problems of moral hazard and remove bankers’ incentives to take undue risks. These precepts, though honored in the breach as well as in the observance, continue to serve as a benchmark and model for central bank policy today.

References


² Note that open market operations would render Bagehot’s penalty rate inoperative. With such operations, however, penalty rates are in any case unnecessary since the market itself rations or allocates newly-created money among cashholders.
Regime-Dependent Sovereign Risk Pricing during the Euro Crisis

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Abstract

We test for regime-dependent dynamics in the sovereign bond markets of European peripheral countries during the debt crisis and explain them. Our estimates based on a panel smooth threshold regression model during January 2006 to September 2012 show: 1) Peripheral sovereign spreads are subject to significant nonlinear dynamics. 2) The deterioration of banking risk changes the way investors price risk of the sovereigns. 3) The spreads of European peripheral countries have been priced above their historical values, given fundamentals, because of amplification effects. 4) A key indicator regulators may want to monitor to check the sovereign tensions is the premium of financial i-Traxx CDS indices. 5) The estimated thresholds to trigger the crisis regime are quite low at less than 200 bp.

Key Words: European sovereign crisis, Panel Smooth Threshold Regression Models, CDS indices.

J.E.L Classification: E44, F34, G12, H63, C23.

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1 Introduction

Financial market participants have a particular taste for locutions that describe the dynamics of asset prices. In 2011, when sovereign spreads for European peripheral countries successively soared, bond market participants asserted the presence of a cliff risk, the point at which a small shift in a bond’s value can have a big impact on its price.¹ A similar pattern was emphasized by policymakers (with different terminology) when they complained about growing mistrust on the part of investors, a fact that drove self-reinforcing dynamics.² A way to picture these comments is to say that the sovereign risk pricing is regime-dependent and subject to threshold effects. It is clear from the first graph in Fig. 1, which plots spreads between 10-year peripheral and German sovereign bonds, that the trend breaks after 2010, a break that is hard to reconcile with the gradual deterioration of economic conditions.³

There has been an extensive body of papers examining the sovereign bond price in the context of the euro crisis and we have learned several important lessons. First, the massive holding of peripheral sovereign bonds by the European banking sector created a dangerous nexus between sovereigns and banks implying feedback loops (Gennaioli et al., 2010, Huizinga and Demirgüç-Kunt, 2010, Acharya and Steffen, 2013, Acharya et al., 2014, Coimbra, 2014). Second, adverse liquidity effects on euro area banks have been documented during the crisis, including a significant fall of inter-bank loans after mid-2010 (Allen and Moessner, 2013). The four first graphs in Figure 2, which plot measures of the liquidity premium, indicate that liquidity conditions in the euro-area did not recover since the sub-prime cri-

¹See for example "Bond investors fear cliff risks.", Financial Times, November 7, 2011.
³In Spain, for example, the public debt amounted to less than 60% of GDP even by end 2009. The Italian primary budget surplus implied that if interest rates had stayed low, only modest fiscal adjustment would have been necessary to service the debt. Unemployment and the trade deficit had been increasing gradually. And Ireland’s trade balance had been improving at the time of the crisis.
sis, with a clear drop in liquidity from 2011 until the Outright Monetary Transactions (OMT) measures. Third, previous empirical work documents a regime-switch in the spread determination model for euro-area peripheral sovereigns during the crisis (Aizenman et al. (2011), Gerlach et al. (2010), Montfort and Renne (2012), Borgy et al. (2011), Favero and Missale (2011)). Two different regimes have been described, a crisis and a non-crisis regime, with additional fundamental factors important in the crisis regime. However the existing papers do not explain what drove the change in regime. Here we explore the possibility that initial shocks on economic fundamentals may have been exacerbated by endogenous mechanisms. We can think of two potential explanations for self-reinforcing effects: the nexus between sovereign and bank risk leading to feedback loop effects and liquidity spirals implying self-amplifying dynamics.

These questions require testing for regime-switching dynamics in bond spread determination and investigating the triggers. To do so, we use the smooth transition regression model developed by Terasvirta (1996) and developed in panel by González et al. (2005). Contrary to the alternative family of nonlinear models, the Markov-switching (MS) models, the STR model offers a parametric solution to account for nonlinearity by allowing the parameters to change smoothly as a function of an observable variable (MS specifications assume that the transition is discrete and the trigger variable is unobserved). In other words, we take an off-the-shelf model estimating the impact of economic fundamentals on the spread of sovereign bonds, and we consider potential threshold variables to account for the time variability of the estimated coefficients. We interpret increasing weights in the spread determination as amplification effects in the sense that the same change in a fundamental has a higher impact on the spread in the crisis period than it had previously. Then we follow Gonzalez et al. (2005) to identify the optimal threshold variable. In sum, our panel threshold regression framework establishes a ranking among hypotheses that might give rise to amplification effects (Fouquau et al. 2008). We estimate equations for the sovereign spreads of five European stress countries: Spain, Ireland, Italy, Portugal and Greece, over the period January 2006 to September 2012. We
deliberately end our sample at the beginning of the OMT programme that has successfully narrowed the spreads and blurred market signals.\footnote{As Paris and Wyplosz (2013) have argued, "Spreads no longer show us what investors think about debt sustainability. They reflect a mix of debt-sustainability expectations and forecasts of ECB reactions".}

A preview of our results is the following. We confirm that sovereign spreads are subject to significant nonlinear dynamics. While we unambiguously detect adverse self-reinforcing liquidity effects, our tests reveal that the banking-sovereign nexus is the leading driver of nonlinearities. The deterioration of market conditions for financial names changes the way investors price risk of the sovereigns. We compute the threshold value that triggers amplification effects in the spreads of the five stress countries, with heterogeneous dynamics that our PSTR approach enables us to capture.

Our work complements earlier research on sovereign credit risk during the euro crisis (Acharya et al. 2013, Attinasi et al. 2009, Dieckman and Planck, among others). We show that market liquidity and banking credit risk not only are significant drivers of sovereign risk but they contribute to it in a nonlinear manner. They actually exacerbate the effect of initial shocks to the fundamentals as theory predicts. We show that aggregate financial variables have a larger impact than country specific variables on the risk-pricing of domestic debt, a result that emphasizes the issues of maintaining an incomplete monetary union.

The remainder of this paper is organized as follows. Section 2 reviews the abundant literature on sovereign bond pricing during the euro-crisis in order to narrow down our contribution. Section 3 introduces the PSTR specification methodology and the test procedure. Section 4 summarizes our data-set, and Section 5 discusses the estimation results. Section 7 sums up the findings and draw lessons for the economic policy.
2 Sovereign risk pricing: what have we learned?

There has been an extensive body of papers examining the sovereign bond price in the context of the euro crisis. On the one hand, there is a consensus about a sovereign-banking nexus implying feedback loops in the dynamics of the sovereign spreads. Acharya et al. (2014) has explicitly modeled the feedback loop. The deterioration of the sovereign’s creditworthiness feeds back onto the financial sector, reducing the value of its guarantees and existing bond holdings and increasing its sensitivity to future sovereign shocks. On the other hand, bank risk affects the sovereigns, which are expected to bail out systemically important institutions. That represents a significant risk given the size of banks compared to the size of the public backstop. Coimbra (2014) shows how the initial shock is exacerbated and feeds back to credit conditions. After a rise in sovereign risk, the banks’ VaR constraint binds, which reduces their demand for sovereign bonds, thereby raising the sovereign risk premium. This in turn leads to adverse sovereign debt dynamics, which raises sovereign risk.

Attinasi et al. (2009) empirically confirm the effect of the bank-sovereign nexus in a model of government bond yield spreads over Germany of 10 European countries. They find that government bond yield spreads are significantly affected by the announcements of bank rescue packages in addition to standard measures of government creditworthiness. Acharya et al. (2013) find that credit default swap (CDS) spreads of banks and those of governments tend to move more closely together after the announcement of financial sector bailouts.  

On the other hand, liquidity spirals have played an important role during the euro crisis. More precisely liquidity spirals occurs when an initial
shock on sovereign bonds degrades the quality of collateral, a fact that forces banks to sell off bonds to regain liquidity or restore their capital ratio, reinforcing the initial downgrading. As an example of a fire-sale driven by more restrictive collateral requirement, in November 2010, a sell-off in Irish bonds was driven by a fire sale of positions by market participants who were unable to meet collateral requirements. Pelizzon et al. (2014) have documented a similar spiral on the Italian sovereign bond market. They find threshold effects in the dynamic relationship between changes in Italian sovereign credit risk and liquidity: there is a structural change in this relationship above 500 basis points (bp) in the CDS spread because of changes in collateral and margins for Italian bonds. Brunnermeier et al. (2009) have theoretically modeled the liquidity spirals. The pricing of debt becomes more "information sensitive", and safe assets become less safe, so investors are more selective about the quality of assets they accept as collateral. Their demand for the sovereign bonds that are perceived to be more risky declines, thereby raising the sovereign risk premium. So there is a liquidity spiral: a falling sovereign bond market leads financial intermediaries to fly to liquidity, and this amplifies the effects of the initial price reduction. Relatively small shocks can cause liquidity suddenly to dry up, leading to a major correction of asset prices (Brunnermeier and Pedersen, 2009).

In total, we have learned that banking credit risk and liquidity deterioration exercised a negative influence on sovereign credit risk during the euro crisis. However the theoretical models mentioned above rather point to amplification effects where both risks exacerbate the effect of shocks to the determinants on risk-pricing. Therefore we think that handling these variables like extra determinants on the rhs of sovereign risk-pricing model is misleading. In this work, we will test the hypotheses that the deterioration of banking risk and liquidity shocks have self-reinforcing effects on sovereign pricing. Before proceeding, we conclude the review of the literature by examining existing evidence of nonlinearities in the Euro-area sovereign bond

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6“Irish bond yields leap after selling wave”, Financial Times, 10 November 2010.
7Stiglitz (1982) and Geanakoplos and Polemarchakis (1986) initially pointed out this externality.
Several papers have pointed to important nonlinearities in the risk-pricing of European countries. Yet, no one offers a satisfying framework to explain regime-shifts, time-varying determinants weights in the relationship and more importantly to relate them to the influence of financial variables. Several empirical papers find a regime-switch in the spread determination model for euro-area peripheral sovereigns during the crisis (Costantini et al., Aizenman et al. (2014), Gerlach et al. (2010), Montfort and Renne (2012), Borgy et al. (2011), Favero and Missale (2011)). For example, Costantini et al. (2014) find evidence for a level break in the cointegrating relationship of sovereign bond yield spreads in nine economies of the European Monetary Union. They also find significant differences in the coefficient weight of fiscal space in determining sovereign risk in peripherals versus core EMU members. They attribute this difference to the fact that international investors perceive which EMU member legitimately entitles for Optimal Currency Area member. As intellectually appealing it may be, their interpretation cannot be tested in their empirical framework because it does not allow them to test the potential drivers of observed nonlinearities. Our objective in this paper is to relax linearity and allow the spread determination model to change according to an observable signal that sets off amplifying spirals. In the following Section, we describe our empirical strategy to do so.

3 Empirical strategy: specification and estimation

We estimate sovereign bond spread determination using a panel smooth threshold regression (PSTR) model developed by González et al. (2005). The choice of panel data is motivated by the low time dimension of macroeconomic data. The PSTR model allows us to characterize nonlinearity as a function of an observable variable. More precisely, the sovereign spread can be estimated as follows:

\[ S_{it} = \mu_i + \beta'_1 X_{it} + \beta'_2 X_{it} g(q_{it}; \gamma, c) + u_{it} \]
for $i = 1, \ldots, N$ and $t = 1, \ldots, T$ where $\mu_i$ represents individual fixed effects, $X_{it}$ is a set of variables that capture credit risk, liquidity risk and international risk aversion and $u_{it}$ are i.i.d. errors. $g(.)$ is a continuous transition function bounded between 0 and 1. We use a logistic function of order 1 that has an S shape:

$$g(q_{it}; \gamma, c) = \frac{1}{1 + \exp[-\gamma(q_{it} - c)]}, \text{ } \gamma > 0,$$

where $q_{it}$ is the observable threshold variable. The $\gamma$ parameter determines the smoothness, i.e., the speed of the transition from one regime to the other, and $c$ the location parameter, which shows the inflexion point of the transition. The higher the value of the $\gamma$ parameter, the faster (i.e., sharper) the transition. This specification allows a smooth transition between two extreme regimes defined by the vectors $\beta_1'$ and $\beta_1' + \beta_2'$. For example, if we take a threshold variable that proxies flight to liquidity, the higher this proxy, the closer the coefficient gets to $\beta_1' + \beta_2'$. The PSTR model is a way to account for individual heterogeneity (Fouquau et al., 2008).

The estimation of the PSTR model consists of several stages. In the first step, a null hypothesis of linearity is tested against the alternative hypothesis of a threshold specification. Then, if the linear specification is rejected, the estimation of the parameters of the PSTR model requires eliminating the individual effects, $\mu_i$, by removing individual-specific means and then applying nonlinear least squares to the transformed model (see Gonzále et al., 2005).

In the Gonzále et al. (2005) procedure, testing linearity in a PSTR model (equation 1) can be done by testing $H_0 : \gamma = 0$ or $H_0 : \beta_0 = \beta_1$. In both cases, the test is non-standard since the PSTR model contains unidentified nuisance parameters under $H_0$ (Davies, 1987). The solution is to replace the transition function, $g(q_{it}; \gamma, c)$, with its first-order Taylor expansion around $\gamma = 0$ and to test an equivalent hypothesis in an auxiliary regression. We then obtain:

$$S_{it} = \mu_i + \theta_0 \ X_{it} + \theta_1 ^* \ X_{it} q_{it} + \epsilon^*_{it}.$$

(3)
In these auxiliary regressions, parameter $\theta_1$ is proportional to the slope parameter $\gamma$ of the transition function. Thus, testing linearity against the PSTR simply consists of testing $H_0 : \theta_1 = 0$ in (3) for a logistic function with the usual LM test. The corresponding $LM$ statistic has an asymptotic $\chi^2(p)$ distribution under $H_0$.

Before proceeding to the estimation, we present our data.

4 Data description

In this Section we present our dataset and sources used to estimate the linear model of sovereign bond spreads and to construct the threshold variables that capture the forces described in Section 3.

The estimation of the model of Eq.(1) is subject to two major data constraints. On the one hand, macroeconomic fundamentals have a low frequency (annual, quarterly or monthly), while our financial data are daily. Therefore we transform all series to monthly data. We calculate the monthly average of the daily series and we transform quarterly to monthly using a local quadratic transformation with the average matched to the source data\(^8\).

On the other hand, the sovereign crisis started in late 2009, and the Oughtright Monetary Transactions (OMT) program implemented in September 2012 successfully narrowed the spreads and blurred market signals. So we have only three years during which the hypothesized transition might have occurred. Therefore, to obtain a sufficient number of observations, our estimation is based on a balanced panel of the five peripheral European countries in which the sovereign yield has been most under pressure (Greece, Ireland, Italy, Spain and Portugal) between January 2006 and September 2012.

4.1 Determinants of the sovereign bond spread

Our dependent variable is the sovereign bond spread, which prices the default risk of a country. It is defined as the difference between the sovereign bond yield and the risk-free rate of the same maturity. For each country

\(^8\)We used Eviews software for this transformation.
in the sample, we use the long-term German yield, which is the benchmark risk-free rate for the Euro area (Dunne et al., 2007), and the government yield of this country at the same maturity. We rely on daily observations of 10-year bond yields provided by Bloomberg, from which we compute a monthly average\(^9\). All data described in this Section are plotted in Figure 1.

A key choice is the set of explanatory variables included in \( X_t \) in Eq (1). The government bond yield spread represents the risk premium paid by governments relative to the benchmark government bond\(^10\). From a theoretical perspective, these instruments can be priced by decomposing the risk premium into credit risk and liquidity risk. Credit risk is influenced by variables that affect the sustainability of the debt and the likelihood of repayment. For a sovereign entity, these are macroeconomic variables determining internal and external balances, more precisely variables important in determining the budget deficit and the current account. The empirical evidence in the euro area context suggests that significant determinants include fiscal variables, activity-related and competitiveness-related variables (see Attinasi et al. 2009, Haugh et al. 2009, De Grauwe and Ji, 2012). Liquidity risk is related to the size of the issuer, with an expected negative relationship due to larger transaction costs in small markets. In contrast with findings on credit risk, empirical evidence is mixed about the pricing of a liquidity premium in the sovereign bond spread\(^11\). Beyond these two theoretical risk premia, Longstaff et al (2011) find that a large component of sovereign credit risk is linked to global factors, while Ang and Longstaff (2013) find that the systemic default risk of European countries is highly correlated to financial market variables.

Drawing on previous works, we therefore test the following variables:

\(^9\)For Ireland only 8-year bond yields are available, so we computed the spread using the 8-year German yield.


\(^11\)For example, Geyer et al. (2004) finds that liquidity plays a minor role for the pricing of EMU government yield spreads. Favero et al. (2009) find that investors value liquidity, but they value it less when risk increases.
debt-to-GDP ratio, deficit, unemployment, unit labor cost, risk, liquidity.

We include the debt-to-GDP ratio and fiscal deficit from Eurostat. We add the squared value of the debt-to-GDP ratio to capture non-linear dynamics that might be due to threshold effects of sovereign debt on real growth. The fiscal data are revised data, necessary because of the presence of Greece in the sample, although these are not the data initially observed by market participants. Other relevant variables are economic activity and the country’s competitiveness. We proxy economic activity using the unemployment rate rather than GDP to avoid collinearity with the debt-to-GDP ratio. The unit labor cost and trade balance are included to proxy the country’s competitiveness.\(^{12}\) Second, we include a variable for liquidity risk, proxied as the bid-ask spread of the dependent variable and alternatively measured by market size, as the country’s share of total outstanding Euro-denominated long-term government securities issued in the Euro zone. Data are available on a monthly basis from the European Central Bank (ECB), while the bid-ask spread is taken from Bloomberg. Third, we include the CBOE Volatility Index (VIX) as a measure of international risk aversion, because it is often considered by many to be the world’s premier barometer of investor sentiment and market volatility (\textit{e.g.}, Rey, 2013).\(^{12}\)

Last, we control for the effect on peripheral spreads of non-standard monetary measures adopted by the ECB during the crisis. In May 2010, the ECB decided to start the Securities Markets Programme (SMP) with large securities purchases in order to address tensions in certain market segments\(^{13}\). We use the amount of securities held for monetary purposes (divided by 100), as shown in the ECB’s weekly financial statements, and including Securities Market Program, 1st and 2nd Covered Bond Purchase Programs (available in ECB Statistical Data Warehouse)\(^{14}\).

\(^{12}\)All data are available at a quarterly frequency, except for unemployment (monthly) and fiscal deficit (annual).

\(^{13}\)The SMP was terminated in September 2012 in favour of Outright Monetary Transactions (OMTs) in sovereign secondary bond markets.

\(^{14}\)On the other hand, the ECB provided in December 2011 and March 2012 more than 1 trillion Euros of additional liquidity to the financial system with the very long-term refinancing operations (LTRO). Unfortunately publicly available data are not broken down
4.2 Endogenous drivers of nonlinearities, two hypotheses

We present the set of financial data used to capture our two hypotheses presented in Section 2. They represent the set of threshold variables that we will include alternatively in our nonlinear estimations in the next Section. We propose several alternatives in order to check the robustness of our results. In the following Section, we will explain how we select the optimal threshold variable. All threshold variables are plotted in Fig. 2.

1. Feedback loop from banks to sovereigns

- CDS prices are a reliable measure of risk as they are precisely the premium an investor must pay to hedge the risk or express a credit view of a reference entity. CDS indices are baskets of single CDS covering specific sectors. Therefore the most straightforward measure of financial risk is the price of CDS indices covering the financial risk in the euro-area, \(SenFin\) and \(SubFin\), both being in the family of the i-Traxx Europe, a broad tradable credit default swap family of indices.

Second, we construct disaggregate indicators of uncertainty and stress in the banking sector borrowed from an aggregate indicator of systemic risk designed by the Kansas Fed (Hakkio and Keeton, 2009). More precisely, we compute components of their indicator with European data:

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by country, which makes the inclusion of the data composed of two observations irrelevant in our panel estimates.

\(^{15}\)The main advantages of these new classes of credit derivatives are standardization and liquidity, which explain their growth. CDS indices accounted for 43% of gross notional amount of the CDS market in December 2012, up from 20% in 2004 (Vause, 2011). CDS trading has continued to grow after 2007 (IOSCO, 2012). At the end of 2012, the gross notional value of outstanding CDS contracts amounted to approximately 25 trillion US dollars, and the corresponding net notional value to approximately 2.5 trillion US dollars. The fact that the gross notional value of the CDS contracts has more than halved since the peak of 2007 (with 60 trillion US dollars) is mostly attributed to the development of compression mechanisms that eliminate legally redundant contracts (Vause 2011).
• *IVolbank* denotes the idiosyncratic volatility of bank stock prices. It serves as an equivalent of the VIX for the banking industry rather than for the corporate sector as a whole. It is computed as the standard deviation of residual returns from a CAPM regression using an aggregate European banking sector price index and the S&P Europe 350 taken from Datastream.

• *CMAXFin* is an indicator of stress widely used by market practitioners to identify periods of extreme price declines (Patel and Sarkar (1998)). We take the five domestic banking stock indices from Datastream and calculate *CMAXFin* as the maximum cumulated index losses over a moving two-year window with 

\[ Cmax_t = 1 - \frac{P_t}{\max[P_{t-24},...,P_t]} \]

The more bearish the market, the closer to 1 the indicator.

• An additional useful indicator of stress in the banking system is the *Euribor-OIS spread*, calculated as the difference between the Euro Interbank Offered rate and the overnight indexed swap rate. This indicator must be taken with some caution because of the alleged manipulation of the Euribor rate.

2. **Negative externality due to fire-sale liquidation**

We calculate standard indicators of *flight to liquidity* complemented by indicators of *flight to quality* and *asymmetry of information* because they occur simultaneously during a liquidity run and strengthen self-amplifying dynamics (as put in Section 2).

• *Aaa/10-year Treasury spread* denotes the spread between European corporate bonds rated Aaa and the 10-year German Treasury bond. It is a standard measure of liquidity premium, because even the highest-rated corporate bonds tend to be less liquid than Treasury securities. All corporate bond indices are Markit i-boxx European corporate bonds, taken from Datastream.

• *High-yield bond/Baa spread* denotes the spread between "junk
bonds”, i.e. bonds with too low a rating to be considered investment-grade, and Baa-rated corporate bonds, the lowest-rated bonds considered as investment-grade. High-yield bonds are issued in smaller quantities and traded by a limited set of investors (institutional investors are banned from the market) in comparison with Baa-rated bonds, implying a liquidity premium to compensate investors for holding the less liquid asset.

- **10-year swap spread.** The fixed-rate payment leg of a swap is expressed as the Treasury yield plus a spread that compensates investors for the fact that claims on fixed-rate payments are considerably less liquid than Treasury securities.

- **StockbondsCorr** proxies *Flight to quality* by measuring the correlation between domestic stock total return indices and the total return German Treasury index. It is well-documented that the correlation between stock and government bond returns is usually significantly negative during financial crises, because investors consider government bonds safer (Andersson et al. 2008). We compute the correlation over rolling three-month periods using the domestic stock index of each country of our panel and the 10-year German government bond index taken from Datastream. We use the negative values of the correlations, so that an increase in the measure corresponds to higher *flight-to-quality*.

- **Cross-section dispersion bank** computes the cross-section dispersion of bank stock returns to capture uncertainty about the relative quality of banks and to proxy *asymmetry of information*. The intuition is that the larger the cross-section dispersion, the larger proportion of returns is unexpected, so the larger the information asymmetry. It is calculated using daily data on the S&P Europe 350 and the stock prices of the 82 largest commercial banks in terms of market value\textsuperscript{16}.

\textsuperscript{16}More precisely we estimate a CAPM regression of the daily return on each bank’s stock index against the daily return on the S&P Europe 350 index, using data for the previous
3. Control Variables

Last, we control for an overall effect of uncertainty and stress outside the banking sector by including indicators on non-financial sectors:

- **i-Traxx Europe** comprises the most liquid 125 CDS referencing European investment grade credits
- **X-over** comprises the most risky 40 constituents
- **HiVol** is a subset of the main Europe index consisting of what are seen as the most risky 30 constituents
- **Vstoxx** is the European equivalent of the VIX, considered by many to be the leading measure of market volatility\(^\text{17}\).
- **FTSE300** and **S&P350** denote the returns of the European aggregate stock market indices
- **DomesticIndex** is the matrix of the domestic stock returns indices of the five countries in our panel (PSI, IBEX, ATHEX, FTSEMIB, ISEQ).
- **RvolGerm** captures bond market volatility using the 10-year German government bond index. It is the realized volatility computed as the monthly average of absolute daily rate changes.
- **Rvol Nonfi** is the realized volatility of domestic non-financial sector stock market indices taken from Datastream.
- **Rvoldollar, Rvolyen** and **Rvolfpound** are the realized volatility of three bilateral euro exchange rates for the US dollar, the Japanese yen and the British pound respectively.

Looking at the set of threshold variables plotted in Fig. 2, we see that most variables experienced a first peak during the subprime crisis, followed

\(^\text{12 months. The estimated coefficients are then used to calculate the forecast errors of the current month. Last we calculate the interquartile range for these residuals in order to keep the central 50%. The lower the interquartile value, the smaller the dispersion across banks.}\)

\(^\text{17We use Vstoxx to proxy the European market volatility, while we use VIX to capture international risk aversion.}\)
by a second peak due to the sovereign debt crisis in Europe. Thus our financial series capture two episodes of crisis, contrary to our dependent variable, which is mostly affected by the second episode. This pattern represents a methodological challenge to detect the drivers of nonlinearity during the European crisis. In the following, we present our results.

5 Estimation results: Nonlinear dynamics in the European sovereign market.

We recall that the PSTR specification of the spread is as follows:

\[ S_{it} = \mu_i + \beta'_1 X_{it} + \beta'_2 X_{it} g(q_{it}; \gamma, c) + u_{it} \]

for \( i = 1, ..., n \) and \( t = 1, ..., T \), \( X \) represents the vector of determinants, \( \mu_i \) the country fixed effects, \( g(\cdot) \) the threshold function, \( q_{it} \) the threshold variable, \( \gamma \) the smooth parameter, \( c \) the location parameter.

5.1 Selection of the optimal linear model

First, we proceed to the linear estimation using a panel estimation with fixed effects. The first step is to select the optimal linear model. We use alternative series in the vector of explanatory variables and select the optimal combination based on standard selection criteria. Results displayed in Table 1 suggest that our specifications are robust with similar estimated values in different specifications. The information criteria suggest that specifications 1 and 2 could both be considered as optimal (Schwarz = 0.207, AIC = 0.197), and we keep specification 2 which is the most parsimonious.

With a negative and a positive coefficient respectively, the evolution of the sum of Debt and squared Debt is ambiguous, while trade balance is not significant. As expected, unemployment and international risk aversion have an upward impact on the spread: a rise in unemployment and in the VIX increase the sovereign spread. Liquidity effects are properly captured by our
measures based on the bid-ask spread (an increase in the bid-ask spread increases the sovereign spread) and volume (a reduction of outstanding issues increases the spread). We keep both in the vector of determinants because information criteria are systematically better when both measures are included. In addition, as in other studies (De Grauwe and Ji, 2012, Wyplosz, 2013), we find that competitiveness is not relevant: the unit labor cost has an unexpected sign (higher labor cost reduces the spread) while the trade deficit is never significant. Last, in all specifications the unconventional monetary measures adopted by the ECB have a significant effect.

In the following we adopt a parsimonious approach and proceed to the tests and nonlinear estimation of specification 2.

5.2 Linearity tests: the prominent role of the feedback loop

In the second step, we test this linear specification of the spread (spec 2) against a specification with threshold effects.

The linearity test results reported in Table 2 clearly reject the null hypothesis of a linear relationship, regardless of which threshold variable is included in the specification. The remarkably high level of rejection in most models makes the presence of nonlinear dynamics unambiguous. This is consistent with previous empirical work and makes it clear that linear models of sovereign spreads are misspecified. Now, we would like to identify the prominent determinants of bond pricing shifts. To do so, we select the best threshold variables, which as suggested by González et al. (2005), is that which leads to the strongest rejection of the linearity hypothesis. Given the high rejection statistics obtained in every model, we check the robustness of our selection choice using BIC information criteria which yield overall consistent results (see Table 2 bis).

The ranking of the test statistics reveals that the feedback loop hypothesis unambiguously stands out with $C_{max}Fi$, $CDSSurFin$, $CDS_{SubFin}$, Euribor-OIS and $IVolBank$ rejecting linearity (with 194.2, 148.3, 130.9, 17
119.4 and 116.2 respectively). It is interesting to observe that indicators of uncertainty about the non-financial sector, \( rvol\ NonFin\) and \( rvol\ Germ\), rank among the last with low statistics (39.5 and 30.4 resp.).

In sum, investors are sensitive to the risk in the banking sector, and this triggers nonlinear dynamics. While the sovereign-nexus has been well-documented before, we are the first to give a functional form to the subsequent amplification effects. More precisely, the pricing model is a nonlinear function of fundamentals, where the weight of these fundamentals varies with the risk of banks (we examine the evolution of the estimated coefficient below). The deterioration of market conditions for banks changes the way investors price risk of the sovereigns.

Second, we can not reject the hypothesis of adverse effects due to fire-sale liquidation, which also gets empirical support with LM statistics from 51.2 to 111.4. *Flight to liquidity, Flight to quality* and *asymmetry of information* have been unambiguously relevant factors of amplification in the European sovereign debt crisis. Nevertheless, our empirical strategy ranks the influence of both hypothesis and concludes that the sovereign-nexus was prominent in driving nonlinearities.

Last the tests reveal that the volatility of different market segments play a less significant role in nonlinear dynamics. While the volatility of FTSE and S&P get a fairly high rejection statistics (111.8 and 111.6), other volatility measures such as Vstoxx do not confirm the effect of overall volatility (LM= 64.2). This suggests that aggregate equity indices correlate with bank stocks indices and thus convey a similar information. Volatility of the foreign exchange market is less relevant (\( rvol\ Pound\), \( rvol\ Doll\) and \( rvol\ Yen\) get 49.5, 40.0 and 43.9 resp) probably because intra-Euro zone, not extra-Euro zone capital transfers have been relevant since 2010 (IMF, 2012a). Peripheral countries have suffered massive capital flight back to the core countries, resulting in monetary fragmentation of the euro-zone. But the aggregate external position of the eurozone has not deteriorated significantly.

\(^{18}\)The BIC information criteria confirm the selection, see Table 2 bis
In the last step of our empirical investigation, we estimate the models to compute the threshold values triggering regime switch and the variation of coefficient loads.

### 5.3 Heterogeneity in the sample

Table 3 reports the linearity test statistics, the smooth parameter, $\gamma$, the location parameter $c$ and the residual sum of squares in the three specifications that best reject linearity.

According to the selection criteria of González et al. (2005), the indicator of stress in the banking sector, $C_{maxFi}$, is the optimal threshold variable because it rejects linearity with the highest statistics. This is also confirmed by the information criterion (Schwarz : $-0.485$) in this specification the smooth parameter is high ($\gamma = 111.4$), implying a sharp transition between two extreme regimes. However, a thorough investigation indicates that this variable $C_{maxFi}$ captures the heterogeneity in our sample. In fact, Italy, Spain and Portugal remain exclusively in the first regime (in these countries $C_{maxFi}$ is always lower than the estimated location parameter $c = 0.819$ as shown in Fig 2, graph entitled max Financials), while Ireland and Greece went from the first to the second regime (47 and 12 observations respectively as shown in Fig 2). Heterogeneity in the sample is confirmed also in the specification including an individual threshold variable, $I_{vol Bank}$, with similar patterns: the transition is sharp ($\gamma = 141.0$), and only Ireland and Greece went from the first to the second regime (27 and 12 observations respectively as shown in Fig 2, graph $I_{vol Bank}$).

Therefore, while the five peripheral countries are usually gathered in the same bundle, our estimates suggest that their spreads have a different dynamics. 19 This finding leads us to split our sample into two sub-samples, one including Italy, Spain and Portugal, the other Greece and Ireland. The

---

19 González-Hermosillo and Johnson (2014) also point out heterogeneous dynamics in the sovereign CDS of the five stressed countries.
smaller sub-sample still has 162 observations, which is sufficient for reasonably precise and stable estimates.

We re-estimate the model in each sub-sample (Table 4) and find that linearity is strongly rejected again with a slightly different ranking from the full sample. What is the threshold value and how do elasticities change? To answer, we estimate $\hat{\beta}_1$ and $\hat{\beta}_2$ in Eq. (4) and we compare the determinants coefficients before and after the transition, $\hat{\beta}_1$ and $\hat{\beta}_1 + \hat{\beta}_2$ respectively. We adopt a general-to-specific modeling approach where we eliminate non-specific variables based on their statistical significance and the Schwartz information criterion.

5.3.1 Italy, Portugal and Spain

Results in Table 5 report the estimated coefficients in regime 1 and regime 2 ($\hat{\beta}_1$ and $\hat{\beta}_1 + \hat{\beta}_2$). First, it indicates that the transition from the first to the second regime is sharp ($\gamma = 53.7$) and the threshold value, $c$ is 135.7 bp. Our model predicts that investors price the sovereign risk differently when the financial CDS index is over 135.7 bp. It is worth noting that this value was crossed in autumn 2010 just after the Greek crisis broke. Now we examine the variation of the coefficient. Recall that amplification can be modeled through increasing weights in the spread determination.

Our estimates suggest amplification effects that operate in regime 2 through a much stronger influence on the spread of all macroeconomic determinants: debt, fiscal balance and unemployment as well as the international risk aversion ($|\hat{\beta}_1 + \hat{\beta}_2| > |\hat{\beta}_1|$). In other words, when the price of iTraxx CDS SnrFin exceeds 135.7 bp, the weight of these fundamentals increases

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20In fact, in both samples, CDSSnrFin and CDS Sub-Fin best reject linearity (LM =88.2/82.8 and 67.3/61.9 resp), while CmaxFi ranks lower. This result confirms that the individual variable CmaxFi was mostly capturing heterogeneity in our previous estimates (as was IvolBank). In turn, CDS SnrFin and CDS Sub-Fin, which are two homogeneous variables, account for the time-instability in the spread determination model.

21In the alternative model $\gamma = 2.18$ which corresponds to a sharp transition too, see Table 5.
in the determination model, so the shocks to fundamentals have more effect on the bond spread. It is worth observing that the coefficients in the second regime are much larger, often more than twice as much as in the first regime. In sum, we detect sizable amplification effects.\textsuperscript{22} Last, we observe that the influence of the SMP program has not changed during the crisis.

5.3.2 Greece and Ireland

Results of the second sub-sample including Greece and Ireland are reported in Table 7. Transition is sharp and the threshold value is 155 bp, a value similar to the previous sub-sample.\textsuperscript{23} However, the dynamics differ here because amplification effects operate through a stronger influence of unemployment only. In turn, the effects of debt and squared debt compensate for each other, while the effects of the VIX and of the bid-ask spread are positive, as expected, but they remain stable in the second regime. As in the linear estimate, the unit labor cost has the same unexpected sign. An interesting difference is that contrary to the previous sample, we observe that the SMP has a negative effect on the spread in the second regime ($\hat{\beta}_1 + \hat{\beta}_2 < 0$). In other words, our estimates suggest that the bond purchases carried out by the ECB have counterbalanced amplification effects on the bond spreads of Greece and Ireland.

\textsuperscript{22}In turn, the influence of liquidity is ambiguous because the coefficients of both variables capturing liquidity show two contrary movements in regime 2: we find a stronger negative influence of the relative stock of outstanding debt (implying that a deterioration of liquidity affects the spread more in regime 2 than in regime 1), while the influence of the bid-ask spread is lower in the second regime ($|\hat{\beta}_1 + \hat{\beta}_2| > |\hat{\beta}_1|$, implying that a rise in the bid-ask spread affects the spread less in regime 2). In addition, we observe that the sign on unit labor cost is contrary to the expected sign, as in the linear estimates (see Table 1). As in the linear estimates, models excluding this variable have a lower RSS, so we decide to keep it in the vector of explanatory variables.

\textsuperscript{23}The transition speed depends on $\gamma$ and the distance between the threshold variable and the threshold parameter $c$. Despite the low value of the slope parameter ($\gamma = 0.43$), the fact that CDS indices increase strongly during the crisis implies that the transition from one regime to the other is fairly fast, as in the other sub-sample.
Robustness

To check the robustness of our estimates, we proceed to alternative estimates. In the first sub-sample (including Italy, Spain and Portugal), overall amplification effects are confirmed when $C_{max \text{ Fin}}$ is used as a threshold variable in an alternative specification (see Table 6).\textsuperscript{24} Second, financial CDS and sovereign bonds may price the same information, which would raise an endogeneity bias due to simultaneity. To address this, we re-estimate our optimal model by lagging the threshold variable. Linearity is rejected with a similar statistic ($LM = 63.2$ versus 62 in the core estimate), and amplification effects are confirmed. Last, we check that our nonlinearity finding does not result from omitting the financial CDS index as an explanatory variable. Our results are not affected by the introduction of the financial CDS index in the vector of determinants ($X_{it}$ in Eq. 4), a result that confirms that this variable nonlinearly affects the sovereign bond pricing.\textsuperscript{25}

In the second sub-sample (including Greece and Ireland), we proceed to the same alternative estimates reported in Table 8. Model 1 confirms the stronger influence of debt and unemployment and indicates a stronger influence of liquidity, a result not uncovered in the core estimates. The downward influence of the SMP is confirmed too.

6 Concluding remarks

We estimated the sovereign spread of five peripheral members of the euro-area using panel non-linear estimation methods. Our objectives were threefold: 1) test for nonlinear sovereign bond pricing 2) discriminate between two potential drivers of non-linearity, sovereign-bank nexus and liquidity spirals and 3) quantify the threshold effects and coefficient regime shifts in order to draw lessons for economic policy.

\textsuperscript{24}We observe that the combined influence of debt and squared debt increases in regimes 2 as well as the weight of fiscal balance and unemployment. Only the influence of VIX, which is found to be stable, differs from the core estimate.

\textsuperscript{25}Results available on request.
Our PSTR estimations confirm that investors have priced the European sovereigns differently since Fall 2010. The increasing risk in the banking sector was not only a significant determinant of sovereign risk but it amplified the initial shock on fundamentals. A key indicator the ECB may want to monitor to check the sovereign tensions is the premium of financial i-Traxx CDS indices. The estimated thresholds to trigger the crisis regime are quite low at less than 200 bp. We document amplification effects due to liquidity spirals too, although to a lesser extent. In addition, while we find unambiguously strong amplification dynamics in the sovereign bonds of Italy, Spain and Portugal, we find lower effect in Greece and Ireland. It suggest that the latter are mostly facing domestic issues while the three other peripherals are highly vulnerable to a shock at the aggregate European level. In these three countries, the elasticity of sovereign yield to a variation of most fundamental more than doubles in the crisis regime. Why should we care? Because it suggests that addressing domestic fiscal imbalances and real economy issues will lower down sovereign tensions only when the aggregate banking-sovereign nexus is definitely cleaned out. Doubts unfortunately persist about the ability of the modest banking union recently adopted to restore banking stability.

References


20. Davies R.B. "Hypothesis testing when a nuisance parameter is present only under the alternative", *Biometrika* 74, 33-43 (1987).


52. Páris P., and Wyplosz C. , ”To end the Eurozone crisis, bury the debt forever”, voxEU, 6 August (2013).


Table 1: Selection of the optimal linear model

<table>
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<tr>
<th></th>
<th>spec 1</th>
<th>spec 2</th>
<th>spec 3</th>
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<th>spec 5</th>
<th>spec 6</th>
<th>spec 7</th>
<th>spec 8</th>
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<td>-0.128***</td>
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<td>-0.213***</td>
<td>-0.128***</td>
<td>-0.165***</td>
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<td>0.001***</td>
<td>0.001***</td>
<td>0.001***</td>
<td>0.001***</td>
<td>0.001***</td>
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Note: (*) significant at the 10% level; (**): significant at the 5% level and (***): significant at the 1% level.
Table 2: Linearity Tests with a PSTR model

<table>
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<tr>
<th></th>
<th>H1: Fire-sale liquidation</th>
<th>H2: Feedback loop</th>
<th>Control</th>
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<td></td>
<td>Flight to liquidity</td>
<td>Flight to quality</td>
<td>Asymmetry information</td>
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<tr>
<td>AAA/ 10-year Treasury spread</td>
<td>111.4***</td>
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<tr>
<td>10-year Swap spread</td>
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<td>78.2***</td>
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<td>A/ 10-year Treasury spread</td>
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<td>84.8***</td>
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<td>70.8***</td>
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<td>Cross-Section dispersion banks</td>
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<td>IVOL bank</td>
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<td>Euribor-ois</td>
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<td>119.4***</td>
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<td>CDS Sub-Fin</td>
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<td>S&amp;P 350</td>
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<tr>
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Notes: The corresponding LM statistic has an asymptotic $\chi^2(p)$ distribution under $H_0$. (*) significant at the 10% level; (**) significant at the 5% level and (***) significant at the 1% level.
Table 3: Estimation of the sovereign bond model with a PSTR model (Full Sample)

<table>
<thead>
<tr>
<th></th>
<th>Model 1 Cmax Fin</th>
<th>Model 2 CDS Snr-Fin</th>
<th>Model 3 CDS Sub-Fi</th>
</tr>
</thead>
<tbody>
<tr>
<td>Linearity Stat</td>
<td>194.2***</td>
<td>148.3***</td>
<td>130.9***</td>
</tr>
<tr>
<td>Smooth Parameter</td>
<td>111.4</td>
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<tr>
<td>Loc Parameter</td>
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Notes: (*): significant at the 10% level; (**:): significant at the 5% level and (**): significant at the 1% level.

Table 4: Estimation of the sovereign bond model with a PSTR model (two sub-samples)

<table>
<thead>
<tr>
<th></th>
<th>Model 1 Cmax Fin</th>
<th>Model 2 CDS Snr-Fin</th>
<th>Model 3 CDS Sub-Fi</th>
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</thead>
<tbody>
<tr>
<td>Sub-panel Italy, Spain and Portugal</td>
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<td>Linearity Stat</td>
<td>54.2***</td>
<td>88.2***</td>
<td>82.8***</td>
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<td>Smooth Parameter</td>
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<tr>
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<td>Sub-panel Grece and Ireland</td>
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<tr>
<td>Linearity Stat</td>
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Notes: (*): significant at the 10% level; (**:): significant at the 5% level and (**): significant at the 1% level.
<table>
<thead>
<tr>
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<th>Model 1</th>
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<th>Model 3</th>
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<tr>
<td>β2</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>β1</td>
<td>0.015</td>
<td>0.112***</td>
<td>0.100***</td>
</tr>
<tr>
<td></td>
<td>(0.54)</td>
<td>(2.70)</td>
<td>(3.59)</td>
</tr>
<tr>
<td>β2</td>
<td></td>
<td></td>
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</tr>
<tr>
<td>β1</td>
<td>0.004</td>
<td>-0.024**</td>
<td>-0.006</td>
</tr>
<tr>
<td></td>
<td>(0.48)</td>
<td>(-2.54)</td>
<td>(-0.66)</td>
</tr>
<tr>
<td>β2</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>β1</td>
<td>0.015***</td>
<td>0.035***</td>
<td>0.014***</td>
</tr>
<tr>
<td></td>
<td>(5.67)</td>
<td>(4.71)</td>
<td>(4.9)</td>
</tr>
<tr>
<td>β2</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>β1</td>
<td>-4.61</td>
<td>-9.32***</td>
<td>-11.67**</td>
</tr>
<tr>
<td></td>
<td>(-0.78)</td>
<td>(-5.70)</td>
<td>(-1.99)</td>
</tr>
<tr>
<td>β2</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>β1</td>
<td>0.0074***</td>
<td>0.0013</td>
<td>0.0072***</td>
</tr>
<tr>
<td></td>
<td>(4.20)</td>
<td>(0.57)</td>
<td>(5.79)</td>
</tr>
</tbody>
</table>

| Smooth Parameter γ | 60.3 | 2.18 | 39.62 |
| Loc Parameter c    | 135.7 | 227.9 | 0.545 |
| Linearity Stat.    | 96.9*** | 90.0*** | 62.0*** |
| RSS                | 27.6 | 26.81 | 26.4 |
| Schwarz Crit.      | -1.685 | -1.716 | -1.786 |

Notes: The T-stat in parentheses are corrected for heteroskedasticity. (*): significant at the 10% level; (**): significant at the 5% level and (***): significant at the 1% level. β1 and β2 correspond to the coefficient in Eq (11). β1 is the coefficient in the first extreme regime. The coefficient in the second extreme regime is β1 + β2.
Table 6: Estimates of the sovereign bond model with a PSTR model for Greece & Ireland

<table>
<thead>
<tr>
<th></th>
<th>Model 1</th>
<th>Model 2</th>
<th>Model 3</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>CDS Snr Fin</td>
<td>CDS Sub Fin</td>
<td>Cmax Fi</td>
</tr>
<tr>
<td></td>
<td>$\beta_1$</td>
<td>$\beta_2$</td>
<td>$\beta_1$</td>
</tr>
<tr>
<td>Debt</td>
<td>$-0.101^{***}$</td>
<td>$0.086^{**}$</td>
<td>$-0.114^{***}$</td>
</tr>
<tr>
<td></td>
<td>($-4.20$)</td>
<td>($2.13$)</td>
<td>($-4.99$)</td>
</tr>
<tr>
<td>Squared Debt</td>
<td>$0.005^{****}$</td>
<td>$-0.0004^*$</td>
<td>$0.001^{***}$</td>
</tr>
<tr>
<td></td>
<td>($4.89$)</td>
<td>($1.82$)</td>
<td>($6.50$)</td>
</tr>
<tr>
<td>Fiscal Balance</td>
<td>$0.057^{****}$</td>
<td>$0.031$</td>
<td>$0.056^{***}$</td>
</tr>
<tr>
<td></td>
<td>($2.63$)</td>
<td>($0.65$)</td>
<td>($2.91$)</td>
</tr>
<tr>
<td>Unemployment</td>
<td>$0.57^{****}$</td>
<td>$0.09^{***}$</td>
<td>$0.602^{***}$</td>
</tr>
<tr>
<td></td>
<td>($8.98$)</td>
<td>($4.30$)</td>
<td>($7.48$)</td>
</tr>
<tr>
<td>Unit Labor Cost</td>
<td>$0.03^{*}$</td>
<td>$-0.008^{***}$</td>
<td>$0.022$</td>
</tr>
<tr>
<td></td>
<td>($1.73$)</td>
<td>($4.13$)</td>
<td>($1.45$)</td>
</tr>
<tr>
<td>VIX</td>
<td>$0.03^{****}$</td>
<td>$-0.0135$</td>
<td>$0.033^{***}$</td>
</tr>
<tr>
<td></td>
<td>($3.84$)</td>
<td>($-0.44$)</td>
<td>($4.53$)</td>
</tr>
<tr>
<td>Bid-Ask</td>
<td>$4.55^{***}$</td>
<td>$-1.7$</td>
<td>$4.735^{***}$</td>
</tr>
<tr>
<td></td>
<td>($3.5$)</td>
<td>($-1.27$)</td>
<td>($4.19$)</td>
</tr>
<tr>
<td>Outstanding Stock of gov</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td></td>
<td>($3.31$)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Uncon. Monet. Policy</td>
<td>$0.026^{***}$</td>
<td>$-0.038^{***}$</td>
<td>$0.024^{***}$</td>
</tr>
<tr>
<td></td>
<td>($6.26$)</td>
<td>($-5.48$)</td>
<td>($6.49$)</td>
</tr>
</tbody>
</table>

|                      | Smooth Parameter $\gamma$    |                                 |                                 |                                 |                                 |                                 |
|                      | $0.43$                        |                                  |                                 |                                 |                                 |                                 |
|                      | ($6.57$)                      |                                  |                                 |                                 |                                 |                                 |
|                      | Loc Parameter $c$             | $154.8$                          | $262.0$                          | $0.863$                          |                                 |                                 |
|                      | ($116.3$)                     |                                 |                                 |                                 |                                 |                                 |
|                      | Linearity Stat.              | $63.4^{***}$                     | $60.2^{***}$                     | $42.8^{***}$                     |                                 |                                 |
|                      | ($111.1$)                     |                                 |                                 |                                 |                                 |                                 |
|                      | RSS                           | $116.3$                          | $111.1$                          | $75.1$                           |                                 |                                 |
|                      | Schwarz Crit.                | $0.358$                          | $0.312$                          | $-0.001$                         |                                 |                                 |

Notes: The T-stat in parentheses are corrected for heteroskedasticity. (*) significant at the 10% level; (**) significant at the 5% level and (***): significant at the 1% level. $\beta_1$ and $\beta_2$ correspond to the coefficient in Eq (11). $\beta_1$ is the coefficient in the first extreme regime. The coefficient in the second extreme regime is $\beta_1 + \beta_2$. 


Figure 1: Dependent and Explanatory Variables
Figure 2: Threshold Variables

- **AAA/10-year Treasury spread**
- **A/10-year Treasury spread**
- **10-year Swap spread**
- **High-Yield bond/ Baa spread**
- **Stock Bond Correlation**
- **Cross-section dispersion banks**

The graphs illustrate time series data for various financial variables, including Treasury spreads, Swap spreads, and correlations between stock and bond yields, alongside the cross-section dispersion of banks' spreads over time from 2006 to 2013.
Figure 3: I-Traxx CDS Indices, Volume and Prices

Notes: Source: DTCC. Lh scale: prices in basis points. Rh scale: volumes in US$
An Open Letter to Dr Jens Weidmann

Charles Wyplosz 18 November 2011

The EZ crisis is approaching a tipping point beyond which market panic and slow government reaction threaten to create a generation-defining loss of jobs, savings, and pensions. This open letter to the president of the German central bank presents arguments that counter German objections to using the Eurozone’s last remaining defence against economic calamity – the ECB.

Dear Jens,

A growing number of competent economists have come to the conclusion that the debt crisis will not come to an end until the ECB intervenes as lender of last resort. You have taken the opposite view. The question, for me, is why?

As I see it, your objection rests on three points:

- Legality of bailouts;
- moral hazard; and
- independence of the ECB.

These are important issues, but the answer cannot be simply: “No, never.”

**Legality**

You read Art.123 as preventing support to governments. That is also my reading, but the ECB already violated this all-important article in May 2010. That was a historical mistake, but with no legal consequences so far. By deciding to buy outright Greek public debt instruments, the ECB has not just violated the spirit of the Treaty, it also changed the Eurozone regime.

We agree, I am sure, that a monetary union requires fiscal discipline in every member country. The unfortunate solution that was chosen more than a decade ago was the Stability and Growth Pact. This pact could never work, not just because it was ill designed, but also because its implementation requires that national sovereignty in fiscal policy matters be lifted, in contradiction with the Treaty prescription that governments and their parliaments retain full authority.
The Treaty was flawed, but not fatally, because the no-bailout clauses (Art. 123 and 125) implied that a country that did not respect fiscal discipline would eventually face the consequences alone. It was reasonable to believe that this would happen one day – that a delinquent but sovereign country would be left to default and that, henceforth, a lesson would have been learned and discipline would be adhered to.

By removing the only effective instrument available to enforce discipline, the Eurozone governments and the ECB effectively Europeanised national public debts. I know that your predecessor disagreed publicly, as I did, but the harm has been done and cannot be undone.

Now the ECB must move down that path, to its bitter end. Legalities will not change this fact. I understand how hard it is for you and the Bundesbank to swallow this reality, but the alternative is a breakup of the Eurozone. This is a solution that is potentially so destructive that you cannot choose it over your justified rancor. At least, I hope. A reassurance from you would be a very positive contribution.

**Moral hazard**

Of course, the May 2010 decisions have created a massive moral hazard. We will have to deal with that disastrous consequence. Now, however, is not the time. We have a crisis on our hands which requires urgent treatment.

Punishing undisciplined countries is apparently popular in your country, but it will not work. Forcing austerity programs on countries in recession, or about to enter into recession, will not reduce the budget deficits, as the Greek example abundantly illustrates.

The proper response is to carefully design a new regime that will deliver fiscal discipline while respecting national sovereignty. There are various possible solutions, many of which rely on the ECB. For instance, before the crisis, the ECB had long complained that the spreads on government bonds were far too small. But the ECB holds a big responsibility there.

By accepting all bonds as collateral for its repo operations, the ECB effectively guaranteed their values. We need no Treaty change for the ECB to decide that it will only accept repo bonds from governments with established adequate national arrangements that enforce fiscal discipline.

At the last summit, European leaders agreed that all countries would adopt a version of the German constitutional debt brake arrangement and establish independent fiscal councils. Once the crisis is over, the ECB can simply take good note of that commitment and act accordingly in its repo operations.

That would go a long way towards redressing the moral hazard problem. It should also reassure the ECB that its remonstrations will be taken to heart in the future.

Several other ideas should be considered – like ESBies or blue-red bonds – but only after the crisis is over. They are not ways to solve the crisis. If you think that none of these arrangements will work, please tell us precisely why.

**Independence**

Finally, you are rightfully concerned that the ECB’s independence should be preserved. Making the
Eurozone’s central banks independent is arguably one of the main European achievements of the last two decades. The importance of central bank independence is a lesson that the Bundesbank can be proud to have taught all of us.

With its independence guaranteed by the Treaty, the ECB is undoubtedly the most independent central bank in the world. This is de jure true, but is it so de facto?

The May 2010 decision to contribute to the Greek bailout is worrisome, but not fatal. Why has the ECB taken that step? While not an excuse, there is a good, fundamental reason.

- The border between fiscal and monetary policy cannot, unfortunately, be clear-cut.

This is a consequence of the policy dominance issue.

- It is a fact that there exists a unique public-sector budget constraint that combines public debts, fiscal balances and seigniorage.
- Monetary independence exists when seigniorage is exogenous and budget balances are endogenous under all circumstances.

The residual is the real value of the public debt.

In May 2010, implicitly at least, the ECB must have concluded that public debts cannot be defaulted upon. In the end, as we now know, defaults will happen. This was a misjudgment, but also a very general warning that situations are not always black or white.

German history has shown how disastrous monetary financing of public debts can be, but that lesson is more subtle than just saying “no”. Hyperinflation was the consequence of continuing monetary financing of the budget deficit, with no end in sight. Today we are talking about dealing with the existing stock of debts that cannot be refinanced on the market anymore. We need a one-off guarantee by the ECB that sets a floor on these bond prices, and of course defaults to eventually regain market access. A guarantee does not mean actual purchases; most likely very little will be needed, and that can be sterilised. The German precedent simply does not apply to the current situation. If you agree, please say so. If not, please explain.

More generally, we need to recognise that there are situations when a central bank cannot disentangle itself from the public-sector budget constraint and must be the lender of last resort.

Rather than denying that this possibility exists, we need to anticipate the situation.

- The first thing to do is to adopt institutions that enforce discipline.
- The second thing is to accept that disasters may happen, and plan accordingly.

Within a country, it is indeed understood that central banks may have to act as lender of last resort for their governments, as we now see in the US and the UK, for instance. You may infer from Germany’s interwar experience that this will ultimately be inflationary, but this is not what many believe will happen this time around. Are they obviously wrong? We need to investigate this issue with an open mind.

Within a monetary union, things are even more complicated, if only because distributional issues arise. With adequate disciplining institutions in place in each country, the situation may still arise because of large-scale bank failures. Proper micro and macro surveillance should make such an
event unlikely.

In the Eurozone, the solution is to keep improving the system that has been put in place, by making the European Banking Authority independent and building a strong European Systemic Risk Board. But we must also admit that mistakes can be made, much as natural disasters can occur.

We need a sort of Bagehot Rule for emergency central bank support to governments. This time around, we have tried to invent rules as events have arisen. Hopefully, we will draw the lessons of this crisis. This seems a better way to proceed than to deny that such things can happen and then be unprepared when they do.

**Conclusion**

These are all complex issues that require considerable thought. The answers will not be black or white. Your task is to balance daunting trade-offs. One possibility is that the ECB refuses to intervene as lender of last resort and the Eurozone breaks up. The other is that the ECB acts as lender of last resort and some of your fears are realised.

You may have a better plan, but we have not heard it yet.
Why the ECB refuses to be a Lender of Last Resort

Paul De Grauwe 28 November 2011

The euro has a matter of weeks to save itself, with several institutions now preparing for its collapse. Given this, why does the ECB still refuse to bail out Europe’s heavily indebted countries? This column provides an explanation. It says that the ECB may well be behaving rationally but adds that such behaviour is also foolish – and dangerous.

A rational, non-dogmatic explanation

Here is a possible explanation that has the merit of being based on rational behaviour. Other explanations that have been popular are based on a belief that the persons deciding about this issue are driven by dogmatic thinking preventing them to see the need to act. This may be the case, but it remains interesting to try to explain the ECB’s behaviour assuming that its decision-makers behave rationally.

When a central bank is called upon to be the lender of last resort it has to evaluate costs and benefits of its actions. Let us rephrase the problem in terms of the costs and benefits of inaction, ie of not providing the last-resort buying service.

Why central banks act as last-resort buyers for banks

Picture central bank facing a banking crisis. (Later we will do the same analysis for the case of the government bond market.)

- The cost of inaction arises from the risk that inaction will lead to a collapse of the banking system.

If the latter collapses the central bank will most likely be made responsible.
The benefit of inaction is the avoidance of future moral hazard risk which is beneficial to maintaining a stable banking system in the long run.

When evaluating cost and benefit, the time horizon over which these costs and benefits materialise matters a great deal.

- When the central bank faces a banking crisis the cost of inaction is likely to be realised very quickly.

When banks are close to collapsing, the cost of not providing the lender-of-last-resort service is almost instantaneous. This has to do with the fact that the banks' liabilities typically have very short maturities (demand deposits, interbank deposits).

- The benefits of inaction, however, will be realised in the future, possibly far in the future.

It is even likely that only the successors will reap the benefits, and they may not even be aware of this.

Asymmetric timing of costs and benefits

This asymmetry in the timing of the realisation of costs and benefits goes a long way towards explaining why even the most conservative central bank is likely to wish to avoid the immediate cost (collapse of the banking system) even at the cost of foregone future benefits, even if these benefits are very large. This asymmetry explains why the ECB did not hesitate for a moment to provide last-resort buyer support to Eurozone banks in 2008, despite the fact that in doing so it created moral hazard risk in the future.

What about government bond markets?

We can now apply this cost/benefit analysis to the government bond market. Here we have a striking difference with the banking sector. The sovereign debt crisis occurs at a snail's pace compared to banking crises. When investors sell government bonds and push the interest rate upwards, they affect the cost of borrowing of governments with some delay because the maturity of the bonds is typically of the order of five to seven years. As a result, there is not the imminent threat of a rapid collapse as there is with a banking crisis.

The result is that when the central bank faces a sovereign debt crisis the lack of immediate danger has the effect that a conservative central bank, such as the ECB, will attach more weight on the long-term benefits of reducing moral hazard. The central bank will therefore wait far longer to take action.

Note that this does not mean that moral hazard risk is more important in sovereign bond markets than in the banking sector. Bankers are just as likely to take additional risk when they know that in times of crisis the central bank will provide liquidity, as governments are. In addition, there is no reason to believe that the risks bankers take on is less dangerous than the risk taken on by governments. The only difference is that the imminence of a collapse is higher during a banking crisis than during a sovereign debt crisis. As a result, a central bank is likely to reduce the weight on moral hazard risk.

A forecast of action
The previous analysis leads me to the following forecast.

- The ECB will only act when the cost of inaction is immediate and clear.

As a result, the ECB is likely to wait until the sovereign debt crisis has degenerated into a full-scale banking crisis.

- There can be little doubt that the sovereign debt crisis will lead to a banking crisis.

The reason is that the continuing decline in the price of sovereign bonds will hammer the banks' balance sheets to such an extent that the losses become unbearable.

In addition, sovereign debt crises lead to funding problems for banks and a risk of being shut out from the interbank market. Thus there is a moment when the sovereign debt crisis inevitably triggers a banking crisis. This will be the moment when the timing asymmetry between costs and benefits is such that the ECB will see the merits of being a lender of last resort. Only then will the ECB come to action.

**Concluding remarks**

All this is quite depressing for two reasons.

- First, the amount of liquidity the ECB will have to inject in the banking system is likely to be higher than the amount that is necessary to stabilise the government bond markets.

This assertion is based on a simple fact. Total liabilities of the Eurozone banks are more than three times the liabilities of Eurozone governments (De Grauwe 2011).

- Second, the banking crisis will also trigger a deep and long-lasting recession (see Reinhart and Rogoff 2009).

All this may in the end endanger the Eurozone itself.

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Chap 7: Austerity, secular stagnation and lessons from the interwar period

*Key issue:* We review the debate about austerity and draw lessons from the crisis of the Gold Standard during the inter-war period.

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Redemption Through Austerity?

Jean Pisani-Ferry

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Abstract and Keywords

Shortly after Mario Draghi took office as president of the European Central Bank (ECB), he called for what he named a “fiscal compact”, a further step towards improving fiscal discipline in the euro area. In response, the leaders of 25 European Union countries soon announced their intention to adopt a new fiscal treaty. This was not the first time that European policymakers had put the emphasis on fiscal discipline as a remedy to the crisis. In the aftermath of the global crisis, the United States and the euro area actually adopted two opposite strategies. In the United States, priority was given to private deleveraging, with bold support from the central bank. In contrast, the drive to consolidate was stronger in the euro area and monetary policy less supportive. Although there are several explanations to this, fundamentally, many in Europe genuinely believed that the euro crisis was essentially rooted in fiscal imprudence. Although it is hard to dispute that countries in the euro area must reverse the drift in public-debt ratios, to tighten aggressively when the
Redemption Through Austerity?

Economy is already in recession is a risky strategy. Too-early and too-aggressive tightening can result in dreary economic performances, disappointing budgetary outcomes, and public resistance to austerity – the opposite of the intended result. The backlash came in 2013, when austerity started being widely blamed for the continent’s woes.

Keywords: European Central Bank, euro crisis, fiscal compact, European Union, fiscal treaty, long-term refinancing operation, banks, Germany, fiscal discipline, Treaty on Stability Coordination and Governance, austerity

At Tordesillas on June 7, 1494, the kings of Spain and Portugal agreed on a simple method to divide up the New World: everything to the west of the 46°37’ meridian would belong to Spain and everything to the east to Portugal. It was not a particularly subtle division principle, but it worked. It is what made Brazil a Portuguese-speaking country.

This was perhaps a precedent Mario Draghi had in mind when taking office on November 1, 2011. A few days later, in his first speech as ECB president, he lashed out at the euro area’s serial failure to implement decisions after having announced them. On December 1, on the occasion of his first appearance before the European Parliament, he called for what he named a “fiscal compact” that “would enshrine the essence of fiscal rules and the government commitments taken so far, and ensure that the latter become fully credible, individually and collectively.” Such a compact, he said, “would be the most important signal from euro-area governments for embarking on a path of comprehensive deepening of economic integration,” adding that other elements might follow, but that the sequencing mattered. The further elements quickly followed: meeting on December 8–9, the heads of state and government of 25 EU countries—all except the UK and the Czech Republic—announced their intention to adopt a new fiscal treaty. Even before this summit concluded, on December 8, Mario Draghi announced that the ECB would launch a new longer-term refinancing operation (LTRO) for banks, aimed at providing them a fixed rate with unlimited amounts of funding for a period of up to three years.
Coming after months of procrastination, the sequence was astonishing. There was, at last, a plan, and one that looked as simple as the treaty of Tordesillas: The states would take care of themselves and of each other; the ECB would take care of the banks. There would be no more discussions of lenders of last resort for sovereigns or leverage. Each side would do its job. The fiscal treaty would reassure markets by compelling states to abide by the fiscal rules and the ECB would provide, on cheap terms, as much liquidity as banks needed. Banks would no doubt use some of the liquidity to buy government paper and help bring sovereign spreads down—what became known as the “Sarkozy carry trade” after the French president suggested it—but this would be their own choice, not that of the central bank.

Germany could not agree more with the idea. It involved two key ingredients that Berlin was fully behind. The first was the strengthening of fiscal discipline. Chancellor Merkel had pushed for tighter and more credible rules, but she was not convinced that the legislation proposed by the European Commission and under discussion in parliament—the soon-to-be-adopted “six-pack”—was tight enough. In Deauville at the end of 2010, Nicolas Sarkozy had obtained from her a concession that sanctions for infringements would not be automatic; she regretted having given in to this demand. A new treaty was an opportunity to emphasize the importance of fiscal discipline and to put the issue of automatic sanctions back on the table. The other reason why Angela Merkel was pleased was that Mario Draghi’s stance apparently brought an end to the bazooka dispute. He, visibly, was keen on concluding the endless and acrimonious debate about the role of the ECB as a lender of last resort for sovereigns.

The plan was swiftly implemented. Negotiations on a new intergovernmental “fiscal compact” that constituted the essential component of a Treaty on Stability Coordination and Governance (TSCG), were conducted at exceptional speed and completed in time for it to be signed in March 2012 and to enter into force on January 1, 2013. On December 21, 2011, shortly after European leaders committed to these moves, the ECB launched its first three-year refinancing operation, lending banks a total of €489 billion, followed by another €529
billion on a second similar operation on February 28.\textsuperscript{4}
Banks—especially those in southern Europe—used the liquidity obtained from the ECB to buy sovereign bonds—especially those issued by southern European countries. Tension on bank-funding markets and sovereign-bond markets abated. Markets cheered, also, because, in the meantime, new reform-minded governments had taken office in Italy, under the stewardship of former European Commissioner Mario Monti, and in Spain, where Mariano Rajoy’s Popular Party won the elections by a landslide. Long-awaited decisions were simultaneously completed: in February, the final agreement between Greece and its private creditors on debt restructuring; in March, a replenishment of the European financial facility that increased its new lending capacity to €500 billion; and in April, pledges from IMF members to increase its resources and make it able to intervene in case of need. For a while, it seemed that the Europeans had got serious and that the corner had been turned.

To be honest, it was certainly not the first time that European policymakers put the emphasis on fiscal discipline as a remedy to the crisis. Already, in the autumn of 2009, barely a year after they had embarked on a coordinated stimulus, ministers of finance had started to prepare an “exit strategy” from it. Meanwhile, the EU initiated a series of procedures for excessive budgetary deficits against all countries with significantly imbalanced public finances. Shortly after being asked to contribute to the stimulus, governments were requested to prepare for the consolidation.

A series of legislative initiatives had also taken place: in March 2010 Europe’s leaders tasked Herman Van Rompuy, the EU president, with the preparation of a report on the strengthening of economic governance. The report recommended tightening the procedures of the Stability and Growth Pact—resulting in the already mentioned “six-pack” legislation of December 2011, which made room for earlier financial sanctions against imprudent budgetary behaviour;\textsuperscript{5} in November 2011 Olli Rehn, the European Commission’s vice-president for economic and monetary affairs, tabled an additional “two-pack” legislative package to compel member
states to provide in early autumn each year full information on their budget plans, making it possible for the Commission to request changes before national budgets are adopted by parliaments. The intention was to overcome the ineffectiveness of ex-post sanctions by giving the Commission an ex-ante near-veto on national budget plans if they were in infringement of commonly agreed commitments.

To this already significant tightening, the new “fiscal compact” added a request to formalize the commitment to nearly balanced budgets as part of the domestic constitution (or at least of framework legislation), and to establish, in each country, domestic institutions conducive to fiscal discipline. The compact also made the adoption of sanctions for infringements of the rules easier: instead of requiring the approval of the Council of ministers, European Commission proposals for recommendations and fines will be automatically enforced unless a majority of participating countries opposes them.

Some, like German finance minister Wolfgang Schäuble, have suggested to go further and introduce a formal veto right over euro-area national budgets. The European commissioner for economic and monetary affairs would be made independent from the rest of the European Commission and be given the power to reject national budget plans. In this case the national parliament in question would be forced to reexamine the budget law and cut spending or raise taxes in order to reduce the deficit.

Even without this addition, however, the euro area has already agreed on major steps towards stronger, more binding commitments to fiscal discipline. The contrast with the United States and Japan is especially stunning; at the time of writing, neither of these countries has adopted a credible fiscal framework for the medium term even though their fiscal situations are worse than Europe’s. In the US, fiscal policymaking has become completely hostage of partisan bickering and it has lost predictability altogether. In Japan, the first thing the Abe government did in 2013 after having been sworn in was to introduce stimulus measures. The euro area is, in fact, characterized by lower deficits and debts than its
main partners: in 2012 3.6% of GDP on average against 10.2% in Japan, 8.5% in the United States and 8.3% in the UK; even Ireland had a lower deficit than the United States. Similarly, at 72% of GDP, the net public debt level is lower than in the United States (88%) and in Japan (134%). Yet the drive to consolidate remains unambiguously stronger in Europe.

The United States and the euro area actually adopted two opposite strategies—or at least de facto strategies—in the aftermath of the global crisis. Although both engineered a stimulus to counter the 2008–2009 recession, they approached the recovery in very different ways. In the United States, the Obama administration and the Federal Reserve gave priority to private deleveraging. Households were given time to reduce mortgage and consumer credit debts (and could rely on personal bankruptcy procedures). Consumption remained subdued as a consequence, but the central bank provided support through a series of bold initiatives: through committing to keep policy rates low for an extended period and through purchases of government and agency bonds, it worked very hard, and with success, to lower long-term interest rates. Federal fiscal support was not as substantial and did not last as long as wished by some in the administration, such as Larry Summers, the former chief economic advisor to President Obama. In particular, balanced budget rules at state and local government levels led them to cut spending precipitously. But overall, consolidation between 2010 and 2012 proceeded at the pace of one percentage point of GDP per year only. It was only in 2013 that the pace of retrenchment accelerated.

In the euro area, monetary policy was less supportive. In spite of what rough comparisons may suggest, the ECB in 2008–2012 did not embark on a similar monetary stimulus; rather, its efforts were devoted to counteracting the effects of impairments to the banking system. The ECB did much to limit the credit contraction that resulted from the weakness of euro-area banks and their difficulty to access funding, but beyond its regular setting of the policy rate, it did not even contemplate quantitative easing or forward announcements. It did not try to lower bond rates or, more generally, to prop up the economy.
On the fiscal side, the average pace of consolidation was faster in the euro area—1.5% of GDP per year in 2010–2012, rather than 1%—and it was especially sustained in the crisis-affected countries. Between 2009 and 2012, Greece tightened 4% per year, and Portugal, Spain, and Ireland by more than 2% per year. In Italy consolidation was delayed, but when it took place, in 2012, the adjustment amounted to 2.5% of GDP. Unlike the United States, the Europeans did not give the private sector any time to heal. Consolidation was the priority.9

There are several explanations for this contrast. To start with, the euro area is more vulnerable than the United States. In spite of its higher debt level and the absence of any political consensus about the pace and contours of the necessary future consolidation, and even after having been downgraded by the rating agency Standard and Poor’s, the United States federal government continues to benefit from exceptionally low bond rates, de facto borrowing at negative interest rates, once inflation is taken into account. Japan’s situation is even more astonishing: households there routinely park their savings in accounts that yield virtually no return, providing the government with a domestic source of cheap and stable financing. As a consequence, foreigners account for only a small part of the government bond holdings. In Europe by contrast, markets turned nervous already in 2009 and since then a number of countries have been facing high borrowing costs. Since the start of the crisis, most of them—including northern Europeans such as France, the Netherlands and Belgium—have, at some point, seen the interest-rate spread with Germany widen. Governments, therefore, are understandably anxious to show markets that they are serious managers of their public finances.

A second reason that Europe needs to consolidate more aggressively is that its long-term outlook is grim. Labour force decline expected in the coming decades mechanically implies low growth, whereas extensive public coverage of health and pension costs implies that ageing is bound to weigh heavily on public finances. The issue, for sure, is not specific to Europe, but demographic perspectives are more severe and their implication for budget deficits more adverse in Europe than in
the United States, whereas the room for tax increases is narrower. Problems that governments expected to be facing in 10 or 20 years have become pressing.

A third reason motivating budget consolidation is that it is intended to contribute to macroeconomic adjustment. Countries in southern Europe that have lost competitiveness relative to those in the North must find a way to rebalance after years of excessive domestic demand growth. Budgetary policy geared to deficit contraction is an instrument to suppress domestic demand, push prices and wages down, and indirectly deliver the competitiveness gains that are needed to restore external balance. More broadly, constraining the deficit is a powerful way to close a door—that is, to signal to all domestic stakeholders that growth is not going to come from more public spending. Rather, the only way to foster it is to improve supply-side conditions and deliver better, cheaper products that find demand on world markets. Seen from that angle, budgetary consolidation—especially when it takes the form of spending cuts—is merely an instrument at the service of the goal of shaking up the economy.

Finally, many in Europe genuinely believe that the euro crisis was essentially rooted in fiscal imprudence. Despite the much bigger size of the Spanish problem and the fact that its causes cannot be traced back to fiscal imprudence, Greece frightened politicians and public opinion so much that energy has been focused on the prevention of future nightmares of the same sort. Furthermore, past failure to abide by the commitments to fiscal discipline—by Greece for sure, but also by Italy, France, and even, in 2003, Germany—is now regarded as a deadly sin. Seen from northern Europe, the euro contract was quite simple: southern countries with a lousy macroeconomic management record were given the benefits of a stable currency by their northern neighbours, in exchange for a commitment to stick to the rules and principles of the Stability and Growth Pact. They did not stand by their commitment and their breach of the contract jeopardizes the stability of the currency that their unfortunate northern neighbours now share with them. Beyond economics, fiscal consolidation and the enforcement of strict fiscal rules appear, therefore, to be a moral imperative.
These are all respectable motives. It is hard to dispute that countries in the euro area must reverse the drift in their public-debt ratios; that they need to prepare for ageing populations; that southern Europe cannot escape from austerity; and that a multinational policy cooperation regime cannot last, if the rules on which it is based are overlooked by participants. The question is whether these motives lead to good policy. This is a more difficult issue. To tighten aggressively when the economy is already in a recession, when the interest rate of the central bank is at near-zero level, when many households and businesses are cut off from access to credit and when trade partners are doing the same, is a risky strategy because these are conditions that make the recessionary effects of a consolidation particularly strong. In such a situation the ratio of the change in GDP triggered by a fiscal move, to the change in the fiscal stance (or the “multiplier,” as economists call it), tends to be significantly higher than in boom times. A cut in public expenditures of 1% of GDP is, therefore, likely to result in a drop in GDP that is more than proportional, and in a decrease in tax revenues. In the end, the results of consolidating in such an environment could potentially be deeper recession, a meagre deficit reduction, and possibly a rise in the debt-to-GDP ratio. Effectively, it would be a self-defeating strategy. When possible, to backload the adjustment and tighten aggressively only when the private economy is in better shape can be a less costly and more effective strategy. But in fairness, it is not always a feasible strategy.

Public finances cannot be left unattended and retrenchment cannot be postponed in spite of the economic conditions. But too-early aggressive tightening may well result in the combination of a dreary economic performance and a disappointing budgetary outcome. This could, in turn, make citizens wary of austerity and lead to their resisting further efforts. If this were to happen, markets would be quick to conclude that debts approaching 100% of GDP will, in fact, not be repaid. This would be the exact opposite of the desired outcome. Those who advocated sprinting at the moment that European countries needed to embark on a marathon took the risk of exhausting the citizens’ willingness to endure
sacrifices. The backlash came in 2013, when austerity started being widely blamed for the continent’s woes.

At any rate, it was clear already in the spring of 2012 that the Tordesillas strategy had failed to deliver the desired outcome. The bond market rally triggered by the ECB’s initiatives had proved short lived. By early April 2012, Italian and, especially, Spanish spreads were on their way up amidst mounting concerns about the state of Spanish banks. By June, the entire effect of the ECB’s liquidity provision had dissipated. Renewed commitments to fiscal discipline, structural reforms, the firewall, and the ECB’s generous liquidity supply had failed to turn the tide.

Notes:

(1) Speech at the 21st Frankfurt European Banking Congress, Frankfurt am Main, November 18, 2011.

(2) Hearing before the plenary of the European Parliament, December 8, 2011.

(3) Strictly speaking, the “fiscal compact” is only Title III of the TSCG. Other titles include a renewed commitment to coordination, and provisions regarding the governance of the euro area, in particular arrangements for the chairing of the Euro summits.

(4) These were gross amounts. As banks made use of the new facility to swap shorter-term ECB loans for longer-term ones, the net injection of fresh liquidity was significantly less.

(5) The “six-pack” was mostly the result from the initiative of the European Commission, which did not wait until the conclusions of the Van Rompuy task force to put forward its legislative proposal. As a result, the issue was discussed in the European parliament, and amendments were made to the proposal.


(7) Wolfgang Schäuble, speech in Singapore, October 17, 2012.
Redemption Through Austerity?


(9) Comparisons in this paragraph are based on data from the IMF’s April 2013 Fiscal Monitor.

Access brought to you by: Princeton University Library
Olivier Accominotti and Barry Eichengreen look at the crisis in Europe, and tell us something new. I knew that it was best viewed as a balance-of-payments crisis, not a debt crisis — a case in which large capital inflows to Europe’s periphery suddenly went into reverse. What I didn’t know was that something quite similar happened in Europe from 1919 to 1933, with huge inflows to Austria, Hungary and Germany suddenly shifting to huge outflows, and with similarly disastrous results.

One thing worth following up on, however, is an issue suggested by their use of the term “sudden stop”, which was coined by Guillermo Calvo after the Asian crisis of the 1990s. One thing Calvo went on to point out, however, was that sudden stops are often followed by “phoenix miracles,” in which the economy comes roaring back (pdf).

Seen any phoenixes lately?

The thing is, there were indeed phoenix-like recoveries after 1929-33, everywhere except France:

Why was France different? It stayed on the gold standard. And it’s hard to avoid the notion that the absence of any phoenixes in Europe today comes from the role of the euro, which is acting as a similar constraint, only worse.

But hey, Europe has just had one quarter of (modest) growth. The euro is a triumph!
Proposed remedies for the Eurozone crisis abound. But proven, working solutions are hard to come by, especially when traditional solutions – structural adjustment and monetary policy – are seen as causing problems. This column concentrates on the policy recipes prescribed on both supply-side and demand-side to jump-start economic recovery and reduce the extent and spillovers of the crisis itself. It finds that there is no easy and straightforward strategy and that there are no obvious answers. That doesn't mean, however, that there are absolutely no answers. The alternative option to finding a way out – that is, continuing reliance on deflationary adjustment in a currency union stuck at the zero lower bound – is probably unlikely to convince anyone that structural reforms and monetary policy are back to being part of the solution.

“In the midst of this turmoil, we cannot stop to make reflections; but Renzo, causing disturbance at night in another person’s house, and holding the master of it besieged in an inner room, has all the appearance of an oppressor; when in fact he was the oppressed. Don Abbondio, assaulted in his own house, while he was tranquilly attending to his affairs, appeared the victim; when, in fact, it was he who had inflicted the injury. Thus goes the world, or rather, thus it went in the seventeenth century”

– Alessandro Manzoni, The Betrothed.

In a volume devoted to the assessment of the roots and causes of the European crisis, it may come as a surprise to find a contribution focused on the interaction between structural reforms and monetary accommodation. That is what this essay will do – concentrate on the policy recipes prescribed on both supply-side and demand-side to jump-start economic recovery and reduce the extent and spillovers of the crisis itself. But, in the complex and murky reality of the European crisis, what typically would have been part of the solution has been highlighted as part of the problem by a large and vocal group of critics.

The above citation - probably quite familiar to many Italian high-school students - nicely conveys a
similar sense of confusion and disorientation, whereas the distinction between oppressors and victims, diseases and treatments, problems and solutions gets blurred and uneasy. Beyond the audience of Manzoni acolytes, for a lower-brow reference one may want to think of the Eurozone as ‘Bizarro world’ – an alternate place where fast is slow, good is bad, and structural reforms and monetary policy (the super-heroes under ‘normal’ circumstances) reappear under disfigured and distorted semblances as the villains of the situation.1

Competing views, polar extremes

To be fair, not many observers are willing to take the extreme view that economic policy tout-court is at the root of the European crisis and both supply-side and demand-side policies are jointly co-culprits. Most critics seem happy to highlight that reforms and monetary policy are not on the same level, praising one side of the coin for its contribution to improving macroeconomic conditions and blaming the other side for its unnecessarily contractionary or not sufficiently growth-oriented effects. Problem is, there is no universal agreement on which one of the two is actually the good side.

- One extreme view is that structural reform, considered as the progressive elimination of distortions and frictions in labour, product and financial markets, is all that matters.

Eliminate microeconomic attrition and institutional inefficiencies, the argument goes, and markets will do their magic, in terms of restoring firms to their lost competitiveness.

Of course it is easy to think of monetary accommodation according to this view as unnecessary and ineffective, perhaps as an additional source of randomness and volatility. But things get worse – monetary policy is deemed to be counterproductive even when it is effective and predictable. It is counterproductive because it is effective and predictable. In fact, reforms tend to be undertaken only when governments are under general pressure and can afford to overlook specific lobbying efforts by special interest groups.

If monetary policy effectively provides some macroeconomic breathing space that reduces this urgency, it then jeopardizes the social cohesion and electoral consensus required to push forward unpopular reforms. Also, an injection of liquidity that lowers the cost of money is bound to keep alive unprofitable firms that would otherwise be restructured or disappear, thus preventing the survival of the fittest, upholding a sectoral composition skewed toward low average productivity, and condemning the economy to a limbo of inefficient stagnation.

The bottom line, according to this view, is that monetary stimulus is paradoxically criticized not because it is ineffective or inconsistent, but because it ends up delaying and destroying the very incentives for market adjustment.

A second extreme view is to some extent the polar opposite of the first. Societies are predominantly present-oriented and discount the future heavily.

- In an environment in which in the long run we are all dead and we want it fast and we want it now, structural efficiency is bound to be just an abstract tendency – an ideal for the very long term whose policy relevance is always subordinated to the more immediate search for cyclical stabilisation.

Yes, it is understood that reforms may end up enhancing potential growth and reduce labour market...
frictions tomorrow, but it is output and employment today that matter. Which means, reform is given a narrow time span to flaunt its promised benefits. As soon as the cyclical costs of structural adjustment become obvious, reform ceases to be a key element of a growth-oriented strategy and metamorphoses into hideous austerity. And when adjustment is perceived (correctly or not) as imposed from outside as part of a conditionality programme of doubtful coherence and effectiveness, rather than an internal decision undertaken by a democratic society with full control of its own destiny, popular support vanishes and political fatigue ensues, leaving short-term stimulus – if and when available - as the only game in town to restore full employment and provide insurance against the tail risks of deflation.

**Less extreme views**

Less extreme views of course tend to mix and match elements of these polar approaches. They end up recognising the relevance of both supply-side reforms that promote high and sustainable growth trends, and countercyclical policies that smooth consumption, incomes and employment around these trends.

As the 2015 Sintra speech by Mario Draghi - quite obviously an excellent starting point for any conversation on the interdependence between reforms and monetary policy – makes clear, the not so hard truth is that both structural reforms and monetary accommodation are imperfect, costly, and uncertain tools of growth-oriented policy (Draghi 2015). Firms and households in the European periphery have long shunned an excessively naïve reliance on the confidence-boosting effects of expected gains from structural adjustment, but are the first in line to emphasise that muddling through with patches and patches of short-term stimulus is not exactly a panacea for sustainable performance over time.

A common ingredient of all ‘intermediate’ approaches is the idea that the natural real interest rate in (parts of) Europe is persistently lower than in earlier decades. The natural rate is associated by definition with the equilibrium between saving and investment at full employment. A vast literature discusses in detail the potential drivers of a lower natural rate in Europe, whether related to demographic factors, globalisation trends, deleveraging, reduced risk appetite, diminished expectations about income growth and employment prospects, higher investments costs of investment, or quite simply catatonic animal spirits. As Draghi mentions in his Sintra speech, a lower natural real interest rate means that, faced with a negative output gap, nominal policy rates need to go lower still to steer output back to potential. This materially increases the likelihood that central bank policy runs into the constraint set by the zero (or effective) lower bound. It therefore also increases the likelihood that the central bank has to resort to unconventional policies of unknown or doubtful efficacy to meet its mandate.

**Two stories as to how intermediate solutions work**

There are probably two different but related ways to articulate an 'intermediate' view. In both cases, there are substantial long-term benefits from structural reform. But whether expected long-term benefits translate into short-term gains depends on the extent to which monetary policy can operate effectively.

- **Story 1** – as highlighted in recent research work on the subject (see Cacciatore et al. 2013 and Eggertsson et al. 2014) structural reforms that reduce the income and competitiveness gap between core and periphery may well be contractionary during crisis episodes that push
the nominal interest rate to its zero lower bound.

In normal times, reforms reduce prices in labour and product markets, increasing agents' permanent real income and stimulating consumption. With falling aggregate prices, the central bank is able to lower nominal interest rate and the economy exhibits a cyclical expansion as well as a sustainable higher rate of long-term growth (see Bayoumi et al. 2004).

Things are different, however, in crisis times when the central bank's nominal interest rate is at the zero lower bound. In this case reforms are contractionary, as expectations of prolonged deflation increase the real interest rate well above its natural rate and depress consumption. In the literature, the short-run output losses associated with the ZLB constraint are increasing with the magnitude of the reforms and become particularly large when reform efforts are half-hearted. When you are stuck in the zero lower band quicksand, energetic 'structural' efforts to get out of the doldrums often make things worse, and provide no guarantee to getting out alive.

• Story 2 – take the previous story, but now replace the intertemporal dimension with a geographic one.

Think of structural reform as being implemented in one specific region but not in the whole of the Eurozone.

As the region has no control on its monetary policy and cannot rely on exchange rate adjustment, no expenditure switching effects arise to redirect system-wide aggregate demand toward the goods and services produced in the region. Lack of exchange rate flexibility plays at the intratemporal level the same role that the zero lower bound plays at the intertemporal level. It is a constraint on the ability of monetary policy to offset the deflationary effects of structural reform.

A narrative of the Eurozone crisis

It is straightforward to combine the two stories above into a narrative of the European crisis, to understand how the hero becomes the villain. At the onset, there is a series of shocks to the natural rate of the periphery countries. To offset these effects and raise the natural rate, structural reforms would be welcome as harbingers of higher productivity growth. But monetary policy is at the zero lower bound, so there is no intertemporal escape. And the periphery is part of a currency union, so there is no intratemporal expenditure switch through exchange rate depreciation. So structural reform makes things worse, and insisting on structural reform as the only way out of the crisis contributes to a vicious circle of disinflation, low demand and low activity, low expected demand and further disinflation.

Ways forward

This is not terribly comforting. Is it actually possible to engineer a strategy to escape such vicious circle, besides sheer luck? Maybe, provided one is willing to reconsider the case for structural reform and think outside the 'competitiveness' box.

When policymakers stress the competitiveness gains of structural adjustment, implicitly or explicitly they consider reforms as a reduction in the degree of monopoly power in the product or labour markets, and therefore a reduction in markups – the same result that one would obtain by increasing the elasticity of substitution between varieties produced under conditions of monopolistic
In fairness, this is precisely how reforms are modelled in standard dynamic stochastic general equilibrium models such as, say, Bayoumi-Laxton-Pesenti (2004) or Eggertsson-Ferrero-Raffo (2014). The expected effect is an expansion in economic activity and an increase in the amount of resources available for consumption by domestic and international households. Or, as you like it, more competitive firms dump their excess output in their export markets at lower international prices. The external and internal terms of trade are bound to deteriorate, as either the relative price of imports or the relative price of leisure or both increase.

A similar scenario arises in the context of what international macroeconomists would refer to as a variant of the transfer problem (Corsetti et al. 2005). The so-called transfer problem has a long intellectual history which goes back to Keynes’ classic criticism of German international obligations after World War I. He stressed that the macroeconomic costs of war reparations – the ‘primary burden’ of a transfer - were magnified by deteriorating terms of trade – the ‘secondary burden’ or ‘double punishment’.

Arguably, the transfer problem is the intellectual matrix of any meaningful analysis of current account rebalancing, or adjustment between a debtor country and its creditors. The basic mechanism of adjustment requires transfer of real resources from debtor countries such as the US or the European periphery to surplus countries such as China or Germany, with a decrease in domestic spending relative to production in the debtor countries. To the extent that adjustment requires a significant reversal in cost-competitiveness among trading partners, one can immediately recognise the links with the analysis of structural reforms.

The key question concerns the role played by relative prices in the adjustment process. Building on Keynes' approach to the transfer problem, one is tempted to acknowledge that large real depreciations in debtor country are needed to close current account imbalances, either through currency fluctuations or through significant ‘internal’ real devaluations. So substantial currency flexibility (or alternatively, wage flexibility and deflation) is seen as a precondition for adjustment.

However, over the time horizon relevant for adjustment, the baskets of tradable and non-tradable goods in consumption and production are bound to change and there is substantial entry and exit of firms across sectors and countries. New product varieties are created or destroyed as a consequence of shifts in world aggregate demand. Now, if a large fraction of adjustment occurs through changes in quantities at the extensive margin, the trade gap is closed by producing and exporting new tradable goods to the rest of the world. International prices of new varieties need not fall, and a large real exchange depreciation is neither a sufficient nor a necessary condition for resolving global and regional imbalances.

There is an intriguing application to intra-European imbalances. The conventional therapy for the structural ills of the countries in the European periphery prescribes real depreciations - possibly fostered by policies and reforms accelerating large-scale wage and price disinflations - with the goal of regaining cost competitiveness and closing trade gaps. If the reforms-cum-internal-devaluation plan does not work, then one can bring this view to its extreme consequences and claim that, for crisis countries there may be no alternative to abandoning the Eurozone, and adjusting relative prices via large nominal depreciations.

In contrast, a slightly refocused (and unconventional?) approach would suggest that to foster competition.
European adjustment, policy and reforms should target obstacles to firms’ entry, start-up costs, and the incentives for product differentiation, not to achieve a narrow objective of cost-competitiveness but to expand the net array of tradable varieties of goods and services. Of course, this story does not deny that some real depreciation (internal or external) may be needed to facilitate the adjustment process. But the main message is that structural reforms focusing on market liberalisation and reduction of inefficient barriers to entry may not require deflationary pressures – and the associated contractionary effects - as dramatic as some observers claim is unavoidable.

If this unconventional view is correct or appropriate, then the link between structural reforms and monetary policy may be consistently reassessed. Setting up firms and new production lines is costly and typically requires financial resources. Structural reform cannot succeed without appropriate policies that address tight credit constraints on investment and firms' activity due to liquidity and balance sheet problems hitting banks. We no longer have a dichotomy between costly reforms and anti-recessionary monetary policy, but rather an integrated and perhaps coordinated vision of ‘whatever it takes' to restore growth.

Needless to say, there is no easy and straightforward strategy. How to guarantee that entrepreneurship is rewarded and the appropriate resources flow to the right sectors? How to provide incentives to achieve the desired allocative efficiency without falling in the trap of directed credit? Who assesses (and according to what metrics) which sectors will flourish and which sectors will decline? There are no obvious answers, but this need not imply that there are no answers. The alternative option, i.e. continuing reliance on deflationary adjustment in a currency union stuck at the zero lower bound, is probably unlikely to convince anyone that structural reforms and monetary policy are back to being part of the solution and no longer being part of the problem. Thus goes the world, or rather, thus it goes in the twenty-first century.

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The deficit reduction policies followed by several Organization for Economic Co-operation and Development (OECD) countries in 2009–13, often referred to as fiscal austerity, were motivated by the bond market’s reaction to the large debts and deficits that followed the Greek crisis. Austerity was clearly not meant to cool down overheating economies; on the contrary, several countries adopted austerity measures when recessions were not quite over and credit crunches were still retarding the recovery. This is not ideal, but the risk of a meltdown of the Euro area was significant.

Our research examines the effects of austerity on output growth. We focus especially on the composition of austerity measures: how they were divided between tax increases and spending cuts. We also examine whether this round of fiscal adjustments, which occurred after a financial and banking crisis, had different effects on the economy compared with consolidations in “normal” times. One possible reason is that many of the recent fiscal adjustments occurred at the same time, possibly deepening their recessionary effects due to interdependence across economies.

This research builds upon an earlier literature that assessed fiscal adjustments using data up to 2007, before the latest rounds of adjustments. That literature faced two key challenges. One was identifying exogenous shifts in fiscal policy: those determined by the need to reduce excessive deficits rather than respond to the state of the economy. The second challenge was isolating the effect of fiscal policy from other factors such as devaluations, monetary policy, or labor and product market reforms.

This earlier literature, surveyed in Alesina and Ardagna (2010), used large changes in cyclically adjusted deficits to measure fiscal adjustments. This work found that fiscal consolidations based on spending cuts have been less costly than those based on tax increases. In fact, spending cuts were sometimes associated with almost immediate increases in output growth, confirming earlier findings by Giavazzi and Pagano (1990). Alesina and Ardagna (2013) investigated whether accompanying policies, such as labor market reforms, helped fiscal adjustments. Devaluations sometimes helped (e.g., Ireland in 1988), but they were not consistently the driving force of successful adjustments. Perotti (2013) also emphasized the role of accompanying policies, arguing that one should not study budget cuts in isolation.

Cyclically adjusted budgets, however, are unable to filter out fiscal actions correlated with the cycle, such as discretionary responses to a recession. This limitation has been overcome by the “narrative” method pioneered by Romer and Romer (2010). These authors use original sources (budget documents, records of Congressional
debates, etc.) to identify changes in U.S. tax rates not dictated by the cycle but motivated by the aim of improving long-run growth or of reducing an inherited deficit. Applying this strategy, Romer and Romer estimate large tax multipliers: over the course of three years an increase in taxes equivalent to 1 percent of GDP lowers output by 3 percent.

Devries et al. (2011) use this methodology to construct narrative time series shifts in taxes and spending for 17 OECD countries since the early 1970s. The shifts identified by these authors are motivated solely by the need to reduce an inherited deficit, a definition that fits the fiscal consolidations in Europe since 2009–10. Guajardo et al. (2014) use these data to estimate fiscal multipliers and find that tax-based adjustments generated bigger output losses than expenditure-based ones, consistent with the earlier literature based on cyclically adjusted deficits.

Alesina, Favero, and Giavazzi (2012) use the fiscal consolidation episodes identified by Devries et al. (2011) but propose a methodological innovation. They observe that shifts in taxes and spending in a fiscal adjustment rarely happen in isolation but instead are part of a multi-year plan: some policies are announced in advance, others are implemented unexpectedly, and both tax hikes and spending cuts are used simultaneously. Also, as these plans unfold, they are often revised; ignoring the connections between taxes and expenditures, and between unanticipated and announced changes, can produce biased estimates of the effects of fiscal consolidations.

The results from Alesina, Favero, and Giavazzi again confirm a large difference between expenditure-based adjustments and tax-based ones. These authors also show that the shifts in monetary policy that accompany fiscal adjustments cannot explain this result, although other contemporaneous economic reforms may make certain plans less costly than others.

The research we summarize here uses the model estimated in Alesina, Favero, and Giavazzi to estimate the effects of the fiscal consolidations that occurred during 2009–13. We start by documenting how austerity has been implemented in each country. We estimate such a model with data running up to 2009. Then we simulate the model over 2009–13, feeding in the actual plans adopted in those years. This allows us to analyze not only the output effects of austerity as implemented, but also to ask what output growth would have been had the same fiscal contractions been implemented in a different fashion, that is, relying less on tax increases and more on spending cuts.

Our main finding is that fiscal adjustments based on spending cuts are less costly, in terms of output losses, than those based upon tax increases. Over our estimation period (1978–2007) the output effect of tax-based adjustment plans with an initial size of 1 percent of GDP is a cumulative contraction in GDP of 2 percent or more in the following three years, a result which is roughly consistent with Romer and Romer. In contrast, spending-based adjustments generate small recessions with an impact on output growth not significantly different from zero.

We then use the coefficient estimates of our estimation for out-of-sample simulations, which project output growth conditional only upon the fiscal plans implemented since 2009. Our model does reasonably well in predicting the total output fluctuations of the countries in our sample over the years 2010–13, particularly, and not surprisingly, for those countries in which the main shock in that period was fiscal policy. For example, the tax-based adjustment implemented in Italy in 2010–13 is sufficient by itself to explain the recession experienced by the country over 2011–2012 (with negative GDP growth of around 2 percent in each year).

We also find little evidence that recent fiscal adjustments had larger negative output effects than past ones. This suggests that fiscal multipliers estimated using pre-crisis data give valuable information about the output loss associated with the post-crisis fiscal consolidations. This result contrasts with Blanchard and Leigh (2013), who argue that the costs of fiscal adjustments have been higher in recent years than previously estimated. The difference between our results and theirs is that we construct forecast errors that are conditional only upon deficit-driven fiscal consolidations. Instead, the forecast errors in Blanchard and Leigh are conditional upon a scenario for all the exogenous variables that enter the International Monetary Fund (IMF) forecasting model. In other words, Blanchard and Leigh attribute any deviations from forecasted growth to fiscal policy. This is a questionable assumption. For instance, countries with especially deep banking crises might have needed larger fiscal adjustments and had larger recessions, but that was because of the banking problem, not because of fiscal multipliers larger than what were estimated earlier.

To conclude, we note that our evidence has nothing to say about the desirability of the fiscal consolidations
What we can say is that, assuming that austerity was necessary (to avoid a collapse of the Euro, or banking crises, or even worse recessions), spending cuts were much less costly than tax increases. In other words, this paper shows there was significant heterogeneity in the effects of such fiscal adjustments depending on their composition—taxes versus spending—and, partly, on their credibility and persistence.

NOTE

Secular stagnation: US hypochondria, European disease?

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After the Great Depression, secular stagnation turned out to be a figment of economists’ imaginations. This chapter argues that it is still too soon to tell if this will also be the case after the Great Recession. However, the risks of secular stagnation are much greater in depressed Eurozone economies than in the US, due to less favourable demographics, lower productivity growth, the burden of fiscal consolidation, and the ECB’s strict focus on low inflation.

The first time around, ‘secular stagnation’ was a hypothesis famously articulated by Alvin Hansen in his Presidential Address to the American Economic Association in Detroit in December 1938 (Hansen 1939). Hansen argued that the US economy faced a crisis of underinvestment and deficient aggregate demand, since investment opportunities had significantly diminished in the face of the closing of the frontier for new waves of immigration and declining population growth. It was as if the US was faced with a lower natural rate of growth to which the rate of growth of the capital stock would adjust through a permanently lower rate of investment.

As we all know, these fears were completely without foundation – the delusions of a hypochondriac rather than the insightful diagnosis of a celebrated economist. Trend growth in the US regained or even exceeded its pre-Depression rate in the following decades that were characterised by full employment (Ben-David et al. 2003). The US economy delivered a rapid rate of TFP growth building on the technological prowess that it had established prior to the Depression (see Table 1), and this sustained a high
level of investment while population growth revived under the auspices of the ‘baby boom’. Moreover, the textbook antidote for secular stagnation in a depressed economy at the zero lower bound for nominal interest rates – namely, to cut real interest rates dramatically by credibly committing to higher inflation – had already been shown to work by Roosevelt’s New Deal, which delivered a strong recovery in the years after 1933 (Eggertsson 2008).

**Table 1** Contributions to labour productivity growth in US (% per year)

<table>
<thead>
<tr>
<th></th>
<th>K/HW growth</th>
<th>HK/HW growth</th>
<th>TFP growth</th>
<th>Y/HW growth</th>
</tr>
</thead>
<tbody>
<tr>
<td>1906-19</td>
<td>0.51</td>
<td>0.26</td>
<td>1.12</td>
<td>1.89</td>
</tr>
<tr>
<td>1919-29</td>
<td>0.31</td>
<td>-0.06</td>
<td>2.02</td>
<td>2.27</td>
</tr>
<tr>
<td>1929-41</td>
<td>-0.19</td>
<td>0.14</td>
<td>2.97</td>
<td>2.92</td>
</tr>
<tr>
<td>1941-48</td>
<td>0.24</td>
<td>0.22</td>
<td>2.08</td>
<td>2.54</td>
</tr>
<tr>
<td>1948-73</td>
<td>0.76</td>
<td>0.11</td>
<td>1.88</td>
<td>2.75</td>
</tr>
</tbody>
</table>

*Note:* Estimates are for private non-farm economy. K/HW = capital per hour worked; HK/HW = human capital per hour worked; Y/HW = real GDP per hour worked.

*Source:* Derived from Field (2013).

The rediscovery of secular stagnation in the context of a sluggish recovery from the financial crisis of 2008-9 has similar foundations. Forecasts of US economic growth over a medium- to long-term horizon have been revised down in recent times as the growth of labour inputs decreases and questions are raised about the future (post-ICT-revolution) rate of technological progress (Gordon 2014), with the result that investment opportunities are curtailed. Models have been devised in which, faced with shocks of this kind, it would be necessary to find a way to have a lengthy period of negative real interest rates to avoid a prolonged slump (Eggertsson and Mehotra 2014). Aggressive use of fiscal stimulus might be appropriate in this scenario.

It must be said that once again, this could well turn out to be hypochondria rather than far-sighted prediction. Even after downward revisions, mainstream projections for growth over the next ten years or so in the US cluster around 2.1% per year for GDP and 1.6% per year for labour productivity. This productivity growth rate would basically be a continuation of the average performance of the last 40 years (Fernald 2014), with
the main headwind being diminished growth of labour inputs in the face of adverse demographic trends. The future rate of TFP growth is, of course, quite uncertain and techno-optimists such as Brynjolfsson and McAfee (2014) imagine a much rosier future. Be that as it may, it is not obvious why an economy with a steady-state growth rate of more than 2% per year should have a permanent shortfall in demand or a need for a permanent negative real rate of interest.

However, the threat of secular stagnation may be much more real for Europe. Although relatively little attention seems to have been given to this possibility, Europe is surely much more vulnerable, especially in the Eurozone. There are four obvious reasons for this, two stemming from economic performance and two from policy responses:

• European demographics are less favourable
• Productivity growth in Europe will underperform whatever US achieves
• Fiscal consolidation in the context of a high public debt ratio will bear relatively heavily on Europe
• In a depressed economy, the Fed is more likely to take appropriate policy action than the ECB

Table 2 reports OECD growth projections for 2014-2030. In the context of ageing populations, Eurozone employment growth is projected at 0.2% per year compared with 0.5% for the US, and for most European countries the demographics are relatively unhelpful.

It is clear from Table 2 that pre-crisis productivity growth in Europe generally failed to match that in the US, as was widely noted at the time. A major reason for this in many countries was the relatively slow exploitation of the potential of ICT (Oulton 2012). More generally, productivity growth in European countries was frequently held back by weak competition, excessive regulation and shortfalls in human capital that particularly undermined productivity performance in marketed services, where the single market has been ineffective (Crafts 2013a). Europe relies heavily on the US for new technology
and its track record suggests that this will diffuse more slowly in Europe. As Table 2 reports, the OECD (2014) is hopeful that future European productivity growth will generally better the dismal pre-crisis outcome, presumably because supply-side policy will improve. However, this does seem to favour hope over experience, given the protectionist and anti-market responses that the economic history of the 1930s suggests are likely to be nurtured by prolonged stagnation.

Table 2  Pre-crisis growth and OECD long-term growth projections (% per year)

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Eurozone</td>
<td>2.3</td>
<td>1.3</td>
<td>1.0</td>
<td>1.7</td>
<td>0.2</td>
<td>1.5</td>
</tr>
<tr>
<td>USA</td>
<td>3.2</td>
<td>1.2</td>
<td>2.0</td>
<td>2.4</td>
<td>0.5</td>
<td>1.9</td>
</tr>
<tr>
<td>France</td>
<td>2.2</td>
<td>1.1</td>
<td>1.1</td>
<td>2.2</td>
<td>0.3</td>
<td>1.9</td>
</tr>
<tr>
<td>Germany</td>
<td>1.6</td>
<td>0.4</td>
<td>1.2</td>
<td>1.1</td>
<td>-0.5</td>
<td>1.6</td>
</tr>
<tr>
<td>UK</td>
<td>3.3</td>
<td>1.0</td>
<td>2.3</td>
<td>2.6</td>
<td>0.6</td>
<td>2.0</td>
</tr>
<tr>
<td>Greece</td>
<td>3.9</td>
<td>1.3</td>
<td>2.6</td>
<td>2.2</td>
<td>0.2</td>
<td>2.0</td>
</tr>
<tr>
<td>Ireland</td>
<td>7.2</td>
<td>4.3</td>
<td>2.9</td>
<td>2.3</td>
<td>1.2</td>
<td>1.1</td>
</tr>
<tr>
<td>Italy</td>
<td>1.5</td>
<td>1.2</td>
<td>0.3</td>
<td>1.5</td>
<td>0.3</td>
<td>1.2</td>
</tr>
<tr>
<td>Portugal</td>
<td>2.4</td>
<td>1.0</td>
<td>1.4</td>
<td>1.4</td>
<td>0.3</td>
<td>1.1</td>
</tr>
<tr>
<td>Spain</td>
<td>3.7</td>
<td>3.6</td>
<td>0.1</td>
<td>1.5</td>
<td>0.9</td>
<td>0.6</td>
</tr>
</tbody>
</table>


In the aftermath of the financial crisis, many European countries have high public debt-to-GDP ratios and for those in the Eurozone extended periods of severe fiscal consolidation lie ahead if they are to comply with the fiscal rules agreed in 2012. For example, the OECD (2013) calculates that for every year from 2014 to 2023, Greece will have to maintain a primary budget surplus of about 9% of GDP, Italy and Portugal about 6% of GDP, and Ireland and Spain about 3.5% of GDP. Dealing with the debt legacy of the crisis in this way will clearly be quite painful and is likely to undermine growth. If fiscal stimulus is required to combat secular stagnation, these countries are not well placed. Moreover, it is noticeable that, at high levels of debt, restoring fiscal sustainability typically entails cuts in both public investment and education spending (Bacchiocchi et al. 2011). The strong likelihood that post-crisis fiscal consolidation will
undermine these expenditures does not bode well for the growth prospects of highly indebted EU countries.

The ECB was designed to be a highly independent central bank mandated to achieve a low inflation target. It has been reluctant to embrace quantitative easing and relatively content with a rate of inflation close to zero. By contrast, the Fed has been far more willing to undertake unconventional monetary policy and has a ‘dual mandate’ that requires weight to be given to employment as well as inflation. It may be that neither central bank is well placed to make a credible commitment to raising inflation to deliver negative real interest rates, but the ECB is surely much the less likely to pursue the monetary policies that the secular stagnation scenario would demand.

If adequate monetary and fiscal responses to a threat of secular stagnation in Europe are not forthcoming, then that leaves supply-side reform, which might crowd in private investment and/or consumer expenditure, as well as increase productivity in the long run, as the only game in town. Such a strategy was successfully pursued in 1980s Britain with the relaxation of credit rationing, and the relaxation of land-use planning rules could play a similar role in Britain now (Crafts 2013b). OECD economists have quantified the possible effects of structural reforms in European economies on productivity and in many cases they are quite sizeable, as can be seen in Table 3. Moreover, such reforms need not be fiscally expensive. Unfortunately, however, in practice this is unlikely to be a feasible way to address a threat of secular stagnation, partly because the impacts are slow to come through, but more importantly because they are politically very difficult to implement effectively.
Table 3  Potential impact on real GDP per person of structural policy reforms (%)

<table>
<thead>
<tr>
<th>Moving to OECD average</th>
<th>Labour market</th>
<th>Taxation</th>
<th>Product market regulation</th>
<th>Education</th>
<th>R &amp; D incentives</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>USA</td>
<td>0.3</td>
<td>1.4</td>
<td>0.0</td>
<td>2.5</td>
<td>0.0</td>
<td>4.2</td>
</tr>
<tr>
<td>France</td>
<td>4.5</td>
<td>10.9</td>
<td>2.2</td>
<td>2.1</td>
<td>1.5</td>
<td>21.2</td>
</tr>
<tr>
<td>Germany</td>
<td>6.1</td>
<td>9.9</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>16.0</td>
</tr>
<tr>
<td>UK</td>
<td>1.1</td>
<td>0.0</td>
<td>0.0</td>
<td>4.6</td>
<td>0.0</td>
<td>5.7</td>
</tr>
<tr>
<td>Greece</td>
<td>6.0</td>
<td>10.1</td>
<td>22.0</td>
<td>5.8</td>
<td>0.0</td>
<td>43.9</td>
</tr>
<tr>
<td>Ireland</td>
<td>6.8</td>
<td>0.9</td>
<td>9.7</td>
<td>0.0</td>
<td>0.0</td>
<td>17.4</td>
</tr>
<tr>
<td>Italy</td>
<td>0.3</td>
<td>10.8</td>
<td>0.3</td>
<td>5.4</td>
<td>0.2</td>
<td>17.0</td>
</tr>
<tr>
<td>Portugal</td>
<td>7.3</td>
<td>0.7</td>
<td>8.5</td>
<td>21.8</td>
<td>1.3</td>
<td>39.6</td>
</tr>
<tr>
<td>Spain</td>
<td>3.5</td>
<td>4.6</td>
<td>0.0</td>
<td>6.3</td>
<td>1.4</td>
<td>15.8</td>
</tr>
</tbody>
</table>

Source: Barnes et al. (2011).

In sum, it is too soon to tell whether secular stagnation is going to materialise in the OECD economies. But it does seem clear that Europeans should be much more afraid than Americans. The depressing effects of slower growth of productive potential will probably be felt more keenly in Europe and economic policies to address such problems will probably be less effective there than in the US.

References


Fetters of Gold and Paper  
Barry Eichengreen and Peter Temin  
NBER Working Paper No. 16202  
July 2010  
JEL No. F33,N20

**ABSTRACT**

We describe in this essay why the gold standard and the euro are extreme forms of fixed exchange rates, and how these policies had their most potent effects in the worst peaceful economic periods in modern times. While we are lucky to have avoided another catastrophe like the Great Depression in 2008-9, mainly by virtue of policy makers’ aggressive use of monetary and fiscal stimuli, the world economy still is experiencing many difficulties. As in the Great Depression, this second round of problems stems from the prevalence of fixed exchange rates. Fixed exchange rates facilitate business and communication in good times but intensify problems when times are bad.

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While we are lucky to have avoided another catastrophe like the Great Depression in 2008-9, mainly by virtue of policy makers’ aggressive use of monetary and fiscal stimuli, the world economy still is experiencing many difficulties. As in the Great Depression, this second round of problems stems from the prevalence of fixed exchange rates. Fixed exchange rates facilitate business and communication in good times but intensify problems when times are bad. We argue that the gold standard and the euro share the attributes of the young lady described by Henry Wadsworth Longfellow (American, 1807-82):

There was a little girl, who had a little curl
Right in the middle of her forehead,
And when she was good, she was very, very good,
But when she was bad she was horrid.

We describe in this essay how fixed exchange rates share this dual personality, why the gold standard and the euro are extreme forms of fixed exchange rates, and how these policies had their most potent effects in the worst peaceful economic periods in modern times. We do not ask or attempt to answer whether widespread adoption of the gold standard in the mid-1920s or the creation of the euro in 1999 were mistakes. Both decisions reflected deep-seated historical forces that developed over long periods of time: a set of gold standard conventions and a mentalité that flowered in the 19th century, allowing the gold standard to be seen as the normal basis for international monetary affairs; and a process of European integration with roots stretching back well before
World War II that came into full flower in the fertile seedbed that was the second half of
the 20th century. We take these deep-seated circumstances as given and ask how they
could have been managed better. We ask, in particular, whether they could have been
managed to prevent economic disaster.

The gold standard was characterized by the free flow of gold between individuals
and countries, the maintenance of fixed values of national currencies in terms of gold and
therefore each other, and the absence of an international coordinating organization.
Together these arrangements implied that there was an asymmetry between countries
experiencing balance-of-payments deficits and surpluses. There was a penalty for
running out of reserves (and being unable to maintain the fixed value of the currency),
but no penalty (aside from foregone interest) for accumulating gold. The adjustment
mechanism for deficit countries was deflation rather than devaluation, that is, a change in
domestic prices instead of a change in the exchange rate.2

This last point—the choice of deflation over devaluation—can be seen clearly in
contemporary views at the nadir of the Depression. Lionel Robbins argued that ‘a greater
flexibility of wage rates would considerably reduce unemployment’. He applied this
view to the Depression: ‘If it had not been for the prevalence of the view that wage rates
must at all costs be maintained in order to maintain the purchasing power of the
consumer, the violence of the present depression and the magnitude of the unemployment
which has accompanied it would have been considerably less’. Robbins had the wit to
acknowledge that this was a ‘hard saying’ and to insist that all prices, not just wages,
needed to be flexible. These caveats did not moderate his prescription; they simply
exposed the depth of his conviction that internal deflation was the only way to deal with a fall in demand (Robbins 1934, p. 186).³

The gold standard was preserved by an ideology that indicated that only under extreme conditions could the exchange rate be unfixed. The euro has gone one step further by eliminating national currencies. Modifying the policy regime unilaterally is even more difficult than under the gold standard. While it is conceivable, in theory, that an incumbent member of the euro area could opt to reintroduce its national currency and depreciate it against the euro, there is no provision for doing so in the Lisbon Treaty.⁴ It similarly is conceivable that an incumbent member might choose to disregard its treaty obligations. But, even then, if the decision to reintroduce the national currency and convert all the financial assets and liabilities of residents into that unit was not done instantly, a period of extreme financial instability would follow, as investors withdrew their money from the domestic banking system and financial en masse, creating what one of us has called ‘the mother of all financial crises’ (Eichengreen 2010). This spectre raises the question of whether the operation can be done at all, parliamentary democracies not being good at taking decisions overnight. And, if it cannot, the question is what to do instead.

**The Gold Standard**

Keynes was clear about the impulse that set off the Great Depression. He said in mid-1931 that in ‘the fall of investment…I find—and I find without any doubt or reserves whatsoever—the whole of the explanation of the present state of affairs’. (Keynes 1931, pp. 349-351).⁵ We follow Keynes but take the argument one step further. The tight
monetary and fiscal policies of the late 1920s that induced investment to fall were due to
the adherence of policymakers to the ideology of the gold standard. Choices in the years
around 1930 were made according to a worldview in which maintenance of the gold
standard—such as it was by the late 1920s—was the primary prerequisite for prosperity.
As a result of this ideology, monetary and fiscal authorities implemented contractionary
policies when hindsight shows clearly that expansionary policies were needed. No
analogous pressure to adopt expansionary policies was felt by the authorities with the
freedom to do so.

We refer to the ideology that determined specific actions as the policy regime. It
ddictated a stable reaction to external events. This regime was well known to
contemporary observers. Both policy-makers and people affected by their actions
operated within this regime. When they thought of alternative actions, they thought of
alternatives within this regime, that is, within the gold standard. Alternatives outside the
regime were not taken seriously, whether by policymakers when proposed or by investors
and consumers when undertaken. They were interpreted as aberrations from the stable
gold-standard regime. In previous work we have identified this policy regime as a gold-
standard mentalité (Eichengreen and Temin, 2000).

The gold standard was revived with some difficulty after World War I in an effort
to extend the stability and prosperity of the great Victorian boom (Wolf, this issue). The
major industrial countries went back on gold, many at pre-war levels. Yet within a few
years, the asymmetry of the gold standard had made its maintenance impossible. We
show this evolution by analysis of the four major countries in turn: the United States, the
United Kingdom, France, and Germany.
The story is summarized in Figure 1, which shows world gold reserves for several interwar dates, divided into those of the four major countries and the residual. The height of the bars show that total reserves rose continuously from 1927 to 1935. The bottom (black) bars show that US gold reserves jumped dramatically after 1933. The next (speckled) bars show that France’s gold reserves rose continuously from 1927 to 1933 and then declined. The UK and Germany never had reserves anywhere as large, and German gold reserves in any case vanished in 1931. The disparity of gold reserves and their scarcity in the UK and Germany drove the economic fortunes of these countries.

We speak of the interwar years, but contemporaries in the 1920s knew only that the world was different after the Great War. Trade patterns had shifted as European agriculture was largely out of commission during the war. The capital positions of countries changed even more drastically as the combatants dissipated their capital stocks in fighting one another. The pattern of international settlements was further complicated by the reparations imposed on Germany, the war debts owed to the US by England and France, and loans from the US to back Germany.

Inflation during the war also put strain on the gold standard. Prices in the 1920s were higher than before in relation to the value of gold reserves. This created a deflationary bias that aggravated the pressure for deficit countries to reduce prices (Johnson 1998, Mundell, 2000).

The United States never went off gold during World War I. To the contrary, the Federal Reserve Act that went into operation in 1914 limited the legal cash reserves of the U.S. central bank to gold and lawful money. It required reserve banks to hold gold equal to 40 percent of the value of Federal Reserve notes issued, not merely Federal
Reserve notes in public circulation. This effectively raised the gold backing requirement for the note circulation by a quarter, from 40 to 50 percent. The provision was designed to assure the public that Federal Reserve notes were ‘fully backed’ with gold and real bills. If eligible securities fell short of 40 percent of notes issued to reserve banks, the shortfall had to be covered with additional gold. Additional gold equal to 35 percent of deposits placed with the reserve banks also had to be maintained.

The United States in the 1920s thus became a gigantic sink for the gold reserves of the rest of the world. Despite accumulating by the end of the decade nearly 40 percent of global gold reserves, the Fed’s free gold—the amount left over after statutory requirements were subtracted—was small. The US central bank had only limited scope for engaging in expansionary open market operations. Moreover, there was reason to fear that these restrictions would bind precisely when the need for expansionary open market operations was greatest. In a recession, as lending opportunities evaporated, member banks would use their available liquidity to pay back their borrowings from the Fed. As the Fed’s rediscouts of member bank paper declined, so would its eligible securities, increasing the required gold cover and further reducing the scope for expansionary open market operations.

Scholars debate exactly when and how tightly these constraints bound (Eichengreen 1992; Hsieh and Romer 2002). The important point, however, is not when the free gold constraint technically bound or whether it could, theoretically, have been circumvented, but whether its presence, in conjunction with the mentalité of the time, inhibited tendencies to adopt more expansionary policies. For example, the Federal Reserve’s expansionary open market operations in the summer of 1932, analyzed by
Hsieh and Romer, came in the aftermath of its stunning support of the gold standard the previous autumn. No investor could doubt the Fed’s commitment to maintaining the gold standard in 1932, even if at the moment it was not up against that constraint.

France also accumulated gold in the run-up to the Depression. In the first half of the 1920s, the left and right had engaged in a protracted struggle over who would bear the burden of taxation after the war. The fragmentation of the polity, attributable in part to the modified system of proportional representation under which members of the Chamber of Deputies were elected, heightened the difficulty of resolving the dispute. Reluctance to compromise was reinforced by the reparations tangle, for to raise taxes was to admit the unrealism of the nation’s reparations demands and reduce the pressure on Germany. The longer the stalemate persisted, the further the franc depreciated, and more perilous the financial situation became.

France’s crisis had two distinct phases. The war of attrition over taxes and public spending produced a succession of budget deficits that could be financed only with money creation. Inflation and currency depreciation were outgrowths of this budgetary deadlock. By 1924 the situation had deteriorated so alarmingly that the politicians, to avert disaster, finally compromised. The Bloc National, the governing coalition of centre-right parties led from January 1922 by Raymond Poincaré succeeded in increasing existing taxes—mainly turnover and excise duties—by 20 percent. The budget moved into balance, inaugurating an interlude of financial stability.

In the second phase of the crisis, from mid-1924 through mid-1926, the dispute over taxation provoked a series of sharp bond market sell-offs, even though the budget was broadly balanced. Each time it appeared that the tax burden might be shifted from
workers to rentiers, the latter refused to renew their maturing treasury bills, forcing the authorities to print money to refund the principal. Monetization produced inflation, depreciation, and a deepening crisis. When financial chaos reached intolerable heights, the left-wing Chamber finally accepted the leadership of Poincaré, whose opposition to economic radicalism was beyond question. Poincaré’s accession to power is popularly credited with reassuring effects even though, as revealed by the earlier episode of financial instability that Poincaré had also oversee, it was not his personal reputation that mattered. Instead, his return to office at a time of left-wing control of the Chamber signalled wider recognition of the need for political compromise.

It would seem that the fiscal crisis had come to an end. Yet the exchange rate crisis reappeared, in even more virulent form, in 1925-26. Though there was no obvious fiscal problem, the franc fell, from 19 to the dollar at the beginning of 1925 to 27 at year’s end and to more than 41 at the height of the crisis in July 1926. Presumably it was not current but future policies about which investors were concerned. Parliament granted Poincaré full powers of decree to take unilateral financial action. In effect, financial decision making was temporarily removed from the political arena. To buttress the budgetary position, Poincaré imposed increased indirect taxes and spending reductions. The magnitude of these measures has been the subject of some exaggeration, perhaps because a dramatic return to financial stability accompanied their adoption. France then stabilized the franc at the low level that had resulted from the inflation. This decision to restore the franc’s gold standard parity, de facto in 1926 and de jure in 1928, was designed to signal that the new policy regime was permanent.
This combination of policies—fiscal tightening in conjunction with one last depreciation—can be understood as a way of making stabilization politically tolerable. It allowed Poincaré to cut domestic demand as needed for budget balance while goosing export demand as a way of avoiding a more painful post-stabilization recession. But the strategy had implications not just for France but also for the larger international system. As a result of the low value at which the franc was stabilized, French exports were rendered artificially competitive. France accumulated gold at a rapid rate after 1927, as shown in Figure 1.8

Debate over how to apportion the costs of stabilization took place also in Britain. Labour felt that it already had paid enough during the Great War. After its defeat in 1924, the Labour Party adopted a program of ‘socialism now’, which meant a minimum wage and state-provided family allowances legitimated by the workers’ contribution to the war effort. Allowances were required because the reduction in costs required for the restoration of gold payments at the pre-war parity was threatening to reduce wages. For defenders of the gold standard, the problem was not that wages would fall, of course; the danger was that they would not. The growth of trade unionism, the provision of unemployment benefits, and the existence of minimum wages for unskilled workers in industries where Trade Boards had been established immediately before or during the war all worked to slow downward wage adjustment. In this setting the danger was that deflation would worsen the lot of the workers by both lowering wages and producing unemployment.

The wage issue was particularly contentious in the coal industry, a hotbed of labour activism. The demand for coal received a boost in 1923-24 when Ruhr supplies
were disrupted by the French occupation. For the miners, these were favourable circumstances, and the agreement they negotiated guaranteed a minimum wage. But when the conflict on the continent went into remission, the demand for British coal fell, and the agreement collapsed.

The Conservative Prime Minister, Stanley Baldwin, repeated the mantra of the gold standard: men would have ‘to face a reduction in wages’ to put the coal industry on its feet.9 This of course was just one way of putting industry on its feet. But it was the only way open under the gold standard, alternatives involving higher prices and a lower exchange rate being inadmissible.10 Countries on the gold standard could not devalue their currencies or allow the demand for exports to determine their exchange rate. They could not expand the money supply to stimulate domestic demand, for doing so would push up prices, provoke gold exports, and weaken the currency. The only way of reducing prices was to reduce production costs, the largest of which was labour.

The Royal Commission on the Coal Industry, chaired by a Liberal, Sir Herbert Samuel, insisted that wages had to be lowered. The mine owners based their wage offer on the Commission's recommendation, insisting on lower wages and longer hours. From labour’s point of view, pushing down wages reduced the purchasing power of the employed and implied job losses insofar as the mechanism for depressing wages was further restriction of demand. And union leaders did not share the central bankers’ apocalyptic vision of a world of managed money. They were not sufficiently secure to trade current sacrifices for purported future gains. They had participated in the war effort and now expected recompense.
The result was not just a coal strike but a general strike. It ended in defeat for labour, which only hardened the unions’ opposition to the constraints of the gold standard. Ultimately, that opposition would weaken both the Tory government (defeated in 1929) and Britain’s commitment to the gold standard (abandoned in 1931). The Treasury tried to defuse this conflict in the late 1920s by asserting that the ‘rationalisation’ of industry, rather than wage reductions, was a better way of cutting labour costs, but the gold-standard mantra of lowering costs remained clear.

Montagu Norman, the governor of the Bank of England, was so eager to maintain this pressure on the British economy and on wages that he refused to expand the money supply even on those relatively rare occasions when he had excess gold, such as in the immediate aftermath of the 1925 stabilization. Norman hid his excess gold in an account at the Federal Reserve Bank of New York where it was not visible to contemporaries. The excess gold dissipated in late 1928, but Norman still understated the Bank of England’s gold reserve in order to maintain control over the increasingly volatile foreign-exchange market (Garrett, 1995).

Germany represented the other side of the French coin. Balancing the budget and stabilizing the currency might be seen as admissions that the government’s obligations did not exceed its financial capacity—that the Reich could afford to pay reparations after all. The incentive to inflate preceded France and Belgium’s invasion of the Ruhr, but foreign occupation of Germany’s industrial heartland provided ample justification for running the printing presses full out. Hyperinflation, though an effective weapon in the diplomatic battle with Paris, grew increasingly disruptive of the operation of the German economy. As inflation ran out of control, its main effects came to be aggravating
uncertainty and demoralizing consumers. Industrial production went into decline, and influential industrialists like Hugo Stinnes swung toward compromise, accommodation, and exchange-rate stabilization. In 1924 these shifts in sentiment allowed stability to be re-established under the provisions of the Dawes Plan, a critical component of which was restoring the mark to its pre-war parity with the aid of a massive loan from the United States.

The sanctimonious quality of the restored gold standard is evident in the missions sent by the U.S. government to help Weimar. The Agent-General for Reparation Payments appointed under the Dawes Commission, S. Parker Gilbert, was clear that he saw the means for doing so as preserving the gold standard at all costs. As he explained, ‘The Experts’ Plan thus established a protected system, which was intended to safeguard the German exchange against the danger of instability through excessive reparations transfers’.12 There was no need in Gilbert's mind to do more than assert the link between a stable exchange and a stable economy.

The Great Depression

Like the Baring Crisis and the Great War, the Great Depression was a shock to this happy world. It started out as a not atypical economic contraction, first in Germany and then in the United States. This unexceptional downturn then was converted into the Great Depression by the actions of central banks and governments, notably in the wave of currency crises in the summer and fall of 1931. Economic policies did not alleviate the
Depression; they worked to intensify it. Actions that worked well in more prosperous times had damaging results when economies contracted in the early 1930s.

Policies were perverse because they were formulated to preserve the gold standard, not to stabilize output and employment. Central bankers thought that maintenance of the gold standard would in time restore employment, while attempts to increase employment directly would fail. The collapse of output and prices and the loss of savings as banks closed in the early 1930s were precisely what the gold standard promised to prevent. Reconciling outcomes with expectations consequently required interpreting these exceptional events in unexceptional terms. Where the crisis was most severe, blame was laid on the authorities' failure to embrace the gold-standard mentalité. The Federal Reserve and the Bank of England, it was alleged, had succumbed to the lure of managed money. Having refused to obey the rules of gold standard, they had committed abuses of credit, sterilized international gold flows and prevented them from exerting their normal stabilizing influence on credit conditions. This in turn prevented prices and costs from adjusting.

This was the view that prevailed in Washington D. C. and in the regional branches of the Federal Reserve System. As unemployment spiralled upward, Lynn P. Talley of the Federal Reserve Bank of Dallas wrote George Harrison of the New York Fed that his directors were not ‘inclined to countenance much interference with economic trends through artificial methods’. Treasury Secretary Andrew Mellon famously advised President Hoover that the only way to restore the economy to a sustainable footing was to ‘liquidate labor, liquidate stocks, liquidate the farmers, liquidate real estate . . . purge the rottenness out of the system . . . People will work harder’ (Hoover, 1951-52, 3, 30).
Those espousing the puritanical strand of gold-standard dogma grew more strident as unemployment mounted. Hoover himself regarded the gold standard as little short of a sacred formula. Any deviation he dismissed as collectivism, an all-embracing label for economic and social decay.

The British Committee on Finance and Industry (the Macmillan Committee), reporting in the summer of 1931, was prepared to entertain the heresy of a tariff before recommending that the gold standard be abandoned. Even internationalist politicians like the Labour Prime Minister Ramsay MacDonald were prepared to turn their backs on nearly a century of free trade before jeopardizing sterling’s hallowed status (Boyce, 1987; Williamson, 1992). Keynes, the committee's leading intellectual light, had opposed Britain’s return to gold at the pre-war parity, arguing that the proper target for monetary policy was internal price stability rather than exchange rate stability, but once the decision was made he reconciled himself to it. He was unwilling to recommend going off gold in 1930, seeing it as the linchpin of the international financial system and essential for financial stability. Only in the summer of 1931, when he concluded that the gold standard was doomed, did he recommend bowing to the inevitable and abandoning convertibility (Moggridge, 1969; Clarke, 1988). But as the Depression deepened, his desperation grew. He ‘was willing to try anything—a tariff, quotas, a national treaty on wages, profits and rents, foreign lending restrictions—anything except suspending the gold standard, which was too drastic to contemplate’ (Boyce, 1987, 293).

The gold standard consequently was not abandoned. Its rhetoric was deflation, and its mentalité was one of inaction. Central banks stood ready to withstand financial panics like the Baring Crisis of 1890 or the New York panic of 1907 but not to preserve
output and employment. The Federal Reserve System, inferring from low interest rates and excess bank reserves that no panic was in sight, counselled inaction. But when there was a threat to the U.S. commitment to gold in October 1931, it responded by raising interest rates and driving the country deeper into depression.

In this environment, supplies of money and credit depended on the quantity of gold and foreign exchange convertible into gold in the hands of central banks. As uncertainty mounted about the stability of key currencies, and hence about the future price at which they might be converted into gold, central banks liquidated their foreign balances and scrambled to replace them with gold reserves. The share of foreign exchange in global monetary reserves fell from 37 per cent at the end of 1928 to a mere 11 per cent by the end of 1931 (Nurkse, 1944, Appendix A). But there was only so much gold to go around. Central banks jacked up interest rates in a desperate effort to obtain it, destabilizing commercial banks and depressing prices, production and employment. Bank closures disrupted the provision of credit to households and firms, forcing the former to cut their consumption, the latter to curtail production. Deflation magnified the burden of outstanding debt, forcing debtors to curtail their spending still further in the effort to maintain their credit worthiness. As the gold-exchange standard collapsed back into a pure gold-based system, markets were destabilized as never before.

Sustaining the gold standard required a stomach for harsh medicine, as true believers incessantly repeated. But deflation that once might have elicited mute acceptance now provoked hunger marches and mass demonstrations. In Germany, the Communist-led Reich Committee of the Unemployed took to the streets in December 1929 before the streets were taken over by the Nazis. The British National Unemployed
Workers’ movement staged demonstrations. Farm workers in California and auto workers in Michigan clashed with police; the 1932 Bonus Army of veterans who camped out in Washington to get their bonus had their tents in ‘Hooverville’ set on fire by the army. Hunger and despair which had once led to alienation from politics and disenchantment with political parties now led workers to organize and voice their objections. Even conservative governments intellectually committed to deflationary measures hesitated to stay the course for fear of inciting a political backlash.

Importantly, these national policies had cross-border repercussions—in economist’s terminology, ‘externalities’. When the United States jacked up interest rates in October 1931 to defend the dollar’s gold parity—the sharpest such increased in the short history of the Federal Reserve System—it drained gold and ratcheted up the deflationary pressure on other gold standard countries. When in 1933 France did likewise, it intensified the deflationary pressure on other members of the so-called gold bloc. Had there been a policy regime where countries acknowledged their interdependence and acted on it—where they sought to internalize the externalities in question—things might have been different. While it was impossible for one country acting alone to cut interest rates to counter deflation, because doing so would cause gold losses and jeopardize gold convertibility, several countries acting together would have been able to do so, since my interest rate cuts would cause me to lose gold but your interest rate cuts would cause me to gain it (Eichengreen 1984). But this kind of cooperation was not part of the policy regime. Efforts to arrange it at, inter alia, the London World Economic Conference of 1933, went nowhere.
Similarly, emergency financial assistance to counter threats to financial stability in individual countries—Austria in May 1931 being the prototypical example—came to naught. The effort to arrange a Bank for International Settlements loan in response to the Creditanstalt crisis was torpedoed by France, angry that Austria and Germany were engaged in customs union negotiations in violation of the provisions of the Versailles Treaty and that Germany was building pocket battle ships. Domestic politics got in the way of international financial cooperation. In the Petri dish that was the gold standard mentalité, what started as a threat to one bank was allowed to mutate into a threat to the international financial system and the world economy.

The Euro and Renminbi

The 21st century analogues—the euro and the dollar-renminbi peg—are not identical to the gold standard, but the parallels are there. Adopting the euro, unlike adopting the gold standard, was an absolute rather than a contingent commitment. Countries could leave the gold standard during wars without angering investors, but countries cannot temporarily abandon the euro in times of crisis. No provision was made in the Maastricht Treaty or the subsequent Lisbon Treaty for a participating country to withdraw. Procedures by which a member state adopting their euro might reintroduce its own national currency were not even alluded to, much less detailed. This reflected a political logic: European leaders wanted their new monetary union to appear solid, progressive and irreversible. This approach also had an economic logic: escape clauses providing for exit might become destabilizing if investors began to bet on their
activation. Since the expectations they engendered could become self-fulfilling, it was better not to lift the lid on this Pandora’s Box.

The euro area did not simply follow the gold standard; it also followed the Bretton Woods System implemented after the Second World War. The importance of this interlude for our story is not the Bretton Woods System itself, but rather the war-time negotiations that led to it. Keynes in particular had come to realize the pernicious influence of the gold standard as it operated in the interwar years. He acknowledged that deflating in response to a loss of reserves was not only harmful for the country itself but also had the external effect of depressing economic activity in other countries—leading to the race to the bottom seen in the Great Depression (Vines 2003).

Keynes sought to avoid a similar outcome in the post-war world. He wanted to avoid the conditions shown in Figure 1 where asymmetries in the operation of the international system imparted a chronic deflationary bias. He therefore proposed a clearing union that would oversee the distribution of international reserves. The essence of his plan was that surplus countries would be obligated to curtail their imbalances in more or less the same way that deficit countries were obliged to curtail their imbalances under the gold standard. These plans did not come to fruition because of the conflict of interest between the U.S. and Britain as expressed in the conflict between Keynes and Harry Dexter White. Keynes did not want Britain to be forced into the continued austerity of the interwar years; White did not want to give the UK a free ride after the war. White, harking back to the gold standard, advocated using monetary restraints to keep excessively expansive countries in line; Keynes implied that fiscal policy would work better in a setting of low interest rates—anticipating a fateful gap in the architecture
of the euro area. The issues were not resolved, and they were largely forgotten by the 1990s (Skidelsky 2000; Vines 2003).

The euro area differed from the gold standard in that it talked the talk, but didn’t also walk the walk, of international cooperation. There was awareness that fiscal and financial policies were a matter of common concern, and that coordinated adjustments in which countries in chronic surplus expanded while countries in chronic deficit did the opposite, were desirable. But the area’s various mechanisms for coordination, the Stability and Growth Pact, the Excessive Deficit Procedure, and the Broad Economic Policy Guidelines, were honoured mainly in the breach. Representatives of Europe’s national governments went to Brussels to discuss them, and then they went home and mainly did as they pleased. Like the Pope, the European Commission had no army to enforce its decisions. While national politicians spoke the language of cooperation, they were mainly concerned with the reaction of their domestic constituents when taking actual decisions. In Southern Europe, deficit spending and government debts were allowed to grow all out of control. In Central Europe, meanwhile, there was nothing to prevent the pursuit of a chronic deflationary bias. For a time, this preference in one region for deficits, combined with a preference in the other for surpluses, seemed like a happy symbiosis – just as it had in the second half of the 1920s. But this did not mean that it was any more sustainable than 80 years before.

The other thing Europe lacks, in addition to mechanisms for adequately coordinating national macroeconomic policies, is an emergency financing facility to provide adjustment assistance to countries in exceptional financial difficulty. In 1931, as we have seen, when the international system began coming apart, there was an
unsuccessful attempt to arrange an international loan for Austria through the BIS. When in 2010 it became necessary to arrange an emergency loan for Greece, there was no analogous organization suitable for arranging a loan for a euro area country. Some suggested that this responsibility should be assigned to the International Monetary Fund. Others objected that the Greek tragedy was Europe’s internal affair; bringing in the IMF would be a little bit like having the Fund bail out California. Unable to decide, Europe in the end had it both ways, which did little to reassure the markets. More generally, this approach ran up against the difficulty that no mechanism existed for extending a loan; a formula for contributions had to be agreed on, and the resulting package of financial aid had to be ratified by the whole set of national parliaments.

The other important exchange rate in this recent period, the dollar-renminbi peg, is best thought of as a central element of the ideology of Chinese development policy. China’s policy is not unlike that of other late-developing Asian economies. It is to grow by moving workers from low-productivity agriculture to high-productivity manufacturing industry, the output of which is sold to consumers in high-income countries. It is to limit consumer spending and financial liberalization so that a high fraction of GDP can be ploughed into investment in fixed capacity and now infrastructure. It is to augment domestic savings by attracting foreign direct investment. The fixed peg to the dollar, maintained rigidly until June 2005 and then put back in place in response to the financial crisis in 2008 after three years during which the renminbi had been allowed to appreciate slowly and gradually against the dollar, was part and parcel with these goals. The role of the peg in China’s development strategy was three-fold: to facilitate the export of manufactures, to ease the decisions of foreign companies contemplating investment in
China, and to enlarge the earnings of Chinese enterprises that were the main source of the savings (retained earnings) ploughed into capacity expansion. Insofar as other Asian countries were concerned with their competitiveness vis-à-vis China, the renminbi’s peg to the dollar became a broader pan-regional and international dollar standard.

As in Europe in recent years and in the 1920s, there was some awareness that policies in each of the countries linked together by this regime had implications for the other participants but little willingness to act on that awareness. In 2006 the IMF engaged in a Multilateral Consultation Initiative involving the U.S., China and three other large economies with the goal of encouraging them to take those cross-border implications into account and undertake mutually beneficial policy adjustments, but to no avail. The U.S. and China meet annually in a bilateral Economic and Strategic Dialogue, but this did not result in significant changes in bilateral currency policy. The IMF conducts multilateral surveillance exercises in conjunction with its World Economic Outlook exercise twice a year, in the process of which it gives public (and, presumably, private) advice on mutually beneficial policy adjustments. But, as of the time of writing, no actual adjustments of significance are evident.

**Toward Symmetry**

The point of this discussion is not to let deficit countries—Germany in the context of the gold standard, Greece in the context of the euro, the United States in the case of global imbalances—off the hook. All three were reluctant, for political and other reasons, to acknowledge that they faced budget constraints. They lived beyond their
means, running budget and current-account deficits and financing them by borrowing abroad, Germany mainly from the United States in 1925-28, Greece mainly from its European partners in 2002-08, and the United States mainly from China and the oil-exporting economies of the Middle East.

In all three cases, borrowing was facilitated by the facade of stability created by pegged exchange rates. The perception that currency risk had been eliminated encouraged finance to flow from capital-abundant economies where interest rates were low to capital-scarce economies where they were high. Deficits were financed more freely, encouraging governments to run them, until markets were disturbed by financial upheavals that raised doubts about the solvency of sovereign borrowers. This of course is just the problem of ‘capital-flow bonanza’ followed by ‘sudden stop’ familiar from the literature on 19th and 20th century emerging markets. The only surprising thing is that parochial advanced-country observers and policy makers, whether in the 1920s or more recently, did not understand that the problem also applied to them.

One possibility (ignoring political realities), is for countries on the receiving end to exercise more restraint: to eliminate excessive budget deficits and, realizing that good times don’t last forever, to borrow less abroad while capital is still flowing. In the U.S. there is now a discussion of whether the Fed erred by keeping interest rates below levels consistent with the Taylor Rule in 2003-5 and whether it should have moved quicker to take away the punch bowl when housing and asset market bubbles were building. There is discussion of whether excessive budget deficits following the Bush tax cuts of 2001-03, passing an unfunded prescription drug plan, and fighting two expensive wars caused an excessive build-up of debts and deficits, much of which were funded by selling the
securities of the U.S. Treasury and the quasi-governmental agencies Freddie Mac and Fannie Mae to China. There is discussion of whether the Fed and the Administration should exit from recent policies of monetary and fiscal stimulus sooner rather than later to prevent dependence on foreign capital from resuming (avoiding the reappearance of global imbalances).

In Europe, there similarly is discussion whether the Stability and Growth Pact can be tightened and new rules can be promulgated to prevent countries from living beyond their means. There is a discussion whether Europe needs to create an emergency financial mechanism (a ‘European Monetary Fund’) to regularize the provision of financial assistance to temporarily illiquid governments and take an orderly approach to restructuring the debts of any which are insolvent.

But there is another side of this coin: namely, the policies of the surplus countries. In the late 1920s and early 1930s the difficulties of Germany and other Central European countries were greatly aggravated by the policies of gold and foreign exchange sterilization undertaken by the U.S. and France. With these countries in balance of payments surplus, someone else had to be in deficit. With their refusal to expand once the Depression struck, someone else had to contract. With their refusal to extend emergency financial assistance, the extent of the contraction to which the deficit countries were subjected became almost unimaginable. In the end, the political consequences were disastrous.

Now, when the surplus countries are Germany and China, we see a similar process begin to unfold. Greece trades with its European neighbours, notably with Germany, which is in strong surplus. With Germany’s reluctance to raise spending, a
cash-strapped Greece has no alternative but to deflate. Whether it can cut government spending by 10 per cent of GDP and the wages of civil servants and other domestic costs also by 10 per cent in short order is to be seen; an adjustment of this order of magnitude has never been made, to our knowledge, except in conjunction with other policy adjustments (like M. Poincaré’s sharp depreciation of the currency, something that is not available to Greece). Greece’s problem now, like Germany’s in the early 1930s, is that cutting costs only makes the burden of indebtedness heavier. This is why even US President Hoover, not exactly a progressive economic thinker, was ultimately forced to recognize the need for a German debt moratorium, and why internal devaluation, the only form of devaluation available to Greece, will require restructuring its debts—which is likely to be cheaper and easier sooner rather than later. Just as the Hoover Moratorium required a change in policy on the part of the US, a Greek restructuring will require a volte face by the European Union and the IMF.

Similarly, in the absence of a willingness of China and other countries shadowing the dollar to move faster to boost domestic spending and allow their currencies to rise, the only way for the United States to grow employment faster is by cutting costs to make its exports more competitive. President Obama’s stated goal of doubling U.S. exports within five years is designed to map this route to full employment. But absent an adjustment in the real exchange rate delivered by more spending and either nominal currency appreciation or inflation in Asia, this will have to be done by cutting costs or miraculously raising productivity, something that is likely to be wishful thinking.

The point is that an exchange rate system is a system, in which countries on both sides of the exchange rate relationship have a responsibility for contributing to its
stability and smooth operation. The actions of surplus as well as deficit countries have systemic implications. Their actions matter for the stability and smooth operation of the international system; they cannot realistically assign all responsibility for adjustment to their deficit counterparts. Keynes drew this lesson from the experience of the Great Depression. It was why he wanted taxes and sanctions on chronic surplus countries in the clearing union proposal that he developed during World War II. Sixty-plus years later, we seem to have forgotten his point.
References


Wolf, Nicolaus, this issue.
Notes

1 This kind of counterfactual history has its place, but not here.
2 Dam, 1982. For more details and documentation on the following argument about the gold standard and the Great Depression, see Eichengreen and Sachs, 1985; Temin, 1989; Eichengreen, 1992; Eichengreen and Temin, 2000.
3 Later he regarded this view as a ‘fundamental misconception’.
4 The treaty contains an obscure provision providing for the possibility that a member might withdraw from the EU, which would presumably entail abandoning the euro (although not necessarily, since a number of non-EU members such as Montenegro utilize the euro). But withdrawing from the EU is an extreme step that even financially-distressed member states would hesitate to take.
5 His interest—like that of his modern-day followers and critics—was in the propagating mechanism, and he consequently did not examine more closely his candidate for the shock.
6 Thus, while Keynes had famously opposed Winston Churchill’s decision to put sterling back on the gold standard at the prewar parity in 1925, once the decision was taken he took the gold standard as a given – as an immutable constraint on policy. For more on this, see below.
7 Some like France went back to gold at significantly devalued exchange rates, which will be important to our story.
8 One is reminded of the modern debate over expansionary fiscal consolidation. France, like Ireland and the Netherlands in the 1980s and Finland in the 1990s, was able to balance the budget without experiencing a severe recession because it could depreciate the exchange rate and crowd in exports (an option not available to members of the euro area like Greece – see below). But as a large country, its policy had adverse systemic implications not shared by those of the small Northern European countries in the 1980s and 1990s.
9 Baldwin was quoted in the newspaper as saying, ‘All the workers of this country have got to take reductions in wages to help put industry on its feet,’ but this more inclusive statement was denied by the government. Middlemas and Barnes, 1969, 387.
10 Keynes famously had argued for a lower exchange rate in 1924-5, but his was a voice in the wilderness. And once the prewar parity was restored, he too took it as a given
11 Sayers, 1976, 3, 349-54, however could see the excess gold in retrospect without difficulty.
12 Gilbert, 1925-1930, 10 Dec. 1927, 172.
13 Martin Feldstein 2010, suggested otherwise, but this does not make it so.
14 See note 4 above.
The mother of all sudden stops: Capital flows and reversals in Europe, 1919-1932

Olivier Accominotti, Barry Eichengreen 14 September 2013

From 2001 to 2008, half of Europe received capital inflows from the other half and beyond. In 2009, that stopped, capital accounts switched signs and a crisis occurred. This column draws parallels from a similar episode in Europe just before the Great Depression. It highlights that in both episodes global factors – largely exogenous to conditions in the borrowing countries – shaped the capital flows and reversals.

From 2001 through 2008 one half of Europe received enormous capital inflows from the other half of Europe and the rest of the world.

- Starting in 2009, the recipients then experienced a sudden stop, a capital-account reversal, and an economic and financial crisis (Pisani-Ferry and Merler 2102).

From 1924 through 1928 one half of Europe received enormous capital inflows from the other half of Europe and the rest of the world.

- Starting in 1929, the recipients then experienced a sudden stop, a capital-account reversal, and an economic and financial crisis.

The fact that there are parallels between the economic and financial crises in Europe in the interwar years and today is invoked frequently, but mainly at an anecdotal level.

New research on the 1919-1932 sudden stop

In recent research, we fill this gap with a new analysis of the determinants of capital flows and capital-account reversals between the wars (Accominotti and Eichengreen 2013).

Whereas other historical studies of international capital movements rely on estimates of net capital flows computed from balance-of-payment statistics, we work here mainly with gross primary issues. We employ new estimates of private long-term European bond issues in six major financial centres: New York, London, Paris, Amsterdam, Stockholm and Zurich from 1919 to 1932. Recent research has emphasised the advantages of gross capital flows in empirical studies of sudden stops (Fostel and Kaminsky 2007, Forbes and Warnock 2012, and Cavallo et al. 2013).

Capital surges and reversals: Comparing 1919-1932 and 2006-2011

Figure 1 shows the value of long-term bonds floated by European countries from 1919 to 1932 in millions of 1990 dollars. The capital surge and sudden stop are both evident.

- Gross capital exports to European countries rose sharply starting in 1924 and peaked in 1927.
- New bond issues then declined by 64% in real terms in 1929.

Figure 1. Bond issues on account of European countries, 1919-1932 (millions of 1990 dollars)
This was followed however by a recovery in 1930, due mostly to the Young plan loans to Germany.

- In 1931 gross long-term capital exports collapsed again.

While almost all major financial centres participated in this sudden stop, there were a few exceptions. The volume of bond issues actually rose in Paris and Stockholm between 1927 and 1931, for example.

Figure 2 compares the current-account deficits of the largest European capital importers of the 1925-1932 and 2006-2011 periods. Current-account deficits were large in both periods. In 1927, the aggregate current-account deficit of Austria, Germany and Hungary was nearly 5% of their aggregate GDP. This was somewhat smaller than the collective current-account deficit of Greece, Ireland, Italy, Spain and Portugal in 2008 (6.7% of collective GDP). However, the subsequent reversal was even larger in the 1920s; the shift in Central European countries’ current-account deficit between 1927 and 1931 represented 6.0% of their collective GDP, whereas between 2008 and 2011 Greece, Ireland, Italy, Spain and Portugal experienced a current-account contraction amounting to 3.2% of their aggregate GDP (the most recent estimate for 2012 however suggests that the GIIPS’ current-account deficit contracted further in that year).

**Figure 2.** Ratio of current-account deficit to GDP (%) 1925-1932 vs. 2006-2012

Important differences between the two episodes

The larger provision of official financing in the more recent episode accounts for this difference. Indeed, one important difference between the two periods is the extent to which official capital inflows compensated for private outflows.

- In the early 1930s official flows took the form of loans for Germany, Austria and Hungary from foreign governments as arranged by the Bank for International Settlements and central bank finance of the balance of payments (central bank purchases and sales of gold and foreign exchange).
- After 2007 they took the form of rescue loans for Greece, Ireland and Portugal from foreign governments and arranged through the European Financial Stability Facility and transfers to the affected countries’ central banks through TARGET2, the EU’s real-time interbank payment system.

As apparent in figures 3 and 4, the decline in private capital inflows to Greece, Italy, Portugal, Spain and Ireland in 2008-2011 was larger than that experienced by Central European countries in 1927-1931. However, the rise in official inflows was also larger, making the resulting current-account adjustment less severe for the capital importers. To some extent, then, the Eurosystem has provided collective insurance against sudden stops. In 1929-31, in contrast, Central European countries were forced to rely on their individual insurance against sudden stops (in the form of international reserves), together with much more limited international emergency support.

Figure 3. Private and official capital inflows, 1925-1932. Austria, Germany and Hungary (in % of aggregate GDP)
Source: See appendix A. The graph displays the aggregate ratios of net private and official capital inflows to GDP (in %) for Austria, Germany and Hungary. Private capital inflows correspond to the sum of the current account deficit and accumulation of gold and foreign exchange reserves. Official inflows correspond to international reserves outflows and loans arranged by the Bank for International Settlements.

**Figure 4.** Private and official capital inflows, Greece, Ireland, Italy, Portugal and Spain, 2002-2011, in % of aggregate GDP

Source: Data communicated by Jef Boeckx (originally from Thomson Datastream). The graph displays the aggregate ratios of net private and official capital inflows to GDP (in %) for Greece, Ireland, Italy, Portugal and Spain. Private capital inflows are calculated as the difference between the financial account and the net liabilities of the central bank and government reported under the “Other Investment” item of the balance of payment statistics (see Boeckx, 2012 for details). Official capital inflows correspond to a. TARGET2 liabilities; b. loans granted by the IMF, EFSF, EFSM, and other EU governments and c. changes in the central bank’s reserve assets.

**Pull factors**

In exploring the determinants of capital flows in the 1920s and 1930s, we distinguish between factors specific to the borrowing countries (pull factors) and factors specific to global capital markets (push factors).

Our results indicate that changes in borrowing countries’ conditions (pull factors) cannot account for the surge and sudden stop in European capital issues. Only a handful of borrowing country-specific
variables successfully predict bond issues during this period. We find a large, negative and significant association between capital inflows and the level of borrowing countries’ public debt but only during the sudden stop (1929-1932). Evidently investors only grew seriously concerned with debt levels when liquidity dried up and growth rates declined.

**Push factors**

By contrast, our results indicate that changes in global capital markets’ conditions (push factors) were significant drivers of capital flows. In particular, we find a strongly negative relationship between the volume of capital issues in a given financial centre and the level of long-term interest rates and stock market volatility (a proxy for risk perceptions) in the same market. These effects are large. Evidently, risk perceptions and the cost of capital in international capital markets mattered importantly for the volume of new bonds issued.

The negative association between stock market volatility and capital flows resembles findings for the recent period. Milesi-Ferretti and Tille (2011), Forbes and Warnock (2012) and Rey (2013) also conclude that global risk perceptions have been important determinants of capital flow surges and reversals in the past 30 years.

This result also sheds light on contemporary perceptions of foreign lending. Authors like Harris (1935) and Nurkse (1944) expressed strong scepticism about international capital flows, arguing that they were economically and financially destabilising on balance. Their conclusions were informed by this interwar experience when, our results suggest, debtor countries were first inundated by and then starved of foreign capital, due as much to changing conditions in international capital markets as any changes in local economic circumstances and policies.

**Conclusion**

The parallels between capital flow surges and reversals in Europe in the periods leading up to the two great financial crises of the modern era, the Great Depression and the Global Credit Crisis, are more than skin deep.

- In both periods there was a flood of capital from one half of Europe to the other, as well as to the continent’s recipient half from the rest of the world.

There was neglect by lenders of public debt burdens and their implications for credit worthiness during the boom and then the sudden rediscovery of sovereign risk once capital dried up.

- In both periods, countries that imported foreign finance most liberally during the boom suffered the largest reversal and most serious dislocations when the surge of capital inflows came to an end.

But recipient-country characteristics explain only a part of trends and fluctuations in private long-term capital flows in the 1920s and early 1930s. At least as important were conditions in international capital markets. Among the important factors there was the level of interest rates, as emphasised in a host of earlier studies, but also perceptions of the riskiness of the investment environment, as captured by the volatility of equity prices, the same proxy utilised in studies of the recent period.

Interwar experience thus underscores the extent to which global factors largely exogenous to conditions in the borrowing countries shaped the capital inflows and outflows to which European countries were subject. This was a precedent of which European countries in the period leading up to subprime/global credit crisis of 2007-8 could have usefully taken heed.

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1 Computed by aggregating current-account deficits and GDP at market exchange rates.
The eurozone is in trouble. Unemployment is over 12 percent and is getting worse. Youth unemployment is 24 percent. In Spain and Greece, total unemployment exceeds 26 percent, and youth unemployment exceeds 55 percent. These two countries, together with Ireland, Cyprus, and Portugal, are in official bailout programs. If Slovenia eventually joins the club, as seems possible, then a third of the eurozone’s 17 members will be in such programs. Capital controls imply that Cypriot euros are no longer convertible into euros elsewhere. There has been a sharp decline in eurozone citizens’ confidence in European institutions: reported “distrust” in the European Union exceeds “trust” in 15 out of 17 countries and by an average 28 percentage points overall. In Greece, the fascist Golden Dawn party entered Parliament in 2012 and is gaining in opinion polls. Economies, societies, and political systems are fraying at the seams.

In the Cypriot, Irish, and Spanish cases, banking crises caused economic collapse and loss of political sovereignty. Pre-crisis cross-border flows of capital pushed up wages, prices, and asset prices in recipient countries, implying major adjustment problems that now have to be faced, but the fact that many of these flows have been

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† To access the disclosure statements, visit http://dx.doi.org/10.1257/jep.27.3.167 doi=10.1257/jep.27.3.167
channeled through banks has led to some of the eurozone’s most intractable problems. The costs of dealing with banking crises has worsened governments’ fiscal positions, putting further strain on banks’ balance sheets, in turn crimping credit creation, thus leading to a further deterioration in the economy and governments’ fiscal positions, and so on.

The eurozone crisis gives rise to three questions. First what macroeconomic policy mix is consistent with running a diverse monetary union involving 17 independent nation states? More specifically, what policy mix will be required to ensure that the adjustment problems that countries like Greece and Spain now face can be successfully overcome and that the eurozone does not collapse in the short to medium run? Second, what is the minimum institutional framework consistent with the survival of the eurozone in the medium to long run? If macroeconomic adjustment problems cannot be overcome in the shorter run, and if necessary institutional reforms cannot be delivered in the longer run, then a third question becomes potentially relevant: how can the costs of a eurozone break-up be minimized?

Although there are no convincing historical analogies for the eurozone, which is a unique experiment (Eichengreen 2008), we begin with an overview of some of the historical analogies that are often mentioned. Nonetheless, history can provide us with lessons regarding all three questions. The gold standard provides lessons regarding what short-run adjustment strategies the eurozone should be pursuing today (Eichengreen and Temin 2010). The history of American monetary union provides lessons regarding what institutions the eurozone will need in the longer run to survive, and, perhaps more pessimistically, the circumstances in which these are likely to come about, if they ever do. Finally, history also provides lessons relevant to the break-up of the eurozone, should it come to that.

Why Previous “Monetary Unions” Offer a Poor Analogy

In this section, we offer some comparisons and contrasts between the euro and previous arrangements that superficially appear somewhat similar, but were actually very different. Table 1 summarizes the other arrangements and the key points of comparison.

European monetary union has eliminated exchange rate variability among eurozone members by replacing national currencies with a single currency, the euro. The euro is managed by a common European Central Bank whose primary objective is price stability, defined in practice as involving inflation less than 2 percent. If this goal is satisfied, the central bank is also supposed to support “general economic policies in the Union” with a view to achieving objectives such as full employment. The eurozone members are all members of the European Union, but remain independent states. Under the original architecture, national authorities handle banking supervision, resolution, and deposit insurance; there is no banking union. Neither is there a common eurozone fiscal authority, nor anything approaching a
eurozone government. Bailouts of member states are supposedly prohibited, and a series of fiscal rules were (unsuccessfully) adopted to make this credible. There is no legal means of leaving the eurozone, even temporarily, aside from leaving the European Union altogether.

The Latin Monetary Union was created in 1865, initially involving Belgium, France, Italy, and Switzerland. Its purpose was to harmonize the gold and silver content of the coins of the four countries (Redish 1993); it was a coinage agreement, not a monetary union. There was no common unit of account, no common political framework, and no common central bank. The Scandinavian Monetary Union involved Denmark, Norway, and Sweden (Henriksen and Kærgård 1995). Gold coins, and token silver and bronze coins, were legal tender in all three countries. In 1885 the three central banks opened current accounts with each other, gaining the right to draw drafts in each other’s currencies at par. Nevertheless, the central banks remained independent of each other, there was no economic policy coordination in other areas, and countries retained their own currencies.

### Table 1
Comparing Currency Unions

<table>
<thead>
<tr>
<th></th>
<th>Latin Monetary Union</th>
<th>Scandinavian Monetary Union</th>
<th>Anglo-Irish monetary union</th>
<th>Currency boards</th>
<th>United States</th>
<th>Gold standard</th>
</tr>
</thead>
<tbody>
<tr>
<td>Does it eliminate exchange rate variability?</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Does it eliminate national currencies?</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Is exit easy?</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Is there a temporary escape clause?</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Is there a common central bank?</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Are high-denomination coins mutually acceptable?</td>
<td>N/A</td>
<td>Yes</td>
<td>Yes</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
</tr>
<tr>
<td>Are low-denomination coins mutually acceptable?</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Is paper currency mutually acceptable?</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Is there a fiscal union?</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Is there a political union?</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Is there a banking union?</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Is the union symmetric?</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>High labor mobility?</td>
<td>No</td>
<td>Partial</td>
<td>Partial</td>
<td>Yes</td>
<td>Varies</td>
<td>Yes</td>
</tr>
</tbody>
</table>

a Could suspend convertibility of paper currency into specie.
b Occurred in stages; agreements in 1894 and 1901.
c British currency accepted in Ireland.
d Except in cases involving dollarization.
e There are two common central banks in the CFA franc zone, corresponding to the West African and Central African Currency Unions.
There have been a number of small-scale “monetary unions,” typically between a larger and a smaller state, in which each state’s currency is legal tender in the other (or the larger state’s currency has legal tender status in the smaller state). The Anglo-Irish monetary union which lasted from Irish independence in 1922 until 1979 is one such example: Honohan (1994) considers this to have been de facto a currency board arrangement throughout virtually the entire period. History records more than 60 currency board systems, mostly occurring in colonial situations where dependent states and territories issued their own currency (Hanke and Schuler 1998). The key requirements are that the issuer must freely exchange local for foreign currency at par and must hold enough foreign-denominated safe assets to cover its entire monetary base liabilities. Currency boards typically do not involve a common central bank or currency, and countries can choose to leave at any time.

The United States has a true monetary union, not simply a more or less hard exchange rate peg between state currencies. As we will see, it gradually developed a common central bank, a banking union, and a fiscal union. The obvious difference between the United States and the eurozone is that in the American case political union preceded monetary union, while the European gamble has been to try to develop a monetary union in the absence of political (and fiscal and banking) union.

Finally, the gold standard was not even formally speaking an exchange rate agreement. Rather, it was a series of country-by-country monetary regimes linking the value of currencies to the price of gold, obliging central banks or their equivalents to hold sufficient reserves to be able to make this commitment credible. It only became a quasi-fixed exchange rate regime as a by-product of free trade in gold, which led to gold prices being almost (not entirely as arbitrage was costly) equalized in different countries. Countries retained their own currencies, central banks, and political and financial sovereignty and could sever the link between their currencies and gold whenever they wished.

The Adjustment Problem: What Can We Learn from the Gold Standard?

Most of the debate in the run-up to the adoption of the euro was couched in terms of traditional optimum currency area theory (Mundell 1961; Kenen 1969). If the benefits of a common currency are that it increases trade, then benefits should be increasing in the extent of trade integration within the currency area. What about the costs? Here, optimum currency area theory focuses on how the regions within the area are able to adjust to macroeconomic shocks. If shocks are symmetric across regions, then a common monetary policy response is appropriate, reducing the cost of a common currency. If shocks are asymmetric, then labor flows from depressed to booming regions will help adjustment, as will wage and price flexibility, or a central fiscal authority that can smooth shocks across regions; but if these
alternative adjustment mechanisms are absent, the regions may be better off with separate currencies so that the exchange rate can be used as a tool of adjustment. The history of the gold standard is a rich source of lessons on how adjustment across countries takes place in modern economies and polities.

The Gold Standard, the Trilemma, and Adjustment in Theory and Practice

The gold standard was supposed to ensure aggregate price stability by making it impossible for governments to engage in inflationary policies. It also offered the prospect of microeconomic benefits by encouraging international integration, and indeed it boosted trade by more than the euro has done (Estevadeordal, Franz, Taylor 2003; Mitchener and Weidenmier 2008; Baldwin 2006; Santos Silva and Tenreyro 2010). But how did it cope with macroeconomic adjustment?

The gold standard operated as a straitjacket on macroeconomic policy, according to the macroeconomic policy trilemma which says that a country cannot simultaneously choose three policies: 1) a fixed exchange rate, 2) open capital markets, and 3) monetary policy autonomy. It must pick two. If a country chooses open capital markets, “uncovered interest parity” must hold; that is, since arbitrage equalizes expected returns at home and abroad, the domestic interest rate must equal the foreign interest rate plus the expected appreciation of the foreign currency. If a country chooses open capital markets and fixed exchange rates, domestic interest rates have to equal the base-country interest rate, ruling out monetary policy autonomy. If a country chooses open capital markets and wishes to set domestic interest rates at levels suitable to domestic conditions, then exchange rates can no longer be fixed. However, a country can choose an autonomous monetary policy and a fixed exchange rate if it imposes capital controls. While the trilemma is a simplification, ample historical evidence supports its key predictions (Obstfeld, Shambaugh, and Taylor 2004, 2005). It provides a useful organizing framework for international macroeconomic history (Eichengreen 1996; Obstfeld and Taylor 2004) as the essential historical plot lines revolve around which leg of the trilemma countries have chosen to sacrifice.

The gold standard, like the eurozone and the US monetary union, offers lessons about what happens when the exchange rate across an area is fixed and capital markets are open, implying that monetary policy is the same across gold standard adherents, eurozone members, or US states, as the case may be. Many scholars have stressed the potential for economic instability in this setting, and the paucity of tools available in response. With a flexible exchange rate, a local demand boom would drive up interest rates, drawing in capital from abroad and appreciating the currency. This in turn would moderate the boom. With a fixed exchange rate, local interest rates cannot rise. Indeed, local central banks must prevent interest rates from rising by expanding money supplies, amplifying the boom. The opposite follows in slumps. As Ford wrote (1962, p. 188), “It is easy to understand the dislike of some Argentines for a system which dictated that a slump must be aggravated by monetary reactions, although, doubtless, they had forgotten that the same system served to enhance booms.”
Under the gold standard, the key goal for policymakers was to avoid losing gold. When a country found itself with a balance-of-payments deficit (that is, a current account surplus insufficient to finance capital outflows, or borrowing insufficient to finance a current account deficit), it needed a mechanism to staunch the resulting outflow of gold and eventually to reverse it. Such a mechanism involved, among other things, lowering the prices of domestic goods relative to those of foreign goods (depreciating the real exchange rate), thus improving the trade balance. Such “real depreciation” can be achieved by depreciating the nominal exchange rate—that is, lowering the value of the currency in which domestic prices are expressed—but this step was ruled out under the gold standard. Real depreciation had to be achieved by lowering the domestic price level, a strategy sometimes referred to as “internal devaluation” in the eurozone context.

In Hume’s (1742) formulation of the “price-specie-flow mechanism,” adjustment was supposed to be automatic. He argued that gold outflows, which were needed to pay for trade deficits, would lower the money supply, since the latter was tied to gold reserves. This in turn would lower the internal price level, depreciate the country’s real exchange rate, and improve the trade balance. Conversely, surplus countries would experience gold inflows, inflation, and real exchange rate appreciation.

The late nineteenth century world was more complicated than the world envisaged by Hume. Rapidly expanding international financial markets meant that trade deficits could be financed by borrowing rather than by gold exports. Yet interwar observers, looking back at the pre-1914 experience, believed that adjustment under the gold standard had been smooth as a result of monetary authorities following the “rules of the game.” Central banks in deficit countries were supposed to raise discount rates, thus shrinking money supplies and allowing for Humean price reductions and real depreciations. In surplus countries, they were supposed to lower discount rates, implying symmetric adjustment. Economic historians have known for a long time that central banks did not follow the rules of the game: adjustment was far from automatic, much less symmetric (Bloomfield 1959; Morgenstern 1959; Eichengreen 1992, Chapter 2). And yet the classical gold standard worked fairly smoothly during the late nineteenth century, at least in core economies such as Britain, France, and Germany.

One reason for this was that key economies such as Britain did not suffer from severe balance-of-payment imbalances so not much adjustment was required. In addition, five specific pre-1914 economic and political conditions meant that insofar as macroeconomic adjustment was needed, it was easier to achieve it than it would become in the interwar period (or in the eurozone today).

\[1 \text{For example, Britain’s payments remained fairly well balanced because sterling’s role as a “vehicle currency” facilitating international transactions meant that long-term capital outflows were in part matched by short-term capital inflows, as borrowers placed money on deposit in Britain; and they were in part matched by exports of British capital goods (Eichengreen 1992, 2008).}\]
First, wages and prices were more flexible then than subsequently: Hanes and James (2003) find no evidence of downward nominal wage rigidity in the United States between 1841 and 1891. This nominal flexibility was already declining before World War I: Hanes (1993, 2000) finds a decline in flexibility from the 1890s onwards associated with the spread of large-scale, capital-intensive, concentrated industry. Cross-country analysis by Basu and Taylor (1999) and Chernyshoff, Jacks, and Taylor (2009) provides further evidence of greater nominal flexibility in the pre-1914 era. By contrast, the escape route of internal devaluation via downward nominal price adjustment appears elusive in today’s world, where most significant real depreciations have come through nominal exchange rate adjustments (Shambaugh 2012).

Second, even in cases where macroeconomic adjustment increased unemployment (for example, because falling prices and downwardly sticky wages implied rising real product wages), typical nineteenth century limits on who was allowed to vote meant that the interests of the workers who suffered most could be largely ignored by policymakers with few adverse repercussions (Eichengreen 1992). Modern democracies work differently.

Third, this period was also one of international mass migration, whose timing was influenced by business cycle conditions, and which therefore relieved labor market pressures during periods of stress (Hatton 1995; Hatton and Williamson 1998, chap. 4).

Fourth, limited political opposition to the gold standard, and ample gold reserves that were spread out among the core countries, implied that policymakers’ commitment to the gold standard was usually regarded as credible. Credibility implied that capital flows tended to be stabilizing: that is, if an exchange rate started depreciating, it was expected that it would soon appreciate, meaning that private investors would buy the currency—thus helping to bring about the needed appreciation and in the process reversing gold outflows (Eichengreen 1992).

Fifth, when these mechanisms did not suffice, international cooperation between core central banks willing to lend to each other, or intervene together, could be relied upon to stabilize the situation.

It was a different story for countries in southern and eastern Europe, Latin America, and Asia. Trade with these countries amounted to two-thirds of core European trade, and more than 40 percent of US trade. Some pegged to silver, others had inconvertible currencies, and still others tried to peg to gold with only sporadic success. Catão and Solomou (2005) find evidence of large nominal and real depreciations in peripheral economies vis-à-vis the core during time of crisis, such as the late 1870s and early 1890s, and also find that trade balances improved when real exchange rates depreciated.

Summing up, adjustment under the classical gold standard was, in principle, supposed to involve “internal devaluation.” Such a strategy was easier before World War I in both economic and political terms than it was during the interwar period. Nevertheless, in the core economies adjustment typically happened in other ways, and only limited adjustment was required in the first place. In the periphery, where
more adjustment was required at times of stress in the international economy, and where countries did not benefit from the same international cooperation that core economies enjoyed, countries frequently adjusted via nominal depreciation. Even in the heyday of the gold standard, the “internal devaluation” strategy was nowhere near as ubiquitous as is sometimes thought.

**The Gold Standard and the Great Depression**

The economic and political environment was very different after World War I, implying that the gold standard worked much less smoothly than it had before (Kindleberger 1973; Temin 1989; Eichengreen 1992).

First, the underlying imbalances facing core economies and requiring adjustment became much larger than previously. Britain’s balance-of-payments position was more fragile. Its net international asset position had been greatly weakened by the war, implying less investment income, while war debts were another drain on the economy. Its trade position had been weakened as a result of competitors seizing overseas markets during the conflict. The pound went back onto the gold standard at the pre-war rate in 1925, implying an overvalued exchange rate, particularly vis-à-vis the US dollar and the French franc. Britain experienced large balance-of-payments deficits from about 1925 onwards and a deep industrial slump. Moving beyond the British case, the United States was now emerging as the largest net lender, especially to Latin America and countries such as Germany. When the Federal Reserve raised interest rates in 1928 in an attempt to halt a runaway stock market, these borrowing countries faced a sudden stop in capital imports, and with it, a need to adjust. Many countries abandoned the gold standard soon thereafter.

Second, the process of adjustment to economic shocks became less smooth than it had been before 1914 (Eichengreen 1992). Nominal wages were more rigid. Voting rights had broadened. The macroeconomic and political costs associated with adjustment based on internal devaluation were thus higher than before. These changes reduced the credibility of governments’ commitment to the gold standard, implying that capital flows were now potentially destabilizing (Obstfeld and Taylor 2003). Credibility also suffered because World War I had brought general distrust, periods of capital controls, devaluations, and later some hyperinflations, trade barriers, and other shocking forms of economic and political uncertainty. International cooperation between central banks was less effective given political frictions and different views on what constituted appropriate economic policy.

Perhaps most damaging was the asymmetric nature of international adjustment under the interwar gold standard. Countries with a balance-of-payments deficit (like Britain) had an incentive to raise discount rates to prevent gold outflows, while surplus countries (like France) who were experiencing gold inflows had an incentive to “sterilize” them—that is, to adjust the money supply in ways that prevented the inflow of gold from causing inflation—so that they would continue accumulating gold. World gold reserves rose steadily between 1925 and 1932, but with the United States not lowering its gold holdings, and with France rapidly increasing its reserves, there was insufficient gold elsewhere (Irwin 2010). Deflation in countries
like Germany was not matched by inflation elsewhere, making macroeconomic adjustment all the more difficult.

Several lessons from this disastrous interwar experience are directly relevant for today's Europe.

First, nominal wages were sticky downward during the Great Depression (Bernanke and Carey 1996), implying that deflation led to rising real wages, and falling employment and output. Wages were not unusually rigid during this period (Hanes 2000); rather, downward stickiness is a fact of life in modern economies.

Figure 1 shows indices of wages and salaries between 2008 and 2012 in Greece, Ireland, Portugal, and Spain, four countries currently trying to achieve nineteenth-century style internal devaluations. As can be seen, wages have been steadily rising in Portugal and Spain, despite very high levels of unemployment there. Even in
Ireland, a country widely regarded as having unusually flexible labor markets and as having successfully accomplished an “internal devaluation,” there is no sign of wages falling, although they have managed to avoid rising. In all four countries, by contrast, employment levels have been continually falling, although the Irish decline came to an end in the second half of 2012.[2]

The one important eurozone exception to the general conclusion that nominal wages are rigid downwards is Greece, where manufacturing wages declined by more than 10 percent in the three years starting in 2010. The impact of the depression on the fabric of Greek society has been particularly harsh: if this is what it takes to produce nominal wage declines, prudence might suggest alternative adjustment mechanisms, such as rising wages and prices in surplus countries. As in the interwar period, however, eurozone countries running current account surpluses are reluctant to accept temporarily higher inflation rates.

Second, deflation during the interwar period was dangerous in other ways. It increased the real value of debts, placing indebted households, businesses, and financial institutions under pressure (Fisher 1933). It weakened bank balance sheets in the financial crisis, with knock-on effects for businesses reliant on bank lending. It increased real interest rates and induced households to postpone expensive purchases. Deflation helped deepen the Depression; even if internal devaluation were possible in modern economies, deflation would not be desirable.

Third, large public debts are difficult or impossible to stabilize when deflation is increasing the real value of the debt and slowing economic growth.[3] During the interwar period, Britain ran primary budget surpluses of 7 percent of GDP during the 1920s. Despite these efforts, the deflationary low-growth environment meant that the British debt-to-GDP ratio increased substantially over the decade. The IMF’s (2012, p. 112) conclusion is that this episode is “an important reminder of the challenges of pursuing a tight fiscal and monetary policy mix, especially when the external sector is constrained by a high exchange rate.”

Fourth, as the interwar period wore on, more countries (such as Germany) attempted to adjust based not only on internal devaluation, but also with fiscal austerity. This strategy was costly, since fiscal multipliers were high in the 1930s, given weak economies and interest rates affected by the zero lower bound. Almunia, Bénétrix, Eichengreen, O’Rourke, and Rua (2010) find multipliers well in excess of one in a sample of 27 countries between 1925 and 1939; thus, fiscal austerity policies amplified the Great Depression.

Fifth, countries only started to recover from the Great Depression once they left the gold standard (Eichengreen and Sachs 1985; Campa 1990). Revaluing countries’ gold reserves as they exited made it possible to boost the money supply. In leaving

[2] Constant nominal wages are consistent with falling unit labor costs if labor productivity increases. Irish unit labor costs fell in the initial stages of the crisis, but the effect is partly a statistical illusion due to a shift in the composition of the Irish workforce, with low-productivity workers being laid off (Darvas 2012).

gold, expectations of deflation were replaced by expectations of inflation (Temin and Wigmore 1990; Romer 1992; della Paolera and Taylor 1999; Eggertsson 2008). There were transitory competitiveness gains for early movers who depreciated first. Countries also tended to do better when they embraced capital controls and used the policy space so liberated, even if their exchange rate remained officially pegged to gold (Obstfeld and Taylor 2004). Regaining monetary independence, one way or another, was the route to recovery.

Sixth, the Depression had calamitous political consequences. Voting for extremism was negatively related to GDP growth during this period, at least in countries that had not been inoculated by a history of democracy stretching back to before World War II (de Bromhead, Eichengreen, and O’Rourke 2013). Ponticelli and Voth (2011) find a strong correlation between fiscal austerity and political chaos (as measured by riots and other disturbances) over the last 100 years or so, and the result is robust when restricted to the interwar sample. It is foolish to ignore the potential political consequences of internationally lopsided and deflationary adjustment strategies.

The experience of the 1930s is not only a cautionary tale of the limitations of adjustment strategies based on internal devaluation and fiscal austerity, but an illustration of the power of monetary policy and of the value of macroeconomic policy flexibility. It is a useful reminder that Keynes’ short run is the time frame within which politics occurs, for good or ill.

**From Optimum Currency Area Theory to the Fiscal and Banking Nexus: Lessons from the United States**

The United States is more likely than the eurozone to satisfy the three Mundell-style optimal currency area criteria regarding the integration of product markets, symmetry of shocks, and labor mobility, as well as Kenen’s criterion regarding the ability of a central fiscal authority to smooth shocks across regions. Figure 2 illustrates some of the key differences organized around these four criteria.

Regarding market integration, Panel A shows that cross-border interstate trade amounts to 66 percent of GDP in the United States; in the 17-country eurozone, such trade amounts to only 17 percent of eurozone GDP. The US economy is strongly ahead on this criterion.

For the symmetry criterion, we look at the correlation between local growth and growth in the monetary union as a whole. Panel B indicates that the average correlation between real GDP growth in the eight US Census regions and national real GDP growth is 0.78. In the eurozone, the average correlation between GDP growth in the eurozone countries and GDP growth across the whole eurozone is about 0.5. Thus, on the symmetry criterion, the eurozone has lower average correlations between the shocks in its constituent countries than we see in the United States (and the eurozone correlations are also far more varied). This difference may reflect aggregation in large Census regions: it disappears if we take the sample
Figure 2
Optimum Currency Area Criteria: Eurozone versus the United States

A: Integration Criterion:
Interstate exports [Inter-eurozone country exports] relative to US GDP [eurozone GDP]

B: Symmetry Criterion:
Correlation of local growth with US [eurozone] average growth

C: Labor Mobility Criterion:
Persons born outside state [country] in US [eurozone]

D: Fiscal Criterion:
Share of local income shock offset by federal transfers

of 50 US states, but these are smaller and more diverse units than the 17 eurozone countries. The US economy has perhaps a minor advantage as a single currency area based on the symmetry criterion.

As regards the labor mobility criterion, in Panel C, the average share of people in a US state who were born outside that state is 42 percent. The equivalent index for the eurozone, people born outside the country where they currently reside, is only about 14 percent. This difference is deep-seated: the US economy attained something approaching a single labor market sometime in the nineteenth century. Elastic flows of population from Europe, and then across North America to the open frontier, ensured that labor markets were very fluid, and they have remained so ever since. Over two centuries, US regional real wage gaps have never exceeded 10–30 percent (Margo 1998; Rosenbloom 1996, 2010). Such levels of mobility and integration remain a distant prospect for most of Europe, given language and other barriers.

The US economy also has a central federal fiscal authority, implying national fiscal taxes and transfers that vary with the local business cycle and operate as intra-union automatic stabilizers. Such cross-border automatic stabilizers are absent in both the eurozone and the European Union, and there seems to be no appetite to create them. On the fiscal criterion, Panel D shows a wide range of measures of these federal fiscal stabilizer effects for the United States, but a recent estimate based on income tax alone shows an offset of 28 cents for a state-level $1 income loss, while among eurozone countries, the corresponding figure is effectively nil.

Figure 3 presents a different and arguably more direct take on the question of whether the US economy is better suited for a common currency than the eurozone. It plots estimates of optimal monetary policy responses based on rates of inflation and unemployment (Taylor 1993) for four US regions versus the whole country since 1987, and for the eurozone core and periphery versus the whole since 1999. The contrasts are striking. The estimated rule for the four US regions considered separately indicates small gaps between their “desired” policy rates and the national Fed target rate: divergences are usually between 0 and 200 basis points, a little more after the crisis. The “desired” policy-rate gaps between the eurozone and its core and periphery regions are much larger and more persistent. Prior to the crisis, the target interest rate for the periphery was consistently 300 basis points above the core; afterwards it was between 500 and 700 basis points lower. By this metric, a one-size-fits-all monetary policy appears more tenable in the United States than in the eurozone.

**Banking Union**

That said, optimal currency area theory neglects some of the most important issues facing the eurozone since the crisis exploded, in particular those having to do with banking and financial stability (Obstfeld 2013). The United States has since the 1930s had an effective national banking union, fully backstopped by a combination of the Federal Reserve and the US Treasury, and augmented by deposit insurance and other collective programs. As of now, the eurozone has virtually nothing in
Figure 3
Monetary Policy Taylor Rules: Eurozone versus the United States

A: Taylor rule by US census region

Notes: The two scales are commensurate (1800 basis points). The Taylor rule used is: \( \text{Target} = 1 + 1.5 \times \text{Inflation} - 1 \times \text{Unemployment gap} \), where the last term is the difference between the measured unemployment rate and the natural rate (the unemployment rate where inflation neither decelerates nor accelerates).
place, except for ad hoc measures offered by the European Central Bank directly or, when collateral is weak, via emergency liquidity assistance through national central banks. Absent banking union, these are ultimately national burdens on taxpayers (as in Ireland) or depositors (as in Cyprus).

America had neither a banking union nor an economically meaningful fiscal union when it gained its independence in the late eighteenth century. However, the United States has maintained a single currency area since the beginning (apart from a brief time during the Civil War when three currencies were in use). How did American monetary union function in the absence of these institutions? And what did it take—and when, and how—to eventually deepen the US institutional architecture?

For a long period, until the US Civil War, bank notes in the United States—that is, promissory notes issued by banks that could be used to transfer funds or to make payments—did not uniformly trade at par with currency (Gorton 2012). Even after this, bank deposits did not always trade at par with currency: that is, if you deposited currency in a bank account, and later withdrew it, the amounts might not match. “Free banking” was mostly the norm, there was no monetary authority, and in this decentralized system only gold functioned as a fixed reference value for money, or as true (par) money itself.

Yet payments frictions were in many respects the least of America’s problems. Throughout this time, the US economy suffered asymmetric shocks at the regional level which states felt they couldn’t or didn’t want to offset given fiscal orthodoxies, and which centralized monetary policy, such as it was, was designed to ignore (Rockoff 2003). How did the economy adjust? States and localities suffered, and defaulted if necessary, banks went under, and labor emigrated to more prosperous towns nearby or states far away.

Eventually the United States experienced a sequence of crises sufficiently intense to spur change. The first shock came at the time of the US Civil War (Gorton 2012). The need for union war finance spurred the National Banking Acts, creating a new standardized national currency, with these uniform notes backed by banks’ holdings of US Treasury debt. The Acts also set up a Comptroller to regulate the new form of nationally chartered banks. The new structure placed a large quantity of US Treasury debt on bank balance sheets and not just as a wartime expedient; it remains there to this day as the US banking system’s reference safe and liquid asset. Yet no central bank or lender of last resort appeared at this time, and pockets of “non-par” banking survived, especially in rural areas. Bank runs and crises remained, and recessions recurred frequently, but in a political-economic equilibrium where macroeconomic management was not expected to play a role.

Still, by the time, in the early twentieth century, that US banks had become large enough that they constituted systemic risks, they were holding US government securities as their safe and liquid assets, rather than state and local debt: Illinois banks do not hold much, if any, Illinois debt, for example. As a result, defaults by state and/or local governments did not entail a systemic threat to the financial system as a whole. By contrast, in today’s eurozone, each “subsidiary sovereign”
nation’s banks largely hold national debts of their own country, implying a national sovereign-bank doom loop (Goodhart forthcoming).

Despite the National Banking Acts and even with the emergence of banks’ collective self-regulation by clearinghouses, the US economy was characterized in the late nineteenth and early twentieth centuries by increasingly frequent and serious financial crises (1893 and notably 1907) and by deep recessions and depressions (the 1880s and 1990s). During the Panic of 1907, only a large privately coordinated intervention led by J. P. Morgan restored calm. This raised the fear that without a true central bank, with lender of last resort capability backed by unlimited balance-sheet capacity, the system was becoming increasingly fragile, and unacceptably so. In response to this sense of rising systemic risk, the Federal Reserve was established in 1913, creating a full-fledged monetary union with monopoly note issue, par clearing for all member banks, and a national payments system.

However, in its early years the new Federal Reserve System suffered regional tensions, and proved ineffective in halting the 1930s banking panics. It was politically hobbled at first by a mindset suspicious of central banking. In a small but revealing example, the Fed’s attempt to eliminate non-par banking was halted by Supreme Court action in the 1920s in the case of American Bank v. Federal Reserve Bank (262 U.S. 643 [1923]). Non-par banks clung on until the Monetary Control Act of 1980. In the depths of the Great Depression, some regional Federal Reserve banks threatened not to lend gold to one another through the interregional Gold Settlement Account (set up in 1915). Doubts as to whether Federal Reserve banks would lend to each other were decisively squashed by changes to the Federal Reserve Act in 1935. From then on, the subtly renamed Interdistrict Settlement Account cleared balances in infinitely suppliable fiat money via the System Open Market Account and mutual imbalances are periodically reset to zero reflecting a common pool approach. Today’s eurozone equivalent of the Interdistrict Settlement Account is TARGET2, with balances that net out among the separate national central banks and the European Central Bank. These within-system balances represent a small fraction of banking system assets in both the United States (1.9 percent) and the eurozone (2.6 percent); but while they represent only 1.7 percent of US GDP, they represent a much larger 9.4 percent share of eurozone GDP (due to the eurozone’s larger banking system). Crucially, since the 1930s there has been absolutely no concern that the US intersystem balances might be limited in size or be subject to settlement (exit/redenomination) risk.\(^4\)

The US financial collapse of the 1930s was utterly devastating, consistent with the pattern of more common and destructive crises in modern, credit-fueled, highly financialized economies where levered balance sheets imply “financial acceleration”

\(^4\) For more on the Interdistrict Settlement Account versus TARGET2, see Koning (2012), Bijlsma and Lukkezen (2012), and Cour-Thimann (2013). The last paper stresses that nothing like the exploding TARGET imbalances can occur in the United States because the Interdistrict Settlement Account is mutualized: it is zeroed out on a regular basis, effectively by treating the Fed’s SOMA securities as a “common pool” of assets shared by the system and owned by the national political entity.
(Schularick and Taylor 2012; Jordà, Schularick, and Taylor 2012). In good times, banks, firms, and households feed off wealth effects, borrow, and drive up asset prices after positive shocks and create more wealth and leverage; but after negative shocks this process goes into reverse, producing a vicious circle of contraction (Bernanke 1983; Bernanke and Gertler 1989). The US policy response was to legislate a new prudential architecture, built around the Banking Act of 1935 and other measures. Central regulation and insurance edicts were promulgated; deposit insurance was instigated with concomitant supervision; the Glass–Steagall Act of 1933 separated commercial and investment banking; and the role of the Federal Reserve Board of Governors was upgraded, permitting them to impose uniform monetary policy in all regions without opposition. A century and a half after its founding, the United States finally had a strong central bank and lender of last resort, with substantial powers, especially if exigent circumstances should recur.

**Fiscal Union**

Just as banking union progressed gradually in the United States, so too did fiscal union. Initially the central government left states to themselves under a “no bailout” constitutional settlement brokered by Alexander Hamilton: the US central government enacted a once-and-for-all debt mutualization, assuming all state-level Revolutionary War debts, but then expected each of the states to stand on its own fiscally, observe near–budget balance, and, if need be, default (Sargent 2012). These rules survive to the present, and many states have been through fiscal distress and even default. The ability to default provided a dimension of flexibility at times of crisis, while protecting federal taxpayers from moral hazard risk and bailout burdens entailing higher taxes and/or inflation on the collective. State-level debts are typically modest in size, and, as noted, that paper is largely kept off US banks’ balance sheets. But such arrangements also implied a potential bias toward pro-cyclical fiscal policies at the state-and-local level, a destabilizing feature witnessed again in today’s Great Recession.

Under these constitutional arrangements, US fiscal union was weak or nonexistent in the nineteenth century. An important step was the Sixteenth Amendment to the US Constitution in 1913 allowing a federal income tax. After World War I and the Depression, federal expenditures and taxes grew consistently large enough to provide substantial and elastic fiscal transfers (unemployment insurance, agricultural support, and later Social Security) and steady components of spending (like defense spending) that were shared between states and so helped smooth out asymmetric shocks. The federal system also leads to longer-run transfers between states, reflecting persistent cross-state imbalances in incomes, defense activity, the location of retirees on Social Security and so on.

Thus, the US fiscal and banking union has gradually evolved an interesting and, so far, durable mix of hard long-run rules, such as the “no bailout” setup allowing state...
default, and institutional innovations that have made the system more stable. Since the Civil War, the system has been insured from a state-level financial doom loop by the primary role of US Treasury securities as liquid bank assets; since the Great Depression, it has provided an even more elastic short-run policy regime, embedded in intra-union fiscal stabilizers and union-level banking sector backstop and oversight. In contrast, since the current eurozone crisis began, the authorities involved have been unable to decide on whether there should be bailouts or not, defaults or not, automatic stabilizers or not, or bank backstops and oversight or not. Indeed, at various times they have veered towards almost all of these positions.

With US history in mind, an optimist might argue that since the eurozone project is barely 10 years old, and the United States took perhaps 140 years to fully develop an appropriate institutional structure, we should be impressed rather than concerned by how far the eurozone has come already. The evolution of US monetary and fiscal institutions was a fitful and crisis-ridden process, from the fights (ongoing) over the role, if any, for central banking and for large fiscal transfers; the longstanding political obstacles to government deposit insurance, at the state and then federal levels; and the conflict over a hard monetary regime, only resolved by the gigantic disaster of the 1930s, but not before a series of disputes, notably the bimetallism and “cross of gold” arguments of the 1890s, had posed deep questions about the desirability of a deflation-prone and asymmetrically adjusting regime. There were times when the monetary regime, sometimes even the monetary union itself, were deeply unpopular and the subject of national or regional tensions.

Recent developments in Europe, such as the 2012 decision in principle to move towards a banking union, offer some hope of eventual institutional reform. Unfortunately, more rapid change may be required today in the eurozone than was the case in nineteenth-century America. The nature of modern economies, and of politics in the independent democracies that comprise the eurozone, is such that Europe may not have the luxury of experimenting for 140 years before finding workable arrangements. Popular calls for public goods, social insurance, countercyclical macroeconomic policy, and financial stability cannot be brushed aside so easily as in the less-democratic era of the nineteenth-century classical gold standard.

The United States began with a secure political union from which exit (although tried once during the Civil War) is now unthinkable and this provided a stage on which economic and monetary union developments could be slowly constructed. The US national constitution embodied key assumptions about the existence and permanence of the national debt (a key collective safe asset), federal

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6 The Democratic Party Platform adopted at Chicago, July 9, 1896, was “Opposed to the Gold Standard”: “Gold monometallism is a British policy, and its adoption has brought other nations into financial servitude to London. It is not only un-American, but anti-American . . . .” (http://projects.vassar.edu/1896/chicagoplatform.html.) On political cleavages over gold in the Populist era, see Rockoff (1990). Calls to end, audit, or otherwise change the Federal Reserve, or to return to gold, echo today.
taxing power (ultimate central fiscal capacity), as well as the common currency and the commerce clause (truly free interstate trade). Onto this, after major crises, a banking union and an economically meaningful fiscal union were later grafted. In comparison, neither the eurozone nor the European Union comprise a political union; exit is conceivable from both and openly discussed; there is no central fiscal authority in either, nor any common debt, and there seems to be no appetite on the part of creditor nations to go down that route. Recognizing these limits means that what is desirable for the eurozone may not be feasible, a glum thought to which we will return in the conclusion.

**Costs of Exit: Lessons from Past Break-ups**

What if the eurozone ultimately fails? History can speak of past cases in which common currencies split up, although again the analogies are imperfect.

**Austro-Hungarian Empire**

Following the end of World War I in 1918, the Austro-Hungarian empire was rapidly divided into successor states: the Kingdom of Serbs, Croats and Slovenes (Yugoslavia after 1929); Czechoslovakia; Austria; Hungary; and Romania. Initially the monetary union based on the krone continued, with banknotes for the entire region being printed in Budapest and Vienna, but this arrangement proved unsustainable (Garber and Spencer 1994). The separate states decided to introduce their own currencies from early 1919 onwards.

In one way, this process proved straightforward: countries typically over-stamped existing banknotes and converted bank deposits into the new currency at a prearranged parity, imposing levies or forced loans in the process as needed. However, Garber and Spencer (1994) note a feature of the process with obvious implications for any eurozone break-up: the fact that these measures were enacted at different times in different countries led to large flows of currency across borders, despite attempts by the authorities to block them, as people sought to move their currency holdings to wherever they thought they would be most valuable. These decisions were based partly on assumptions about where the conversion would take place at the most favorable rate and partly on assumptions about future rates of inflation; the old currency also tended to flow to where it remained legal tender the longest (in this instance, Hungary). The obvious implication is that any break-up of the eurozone would work best if it happened quickly and in a coordinated manner, with “temporary” capital controls being essential. Another implication is that any suggestion of a future break-up could prove extremely destabilizing as investors and households anticipate the capital gains and losses that it would imply (Eichengreen 2010).

The Austro-Hungarian example does not imply that hyperinflation is a necessary consequence of a currency break-up, as is sometimes suggested: the hyperinflation experienced in both Austria and Hungary reflected the inflationary financing of
large budget deficits that had helped precipitate the break-up of monetary union in the first place. Czechoslovakia put in place an institutional framework prohibiting such policies, and suffered deflation rather than inflation, as it attempted to rejoin the gold standard at the pre-war parity.

** Argentine Currency Board **

Argentina has exited currency board experiments three times, in 1914, 1929, and 2002. The most recent exit illustrates some problems that could occur in the event of a eurozone break-up. A recession was followed by a sudden stop in lending by foreign creditors in 2001, including (eventually) even the IMF; fiscal space was gone. In the endgame especially, Argentina had borrowed large amounts from local banks. When the government defaulted, the banks became insolvent as well, leading to a textbook “triple crisis”: a banking crisis, a sovereign debt crisis, and a currency crash (della Paolera and Taylor 2003). In the aftermath came the problem of who bore the losses.

In 2002, Argentina declared that dollar loans would be repaid in pesos. This reduced the cost to the government of bailing out Argentina’s banks, but also led to a plethora of costly legal disputes (Roubini and Setser 2004). These included disputes about “pesification” itself and about the asymmetric pesification values attached to different claims; these dragged on for many years, generating considerable uncertainty. The external default led to an eventual bond exchange where, although a majority of creditors accepted a write down, there remain minority “vulture” holdouts who are still fighting in New York courts a decade later. Capital controls (corralito) had to be imposed immediately to prevent arbitrage and have never been fully dismantled. Costly side effects thus have to be set against the benefits of devaluation and default to Argentina—costs which must likewise be weighed up by any states looking at a possible eurozone exit.

** Conclusions **

Europe’s current depression drags on. The jury is still out on whether the eurozone can achieve the minimal collective institutions needed to sustain deep integration and macro-financial stability of the kind that the US economy can take for granted. Drawing on the lessons of history, what do we think these institutions might be?

The fact that the eurozone scores so poorly on optimal currency area grounds suggests a need for mechanisms allowing smoother and more symmetric adjustment between its members. Moves to enhance labor mobility, for example by improving pension or health insurance portability, can help—but, we suspect, only to a limited extent. A stronger fiscal center as in the United States is desirable, but there seems

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7 Indeed, emigration reduces the tax bases of the countries concerned, making it more difficult to pay for the fixed costs of running states and the retirements of those left behind; and it makes it more difficult to pay back large debts, which is another argument in favor of debt restructuring in these countries (see O’Rourke, 2010; Coppola, 2013).
little prospect of this; thus, member states will have to engage in countercyclical fiscal policy, if at all, by themselves. For some countries, the size of their existing debts means that debt restructuring will be required for them to regain the ability to do this (Wyplosz 2012).

The difficulty of developing eurozone-wide automatic stabilizers should focus attention on the design and policies of the European Central Bank. Since asymmetric adjustment based on internal devaluation is so costly and ineffective, the European Central Bank should allow a higher rate of inflation for the eurozone as a whole at times of economic and financial stress to facilitate relative price adjustment. This could be embedded in various policy regimes, like the much-debated nominal GDP target or the “Evans rule” of the US Federal Reserve, which promises to keep interest rates low until certain unemployment targets are reached. A shift to such a regime need not be viewed as incompatible with the price stability mandate of the European Central Bank. If these kinds of changes are politically impossible, pessimism about the euro’s survival becomes more justifiable.

The institutional architecture of the eurozone needs to be deepened if a recurrence of the present crisis is to be avoided. A banking union seems essential. This would involve common banking supervision, common resolution procedures, and common deposit insurance—and in consequence at least some elements of a fiscal union (Pisani-Ferry, Sapir, Véron, and Wolff 2012; Goyal, Brooks, Mahmood, Tressel, Dell’Ariccia, and Pazarbasioglu 2013). However, Europe’s banking system will remain fragile as long as national banks hold national debt of the “subsidiary sovereign” (Goodhart forthcoming); in contrast, a “safe” eurozone asset would allow governments to default or restructure their debts without collateral damage to financial systems in their own countries and potentially, via contagion, across the entire eurozone (Brunnermeier et al. 2011). The creation of such a safe European asset is particularly important since the ability of national governments to default is also essential, being the logical corollary of the no-bailout clause which has worked well in the US context and which seems consistent with the requirements of national democracies. By contrast, the eurozone attempt to avoid fiscal free riding by legally constraining national governments has been an intrusive failure, mimicking the German “centralized-federal” approach, which has not even worked well within Germany (Mody 2013; Wyplosz 2012).

So where the eurozone needs to go in the long run, we argue, is towards a genuine banking union; a eurozone-wide safe bond to break the sovereign-bank doom loop; a central bank that is more flexible and willing to act as a true lender of last resort against such bonds and other assets as necessary; and a fiscal union at least sufficient to support the above. But the short-run problems facing countries in the periphery of Europe are now so great that politicians may never get a chance to solve these long-run problems because the eurozone may well have collapsed in the meantime. The history of the gold standard tells us that an asymmetric adjustment process involving internal devaluation in debtor countries, with no corresponding inflation in the core, is unlikely to be economically or politically sustainable. A more flexible and countercyclical macroeconomic policy mix, involving some combination
of looser monetary policy, a higher inflation rate, a weaker euro, debt restructuring, and fiscal stimulus by core governments (or some European Union–level institution such as the European Investment Bank) is currently needed in order to make the adjustment process less asymmetrical and lessen the risk of a eurozone collapse.

US experience suggests that major institutional reforms tend to follow major political and economic crises, such as the Civil War, the Panic of 1907, and the Great Depression. But these crises occurred within the context of a pre-existing state. It is one thing to develop deeper US federal institutions at times of crisis within what is already one country, but another thing to do so in a union of 17 independent states. There, a sufficiently major crisis may lead to countries deciding to abandon the euro project altogether, which is why the possibility of a eurozone break-up cannot be excluded. In 1978, Chancellor Helmut Schmidt, seeking to reassure a Bundesbank nervous that the proposed “European Monetary System” would not pose excessive demands on Germany, quoted a Latin legal phrase, “Clausula rebus sic stantibus. . . . Ultra posse nemo obligatur.” This roughly translates as “a fundamental change of circumstances could make a treaty inapplicable . . . no one [country] is obligated to do more than they can do.”

A number of countries across Europe may eventually ask themselves if fundamental circumstances have changed in a way that renders their previous commitment to the eurozone inapplicable. A eurozone break-up would involve the redenomination of assets and liabilities, and in all likelihood sovereign defaults in some cases as well. This would imply large cross-border redistributive effects with substantial official-sector claims in dispute. An even larger plethora of private contracts would be affected, involving not only eurozone banks and firms; the scope for legal chaos seems clear. If the eurozone is destined to break up, then speed and cooperation are essential if both destabilizing capital flows and years of costly litigation and uncertainty are to be avoided. Such a benign scenario may seem fanciful in the extreme, but if eurozone policymakers do not rapidly move towards a different macroeconomic policy mix, and at the very least a meaningful banking union, then Europe may ultimately find itself clutching at such straws.

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[8] “EMS: Bundesbank Council meeting with Chancellor Schmidt (assurances on operation of EMS) [declassified 2008].” Bundesbank Archives (N2/267). Translation from the Margaret Thatcher Foundation, http://www.margaretthatcher.org/document/111554. Schmidt noted that such considerations had already led Germany to unilaterally and without prior notification contravene international treaty law on the Bretton Woods intervention commitments and withdraw support for the US dollar in 1973, precipitating a crisis; the same issues would arise with Germany’s decision to terminate support for the Exchange Rate Mechanism in 1992, precipitating another crisis.
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Chap 8: The political identities of European integration

Key issue: We review the political identities of European integration: functionalism, intergovernmentalism and federalism.

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ABSTRACT

Europe’s monetary union is part of a broader process of integration that started in the aftermath of World War II. In this “political guide for economists” we look at the creation of the euro within the bigger picture of European integration. How and why were European institutions established? What are the goals and determinants of European Integration? What is European integration really about? We address these questions from a political-economy perspective, building on ideas and results from the economic literature on the formation of states and political unions. Specifically, we look at the motivations, assumptions, and limitations of the European strategy, initiated by Jean Monnet and his collaborators, of partially integrating policy functions in a few areas, with the expectation that more integration will follow in other areas, in a sort of chain reaction towards an “ever-closer union.” The euro with its current problems is a child of that strategy and its limits.
As an economic and financial crisis unfolds across the European Union, critics argue that European institutional integration has gone too far, blame misguided political motivations, and assert that the monetary union has failed (for example, Feldstein 2012). On the other side, supporters of European integration attribute the euro crisis to institutional incompleteness—what Bergsten (2012) called a “half-built house.” They argue that the solution to Europe’s woes should be sought in additional integration: a banking union, a fiscal union, or perhaps even a full political union and the formation of a federation.

Tommaso Padoa-Schioppa (2004, p. 1), the economist and central banker who played a key role in the birth of the euro, wrote: “[T]he euro was the result of a long-term development that started in the aftermath of World War II. After experiencing political oppression and war in the first half of the twentieth century, Europe undertook to build a new order for peace, freedom, and prosperity. Despite its predominantly economic content, the European Union is an eminently political construct. Even readers primarily interested in economics would hardly understand the euro if they ignored its political dimension.”

This political guide for economists takes a step back and looks at the creation of the euro within the bigger picture of European integration. How and why were European institutions established? What is European integration really about?

The history of European integration is complicated, with a big cast of actors including governments, technocrats, interest groups, and voters, who in turn pursue a range of economic and political goals. This complexity is reflected in a variety of interpretations by political scientists and political economists (for overviews, see Gilpin 2001, chapter 13; Eichengreen 2006; and Sadeh and Verdun 2009). This article discusses facts and theories about European integration from a political-economy perspective, building on ideas and results from the economic literature on the formation of states and political union (for overviews, see Spolaore 2006, 2012). Specifically, we look at the motivations, assumptions, and limitations of the European strategy of partially integrating policy functions in a few areas, with the expectation that more integration will follow in other areas, in a sort of chain reaction towards an “ever-closer union.” The euro with its current problems is a child of that strategy and its limits.

**A European Federation?**

The idea of a new sovereign federation across Europe goes back a long time, but it received a big push from the first half of the twentieth century. At the end of World War II, the promoters of European integration looked back at the previous decades and saw a continent fragmented in independent and unconstrained nation states, which had pursued costly beggar-thy-neighbor policies during the Great Depression and engaged in two major wars. The goal
of European integration was to create a system where nation states would no longer follow such unilateral and destructive policies.

In 1943 a group led by Altiero Spinelli founded the European Federalist Movement. In 1946, Winston Churchill argued for the creation of “the United States of Europe” (which in his view did not include Britain). By definition, a federation would have eliminated national borders and international conflict (but not civil conflict) among Europeans. However, no European federation was created immediately after World War II.

Instead, the founding document of European integration is the Schuman declaration of May 9, 1950, named after France’s foreign minister Robert Schuman and inspired by Jean Monnet, a businessman and civil servant who played a crucial role in starting European institutions in the following years. The declaration proposed that “Franco-German production of coal and steel as a whole be placed under a common High Authority, within the framework of an organization open to the participation of the other countries of Europe.” The plan was motivated by security, as a way “to make it plain that any war between France and Germany becomes not merely unthinkable, but materially impossible.” The pooling of coal and steel production was ambitiously defined as “a first step in the federation of Europe.”

The Schumann declaration led in 1951 to the European Coal and Steel Community (ECSC) among six countries. The ECSC was then used as the institutional template for two proposed communities: the European Defense Community and the European Political Community, which included the formation of a common army, a common budget, and common institutions with significant legislative and executive powers. It would have basically amounted to a European federation (Moravcsik 1998; Rector 2009). A treaty was signed among the six countries in 1952 but failed to obtain ratification in the French parliament, and never took effect. In 1955 several politicians, including Jean Monnet, created an “Action Committee for the United States of Europe.” But, again, no United States of Europe actually formed.

The fundamental reasons behind these failures to form a federation have bedeviled the supporters of a United States of Europe, then and since. There are two issues which are key to understanding the beginning of the integration process, its setbacks, and the following path of European integration. One issue is a general problem in political economy: the trade-off between costs and benefits when heterogeneous groups are politically integrated under a

\[1\] France, West Germany, Italy, the Netherlands, Belgium, and Luxembourg.

\[2\] Subsequent less ambitious attempts to integrate European defense and foreign policy have not been very successful either. For instance, see Alesina and Perotti (2004) for a critical discussion of the more recent experience of the European Union in these and other areas.
common authority. The other issue involves the particular role of Germany, the country that played a central role in World Wars I and II.

*The Political Economy of Heterogeneous Populations*

The formation of a European federation across heterogeneous populations, which share diverse social and economic structures, languages, cultures and identities, would come with several benefits but also with high costs. The trade-off between such costs and benefits is central to the political feasibility and stability of institutional integration among those populations (Alesina and Spolaore 1997, 2003).

Potential benefits from full political unification include economies of scale in the provision of federal public goods, such as defense and security, and the ability to internalize positive and negative externalities over a large area. A European federation with its own budget and redistribution policies could also provide insurance against asymmetric shocks that only affect some of its regions, whether natural, like an earthquake, or man-made, like the bursting of a housing bubble. These benefits from fiscal federalism are often stressed when comparing Europe to the United States (for example, Sala-i-Martin and Sachs 1992; Krugman 2012), and are now at the forefront of the debate about the European sovereign debt crisis (Lane 2012).

However, political unification comes with significant costs when various groups speak different languages, share different cultural norms and identities, and have different preferences for public policies and institutions that cannot be decentralized at the sub-federal level (Alesina and Spolaore 1997, 2003). Among those institutions is the ultimate “public good”: the federal government itself, with all its constitutional and legal traits, policies, official language(s), and so on, about which German or Dutch people may have very different views from those prevalent in France or Italy.

A growing literature has explored the links between measures of heterogeneity and political outcomes, such as the provision of public goods, the extent of redistribution, the quality of government, and the likelihood of civil and international conflict. Microeconomic evidence links ethnic heterogeneity to underprovision of public goods at the local level (Alesina and La Ferrara 2005). There is also macroeconomic evidence of negative correlations between ethnolinguistic fractionalization and government performance, although causality and robustness are less clear-cut (Alesina et al. 2003). In addition, Montalvo and Reynal-Querol (2005) and Esteban, Mayoral and Ray (2012) find that ethnolinguistic polarization is associated with civil conflict. Desmet, Ortuño-Ortín and Weber (2009) show that once distances between languages are accounted for, linguistic diversity has a significant negative effect on redistribution. Desmet, Ortuño-Ortín and Wacziarg (2012) find that deep linguistic
distances are good predictors of civil conflict and redistribution, while even finer distinctions between languages, such as those among different dialects, matter for economic growth and public goods provision. The bottom line of this literature is that measures of ethnic, linguistic, and cultural diversity have significant effects on policy outcomes, redistribution, and the provision of public goods. A European federation would be quite heterogeneous by most of these measures, and likely to face significant political costs when choosing common public goods and policies at the federal level.\(^3\)

The example of defense and security – which played a fundamental role in Europe’s early attempts to integrate - can serve to illustrate these issues. These are public goods with high economies of scale, but also high heterogeneity costs stemming from diverse preferences across populations. Military power has historically been a central tool to ensure a government’s monopoly of legitimate use of coercion over a territory. Integration of defense and security under one authority usually goes hand in hand with the centralization of this monopoly of coercion – that is, with the formation of a sovereign state or federation (Alesina and Spolaore 2003). However, different populations with different histories, cultures and identities are likely to disagree over the type of government in charge of such a federation. Moreover, coercion can then be used to collect taxes, finance a larger set of other public goods and redistribute resources across different groups. This redistribution is more likely to be resisted when groups are different not only economically but also along ethnic and linguistic lines. For instance, Western Germans may be more willing (or less unwilling) to redistribute resources to Eastern Germans than to Greeks or Italians. Consequently, centralized provision of defense and security across large and diverse populations usually takes place when dictatorial rulers are able to ignore the heterogeneity costs of the populations they conquer, and/or when there are overwhelming benefits of scale from defense that offset high heterogeneity costs (Alesina and Spolaore 2005, 2006). The two most successful federal republics, Switzerland and the United States, emerged in response to external security threats, and the unification of Germany in the nineteenth century resulted from conquest by Prussia (Riker 1964; Gilpin 2001).

Military and political union is not the only way to deal with security threats. Heterogeneous sovereign states can benefit from economies of scale in defense by forming military alliances, while still maintaining their political and fiscal independence. But military alliances, where each state can autonomously decide its own level of military spending and pay for it, can lead to undersupply of defense from the perspective of the whole alliance because of free riding (for a discussion, Spolaore 2012). Western Europeans failed to form a

\(^3\)Fractionalization is maximized when each individual belongs to a different group, while polarization is maximized when there are only two large groups of equal size. A larger European federation formed by many groups would be more fractionalized but less polarized than a smaller federation dominated by a couple of groups (e.g., Germans and French).
federation even when faced with an existential threat from the Soviet Union, and relied instead on an international alliance (NATO), where issues of undersupply and free riding were in part addressed by the dominant role of the United States.

If heterogeneity can explain failures to integrate in the past, does it need to be an obstacle to future political integration? Over time, couldn't a federal Europe change political and social interactions and affect cultures and identities among Europeans, leading to a shared identity within a “European nation”? After all, nineteenth century France famously turned “peasants into Frenchmen” through public policies and modernization (Weber 1976).

This question is part of the broader debate on the persistent political and economic effects of historical and cultural traits, and the extent that culture itself can be changed by policies and institutions (for recent discussions, Bisin and Verdier 2010; Spolaore and Wacziarg 2013). In the long run, people can learn new languages, modify their cultural traits and identities, and transmit different traits to their children in response to changing incentives, including public policies. However, it is at best a gamble to hope that political integration of modern democratic nations will lead to cultural integration. Historically, nation-building and attempts to “homogenize” populations were implemented by rulers of undemocratic societies who had an interest at reducing heterogeneity costs in order to maximize their own rents (Alesina and Spolaore 2003, pp. 76-78) or pursue their own preferences (Alesina and Reich 2013). Realistic supporters of European integration understand that convergence of political preferences through reduction of linguistic and cultural barriers, if it is going to occur at all, will be a slow and gradual process, which should take place naturally and consensually.

For Europeans, heterogeneity has been a source of benefits as well as of costs. When people have different preferences and traits, societies can benefit economically and culturally through specialization, learning, and exchange of goods and services, as well as ideas and innovations. Benefits from heterogeneity, however, are mostly about interactions over rival goods, not public goods, which are non-rival. Similar preferences over the same rival goods can lead closely related groups to conflict and war (Spolaore and Wacziarg, 2012), while different preferences over rival goods can facilitate peaceful exchanges and a better allocation of resources. In contrast, diverse preference over public goods, like a federation’s government, laws, and public policies, will be much harder to reconcile because one kind must apply to everyone within the federation, whether everyone likes it or not. As a result, heterogeneity of preferences is mostly beneficial when people interact about rival goods but costly when sharing non-rival goods. This is an important reason why, as we will see, the European project has been much more successful when fostering economic exchanges and a

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4 There is also an extensive political literature debating whether the social and political relevance of ethnic and linguistic divisions can be altered by politics and institutional change (for a discussion, Fearon 2006).
common market, while it has stalled when attempting to pool “federal” public goods, such as defense and security.

The Role of Germany

In hindsight, as we look back at the 1952 treaty that would have established a European Defense Community and a European Political Community, what’s perhaps more surprising is not that France rejected it, but that the other states ratified the treaty. A reason is that the other two largest states at that time, West Germany and Italy, had just emerged from a severe military defeat, and faced significant constraints to their own defense and foreign policy. West Germany was the more extreme case: a divided country, technically under military occupation until 1955. In those circumstances, the costs of constraints on German sovereignty by pooling defense and security were low and could be traded against other political and economic benefits. As Germany’s status as a sovereign state “normalized” over time, its incentives to join a security-based federal union decreased.

The agreement for a European Coal and Steel Community is often interpreted from a similar perspective. According to Milward (1984), France proposed the coal and steel community to constrain German control of its own industry, in response to U.S. plans in 1949 to allow a Germany relatively free of allied supervision. Germany agreed to the Schuman plan because, by sharing management of its coal and steel, it could obtain important concessions, such as “the removal of ceilings on permissible levels of industrial production” (Eichengreen 2006, p, 802). According to Berger and Ritschl (1995), French access to German coal was “the most important element of the Monnet Plan for France's reconstruction.”

These examples illustrate a continuing issue in the history and politics of European integration: the extent to which European supranational institutions can be interpreted as tools to constrain German power in the interest of its neighbors, especially France. This theme has come to the forefront again with the creation of the euro. A popular view is that giving up its currency was the price that Germany had to pay to overcome France’s opposition to German reunification (Garrett, 1993; Marsh 2011), a deal summarized by the witticism quoted by Garton Ash (2012, p. 6): “[T]he whole of Deutschland for Kohl, half the deutsche mark for Mitterrand.” Literally taken, as a quid pro quo, this interpretation is not held by most scholars (Sadeh and Verdun 2009). It is questionable that a French threat to veto the reunification of Germany could be credible. Moreover, key decisions about the single currency had already been taken before the fall of the Berlin Wall in 1989, and German politicians and interest groups (like exporters) had other strong reasons to favor a monetary union (Moravcsik 1998; Frieden 2002).
However, it is not fully coincidental that the implementation of the euro took place during and right after German reunification and the opening of political and economic relations between Western and Eastern Europe. Germany’s chancellor at that time, Helmut Kohl, viewed the euro as a big step in the broader process of European integration, which he considered essential to reassure Germany’s neighbors about his enlarged country’s commitments to peace, security, and economic cooperation (Garton Ash 2012). And even though the process leading to economic and monetary union had started before the fall of the Berlin Wall, a detailed analysis of the interactions among key participants in the negotiations show that German reunification led to a reassessment of the relative payoffs from economic and monetary union, and was used “to reshape […] negotiations” (Dyson and Featherstone 1999, p. 16).

The increase in Germany’s potential power might also have affected the borders of the future euro area, making it much larger than predicted by efficiency criteria, such as the theory of Optimum Currency Areas. For example, Eichengreen (2012, p. 125) mentions the view that France and others pushed for the inclusion of many countries at the “periphery,” like Southern Mediterranean countries, to “balance” Germany’s larger size and influence within the monetary union.

Whether these Realpolitik interpretations are fully persuasive, the French government saw a close link between German reunification and European integration. According to an adviser to the French President, "Mitterrand did not want [German] reunification without advances toward greater European integration, and the currency was the only topic that was open to debate" (Spiegel, 2010).

How had a monetary issue become “the next step” in the process of European integration? What was (and is) such a process about? To answer these questions we need to go back to what happened after the rejection of the defense and political communities in the mid-1950s.

**From the Common Market to Economic and Monetary Union: Jean Monnet’s Chain Reaction?**

From the successful creation of the European Coal and Steel Community and the rejection of the European Defense Community, Jean Monnet and the other supporters of European integration learned a lesson in political realism (Duchêne 1994). Partial integration in narrowly defined areas, such as coal and steel, was feasible, while more ambitious integration in broader areas such as defense and policy coordination would meet too much political opposition. Their next step was the creation in 1957 of a community similar to ECSC for civilian atomic energy (EURATOM), and, more importantly, a European
Economic Community (EEC) to set up a customs union: the “common market.” The institutions of the three communities were later merged and became known as the European Community. The treaties of Maastricht (1992) and Lisbon (2009) reorganized and replaced the European Community with the European Union.

The Treaty of Rome of 1957 establishing the European common market no longer referred to steps “toward a federation,” but included the vaguer objective of laying the “foundations of an ever-closer union among the peoples of Europe.” The signatories’ main stated goal was “to ensure the economic and social progress of their countries by common action to eliminate the barriers which divide Europe,” while claiming that this would strengthen peace and security. To foster those goals, European states created two sets of institutions: supranational institutions such as the European Commission, Parliament, and Court of Justice, and intergovernmental institutions, such as the Council of Ministers and, later, the European Council, formed by the heads of state or government of the member states.

Over time, policy functions have been delegated to European institutions in an increasing range of areas. Nonetheless, national governments have kept control over fundamental decisions, and must decide unanimously on all changes to the international treaties that set Europe’s informal “constitution.” An attempt to establish a formal “Constitution for Europe” failed when it was rejected by French and Dutch voters in 2005.

The history of European integration reflects this tension between the role of supranational institutions and the power of national governments. The conflict is also mirrored by the two most influential political theories about European integration: functionalism and intergovernmentalism. This terminology is rather confusing for the uninitiated. In a nutshell, the theories are distinguished by how they answer the question: who is in charge of European integration?

Intergovernmentalists believe that national governments are in charge, and that supranational institutions are tools of the national states, which use them to pursue their own goals. Moravcsik (1993, 1998), an influential proponent of this theory, believes that national governments have built European institutions in order to pursue the economic interests of their domestic constituencies. In this spirit, Moravcsik (2012) views the euro as an economic gamble, mostly reflecting the interests of powerful national producers. This interpretation fits within a broader literature emphasizing the link from domestic economic interests to national attitudes and policies towards European integration (for example, Frieden 1998, 2002). The

6 The jargon is furthermore complicated by “neo” prefixes and other qualifications. Haas (1958,1964), the father of the functionalist approach to European integration, called his theory “neo-functionalism,” to distinguish it from a previous theory of international cooperation developed by David Mittrany. Moravcsik (1993, 1998) calls his approach “liberal intergovernmentalism” to distinguish it from “realist” theories that also place national states at the center of the analysis, but emphasize power and interstate rivalry rather than domestic economic interests. In this article I only use the simpler terms.
political-economy approach to regional integration based on domestic economic interests is familiar to the economics profession, and therefore I will not say more here. I will focus instead on the alternative theory of functionalism, which is much less known among economists, even though it has played a significant role in the ideology and practice of European integration and the creation of the euro.

Functionalists believe that European integration is not primarily driven by national governments and their voters, but mostly pushed by elites and interest groups that transcend national boundaries. They stress the role of supranational entrepreneurs and civil servants like Jean Monnet in the 1950s and Jacques Delors in the 1980s and 1990s. The theory is called “functionalism” because it is about the dynamic effects of transferring specific “functions” to supranational institutions – for example, regulation of coal and steel production to the European Coal and Steel Community or monetary policy to the European Central Bank. Although this integration starts in economic areas, integration in one area may well lead to further integration in many other areas, not only economic but also political (Haas 1958, 1964; Pierson 1996; Sandholtz and Stone Sweet 1998). In sum, while intergovernmentalists believe that European integration is rooted in the pursuit of national economic interests, functionalists believe that it is about economic integration as a path towards political integration.

The theory of functionalism was directly inspired by Jean Monnet’s strategy to delegate specific functions to supranational institutions in relatively narrow areas, mostly technical and economic, with the expectation that it would lead to more institutional integration in other areas over time. Functionalists believe that moving only some policy functions to the supranational level, while leaving other functions at the national level, creates pressure for more integration through positive and negative mechanisms. A positive mechanism would work through learning: as politicians and interest groups observe the benefits of integrating a few functions, they will want more. This idea is implicit in the Schumann declaration, stating “Europe will not be made all at once, or according to a single plan. It will be built through concrete achievements.” Another positive mechanism is assumed to work by changing people’s preferences. As groups cooperate on specific functions, barriers to communication and interaction would decline, which would bring an “endogenous” convergence of values and norms and a demand for more integration. This rather optimistic outlook was inspired by Karl Deutsch’s (1964) influential research on communication theory and political integration.

A darker mechanism through which partial integration could lead to more integration is, paradoxically, by generating problems and crises. Because integration is only partial, important complementary functions are missing at each step. For the functionalists, such
incompleteness is not a bug but a feature, because it creates pressure for further integration. Monnet’s method was explained by his collaborator George Ball (1994, p. 10):

“There was a well-conceived method in this apparent madness. All of us working with Jean Monnet well understood how irrational it was to carve a limited economic sector out of the jurisdiction of national governments and subject that sector to the sovereign control of supranational institutions. Yet, with his usual perspicacity, Monnet recognized that the very irrationality of this scheme might provide the pressure to achieve exactly what he wanted - the triggering of a chain reaction. The awkwardness and complexity resulting from the singling out of coal and steel would drive member governments to accept the idea of pooling other production as well.”

A challenge for this story is to explain why national politicians don’t anticipate Monnet’s chain reaction. Implicit assumptions here are that integration is irreversible, and that national politicians or voters would prefer limited integration to either more integration or no integration. But then, if politicians see that limited integration will lead to more integration, they should either agree to the outcome of more integration right away, or they should object to starting the process at all. What factors could allow elites and supranational technocrats to move ahead with initiatives leading to outcomes that national politicians or voters would not have approved in advance? A first possible explanation proposed by functionalists is that national politicians have short horizons: they approve the first step, but do not care about the next steps. A second explanation is asymmetric information. The initial steps of functional integration are taken in narrow and technical areas, such as coal and steel in the 1950s or, later, anti-trust regulations and monetary issues. In those matters, national politicians and voters are much less informed than technocrats, political elites, and supranational entrepreneurs. Hence, it is difficult for them to monitor these agents and anticipate the consequences of their actions (Pierson 1996; see Eichengreen 2006 for a discussion). A third, even less flattering reason why the mechanism may work is that European supranational institutions and bureaucracies have been set up (on purpose?) with little democratic accountability—the so-called “democratic deficit”—reducing the opportunities of national voters to monitor the technocrats (for a discussion, Alesina and Spolaore 2003, chapter 12).

Functionalism was the dominant theory of European integration in the 1950s and 1960s, then came to seem less plausible (Haas 1975) following a series of political setbacks to integration. A major setback was the “Empty Chair Crisis,” when French President Charles de Gaulle boycotted European institutions because he objected to their plans for more supranational integration. The crisis was resolved in a truly “intergovernmentalist” way with the Luxembourg compromise of 1966, in which _de facto_ veto power was given to every member state on issues of “very important national interest.” However, the functionalist view
returned in fashion with the revival of European integration in the 1980s and 1990s when Jacques Delors was head of the European Commission. Functionalism continues to be very influential not only academically but also among European policy-makers and supranational civil servants (perhaps not surprisingly, given that they play the main role according to the theory).

In 1992 the members of the European Community signed a Treaty on European Union at Maastricht, which reorganized European institutions and designed an Economic and Monetary Union (EMU), establishing the institutional foundations for the euro. Jacques Delors and his Committee for the Study of Economic and Monetary Union, also known as the “Delors Committee,” played a crucial role, as documented in a detailed analysis of the negotiations leading to the economic and monetary union (Dyson and Featherstone, 1999). The design and rationale for the European economic and monetary union, as laid out in official documents and studies (Committee for the Study of Economic and Monetary Union, 1989; Commission of the European Communities, 1990), was deeply influenced by the functionalist view of European integration (Sadeh and Verdun 2009, p. 283).

An important functionalist argument was based on the “inconsistent quartet:” the mutual incompatibility of free trade, mobility of capital, fixed exchange rates, and independence of national monetary policies (Padoa-Schioppa 2004). Assuming that fixed exchange rates were essential for Europe’s single market, then moving from commercial integration to liberalization of capital movements had to lead to the loss of national monetary autonomy. In fact, Padoa-Schioppa (2004, p. 14), one of the architects of the economic and monetary union and key member of the Delors Committee, explained the path to the euro in terms that explicitly echoed the chain-reaction metaphor:

“[T]he road toward the single currency looks like a chain reaction in which each step resolved a preexisting contradiction and generated a new one that in turn required a further step forward. The steps were the start of the EMS [European monetary system] (1979), the re-launching of the single market (1985), the decision to accelerate the liberalization of capital movements (1986), the launching of the project of monetary union (1988), the agreement of Maastricht (1992), and the final adoption of the euro (1998).”

7 “EMU” is a confusing acronym. It does not stay for “European Monetary Union” (a widespread and understandable confusion). Instead, it means “Economic and Monetary Union,” including both the monetary union and the single market (for the official definition, http://ec.europa.eu/economy_finance/euro/emu/). In the 1990s, some even referred to EMU as short-hand for the whole Maastricht agreement, which included several other provisions besides those about economic and monetary union. In contrast, many now use EMU in a narrower sense, only for the monetary union. Given such ambiguities, I avoid the acronym EMU and spell out “economic and monetary union” whenever possible in this article.

8 Fixed exchange rates were viewed as essential for free trade within Europe not only for economic reasons, but also and perhaps chiefly for political reasons, because of the fear that competitive devaluations could trigger a protectionist policy reaction by other member states, leading to the eventual unraveling of the single market (Eichengreen and Frieden 2001, pp. 12-13).
Also, in the functionalist tradition, each step in this chain reaction was viewed as irreversible. A joke attributed to Padoa-Schioppa refers to how EMU, the economic and monetary union, like the Australian bird with the same name, could not walk backward.

Not only was the path to the euro explained in functionalist terms from a technical perspective, but was also viewed, in Schumann and Monnet’s tradition, as “a further step—and as a prerequisite for yet other steps—in the political unification of Europe” (Padoa-Schioppa 2004, p. 6). Wim Duisenberg, the first President of the European Central Bank, said (as quoted in Van Overtveldt 2011, p. 63): “EMU is, and was always meant to be a stepping stone on the way to a united Europe.” German Chancellor Helmut Kohl famously said in 1991 (as quoted in Marsh 2011, p. 301): "It is absurd to expect in the long run that you can maintain economic and monetary union without political union."

From the perspective of Monnet’s method, such an “absurd” economic and monetary union without political union should create pressures for still more integration. The euro area lacked many institutions historically associated with a successful monetary union: for example, a central bank that could really act as market maker and lender of last resort, a banking union, and a fiscal union. But this incompleteness could be rationalized as a natural and unavoidable feature of partial integration in the functionalist tradition. Even though present political constraints prevented the immediate implementation of a more comprehensive design, the launching of an “incomplete” monetary union would set the steps for further integration in due course, as predicted by functionalist theories. For example, people would learn with time about the large benefits from economic and monetary union and ask for more integration in other areas. Also, supporters of the euro embraced two arguments mirroring the long-standing functionalist view that preferences and behavior endogenously converge following integration. One argument was that regions become economically more homogeneous after they share a common currency (Frankel and Rose 1998).9 Secondly, the economic and monetary union was supposed to provide discipline to governments, including those that used to pursue erratic policies. As a result, all member states would eventually converge to common values and policies emphasizing macroeconomic stability. Supranational institutions could provide the necessary sanctions if national governments deviated from agreed rules of stability. No-bailout rules would also be enforced. If, in spite of these positive effects and precautions, future crises were to occur, they could be resolved with more institutional integration.

Assuming that such logic could really work – and events of the last few years certainly sound a skeptical note - where would Monnet’s chain reaction lead to in the long run? Jean Monnet himself was ambiguous about his long-term vision of European integration (Hoffmann 1966;

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9 In contrast, the anti-functionalist argument that integration can lead to specialization and more heterogeneity (Krugman and Venables, 1996) received much less attention in Brussels.
Duchêne 1994). He oscillated between two visions. One was the original federalist dream of the United States of Europe, in which Europe was an “incomplete federation” to be completed. The other vision was of a “post-modern” world where traditional sovereign states, including classic federations like the United States of America, would play a marginal role compared to supranational institutions and norms, which would represent a novel way to organize interdependence among individuals and groups: Europe as a “post-federation.” This same ambiguity is present in the conflicting views about the euro among its supporters: is it a currency without a state yet, or is it a currency without a state ever?

**The Limits to Monnet’s Chain Reaction**

Since the Schumann declaration of 1950 which launched the Monnet strategy of partial integration, European institutions have grown from a coal and steel community of six countries to a European Union of 28 countries (as of summer 2013), building along the way a customs union, a single market, an economic and monetary union, and much more. This list of achievements has brought several benefits, to which we will return. Nonetheless, the “functionalist” view, deeply embodied in the ideology and practice of the European Union, that each step is part of a chain reaction leading to ever closer integration has serious limitations.

As a starting point, the functionalist emphasis on the rising power and autonomy of supranational institutions compared to national governments must be taken with a grain of salt. National governments do agree to delegate responsibilities to supranational institutions as commitment devices to achieve collective goals which are in each government’s long-term interest. To be credible, those institutions must have some autonomous power and independence; the rules for the autonomy of the European Central Bank come to mind. In addition, as in all complex organizations, supranational agents cannot be perfectly monitored by their principals (in this case, national governments and voters), and some principal-agent slack always exist. However, none of this means that Europe’s supranational institutions can go very far against the ultimate interests of national governments. While supranational institutions and procedures are important in the day-by-day working of Europe, they “could not work for a week in the absence of the will to cooperate of the member states, especially the largest ones – Germany and France above all” (Gilbert 2012, p. 3).

A well-known illustration of how centralized discipline does not work when ultimate power is in the hands of sovereign governments is the spectacular failure of the Stability and Growth Pact, which came into force in the late 1990s and included mechanisms to ensure that member states would hold their annual budget deficits below 3 percent of GDP and their accumulated government debt below 60 percent of GDP. The Stability and Growth Pact was never credible, and became moot after 2003, when France and Germany used their political
power to prevent sanctions against their own violation of the pact’s fiscal rules. In general, the success of supranational agents’ ability to take autonomous decisions can only be sustained in matters where the extent of disagreement among national governments over policy outcomes is relatively low, like the enforcement of trade liberalization agreements. But success in those areas does not imply that supranational institutions and rules could also trump national institutions and rules in other areas with much higher heterogeneity of preferences and interests, like fiscal policies.

The role of the European Court of Justice is instructive. In a series of landmark cases, the Court enunciated the doctrine that European Community norms have direct effect in member states and trump domestic law, and that individuals can directly invoke European law before national and European courts. For example, the 1963 case of Van Gend en Loos v Nederlandse Administratie der Belastingen (26/62) was decided in favor of a Dutch importer of German chemical products that had objected to a tariff charged by the Dutch authorities in violation of article 12 of the Treaty of Rome, which forbids member states from raising customs duties between themselves or introducing new ones. The aggressive interpretation of its role by the European Court of Justice in this and other cases went beyond the legal framework that had been formally agreed with the Treaty of Rome, and, according to some scholars, brought Europe close to a federal system from a legal perspective (Weiler 1991; Krasner 1999), expanding supranational powers beyond the control of national governments (Pierson 1996; Stone Sweet 2000). However, these new legal doctrines were established to enforce norms consistent with national governments’ own collective objectives, such as trade liberalization. The acceptance of these decisions by national governments and courts did not imply that any European norms would be as easily accepted in the future. In more recent years the German Constitutional Court has elaborated the legal theory of conditional acceptance of European Union norms, according to which Germany only accepts the supremacy of EU law insofar as it is consistent with fundamental German rights. In a famous decision on the constitutionality of the Maastricht Treaty (BVerfGE 89,155 of October 12, 1993), the German Court ruled that there is a legal limit to the powers of EU norms, defined by their effects on national democratic sovereignty. In a landmark ruling on the Lisbon Treaty (BVerfG, 2 BvE 2/08 of June 6, 2009), the German Court explicitly stated that the national states are “the masters of the treaties,” and "therefore must see to it that there are no uncontrolled, independent centralization dynamics" within the EU (quoted in Spiegel, 2009), a clear and explicit brake on functionalist dynamics.

In general, the central problem with the chain-reaction method is the unwarranted expectation that gradual integration, which has been successful in low-heterogeneity-costs areas, can continue unabated when moving to areas with much higher heterogeneity costs. This problem stems from the lack of a realistic assessment of the increasing costs and
constraints imposed by heterogeneity of preferences. Successful integration is more likely to take off in areas such as commercial integration, where heterogeneity costs are relatively low, and partly offset by the benefits from diversity. As integration proceeds to other areas, after low-hanging fruits are picked, heterogeneity costs continue to increase along a convex curve. At some point, those high costs become politically prohibitive, and the pressure from spillovers, inefficiencies and crises will no longer lead to further integration, but just to losses, and possibly even the collapse of the whole system. The chain-reaction approach does not anticipate that heterogeneity costs and constraints will eventually become binding and stop the process for good. Followers of this approach are therefore prone to setting up incomplete and inefficient arrangements, relying on the overoptimistic expectation that such inefficiencies can always be addressed at a later stage through additional integration.

For these reasons, there is no guarantee that regional integration in economic areas, such as a common market, should lead to political unification down the road. The example of the German customs union (Zollverein) in the nineteenth century, often mentioned in this respect, is misleading, because the main force behind commercial integration was political integration pushed by Prussia’s military power (Gilpin 2001). In fact, international cooperation and political unification can be viewed as substitute ways to lower barriers to trade. If two regions can already agree to reduce their trade barriers with each other while remaining independent, they are going to obtain smaller additional gains from trade if they also form a political union with a unified domestic market. Empirically, this direct negative effect of economic integration on the incentives to form a political union is likely to be larger than possible indirect effects of economic integration on the costs of political integration, such as those stressed by Monnet and his followers (for example, a possible reduction of communication and coordination costs). The historical record up to now indeed suggests that international economic integration is more likely to go hand in hand with political disintegration (Alesina and Spolaore 1997, 2003; Alesina, Spolaore, and Wacziarg 2000).

The euro is a child of the functionalist method. The method of partial integration provided the institutional framework and rationale for monetary integration. Without Monnet’s idea of delegating specific policy functions and prerogatives to supranational institutions, the euro would not have come into existence. Of course this does not mean that the euro was created exclusively for “functionalist” reasons and goals, or that the decision-makers were only supranational civil servants and elites. There would be no euro without the actions of powerful national politicians pursuing their own geopolitical and domestic objectives or without the backing of powerful economic interests (like German exporters). However, statesmen with political goals and producers with economic interests exist elsewhere, but do not end up with a “currency without a state.” Such a currency was only possible — politically, technically, and intellectually — in the exceptional institutional framework provided by European integration.
By creating the euro, the chain reaction crossed the border between “pure” economic integration which can be achieved through international cooperation, in the form of liberalization of trade and capital flows, and the form of monetary integration that, historically, had only been obtained by a sovereign state using its power of coercion to establish one currency within its borders.

The exceptional nature of the euro does not mean that Europe’s monetary union is unsustainable in the long run, or only sustainable if Europe becomes a sovereign federation. The parameters of the questions have been well stated by Mario Draghi (2012), the head of the European Central Bank, who said that “those who claim only a full federation can be sustainable set the bar too high.” Instead, Draghi focuses on the “minimum requirements to complete economic and monetary union.” In such framework, the future of the euro depends on a key political variable: the heterogeneity costs associated with the minimum set of functions that must be pooled or delegated for a currency union to work.

If heterogeneity costs were small, the euro area crisis of the last few years could perhaps be addressed with deep fiscal and political integration. This outcome seems out of reach at present given the historical experience of European integration. In principle, monetary union could lead to a fiscal and political union even if heterogeneity remains high, if the costs from leaving the euro are even higher, and fiscal and political integration are perceived by national governments and voters as the only solution. That outcome could be seen as a vindication of the darker version of Monnet’s chain reaction: heterogeneous Europeans would have been “trapped” in a fiscal and political union because they took an irreversible decision to enter a monetary union without anticipating the spillover to further integration. However, political union on those grounds would hardly be a solid start for a European federation; it would be very unlikely that such political union could trigger the positive cultural changes that would be the only sustainable foundation for a cohesive federation in the long run.

A more promising way to ensure the stability of monetary union in Europe is to focus on a narrower set of minimum requirements, as suggested by Draghi (2012). High priority is likely to be given to banking and financial integration. Those gains could in part be secured with tools and institutions similar to those already profitably employed in areas where the European Union has been most successful, like commercial integration, antitrust regulation, and the formation of a single market (for instance, Enderlein et al. 2012). At the same time, though, the close links between banks and sovereign states in Europe can create dangerous spillovers, crises, and clashes between supranational authorities and national governments.

**Back Where We Started: The Benefits from European Integration**

European integration in the aftermath of World War II started to counteract war and protectionism. We saw the timid beginnings with coal and steel, the defeat of the ambitious
plan to pool defense, the establishment of a common market, and the building of ever more complex and ambitious supranational institutions—eventually including monetary union. We discussed the serious problems with the expectation that this would necessarily be a chain reaction towards ever closer political integration. Now, it is time to offer a few final comments on the sources of strengths of the European integration project.

While the chain-reaction method can be carried too far, key aspects of Monnet’s strategy have in fact contributed to the concrete successes of the European project, when the tools of integration have been applied to the appropriate areas: those with lower heterogeneity costs and higher economies of scale. These aspects include: partial integration with a focus on economic areas; deep “institutionalization,” with the delegation of substantial prerogatives to supranational institutions, going well beyond the institutional framework of more traditional international organization; and integration of several functions, creating useful “linkages.”

Trade integration is a good example of the effectiveness of partial integration in economic areas. Trade is an area where costs of heterogeneity are offset by benefits from heterogeneity and large economies of scale. The removal of trade barriers was in the general interest of Europeans, even though specific sectors and groups within each country benefited from protectionist policies. European supranational institutions provided a way to coordinate trade liberalization and to lock in the commitment not to raise barriers unilaterally when faced with domestic political pressure. In this respect, European integration was one of the earliest and most successful examples of regional arrangements set up to solve coordination problems and to provide credible commitments (Eichengreen 2006). Partial institutional integration in different areas also allowed “linkages” between issues and provision of credible side-payments to potential losers from commercial integration. For instance, the notoriously wasteful Common Agricultural Policy has been often explained as a political compromise between France and Germany: German manufacturers gained access to the French market, and German taxpayers helped subsidize French farmers.

Trade integration within Europe has also benefited peace and security. The view that international trade can reduce the risk of war goes back to Montesquieu and Kant, and has spurred a large empirical literature. Multilateral openness (or “globalization”) does not reduce the risk of war between pairs of countries. However, bilateral trade, by increasing the opportunity cost of conflicts between two partners, reduces the probability of conflict between that pair of countries (Martin, Mayer and Thoenig 2008), even when controlling for historical, linguistic and cultural similarities between populations (Spolaore and Wacziarg 2012). In fact, Martin, Mayer and Thoenig (2010) find that country pairs with a high frequency of old wars are more likely to sign regional trade agreements, which can be explained as a consequence of the complementarity between economic and political gains.
from trade. They also show that multilateral trade openness reduces the opportunity cost of bilateral conflict, thereby increasing the risk of war between pairs of countries which can trade with third partners. Therefore, globalization also increases the political incentive to sign regional agreements for security reasons.

This interaction between economic and political factors can explain important aspects of European integration. For instance, it can shed light on why Konrad Adenauer, the Chancellor of West Germany from 1949 to 1963, pushed for a geographically narrower but institutionally deeper customs union with France, Germany’s old enemy, therefore reducing the risk of war between the two countries. Adenauer overruled his economic minister Ludwig Erhard, who was primarily interested in economic benefits and would have preferred a broader free-trade area, which France would have been unlikely to join given its own commercial and political interests (Garton Ash 1993; Moravcsik 1998).

An open question is whether European integration has played a central or only a marginal role in securing peace in Europe. Skeptics of the “pacifying” effect of European institutions stress the crucial involvement of the United States and NATO in Europe during the Cold War and afterwards, and the Europeans’ failure to deal with the breakup of Yugoslavia on their own. Moreover, peace has also held between Japan, the other loser of World War II, and its neighbors, and trade has prospered among them in the absence of Asian institutions analogous to the European Union. However, the Cold War ended in Europe with the fall of the Berlin Wall, Germany is now unified, and European institutions have played a very significant role in the process of democratization and integration of Eastern and Central Europe. In contrast, the relation between a still formally communist China and Taiwan remains tense and unresolved, and Korea is still divided and even at risk of a nuclear war, which could spread to Japan and other neighboring countries. On balance, whether because of European integration or other factors, in recent decades Europe has fared quite well in terms of peace and democracy relative to other areas of the world.

In general, pooling and delegating functions and policies to supranational institutions to take advantage of economies of scale and scope, while maintaining other prerogatives at the national (or sub-national) level, has brought substantial benefits to Europeans when appropriately implemented in areas with relatively low heterogeneity costs. Those benefits have been obtained while keeping ultimate sovereign control and the monopoly of the legitimate use of coercion at the national state level. A centralized European authority could provide a broader range of public goods with large economies of scale and scope, while using coercion to prevent free riding. But that would come with much higher heterogeneity costs. Europeans have probably been wise not to travel all the way to a sovereign federation so far, given their existing differences in preferences and cultures. If those preferences
change, Europe may benefit from a reorganization in a federal direction, but of course that should be decided only through broad and democratically expressed consensus.

At the moment, Europeans are sticking to the current system of cooperation among sovereign states within a supranational organization. Within those boundaries, and in spite of the serious limitations that we discussed, European institutions have provided useful commitments to overcome some (but not all) problems from free riding and beggar-thy-neighbor policies. European cooperation has at least turned out better than the alternative system of destructive unilateral national policies plaguing European history until 1945. In this respect, Moravcsik (2012), a leading “intergovernmentalist” scholar of European Integration, is hopefully not far from the truth when he writes: “Whatever the outcome of the crisis, the EU will remain without rival the most ambitious and successful example of voluntary international cooperation in world history.”

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Monnet’s Error?

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Abstract
Do partial steps toward European integration generate support for further steps or do they create a political backlash? We try to answer this question by analyzing the cross sectional and time series variation in pro-European sentiment in the EU 15 countries. The two major steps forward (the 1992 Maastricht Treaty and the 2004 enlargement) seem to have reduced the pro-Europe sentiment as does the 2010 Eurozone crisis. Yet, in spite of the worst recession in recent history, the Europeans still support the common currency. Europe seems trapped in catch-22: there is no desire to go backward, no interest in going forward, but it is economically unsustainable to stay still.

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L’Europe se fera dans les crises et elle sera la somme des solutions apportées à ces crises.

[Europe will be forged in crises, and will be the sum of the solutions adopted for those crises.]


The process of European integration has been one of the most significant institutional changes in the world during the last 60 years. What started as a limited economic cooperation project involving only six nations, is now a political entity involving 28 countries. The “dream” of a generation emerging from the disasters of World War II has now become an institutional reality, with a common market, a common currency, a common central bank, and a lot of common regulation. Much of this evolution took place in leaps and bounds at time of crises. It was the tension of the Cold War that pushed the formation of the first European Coal and Steel Community (ECSC) and it was (at least in part) the fall of the Berlin Wall that accelerated the creation of the common currency. In this respect, the progress of the European Union seems to fit the prediction made by Monnet (one of its founding fathers), that Europe will be forged in crises.

Following the 2010 euro crisis, however, the consensus toward Europe in Southern Europe dropped significantly (from 54% to 44%), reaching the lowest level among all the groups. Not only the European project is losing support as a result of the crisis, but it is losing even more support among the younger generations. Was Monnet’s wrong or is it just a temporary blip in an otherwise successful strategy?

In this paper we try to answer this question by examining the evolution of European sentiments toward the European integration project from 1973 to 2013. By using Eurobarometer’s surveys we put together the longest possible time series of questions regarding Europeans’ perceptions of the past and future benefits of European membership, support for the common currency as well as the level of trust in European institutions in the 15 European countries that joined Europe up to 1995 (France, Germany, Italy, Belgium, Netherlands, Luxembourg, UK, Ireland, Denmark, Greece, Spain, Portugal, Austria, Finland, and Sweden).
The functionalist view, advanced by Jean Monnet, assumes that moving some policy functions to the supranational level will create pressure for more integration through both positive feedback loops (as voters realize the benefits of integrating some functions and will want to integrate more) and negative ones (as partial integration leads to inconsistencies that force further integration). In the functionalists’ view integration is the result of a democratic process, but the product of an enlightened elite’s effort. In its desire to push forward the European agenda, this élite accept to make unsustainable integration steps, in the hope that future crises will force further integration. In the words of Padoa-Schioppa (2004, p. 14), a passionate Europe-supporter who espoused this theory, “[T]he road toward the single currency looks like a chain reaction in which each step resolved a preexisting contradiction and generated a new one that in turn required a further step forward.”

A more benign interpretation of this “chain reaction theory” is that European voters desire more integration, but local politicians do not, because they do not want to give up their power. Thus, it is incumbent upon enlightened pro-European technocrats to force the politicians’ hands, taking advantage of any opportunity, especially moment of crises.

Both interpretations of the chain reaction theory, however, rely on the assumption that the contradictions are always resolved with a step forward, not a step backward, leading to further support for the European project. In a democracy, this outcome depends very much on how crises affect the political support for the European project, support also affected by the cost of reverting it back. Do Europe-related crises increase the skepticism toward the European project or do they generate more demand for European integration? Does integration leads to further demand for integration?

To answer these questions we analyze the cross sectional and time series variations in attitudes of European voters and how they change at three crucial times: the 1992 Maastricht treaty, the 2004 enlargement to Eastern Europe, and the 2010 Eurozone crisis.

To begin with there is a very different level of pro-European sentiment (Europhilia), across EU members. Initially, Southern European countries were much more pro Europe than Northern European ones. This difference appears related to the
quality of institutions of each country vis-à-vis Germany. The worse the relative quality of domestic institutions, the higher the demand for Europe was.

When we look at the temporal patterns of Europhilia, we find that between 1973 and 1991 Europeans’ views about the current benefits of European membership improved considerably. This increase seems consistent with positive feedback loop implicit in Monnet’s chain reaction theory: the experience of a common governance leads to an increase demand for more common governance.

This positive feedback loops, however, seems to break down with the 1992 Maastricht treaty. There is a drop in support for European membership and by looking at individual data this drop is highly correlated with a reduced support for the single market and for further political integration. This step seems to have created a permanent backlash. The same effect occurs after the 2004 European enlargement to Eastern Europe.

With the 2010 euro crisis the Southern European countries’ consensus toward Europe drops further (from 54% to 44%), reaching the lowest level among all the groups. Not only the European project is losing support as a result of the crises, but it is losing even more support among the younger generations. We find that the youngest cohort, who was significantly more favorable towards Europe in the past, has become significantly less favorable than all the other cohorts in more recent years.

While the question on past benefits of European membership exhibit a similar behavior, the attitudes towards the common currency and the trust towards the EU and the ECB show very different patterns. The support for the Euro seems to be remarkably stable, in spite of the Eurozone crisis, while trust in European institutions plummeted, even more so than the trust towards national institutions. Europeans have not given up on the European project, but do not like the way it is managed.

By using the surveys before and after the watershed moments, we build pseudo-panels (Deaton, 1985) to probe deeper into the causes of the consensus drop. The deterioration in the support for Europe in 1992 appears directly linked to a worsening in opinion regarding the benefits of a single European market, a single currency, and further political integration. This effect is similar across all countries, with the exception of Denmark, for which is worse.
By contrast, the drop in support for Europe around the 2004 enlargement seems to be mostly driven by country-specific factors. In particular, the support for the single currency drops significantly among Southern European countries.

Finally, when we look at the Eurozone crisis, the most important determinants seem to be level of unemployment, which affects negatively the support for Europe. After the adoption of the Euro, the spread of a country public debt vis-à-vis the German bunds also has a negative impact on support for EU membership for the Eurozone countries. This effect, however, disappear if we allow a separate time trend for Southern European countries. We confirm this evidence by creating a pseudo-panel with the two surveys before and after the crisis and using individual perceptions of the economic conditions.

Because the single currency forces also a single monetary policy, disappointment with Europe may arise because common policy decisions may be suboptimal from a domestic point of view. To estimate how much of the disenchantment towards Europe is correlated with the suboptimality of a common monetary policy, we compute the difference between the country optimal Taylor rule and the ECB policy rule for each country. We find that these deviations are highly predictive of the drop in support for Europe and in the trust towards the ECB. Yet, paradoxically, they are not predictive of the drop in support for the common currency. Europeans seem to believe in the common currency, not in the way it is managed.

Most Europeans are unhappy with the direction that the European Union has right now, but they still consider it a useful institution to deal with crises. In spite of the worst recession in recent history, the Europeans still believe in the common currency. Yet, they show no appetite to delegate more power to the EU.

Since the survival of the Euro is dependent upon further transfers of national powers to the EU, then the European Project is in a catch-22. Europeans do not want to go forward, they do not want to go backward, but they cannot stay still.
1. Theories of the European Integration Process

The process of European Integration has been greatly influenced by the functionalist view, as interpreted and advanced by Jean Monnet, one of the EU founding founders. The functionalist view believes that European integration is mostly pushed by elites and interest groups that transcend national boundaries (Haas (1958, 1964). It is called "functionalism" (sometimes neo functionalism) because it aims at transferring specific "functions" to supranational institutions.

The functionalist approach finds its first institutional implementation in the European Coal and Steel Community Treaty. The treaty established five main institutions, which constituted the foundation of the institutional framework of the European Community (Laffan and Mazey, 2006). These institutions, which do not respond directly to voters, are deputized to push further the integration process.

The institutional counterpart to this strategy is the so called *methode communautaire* (Community Method), which granted to the supranational institutions of the EU, rather than the governments of the member states, a central role in formulating proposals. The appointment method naturally led to a Commission populated by pro-European members, who made proposals for further integration.

A corollary of this approach is that the Commission must not be highly politicized, but represent all mainstream parties in Europe. In so doing this method favored the formation of an elite of pro-European bureaucrats, with little or no political accountability. It is what Marquand (1979) calls Europe’s “democratic deficit”.

As discussed in Spolaore (2013), functionalists believe that moving some policy functions to the supranational level creates pressure for more integration through both positive and negative feedback loops. The positive feedback occurs as politicians and voters observe the benefits of integrating some functions and will want to integrate more. The negative feedback occurs when partial integration leads to institutional and economic inconsistencies that will push further integration by forcing the introduction of the complementary reforms needed. Needless to say, for the negative feedback mechanism to push further integration that fixes the institutional inconsistencies, it must be true that dismantling the initial integration is costly – that is institutional and economic integration comes with irreversibility, so that pushing forward may be less costly than pulling back.
According to Eichengreen (2006) and Pierson (1996) technocrats typically start from narrow areas of expertise (e.g. coal, steel) where they have an informational advantage and voters and national politicians are not able to predict or anticipate the contradictions generated by these partial integrations, nor are interested in opposing them because they affect a limited number of voters.

A leading example of this “burning the ships” strategy is the euro. In the words of the former German Chancellor Helmut Schmidt “This is the great strength of the euro, that nobody can leave it without damaging his own country and his own economy in a severe way.” 1

As explained by Monnet’s collaborator George Ball (1994): “Monnet recognized that the very irrationality of this scheme might provide the pressure to achieve exactly what he wanted - the triggering of a chain reaction. The awkwardness and complexity resulting from the singling out of coal and steel would drive member governments to accept the idea of pooling other production as well.”

At least some European founding fathers seem to have conceived the mechanism knowing that these inconsistencies would lead to crises. These crises were seen as opportunities to force further integration which voters would have not favored otherwise. In the words of Romano Prodi, one of these founding fathers, “I am sure the euro will oblige us to introduce a new set of economic policy instruments. It is politically impossible to propose that now. But some day there will be a crisis and new instruments will be created.”

Therefore, in order for the functionalist approach to work, an initial integration step should lead to more demand for integration later, either through the positive or the negative feedback loop (or both). Most importantly, functionalist approach implicitly assumes that there is no risk of a backlash, pushing the integration project backward. Padoa-Schioppa, one of the founding father of the euro, once said that the Economic and

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Monetary Union (EMU) has the same name of an ostrich-like Australian bird. “Neither,” he said, “can go backwards.”

Yet, there is a contradiction implicit in this approach. On the one hand, this strategy makes sense only if further integration is not desired today. If voters were in favor of further integration from the start, the functionalist approach would be redundant. On the other hand, if voters were against further integration and fully anticipated the feedback effects, they will oppose even the first move. Thus, to work the functionalist approach requires a certain degree of voters’ deceptions, which adds to the perception of a democratic deficit.

In this paper we analyze the public opinion regarding the European project through the lenses of Monnet’s conjecture. First, we analyze the functioning of the positive feedback loop. In particular, we study whether the pro European sentiment evolves as a function of the time spent in the Union. We also analyze the evolution of a country xenophobic attitude as a function of the number of immigrants coming from Europe and from outside of Europe. It is possible that mistrust toward other nations and citizens prevents comprehensive integration, at the start, but as citizens learn to trust other immigrants and get to know them, the public opinions may shift. According to this hypothesis, as Europe becomes more integrated, especially with the abolition of the internal border of control and several European initiatives, such as the Erasmus program, European citizens learn to trust more their counterparts. This positive feedback could, in turn, change positively the sentiment toward further integration.

Second, we analyze the negative feedback loop at three critical junctures of the European project: i) the signing of the Maastricht treaty; ii) the 2004 EU enlargement to Eastern Europe; iii) the effect of the 2010 Eurozone crisis.

2. The Data

2.1 The Eurobarometer Surveys

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The Eurobarometer surveys are the product of a unique program of cross national and cross temporal social science research. The effort began in the early 1970s, when the European Economic Community (EEC)’s Commission sponsored simultaneous surveys in the EEC to measure public awareness of, and attitudes towards, the Common Market and the European Community institutions. In 1974, the EEC Commission launched the Eurobarometer series, designed to provide a regular monitoring of the social and political attitudes in the nine member-nations: France, Germany, Great Britain, Italy, the Netherlands, Belgium, Denmark, Ireland, and Luxembourg.

These Eurobarometer surveys are carried out in the spring and fall of each year. In addition to regular readings of support for European integration, each survey explores some special topics. Beginning with Barometer 7 in the spring of 1977, the surveys measure also the support for the European Parliament.

The geographic scope of Eurobarometer surveys has gone hand in hand with the Community’s enlargement process: it has included Greece since fall 1980, Portugal and Spain since Fall 1985, the former German Democratic Republic (East Germany) since 1990, Finland since the Spring of 1993, and Sweden and Austria since the Fall of 1994. Since the 2004 eastern enlargement of the Union, the survey has included the Republic of Cyprus, the Czech Republic, the Baltic States, Malta, Poland, Slovakia and Slovenia. In spring 2007 Romania and Bulgaria have also been included.

For the sake of consistency, we excluded citizens from countries not yet in the European Union at the time of the survey3 as well as respondents below the age of 18. Among all the Eurobarometer waves, we select those in which questions about the attitudes towards membership, the euro, and the European Central Bank are asked, as well as questions on trust in the national institutions, voting behavior in the elections for the European Parliament and in the national general elections. The exact wording of these questions is reported below

<table>
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3So that, for instance, Finns are included since spring 1995 as opposed to spring 1993.
MEMBERSHIP: Generally speaking, do you think that (OUR COUNTRY)'s membership of the European Union is (Good, Neither good nor bad, Bad)? We compute the share of respondents who answer Good.  

BENEFIT: Taking everything into consideration, would you say that (OUR COUNTRY) has on balance benefitted or not from being a member of the European Union (Benefitted, Not benefitted)?. We compute the share of respondents who answer Benefitted.  

EURO: Please tell me for each proposal, whether you are for it or against it. [...] There has to be one single currency, the euro, replacing the (NATIONAL CURRENCY) and all other national currencies of the member states of the European Union. (For, Against). We compute the share of respondents who answer “For”.  

TRUST EU: For each of the following institutions, please tell me if you tend to trust it or tend not to trust it? [...] The European Union. (Tend to trust, Tend not to trust). WE compute the share of respondents who answer “Tend to trust”.

TRUST ECB: For each of [the following European institutions], please tell me if you tend to trust it or tend not to trust it? [...] The European Central Bank (Tend to trust, Tend not to trust). We compute the share of respondents who answer “Tend to trust”.

The MEMBERSHIP variable is a measure of the view of the current and future benefits of belonging to the EU. By contrast, the variable BENEFIT represents an assessment about the past benefits, while we interpret TRUST EU as an assessment of how the European project is managed. Similarly, the EURO variable assesses the beliefs in the necessity of a common currency, while we interpret the TRUST ECB variable as a judgment on the way the common currency is managed. In this way we are able to distinguish between opinions about the validity of the European unification project and opinions about the performance of the current European institutions. As we will see, this distinction will turn out to be empirically important.

The summary statistics of these variables are contained in Table 1. Panel A reports the individual data, while Panels B and C report averages by country. Finally,

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4In earlier datasets the coding of the third option “Neither good nor bad” is inconsistent. Even after reviewing the codebooks we were unable to reach a desired level of confidence in our results. For this reason we limited ourselves to the dichotomist choice.
Panel D reports sample statistics on electoral variables. For a detailed description of these variables see Table A1 in Appendix.

2.2 Demographic variables
The Eurobarometer surveys contain information on the date of birth of respondents. By using this date, we cluster people in five cohorts: the War II generation (born before 1945), the post War II generation (between 1946 and 1957), the baby boom generation (between 1958 and 1967), the Erasmus generation (so called because they benefitted from European fellowship program to study abroad between 1968 and 1979), and the millennia generation (born after 1979).


2.3 Macroeconomic Variables
The exact description of the macroeconomic variables we use is contained in Table A.1 in the Appendix. For the unemployment rate (unemployed persons as a share of the total active population) we use the Annual Macro-Economic Database of the European Commission; for inflation, the OECD Consumer Price Indices. As ECB policy rate we use the Marginal Lending Facility Rate (MLR), i.e. the interest rate at which mayor financial institutions obtain overnight liquidity from national central banks in the Eurosystem, against eligible assets. We obtain the pre-Euro national central bank discount rate from the IMF International Financial Statistics (line 60).


2.4 Attitudinal and Cultural Variables
We derive some indicators of cultural and attitudinal differences across countries from the European Social Studies surveys. As indicators of racism we use the answer to the following question “On this list are various groups of people. Could you please mention any that you would not like not to have as neighbors?” One measure (called “no neighbors: race”) equals to one if the respondent mentions “People of a different race” as a possible answer. The other measure (called “no neighbors: immigrants”) equals to one if the respondent mentions “People of a different race” as a possible answer.

As a measure of pride we use the question “how proud are you to be a ... (country) citizen.” We compute the share of respondents who declare themselves Very Proud on a 4pt scale (1 = Very Proud, 2 = Quite Proud, 3 = Not very proud, 4 = Not at all proud).

The genetic distance is the bilateral genetic distances between countries computed by Cavalli Sforza (2000) and used by Guiso et al. (2009) and Spolaore and Wacziarg (2009).

3. Sentiment toward the European Union

Before analyzing the evolution of sentiments toward Europe it is important to study whether citizens of different countries have a different baseline attitude vis-à-vis the European project. As the Union was formed, did the initial level of support differ across countries? Why?

Table 2 shows the sentiments toward the European project the first time this question was asked (which changes from question to question and from country to country). The oldest question is whether EU membership is a good thing for the country, which was asked since 1973. For the core countries (France, Belgium, The Netherland, Germany, and Italy), thus, the question is asked several years after they joined the EU, something we need to keep in mind in the interpretation.

The first column reports the fraction of people, by country, who answer “Good” to the question “Generally speaking, do you think that (OUR COUNTRY)'s membership of the European Union is (Good, Neither good nor bad, Bad)?” The data show a large difference of opinions across geographical areas. Among the core countries there is an overwhelming majority in support, with Italy being the most favorable (80%) and France being the least favorable (69%). By contrast, for later entrants the picture is mixed.
United Kingdom (36%) and Denmark (46%) joined with only a minority supporting the EU. So did Greece (42%), Sweden (40%), and Austria (42%). Instead, Portugal (72%) and Spain (78%) enjoyed a large majority of supporters for the project at the time of entry.

The remarkable difference in support between early and later entrant (73% vs 52%) may reflect a selection effect (the more enthusiastic joined first) or an acquired taste effect (consistent with the positive feedback effect predicted by the functionalist approach).

The other answers show a similar pattern. Yet, there are some differences. The fraction of respondents who in 1984 agreed that their country benefitted from being a member of the European Union is the majority in France (55%), Belgium (52%), the Netherlands (69%), Luxemburg (72%) and Ireland (61%), while is less than half in Germany (41%), Denmark (44%), Greece (47%) and the UK (34%). The difference may reflect the fact that this question focuses on the past (have you benefited), rather than the present/future (is membership good today).5

On average, citizens of the core countries seem to trust the European Union less than they think it is beneficial. The fraction of respondents who trust it are the majority only in Italy (63%) and Luxembourg (76%). Among the late entrants, Southern countries have a more positive view, while Northern ones do not trust the European Union.

Can we explain these differences in opinion with country-specific variables? To this purpose, we extract the country fixed effects from the following O.L.S. regression run on the sample of respondents to the pooled Eurobarometer surveys in the year when a country entered in the EU (or 1973 for the original six countries):

\[
Membership_{ijt} = \alpha + \beta X_{ijt} + \gamma D_j + \delta D_t + \epsilon_{ijt}
\]

where \(i\) stands for individual, \(j\) for country and \(t\) for the entry year. The Membership variable is a dummy variable equal to 1 if a respondent answers “Good” to the Membership question in that country year. \(X_{ijt}\) are individual demographics (gender, cohorts, education, occupation), \(D_j\) are country fixed effects and \(D_t\) year fixed effects.

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5 For the newcomers, Spain and Portugal in 1986 and Finland Sweden and Austria in 1995, the answer has not much relevance, since they have just joined the EU.
Figure 1 plots the country fixed-effects (relative to Germany) derived from (1). There is a very strong North-South component in these country fixed effects, with the exception of Ireland, which behaves more like a Southern European country, and Austria, which is more similar to a Northern one. The picture is similar (not reported) if, instead of the Membership variable, we use the Benefit one (a dummy variable =1 if a respondent thinks that his country has on balance benefitted from EU), the support for the Euro, or the Trust in EU and ECB. For simplicity, we will refer to all these variables measuring the support towards the European projects as Europhilia indicators.

In Table 3 we regress these countries’ fixed effects on potential determinants of Europhilia. Each RHS variable is a proxy for a motive for supporting Europe cited in the public debate. Since we only have 15 observations, we run univariate regressions with each of the variables in the rows of Table 2A as RHS variables. Each entry in the table shows the slope coefficient (and its standard error) of the regression where the LHS is the variable reported at the top of the column and the RHS is the one variable indicated at the beginning of the row. Statistically significant coefficients are marked in bold.

Though not all motives should affect each indicator of support for the European project, we are not very successful in explaining these country fixed effects. Given the number of right hand side variables, the level of statistical significance is close to what we would expect just by chance. Thus, the main objective of this table is to show which theories do not matter.

To begin with, a prevailing view is that Europe was the response to the horrors of the two World Wars. For this reason, we use as a possible determinant of Europhilia the sum in number of deaths in World War I and in World War II divided by population at the beginning of each war. We do not find any evidence to support that the European unification is a mere consequence of the destruction of the war. One could argue that the relative number of deaths might not capture well the destructions of war. However, countries that were spared the horrors of WWII, such as Spain and Portugal, exhibit a higher level of Europhilia than countries devastated by the war, such as Austria and England.

Similarly, we do not find any support for the idea that a country’s average attitude towards Europe depends upon its relative GDP per capita, the ratio between Net Receipts
from the EU and GDP, the openness to trade (proxying for an “Economic insurance”, “Economic Transfers”, and “Trade Opportunities” motives respectively), the level of xenophobia, the level of patriotism, and the genetic distance of its indigenous population with the indigenous population of the rest of the European Union (a proxy for cultural barriers).

By contrast, a measure of institutional quality (the difference in each country government effectiveness vis-à-vis Germany, computed in 2007) seems to be correlated with Europhilia. The government effectiveness is a World Bank’s World Government Indicator Index, capturing “perceptions of the quality of public services, the quality of the civil service and the degree of its independence from political pressures, the quality of policy formulation and implementation, and the credibility of the government's commitment to such policies (increasing in government capacity” (Kauffman et al (2010)). Countries with more effective governments than Germany are less Europhile. By contrast, countries with relative bad institutions seem to be happier to be part of the EU. This result suggests that citizens believe that the European institutions will have a quality that averages the quality of the member states. Joining Europe could signify that the political and economic institutions will improve in the European Union for weaker quality countries.

An alternative explanation is that institutional quality is a proxy for the years a country had democratic institutions. Thus, countries with younger democracies are more likely to favor the European project. We try to distinguish between these two hypotheses by correlating the number of years each country had a democratic government with Europhilia. The results (unreported) show that proxies for democracy are not correlated with European consensus.

We repeat the same exercise by using the variable BENEFIT, which measures the past benefit and not the future one. This question is not the most meaningful one for countries at entry, since they do not have much an experience. Not surprisingly, no variable seems to have any explanatory power.

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6From 1880 to today the number of years for each country Polity IV gives a score of 6 or more.
When it comes to support for the Euro, we find that, besides the relative institutional quality, also the xenophobia indicator seems to have an effect: more xenophobic countries tend to support the euro more. This effect seems to be the result of a higher level of xenophobia among southern European countries, who support the Euro more.

In sum, attitudes towards Europe do not seem to be affected either by cultural barriers or by the claimed desired to avoid a future war. We find some support for the “Institutional quality transfer.”

4. The Temporal Dynamics of Europhilia

With these different baselines in mind, we can now analyze the evolution of sentiments over time.

4.1 Aggregate Analysis

Figure 2 reports the evolution of the fraction of people with a positive sentiment about EU membership from 1973 to 2013 for the 15 core EU countries. In this figure we have grouped the countries into three areas, Northern Europe (Denmark, Ireland, and United Kingdom), Central Europe (France, Belgium, Netherlands, Luxemburg and Germany), and Southern Europe (Greece, Italy, Portugal, and Spain). While there is some variation within each group, the geographical three-partition seems to fit the data well.

Given the continuing enlargement of the EU, we are concerned that the increase in the set might confound the temporal pattern. For this reason, we limit the sample to the earliest 15 members, imputing to a missing country its entry level of the corresponding variable until it enters to make the series homogenous. However, in Figure 2, panels B, C, and D we analyze each country separately to distinguish any compositional effect deriving from new entrants’ opinions.

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7 Until 1991 the European Union was called European Economic Community. From now on we are going to refer it to EU, regardless of the time period.
Figure 2 shows a steady improvement in Europhilia during the period leading to the Maastricht Treaty (1992): at the peak, in the first quarter of 1992, the fraction of Southern Europe supporters was 69%, the fraction of Central European supporters was 62%, while in Northern Europe a majority of respondents (54%) believed that EU membership provided a benefit to their country.

As figures 2B show most of the increase in consensus is concentrated among the Eurosceptic countries located in the North and in Greece. This trend seems consistent with the positive feedback reaction of Monnet. The support for Europe rises among initially skeptical countries thanks to a positive feedback effect of membership.

The year 1992 is a watershed from many points of view. In February 1992 the Maastricht treaty is signed, establishing not only the path to a common currency, but also final political unification as the ultimate goal. In September 1992 the Italian Lira and the British pound were forced off the EMS system. Finally, in January 1993 the single market becomes a reality, thanks to the adoption of 280 pieces of legislation that replace national regulation with common European laws. It is hard to disentangle the relative importance of these three factors with aggregate data. Nevertheless, the fact that this drop is not concentrated or particularly pronounced in the two countries that were forced to exit the EMS rules out the EMS as a main factor.

One possible interpretation – consistent with Monnet’s chain reaction theory-- is that the positive feedback loop generated by the initial European experience allows the pro-European elite to make a step forward, step that is later resented by voters, once they appreciate the consequences of this step. An alternative interpretation is that to create consensus for a further integration step, the European Union spent a great deal in promoting the idea. This promotion temporarily boosted consensus. Once it subsided, consensus dropped.

After 1992, the consensus towards Europe seems to decline. During this period the discontent are mostly concentrated among Southern European countries, the ones that were most enthusiastic to begin with. Over time the initial difference among pro-

\[http://ec.europa.eu/internal_market/20years/singlemarket20/facts-figures/history_en.htm\]
European countries and skeptics disappears and the ranking seems to flip in the last survey, where a minority (44%) in Southern Europe perceives membership as beneficial, while a majority supports the European project in Central Europe (60%) and in Northern Europe (53%). It looks as if Southern European countries initially believed in an institutional arbitrage (which would enable them to benefit from Northern European superior institutions at no cost). Over time they learned that there is no free lunch.

In Figure 3 we plot the year fixed effects of a modified version of regression (1) where we consider all the years available (t instead of being the entry year is any year from entry to 2012). These fixed effects capture the dynamic in Europhilia common to all the 15 countries after we control for demographic changes in the various countries. It clearly confirms that overall there is a general increase in Europhilia from 1981 to 1991, followed by a large drop from 1992 to 1997.

One may wonder whether the changes over time are due to the same people switching opinion or to younger generations having different opinions from older generations. Figure 4 tries to study this question. In the modified version of regression (1) we estimated the cohort effects, leaving as omitted cohort the War II generation (born before 1945). These cohort fixed effects are plotted in Figure 4.

Interestingly, all cohorts have a similar attitude toward Europe, with the exception of the millennia generation (born after 1979). Given the structure of the data, the evolution of beliefs of this generation only affects the more recent years. People born after 1979 are significantly more pro Europe at the beginning (1998) than all the other cohorts and they end up being significantly less favorable than all the other generations in 2012. To the extent the younger generation is predictive of future trends this is a worrisome sign for the European project. Starting in 2003, all cohorts start to become less pro-Europe than the war generation, albeit these differences are not statistically significant.

4.2 A Panel Analysis

With these data we cannot clearly identify causality. Nevertheless, in this section we study how the sentiment toward Europe correlates with macro-economic variables. In Table 4 we report the results of the following regression
\begin{equation}
\text{Membership}_{jt} = \alpha + \beta X_{jt} + \gamma D_j + \delta D_t + \epsilon_{jt}
\end{equation}

where the symbol \( .jt \) indicates the average across individuals in a given country-year of a certain variable. Thus, the LHS is the country average of the MEMBERSHIP variable in each year from 1973 to 2012.

In column (1) we control only for year fixed effects, which explain 14% of the total variation. In column (2) we control only for country fixed effects, which explain 65% of the total variation. Controlling for year and country fixed effect at the same time (column (3)), we can explain 74% of the total variation.

In column 4, instead of the year fixed effects, we insert a post 1992 dummy and a post 2004 one. Both have a negative and statistically significant coefficient. This result confirms the visual impression of Figure 2. Yet, the year fixed effects have more explanatory variables than the two dummies.

In column (5) we return to the specification in column (3) that includes both country and year fixed effects and add to it two economic variables that capture country specific macroeconomic dynamic: the level of unemployment and the difference between the yield of the local sovereign and that of the German Bund. This latter variable is computed only for countries belonging to the Eurozone (for the others it is set to zero).

As expected the level of unemployment has a negative and statistically significant effect on Europhilia. A one percentage point increase in unemployment reduces MEMBERSHIP by one percentage point (16% of the sample mean). A similar result is true for the spread. An extra percentage point in the spread reduces MEMBERSHIP in a Eurozone country by 75 basis points (12% of the sample mean).

Interestingly, when we look at the year fixed effects (not reported) the 2011 and 2012 dummies lose statistical significance if we insert these two variables relatively to the omitted years.\(^\text{10}\) Thus, the drop in Europhilia in recent years seems to have been entirely explainable with economic factors.

In commenting Figure 2 we noticed that most of the post 2004 drop was concentrated in Southern European countries. For this reason in column (6) we interact the post 2004 dummy with the South dummy. The post 2004 dummy becomes

\(^{10}\text{An F-test of the dummies of 2011 and 2012 has a p value of 0.25.}\)
insignificant, suggesting that the effect is concentrated in the Southern countries. Instead, the post Maastricht dummy remains significant, albeit some of the effect is absorbed by the unemployment variable. Because 1992 and 2004 are particularly relevant points in the data we will try to study them in more detail in the next session by using the micro-level data.

In Column (6) the magnitude of the spread coefficient drops to a third of its previous level and loses statistical significance. The most likely interpretation is that the spread variable was capturing the effect of the post 2004 variable limited to the Southern countries. Once we allow for this separate trend, the spread variable per se does not have an impact, while the unemployment variable continues to have an impact. The effect of unemployment on whether EU membership is perceived as beneficial is not different across different periods: when we interact unemployment and some specific year dummies (euro-crises years) we do not find a significant coefficient.

Thus far, we have focused all our attention on MEMBERSHIP, for which we have the longest time series. The pattern for the BENEFIT variable (unreported), which is available only since 1983, is very similar. By contrast, the picture is quite different if we look at the trust toward the EU (Figure 5). While this variable is available only since 1997, it presents a much more dramatic pattern. Among Southern European countries trust towards the EU drops from 70% to 20% in six years. For the rest of Europe the drop is less pronounced, but still very large (from 62% to 37% for the Central countries and from 59% to 35% for the Northern ones). Thus, while Europeans continue to see the benefits of the EU membership, they are very unhappy of the way this membership is managed by the current institutions. This performance suggests that if the founding fathers hoped to win over the skeptics, they miscalculated that the public opinion could be turned against European institutions, rather than convinced of their necessity.

It is possible that this malcontent is entirely driven by economic conditions. In the last six years Europe has been affected by a recession that is in many cases deeper and longer than the one experienced in the 1930s. Hence, it is not surprising, that Europeans express their dissatisfaction towards existing institutions, being them national or supranational. Thus, to assess the health of the European project we should not focus too much on the trust towards the EU, but on the relationship between the trust towards the
EU and the trust towards the local government. The ratio between these two variables is plotted in Figure 6.

Consistent with our previous results, on average Southern European people trust the EU more than their local governments, while Center and North Europeans do not. Interestingly, however, there is a severe drop in relative trust after 2009. Part of that drop reflects the rise in the previous two years. As the 2008 crisis hits the various economies there was an immediate loss in the trust towards local government, and only later a drop in the trust towards the EU. In 2013 the relative trust in all three geographical areas is lower than at the beginning of our sample period (1997), but not by a lot. There are exceptions, though. In 1999 Italians trusted the EU much more than their own government. In 2013 this difference was cut in half.

In Figure 7 we look at the support towards a common currency. Interestingly, this question was asked well before the introduction of the Euro, so we can track public opinion for a long time. Surprisingly, we do not observe a pattern similar to Figure 2. While there is a decline in support among Southern countries, this decline takes place after 2002, not after 2010. The Eurozone crisis seems to affect negatively the support for the common currency in the countries not in the euro (UK, Denmark and Sweden), which see the support drop from 61% to 43% and in the Northern European countries (a drop of 20 percentage points) that have been moderately affected by the crisis. It does not affect support among Southern European countries, which fluctuates around 60%. A very different picture emerges if we analyze the behavior of Trust in the ECB. Here the drop after the Eurozone crisis is severe, especially among Southern European countries, where the trust in the ECB drops from 64% in 2008 to 24% in 2013.

Figure 8 shows a divergence in the pattern of trust toward the euro and trust toward the ECB in few selected countries, especially after the global financial crisis. While the trust toward the Euro remains strong in most of the countries, there is a significant reduction in trust toward the ECB both in strong economies (Germany) and in weak economies (PIGS). This divergence suggests that European citizens are disappointed about the management of the crisis, but maintain a relatively positive attitude toward the common currency. An alternative interpretation for being in favor of the Euro while expressing mistrusts towards the ECB is that countries anticipate the cost
of exiting the single currency and, forcefully, favor the status quo. This explanation, which is consistent with the negative feedback loop theory described in Section 1, seems validated by the fact that support towards the euro dropped substantially for those countries who are not in the euro.

4.3 Xenophobia

Thus far we have only used economic variables to explain the changes in European sentiment toward the European institutions and the European project. It is possible, however, that some cultural variables, such as attitudes towards immigration, can explain the deterioration in support for the EU.

To measure attitudes towards immigrants we rely on the European Social Study (ESS). We use two questions. The first is “Is [country] made a worse or a better place to live by people coming to live here from other countries?”, where the answers range from 0 = Worse place to live to 10 = Better place to live. The second question is “Would you say it is generally bad or good for [country]’s economy that people come to live here from other countries?”, where the answers range from 0 = Bad for the economy to 10 = Good for the economy.

Figure 9 plots the share of respondents in each country who answer 4 or less in these two questions. As we can see, the two responses are highly correlated, but they do not show a very high variation over time. The two countries where we see a pronounced increase are Greece and Ireland. Thus, it is unlikely that such slow moving variables can explain the changes in Europhilia.

In unreported regressions we try to explain the change in the MEMBERSHIP variable with our proxy for xenophobia. The coefficient is statistically insignificant both alone and interacted with unemployment, suggesting that xenophobia plays no significant role in the decline of support towards the European project.

Overall, we can conclude that the economic crisis tends to undermine the trust in the European institutions, but not (at least not yet) the beliefs in the benefits of Europe. On a one hand, we could say that Monnet’s chain reaction theory might have some validity. If economic crises increase the desire to reform European institutions, but do not reduce the desire for Europe, then Monnet’s chain reaction might work. We will return to
this in the next section. On the other hand, (contrary to Monnet’s view) we see that the support for Europe dropped any time there was a milestone toward more European integration (such as the 1992 Maastricht Treaty and the 2004 enlargement) and this drop does not seem to disappear with time.

5. The Three Watershed Moments

The analysis so far only reports correlations based on aggregated data. One obstacle to the use of micro-data is the fact that in every survey Eurobarometer interviews a different sample of citizens, so it is not possible to study in a panel how changes in individual economic conditions affect the perception toward the European project. Moreover, many interesting questions are not asked every period, making it impossible to dig deeper into the reason of some changes.

To circumvent these problems, we use the pseudo-panel technique (Deaton (1985)) by using surveys just before and after the three major turning points in the European project (the Maastricht treaty, the 2004 enlargement, and the 2010 Eurozone crisis).

5.1 The Maastricht Treaty

Figure 10 plots some similar or identical questions which were asked in both the March 1992 and 1993 surveys. The first graph to the left shows the support for the single market. The bar graph on the left depicts the share of respondents who in 1992 answered “A Good Thing’ to the question “Overall, what do you think that the completion of the Single European Market in 1992 will be?” On the right is the percentage of people who answer “Advantages” to the question “Do you think that Single European Market brings more advantages or more disadvantages for (OUR COUNTRY)” in 1993. The two questions not being identical, we mostly focused on the differential changes across group of countries, rather than on the difference itself.

The most striking fact is that in 1992, when it was approved, there was not a majority in favor of the single market. The only countries where the majority of the respondents supported the single market were Italy, Portugal, Spain, Greece, and Ireland. As a consequence, only in Southern Europe a majority of respondents thought that the
completion of the single market was a good thing, while in the Northern European countries citizens were split in half among those who thought the change was positive and those who did not. In the Center less than 40 percent supported the change.

One year after the implementation, respondents were asked to reflect on the change and decide whether completing the single market was advantageous to the domestic economy. The support drops dramatically in the South from 63% to 42% and in the Center from 34% to 18%, while it remains substantially stable in the North.

By contrast, in 1992 there is an overwhelming support in all the countries for further political integration. The panel on the right of Figure 10 depicts the share of respondents who in March 1992 and in March 1993 answered “For” to the question “Are you for or against the formation of a European Union with a European Government responsible to the European Parliament?”.

The figure shows that this overwhelming majority deteriorates between 1992 and 1993 in all geographical areas. The differences, though, are not as dramatic as those for support of the single market. In the South support falls from 85% to 81%, in the Center from 76% to 65%, and in the North from 50% to 40%.

To try to understand whether sentiments toward the single market or the Maastricht treaty are correlated with our variable of interest (whether membership is beneficial), we rely on the micro data. Following Deaton (1985), we construct a pseudo-panel. For each of the two cross-sections, we define synthetic individuals (or, as they are often referred to in literature, cohorts, not to be confounded with our generational cohorts used before) identified by a set of demographic characteristics. We finally use these units as if they were true individuals on a panel data set.

We define cohorts using five characteristics: age, gender, nationality, education, and job. Variables are recoded in a way that ensures approximately equal unconditional probability of belonging to a certain cohort (Verbeek and Nijman, 1992). Data are then collapsed averaging values across cohorts for each time period (Deaton, 1985) and the

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11 Sometimes in literature the term “cohort” is used to specifically define year-of-birth groups. In this case we employ the term in a broader sense (Verbeek, 2008), as groups of individuals sharing some common characteristics among which we include year-of-birth cohorts.
corresponding synthetic individuals in the two dataset are matched to finally set up the pseudo panel.\textsuperscript{12} Thus, the model we estimate is of the generic form:

\begin{equation}
\Delta \bar{y}_{ij} = \alpha_{ij} + \Delta \bar{x}_{ij} \beta + \gamma_j + \epsilon_{ij}
\end{equation}

where $\Delta \bar{y}_{ij}$ is the change in sentiments for the synthetic individual $i$ leaving in country $j$, $\Delta \bar{x}_{ij}$ is the change in the individual specific characteristics and $\gamma_j$ a country fixed effect. Note that since this is a regression in first differences, the country fixed effect $\gamma_j$ captures differences in time trend across countries.

Table 5 presents the results of a regression where the dependent variable is the difference in our MEMBERSHIP variable over the period 1992-93. The explanatory variables reflect the change of opinion in support for the economic integration (Single Market), in support for political integration (Single Government), and in support for monetary integration (Single currency). All the variables indicating change in support for the advancement of the euro project have a statistically significant coefficient, suggesting that the deterioration in Europhilia during this period is linked to a worsening in opinions regarding the benefits of a single European market, a single currency, and further political integration. Interestingly, no country fixed effect, besides Denmark, is significantly different from Germany.

The large drop in MEMBERSHIP variable observed in Figure 2 does not seem to be a simple time effect, but it is directly correlated with the support for further integration. What we are unable to explain is the cause of this drop, which is generalized across all members. It is reasonable to conjecture that is related to the gap between the perception of the European project that is portrayed at the official level and the reality perceived by the citizens. In light of Eichengreen (2006), European technocrats choose to push agendas where the asymmetry of information between them and the voters is large, so to avoid political opposition at the time of implementation. A corollary of this approach is that consensus is higher before the change when voters are less informed. However, when the change takes place and voters learn about the consequences, support may drop.

\textsuperscript{12}To verify that our pseudo-panel well reflects the original data we compare the aggregate behavior of our key variables of interest and check that they exhibit similar trends.
5.2 Enlargement of the European Union: 2004

We follow a similar approach to try to explain the variation in Europhilia around the 2004 Eastern European enlargement, using a 2002 and a 2005 survey. In the left panel of Figure 11 we report the fraction of people who answered “For” to the question “What is your opinion of further enlargement of the EU to include other countries in future years”. In 2002 the majority of the respondents in each sub-area supported the enlargement. Once again, the majority of the support comes from the Southern countries, despite those countries are more likely to lose European subsidies in favor of new poorer entrants. The Northern countries come second in their support for enlargement, the Central European last.

In 2005, respondents were asked the same question. Note that while the question is the same, the meaning is different. In 2002 the candidates for further enlargement were the Eastern European countries that became members in 2004, while in 2005 the candidates for further enlargements are Turkey and the former Yugoslavian republics that are not members yet. Thus, once again, we should focus on the differential change across groups of countries, rather than on the change itself. Consensus for further enlargement drops across the board, but it drops more in Central and Northern European countries than in the South.

In the right panel we plot the fraction of people who states that they were in favor a European Monetary Union with a single currency: the Euro. Here the question is not only the same, but can also be interpreted in the same way. Thus, we can also look at the absolute change. The evidence shows a strong support for the single currency in all the geographical areas and a reduction in support only in the South, mostly driven by Greece and Spain.

To better understand these shifts in opinions, we use a pseudo-panel to correlate the change in the variables presented in Figure 11 with individual opinions about the economy and country fixed effects, similar to specification (3). The results are presented in Table 6. When the LHS is the change in support for further enlargement, the only variable that is statistically significant is the change in perception about the future national economic situation. Not surprisingly, individuals who have a more upbeat view
of the future support further enlargements more. The same is true for the change in support for the single currency. Here, even the change in perception about future national employment situation comes in positive and significant. Interestingly, unlike in the previous pseudo-panels, many country fixed effects are statistically significant. In part this is the result of the poor R-squared. In the previous table we were able to explain 26% of the cross sectional variation, in Table 6 less than 5%. Yet, this result suggests that the changes in Europhilia around 2004 have more to do with country-specific factors than with individual specific-ones. In particular, the regression where the dependent variable is the change in support for the single currency exhibits significantly negative country fixed effects for all the Southern European countries. Thus, it looks like the South of Europe started to fall out of love with the euro much before the Eurozone crisis. However, we still need to identify the reason.

5.3 The Eurozone crisis

Figure 2 shows a drop in the perception of membership’s advantages after 2008. To investigate further this sentiment shift around the Euro crisis we use individual data to construct a pseudo panel for the period of 2009-13, like we have done for the previous turning points.

Table 7 presents the results of the regressions using this pseudo-panel. The LHS variables are respectively the changes in support for the Euro (first column), the change in Trust towards the EU (second column), the change in trust toward the ECB (third column), and the change in the difference between percentage of people supporting the Euro and percentage of people trusting the ECB. Unfortunately, the MEMBERSHIP question was not asked in the last period, thus we could not use it.

Overall, Table 7 confirms the result obtained on a longer panel with aggregate country data (Table 4): economic conditions are highly predictive of euro-sentiments. Changes in the perception of the Euro, Trust in the EU, and Trust in the ECB are correlated with the change in expectations on future personal job situation, household financial situation, as well as changes in perception of the national employment situation.

By using aggregate country data – as we did in Table 4-- it is hard to exclude that the observed correlations are driven by country-level omitted variables. Individual level
regressions allow us to measure economic conditions at the individual level, providing more credibility to the results.

Table 7 also shows that the economic variables do not eliminate independent country-level fixed effects, which remain quantitatively strong and statistically significant.

5.3 The Effect of the ECB policy

In explaining the changes in trust toward the ECB the country fixed effects are economically and statistical significant. They show that the loss in trust towards the ECB has not been homogenous. To what extent the ECB policy has reduced Europhilia or, worse, has fed Europhobia?

To answer this question we need to determine first how the ECB policy fitted the needs of each country. Figure 12 plots the optimal policy rate (in percentage points) and the actual ECB policy rate for each country. The optimal policy rate $i^*_i$ is based on a Taylor’s (1993) rule defined as

$$i^*_i = r^*_i + \pi^*_i + 0.5(\pi^*_i - \pi^*_r) - (u^*_i - u^*_r)$$

where $\pi^*_i$ is the inflation rate for country $i$ at time $t$, measured as the change in the non-food, non-energy consumer price index; $u^*_i$ is the seasonally adjusted unemployment rate for each country published by Eurostat, $u^*_r$ is the Non-Accelerating Wage Rate of Unemployment. In this formula, for each country, we set $r^* = \pi^* = 2$.

It emerges quite clearly that there are two set of countries: the so called PIGS (Portugal, Ireland, Greece, and Spain), for which the ECB policy rate is quite distant from the optimal national rate, and the rest, for which the ECB policy rate approximates well the optimal national rate.

In Figure 13.A we correlate the 2008-2011 drop in MEMBERSHIP with the mean absolute deviation of the monetary policy rate from the country Taylor rule. There is a clear negative relation, which is statistically significant. The PIGS, which were most penalized by the ECB policy, are the ones where Europhilia drops the most. The same relationship is present for most of the other variables. For example, in Figure 13.B the relationship between loss of trust in the ECB and mean absolute deviation of the
monetary policy rate from the country Taylor rule is almost a perfect straight line. Thus, European citizens recognize when the European policy hurts them and respond accordingly.

The Taylor rule does not simply reflect unemployment but also inflation and inflation dispersion was far from negligible over the period of the analysis. If we force the country Taylor rule to depend only on inflation and plot the average absolute deviations of this Taylor rule from the ECB policy rate against the change in trust towards the ECB we find a very similar pattern to the one shown in Figure 13 (not reported). This result rules out the possibility that the correlations in Figure 13 reflect just the movements in national unemployment rates.

Most surprisingly, the only variable that does not seem to be correlated with the mean absolute deviation of the monetary policy rate from the country Taylor rule is the support for the common currency. As we can see in Figure 13.C, if anything the relation is positive, albeit not statistically significant.

To understand this paradox we need to realize that even before the introduction of a common currency National Central Banks were not completely free to set their rates. The EMS system was imposing some limits on the ability of each country to deviate from a common interest rate. To see how much the introduction of a common currency has worsened the monetary policy flexibility of each country we compute the mean absolute deviation of the national monetary policy rate from the country Taylor rule in the pre-euro era (1991-1999).

Figure 14 plots each country’s mean absolute deviation of the actual monetary policy rate from the country Taylor rule in the euro era against the same value in the pre-euro area. The most remarkable fact is that basically every country is below the 45 degree line, implying that for no country the ECB monetary policy deviated from the optimal country-specific Taylor rule more than what their pre-euro monetary policies deviated from optimal country-specific Taylor rules. The three countries that seemed to have gained in flexibility are Greece, France, and Finland.

This result helps explain why European citizens blame the ECB, but not the common currency. The common currency per se is not the culprit (at least vis-à-vis the
pre-existing situation). Yet, the ECB policy could have been more sensitive to the PIGS country needs. Hence, the growing distrust towards the ECB.

At the same time, citizens seem to draw a distinction between the ECB – the manager of monetary policy under the single currency – and the single currency itself, blaming not the latter, not the former, as suggested by the patterns of correlation in Figures 13B and 13C.

6. Quo Vadis Europe?

The Eurobarometer being a European institution is avoids asking questions that might lead to very clear anti-European answers. For this reason, it is not easy to find questions that allow us to gauge where Europeans want Europe to go.

One indirect way we can glance at this issue is a question asked in 2009 and 2013. European citizens are asked which institution they think is most capable to take action against the recent economic crisis. The possible answers are the domestic government, the United States, the European Union, the International Monetary Fund, and the G20 group. Once again, while the question is exactly the same in 2009 and 2013, the context might be different. In 2009 the crisis was entirely due to a U.S. problem, while by 2013 the Eurozone crisis had exploded.

Figure 15 plots the answer for the EU 15 divided by geographical areas. Each bar represents the share of respondents who mentioned the corresponding institution as the most capable. In 2009 the EU is indicated as the most capable (or the second most capable) institution to tackle the crisis in all groups. The Northern European countries trust more the local government, the Center European one the G20.

Surprisingly, the results are not very different in 2103. The Southern European countries have lost a bit of confidence toward the EU, but the Center and North European once have gained a bit more confidence. This evidence is particularly remarkable in face of the fact that between 2010 and 2013 the European Unions did not show a great degree of coordination and ability to act. Yet, in the world everything is relative. May be we can say about the EU what Winston Churchill said about democracy: the worst institution, until you consider all the existing alternatives.
Another question in Eurobarometer that can help us gauge the overall attitude towards Europe is the opinion about the direction of one’s own country and that of the EU. More specifically, both in 2009 and in 2013 Eurobarometer asks “At the present time, would you say that, in general, things are going in the right direction or in the wrong direction, in our Country/In the EU?” The possible answers are: Wrong Direction, Neither Right Nor Wrong and Right Direction. The bar graphs in Figure 16 show the percentage of people who respond “Wrong Direction” both for “our country” (left panel) and for “the European Union” (right panel).

Not surprisingly, the percentage of people who think the EU is going in the wrong direction increased dramatically between 2009 and 2013, in all three groups, particularly so in Southern Europe. More people think that the EU is going in the wrong direction than in the right one.

Yet, it is interesting to contrast the opinion about the direction of the country and that of the EU. In Southern Europe more people think the country is going in the wrong direction than the EU is. This is not true for the Center and the North. To some extent, thus, there is a negative “halo” effect. People unsatisfied with their economic situation blame all institutions. It is hard, thus, to take this result as evidence of anti European sentiments.

A partial alternative to Eurobarometer is provided by the Pew Research Center. A May 2014 survey conducted by this center shows that in all the seven countries surveyed there is a majority of citizens against devolving further power to Europe. This majority is barely 50% in Germany and 76% in the UK, but always a majority is. The fraction of citizens opposing more power to the EU is perfectly negatively correlated with the degree of Europhilia of a country. Yet, in all countries, other than Italy, there is a strong majority to retain the euro. Thus, Europeans do not seem to want to move forward but they do not want to move back either.

Yet, if – as most economists think—the survival of the Euro is dependent upon further transfers of national powers to the EU, then the European Project is in a catch-22. Europeans do not want to go forward, they do not want to go backward, but they cannot stay still.
7. Conclusions

While EU membership has strong support in most of the EU-15, this support dropped every time the European project made a step forward and never recovered. Rightly or wrongly, the Eurozone crisis has contributed to further erode this support, albeit the drop appears more related to the terrible economic conditions and, thus, potentially more reversible.

Today a majority of Europeans think that the EU is going in the wrong direction. They do not want it to go further, but overall they do not want it to go backward either, with all the countries (except Italy) having a pro Euro majority.

One possible interpretation of these results is that Europeans like the idea of Europe but dislike the way this idea has been implemented. Another possible interpretation is that the attempt to jump start the chain reaction has left the Continent stuck in a political impasse: in spite of the unpleasant current conditions, there is no desire to move forward, while there is too much fear to move backward. This interpretation is consistent with the fact that support for the euro has plummeted in EU countries not belonging to the Eurozone, which do not face this irreversibility problem. Thus, one could infer that if it were not for fear of the unknown, even Eurozone countries might be less supportive of the common currency.

On the one hand, Monnet’s chain reaction theory seems to have worked. In spite of limited support in some countries, European integration has moved forward and has become almost irreversible. On the other hand, the strategy has worked so far at the cost of jeopardizing the future sustainability. The key word is “almost.” Europe and the euro are not irreversible, they are simply very costly to revert. As long as the political dissension is not large enough, Monnet’s chain reaction theory delivered the desired outcome, albeit in a very non-democratic way. The risk of a dramatic reversal, however, is real. The European project could probably survive a United Kingdom’s exit, but it would not survive the exit of a country from the euro, especially if that exit is not so costly as everybody anticipates. The risk is that a collapse of the euro might bring also the collapse of many European institutions, like the free movement of capital, people and goods. In other words, as all chain reactions, also Monnet’s one has an hidden cost: the risk of a meltdown.
References

Marquand, Jean, “Parliament for Europe”, Jonathan Cape, 1979

Figure 1. Differences across countries in sentiments toward membership in European Union

Country fixed effects derived from an OLS regression using individual level data and regressing sentiments towards E.U. membership on individual demographics. Sentiments toward EU membership are derived from the question “Generally speaking, do you think that (OUR COUNTRY)’s membership of the European Union is ...?” Answers were on a 3 point scale (“Good”, “Neither good, nor bad,” “Bad”). We coded the question as a dummy variable equal to one if the respondent answered “Good.” Individual demographics: gender, cohort (omitted cohort: born before 1945), education, occupation (omitted job: farmer/fisherman), country fixed effect (omitted country: Germany) and year fixed effect (omitted years: 1973 for the top quadrants, 2002 for the bottom quadrants). Sample period: 1973-2012. For all variable definition see Appendix.
Figure 2. Evolution of positive sentiments about membership in European Union (E.U. 15)
Share of respondents who answer *Good* to the question “*Generally speaking, do you think that (OUR COUNTRY)’s membership of the European Union is ...?*” Answers were on a 3 point scale (*Good, Neither good nor bad, Bad*). In Panel A the data are arranged by geographic subdivisions in E.U. 15. *North*: Denmark, Sweden, Finland, United Kingdom, Ireland. *Centre*: Austria, Germany, France, Belgium, The Netherlands, Luxembourg. *South*: Italy, Greece, Spain, Portugal. In Panel A, to deal with potential compositional effect due to new accessions to the E.U. we have assigned to each country its entry-year membership score in each year before entry (applies to Greece, Spain, Portugal, Finland, Sweden, Austria). Each country weighs according to its specific sample size (sample at entry-year for post-1973 entrants). In Panel B, C and D the data for each individual country is shown with no backfilling. *Source*: Eurobarometer surveys from 1973:H2 to 2012:H1.
Panel D

North

- UK - United Kingdom
- IE - Ireland
- DK - Denmark
- FI - Finland
- SE - Sweden
Figure 3. Differences across time in positive sentiments toward membership in European Union

Year fixed effects derived from an OLS regression using individual level data and regressing sentiments towards E.U. membership on individual demographics. Sentiments toward EU membership are derived from the question “Generally speaking, do you think that (OUR COUNTRY)’s membership of the European Union is ...?” Answers were on a 3 point scale (“Good”, “Neither good, nor bad,” “Bad”). We coded the question as a dummy variable equal to one if the respondent answered “Good.” Individual demographics: gender, cohort (omitted cohort: born before 1945), education, occupation (omitted job: farmer/fisherman), country fixed effect (omitted country: Germany) and year fixed effect (omitted years: 1973 for the top quadrants, 2002 for the bottom quadrants). Sample period : 1973-2012. For all variable definition see Appendix.
Figure 4. Cohorts’ positive sentiments toward membership in European Union
Each series represent the coefficients of the cohort dummies in an OLS regression by year of individual sentiments towards the E.U. membership (*Membership is good*) on individual demographics: gender, cohort (omitted cohort: born before 1945), education, occupation (omitted job: farmer/fisherman) and country fixed effect (omitted country: Germany). For variable definition see Appendix. The sample varies according to accessions to the E.U. over time, stopping at E.U. 15: E.U. 9 (FR, BE, NL, IT, DE, LUX, DK, UK, IE) from 1973 to 1981; Greece joins in 1981; Spain and Portugal in 1986; Finland, Sweden and Austria in 1995. Cohorts also stem over time as respondents are selected from citizens of 18 years of age and above. Error bars represent the 95% level confidence interval. Sample period: 1973-2012.
Figure 5. Evolution of trust toward the European Union (E.U. 15)

Share of respondents who answer Trust/Tend to trust on a binary scale (Tend to trust, Tend not to trust) to the question: “I would like to ask you a question about how much trust you have in certain institutions. For each of the following institutions, please tell me if you tend to trust it or tend not to trust it....The European Union” The data are arranged by geographic subdivisions in E.U. 15. North: Denmark, Sweden, Finland, United Kingdom, Ireland. Centre: Austria, Germany, France, Belgium, The Netherlands, Luxembourg. South: Italy, Greece, Spain, Portugal. Source: Eurobarometer surveys 1997-2013. Question asked in all countries in the sample from Eurobarometer 48 (1997Q4) to Eurobarometer 79.3 (2013Q2). Not asked in any wave during 1998, 1999H2, 2000, 2002H2, 2010H2.
Figure 6. Evolution of the ratio of trust toward the European Union and national government (E.U. 15)

Differential over time in the ratio between people that answer Trust/Tend to trust on a binary scale (Tend to trust, Tend not to trust) to the question: “I would like to ask you a question about how much trust you have in certain institutions. For each of the following institutions, please tell me if you tend to trust it or tend not to trust it…. The European Union” and the same fraction of people that answer Trust to the question “I would like to ask you a question about how much trust you have in certain institutions. For each of the following institutions, please tell me if you tend to trust it or tend not to trust it…. The (NATIONALITY) Parliament” The data are arranged by geographic subdivisions in E.U. 15. North: Denmark, Sweden, Finland, United Kingdom, Ireland. Centre: Austria, Germany, France, Belgium, The Netherlands, Luxembourg. South: Italy, Greece, Spain, Portugal. Source: Eurobarometer surveys 1997-2013. Question asked in all countries in the sample from Eurobarometer 48 (1997Q4) to Eurobarometer 79.3 (2013Q2). Not asked in any wave during 1998, 1999H2, 2000, 2002H2, 2010H2.

Ratio of trust in EU over trust in National Government

- 42 -
Figure 7. Evolution of support towards the single currency (E.U. 15)

Share of respondents who answer For on a binary scale (For, Against) to the question: “What is your opinion on each of the following statements? Please tell me for each proposal, whether you are for it or against it...There has to be one single currency, the euro, replacing the (NATIONAL CURRENCY) and all other national currencies of the member states of the European Union.” The data are arranged by geographic subdivisions in E.U. 15. North: Denmark, Sweden, Finland, United Kingdom, Ireland. North in Eurozone: Ireland, Finland. Centre: Austria, Germany, France, Belgium, The Netherlands, Luxembourg. South: Italy, Greece, Spain, Portugal. Source: Question asked in all countries in the sample from the European Community Study of 1970 (1970Q1) to Eurobarometer 79.3 (2013Q2). Opinions polled before 1991 (4 waves) have been discarded. Each country weighs according to its specific sample.
Figure 8. Divergence of trust on Euro and trust towards E.C.B. in selected countries

Share of respondents who favor the European single currency (blue line): respondents who answer For on a binary scale (For, Against) to the question: “What is your opinion on each of the following statements? Please tell me for each proposal, whether you are for it or against it...There has to be one single currency, the euro, replacing the (NATIONAL CURRENCY) and all other national currencies of the member states of the European Union.” And share of respondents who trust the European Central Bank (red line): respondents who answer Trust/Tend to trust on a binary scale (Tend to trust, Tend not to trust) to the question: “And, for each of the following European bodies, please tell me if you tend to trust it or tend not to trust it?...The European Central Bank”. Black line marks the onset of the Global Financial Crisis (2008:H2). Data at half-yearly frequency. Period: 1999:H1-2013:H1.
Figure 9. Evolution of xenophobia over time
The blue line represents the average value of a variable coded from 0 to 10 (0 = Worse place to live, …, 10 = Better place to live) corresponding to the answer to the following question: “Is [country] made a worse or a better place to live by people coming to live here from other countries?”. The red line represents a variable coded like the previous one (scale: 0 = Bad for the economy, …, 10 = Good for the economy) for the following question: “Would you say it is generally bad or good for [country]’s economy that people come to live here from other countries?”. Source: European Social Study (E.S.S.) Round 1 (2002/03) to Round 6 (2012/13), variables imwbcnt (blue) and imbgeco (red). Frequency: bi-annual. Sample: E.U. 15. Sample period: 2002-2012.
Figure 10. Change in Support for a single European market and for more European political integration, before and after Maastricht (E.U. 12) – EU 12

The two bar graphs depict the average sentiments by region in March 1992 and March 1993. The bar graph on the left depicts the share of respondents who answered *A Good Thing* to the question “Overall, what do you think that the completion of the Single European Market in 1992 will be?” in 1992 and *Advantages* to the question “Do you think that Single European Market brings more advantages or more disadvantages for (OUR COUNTRY)?” in 1993. The bar graph on the right depicts the share of respondents who answered *For* to the question “Are you for or against the formation of a European Union with a European Government responsible for the European Parliament?” Sources: EB37.0 and EB39.0. Sample: EU 12
Figure 11. Change in support for further enlargements of the EU and for a single currency, before and after the 2004 Eastern European enlargement. – EU 15

The two bar graphs depict average sentiments by region in 2002 and 2005. The two graphs depict the share of respondents who answered For to the question “What is your opinion on each of the following statements? Please tell me for each statement, whether you are for it or against it.”. In the case of the graph on the left the statement is Further enlargement of the EU to include other countries in future years. While in the case of the right graph, the statement is A European Monetary Union with a single currency: the Euro. Sources: EB58.1 and EB63.4. Sample: EU 15
Figure 12. Distance of national Taylor rule from ECB rate (post 1999)

E.C.B. Marginal Lending Facility Rate (red line) and optimal monetary policy target rates as dictated by a country-specific generalized Taylor rule (blue line). The Taylor rule optimal rate ($i_t^*$) is defined – for each country – as follows: $i_t^* = r^* + \pi_t + 0.5 (\pi_t - \pi^*) - (u_t - u_t^*)$, where $\pi_t$ is the inflation rate measured as the change in the non-food, non-energy consumer price index; $u_t$ is the seasonally adjusted unemployment rate published by Eurostat (une_rt_q); $u_t^*$ is the Non-Accelerating Wage Rate of Unemployment and $r^* = \pi^* = 2$. Variables are at quarterly frequency except N.A.W.R.U. (annual). For variable definitions see Appendix. All rates have been rescaled in percentage points. Sample period: 1999:Q1-2013:Q4
Panel A. Positive sentiments about EU membership and ECB monetary policy

Change (between 2008 and 2011) in the share of respondents who state that membership in the E.U. is a good thing for their country against the mean absolute difference by country between the ECB during the same period. Marginal Lending Facility rate and the optimal monetary policy target rate as dictated by a country-specific generalized Taylor rule. The average country-specific deviation is computed across the period 1999-2013. The Taylor rule optimal rate ($i^*_t$) is defined – for each country – as follows: $i^*_t = r^* + \pi_t + 0.5 (\pi_t - \pi^*) - (u_t - u^*_t)$, where $\pi_t$ is the inflation rate measured as the change in the non-food, non-energy consumer price index; $u_t$ is the seasonally adjusted unemployment rate published by Eurostat; $u^*_t$ is the Non-Accelerating Wage Rate of Unemployment and $r^* = \pi^* = 2$. Variables are at quarterly frequency except N.A.W.R.U. (annual). For variable definitions see Appendix. Sample: E.U. 15 countries in the Eurozone. The shaded grey area represents the 95% level confidence interval for the fitted values (blue line) obtained in an O.L.S. univariate regression with constant. t-statistics reported in the upper right corner.

Figure 13. Change in Europhilia (2008-2011) and deviation of ECB policy rate from country Taylor rule (post 1999)
Panel B Trust in ECB and ECB monetary policy

Change (between 2008 and 2011) in the share of respondents who trust the European Central Bank against the mean absolute difference (during the same period) by country between the ECB Marginal Lending Facility rate and the optimal monetary policy target rate as dictated by a country-specific generalized Taylor rule. The average country-specific deviation is computed across the period 1999-2013. The Taylor rule optimal rate ($i_t^*$) is defined – for each country – as follows: $i_t^* = r^* + \pi_t + 0.5 (\pi_t - \pi^*) - (u_t - u_t^*)$, where $\pi_t$ is the inflation rate measured as the change in the non-food, non-energy consumer price index; $u_t$ is the seasonally adjusted unemployment rate published by Eurostat (une_rt_q); $u_t^*$ is the Non-Accelerating Wage Rate of Unemployment and $r^* = \pi^* = 2$. Variables are at quarterly frequency except N.A.W.R.U. (annual). For variable definitions see Appendix. Sample: E.U. 15 countries in the Eurozone. The shaded grey area represents the 95% level confidence interval for the fitted values (blue line) obtained in an O.L.S. univariate regression with constant. t-statistics reported in the upper right corner.
Panel C. Sentiments toward euro and ECB monetary policy

Change (between 2008 and 2011) in the share of respondents who favor the European single currency against the mean absolute difference by country (over the same period) between the ECB. Marginal Lending Facility rate and the optimal monetary policy target rate as dictated by a country-specific generalized Taylor rule. The average country-specific deviation is computed across the period 1999-2013. The Taylor rule optimal rate ($i_t^*$) is defined— for each country— as follows: $i_t^* = r^* + \pi_t + 0.5 (\pi_t - \pi^*) - (u_t - u_t^*)$, where $\pi_t$ is the inflation rate measured as the change in the non-food, non-energy consumer price index; $u_t$ is the seasonally adjusted unemployment rate published by Eurostat (une_rt_q); $u_t^*$ is the Non-Accelerating Wage Rate of Unemployment and $r^* = \pi^* = 2$. Variables are at quarterly frequency except N.A.W.R.U. (annual). For variable definitions see Appendix. Sample: E.U. 15 countries in the Eurozone. The shaded grey area represents the 95% level confidence interval for the fitted values (blue line) obtained in an O.L.S. univariate regression with constant. t-statistics reported in the upper right corner.
Figure 14. National monetary policies (pre 1999) and E.C.B. monetary policy (post 1999)
Mean absolute difference by country between the National Central Bank discount rate and the optimal monetary policy target rate as dictated by a country-specific generalized Taylor rule in the periods 1991-1999 and 1999-2013. For the latter period, the policy rate is the E.C.B. Marginal Lending Facility rate. The Taylor rule optimal rate ($i_t^*$) is defined – for each country – as follows: $i_t^* = r^* + \pi_t + 0.5 (\pi_t - \pi^*) - (u_t - u_t^*)$, where $\pi_t$ is the inflation rate measured as the change in the non-food, non-energy consumer price index; $u_t$ is the seasonally adjusted unemployment rate published by Eurostat; Due to lack of data, Greece reports the annual unemployment rate from AMECO for the period 1991:Q1-1998:Q2; $u_t^*$ is the Non-Accelerating Wage Rate of Unemployment and $r^* = \pi^* = 2$. Variables are at quarterly frequency except N.A.W.R.U. and the N.C.B.’s discount rate (annual). For variable definitions see Appendix. All rates have been rescaled in percentage points. 45° reference line represented in red. Sample: E.U. 15 countries in the Eurozone. For Luxembourg the discount rate is the same as Belgium by virtue of the BLEU currency union. For France the red line represents the repo rate, as historical discount rates are not available.
Figure 15. Most Capable actor to take action against recent economic crisis (2009 and 2013) EU 15
The bar graph below plots the share of respondents who mentioned the corresponding institution when answering to the question: “In your opinion, which of the following is best able to take effective actions against the effects of the financial and economic crisis?”.
Figure 16. Change in perception of general direction before and after Eurocrisis. – EU 15
The two bar graphs depict sentiments by region in 2009 and 2013. The bar graph on the left depicts the share of respondents answering Wrong Direction to the question “At the present time, would you say that, in general, things are going in the right direction or in the wrong direction, in our Country?” The bar graph on the left depicts the share of respondents answering Wrong Direction to the question “At the present time, would you say that, in general, things are going in the right direction or in the wrong direction, in the European Union?”
Sources: EB72.4 and EB81.0. Sample: EU 15
Table 1. Sample statistics

Panel A. Micro dataset sample statistics (in E.U. 15)

<table>
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<tr>
<th>Variable</th>
<th>Mean</th>
<th>Std. Dev</th>
<th>Median</th>
<th>Min</th>
<th>Max</th>
<th>Obs</th>
</tr>
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<tbody>
<tr>
<td>Year of birth</td>
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<td>19.698</td>
<td>1953</td>
<td>1874</td>
<td>1998</td>
<td>1,359,947</td>
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<tr>
<td>Cohort</td>
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<td>2</td>
<td>1</td>
<td>5</td>
<td>1,359,947</td>
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<tr>
<td>Age</td>
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<td>43</td>
<td>15</td>
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<td>Years of education</td>
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<td>2.875</td>
<td>11</td>
<td>8</td>
<td>16</td>
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<td>Gender</td>
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<td>1</td>
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<td>Occupation</td>
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<td>2.22</td>
<td>6</td>
<td>1</td>
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<tr>
<td>Membership is good</td>
<td>0.6</td>
<td>0.49</td>
<td>1</td>
<td>0</td>
<td>1</td>
<td>1,179,098</td>
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<tr>
<td>Country benefitted</td>
<td>0.657</td>
<td>0.475</td>
<td>1</td>
<td>0</td>
<td>1</td>
<td>826,173</td>
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<tr>
<td>For Euro</td>
<td>0.643</td>
<td>0.479</td>
<td>1</td>
<td>0</td>
<td>1</td>
<td>755,180</td>
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<td>Trust in the European Union</td>
<td>0.504</td>
<td>0.5</td>
<td>1</td>
<td>0</td>
<td>1</td>
<td>358,269</td>
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<tr>
<td>Trust in the European Central Bank</td>
<td>0.626</td>
<td>0.484</td>
<td>1</td>
<td>0</td>
<td>1</td>
<td>346,474</td>
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<tr>
<td>Left-right self-placement</td>
<td>5.287</td>
<td>2.056</td>
<td>5</td>
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<td>10</td>
<td>1,047,588</td>
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Panel B. Macro panel dataset sample statistics

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<th>Variable</th>
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<th>Max</th>
<th>Obs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Membership is good (country-year share)</td>
<td>0.609</td>
<td>0.151</td>
<td>0.626</td>
<td>0.254</td>
<td>0.902</td>
<td>500</td>
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<tr>
<td>Country benefitted (country-year share)</td>
<td>0.662</td>
<td>0.156</td>
<td>0.693</td>
<td>0.194</td>
<td>0.968</td>
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<td>For Euro (country-year share of for)</td>
<td>0.660</td>
<td>0.172</td>
<td>0.700</td>
<td>0.158</td>
<td>0.936</td>
<td>369</td>
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<tr>
<td>Trust in the European Union (country-year share)</td>
<td>0.501</td>
<td>0.135</td>
<td>0.496</td>
<td>0.179</td>
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<tr>
<td>Trust in the European Central Bank (country-year share)</td>
<td>0.628</td>
<td>0.149</td>
<td>0.652</td>
<td>0.165</td>
<td>0.885</td>
<td>225</td>
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<td>Unemployment rate</td>
<td>0.076</td>
<td>0.040</td>
<td>0.072</td>
<td>0</td>
<td>0.270</td>
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<td>Nominal G.D.P. in bn EUR/ECU</td>
<td>494.876</td>
<td>604.504</td>
<td>222.065</td>
<td>1.778</td>
<td>2804.168</td>
<td>520</td>
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<tr>
<td>Gross contributions to E.U. budget in EUR mln</td>
<td>4742.683</td>
<td>5587.023</td>
<td>2282</td>
<td>12</td>
<td>26213.801</td>
<td>473</td>
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<tr>
<td>Gross receipts from the E.U. budget in EUR mln</td>
<td>4185.700</td>
<td>3816.310</td>
<td>2634</td>
<td>6</td>
<td>16355</td>
<td>473</td>
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<td>Net receipts from E.U. over nominal G.D.P.</td>
<td>0.006</td>
<td>0.015</td>
<td>-0.001</td>
<td>-0.009</td>
<td>0.065</td>
<td>473</td>
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<td>10y government harmonised bond yield spread with German Bund</td>
<td>0.016</td>
<td>0.027</td>
<td>0.004</td>
<td>-0.012</td>
<td>0.21</td>
<td>415</td>
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<td>Dummy = “2004 onwards” (Eastern accession)</td>
<td>0.288</td>
<td>0.453</td>
<td>0</td>
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### Panel C. Cross section sample statistics

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<th>Max</th>
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</thead>
<tbody>
<tr>
<td>WGI: government effectiveness</td>
<td>1.478</td>
<td>0.574</td>
<td>1.61</td>
<td>0.21</td>
<td>2.36</td>
<td>15</td>
</tr>
<tr>
<td>WGI: government control of corruption</td>
<td>1.599</td>
<td>0.72</td>
<td>1.72</td>
<td>0.25</td>
<td>2.53</td>
<td>15</td>
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<tr>
<td>Deaths in WWII over population in 1939</td>
<td>0.026</td>
<td>0.037</td>
<td>0.01</td>
<td>0</td>
<td>0.114</td>
<td>15</td>
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<tr>
<td>Net receipts from E.U. over nominal G.D.P. in first year after accession</td>
<td>0.001</td>
<td>0.006</td>
<td>0</td>
<td>-0.005</td>
<td>0.02</td>
<td>15</td>
</tr>
<tr>
<td>Export over nominal G.D.P. at accession</td>
<td>0.296</td>
<td>0.165</td>
<td>0.25</td>
<td>0.114</td>
<td>0.642</td>
<td>15</td>
</tr>
<tr>
<td>Percentage difference with average G.D.P. per capita of the EEC/E.U. at accession</td>
<td>2.823</td>
<td>35.802</td>
<td>4.427</td>
<td>-53.723</td>
<td>94.638</td>
<td>15</td>
</tr>
<tr>
<td>Exports towards the E.U. over nominal G.D.P. at accession</td>
<td>0.178</td>
<td>0.138</td>
<td>0.124</td>
<td>0.049</td>
<td>0.424</td>
<td>11</td>
</tr>
<tr>
<td>Relative genetic distance with other EEC/E.U. countries at entry</td>
<td>99.752</td>
<td>239.503</td>
<td>25.172</td>
<td>17.673</td>
<td>955.026</td>
<td>15</td>
</tr>
<tr>
<td>Average share of people against neighbours of a different race (3 earliest waves available)</td>
<td>0.098</td>
<td>0.029</td>
<td>0.091</td>
<td>0.05</td>
<td>0.154</td>
<td>15</td>
</tr>
<tr>
<td>Average share of people against foreign workers neighbours (3 earliest waves available)</td>
<td>0.113</td>
<td>0.04</td>
<td>0.11</td>
<td>0.053</td>
<td>0.187</td>
<td>15</td>
</tr>
<tr>
<td>Average share of people who are proud of their country (3 earliest waves available)</td>
<td>0.424</td>
<td>0.152</td>
<td>0.396</td>
<td>0.2</td>
<td>0.724</td>
<td>15</td>
</tr>
<tr>
<td>Variable</td>
<td>Mean</td>
<td>Std. Dev</td>
<td>Median</td>
<td>Min</td>
<td>Max</td>
<td>Obs</td>
</tr>
<tr>
<td>-----------------------------------------------</td>
<td>-------</td>
<td>----------</td>
<td>--------</td>
<td>------</td>
<td>------</td>
<td>------</td>
</tr>
<tr>
<td>Cohort</td>
<td>2.383</td>
<td>1.304</td>
<td>2</td>
<td>1</td>
<td>5</td>
<td>282,412</td>
</tr>
<tr>
<td>Age</td>
<td>44.812</td>
<td>18.026</td>
<td>43</td>
<td>15</td>
<td>99</td>
<td>282,412</td>
</tr>
<tr>
<td>Years of education</td>
<td>11.478</td>
<td>2.873</td>
<td>11</td>
<td>8</td>
<td>16</td>
<td>257,041</td>
</tr>
<tr>
<td>Gender</td>
<td>0.548</td>
<td>0.53</td>
<td>1</td>
<td>0</td>
<td>2</td>
<td>283,973</td>
</tr>
<tr>
<td>Occupation</td>
<td>6.124</td>
<td>2.193</td>
<td>6</td>
<td>1</td>
<td>12</td>
<td>271,195</td>
</tr>
<tr>
<td>Membership is good</td>
<td>0.598</td>
<td>0.49</td>
<td>1</td>
<td>0</td>
<td>1</td>
<td>273,567</td>
</tr>
<tr>
<td>Country benefitted</td>
<td>0.65</td>
<td>0.477</td>
<td>1</td>
<td>0</td>
<td>1</td>
<td>213,826</td>
</tr>
<tr>
<td>For Euro</td>
<td>0.639</td>
<td>0.48</td>
<td>1</td>
<td>0</td>
<td>1</td>
<td>154,554</td>
</tr>
<tr>
<td>Trust in National Government</td>
<td>0.455</td>
<td>0.498</td>
<td>0</td>
<td>0</td>
<td>1</td>
<td>112,002</td>
</tr>
<tr>
<td>Trust in National Parliament</td>
<td>0.495</td>
<td>0.5</td>
<td>0</td>
<td>0</td>
<td>1</td>
<td>110,301</td>
</tr>
<tr>
<td>Trust in the European Union</td>
<td>0.542</td>
<td>0.498</td>
<td>1</td>
<td>0</td>
<td>1</td>
<td>89,327</td>
</tr>
<tr>
<td>Trust in the European Central Bank</td>
<td>0.647</td>
<td>0.478</td>
<td>1</td>
<td>0</td>
<td>1</td>
<td>85,564</td>
</tr>
<tr>
<td>Respondent voted at last European elections</td>
<td>0.67</td>
<td>0.47</td>
<td>1</td>
<td>0</td>
<td>1</td>
<td>101,946</td>
</tr>
<tr>
<td>Respondent intends to vote at next European elections</td>
<td>0.745</td>
<td>0.436</td>
<td>1</td>
<td>0</td>
<td>1</td>
<td>134,194</td>
</tr>
<tr>
<td>Respondent voted at last general elections</td>
<td>0.781</td>
<td>0.413</td>
<td>1</td>
<td>0</td>
<td>1</td>
<td>115,703</td>
</tr>
<tr>
<td>Left-right self-placement</td>
<td>5.285</td>
<td>2.087</td>
<td>5</td>
<td>1</td>
<td>10</td>
<td>223,995</td>
</tr>
<tr>
<td>Respondent voted an Eurosceptic party</td>
<td>0.049</td>
<td>0.216</td>
<td>0</td>
<td>0</td>
<td>1</td>
<td>28,056</td>
</tr>
<tr>
<td>Voter turnout behavior because of anti-E.U. feelings</td>
<td>0.056</td>
<td>0.231</td>
<td>0</td>
<td>0</td>
<td>1</td>
<td>31,399</td>
</tr>
</tbody>
</table>
Table 2. Sentiments toward Europe at the first survey
The table depicts average sentiments by country in the first year in which questions are asked in that specific country and included in the survey series. The corresponding wordings of each variable are the ones described in details in the Appendix.

<table>
<thead>
<tr>
<th></th>
<th>Membership is Good</th>
<th>Membership Benefits</th>
<th>Trust in European Union</th>
</tr>
</thead>
<tbody>
<tr>
<td>FRA</td>
<td>69.2%</td>
<td>55.2%</td>
<td>47.6%</td>
</tr>
<tr>
<td>BEL</td>
<td>69.9%</td>
<td>52.0%</td>
<td>33.2%</td>
</tr>
<tr>
<td>NED</td>
<td>72.9%</td>
<td>69.2%</td>
<td>42.8%</td>
</tr>
<tr>
<td>GER</td>
<td>70.6%</td>
<td>40.7%</td>
<td>36.9%</td>
</tr>
<tr>
<td>ITA</td>
<td>80.0%</td>
<td>60.4%</td>
<td>63.1%</td>
</tr>
<tr>
<td>LUX</td>
<td>72.5%</td>
<td>72.9%</td>
<td>56.3%</td>
</tr>
<tr>
<td>DEN</td>
<td>46.3%</td>
<td>44.3%</td>
<td>40.9%</td>
</tr>
<tr>
<td>IRE</td>
<td>60.3%</td>
<td>61.0%</td>
<td>76.5%</td>
</tr>
<tr>
<td>UK</td>
<td>36.1%</td>
<td>34.2%</td>
<td>36.0%</td>
</tr>
<tr>
<td>GRE</td>
<td>42.1%</td>
<td>46.9%</td>
<td>63.7%</td>
</tr>
<tr>
<td>SPA</td>
<td>78.3%</td>
<td>11.9%</td>
<td>64.2%</td>
</tr>
<tr>
<td>POR</td>
<td>72.0%</td>
<td>53.9%</td>
<td>65.2%</td>
</tr>
<tr>
<td>FIN</td>
<td>51.8%</td>
<td>47.4%</td>
<td>39.2%</td>
</tr>
<tr>
<td>SWE</td>
<td>39.8%</td>
<td>30.4%</td>
<td>24.0%</td>
</tr>
<tr>
<td>AUS</td>
<td>41.7%</td>
<td>56.4%</td>
<td>43.4%</td>
</tr>
</tbody>
</table>

First recording year  First recording year  First recording year
Table 3. Cross country determinants of Europhilia

This table correlates country fixed effects in sentiments towards the E.U. and its institutions with country-specific characteristics. Fixed effects have been obtained from an OLS regressions of country-year means of one of the L.H.S variables reported in bold on individual demographics. **Individual demographics:** gender, cohort (omitted cohort: born before 1945), education, occupation (omitted job: farmer/fisherman), country fixed effect (omitted country: Germany) and year fixed effect. Contrary to previous specifications, the sample has not been restricted to Eurozone members in (3) and (5). Each coefficient has been computed in an univariate O.L.S. regression of one R.H.S. at a time and a constant (not reported). Government effectiveness and ability to control corruption have been taken in difference with their respective values for Germany in 2007. Relative G.D.P. per capita at entry is reported as percentage deviation from the E.U. median in the year of entry. For countries who entered the E.U. before 1976, the entry year has been artificially set to 1976 for lack of older data on contributions and receipts to the E.U. budget. For all variable definitions see Appendix. Significant coefficients are highlighted in bold. Standard errors in parentheses. * denotes significance at 10% level; ** significant at 5%; *** significant at 1%. **Unit of observation:** country. **Sample:** E.U. 15.

<table>
<thead>
<tr>
<th>Fixed effect computed with L.H.S.:</th>
<th>Membership is good</th>
<th>Benefit</th>
<th>For Euro</th>
<th>Trust in EU</th>
<th>Trust in E.C.B.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deaths in WWs over pop †‡</td>
<td>-0.558</td>
<td>0.426</td>
<td>0.333</td>
<td>-0.215</td>
<td>-0.315</td>
</tr>
<tr>
<td>(0.810)</td>
<td></td>
<td></td>
<td>(0.571)</td>
<td>(0.909)</td>
<td>(0.623)</td>
</tr>
<tr>
<td>Gov’t effectiveness vis à vis German gov’t (2007)</td>
<td><strong>-0.114</strong> *</td>
<td>-0.0229</td>
<td><strong>-0.110</strong> **</td>
<td><strong>-0.188</strong> ***</td>
<td>-0.0398</td>
</tr>
<tr>
<td>(0.0614)</td>
<td>-0.0735</td>
<td></td>
<td>(0.0376)</td>
<td>(0.0558)</td>
<td>(0.0515)</td>
</tr>
<tr>
<td>Gov’t ability to control corruption</td>
<td>-0.0701</td>
<td>0.00617</td>
<td><strong>-0.0810</strong> **</td>
<td><strong>-0.131</strong> **</td>
<td>-0.000198</td>
</tr>
<tr>
<td>(0.0515)</td>
<td>-0.0588</td>
<td></td>
<td>(0.0314)</td>
<td>(0.0487)</td>
<td>(0.0420)</td>
</tr>
<tr>
<td>Relative G.D.P. per capita at entry</td>
<td>-0.000494</td>
<td>0.00142</td>
<td><strong>-0.00135</strong> *</td>
<td><strong>-0.00202</strong> *</td>
<td>0.000391</td>
</tr>
<tr>
<td>(0.00110)</td>
<td>-0.00112</td>
<td></td>
<td>(0.000680)</td>
<td>(0.00109)</td>
<td>(0.000838)</td>
</tr>
<tr>
<td>Net receipts from E.U. over G.D.P. at entry</td>
<td>0.907</td>
<td>6.889</td>
<td>-3.390</td>
<td><strong>16.79</strong> ***</td>
<td>7.261</td>
</tr>
<tr>
<td>(6.538)</td>
<td>-6.718</td>
<td></td>
<td>(4.486)</td>
<td>(5.520)</td>
<td>(4.565)</td>
</tr>
<tr>
<td>Openness to trade (1988)</td>
<td>0.201</td>
<td>0.513</td>
<td>-0.0670</td>
<td>-0.0978</td>
<td>0.403</td>
</tr>
<tr>
<td>(0.359)</td>
<td>-0.307</td>
<td></td>
<td>(0.272)</td>
<td>(0.380)</td>
<td>(0.236)</td>
</tr>
<tr>
<td>No neigh. of different race</td>
<td>0.812</td>
<td>0.681</td>
<td><strong>1.604</strong> *</td>
<td>1.041</td>
<td>0.314</td>
</tr>
<tr>
<td>(1.342)</td>
<td>-1.44</td>
<td></td>
<td>(0.843)</td>
<td>(1.474)</td>
<td>(1.034)</td>
</tr>
<tr>
<td>No neigh. immigrant worker</td>
<td>-0.770</td>
<td>0.927</td>
<td>-0.175</td>
<td>-1.100</td>
<td>-0.499</td>
</tr>
<tr>
<td>(0.979)</td>
<td>-1.038</td>
<td></td>
<td>(0.700)</td>
<td>(1.063)</td>
<td>(0.751)</td>
</tr>
<tr>
<td>Pride in country</td>
<td>-0.307</td>
<td>-0.114</td>
<td>0.182</td>
<td><strong>0.621</strong> **</td>
<td>-0.0543</td>
</tr>
<tr>
<td>(0.248)</td>
<td>-0.278</td>
<td></td>
<td>(0.176)</td>
<td>(0.232)</td>
<td>(0.199)</td>
</tr>
<tr>
<td>Genetic distance at entry</td>
<td>-0.000191</td>
<td>-0.0000769</td>
<td>4.32e-05</td>
<td>-9.76e-05</td>
<td>1.77e-06</td>
</tr>
<tr>
<td>(0.000143)</td>
<td>-0.000176</td>
<td></td>
<td>(0.000115)</td>
<td>(0.000181)</td>
<td>(0.000126)</td>
</tr>
</tbody>
</table>

| Observations                       | 15 †                | 15 †    | 15 †      | 15 †        | 15 †           |

† 10 observations for openness to trade in 1988
‡ Country fixed effects computed restricting the sample to pre ’45 cohort.

If I redo with first observation in the sample, the Membership is good is similar, same for the trust in EU. Instead, the result change for Benefit where no significance. Euro changes completely because institutions become important and the others are not. Trust in ECB nothing is significant (does it make sense to ask before the ECB is instituted, anyway).
Table 4. Positive sentiments about membership in European Union

O.L.S. regression of the share of respondents who state that membership in the E.U. is a good thing for their country. The panel covers 1973-2012 time span and it is unbalanced since each country of EU15 is included in the panel starting from its year of entry in the EU, which coincides with the first recording year for the variable MEMBERSHIP, just as it is indicated in Table 2. Columns (1)-(3) provide reference baseline regressions: (1) year fixed effects only; (2) country fixed effects only; (3) country and year fixed effects; Year fixed effects are tested for joint significance via F-tests. Standard errors are in parentheses. *** denotes significance at 1% level. Bund spread * Eurozone is the interaction of a dummy equal to one for each year after the national currency-Euro changeover and the yearly average yield spread of each country’s 10-years benchmark government bond against the German Bund. For all other variable definitions see Appendix. Unit of observation: country-year. Sample: E.U. 15.

<table>
<thead>
<tr>
<th></th>
<th>(1)</th>
<th>(2)</th>
<th>(3)</th>
<th>(4)</th>
<th>(5)</th>
<th>(6)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Post Maastricht (1992 onward)</td>
<td>-0.0203**</td>
<td>-0.0160*</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>(0.00948)</td>
<td>(0.00891)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Eastern block EU accession</td>
<td>-0.0327***</td>
<td>0.00773</td>
<td></td>
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<td></td>
</tr>
<tr>
<td>(2004 onwards)</td>
<td>(0.0104)</td>
<td>(0.0112)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Unemployment</td>
<td>-0.968***</td>
<td>-0.644***</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>(0.186)</td>
<td>(0.156)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bund Spread * Eurozone</td>
<td>-0.747**</td>
<td>-0.367</td>
<td></td>
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<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>(0.345)</td>
<td>(0.338)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Eastern block EU accession*</td>
<td></td>
<td></td>
<td>-0.130***</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>South</td>
<td></td>
<td></td>
<td>(0.0189)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Constant</td>
<td>0.642***</td>
<td>0.596***</td>
<td>0.602***</td>
<td>0.613***</td>
<td>0.623***</td>
<td>0.638***</td>
</tr>
<tr>
<td></td>
<td>(0.0486)</td>
<td>(0.0144)</td>
<td>(0.0299)</td>
<td>(0.0148)</td>
<td>(0.0287)</td>
<td>(0.0166)</td>
</tr>
<tr>
<td>COUNTRY FE</td>
<td>NO</td>
<td>YES</td>
<td>YES</td>
<td>YES</td>
<td>YES</td>
<td>YES</td>
</tr>
<tr>
<td>YEAR FE</td>
<td>YES</td>
<td>NO</td>
<td>YES</td>
<td>NO</td>
<td>YES</td>
<td>NO</td>
</tr>
<tr>
<td>Observations</td>
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<td>500</td>
<td>500</td>
<td>500</td>
<td>500</td>
</tr>
<tr>
<td>R-squared</td>
<td>0.143</td>
<td>0.650</td>
<td>0.738</td>
<td>0.666</td>
<td>0.765</td>
<td>0.715</td>
</tr>
<tr>
<td>F-test</td>
<td>1.975</td>
<td>3.848</td>
<td>3.9</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Prob &gt; F</td>
<td>0.000599</td>
<td>0</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sample</td>
<td>EU15</td>
<td>EU15</td>
<td>EU15</td>
<td>EU15</td>
<td>EU15</td>
<td>EU15</td>
</tr>
<tr>
<td>Excluded countries</td>
<td>Germany</td>
<td>Germany</td>
<td>Germany</td>
<td>Germany</td>
<td>Germany</td>
<td>Germany</td>
</tr>
</tbody>
</table>
Table 5. Pseudo Panel: 1992-93
The pseudo-panel dataset includes observation from two repeated cross sections in 1992 and 1993. The L.H.S. variable is the difference between a dummy variable equal to 1 whenever the respondent states that membership in the E.U. is a good thing for their country. Primary RHS variables (dichotomous 2pt scale of the type For, Against) measure the change in support for the economic integration (Single Market), change in support for political integration (Single Government) and change in support for monetary integration (Single currency). The rest of RHS variables are country dummies with baseline Germany. For detailed variable definitions, see Appendix. Estimation method: OLS on two-periods First Difference. Unit of observation: synthetic individual (cohort) at different points in time. Sources: EB37.0 and EB39.0. Sample: EU 12. Sample period: 1992-1993 (without gaps – delta(1)). Omitted country: Germany. Robust standard errors in parentheses. *** p<0.01, ** p<0.05, * p<0.

<table>
<thead>
<tr>
<th>Pseudo-Panel (1992-1993, delta(1))</th>
<th>Change Is Membership good?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Change in support for a Single European Market</td>
<td>0.283***</td>
</tr>
<tr>
<td></td>
<td>(0.0213)</td>
</tr>
<tr>
<td>Change in support for a Single European Government</td>
<td>0.152***</td>
</tr>
<tr>
<td></td>
<td>(0.0238)</td>
</tr>
<tr>
<td>Change in support for a Single Currency</td>
<td>0.160***</td>
</tr>
<tr>
<td></td>
<td>(0.0245)</td>
</tr>
<tr>
<td>France</td>
<td>-0.0200</td>
</tr>
<tr>
<td></td>
<td>(0.0341)</td>
</tr>
<tr>
<td>Belgium</td>
<td>-0.00715</td>
</tr>
<tr>
<td></td>
<td>(0.0345)</td>
</tr>
<tr>
<td>Netherlands</td>
<td>0.00640</td>
</tr>
<tr>
<td></td>
<td>(0.0275)</td>
</tr>
<tr>
<td>Italy</td>
<td>0.0477</td>
</tr>
<tr>
<td></td>
<td>(0.0319)</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>-0.00859</td>
</tr>
<tr>
<td></td>
<td>(0.0430)</td>
</tr>
<tr>
<td>Denmark</td>
<td>0.0812**</td>
</tr>
<tr>
<td></td>
<td>(0.0353)</td>
</tr>
<tr>
<td>Ireland</td>
<td>0.0253</td>
</tr>
<tr>
<td></td>
<td>(0.0292)</td>
</tr>
<tr>
<td>UK</td>
<td>0.0342</td>
</tr>
<tr>
<td></td>
<td>(0.0306)</td>
</tr>
<tr>
<td>Greece</td>
<td>-0.0406</td>
</tr>
<tr>
<td></td>
<td>(0.0358)</td>
</tr>
<tr>
<td>Spain</td>
<td>-0.0434</td>
</tr>
<tr>
<td></td>
<td>(0.0359)</td>
</tr>
<tr>
<td>Portugal</td>
<td>-0.0101</td>
</tr>
<tr>
<td></td>
<td>(0.0389)</td>
</tr>
<tr>
<td>Constant</td>
<td>-0.0636***</td>
</tr>
<tr>
<td></td>
<td>(0.0196)</td>
</tr>
<tr>
<td>Observations</td>
<td>1,954</td>
</tr>
<tr>
<td>R-squared</td>
<td>0.257</td>
</tr>
</tbody>
</table>
Table 6. Pseudo Panel – 2002-2005
The pseudo-panel dataset includes observation from two repeated cross sections in 2002 and 2005. The LHS variables are the difference between dichotomous variables equal to 1 whenever the respondent states that he/she is in favor of Euro currency (1) and of further enlargements of the European Union. Primary RHS variables (3pt scale variables of the type *Worse, Same and Better*) measure the change in perceptions of the future economic situation at the national, household and personal level. The rest of RHS variables are country dummies with Germany taken as baseline. For detailed variable definitions, see Appendix. *Estimation method: OLS on two-periods First Difference. Unit of observation: synthetic individual (cohort) at different points in time. Sources: EB58.1 and EB63.4. Sample: EU 15. Sample period: 2002-2005 (with some gaps – delta(3)). Omitted country: Germany. Robust standard errors in parentheses. *** p<0.01, ** p<0.05, * p<0.*

<table>
<thead>
<tr>
<th>Pseudo-Panel (2002-2005, delta(3))</th>
<th>(1) Change For Euro</th>
<th>(2) Change For Further Enlargement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Change in expectations on future household’s financial situation</td>
<td>-0.00184 (0.0208)</td>
<td>0.0194 (0.0219)</td>
</tr>
<tr>
<td>Change in expectations on future national employment sit.</td>
<td><strong>0.0407</strong> (0.0163)</td>
<td>0.00342 (0.0176)</td>
</tr>
<tr>
<td>Change in expectations on future national economic sit.</td>
<td><strong>0.0364</strong> (0.0177)</td>
<td><strong>0.0595</strong>* (0.0195)</td>
</tr>
<tr>
<td>Change in expectations on future personal job situation</td>
<td>-0.00560 (0.0233)</td>
<td>0.0351 (0.0255)</td>
</tr>
<tr>
<td>France</td>
<td>0.0811* (0.0415)</td>
<td>0.142*** (0.0427)</td>
</tr>
<tr>
<td>Belgium</td>
<td>0.0352 (0.0369)</td>
<td>0.183*** (0.0438)</td>
</tr>
<tr>
<td>Netherlands</td>
<td>0.0299 (0.0416)</td>
<td>0.0566 (0.0440)</td>
</tr>
<tr>
<td>Italy</td>
<td>-0.0816** (0.0406)</td>
<td>0.218*** (0.0412)</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>-0.00954 (0.0349)</td>
<td>0.0128 (0.0583)</td>
</tr>
<tr>
<td>Denmark</td>
<td>-0.0553 (0.0442)</td>
<td>-0.0403 (0.0469)</td>
</tr>
<tr>
<td>Ireland</td>
<td>0.0540 (0.0333)</td>
<td>0.106** (0.0442)</td>
</tr>
<tr>
<td>UK</td>
<td>0.00678 (0.0411)</td>
<td>0.203*** (0.0415)</td>
</tr>
<tr>
<td>Greece</td>
<td>-0.172*** (0.0428)</td>
<td>0.0873** (0.0599)</td>
</tr>
<tr>
<td>Spain</td>
<td>-0.0855** (0.0403)</td>
<td>0.171*** (0.0448)</td>
</tr>
<tr>
<td>Portugal</td>
<td>0.0181 (0.0403)</td>
<td>0.242*** (0.0465)</td>
</tr>
<tr>
<td>Finland</td>
<td>0.0697* (0.0383)</td>
<td>0.104** (0.0437)</td>
</tr>
<tr>
<td>Sweden</td>
<td>0.0439 (0.0386)</td>
<td>0.0881** (0.0417)</td>
</tr>
<tr>
<td>Austria</td>
<td>-0.0735** (0.0362)</td>
<td>0.00648 (0.0431)</td>
</tr>
<tr>
<td>Constant</td>
<td>-0.0558** (0.0248)</td>
<td>-0.288*** (0.0264)</td>
</tr>
<tr>
<td>Observations</td>
<td>2,639</td>
<td>2,530</td>
</tr>
<tr>
<td>R-squared</td>
<td>0.044</td>
<td>0.046</td>
</tr>
</tbody>
</table>
Table 7. Pseudo Panel – Euro-Crisis.
The pseudo-panel dataset includes observation from two repeated cross sections in 2009 and 2013. The LHS variables in the first 3 specifications is the change in the support for the Euro, Trust in EU, and Trust in ECB as detailed in the appendix, while the fourth specification shows as dependent variable the difference between LHS in (1) and LHS in (3). The first RHS (3pt scale variables of the type Worse, Same and Better) controls for expectations for future personal employment situation. The second and the third (4pt scale variables of the type [Very Bad, Very Good]) control for perception of current household and national economic situation. The rest of RHS variables are country dummies with Germany taken as baseline. For detailed variable definitions, see Appendix.

Estimation method: OLS on two-periods First Difference. Unit of observation: synthetic individual (cohort) at different points in time. Sources: EB72.4 and EB81.0. Sample: EU 15. Sample period: 2009-2013 (with some gaps – delta(4)). Omitted country: Germany. Robust standard errors in parentheses. *** p<0.01, ** p<0.05, * p<0.01.

<table>
<thead>
<tr>
<th>Pseudo-Panel (2009-2013, delta(4))</th>
<th>(1) Change Euro</th>
<th>(2) Change Trust in EU</th>
<th>(3) Change Trust in ECB</th>
<th>(4) Change in the difference between Euro - Trust in ECB</th>
</tr>
</thead>
<tbody>
<tr>
<td>Change in expectations on future personal job situation</td>
<td>0.0399**</td>
<td>0.0947***</td>
<td>0.0407**</td>
<td>0.000865</td>
</tr>
<tr>
<td>Change in household financial situation</td>
<td>0.0374***</td>
<td>0.0419***</td>
<td>0.0449***</td>
<td>-0.00769</td>
</tr>
<tr>
<td>Change in Perception of national employment situation</td>
<td>0.0510***</td>
<td>0.0778***</td>
<td>0.0739***</td>
<td>-0.0198</td>
</tr>
<tr>
<td>France</td>
<td>0.0267</td>
<td>0.209***</td>
<td>0.221***</td>
<td>-0.195***</td>
</tr>
<tr>
<td>Belgium</td>
<td>-0.0762*</td>
<td>0.199***</td>
<td>0.136***</td>
<td>-0.201***</td>
</tr>
<tr>
<td>Netherlands</td>
<td>-0.0193</td>
<td>0.126**</td>
<td>0.164***</td>
<td>-0.181***</td>
</tr>
<tr>
<td>Italy</td>
<td>0.0154</td>
<td>0.0457</td>
<td>0.136***</td>
<td>-0.144***</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>-0.0140</td>
<td>0.0991</td>
<td>0.274***</td>
<td>-0.243***</td>
</tr>
<tr>
<td>Denmark</td>
<td>-0.226***</td>
<td>0.138**</td>
<td>0.189***</td>
<td>-0.390***</td>
</tr>
<tr>
<td>Ireland</td>
<td>-0.118***</td>
<td>0.129***</td>
<td>0.0267</td>
<td>-0.126***</td>
</tr>
<tr>
<td>UK</td>
<td>-0.129***</td>
<td>0.286***</td>
<td>0.196***</td>
<td>-0.303***</td>
</tr>
<tr>
<td>Greece</td>
<td>0.141***</td>
<td>-0.0469</td>
<td>0.0153</td>
<td>0.139**</td>
</tr>
<tr>
<td>Spain</td>
<td>-0.0218</td>
<td>-0.0708</td>
<td>0.0588</td>
<td>0.0498</td>
</tr>
<tr>
<td>Portugal</td>
<td>-0.131***</td>
<td>-0.0861</td>
<td>-0.0587</td>
<td>-0.0589</td>
</tr>
<tr>
<td>Finland</td>
<td>0.0754*</td>
<td>0.278***</td>
<td>0.132**</td>
<td>-0.0469</td>
</tr>
<tr>
<td>Sweden</td>
<td>-0.300***</td>
<td>0.189***</td>
<td>-0.136***</td>
<td>-0.430***</td>
</tr>
<tr>
<td>Austria</td>
<td>-0.0411</td>
<td>0.231***</td>
<td>0.128***</td>
<td>-0.181***</td>
</tr>
<tr>
<td>Constant</td>
<td>-0.0398</td>
<td>-0.334***</td>
<td>-0.294***</td>
<td>0.249***</td>
</tr>
<tr>
<td>Observations</td>
<td>2,615</td>
<td>2,559</td>
<td>2,462</td>
<td>2,412</td>
</tr>
<tr>
<td>R-squared</td>
<td>0.073</td>
<td>0.122</td>
<td>0.082</td>
<td>0.066</td>
</tr>
</tbody>
</table>
Table 8. Sentiments towards the Euro
Percentage of people who favors giving more decision-making power to the EU to deal with Europe’s economic problems. Percentage of people % who thinks country should keep the Euro as their currency or return to their original currency (franc/mark/peseta/lira/drachma). \textit{Source}: 2014 Spring Pew Global Attitudes Survey

<table>
<thead>
<tr>
<th></th>
<th>More power to EU</th>
<th></th>
<th>Euro</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Favor</td>
<td>Against</td>
<td>Keep euro</td>
</tr>
<tr>
<td>Germany</td>
<td>47</td>
<td>50</td>
<td>72</td>
</tr>
<tr>
<td>France</td>
<td>45</td>
<td>55</td>
<td>64</td>
</tr>
<tr>
<td>Poland</td>
<td>44</td>
<td>41</td>
<td></td>
</tr>
<tr>
<td>Spain</td>
<td>43</td>
<td>53</td>
<td>68</td>
</tr>
<tr>
<td>Italy</td>
<td>38</td>
<td>50</td>
<td>45</td>
</tr>
<tr>
<td>Greece</td>
<td>27</td>
<td>71</td>
<td>69</td>
</tr>
<tr>
<td>UK</td>
<td>19</td>
<td>76</td>
<td></td>
</tr>
</tbody>
</table>
APPENDIX

Data description
Most of the details on the data are covered in the data section in the paper. Here we list the variable definition and additional information on how we treat the data. In the Eurobarometer surveys, prior to the German unification, Germany was only

Table A1: Variables Definition

i. Eurosupport Variables

Membership is good
Description: Share of respondents who answer Good on a 3pt scale (Good, Neither good nor bad, Bad). Question asked in all countries in the sample from the European Community Study of 1973 (1973Q3) to Eurobarometer 77.4 (2012Q2). Not asked in any wave during 1974H1 or 2011H2.
Example of wording: EB64.2 “Generally speaking, do you think that (OUR COUNTRY)'s membership of the European Union is ...?”

Country benefitted
Source: Eurobarometer surveys 1984-2011.
Description: Share of respondents who answer Benefitted on a binary scale (Benefitted, Not benefitted). Question asked in all countries in the sample from Eurobarometer 21 (1984Q2) to Eurobarometer 75.3 (2011Q2). Not asked in any wave during 2010H2.
Example of wording: EB64.2 “Taking everything into consideration, would you say that (OUR COUNTRY) has on balance benefitted or not from being a member of the European Union?”

For Euro
Source: Eurobarometer surveys 1991-2013
Description: Share of respondents who answer For on a binary scale (For, Against). Question asked in all countries in the sample from the European Community Study of 1970 (1970Q1) to Eurobarometer 79.3 (2013Q2). Opinions polled before 1991 (4 waves) have been discarded.
Example of wording: EB64.2: “What is your opinion on each of the following statements? Please tell me for each proposal, whether you are for it or against it...There has to be one single currency, the Euro, replacing the (NATIONAL CURRENCY) and all other national currencies of the member states of the European Union”

Expectations on future household’s financial situation
Description: The variable can assume values $x_j \in \{-1,0,1\}$ corresponding to, respectively, the answers Worse, Same and Better. Question asked in all countries in the sample considered.
Example of wording: EB58.1 “(With respect to your household’s future financial situation) What your expectation for the next 12 months?”

Expectations on future national employment situation
Description: The variable can assume values $x_j \in \{-1,0,1\}$ corresponding to, respectively, the answers Worse, Same and Better. Question asked in all countries in the sample considered.
Example of wording: EB58.1 “(With respect to your country’s future national employment situation) What your expectation for the next 12 months?”
Expectations on future national economic situation
*Description*: The variable can assume values $x_j \in \{-1,0,1\}$ corresponding to, respectively, the answers Worse, Same and Better. Question asked in all countries in the sample considered.
*Example of wording*: EB58.1 “(With respect to your country’s future general economic situation) What your expectation for the next 12 months?”

Expectations on future personal employment situation
*Description*: The variable can assume values $x_j \in \{-1,0,1\}$ corresponding to, respectively, the answers Worse, Same and Better. Question asked in all countries in the sample considered.
*Example of wording*: EB58.1 “(With respect to your future employment situation) What your expectation for the next 12 months?”

Households financial situation
*Source*: Eurobarometer 2009, 2013
*Description*: The variable can assume integers values from -2 to +2, corresponding to answers ranging from Very Bad to Very Good. Question asked in all countries in the sample considered.
*Example of wording*: EB80.1 “How would you judge the financial situation of your household?”.

Perception of National employment situation
*Source*: Eurobarometer 2009, 2013
*Description*: The variable can assume integers values from -2 to +2, corresponding to answers ranging from Very Bad to Very Good. Question asked in all countries in the sample considered.
*Example of wording*: EB80.1 “How would you judge the current employment situation in your country?”.

Support for a Single European Market
*Source*: Eurobarometer surveys 1992-1993
*Description*: Dichotomous variable coded on the basis of 2pt scale answers (A Good Thing, A bad thing) or (An advantage, A disadvantage). Question asked in all countries in the sample considered.
*Example of wording*: EB37.0: “Overall, what do you think that the completion of the Single European Market in 1992 will be?”

Support for a Single European Government
*Source*: Eurobarometer surveys 1992-1993
*Description*: Dichotomous variable coded on the basis of 2pt scale answers (For, Against). Question asked in all countries in the sample considered.
*Example of wording*: EB39.0 “What is your opinion on each of the following statements? Please tell me for each statement, whether you are for it or against it – The Community should have a European Government responsible for the European Parliament”.

Support for a Single European Currency
*Source*: Eurobarometer surveys 1992-1993
*Description*: Dichotomous variable coded on the basis of 2pt scale answers (For, Against). Question asked in all countries in the sample considered.
*Example of wording*: EB39.0 “What is your opinion on each of the following statements? Please tell me for each statement, whether you are for it or against it – There should be a European Single Currency replacing all national currencies”.

Trust in the European Union
*Source*: Eurobarometer surveys 1997-2013
Description: Share of respondents who answer Trust/Tend to trust on a binary scale (Tend to trust, Tend not to trust). Question asked in all countries in the sample from Eurobarometer 48 (1997Q4) to Eurobarometer 79.3 (2013Q2). Not asked in any wave during 1998, 1999H2, 2000, 2002H2, 2010H2.
Example of wording: EB73.4, Q.A14.4 “I would like to ask you a question about how much trust you have in certain institutions. For each of the following institutions, please tell me if you tend to trust it or tend not to trust it....The European Union”

Trust in the European Central Bank
Source: Eurobarometer surveys 1999-2012
Description: Share of respondents who answer Trust/Tend to trust on a binary scale (Tend to trust, Tend not to trust). Question asked in all countries in the sample from Eurobarometer 51 (1999Q1) to Eurobarometer 79.3 (2013Q2). Not asked in any wave during 2002H1 and 2010H2.
Example of wording: EB61, Q.23.6 “And, for each of [the following European bodies], please tell me if you tend to trust it or tend not to trust it?...The European Central Bank”

Trust in National Parliament
Source: Eurobarometer surveys 1997-2013
Description: Share of respondents who answer Trust/Tend to trust on a binary scale (Tend to trust, Tend not to trust). Question asked in all countries in the sample from Eurobarometer 48 (1997Q4) to Eurobarometer 79.3 (2013Q2). Not asked in any wave during 1998, 1999H2, 2000H1, 2002H2, 2010H2.
Example of wording: EB73.4, Q.A14.3 “I would like to ask you a question about how much trust you have in certain institutions. For each of the following institutions, please tell me if you tend to trust it or tend not to trust it....The (NATIONALITY Parliament)”

Trust in National Government
Source: Eurobarometer surveys 1997-2013
Description: Share of respondents who answer Trust/Tend to trust on a binary scale (Tend to trust, Tend not to trust). Question asked in all countries in the sample from Eurobarometer 48 (1997Q4) to Eurobarometer 79.3 (2013Q2). Not asked in any wave during 1998, 1999H2, 2000H1, 2002H2, 2010H2.
Example of wording: EB73.4, Q.A14.2 “I would like to ask you a question about how much trust you have in certain institutions. For each of the following institutions, please tell me if you tend to trust it or tend not to trust it....The (NATIONALITY Government)”

ii. Demographics

Age
Description: individual age of respondent in years.

Year of birth
Description: individual year of birth of respondent computed on the basis of the individual age variable.

Cohort
Description: cohort defined by the authors as follows, on the basis of the individual year of birth.
1. Born before 1945
2. Born between 1946 and 1957
4. Born between 1968 and 1979
5. Born after 1979

Years of education
Description: individual years of education, computed on the basis of information on the age at which respondent left school (provided either recoded in groups or exact). It assumes education starts compulsorily for all Europeans at 8 years of age.

**Gender**
*Description*: Sex of respondent (Female = 1).

**Occupation**
*Example of wording*: EB38, D.15A: “What is your current occupation?”

**Left-right self-placement**
*Description*: Respondent is asked to place his/her political views on a 10 point scale (1 = Left, ..., 10 = Right).
*Example of wording*: EB38, D.1: “In political matters people talk of "the left" and "the right". How would you place your views on this scale?”

### iii. Macro-economic Variables

**Unemployment rate**
*Source*: AMECO (Annual Macro-Economic Database of the European Commission). *Series*: ZUTN
*Description*: Unemployed persons as a share of the total active population (labour force). Quarterly frequency. Period: 1960-2013

**NAWRU**
*Source*: AMECO database. *Series*: ZNAWRU
*Description*: Non-accelerating wages rate of unemployment. Annual frequency. Period: 1965-2013

**Inflation rate (non-food, non-energy)**
*Source*: OECD. *Series*: Consumer Price Indices (MEI database)
*Description*: Consumer prices - all items non-food, non-energy. Percentage change on the same period of the previous year. Quarterly frequency. Period: 1970-2013

**E.C.B. Marginal Lending Facility Rate (MLR)**
*Description*: The Eurosystem Marginal Lending Facility Rate is the interest rate at which major financial institutions obtain overnight liquidity from national central banks in the Eurosystem, against eligible assets. Interest rate levels in percentages per annum. MLR revisions have been recast at quarterly frequency. In the occurrence of policy rate revisions during a given quarter, we impute the average of all standing rates during that quarter. Period: 1999-2013

**National central bank discount rate**
*Description*: The Discount Rate/Bank Rate (d60) is the rate at which the central banks lend or discount eligible paper for deposit money banks, typically shown on an end-of-period basis. Luxembourg and Belgium show the same figures by virtue of the Belgium–Luxembourg Economic Union, which pegged the Luxembourgish franc to the Belgian franc since 1921. Period: 1984-1998

**REPO rate (France)**
Description: Repos (Repurchase Agreements) is the counterpart of cash received against securities/gold sold under a firm commitment to repurchase the securities/gold at a fixed rate on a specified date. The repo series includes holdings by households and non-financial corporations. For lack of data, this series substitutes the Banque de France discount rate in the pre-E.C.B. years. Period: 1984-1998

Nominal G.D.P. in bn EUR/ECU
Source: AMECO. Series: UVGN
Description: Gross national income at current market prices (EUR/ECU bn). Period: 1971-2013

Real G.D.P. (2005 prices) in bn EUR
Source: AMECO. Series: OVGD

Gross contributions to – and receipts from – the E.U. budget in EUR mln
Description: Receipts: Total expenditures in the E.U. budget. Contributions: Total own resources (Traditional own resources + total national contribution)

10-year government harmonized bond spread with German Bund
Source: Thomson Reuters Datastream. Series: LXESSFUB, BDESSFUB, ITESSFUB, FRESSFUB, DKESSFUB, IRESSFUB, NLESSFUB, BGESSFUB, GRESSFUB, OEESSFUB, SDESSFUB, ESESSFUB, FNESSFUB, PTSSFUB, UKESSFUB
Description: 10-year benchmark/harmonized government bond yields in percentage points, at daily frequency. Data have been recast at yearly frequency by taking the average within years and are expressed in difference from the German Government Bond. Period: 1980-2013

Exports towards the EU
Source: Eurostat. Series: DS-016890
Description: Bilateral trade flows since 1988 by CN8. For each E.U. country, data have been aggregated by trade partner to obtain the value of exports in billion EUR (current) to other EU/EEC countries. Period: 1988-2012.

Value of exports in current prices
Source: Eurostat. Series:nama_exi_c
Description: Exports and imports by Member States of the EU/third countries, current prices. Period: 1957-2013

Foreign residents by country of citizenship
Source: Eurostat. Series: migr_pop1ctz
Description: Resident population by sex, age group and citizenship. For each E.U. country, data have been aggregated by citizenship to obtain the stock of immigrants from the EU. Period: 1998-2012

iv. Country-specific Institutional/cultural Variables

World Governance Indicator: government effectiveness
Source: World Bank
Description: Index capturing perceptions of the quality of public services, the quality of the civil service and the degree of its independence from political pressures, the quality of policy formulation and implementation, and the credibility of the government's commitment to such policies (increasing in government capacity). Methodology described in Kaufman et al (2010), Policy Reference: Research Working Paper 5430. The measure is provided with 90% confidence intervals and standard error, but we use the point estimate. Period: 1996-2012.

World Government Indicator: control of corruption
Source: World Bank
Description: Index capturing perceptions of the extent to which public power is exercised for private gain, including both petty and grand forms of corruption, as well as "capture" of the state by elites and private interests (decreasing in corruption). Methodology described in Kauffman et al (2010). Policy Reference: Research Working Paper 5430. The measure is provided with 90% confidence intervals and standard error, but we use the point estimate. Period: 1996-2012.

Deaths in the World Wars
Description: The sum of civilian and military deaths during World War I as a percentage of 1915 population and civilian and military deaths during World War II as a percentage of 1939 population.

Population
Source: Eurostat. Series: demo_pjan_1
Description: Total resident population on 1st January. Frequency: annual. Period: 1960-2013

Genetic distance
Source: Authors database from E. Spolaore and R. Wacziarg, The Diffusion of Development, QJE 2009; version of 8/8/2008
Description: Bilateral genetic distances between countries. For missing data (e.g. former Yugoslavia) we have used the genetic distances of a genetically identical country (e.g. one with genetic distance equal to zero). Data have been aggregated to compute weighted genetic distances of each country with the rest of the E.U. at each point in time. Frequency: yearly (genetic distances are constant over time, population and E.U. member countries change). Period: 1960-2013.

Racism: immigrants make [country] worse place to live
Source: European Social Studies, Round 1 to Round 6. Series: imwbcnt
Description: Share of respondents who answer 4 or less on an 11pt scale (0 = Worse place to live, …, 10 = Better place to live). Frequency: bi-annual. Period: 2002-2012
Wording: “Is [country] made a worse or a better place to live by people coming to live here from other countries?”

Racism: immigrant workers are bad for [country]'s economy
Source: European Social Study, Round 1 to Round 6. Series: imbgeco
Description: Share of respondents who answer 4 or less on an 11pt scale (0 = Bad for the economy, …, 10 = Good for the economy). Frequency: bi-annual. Period: 2002-2012
Wording: Would you say it is generally bad or good for [country]’s economy that people come to live here from other countries?

Racism: don't like as neighbors: people of different race
Source: European/World Value Survey
Wording: On this list are various groups of people. Could you please mention any that you would not like not to have as neighbors? ...People of a different race

Racism: don’t like as neighbors: immigrants/foreign workers
Source: European/World Value Survey
Wording: On this list are various groups of people. Could you please mention any that you would not like not to have as neighbors? ... Immigrants/foreign workers

Nationalism: how proud are you to be a ... (country) citizen
Source: European/World Value Survey
How proud are you to be [nationality]?

**Dummy = “2004 onwards” (Eastern block accession)**
*Description*: dummy = 1 for all countries in 2004 and subsequent years.

**Dummy = “Country in Eurozone” (Eurozone)**
*Description*: country-specific dummy = 1 for each year after the changeover from the former national currency to the Euro.

v. **Electoral Variables**

**Intentional turnout at the European Parliament elections**
*Description*: Share of respondents who declare their likelihood to vote in the next European elections is 5 or above on a 10pt scale (1 = Definitely not vote, 10 = Definitely vote). Alternatively, it is the share of respondents who declare their likelihood to vote in the next European elections is 2 or above when the question is measured on a 4pt scale (1 = Will certainly go and vote, 4 = Will certainly not vote).

- 10pt scale: EB69.2 (2008), EB70.1 (2008), EB71.1 (2009)

*Examples of wording:*

- EB51, Q.30: "The next elections to the European Parliament will take place this June in each member State. [...] b) Do you intend to vote in the next European Parliament elections this June?"
- EB71.1, Q.C3: “Can you tell me on a scale of 1 to 10 how likely it is that you would vote in the next European elections in [date]? Please place yourself at a point on this scale where '1' indicates that you would "definitely not vote", '10' indicates that you would "definitely vote" and the remaining numbers indicates something in between these two positions.”
- EB21, Q.349: “Next June, the citizens of countries belonging to the European community, including the (NATIONALITY) will be asked to vote to elect members of the European parliament. Do you think that you will certainly go and vote, probably go and vote, probably will not vote, or certainly will not vote? ”

**Turnout at the European Parliament elections**
*Description*: Share of respondents who declared to have voted at the last European Parliament elections on the total of all eligible voters in the sample by country (binary variable).

*Examples of wording:*

- EB12, Q.120 "In this first European election a lot of people in some of the countries did not go and vote. Were you of voting age at the time of this election? If yes, were you able to go and vote or didn’t you vote?"
- EES2004, Q.09 "A lot of people abstained in the European Parliament elections of [date], while others voted. Did you cast your vote?"

**Turnout at the national general elections**
*Description*: Share of respondents who voted any political party at the last general elections over the total of all eligible voters in the sample by country.

*Wording: EB.31, Q.533/534 “Which party did you vote for at the [general election] of [year of the last general election]?”*

**Vote to an Eurosceptic party at European Parliament elections**
*Description*: For each of the European elections of 1999, 2004 and 2009, we computed the share of respondents who voted for an Eurosceptic political party among all respondents who declared to vote in that election. Eurosceptic parties are listed in a separate appendix.

**Voter turnout behavior because of anti-E.U. feelings**

- 71 -
Source: Eurobarometer surveys 52.0 (1999Q4) and 71.3 (2009Q2)
Description: Share of respondents who declared to have abstained from voting at the last European elections because they oppose the E.U. plus the share of respondents who declared they voted at the last European elections because they oppose the E.U.
Wording: EB.52, Q.42: “What were the two main reasons why you voted in the European Parliament elections?... I was/am against the European Union”. Q.43: “What were the two main reasons why you did NOT vote in that election?... I am opposed to the European Union”

European Parliament: Results of the European elections. Turnout by country

European Parliament: Results of the European elections. Result by national party
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<th>Percent of the overall sample</th>
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Total 1,629,637 100

1 This wave was used only in the pseudo panel analysis of section 5 since one of the main variables MEMBERSHIP was not collected in this survey. Thus, we do not report the size of the sample as a percentage of the overall sample because it is not used in the other figures and tables.
Chap 9: The French-German relationship

Key issue: One pillar of European political decision making, the French-German relationship, is shaking. We review its recent evolution.

Europe’s Middle Child

France’s Statist Liberalism and the Conflicted Politics of the Euro

Mark I. Vail

DOI:10.1093/acprof:oso/9780190233235.003.0007

Abstract and Keywords

This chapter concerns the contradictions and inconsistencies that affect France’s position as Europe’s “middle child.” Three factors have generated a particular set of trajectories in France’s financial and economic policy: the competing allures of statism and liberalism; France’s vacillating commitments to Keynesianism and austerity in policy; and the decline of its core partnership with Germany. The chapter’s central claim is supported by an empirical study of the political debates surrounding the incipient Economic and Monetary Union in the late 1990s and the European financial and ensuing Eurozone sovereign debt crisis after 2007. In both of these instances, but most obviously in the latter, French policy was guided by these contradictory imperatives. As a result, its position and ability to shape policy in Europe is much diminished.
Introduction: France’s Conflicted Euro Politics

This chapter analyzes the legacies of France’s “euro experience” and their implications for both France’s political economy and the future of the euro. In the midst of the ongoing European debt crisis, the historical ambiguities of France’s role in the euro and in the European Union have been thrown into sharp relief. From the immediate postwar period, and in a somewhat different sense after the Socialist “U-turn” of 1983, the related repudiation of reflationary Keynesianism, and the subsequent embrace of the franc fort and “competitive disinflation” as central economic strategies,1 France sought to achieve on the European level the kind of international pre-eminence that it could no longer achieve on its own. In Tony Judt’s elegant formulation, “Unhappy and frustrated at being reduced to the least of the great powers, France had embarked upon a novel vocation as the initiator of a new Europe.”2 This goal was bound up in the Franco-German alliance at the heart of the European project, whereby Germany achieved international legitimacy through its commitment to multilateralism, which in turn served as an obstacle to any potentially revanchist agenda (and, more importantly, dampened others’ fears of renewed German nationalism).

France, by contrast, connected its economic destiny to the German social market economy, the European Community’s largest and most powerful, in the hopes of securing a set of European arrangements that would both [(p.137)](p.137) enshrine France as the European leader in international affairs and “facilitat[e] the voluntarist economic policies that, it was believed, would speed France’s economic modernization.”3 Though the “voluntarist” tendencies of France’s model of state-led growth abated somewhat after the 1983 abandonment of the dirigiste model, the French state remained a guiding force of French social and economic policy, even after the demise of dirigisme.4 The French conception of the EU continued to rest upon a notion that the country could exert a greater influence in world affairs
through its role in the EU while shaping European policy in a more voluntarist (and less “Anglo-Saxon”) direction.

Simultaneously, however, France was never either entirely content to live in the shadow of its larger and more economically powerful neighbor or truly reconciled to the doctrinaire monetarism advanced by the Germans and indeed sought to preserve its ostensible status, dating from the earliest days of European integration, as the political leader of the European project. As German economic pre-eminence became clearer in the 1980s and 1990s, France worked to achieve a somewhat awkward synthesis between political leadership within the EU and a Franco-German economic partnership whereby to anchor its strategy of competitive disinflation to the German “external ally.” At the same time, it sought to advance an alternative model of economic governance, involving greater integration of national economic policymaking but in the service of a policy agenda both more interventionist and countercyclical than anything that Germany would be likely to tolerate.

The obvious tensions in this arrangement became more acute after German reunification in 1990, which, despite the enormous difficulty and expense involved in integrating nearly 20 million citizens in the former DDR into the West German social market economy, created a potentially even more economically powerful country of 80 million people at Europe’s heart, no longer constrained by the geopolitics of the Cold War. Even though, as Abraham Newman argues in Chapter 6, Germany was reluctant to take on a role of regional hegemon, this new political and economic landscape nonetheless presented a stark and unanticipated challenge to France’s claims to European political leadership, with President François Mitterrand and others openly fretting about renewed German nationalism and casting about for a new set of understandings of France and Germany’s respective roles.

In the run-up to the advent of the euro in the late 1990s, France’s effort to reimagine its European role took on added urgency, as the incipient currency union represented both an opportunity and a challenge. It was an opportunity in the
Europe’s Middle Child

sense that France, Europe’s second largest economy, stood to benefit from its role at the heart of what euro enthusiasts, both within and beyond France, hoped would become a new international reserve currency with all of the international economic heft that this implied, in the center of a new and powerful economic bloc capable of rivaling the United States. But it was also a challenge that highlighted many of the older ambiguities in France’s European role: could France, as Germany’s junior economic partner, successfully maintain its putative role as Europe’s political leader in the context of a currency union closely (indeed almost slavishly) modeled on the German Deutschmark and the anti-inflationary, monetarist assumptions embedded within it, while also working to use its voice to soften those biases in favor of greater state involvement in the economy?

Equally important, how was France to reconcile its traditional **dirigiste** focus on the state as the engine of national economic development and its long-standing hopes to use its role in the EU to secure such a policy orientation at the European level, on the one hand, with, on the other, a context in which monetary policy was entirely removed from national decision-making processes and fiscal policy was severely constrained (though such constraints would often be recognized in the breach when it suited national interests) by the so-called Stability and Growth Pact designed to protect the euro’s value? These ambiguities reflected a deeper conflict among France’s reflexive statism, its embrace of the competitive-disinflationary strategy for which the Germans served as an external anchor, and its distrust of the austerity that lay at the substantive heart of the euro project.

As France struggled to define its new role in the early years of the currency union, its older (and increasingly implausible) claims to be Europe’s leading voice—its firstborn son, as it were—in the international arena gave way to something more ambiguous, a role that one might view as analogous to that of a family’s middle child. This role entailed two features of middle children in particular: the role of mediator in family conflicts and the struggle to be heard above the voices of elder siblings, whose leadership of the European “family” they contest. On the one hand, France was clearly larger and more
Europe’s Middle Child

powerful than the small European states to her north, such as the Benelux countries, and the less economically mighty ones bordering the Mediterranean, with respect to which it had long considered itself to be something of a guide and protector, as well as advocate of a less austere economic model than that favored by its richer, northern European neighbors. On the other, it still had to live in the shadow of the larger and more powerful Germany, struggling to make its voice heard internationally while both remaining loyal to their shared European project and providing a somewhat different vision of what the euro meant and how it should operate. France’s effort to walk this line was only partially successful, as the growing discrepancy between French and German economic power both reflected and reinforced a growing imbalance between France’s and Germany’s respective influence in the venerable Franco-German partnership.

France also became Europe’s middle child in another sense, mediating between the increasingly powerful and self-confident Germans and the less affluent, largely Mediterranean states for which Germany’s model of export-led growth and massive trade surpluses were neither possible nor particularly desirable. This mediating role reflects a deeper and more substantive ambiguity in France’s political-economic outlook. While French elites continue to privilege the state as a key driver and organizing force of the French model of capitalism, they have also embraced a broad project of economic liberalization and, though with greater ambivalence than the Germans, the deflationary and monetarist assumptions at the heart of the euro. Elsewhere, I have characterized these conflicting ideas at the heart of French capitalism as “statist liberalism,” embracing both the state’s leading role in economic policymaking and a substantively (but constrained) liberal vision of the content of economic policies. Here, I argue that similar ambiguities—between neo-Keynesian statism and monetarist liberalism, between an embrace of the international influence attendant to the euro and deep ambivalence about the monetarist assumptions at its heart—have guided France’s inconsistent policy preferences, highlighting its diminishing economic payoffs from the euro
and its (often muted but nonetheless real) resistance to the German line in the ongoing European debt crisis. As in its effort to advance a substantive alternative to the German vision of a European economic future modeled on budgetary rigor, export competitiveness, and monetarism, France’s efforts to mediate between northern and southern Europe have been undermined by a lackluster economic performance and the resulting tendency of Germany and other northern European countries to view France as an incipient (albeit outsized) member of the Eurozone periphery rather than its core.

Below, I examine France’s role as Europe’s “middle child” and the tensions at the heart of its “statist liberal” model during the past 15 years. In so doing, I develop this volume’s broad focus on the political bargains that underpin the euro by analyzing France’s evolving role within the single currency and the tensions between its domestic political-economic model and its long-standing yearning for European influence. I argue that, for whatever political and economic benefits France derived from the euro in the currency union’s early days, such benefits have been more recently outweighed by both political and economic costs, as German insistence on deflationary monetarism in the teeth of the European debt crisis is increasingly at odds with France’s “statist liberal” vision. I argue further that the euro crisis since 2009 has confirmed France’s secondary role among Eurozone members, exposing the implausibility of France’s claims to be a co-equal leader of the European project. In the 1990s and early 2000s, France fared relatively well, though the euro’s anti-growth biases and strictures on fiscal policy precluded an aggressive strategy to deal with the stubbornly high unemployment that persisted during this period. In the aftermath of the post-2007 global financial crisis, such strictures have become more significant, as French authorities have struggled to reconcile political and economic leadership in the Eurozone with the desire to use the power of the French state to foster economic recovery.

As a result, France’s long-standing effort to marry its political-economic fortunes to Germany’s ordoliberal system (which marshals but constrains market forces, privileges high-end
exports, and empowers non-state social and economic actors), while pursuing at home a statist liberal model of top-down, technocratic economic management coupled with the expansion of market forces, has proved unfeasible. Even as the ongoing economic downturn has prompted France to adopt a more statist version of “statist liberalism,” the politics of the European debt crisis have placed the country in the awkward and increasingly untenable position of mediating between German-led monetarism and austerity and its own pressing domestic economic needs. This dilemma, exacerbated by a recent record of tepid economic growth that has weakened France’s fiscal balance sheet and therefore undermined its credibility as a counterweight to Germany, has important implications for the future of the euro, as France’s role as the statist voice of countries that reject the German-led austerity position and its ability to mediate between those countries and the Eurozone’s paymaster have been seriously compromised. In practice, I suggest that the weakening of this alternative voice will reinforce the Eurozone’s tendency toward monetarism and austerity, which may ultimately have the (presumably unintended) consequence of forcing the exit from the euro of weaker, peripheral countries such as Greece and Portugal.

Below, I explore briefly the politics of France’s position on the euro during the period of the currency’s creation, between the mid-1990s and the early years of the first decade of the 2000s, when the country made a series of bets that the euro would both shore up France’s influence in European economic policymaking and guide the substance of that policy in ways that were consistent with France’s conception of its economic interests, even as it struggled to adopt labor-market policies that would promote French competitiveness. I then turn to the period of the financial and economic crisis since 2008 and focus more particularly on the impact of the Eurozone crisis on the French economy, elaborating on France’s responses in fiscal and financial policy and its efforts to guide European responses to the debt crisis and act as a counterweight to Germany. I then return to France’s “middle-child” dilemma, offer some observations about the legacies of the “statist liberal” model as they apply to the contemporary
European policy context and revisit developments over the past 10 years with a view to sketching out likely scenarios for the fate of the euro and its member states.

France’s “Faustian Bargain”: European Commitments and National Policy during the Birth of the Euro

On May 10, 1981, François Mitterrand became the first Socialist French president since the advent of the Fifth Republic in 1958, marking the end of the nearly unchallenged Gaullist hegemony that had governed France during the previous two decades. It also embodied hopes for a new economic order in which the working class would be able to share more equitably in the fruits of economic growth.

Supported by a large socialist majority in Parliament, Mitterrand and his government embarked upon a program that represented “the highest stage of dirigisme,” using the powerful executive of the Fifth Republic to develop stepped-up industrial policies designed thoroughly to restructure the French economy while pursuing a “rupture with capitalism.”

This policy of “redistributive Keynesianism” aimed to enact the left’s electoral promises to create jobs, support consumption and incomes, and shelter workers from increasingly widespread economic dislocation. The means by which this new agenda was to be implemented involved reorganizing the supply side of the economy, stimulating demand, “reconquering the domestic market,” and relaunching state-funded research and development on a massive scale.

Due to a combination of political as well as domestic and international economic pressures, however, this brave new political-economic order collapsed nearly as quickly as it had begun. In 1982–1983, the government made an abrupt “U-turn,” opting for budget cuts and broad-based liberalization in an effort to resolve a series of mounting economic problems and to remain within the European Monetary System (EMS), which it viewed as an essential means of influence over European economic policy and whose limits on currency fluctuation were incompatible with reflactionary dirigisme. This abrupt shift did not merely end the experiment
with dirigisme, however; it also initiated a period during which the entire postwar edifice of dirigiste policymaking would be dismantled. During the remainder of the 1980s, successive French governments embarked upon an unprecedented project of market making, involving the abandonment of the system of preferential credit and industrial policies that had fueled les trente glorieuses, the replacement of bank lending with equity financing for French firms, and the introduction of a competitive financial services sector. This process accelerated under the center-right administration of Jacques Chirac, whose government entered into an uncomfortable “cohabitation” with President Mitterrand in 1986. In five years, France had moved from the epitome of heavy-handed, marxisant statism to an acceptance of the market (though still rejecting Anglo-American conceptions of market hegemony) as the guiding principle for its economic development.

The outcome of this period of political ferment was a “statist liberal” model that both preserved the state as the central guide of economic policymaking even as it embraced elements of a more liberal, post-dirigiste identity with respect to policy substance. This somewhat schizophrenic political-economic orientation, which led to a series of market-conforming policy changes in the 1990s, would also color France’s understanding of the stakes of the nascent single European currency. Even as French elites viewed the euro as desirable from the perspective of both policy substance (creating a Europeanized anchor for its strategy of “competitive disinflation”) and process (giving France a prominent seat at the table at which European monetary policy would be made), they (including Jacques Delors himself) were always somewhat uneasy with the monetarist “orthodoxy” enshrined in the euro project, without which German approval was impossible. France was willing to adopt a monetary regime that was more deflationary than it would have preferred for the sake of the political goals of shoring up its influence within European institutions and promoting a single currency that it hoped would enhance its international economic power. In a sense, France was thus making policy from the “outside in,” allowing concerns about its role in the EU and the Economic and Monetary Union (EMU) to shape its own domestic policy.
regime, importing deflation from EMU and Germany for the sake of hoped-for future influence over the substance of European economic and monetary policy.

While this imported monetarism sat awkwardly with the continued prominent role of the French state in domestic policymaking, it did reinforce a pre-existing agenda of marketizing reforms in social and labor-market policy, which, by the late 1980s, had become the central thrust of French economic policy.\(^{14}\) The “statist liberal” strategy during the mid-1990s and the first years of the 2000s privileged labor-market activation and the reduction of France’s stubbornly high unemployment as its central goals. Though driven in part by rising French unemployment, itself a product of a combination of accelerating layoffs in the wake of the abandonment of \textit{dirigisme} and a Bismarckian welfare state whose reliance upon payroll taxes led to high non-wage labor costs, the effort to rationalize and activate the labor market was also a product of mounting French concerns about maintaining competitiveness in an increasingly integrated European marketplace.\(^{15}\) At the same time, French governments in the late 1990s and the first years of the 2000s displayed an increasing eagerness to rectify a growing fiscal imbalance (the budget deficit had grown steadily, reaching 4.1 percent of GDP by 2003).\(^{16}\) This was due in large part to the perceived need (often exaggerated as a way of securing political cover for unpopular cuts) to meet the criteria of the Maastricht Treaty and, after 1999, the rules of the Stability and Growth Pact. Although French governments of both left and right were ambivalent about these criteria, which represented obstacles to their statist liberal strategy for economic revival, they also felt that “the painful economic prescription of respecting the Maastricht Treaty was a necessary evil in order for EMU to happen.”\(^{17}\)

In order to reduce unemployment, a goal that had taken on new urgency with the advent of EMU and its associated fiscal strictures, French authorities embarked on a series of labor-market reforms in the late 1990s and early 2000s. The first element of this strategy was to reduce reliance upon early retirement programs, which had become a favored (and
politically popular) means of reducing labor supply during the 1980s. These programs offered something for everyone: workers were able to retire early with a minimal loss in income, firms were able to externalize the costs of their restructuring onto the state, and governments could limit the social unrest attendant to economic dislocation.

The second, and more significant, element of France’s labor market strategy during this period was a series of reforms of unemployment insurance, which exemplified the country’s statist liberal strategy for shoring up competitiveness and reducing fiscal imbalances. In June 2000, French employers and reformist unions (jointly responsible for the administration of France’s system of unemployment insurance) struck a bargain that limited access to benefits and imposed significant new obligations upon job seekers. The resulting Plan d’Aide et de Retour à l’Emploi (PARE) ended benefit “regressivity” but made receipt of benefits contingent upon a signed contract between job seekers and the ANPE, or national employment office (the Projet d’Action Personalisé, or PAP), making benefits contingent upon a personalized job-search program.

The best-known and most controversial labor market reforms of this period, however, involved two laws which reduced the standard work week from 39 to 35 hours. The first so-called Aubry Law (named after socialist Labor Minister Martine Aubry), passed in 1998, increased social contribution exemptions to employers but made them conditional upon a firm’s or sector’s negotiation of a 35-hour weekly work-time limit, accompanied by proportional job creation. The second law, passed in 2000, introduced an exemption on social security contributions that rose with salaries up to 1.8 times the minimum wage (fixed above that level) and established annual limits on work time and overtime for firms or sectors that negotiated new contracts.18 Aiming to create jobs through a combination of coercion and incentives, the measures were part of the government’s efforts to appeal to its constituencies on the left and embodied its self-image as “the counter-current of ultra-liberalism.”19 While such rhetoric reflected the laws’ partial political inspiration—an attempt by the new government to shore up support among its leftist
constituencies—authorities realized that the law would have to limit costs to employers if the measure were to lead to any significant job creation. Here again, French authorities’ statist liberal strategy involved an uneasy synthesis of liberalizing labor market measures designed to shore up French competitiveness and reduce unemployment and a leading role for the state in both guiding the reform process and imposing constraints on microeconomic decision-making.

France’s statist liberal strategy thus reflected some of the same ambiguities at the heart of its conception of EMU. A combination of geopolitical aims (e.g., the French desire to constrain German power while preserving a platform for French influence) and economic considerations (the desire to anchor France’s “competitive disinflationary” strategy within the EU and securing influence over European monetary policy) led the country to support the structure of a project whose content made many French elites ill at ease. However one might wish to characterize this alloy of factors, it is clear that France’s embrace of a highly monetarist, even deflationary set of rules modeled on the Deutschmark was never complete, nor was it entirely consistent with a set of policy commitments involving rationalizing the labor market while preserving some of the Keynesian tenets that had lain at the heart of the dirigiste model. During the 1990s and early 2000s, given generally supportive conditions in a recovering international economy and the absence of any serious crises on the European level, France was able to nuance these differences, pursuing a national strategy for labor-market competitiveness never sharply at odds with European constraints on fiscal and monetary policy and indeed reinforced by concerns about sustaining economic growth and redressing the country’s fiscal imbalance.

Such a policy regime produced mixed results following the formal introduction of the euro in 1999, with banknotes and coins entering circulation in 2002. Like many of its Continental neighbors, France continued to suffer from chronically high unemployment and sluggish growth, though economic and labor market performance improved somewhat following the downturn of the early 2000s. At the same time,
however, unlike Germany and even Italy, France’s economic performance declined over the first decade after the euro’s adoption, suggesting both constraints on growth and an eroding level of economic competitiveness. In 2004, French economic growth was 2.6 percent of GDP (compared to 1.2 percent in Germany and 1.7 percent in Italy). By 2008 (before the financial crisis and ensuing recession), growth had declined to a relatively stagnant –0.1 percent (collapsing to –3.1 percent in the following year).21 Though Italian and German growth during this period was similarly slow, unemployment remained higher in France (at 9.3 percent in 2004 and 7.8 percent in 2008) than in Germany or Italy. French budget deficits remained higher than those of either Germany or Italy, and its competitive position collapsed, with the current account declining from 0.5 percent of GDP in 2004 to –1.7 percent in 2008 (see Table 7.1).
### Table 7.1 French Economic Performance in Comparative Perspective, 2004-2008

<table>
<thead>
<tr>
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<th>France 2004</th>
<th>France 2008</th>
<th>Germany 2004</th>
<th>Germany 2008</th>
<th>Italy 2004</th>
<th>Italy 2008</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real GDP Growth</td>
<td>2.6%</td>
<td>-0.1%</td>
<td>0.7%</td>
<td>0.8%</td>
<td>1.7%</td>
<td>-1.2%</td>
</tr>
<tr>
<td>Unemployment Rate</td>
<td>9.3%</td>
<td>7.8%</td>
<td>10.5%</td>
<td>7.6%</td>
<td>8.0%</td>
<td>6.7%</td>
</tr>
<tr>
<td>Current Account (BOP) (% GDP)</td>
<td>0.5%</td>
<td>-1.7%</td>
<td>4.7%</td>
<td>6.2%</td>
<td>-0.3%</td>
<td>-2.9%</td>
</tr>
<tr>
<td>Budget Deficit (% GDP)</td>
<td>-3.6%</td>
<td>-3.3%</td>
<td>-3.8%</td>
<td>-0.1%</td>
<td>-3.6%</td>
<td>-2.7%</td>
</tr>
</tbody>
</table>

France’s declining economic performance both reflected and accelerated a growing shift in the Franco-German relationship. In the 1980s, France could plausibly claim to be Germany’s economic equal—a powerful (though differently constituted) country at the economic heart of Europe. After a painful period of adjustment following German reunification in 1990, however, and particularly since 2005, Germany’s economic success has both legitimized its economic model and constrained France’s ability to advance a plausible alternative to it. This economic divergence has reinforced a growing imbalance in the Franco-German relationship, to Germany’s benefit and France’s detriment. It is no longer plausible for France to claim the status of an equal partner to Germany in either economic or geopolitical terms, with the result that its ability to mediate between Germany and the European periphery has been compromised.

The costs of France’s sluggish economic performance have not been limited to its relationship with Germany. With the advent of the post-2007 financial crisis, the deep global recession that followed in its wake, and the apparently intractable and increasingly severe European debt crisis, France’s slow economic decline forced authorities there to respond aggressively, rendering the previous statist liberal strategy of labor market liberalization and marketization unviable in the short term. As the world economy sputtered to a halt, France was forced to confront the implications of its earlier Faustian bargain and the inconsistencies within its statist liberal model in a new and more straightforward way. In the next section, I argue that, as the proverbial chickens of France’s earlier decision to join EMU on German terms came home to roost, different elements of the country’s statist liberal model came to the fore, with the authorities embarking on a strategy of modest Keynesian reflation.

As the Eurozone crisis worsened in 2010, furthermore, France once again struggled to square the circle of leadership in the Eurozone with its own distinctive trajectory of state-led domestic economic recovery. If the 1990s and pre-2007 period had been dominated by state-led labor-market reform designed to shore up France’s competitiveness and reduce budget deficits in the early days of EMU, the post-2007 period
has been characterized by somewhat conflicted resistance to the implications of the terms of EMU to which it had earlier agreed. In the process, France has sought to protect national French economic interests, temper Germany’s hard-edged monetarism (though with greater force since the election of socialist François Hollande to (p.147) the French presidency), and mediate between German economic leadership and doctrinal intransigence vis-à-vis the euro’s smaller and poorer members and its insistence on an orthodoxy of austerity that promises to leave such countries to years of economic decline. Doing so has proved increasingly difficult, however, as France’s continued efforts to offer a counterweight to Germany, and its related public defense of the broad outlines of Germany’s austerity-based strategy for dealing with the crisis, have rendered unavailable the earlier Franco-German strategy of ignoring the Maastricht criteria when it suited them. As a result, France has continued to struggle with the ambiguities of its statist liberal model and the increasingly glaring contradictions between distinctive elements of its European strategy and its own domestic economic priorities.

Statist Liberalism in the Post-2007 Economic Crisis: France as Frustrated Arbiter and Alternative in the Eurozone

From the early 1990s, French authorities had favored a somewhat different understanding of the euro, despite the (somewhat grudging) formal acceptance of monetarist orthodoxy as the apparent price of the project’s inauguration. This alternative approach centered on the conception of gouvernement éconómique, meaning a set of democratically elected European institutions responsible for fiscal and other policies historically reserved to member states and designed to act “as a counterpart to the independent European Central Bank.”22 The French hope was that such an arrangement could temper the influence of the austerity-minded Germans and would provide mechanisms whereby to stimulate the Eurozone’s economy in the event of economic downturns, while also providing an embryonic core of a future coordinated fiscal union.
As in the early days of the European Community, the French goal was at once procedural and substantive. From a procedural point of view, it would allow the French government to have a continued voice in European level debates over economic policy, a voice viewed as all the more important given the relatively fixed and non-discretionary limits on fiscal policy represented by the so-called Stability and Growth Pact and the monetarist orthodoxy advanced by the highly independent European Central Bank (ECB). Substantively, France hoped to both defend itself against speculative attacks in foreign exchange markets and to preserve its leeway to pursue a selectively interventionist strategy with respect to domestic economic policy. Though such hopes remained frustrated during the 1990s and the early years of the first decade of the 2000s, despite some superficial German overtures in the direction of fiscal coordination, it remained at the core of the French conception of how the euro should eventually work.

The advent of the so-called European “sovereign debt crisis” (more accurately described as a bond-market crisis exacerbated by a deflationary monetary-policy regime) in 2010 brought the differences between the French and German conceptions into sharp relief. This debate was driven by deepening divisions among EU member states about both the merits of the French claim that Europe needed deeper fiscal policy coordination and the intransigence of Germany and her northern European neighbors over the question of loosening some of the fiscal strictures imposed on countries such as Greece, Portugal, and Spain that were under assault by bond markets. In the early days of the crisis, French President Nicolas Sarkozy saw close cooperation with German Chancellor Angela Merkel as the best way of pressing France’s case. In substantive terms, Sarkozy hoped to pursue a schizophrenic strategy of what Susan Milner has described as a strategy of “ri-lance (a mixture of austerity and Keynesian boosterism to finance innovation and R&D, financed by borrowing), which it sought to coordinate at the European level.”

Despite French hopes of tempering Germany’s drive to austerity with elements of France’s alternative vision,
however, Germany’s economic might and her necessarily central role in funding a series of (inadequate but numerous) bailouts of Eurozone countries led this “partnership” quickly to devolve into a relatively hierarchical relationship, derided as “Merkozy” by observers, in which Germany effectively led and France followed. Though Sarkozy seemed to view subordination to Merkel as the price of continued relevance (a reprise of France’s position during the 1990s), he deeply resented this secondary role and continued to seek ways to constrain or dilute German orthodoxy. After one of a series of tense meetings with Merkel in late 2011 and early 2012, Sarkozy was able only to endorse a vague Franco-German commitment to economic growth, which he claimed “is the priority,” without, however, ever convincing Merkel to diverge from Germany’s austerity-first strategy, which was inimical to the very growth that both he and Merkel claimed to promote.  

Unable to pursue its vision of reflationary *gouvernement économique* on the European level, France retreated inward, centering its response to the crisis on the national level, though operating in the long shadow of the Maastricht criteria, ECB monetarist orthodoxy, and the fetishization of austerity by Germany and her northern European allies (notably Finland and the Netherlands). The 1990s and the years 2000–2008 were a period in which French policy operated from the “outside in,” applying German and ECB-centered orthodoxy in a series of labor market reforms designed to support France’s competitiveness and restore fiscal balance. The post-2008 era, however, can be thought of as the converse, with the focus of French policy reverting to the national level in the hopes of saving France’s capitalist model and building on the success of the national response to press its case at the European level.

When the scope and severity of the financial crisis became clear in 2008, French authorities acted quickly and in ways that seemed to encapsulate the statist liberal adjustment strategy, even as it was constrained by Sarkozy’s rhetorical commitment to austerity and fears that the euro-induced bond market crisis would spread to France. The first element of the
government’s response was a countercyclical stimulus package, representing one of the first such measures among all advanced economies that were members of the Organisation for Economic Co-operation and Development (OECD). Patrick Devedjian, one of Sarkozy’s top economic advisors, expressed a sense of urgency, claiming that “all projects must start in 2009 [. . .] we want rapid results,” and criticizing the Americans as having “wasted a lot of time.”

The package, which amounted to 26 billion euro, or about 1.3 percent of GDP, prioritized public infrastructure projects, including four new high-speed rail lines, a new canal, renovations of public buildings, and investment in public enterprises.

The core of the French response centered squarely on macroeconomic stimulus in classical Keynesian fashion, though it did so mostly through investment and support for business rather than efforts to boost consumption. Sarkozy demanded that public enterprises “accelerate their future investments,” since “events command us to move quickly in order to put the brakes on the recession.” This sense of urgency was echoed by Budget Director Eric Woerth, for whom the goal was “to spend as quickly as possible.” Laurent Wauquiez, Secretary of State for Employment, added, “this is exclusively a policy designed to support job creation.”

This effort, which was widely viewed by workers as a sop to business, fueled union-led protests demanding support for purchasing power and public employment. The government assumed that the generous network of automatic stabilizers (expanded in the 1980s and 1990s), coupled with renewed economic growth, would accomplish this task. Then-Finance Minister Christine Lagarde observed, “The French model provides shock absorbers that were already in place. We haven’t had to reinvent our unemployment, health, or welfare systems.”

Faced with mounting protests and following a summit with union leaders, however, the government agreed to an additional 3 billion euro aimed at supporting consumption, in part due to its recognition that the original package would be unlikely to provide a sufficient boost to domestic demand. The
package included a 200 euro bonus for recipients of the *Revenu minimum d’activité* (RMA, or France’s minimum income benefit), more generous unemployment benefits, and a 150 euro subsidy for low-income households.\(^{34}\) It thus echoed the initial package’s liberal orientation by focusing support on the poor, rather than undertaking a broad attempt to boost incomes across the economy. Taken together, then, the two packages reflected statist liberalism’s “statist” (through direct spending and a macroeconomic orientation) and “liberal” (through means-tested income support and support for business) components. Equally important, their modesty relative to the efforts of other G20 countries reflected an understanding of the limits on fiscal expansion represented by European strictures. This constraint was particularly acute for France, whose public finances had never recovered from the collapse of economic growth in the aftermath of the crisis, with its public deficit soaring to 7.5 percent of GDP by the end of 2010.\(^{35}\) Such limitations undermined Sarkozy’s promise to “reconstruct a revitalized capitalism, better regulated, more moral and with greater solidarity,”\(^{36}\) even if one assumes for a moment that such a promise was sincere.

France’s relatively modest stimulus measures were thus focused largely on direct spending designed to revitalize the macro economy. This fact reflected the tension between the statist impulse and the limitations of France’s earlier liberalizing turn and the constraints of existing European level strictures on public debt and deficits, as well as Sarkozy’s rhetorical commitment to German-led austerity. By 2010, France had spent a total of 38.8 billion euro on stimulus measures (1.75 percent of GDP), less than half the amount spent in the US (3.8 percent). Of that amount, only 6.5 percent was composed of tax cuts (compared to 45.4 percent in Canada and 34.8 percent in the US), with the rest composed of direct spending.\(^{37}\) About 10 billion euro were spent on public investment, including infrastructure (€1.4 billion), defense (€1.4 billion), publicly funded research (€700 million), monument restoration (€600 million), and subsidies to public enterprises (€4 billion).\(^{38}\) The package was also quite short-term in focus, with 75 percent of the spending taking place in
2009 and only 25 percent (including the time-delimited income-support measures) in 2010.  

This tepid response was particularly surprising given France’s relatively dire economic situation: in 2009, French GDP shrank by 3.1 percent and, by the end of the year, unemployment had risen to 9.5 percent, compared to Germany’s 7.8 percent. As the Eurozone crisis gathered momentum in early 2010 (developments which I discuss below in more detail), confronting an alarming budget deficit of 7.1 percent of GDP in 2010 and feeling compelled to follow the German austerity lead, Sarkozy therefore proposed a total of 65 billion euro in combined budget cuts and tax increases in 2011, with only 7.5 billion euro scheduled for 2012, and most requiring implementation after the 2012 presidential election. These measures generally favored business and seemed designed to demonstrate commitment to the idea of austerity without enacting serious cuts that might undermine Sarkozy’s weakening political position prior to the elections.

After 2010, as bond yields in a number of countries spiked and policymakers struggled to confront revelations about Greece’s parlous financial state and the legacies of a decade of serious financial imbalances in the Eurozone, French authorities responded in ways that continued to reflect the tensions within its statist liberal model and the ambiguities and weaknesses of the country’s political position in the Eurozone. The deepening crisis confronted France with a dilemma that placed the ambiguities of France’s “middle-child” status in stark relief. Prior to the post-2007 global recession, France could maintain the illusion that, despite Germany’s greater economic might, the legacies of the Franco-German partnership and French leadership in shaping European institutions (not to mention the fact that Jean-Claude Trichet, the head of the ECB, was a Frenchman) provided it with a co-equal voice in shaping policy within the Eurozone. The sudden realization of the extent of French and German banks’ exposure to bad debt in the European periphery, combined with gathering fears that the survival of the euro itself was in jeopardy, however, made France’s traditional strategy of generalized public unity with Germany’s position and sub rosa
attempts to soften Germany’s austerity line both more difficult and crucial to France’s continuing relevance to Eurozone decision-making.

As the crisis gathered steam in 2010 and 2011, Sarkozy met with Merkel several times in an effort to work out a common position, but did so in ways that reflected continued German dominance more than French influence. Sarkozy’s preferred strategy differed from the Germans’ in several important respects. For Merkel, both the origins of the crisis and the appropriate response to it had to do with rules about fiscal discipline (insufficiently strict and enforceable before the crisis, requiring additional force and applicability thereafter). In addition, she favored maintaining the ECB’s independence at all costs and limiting the power of political executives to intervene. Sarkozy, by contrast, emphasized European solidarity (meaning both support for weaker countries’ financial systems and the creation of collective debt instruments such as Eurobonds) and a co-equal partnership between political leaders and monetary policymakers at the ECB. The New York Times provided an apt formulation of this different vision: “In Berlin, it is a common belief that the euro zone [would] be just fine if it could somehow turn itself into a large version of Germany: respectful of rules, wary of deficits, cautious of over expenditure. As for the French, they never love Europe so much as when they think it is like France: brilliant rhetoric, lots of rules and a capacity to go around them.”43 Given these divergent understandings of both the appropriate response to the crisis and the broader regime of Eurozone governance that it implied, Sarkozy faced a choice of how and to what extent to press these differing priorities, and the extent to which such differences should be aired privately or in the public arena.

The urgency of bailing out teetering peripheral financial systems, Germany’s stronger economic position, and Sarkozy’s political weaknesses militated in favor of a strategy of substantive concessions to the German line with vague and noisy pronouncements of a “common position” that failed to reflect France’s alternative vision in any meaningful way. This unequal relationship was not lost on many observers, and the
epithet “Merkozy,” ostensibly used to denote a common Franco-German line, really reflected German dominance rather than parity and was generally understood to involve a pejorative reference to French subordination to German whims. As this process played out at a series of summits and other high-level meetings between Merkel and Sarkozy—first at a Franco-German summit at Deauville in October 2010, and then most notably the declaration of a (vaguely defined) “mutual approach” at an October 2011 meeting in Berlin—it became increasingly clear that French relevance to the discussion was preserved only to the extent that France hewed imperatives of austerity. Speaking of France’s and Germany’s relative influence in governing the crisis, former European Commission President Jacques Delors stated bluntly, “The eurozone crisis has evolved in rhythm with the decisions—and lack of decisions—of Ms. Merkel. It is not nice to say so, but that is how it is.”

To be fair, Sarkozy could not shoulder all of the blame for his relative ineffectiveness at pressing the French vision, as he was playing a relatively weak economic hand in a crisis whose urgency and severity lent itself to short-term palliative measures and rule-based quid pro quos. In a context in which such short-term (though ultimately destructive) bargaining dominated, it would be hard for Sarkozy to secure the implementation of a much grander vision of gouvernement économique and long-term growth supported by political initiative. On one level, the relative influence of the French and German position came down to the question of which partner was better able to finance the series of bailouts that came to dominate the euro crisis response in 2011. France’s economic weakness relative to Germany during this period meant that France had few resources with which to bargain. In 2010, French GDP grew by a modest 1.6 percent, compared to a very healthy 3.6 percent in Germany. At the same time, France had much further to climb out of the depths of the recession in 2009; whereas German unemployment had dropped significantly since the financial crisis’s immediate aftermath, declining to 7.1 percent at the end of 2010, French joblessness continued to rise, reaching 9.8 percent in the same year. Even as French authorities confronted a weakening
labor market and sluggish growth, their poor budgetary position thus left them with few resources with which to spur growth or job creation or to put any effective pressure on Germany, by necessity the largest paymaster of bailout funds, to alter its stance on austerity or the conditions imposed on recipient nations.

Despite such strictures, after Sarkozy’s loss to his socialist rival François Hollande in May 2012, French authorities once again seemed ready to add some substance to the long-standing French claims to represent an alternative to the German policy response to the crisis. Proclaiming that “it’s not for Germany to decide for the rest of Europe,” Hollande campaigned on promises to reverse Sarkozy’s modest spending cuts and adopt new spending initiatives designed to restore growth and create jobs. These included hiring 60,000 additional teachers and subsidizing 150,000 new youth jobs, rolling back Sarkozy’s reform that increased the retirement age from 60 to 62, and boosting the annual back-to-school allowance by 25 percent. More controversially, he promised to finance these measures in part through a 75 percent tax on households with annual incomes over one million euro and higher taxes on large firms, while also raising the minimum wage to support consumption. While Sarkozy’s variant of statist liberalism tended to favor finance, big business, and investment, Hollande’s variant emphasizes universalistic measures to boost consumption and economic equality.

With respect to EU policy, moreover, Hollande’s election represented a shift in discourse and the apparent possibility for alterations to some aspects of Europe’s new Fiscal Pact, negotiated in December 2011 under Merkel’s and Sarkozy’s leadership and ratified by most members of the Eurozone in the spring of 2012. Just as France has tried to walk the line between statism and competitive disinflation at home, the country is once again working to move European policymaking in a less deflationary direction, even as Hollande and his government proclaim support for the overall thrust of the fiscal compact. During his campaign, Hollande promised—if elected—to demand the renegotiation of some elements of the pact, particularly in ways that would offer greater support for
economic growth as a counterbalance to its single-minded emphasis on austerity. Following his election, Hollande proclaimed that he intended to give “a new direction to Europe” and that “austerity need not be Europe’s fate.” Such language furnished hope among some leaders in other countries, particularly on the European periphery and on the left, that Hollande’s election represented a chance for the revival of a French-style *gouvernement économique*, involving both greater coordination of European fiscal policies and a push to move such policies in a direction more supportive of economic growth. Despite claims by Merkel and German Finance Minister Wolfgang Schäuble that they would not permit any renegotiation of the Fiscal Compact (and that “we cannot work like that in Europe”), German authorities have, largely at French urging, expressed some openness to negotiating additional agreements that might attenuate some of the harsh edges of the austerity regime.

That said, Hollande’s promises of a new direction in Europe, away from grinding austerity toward a new emphasis on investment and growth, have come up against some significant economic and political obstacles and will likely prove to be more rhetorical than real. Speaking simultaneously to two audiences—his leftist supporters at home and German and European authorities abroad—Hollande has felt compelled to walk a line between maintaining fundamental commitments to the European Union’s policymaking process, on the one hand, and a rejection of much of that regime’s substance, on the other. In classic middle-child fashion, France under Hollande is once again trying to reconcile opposing political blocs, a fact that has led to significant inconsistency in both his rhetoric and his policy initiatives. Even as he proclaimed, prior to his first visit to Greece as president, that he “reject[s] a Europe that condemns countries to austerity without end,” he sought to establish credibility with his European counterparts and with policymakers in Brussels by honoring a commitment made by Sarkozy to cut the country’s budget deficit to 3 percent of GDP, a level at which the ratio of debt to GDP should stabilize, by the end of 2015.

Such promises were unrealistic, given the country’s deficit level of 4.8 percent of GDP at the end of 2012 (in excess of the
government’s target of 4.5 percent), as French authorities were forced to recognize in March, when they revised the 2013 estimate upward to 4.1 percent of GDP. All of these shifting commitments and rhetorical inconsistencies mask a difficult and ironic underlying truth: in order to gain the credibility and influence required to counter the austerity-first regime at the European level, France must first adopt some elements of that austerity regime at home. Such a dilemma poses both political and economic risks for Hollande, whose popularity has been slipping steadily since his election, in part due to frustrations with rising joblessness and sluggish growth, and in part due to perceptions that he has failed to become the promised counterweight to German dominance of European economic policy. It also likely means that France will prove increasingly unable to act as a voice for an alternative, less austere, pro-growth future for the euro, leaving the arrangement predominantly in the hands of northern European advocates of austerity.

Despite the pressures of France’s budgetary situation and the challenges of walking the line between credibility and growth, France has come to represent a touchstone for those wishing for the emergence of an anti-austerity coalition to counterbalance the Germans and their northern European allies, consisting perhaps of Spain, Portugal, and, since Renzi’s arrival, especially Italy. Leaders in all of these countries (along with Germany’s opposition Social Democrats) have increasingly (and with growing sharpness) questioned Merkel and Schäuble’s recipe for European recovery, using France as an example of the potential for resistance to the German line. They have also pointed to the economic stagnation of the UK, which has pursued austerity with almost sado-masochistic zeal under David Cameron’s coalition government, even though 2013 and 2014 saw the advent of rapid (though distributionally highly inequitable) growth, driven primarily by the development of a new housing bubble. At the same time, however, as many observers predicted at the time of his election, Hollande has felt compelled to adopt some modest austerity measures of his own at home, including 30 billion euro of spending cuts and tax increases adopted in September 2012, which preserved the promised 75 percent marginal rate
on top incomes. In part, such a move represents Hollande’s wishes to reassure a nervous Germany and bond markets that he is not an old-style Socialist oblivious to economic reality, even though the cuts that he has proposed are actually quite modest by European standards. At the same time, however, they represent a somewhat different vision of the relationship between European and domestic policymaking, reflected in Hollande’s concomitant promises to increase spending on consumption and to expand the public sector. Also, and equally important, Hollande prefers to use tax increases rather than spending cuts as a significant ingredient in his recipe for fiscal consolidation, especially during his early years in the Élysée.

Not limited to a pattern of domestic policymaking more comfortable with spending increases and intervention in the economy than his German counterparts, Hollande’s policy proposals also differ from Merkel’s with respect to his vision for EU policy. He has been among the most vocal advocates of Eurobonds, a greater role for the European Investment Bank, European investments in infrastructure, and other measures designed both to increase policy coordination among member states and to stimulate growth. Hollande is once again trying to reconcile a statist vision of economic development with an austerity-based policy regime in ways that seek some degree of national economic policy autonomy and to soften some of the austerity orientation of European policymaking. Ever the middle child, France is working to establish a clear role among its European siblings in ways that are both true to its statist liberal tradition and consistent with continued relevance and influence in the European conversation about how best to address the most serious crisis of confidence in European institutions since World War II. The euro crisis has shaken voters’ faith, not only in the wisdom of particular European policy positions, but rather in the sustainability of the European project as a whole. It remains to be seen how successful Hollande will be in these endeavors, but it is clear that he, unlike his predecessor, has introduced a new and distinctive voice into European policy debates and one with which Germany, despite its status as senior partner, will have to contend in the coming years.
The Middle Child in a Dysfunctional Family: Implications for the Future of the Euro

This chapter has argued that France’s statist liberal model of economic development, solidified in the early days of EMU, has created a series of tensions and ambiguities within the country’s trajectory of economic policy and its position in the European Union in general and the Eurozone in particular. From the earliest days of postwar European integration, France sought to achieve influence at the European level that it could not achieve on its own, while cementing a close relationship with Germany that would act as the fulcrum of that strategy. Always the junior partner in this relationship in economic terms, France nonetheless saw itself as the spiritual core of European institutions and as the pre-eminent representative of Europe on the world stage.

With the advent of the Maastricht Treaty in the early 1990s and the consolidation of EMU later in that decade, however, this national self-conception proved increasingly difficult to sustain, as France struggled to reconcile its much-vaunted statist model of economic development with the liberal, monetarist economic-policy regime at the core of EMU. In the late 1990s, France managed this contradiction by embarking on an ambitious set of labor market reforms designed to further France’s “competitive disinflationary” strategy and adapt it to an increasingly challenging international economic environment. But like Germany, France chose to ignore the strictures of the Stability and Growth Pact when it suited its interests. In contrast to France’s initial European strategy, this approach involved an implicit acceptance of the political and economic pre-eminence of Germany and, at least in the medium term, the German understanding of the Eurozone as predicated upon fiscal austerity, an anti-inflationary monetary policy, and a de-emphasis of statist strategies for achieving economic growth.

All of the above conformed to and served the interests of Germany’s ordoliberal, export-based economy, rather than France’s statist liberal model, which relied upon rapid economic growth and significant job creation in order to make liberalization politically viable while preserving the economic
sustainability of its social model. This choice effectively meant accepting a relatively stagnant economy and high levels of unemployment, which the euro’s fiscal and monetary policy regime prevented it from addressing successfully. In this sense, John Driffill and Marcus Miller are right to claim that the label of the so-called Stability and Growth Pact that served as EMU’s foundational bargain is a misnomer, since the Pact “increases unemployment and slows growth.”57 This outcome has both put France in increasingly difficult economic straits and undermined its credibility as an alternative voice to Germany’s model of “austerity for all.”

These trends were both accelerated and exacerbated after 2009. Though France was able to reconcile EMU with its statist liberal model in the relatively calm 1990s, this task became much more difficult in the aftermath of the post-2007 financial crisis and the “Great Recession” that followed in its wake. As opposed to its approach in the 1990s, when France internalized the deflationary biases of EMU primarily by liberalizing its labor market, in the latter period, the country prioritized domestic policy imperatives and returned to an older, statist pattern of policymaking, enacting a modest Keynesian stimulus package and then shifting to a more pro-growth strategy under Socialist President François Hollande.

The scope of Hollande’s tactical shift, however, was constrained by France’s earlier embrace of the stringent fiscal criteria for EMU and the strongly felt imperative of preserving its leadership position within a currency union at odds with its preferred economic strategy. Having signed on to a deflationary and anti-growth EMU for largely political reasons, France found itself much more constrained with respect to economic policy than it would have liked in the face of an unprecedented and unexpected financial and economic crisis. If the statist liberal model represented a uniquely French response to the political-economic imperatives of the 1990s, it is clearly less well adapted to the contemporary context of sluggish growth, high unemployment, and an intractable European debt crisis. Even as it struggled to preserve its place at or near the head of the Eurozone policymaking table, then, it did so in ways that undermined the chances of achieving the
substantive outcomes that such leadership was meant to foster.

As a result, the imbalances in the Franco-German partnership are unlikely to be resolved. France continues to struggle to define its position in the Eurozone and to offer a coherent alternative model to that advanced by its “elder” German sibling. While François Hollande’s election has led to a more explicit embrace of pro-growth strategies at home and rhetorical contestation of Germany’s austerity obsession, it seems increasingly unlikely that France can square these rhetorical and political circles. In practice, this means that the future of the euro is likely to be an austere one—a fact which, as other contributors to this volume suggest, might well force the exit of some of its economically more vulnerable members. Even as the orthodoxy of austerity becomes more and more entrenched within the Eurozone, France’s ability to mediate between core and periphery will continue to be constrained by the Faustian bargain it made in the early 1990s, when it bought political relevance at the cost of a big part of its statist, pro-growth soul.

In this sense, France’s continued calls for some form of _gouvernement économique_ would seem to reflect weakness as much as strength; having long ago lost the battle with Germany for lead authorship of Europe’s economic future, it is relegated to the second-best strategy of trying to soften the edges of an austere currency union. Though France is unlikely to return to the more liberal market variant of “statist liberalism” that characterized its policy strategy in the 1990s and the first years of the 2000s, it is also unlikely that Hollande will be able to successfully implement at the European level the more pro-growth version that he claims to favor, at least as long as the European debt crisis and prevailing economic stagnation endure. Indeed, the endemic political problems surrounding his administration, along with intensifying recrimination focused on rising unemployment and declining competitiveness, will likely undermine Hollande’s capacity to advance an alternative agenda.\(^{58}\)
If it does, then the chances for the euro to survive, at least in its current form, seem slim indeed. From the beginning, the European project was predicated upon a strong Franco-German partnership, which provided the Germans with legitimacy and the French with the potential to extend the scope of its international influence and economic might in the face of its declining postwar status. It also promised to allow the French to accomplish the kind of economic voluntarism that, at least after 1983, it could no longer accomplish on its own. Its embrace of liberal monetarism and a single currency that inhered those priorities in the 1980s and 1990s, however, effectively traded away its potential to shape the euro in a less austere, more growth-friendly, and more politically and economically sustainable direction. In this sense, Hollande’s criticism of Eurozone austerity and French talk of gouvernment économique over the past decade is really full of sound and fury, signifying very little. Such objections are much like closing the barn door after the horse has escaped.

French weakness and subordination to the German vision of the euro present European authorities with a stark choice. As many observers have argued, the single currency both depended upon and was designed to drive the development of European political union. All but the most starry-eyed Europhiles recognize that this project has failed. In the absence of some sort of meaningful political union, and the mechanisms of fiscal adjustment and compensation that such would entail, Germany, its rich northern European neighbors, and the ECB must choose between a smaller Eurozone and a different policy regime. If they keep insisting on endless austerity that seems to have become the ECB’s orthodoxy, it is hard to envision a Eurozone that retains all of its current members. Such pessimism seems even more warranted in view of the disturbing results of the May 2014 elections to the European Parliament, in which anti-EU parties on the far right, including France’s Front National, translated anger at the economic effects of austerity and the remoteness of European policymaking processes into electoral success.

If the single currency is to survive in its current form, and to enable it to recover some of its lost legitimacy, European monetary and German economic authorities must be willing to
accept greater consumption and inflation in the Eurozone core, some monetization of sovereign debt, and less stringent conditions for fiscal transfers among member states. Given their unwillingness to accept such solutions to date, it seems likely that the euro can survive only with a smaller and more economically homogenous membership. To paraphrase Adolphe Thiers’s quip in the 1870s about the relationship between the nascent Third French Republic and conservatism, “the euro will be more accommodating, or it will not exist,” at least not in its current form. Whatever officials in the ECB and the European core decide, for reasons both economic and geopolitical, it seems unlikely that France will be able to play a forceful role in bringing about a shift in policy orientation. With respect to Eurozone economic policy, Europe’s middle child seems to have become more an obsequious younger sibling than the family mediator or alternative conscience.

Notes:


(4.) In the words of Jonah Levy, Mari Miura, and Gene Park 2006, p. 95: “[T]he road to dirigiste rollback is paved with new state interventions. . . . [D]e-dirigisation was purchased at the expense of expanded state activity in the social arena.”


(6.) In a statement that reflected both his apprehensions and a misreading of the geopolitical context, Mitterrand said, “I don’t have to do anything to stop it, the Soviets will do it for me. They will never allow this greater Germany just opposite them.” Quoted in Judt 2006 [2005], p. 640.

(7.) Vail 2014, pp. 63–85.

(8.) As Jonathan Hopkin argues in Chapter 8 of this volume, voters across Southern Europe may well lose patience with the German-led austerity agenda, which seemingly condemns them to years of economic suffering.

(10.) The term is Peter Hall’s, in Hall 1986, p. 193 ff.


(14.) For a full discussion, see Vail, 2010, chaps. 5 and 6.

(15.) Unemployment, which had been a mere 2.7 percent in 1973, rose to an unprecedented 12.3 percent by 1994. Join-Lambert et al. 1997, p. 198.

(16.) OECD 2012.

(17.) Jabko 2006, p. 171.


(20.) For a full discussion, see Parsons 2003, especially chap. 7.

(21.) All data in this section were drawn from OECD and IMF databases at http://www.oecd-ilibrary.org and http://www.imf.org/external/data.htm


(23.) For a full discussion of this rhetorical feint, see Blyth 2013a, especially chaps. 1 and 3.

(24.) Milner 2011, p. 190.

(25.) Huffington Post 2012.

(26.) On the lack of economic government, see Nicolas Jabko’s Chapter 4 in this volume.


(29.) The other significant element of Sarkozy’s “statist liberal” strategy was an aggressive bailout and forced merger of several major French banks. See Jabko and Massoc 2012.

(30.) Delacroix 2008, p. 4.

(31.) Agence France Presse Online 2008a.

(32.) In 2005, France spent 1.2 percent of GDP on non-contributory income support, compared to 0.6 percent in Germany. ILO 2010, p. 264.

(33.) The Economist 2009, p. 28.

(34.) Cornudet 2009, p. 3.

(35.) Economist Intelligence Unit 2011, p. 6.

(36.) Quoted in Boutté 2010, p. 187.

(37.) Prasad and Sorkin 2009; and Horton 2011, p. 115. Estimates of overall fiscal stimulus during this period vary slightly, as a result of differing treatment of such factors as automatic stabilizers and differences between outlays and expenditures. But these figures represent the middle range of available data.

(38.) Delacroix 2008.

(39.) OECD 2009.

(40.) Surprisingly, France’s stimulus measures were much more modest than those of Germany, a country normally associated with fiscal rectitude and a dislike of state intervention in the economy. For a detailed discussion, see Vail 2014.

(41.) OECD 2012.

(42.) At the end of September 2011, the four largest French banks shouldered a combined €63.3 billion in sovereign debt in Ireland, Spain, Portugal, Greece, and Italy (with €7.7 billion

(43.) Ockrent 2011.

(44.) One senior European official had famously observed that the partnership “serve[d] to hide the strength of Germany and the weakness of France.” Quoted in The Economist 2011b.

(45.) Peel and Carnegy 2013.

(46.) It is also worth pointing out that Sarkozy faced re-election in 2012 amidst deteriorating poll numbers as a result of France’s economic woes and his own foibles. He thus had little political capital left to spend on a public fight with Germany over Eurozone policy.

(47.) OECD 2011, pp. 11, 43.

(48.) Wittrock 2012.

(49.) Cowell and Kulish 2012.

(50.) Wittrock 2012.

(51.) Carnegy 2013a.

(52.) Carnegy 2013b.

(53.) Bruno Le Maire, Sarkozy’s former European affairs minister, put it this way: “France has got to regain credibility with Germany and that only comes through the economy, fixing growth, unemployment, and the debt. Nothing works without this.” Peel and Carnegy 2013. See http://www.ft.com/intl/cms/s/0/37c2ae62-6182-11e2-9545-00144feab49a.html#axzz3FBZ5N9mN

(54.) Such skepticism among political elites has paralleled a growing, if limited, disenchantment with the austerity-only recipe. Spiegel and Ehrlich 2013.

(55.) The Economist 2012.
(56.) Much will also depend on Hollande’s ability to keep his fractious Socialist government in line, something that the beleaguered and often ham-fisted president, whose approval ratings have plummeted in the wake of a series of scandals and other missteps, has often struggled to accomplish. One of the clearest examples of such political mismanagement came with the leaking of an internal Socialist Party memo condemning Merkel’s “selfish intransigence” over austerity. Carnegy 2013c.

(57.) Driffill and Miller 2003, p. 42.

(58.) In the words of Dominique Moïsi, “[B] y navigating with excessive prudence between the logic of the bond markets (no Keynesian policy) and that of his Socialist party inside (no courageous measures to free up the labour market), he has reached the exact opposite result. He has encouraged a climate of negative expectations and suspicion vis-à-vis the efficiency of the state.” Moïsi 2013. See http://www.ft.com/intl/cms/s/0/c452f694-a038-11e2-a6e1-00144feabdc0.html#axzz3FBZ5N9mN

(59.) For a range of perspectives surrounding this core contention, see “Forum: How Germany Reconquered Europe: The Euro and Its Discontents,” Harpers (February 2014): 33-43.

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The Reluctant Leader

Germany’s Euro Experience and the Long Shadow of Reunification

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Abstract and Keywords

This chapter examines Germany’s critical role in Europe’s regional architecture. The German government has pushed a euro crisis response motivated by a concern for the moral hazard generated by other member states. As such, Germany has played the role of reluctant leader—cautious and circumscribed—a strategy that was not without risk. While a number of academic and policy analyses have suggested that this halting response inflated the cost of the crisis by sowing the seeds of market doubt and contagion, it is important to understand why policy frames stressing either German exports or the risk of contagion were rejected in Berlin. This chapter stresses how the costs and timing of German reunification combined with the post-2005 economic recovery, relative to the timing of the euro crisis, set in motion a series of political
economy dynamics that favored the use of the “moral hazard” frame over other possible crisis alternatives.

Keywords: Germany, euro crisis, moral hazard, German exports, contagion, German reunification

Introduction

One of the great puzzles of the euro crisis is the striking disconnect between the policy position of Germany and much of the rest of Europe and even the world. Countries ranging from France to crisis-ridden states on the periphery have called on Germany to step up and engage in a broad push for solidarity and growth. The international press from the Financial Times to the New York Times has condemned German policy, casting the German government, and Angela Merkel in particular, as pursuing a failed strategy of austerity. Even the International Monetary Fund (IMF) has criticized the extreme level of structural adjustment being imposed on the crisis-hit countries, and the US Treasury has publicly shamed Germany’s persistent current account surplus in the face of regional and global imbalances.

At the same time, the German government has stood by its policy, focusing on the risk of moral hazard by profligate member state governments and its call for austerity and structural reform. Facing attack from all sides, Finance Minister Wolfgang Schäuble described Germany’s critics as living in a “parallel universe.” In Germany, there is near consensus among the mainstream policy elite supporting the country’s approach, marked by the relative absence of the euro crisis from the 2013 German election. In fact, with its euro policies as a reference, the German electorate in September 2013 delivered Chancellor Merkel and her Christian Democratic Union with the largest electoral success of any party in decades.

German emphasis on individual member state responsibility and reluctance to take on the role of regional stabilizer is all the more surprising in light of its past European and euro experience. First and foremost, the German economy is tightly coupled to the economic future of its neighbors. Roughly 60
percent of German exports have traditionally gone to other European countries, tying future German growth prospects to the success of reform in these markets. Second, Germany has historically played the role of regional guarantor. Many have long argued that German support of the European project results from its desire to undergird a regional order in which Germany prospers.

While some may argue that it is Pollyannaism to think that Germany could have underwritten a swift regional bailout, one only has to look to the US Troubled Asset Relief Program (TARP) as a counterfactual. The US government, along with the Federal Reserve’s swap line program, quickly underwrote counterparties in banking systems across the OECD countries. By the spring and summer of 2010, the German government knew the size and risk of delay with the Greek sovereign debt crisis and had received repeated warnings from the US Treasury, the financial press, and market indicators. Why, then, has the German government followed a particularistic solution focused on moral hazard and a narrative of “throwing good money after bad” rather than a solidaristic response centered on “preventing contagion and guaranteeing exports”? More specifically, perhaps, what factors incentivize the moral hazard policy among policy elites and make it electorally successful? More generally, what can be learned about the future of the euro given Germany’s response?

In order to make sense of this disconnect, Germany’s critics have highlighted a range of factors, including Merkel’s personal leadership style to German elite beliefs in ordoliberalism. On the one hand, Merkel is cast as a cautious incrementalist unwilling to risk a grand bargain. On the other hand, German politicians lost in the fog of crisis have turned to deep-seated beliefs about market stability and economic order. While there is no doubt some truth to both of these arguments, they obscure significant facts on the ground. Importantly, there is a domestic electoral dynamic that has rewarded Merkel’s leadership and her substantive policy position, which is hard to understand from arguments about leadership style or belief structures on their own. How then can one make sense of the near star-like quality of the
unassuming “Schwaebian Hausfrau” as she sweeps up after the crisis-ridden periphery?

The central argument of this chapter is that Germany’s euro experience and response to the crisis are deeply tied to its reunification experience. The timing of these two macro-historical events lock German policymakers into a set of political incentives that make alternative policies emphasizing solidarity and burden sharing exceptionally difficult. This relationship works through two primary channels—solidarity exhaustion and structural adjustment misfit. On the one hand, reunification has sapped the willingness of an already skeptical electorate to devote additional resources to bail out its neighbors, undermining the basic logic behind hegemonic stability arguments. After decades of subsidizing and restructuring eastern Germany, the German electorate is wary of committing more money to subsidies they view as largely ineffective.

At the same time, reunification spurred a set of reforms to respond to the competitiveness drag of incorporating a former communist country into the unified German economy. The timing and nature of these reforms relative to the euro crisis have a number of critical consequences. For many Germans, they set up a sinner/saint dynamic in which Germans perceive that they have made painful sacrifices in terms of welfare cuts, wage restraint, and labor market reforms. This, then, helps the electorate justify similar demands of other nations that are now experiencing the euro crisis. Thus the call for austerity and structural adjustment is simply the externalization of their own lived experience. Additionally, these reforms have had real economic effects that have enhanced Germany’s export position. As the crisis acts as a drag on the value of the euro in foreign exchange markets, it has had the perverse effect of boosting the export-led German economy. As a result, the German economy has been relatively unscathed by the crisis, experiencing modest growth and record low unemployment rates. In short, the effect of the crisis has been blunted for the German electorate, and thus it is extremely difficult for the German government to engage its citizens in a massive crisis response.
The main point of this chapter, then, is to emphasize the way in which macro political conditions structured the German response to the euro crisis. Rather than focusing on individual leaders or their beliefs, the chapter focuses on the way in which reunification filters Germany’s euro experience. Just as the euro crisis is a product of a structural imbalance stimulated in large part by broader regional dynamics, the political decisions of the German leadership have been shaped and constrained by larger regional and structural changes stemming from reunification.

This chapter, then, makes several important contributions to our understanding of the future of the euro. First, and foremost, it makes sense of the radical disconnect between German decision-makers and the rest of the policy community. Given the legacies of reunification, there is little political will within the electorate to support a solidaristic policy path. Rather than being incrementalist or irrational, the German government is responding to the incentives cast by reunification. Second, the approach undermines the fallacy of composition that run rampant in explanations of the euro crisis. Too often, explanatory focus looks at national factors such as leadership or beliefs without considering the larger regional and structural context. Scholars have long cited the relationship between the end of the Cold War and the introduction of the euro. This chapter underscores how the legacies of reunification continue to reverberate through the euro’s future.

Germany in the Crisis: Don’t Throw Good Money after Bad

The focus of this chapter is to use Germany’s response to the euro crisis as a window into its own euro experience more generally. In particular, two things become clear from this latest episode. The first is the public articulation of Germany’s role as regional hegemon. For much of the postwar period, Germany stood constrained by the historical legacy of World War II both institutionally and politically. Labeled the “semi-sovereign state,” Germany was bound by its constitution to a limited military role globally and faced constant suspicion...
from its neighbors. These constraints have slowly eroded, however, with reunification and the end of the Cold War.\textsuperscript{15}

But the euro crisis has produced a dramatic change in the public acceptance of this new role, both within Germany and regionally. In a remarkable speech in Berlin in 2011, Radoslaw Sikorski, the foreign minister of Poland, declared Germany the “indispensable nation.”\textsuperscript{16} Similarly, as Mark Vail describes in Chapter 7 of this volume, the twin engines of Europe—France and Germany—have been replaced by Germany as the sole driver. From Sarkozy to Hollande, France has seen its ability to shape the euro crisis response largely neutered by German demands. In part, this is the result of German economic success since 2005, and it is also the reality of its size within Europe. At the same time, policy paralysis within France and its stalled economic recovery have weakened the French position as co-equal. Even Wolfgang Schäuble, finance minister of Germany, reflected in 2010 that only a “leading nation, a benign hegemon or ‘stabilizer’” could bring economic stability to the region.\textsuperscript{17}

Second, and equally important, the crisis reveals German caution in playing the role of guarantor in this position as regional hegemon. For much of the postwar period, German foreign policy was defined by Einbindungspolitik, the notion that Germany’s interests were served by regional integration. And repeatedly in the postwar period, Germany made commitments to regional causes, most notably the European Monetary System and the euro, which required considerable solidarity and regional support of its neighbors.\textsuperscript{18} The crisis, by contrast, has found Germany asserting the importance of self-responsibility among the member states. Wary of taking on the burden that hegemonic stability provision frequently entails, Germany has been blamed for a failure of leadership.\textsuperscript{19}

These two factors—Germany’s emergence as the indispensable nation in Europe and its reluctance to guarantee regional collective goods—make its policy position vis-à-vis the crisis central to the future of the euro. In particular, Germany has emphasized its concern for moral hazard in its response to the regional crisis. The German characterization of the euro crisis
has been consistent and focused—profligate governments pursued irresponsible policies during the economic boom, and Germany lacked any guarantee that a bailout would alter their behavior. The central narrative coming out of Berlin as early as 2009 focused on the potential moral hazard to German taxpayers of throwing good money after bad in the periphery of Europe. Finance Minister Wolfgang Schäuble summarizes the German position in a 2012 editorial in the *Wall Street Journal*:

Moral hazard is not benign. Setting the wrong incentives would mean stabbing reformist governments in the back. By suggesting that uncompetitive economic structures can endure, we would buoy the populists, scapegoat-seekers and illusion-peddlers who lurk at the fringes of our political landscapes. By discouraging reform, we would not solve Europe’s imbalances but make them permanent.

This brings me to another misconception: that the crisis was caused by a lack of solidarity. Solidarity is a noble idea and among the underlying principles of the European Union. It has been very much on display as euro zone member states have stepped in to support those that had lost access to markets.

Solidarity always goes hand and hand with solidity. Because solidarity on its own can also be an empty promise. In their generosity, European welfare systems are unparalleled, both in the world and in history. If we want to maintain such a level of protection in a rapidly changing world, we must ask ourselves where the wealth to sustain it will come from.

Not from a euro-zone budget, the printing press or eurobonds. All of our economies, not just a few, will have to generate this wealth, and they can only do so if they adapt to the rigors of a hyper-competitive world economy. Prosperity is not a God-granted right—it must be earned.
In addition to a diagnosis of the problem, German officials have offered a policy agenda for its solution—austerity. Countries that supposedly lived beyond their means are now required to reign in spending and cut entitlement programs. Adjustment is thus cast as a cost born primarily by citizens in the periphery, who will face declining incomes, real wages, and welfare state benefits. This policy emphasis rests both on the claim that Germany cannot afford to play the lender of last resort for the Eurozone, as well as a claim about fairness in responding to the crisis. Policymakers leverage the strong role of the German Federal Constitutional Court within the German constitution, as it has repeatedly signaled its wariness for delegating budgetary authority to the supranational level, as a further institutional constraint on a solidaristic approach. As Finance Minister Schäuble—again—explains himself in a 2011 editorial in the Financial Times:

...it is an undisputable fact that excessive state spending has led to unsustainable levels of debt and deficits that now threaten our economic welfare. Piling on more debt now will stunt rather than stimulate growth in the long run. Governments in and beyond the Eurozone need not just to commit to fiscal consolidation and improved competitiveness—they need to start delivering on these now.

And yet, the moral hazard frame has difficulty explaining the problems facing the Eurozone. For Ireland and Spain, for example, government deficits were routinely below those of Germany and well within the Eurozone Maastricht deficit criteria. Deficits in those countries only ballooned as they were forced, through bank bailouts, to nationalize private debt. A banking crisis, then, turned into a sovereign debt crisis. For still others, such as Italy, the real crisis is one of liquidity. While maintaining a relatively large debt, the government has not had difficulty servicing it so long as there is a market for public debt in Europe. As Germany pushed for self-responsibility, this market quickly evaporated. And while the Greek case is often held up as the German poster child of the crisis, it seems odd to risk the future of the
euro on an economy that is less than 2 percent of the overall EU economy.

To understand the roots of public and private debt in Europe, it is critical to examine structural features of the monetary union. With the introduction of the common currency and pressure by the German Bundesbank to commit the new central bank to fight inflation, interest rates across the Eurozone fell to mirror those in Germany. This was an early signal by the markets (irrationally or not) that there was an implicit bailout commitment within the currency union. In other words, markets assumed that national bonds had the backing of the entire Union (an implicit Eurobond). As interest rates fell in peripheral countries, cheap money rushed into these relatively capital poor countries. Germany profited on two fronts. On the one hand, German banks were among the largest lenders to public and private borrowers in the periphery, with over 300 billion euro in loans to Greece, Portugal, Spain, and Ireland. Once the loans had been made, consumers, firms, and governments in those countries used the money to purchase goods from German exporters. This created current account deficits in the periphery and large current account surpluses in Germany. Moreover, the public assumption of private debt held by governments such as Ireland’s, as well as government-orchestrated bailouts in Spain, benefited German banks that had contributed to the unsustainable boom years.

The above discussion of the crisis highlights the selective interpretation by the German government of the problem as well as the solution—moral hazard coupled with austerity. Two alternatives suggest a different set of possible policy prescriptions. The first concerns the risk of contagion and was advocated most vigorously by the IMF as well as the US government. The argument here is that the member state economies are not independent of one another but are linked by market beliefs and fears. Threatening the belief of an implicit bailout commitment would spread the financing troubles beyond small economies such as Greece and Ireland to systemically important countries such as Italy, Spain, and even France. The German government, then, needed to take bold, sweeping action to reassure markets of the ability of the
European Union to engage in crisis management. Without such action, the price of the bailout would escalate exponentially. Despite the apparent realization of many of these fears, the German government has resisted the contagion frame since the initial months of the Greek crisis. Citing moral hazard concerns as well as institutional constraints, Berlin has repeatedly rejected proposals for Eurobonds or a shared bailout guarantee.\(^33\)

A second alternative that could have bolstered a more solidaristic hegemonic response focuses on the European market as vital to the German economy. Once again, the German economy becomes inseparable from those of its European member states. Rather than focusing on the potential prices of an escalating bailout, this frame plays on the centrality of the German export industry to the country. If Europe falls into recession, the German export sector will suffer as the majority of German exports go to other European members.\(^34\) In particular, this policy alternative undermines support for deep austerity by Germany’s neighbors. As successive French governments have argued, the European Union should focus on promoting growth and use fiscal stimulus if necessary.\(^35\) Given Germany’s stable fiscal situation, it is well positioned to spearhead such an initiative. The German government, however, has long resisted this export frame.\(^36\) With German growth stalling in 2013 and 2014, however, the German government is starting to re-examine its long-standing rejection of stimulus and unrelenting commitment to austerity.\(^37\)

While German politicians periodically have made reference to both the risk of contagion or to Germany’s reliance on European export markets, these played a relatively insignificant role in German foreign economic policy, particularly in the early phases of the crisis. It is always difficult to determine the exact consequences of counterfactual policy responses. Nevertheless, several independent researchers have concluded that Germany’s strict moral hazard approach sparked considerable contagion in the Eurozone crisis.\(^38\) In particular, the German policy response to the Greek sovereign debt problem raised concerns within
financial markets that increased interest rates not only for Greece but for Spain and Italy as well. For example, the markets maintained a relatively benign reaction to the repeated recalculation of Greek deficits during 2009. By contrast, interest rate spreads spiked in the wake of official German pronouncements that there was no bailout provision in the Eurozone and that the German government was constrained from acting by the Federal Constitutional Court.\footnote{39} As the private market lost faith in the German commitment to member state governments, similar demands were placed on other peripheral economies.

Despite the fact that the moral hazard approach has encouraged contagion across the Continent, it enjoys considerable support within Germany. In a spring 2013 ARD poll, 70 percent surveyed reported that they were satisfied with Merkel’s handling of the euro crisis.\footnote{40} A spring 2013 PEW Survey found that 67 percent of Germans thought that the solution to the crisis required further cuts to public spending. Similarly, the PEW poll found that \footnote{74 percent} 74 percent supported Merkel’s management of the crisis. All other leaders in the survey fared considerably worse when evaluated by their national electorates, with David Cameron receiving the second best result at 37 percent.\footnote{41} These findings seem remarkably consistent over time, with only 28 percent of Germans responding in a September 2013 Gallup poll that there are better alternatives to the crisis than austerity (by contrast, 80 percent of Spaniards thought there were better alternatives).\footnote{42} Michael Schierack, head of the CDU in Brandenburg, bluntly concluded, “The Swabian housewife, who doesn’t spend money without getting something in return, is seen by voters as the right leader for Germany in the crisis.”\footnote{43} Ultimately, Merkel was re-elected chancellor in 2013, winning 42 percent of the vote and gaining nearly 50 percent of the seats in the lower house of parliament, the party’s best result in decades. Perhaps equally striking for the future of the euro, the Social Democratic Party in Germany quickly relinquished its call for Eurobonds during the coalition negotiations with the CDU. While mainstream parties across Europe saw their results slashed during the 2014 European Parliamentary elections, Merkel’s CDU received the largest
vote share on the backs of a campaign based primarily on the chancellor’s reputation.

Given that the major concerns of the contagion frame and the export frame have at least in part materialized, both the German government’s commitment to the moral hazard argument and its resonance with the German electorate seem puzzling. The next section, then, examines a series of mismatches between events unfolding regionally and within Germany that help to explain Germany’s hegemonic reluctance.

**From “Sick Man” to “Export Miracle”**

The German response to the euro crisis is integrally tied to the ramifications of and its responses to reunification, which have redefined German domestic politics over the last 20 years. This is not simply an argument that reunification has unleashed a “normal” period for German foreign policy, in which Germany may now assert its national self-interests. The end of the Cold War and the Soviet threat has tempered security fears that had motivated deep German commitment to regional integration. Similarly, the peaceful reunification of the country has weakened the long shadow of the past that constrained German foreign policy. While these macro structural and cultural implications of reunification have frequently been employed to explain shifts in German foreign economic policy, this chapter examines parallel changes in the German political economy. In particular, it highlights the economic challenges posed by reunification and how the response to these challenges facilitated the adoption of a moral hazard policy to the euro crisis, as opposed to the more solidaristic contagion or export alternatives. In the end, any of the three alternatives could be conceived as representing the “self-interest” of Germany, so the critical question is to examine why one policy dominated the others and resonated politically.

For the German economy, the real economic crisis started not with the introduction of the euro but in the post-unification period. GDP per capita stagnated in the decade between reunification and the new currency, from $22,692 in 1991 to
$23,019 in 2000, with major economic slowdowns happening in 1993, 1995, and 1996. Similarly, unemployment repeatedly broke postwar records and was already persistently above 8 percent by 1994. It was also during this period that Germany’s fiscal position deteriorated significantly. With a debt-to-GDP ratio of roughly 40 percent in 1992, the government soon found itself facing a 60 percent debt-to-GDP ratio in 1998. The price tag of big bang reunification, including large regional transfers and monetary union between east and west, put a considerable drag on the German economy. Embarrassingly, Germany violated the euro deficit targets in 2003, which were rules that the German government had insisted upon during the currency’s creation in order to reign in profligate spending by other member states. With falling productivity and rising wage costs, the German economy faced stagnant growth well before the introduction of the euro.

While German politicians had pushed for the creation and introduction of the euro, the first years of the currency were particularly rough economically. GDP per capita was stagnant between 1999 and 2004, with official recessions declared in 2001, 2002, and 2004. Unemployment remained consistently over 8 percent, reaching a postwar record of 12 percent, or 5 million unemployed, in March 2005. And even for those with jobs, real net wages were flat, even declining between 2004 and 2008. Additionally, Germany did not experience many of the benefits associated with the currency’s introduction, such as lower interest rates or inflation. The German government had long enjoyed lower borrowing privileges, and the strict monetarist policies of the German central bank had kept inflation low. These trends stood in sharp contrast to many other European neighbors who saw wages rise, borrowing costs fall, and growth pick up. Reports of the Celtic tiger in Ireland or the boom years in Spain filled German newspapers and magazines with the implicit contrast to the local economy (see Table 6.1).

### Table 6.1 Economic Mismatch in Euro Area Post-Unification
Long touted as the postwar economic miracle and considered a rising economic giant in the late 1980s, Germany could not escape the image of the “sick man” of Europe during the 1990s and the first years of the 2000s. Moreover, average Germans repeatedly cited dissatisfaction with the new currency. Despite the fact that inflation remained at a modest level, individuals frequently referred to the *Milchkaffee*-effect—a coffee that used to cost 2 DM now cost 2 euro. This led to the wide perception that the cost of living rose with the introduction of the euro. Given stagnant or falling real wages, the cost of living was in fact rising but not due to the new currency or increasing prices. The overall economic facts were compounded by a slump in consumer confidence and overall faith in the German economy.

In response to the persistent economic slump, the German government, led by Gerhard Schröder, introduced a series of major economic reforms known under the banner of *Agenda 2010*. These reforms, enacted between 2003 and 2004, cut at the heart of the German welfare state, slashing pension and unemployment benefits. Most controversial, the *Hartz IV* reform reduced long-term unemployment benefits to the level of social welfare payments. Credited with introducing flexibility into the labor market and reducing the overall economic burden of social insurance benefits, these reforms continue to represent a major political controversy in German society. The reforms sparked a series of protests across over 100 cities, including some 100,000 people. In many ways, they...
ended Schröder’s career as chancellor, forcing him to resign as party leader in 2004. Seen as a stab in the back to the social democratic agenda, it motivated an internal split within the Social Democratic Party (SPD), giving rise to a new far left party, Die Linke. It is this split and the constant pressure on the left that continue to undermine the SPD’s national ambitions. More generally, the reforms symbolize a retrenchment of the German welfare state and the spread of neoliberal policies on the Continent.  

Whether or not directly connected to these reforms, the German economy entered a new period of growth starting in 2005. Real GDP grew at over 1 percent a year and unemployment fell. While the German economy suffered in the immediate aftermath of the Great Recession starting in 2007, it saw a remarkable upswing with the onset of the euro crisis. Economic growth topped 3 percent in 2010 and unemployment fell to 5.5 percent in 2012. These figures are all the more striking when contrasted to depression-level GDP figures in many peripheral countries, with Spain alone experiencing over 25 percent unemployment. Germany was once again heralded as the driving force behind the region’s economy, reviving talk of a renewed economic miracle. 

The German euro experience is framed by two important macroeconomic trends. The first is the poor performance of the economy in the wake of the currency’s introduction. This heightened insecurity about the currency limited any political capital or euphoria associated with it. The second macro trend concerns the mismatch between the German experience with the currency and that of many of its neighbors. As Germany struggled with years of stagnation, its neighbors saw their economies blossom. Similarly, German fortunes improved as other member state economies fell off a cliff. Unfortunately for Europe, the major economies may finally be falling in synch, as the German economy contracted in the last quarter of 2012 and grew at a scant 0.4 percent in 2013.

Reunification Blowback

Reunification, then, resulted in a number of political economy legacies that have critical consequences for the German
response to the euro crisis. On the one hand, reunification has undermined further German support for solidaristic responses to economic crises. On the other hand, it forced a set of policy changes that have limited the impact of the crisis, undermining political support for a more aggressive regional response.

**Solidarity Exhaustion**

There are important parallels between the way Germany has portrayed the core versus periphery debate in the euro crisis and the consensus narrative about the economic lessons of reunification. After attempting a massive intervention to rebuild competitiveness in eastern Germany, elites, media, and the public, which were already pessimistic about such policies, have grown increasingly suspicious of the long-term success of a solidaristic policy. This disappointment in reunification has in many ways transferred both subconsciously and consciously to the euro crisis assessment and response.

A central tenet of economic reunification focused on the idea of spatial equality—parity in the standard of living across the federal states, which is enshrined in the German Basic Law—under the auspices of a program of reconstruction known as *Aufbau Ost*.\(^59\) In 1991, the government instituted a supplemental income tax, called the *Solidaritätszuschlag* (the solidarity charge), to offset the costs of these efforts. In the 10 years following reunification, over 1 trillion euro flowed from west to east in financial transfers. These policies have had real on-the-ground consequences, as infrastructure in eastern Germany is often far superior to that in western Germany, ranging from public facilities such as pools to telecommunications networks and highways.

After an initial public outpouring of support for these policies, however, the discourse around eastern Germany and the policy of regional solidarity has grown increasingly negative.\(^60\) During the mid-1990s and early 2000s (some of the hardest days of the German economic slump), a deep solidarity fatigue emerged in which the results of economic reunification were put in doubt and at the same time a narrative of moral hazard emerged. Economic transfers were increasingly labeled as
wasteful, as they produced dependence rather than self-sustainability.\textsuperscript{61} The \textit{Die Welt} reporter Uwe Müller summarizes bluntly, “In spite of many billions, which has long since grown to a sum over a trillion, the East is still not able to sustain itself—half of a country is dependent on constant infusion of money ‘just like a junkie depends on the needle.’”\textsuperscript{62}

More than simply a concern of dependence, elites began to directly connect the East’s experience with the long-standing depiction of economic problems in southern European countries. Helmut Schmidt, former chancellor of Germany, warned that if the reconstruction effort was not significantly reformed, “we’ll have a toned-down Mezzogiorno without the mafia in the former GDR. Economically, Germany can perhaps afford that, but politically?”\textsuperscript{63} Public debates followed that questioned the continued use of the \textit{Solidaritätszuschlag}. In an interview with former Federal President Horst Köhler, when asked whether people in Mecklenburg-Vorpommern should just accept its lack of competitiveness, he responded:

\begin{quote}
There were and are currently large differences in living conditions throughout the Republic from north to south and from west to east.\textsuperscript{\textsc{p.130}} When you want to even them out, you cement in place a state based on subsidies (\textit{Subventionsstaat}) and leave the young generation with an untenable amount of debt. We must move away from the subsidy state. Instead, we need to give people the freedom to realize their ideas and initiatives.\textsuperscript{64}
\end{quote}

Increasingly, then, a core take-away from reunification for the electorate is the danger of moral hazard that can occur when governments attempt to support uncompetitive regions and the need for these regions to undergo structural adjustment. In a co-authored piece, the influential German economist Hans-Werner Sinn concludes

\begin{quote}
Along the Elbe, a second Mezzogiorno has emerged, because there, as in Italy, the wage negotiations were handled above the heads of local employees and employers by a third party. And as in Italy, the solution is sought in the form of government transfers as
\end{quote}
compensation for economic disadvantages, instead of addressing the causes of the problem. Thus a skewed incentive system is created, to which the participants all too easily become accustomed and which is difficult to correct.  

It is then almost an identical lens that is reapplied to the crisis-hit countries as is used to describe the policies of reunification—Germany must avoid a cycle of dependence in which subsides replace structural reform. In other words, for many Germans, reunification's solidaristic experiment was deemed a failure, leaving little political appetite for another round.

**Structural Adjustment Misfit**

At the same time that reunification stoked the fears of moral hazard, it spurred a set of policy reforms that leave Germany strangely out of sync with the rest of Europe. As mentioned earlier, domestic economic concerns stemming largely from reunification pressures pushed the Schröder government to enact a series of reforms to enhance labor market flexibility and reduce welfare state commitments. These reforms have been credited with containing Germany's fiscal commitments and supporting German export growth. At the same time, wage-bargaining contracts negotiated between capital and labor resulted in significant wage restraint. Starting in the middle of the first decade of the 2000s, Germany's current account position steadily improved and it returned to modest growth.

Ironically, as the crisis hit Europe, Germany experienced some of its best macroeconomic performance since reunification. With growth at roughly 1 percent and unemployment steady at 5 percent, the German public faced the surreal experience of being bombarded by bad news about Europe when the domestic economy was relatively strong. In a May 2013 PEW research poll, for example, 75 percent of Germans surveyed reported that they thought economic conditions were good, compared with only 9 percent in France and 4 percent in Spain. Similarly, 77 percent of Germans said their individual finances were good compared to 46 percent in Italy and 15 percent in Greece. Given this disparity in
perception, it becomes particularly difficult to motivate the German electorate regarding the severity of the crisis and the need for a comprehensive German response.

Moreover, because reunification forced Germany to impose fiscal and labor market reforms before the euro crisis occurred, the euro crisis, in the short term at least, paradoxically boosted the German economy. As problems started to emerge in 2009 and 2010, a critical consequence of the crisis was a weakening euro. This in turn spurred international exports of German goods, particularly to other growing regions in Asia. A study conducted by Alliance in 2012 estimated that the effect of the euro crisis on the currency’s value boosted German exports outside the Eurozone by roughly 5 percent, which would translate into a 1.25 percent boost in German GDP. This largely offset the slowdown in exports from other European countries, insulating Germany from the immediate effects of the crisis.

At the same time, heightened uncertainty over the value of sovereign debt in other European countries lowered borrowing costs in Germany. At one point in the crisis, the German government was able to sell bonds at a negative interest rate. This flight from risk to German bonds further lowered the cost of borrowing for the export sector, consumers, and the government. The perverse effects of the euro crisis, then, can be seen on many dimensions. German business confidence rose unexpectedly with the onset of the crisis, reaching a post-reunification record in November 2010. Carsten Brzeski, an economist at ING Brussels, concluded, “Amidst new financial market turmoil and sovereign debt woes in the euro zone, the German economy seems to be an island of happiness.” Even the Finance Ministry noted that the government would save nearly 42 billion euro between 2010 and 2014, owing to falling interest rates. Politically, the timing of economic expansion undermined alternative policy frames, as it was difficult to justify the need for sweeping solidarity in the face of a stable (at times robust) economy. Had reunification not forced structural adjustment in Germany, it is very likely that Germany would have faced the euro crisis in a similar position.
to other major economies on the Continent, with the French experience serving as a powerful counterfactual.\textsuperscript{74}

**Statistical versus Real Germany**

Finally, the moral hazard frame offers a powerful retelling of the sacrifices made for unification. Despite Germany’s return to growth in the second half of the first decade of the 2000s, wages in Germany stagnated.\textsuperscript{75} This was due in part to a series of wage bargaining deals struck between business, labor, and the government in the face of stalled growth in the post-unification period, as well as many of the Agenda 2010 reforms.\textsuperscript{76} In the wake of these reforms, exports boomed, but on the back of falling living standards. In particular, real wage growth has fallen considerably for lower paid services jobs since 2000.\textsuperscript{77} This has helped exports to stay competitive, but with real costs to quality of life. A significant number of Germans thus feel that they have already made large sacrifices due to reunification, and this sociohistorical context shapes their attitude toward the euro crisis. Most notably, the number one concern in Germany in a 2012 PEW survey was not unemployment, the public debt, or inflation, but rising income inequality.\textsuperscript{78}

This sentiment found an important expression in the rise of the *Alternative für Deutschland* party during the 2013 election campaign. Founded in 2013, the party is led by a group of conservative academics and intellectuals who oppose the German government’s response to the euro crisis. The party actively campaigned for Germany to leave the euro and strictly enforce the no-bailout clause contained in the Maastricht Treaty. And while the party did not cross the 5 percent threshold necessary to enter the Bundestag (it received 4.7 percent of the vote), many blame its entry into the race for the failure of the Free Democratic Party to cross that same 5 percent threshold.

Moreover, the euro crisis allowed the government and German citizens to justify difficult welfare state cuts and real wage stagnation as part of the belt-tightening that all countries need to endure to compete in the global economy.\textsuperscript{79} During the boom years, German governments cut social programs and introduced labor market reforms so as to enhance export
competitiveness. The moral hazard argument is strengthened by Germany portrayed as the counterfactual, that is, other European governments could have used the period of economic growth to pass hard reforms, rather than engage in reckless spending. Finance Minister Schäuble made the contrast explicit in a series of interviews as he pointed to German structural adjustment in the early 2000s as evidence that similar reforms in the euro area would succeed. He concluded,

Ten years ago Germany was the “sick man of Europe.” We had to tread a long and painful path to become today’s engine of growth and anchor of stability in Europe. We too had extremely high levels of unemployment, even long after we started to adopt urgently necessary reforms. But without these reforms there can be no sustainable growth.

At the same time, it allowed German voters to place the responsibility for reform largely on the backs of the governments that had engaged in reckless policies.

Conclusion and Implications for the Future of the Euro

The euro crisis has underscored the critical role that Germany plays in the currency’s regional architecture. Importantly, the German government has persistently and often successfully pushed a policy response that is motivated by a concern for moral hazard by other member states. This has resulted in a reluctance to engage in quick and forceful commitments to regional bailouts. This is not to say that Germany has been paralyzed in the face of the crisis, or that it has been absent. From Greek sovereign debt to Spanish banking, Germany has actively engaged the euro crisis and has been an important member—if not the most important member—of the resolution team. But in these efforts, Germany has played the role of the reluctant leader—ever cautious and always circumscribed.

This caution has not been without risk. A number of academic and policy analyses suggest that the halting response inflated the cost of the crisis by sowing the seeds of market doubt and
sparking wider contagion. It is then important to understand why policy alternatives stressing either German exports or the risk of contagion were rejected.

The central argument of this chapter is that the timing of reunification and the German recovery from it relative to the timing of the euro crisis set in motion a series of political economy dynamics that favored the moral hazard response over the alternatives. In particular, structural reforms enacted in response to the post-reunification economic malaise, as well as economic transfers resulting from reunification, undermined solidaristic impulses within the German electorate and policy elite. German citizens felt that they had already engaged in significant sacrifices to improve their own economy’s competitive position. These adjustments would most certainly have been put off if not for the burden of reunification. Moreover, reunification undermined the political support for solidarity that had existed prior to reunification. Finally, the timing of reform put the German economic house in order prior to the crisis. As a result, when the crisis hit, it had the short-term perverse effect of stimulating the German export-based economy.

One of the more general implications of the argument is to refocus attention on the temporal context of regional governance. It is clear that there are considerable interactions between supranational and national policy within Europe. The Europeanization literature, for example, has demonstrated convincingly that considerable variation exists in the implementation of policy across the member states. The argument in this chapter points us in a new direction by considering the timing of decisions made at the level of member states relative to regional policy and how that timing shapes regional opportunity structures.

Moreover, the chapter complicates the notion of self-interest within foreign economic policy. In the context of the euro crisis, it is difficult to discern Germany’s objective self-interest. Rather, there is a set of competing claims as to what should be driving national policy. The chapter hopes to help sort out the micro-foundations of support for one “self-interested” agenda over another and thus clarify the
fundamental disconnect between German decision-makers and Germany’s many international critics.

Finally, the chapter offers a somber assessment of the future of the euro. Given the history of monetary orders that lack the backing of the largest economic player, this erosion of support is particularly troubling. Economic crisis is an inherent part of economic interdependence and integration. In other words, the European project cannot always be a “feel good” story. For much of its history, structural constraints—the end of the Cold War and reunification—worked to bolster German support for an expansive role—hegemonic stabilizer, engine, or leader—regionally. Perhaps more important, market actors believed that Germany had taken on this burden. New structural conditions—the burden of reunification and its policy success—have now created an alternative dynamic, one in which Germany is much more weary of picking up the tab for others.

Ending the bargain, however, comes with real costs. The most immediate implication of this shift for the Eurozone is a widening in economic inequality between the core and the periphery. The cost of lending will continue to diverge as investors price in the risk of default in the periphery and, as a result, competitiveness disparities will grow. As citizens in some regions feel the brunt of these disparities, it risks the political legitimacy of the currency. And given the fiat nature of the currency, such legitimacy is critical for its continued stability. In the near term, German ambivalence will likely undermine the strength of the euro as a global reserve currency. Foreign central banks and investors will face the uncertainty of investing in a currency with a wavering commitment by its largest political power. In the long term, Germany’s reticence puts the Eurozone in a precarious position vis-à-vis the next economic crisis, as it has eroded the faith of both market actors and member states in Germany’s commitment to crisis management. This, in turn, raises the specter of the interwar monetary order in which no hegemonic authority could stabilize the region.82

The central point of this chapter, however, is to underscore that this shift in the German position is not irrational or absurd. Rather, it is the logical result of the incentives created...
by the interaction between the downstream consequences of reunification and the evolution of the euro—a currency union without a fiscal or political union\(^8^3\). Just as reunification played a core role in the currency’s birth, it now stands as a significant impediment to its future success.

Notes:

(1.) Wolf 2013; Krugman 2012a; Hawley 2011.

(2.) International Monetary Fund 2013b.

(3.) US Treasury Department 2013.

(4.) Wolfgang Schäuble 2013c.

(5.) Andrei Markovits 2013.

(6.) Abdelal 1998; Banchoff 1999; Grieco 1996.

(7.) Katzenstein 1997.

(8.) Congressional Oversight Panel 2010.

(9.) Jones 2010.

(10.) Beck 2013.

(11.) Newman 2010; Berghahn and Young 2013.

(12.) Matthijs and Blyth, Chapter 1 in this volume.

(13.) Banchoff 1999; Grieco 1996.

(14.) It is important to note that the term “hegemon” is used in reference to the international political economy literature on financial crises, which dates back to the work of Charles Kindleberger (2013). The central insight is that the global economy often requires a guarantor that can resolve potential collective action and cooperation problems. Leading powers, “hegemons,” have an interest in playing this role and covering the costs of smaller states “free riding,” as they benefit disproportionately from the smooth working of international trade. Many German interlocutors resist the term “hegemon” as it raises normative concerns stemming from Germany’s role...
in World War II. The idea invoked here is not that of a revanchist power but rather an actor capable of motivating and supporting cooperation. In many ways, it is similar to the “engine of Europe” concept, which refers to the central role of Germany in promoting regional integration. German audiences much more readily accept this idea.

(15.) Katzenstein 1997; Bulmer and Paterson 1996.

(16.) Sikorski 2011.

(17.) Schäuble 2010.

(18.) Abdelal 1998; Banchoff 1999.

(19.) Matthijs and Blyth 2011.

(20.) Jones 2010.

(21.) Schäuble 2012b.

(22.) Blyth 2013a.

(23.) Schäuble 2011.

(24.) Hopkin, Chapter 8 in this volume.

(25.) Matthijs and Blyth 2011.

(26.) Blyth 2013a.

(27.) Jones 2010.

(28.) Moravcsik 2012.

(29.) Ewing 2010.

(30.) Rosenthal 2012.

(31.) Gore and Roy 2012.

(32.) BBC 2010.

(33.) Jones 2010; Czuczka and Parkin 2011.

(34.) Economist 2013.
(35.) See Vail, Chapter 7 in this volume.

(36.) MNI 2011; Donahue and Czucka 2012; Gomez 2013.

(37.) Boell and Reiermann 2013.

(38.) Jones 2010; Creuset 2014.

(39.) Creuset 2014.

(40.) Euronews 2013.

(41.) PEW Research 2013.

(42.) Gallup 2013.

(43.) Bloomberg News 2012a.

(44.) Katzenstein 1997; Bulmer and Paterson 1996.

(45.) Harding and Paterson 2000; Kitschelt and Streeck 2003.

(46.) GDP per capita is reported in current prices. See World Development Indicators.

(47.) World Development Indicators.

(48.) Heipertz and Verdun 2010.

(49.) World Development Indicators.

(50.) German Institute for Economic Research 2009.

(51.) Dornbusch 1933; Hardin and Paterson 2000.


(53.) Vail 2010; Streeck and Hassel 2003.

(54.) Kitschelt and Streeck 2003; Streeck and Hassel 2003; Streeck and Tampusch 2005.

(55.) Dustmann et al. 2014.

(56.) World Development Indicators.

(57.) Reisenbichler and Morgan 2012.

(59.) Berentsen 2006.

(60.) Johnson 2011.

(61.) Johnson 2011.

(62.) Müller 2006.

(63.) Schmidt as quoted in Müller 2006, p. 29.

(64.) Focus Magazin 2004.

(65.) Giersch and Sinn 2000, p. 15.

(66.) Vail 2010.

(67.) Dustmann et al. 2014.

(68.) PEW Research 2013.

(69.) See also Jacoby, Chapter 9 in this volume.

(70.) Broyer, Petersen, and Schneider 2012.

(71.) Black and Vits 2010.

(72.) Black and Vits 2010.

(73.) Der Spiegel 2013.

(74.) Vail, Chapter 7 in this volume.

(75.) Vail 2009.

(76.) Vail 2009; Reisenbichler and Morgan 2012.

(77.) Dustmann et al. 2014.

(78.) PEW Research 2013.

(79.) Mallaby 2012. See, for example, Vitzthum 2011.

(80.) Schäuble 2013c.

(81.) Schäuble 2013b.
(82.) See McNamara, Chapter 2 in this volume.

From Sick Man of Europe to Economic Superstar: Germany’s Resurgent Economy

Christian Dustmann, Bernd Fitzenberger, Uta Schönberg, and Alexandra Spitz-Oener

In the late 1990s and into the early 2000s, Germany was often called “the sick man of Europe” (for example, Economist 2004), a phrase usually attributed to comments by Czar Nicholas I of Russia about the troubles faced by the Ottoman Empire in the mid-19th century. Indeed, Germany’s economic growth averaged only about 1.2 percent per year from 1998 to 2005, including a recession in 2003, and unemployment rates rose from 9.2 percent in 1998 to 11.1 percent in 2005 (according to World Bank data). Today, after the Great Recession, Germany is described as an “economic superstar” (for example, in the movie “Made in Germany: Europe’s Economic Superstar,” http://films.com/ItemDetails.aspx?TitleId=29218). Germany’s number of total unemployed fell from 5 million in 2005 to about 3 million in 2008, and its unemployment rate had declined to 7.7 percent in 2010 (according to data from Germany’s Federal Employment Agency, the Bundesagentur für Arbeit). In contrast to most of its European neighbors and the United States, Germany experienced almost no increase in unemployment during the Great Recession, despite a sharp decline in GDP in 2008 and 2009 (an episode discussed

† To access the Appendix, visit http://dx.doi.org/10.1257/jep.28.1.167 doi=10.1257/jep.28.1.167

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Our argument is similar in spirit to that of Carlin and Soskice (2008, 2009), who argue that it is restructuring by Germany’s private sector, using traditional German institutions based on employer-worker cooperation, and not government labor market and welfare state reforms that are to be credited for the German recovery.

How did Germany, with the fourth-largest GDP in the world (after the United States, China, and Japan) transform itself from “the sick man of Europe” to an “economic superstar” in less than a decade? One common answer points to a series of legislative labor market reforms that started in the mid 2000s, the so-called “Hartz reforms.” Another explanation focuses on the evolution of Germany’s economy and trade balance in the context of the eurozone. However, we will argue that these factors did not play a decisive role for the transformation of the German economy, namely the restructuring of its labor market and the increase in competitiveness that has helped German exports. We instead present evidence that the specific governance structure of the German labor market institutions allowed them to react flexibly in a time of extraordinary economic circumstances, and that this distinctive characteristic of its labor market institutions has been the main reason for Germany’s economic success over the last decade.

We begin by arguing that the evolution of Germany’s per unit labor costs—that is, labor costs relative to productivity—in both the manufacturing sector and the other sectors in the economy has played an important role in the favorable evolution of German tradable manufacturing industry. We then investigate the mechanisms that allowed for wage restraints and the dramatic decrease in real wages at the lower end of the wage distribution.

The specific feature of the German system of industrial relations that we stress is that it is not rooted in legislation, but instead is laid out in contracts and mutual agreements between the three main actors in Germany: employer associations, trade unions, and works councils. The institutional setup of this system, which is dominated by industry-wide wage bargaining, remained basically unchanged. However, many indicators demonstrate that it did change in the way it operates. For example, the share of German workers covered by any kind of union agreement has sharply declined, and the number of firm-level deviations from industry-wide union agreements has sharply increased since the mid 1990s. Overall, these gradual changes within the system led to an unprecedented decentralization of the wage-setting process from the industry level to the firm level. Alternatively, one may refer to this process as an increasing localization of Germany’s industrial relations.

The decentralization in wage setting in Germany is in contrast to many of its neighbors where the statutory minimum wage is often high (relative to productivity), where union wages and work hour regulations apply to all firms in the

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1 Our argument is similar in spirit to that of Carlin and Soskice (2008, 2009), who argue that it is restructuring by Germany’s private sector, using traditional German institutions based on employer-worker cooperation, and not government labor market and welfare state reforms that are to be credited for the German recovery.
industry, and where institutional change therefore requires broad consensus along the political spectrum.

We then turn to a discussion of why Germany’s labor market experience has been so distinctive within continental Europe. On the one side, the fall of the Berlin Wall in 1989 and the dramatic cost of reunification burdened the German economy in an unprecedented way, leading to a prolonged period of dismal macroeconomic performance. On the other side, it gave German employers access to neighboring East European countries that were formerly locked away behind the Iron Curtain, and that were characterized by low labor cost, yet stable institutions and political structures. These factors changed the power equilibrium between employer and employee associations and forced the latter to respond in a far more flexible way than many would ever have expected. Finally, we discuss the relationship between our analysis of the flexibility of Germany’s labor market institutions and two other events: Germany’s Hartz reforms of 2003 and the arrival of the euro in 1999.

How Did Germany Improve its Competitiveness?

**Relative Unit Labor Cost**

In Figure 1, we plot the “relative unit labor costs” for a country’s overall economy adjusted for the changing composition of the markets in which it competes, for a selection of countries, in dollar terms. This index is computed by the OECD based on year-to-year changes of unit labor costs and shows the relative change in the unit labor costs over time (normalized to 1995) translated into US dollars at the current exchange rate compared to a weighted average of a country’s trading partners. The weights of the trading partners adjust annually to changes in trading patterns. An increase in this index indicates a deterioration of the competitive position. A drop in this index—that is, an improvement in competitiveness—is caused by some combination of three factors: 1) a decrease in the wage per worker (or per hour); 2) an increase in productivity (per worker or per hour); and 3) a nominal depreciation of a country’s foreign exchange rate.

Since 1995, Germany’s competitive position has persistently improved, while the competitiveness of some of its main European trading partners has deteriorated (Spain and Italy) or remained close to the 1995 position (France). The competitiveness of the United Kingdom has likewise deteriorated, although it improved dramatically between 2007 and 2009 due to the sharp depreciation of the British pound against other currencies. The US economy also lost competitiveness relative to Germany in the late 1990s as the US dollar appreciated in value relative to European currencies, but improved consistently after the 2001 recession, partly achieved through a dollar depreciation (for instance, while the euro/dollar exchange rate was around 1 in 2001, it had depreciated to 0.8 in 2009). However, Germany’s gains in competitiveness with regard to France, Italy, and Spain cannot be due to currency depreciation (and in fact the euro appreciated relative to the currency of most trading partners), because these countries all share the euro, and so it must
have arisen because German wages grew at a slower pace than productivity relative to these other eurozone countries.

**Wage Trends and Wage Inequality**

Figure 2 shows the evolution of real wages in West Germany since 1990. The figure illustrates the dramatic development in wage inequality in West Germany over the past 15 years or so (Dustmann, Ludsteck, and Schönb erg 2009; see also Antonczyk, Fitzenberger, and Sommerfeld 2010; Card, Heining, and Kline 2013).

Real wages at the 15th percentile fell dramatically from the mid 1990s onwards. From the early 2000s onwards, median real wages started to fall, and only wages at the top of the distribution continued to rise. Notice that all wage figures that we report stand for West Germany (although, henceforth, we refer to them as “Germany”), because developments in East Germany are strongly affected by the transition after German unification.

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2 Details on the wage data are in Appendix A available online with this journal at http://e-jep.org.
Figure 2
Indexed Wage Growth of the 15th, 50th, 85th Percentiles, West Germany, 1990–2008

Notes: Calculations based on SIAB Sample for West German Full-Time Workers between 20 and 60 years of age. The figure shows the indexed (log) real wage growth of the 15th, 50th, and 85th percentiles of the wage distribution, with 1990 as the base year. Nominal wages are deflated using the consumer price index (1995 = 100) provided by the German Federal Statistical Office.

If the increase in wage inequality and the modest growth in wages overall—and in particular the dramatic decline in real wages at the bottom of the wage distribution—has contributed to the favorable evolution of unit labor costs in Germany relative to the United States and other eurozone countries, then one should expect this development to have been particularly pronounced in the tradable manufacturing sector—the backbone of the German exporting industries accounting for 80 percent of German exports. This insight turns out to hold true, but in an unexpected way.

To further explore the increase in wage inequality, we classify sectors with export volumes below the 25th percentile of the distribution of export volumes in 1995 as “nontradable sectors,” and those with export volumes above this threshold as “tradable sectors.” “Tradable manufacturing” are all those tradable sectors that belong to the manufacturing sector, and “tradable services” are all other tradable sectors. Figure 3 breaks down the evolution of real wages along the wage

3 Details on the construction of these categories can be found in Appendix A, available with this paper at http://e-jep.org.
distribution separately for the nontradable sector, tradable manufacturing sector (henceforth denoted as manufacturing), and tradable services sector. By this measure, real wages in the manufacturing sector rose at all percentiles of the wage distribution until the mid 2000s and afterwards continued to rise at the median and the 85th percentile. Germany’s real wages in the nontradable sector hardly increased at all at any part of the wage distribution during the 1990s and started to decline from the early 2000s onwards even at the 85th percentile, but particularly so at the 15th percentile. The sharpest increase in inequality occurred in the tradable service sector, where between 1990 and 2008 real wages did not show an increase at the median, increased by 12 percent at the 85th percentile and declined by almost

Figure 3

Notes: Calculations based on SIAB Sample for West German Full-Time Workers between 20 and 60 years of age. The figures show the indexed (log) real wage growth of the 15th, 50th, and 85th percentiles of the wage distribution, with 1990 as the base year. Nominal wages are deflated using the consumer price index (1995 = 100) provided by the German Federal Statistical Office. Panel A shows the evolution of these figures for the nontradable sectors, panel B for tradable manufacturing, and panel C for tradable services. We classify sectors with export volumes below the 25th percentile of the distribution of export volumes in 1995 as “nontradable sectors”, and those with export volumes above this threshold and that belong to the manufacturing sector as “tradable manufacturing.” The sectors above this threshold that do not belong to the manufacturing sector are classified as “tradable services.”
15 percent at the 15th percentile. At first glance, these figures do not seem to lend support to the hypothesis that wage restraint in the manufacturing sector was an important factor in improving competitiveness in that sector.

Exports, Tradable Manufacturing, and Domestic Inputs

The end product in manufacturing, however, contains a large share of inputs produced in other sectors: in Germany, the value added in manufacturing is only roughly one-third of the value of the end product, with the remainder of value added being contributed through inputs from other industries, either domestically or from abroad (the literature so far has focused on Germany’s imports of intermediate products from abroad, see Geishecker 2006; Sinn 2006; OECD 2007, chap. 3; OECD 2012, chap. 3). Hence, the manufacturing sector may have benefited from low wages in other domestic sectors and from cheap imports from abroad. In addition, Germany’s manufacturing sector may have experienced increases in productivity which exceeded the increases in wages in the manufacturing sector.

More detailed evidence suggests that both of these factors may be at play. In Germany, the manufacturing sector comprised 21.6 percent of all jobs in 1995, but 17.7 percent of all jobs in 2007, while the value added of this sector (in current prices) remained essentially unchanged at 22.8 percent of all value added in 1995 compared with 22.7 percent of value added in 2007. This pattern suggests larger productivity increases in the manufacturing sector than in the other sectors, where employment shares increased over the same period, with value added remaining roughly constant. This pattern is not uncommon across high-income countries.

However, the share of manufacturing in output value (value of final products), as opposed to value added, rose steadily from 35 percent of all output in 1995 to 39.3 percent of all output in 2007. This pattern reflects that the manufacturing sector indeed relies to an increasing extent on inputs from other domestic sectors and on imported inputs (because the share in final products has increased while the share in value added has remained the same), and may thus have benefited from the low wage growth in other domestic sectors and from cheaper imports.

Digging down into the more detailed data, shown in Table 1, the value of inputs over the value of output is nearly twice as high in manufacturing as in the other two sectors (66.1 percent in 1995 versus 37.8 percent in the tradable service sector) and this share increased by about 7 percentage points to 72.9 percent in 2007. The share of domestic inputs remained constant over the same period at about 51 percent. Thus, the increase in the share of inputs used by Germany’s manufacturing sector, relative to the output value in that sector, is driven by increased

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4 See Table 1 and Table A1 in Appendix C available online with this paper at http://e-jep.org for details and data sources.
5 Pilat, Cimper, Olsen, and Webb (2006) point out that the relatively fast productivity growth in manufacturing is associated with relative declines of the prices for manufacturing products (this is Baumol’s cost disease). Thus, shares in value added at current prices understate the share of value added at constant prices in manufacturing to total value added at constant prices, which makes it remarkable that manufacturing in Germany has retained its share in value added at current prices.
use of inputs from abroad relative to inputs from domestic industries. However, even in 2007, 70 percent of overall inputs in Germany’s manufacturing sector were domestically produced. Thus, the argument that Germany’s manufacturing sector has become nothing more than an assembly place for foreign produced inputs (for example, Sinn 2006) is unjustified. In fact, while German manufacturing has made increasing use of imported inputs, the share of domestic inputs in manufacturing final output value had remained high and relatively stable between 1995 and 2007.

To what extent have Germany’s domestic inputs contributed to competitiveness in its export-oriented manufacturing sector and the two other sectors? In Figure 4, we plot the evolution of unit labor costs in the three sectors, where industries are weighted with respect to their exports for the two tradable sectors.\(^6\) When computing unit labor costs, we first consider only the value added in the sector, as denoted by solid lines in Figure 4. We then consider final output value in the sector, which is the sum of value added in the sector and all inputs into the sector denoted by dotted lines in Figure 4. This index (Unit Labor Costs: “End Products”) incorporates gains in competitiveness in a sector due to the usage of inputs from other domestic sectors. We also plot median real wages, adjusted using Germany’s Consumer Price Index, for the three sectors. While real wage growth in the manufacturing sector is relatively modest,

\(^6\) Details on how unit labor costs are calculated can be found in Appendix A and in Appendix C, which are available online with this article at http://e-jep.org.

Table 1

Evolution of the Share of Value of Total Inputs and Domestic Inputs over the Value of Output, Overall and by Sector, 1995–2007

<table>
<thead>
<tr>
<th></th>
<th>Overall</th>
<th>Nontradable sectors</th>
<th>Tradable manufacturing</th>
<th>Tradable services</th>
</tr>
</thead>
<tbody>
<tr>
<td>Panel A: Value of Total Inputs/Output Value</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1995</td>
<td>48.2%</td>
<td>39.9%</td>
<td>66.1%</td>
<td>37.9%</td>
</tr>
<tr>
<td>2000</td>
<td>51.0%</td>
<td>37.9%</td>
<td>70.1%</td>
<td>41.4%</td>
</tr>
<tr>
<td>2007</td>
<td>53.2%</td>
<td>38.2%</td>
<td>72.9%</td>
<td>41.6%</td>
</tr>
<tr>
<td>Panel B: Value of Domestic Inputs/Output Value</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1995</td>
<td>39.8%</td>
<td>35.3%</td>
<td>51.7%</td>
<td>32.4%</td>
</tr>
<tr>
<td>2000</td>
<td>40.3%</td>
<td>32.2%</td>
<td>51.7%</td>
<td>34.8%</td>
</tr>
<tr>
<td>2007</td>
<td>40.5%</td>
<td>32.1%</td>
<td>51.2%</td>
<td>34.2%</td>
</tr>
<tr>
<td>Panel C: Value of Domestic Inputs/Value of Total Inputs</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1995</td>
<td>82.6%</td>
<td>88.3%</td>
<td>78.1%</td>
<td>85.6%</td>
</tr>
<tr>
<td>2000</td>
<td>79.0%</td>
<td>84.9%</td>
<td>73.7%</td>
<td>84.0%</td>
</tr>
<tr>
<td>2007</td>
<td>76.1%</td>
<td>83.9%</td>
<td>70.3%</td>
<td>82.2%</td>
</tr>
</tbody>
</table>

Notes: Calculations based on input-output statistics from the German Statistical Office (Fachserie 18, Reihe 2, Years: 1995–2007). We classify sectors with export volumes below the 25th percentile of the distribution of export volumes in 1995 as “nontradable sectors” and those with export volumes above this threshold and that belong to the manufacturing sector as “tradable manufacturing.” The sectors above this threshold that do not belong to the manufacturing sector are classified as “tradable services.”
at about 8.2 percent over the 11-year period, in the other two sectors average wages fell in real terms by 1.2 and 4.1 percent, respectively, over this time period.

As visible in the figure, domestic unit labor cost for total production in manufacturing, taking account of inputs produced in other sectors ("end products"), declined far more rapidly than unit labor costs in value added—a decline that cannot be explained by the increase in the share of imported inputs in total output value. Moreover, unit labor costs in end products start to decline at the start of the observation period in 1995, while unit labor costs in value added decrease rapidly only from 2003 onwards when mean wages, and in particular wages at the 15th percentile of the wage distribution start to decrease in real terms (as shown earlier in Figure 3).

Thus, Germany’s manufacturing sector improved competitiveness in several ways. First, manufacturing drew on inputs from domestically provided nontradable and especially tradable services, where real wages fell between 1995 and 2007. Second, the decline in unit labor costs, coupled with the increase in mean real wages in manufacturing, implies that productivity increases in the manufacturing sector have
outpaced wage increases in that sector. In comparison, total unit labor costs fell less in the nontradable sectors (minus 22.2 percent) and much less in the tradable services (minus 9.7 percent), even though nominal wages grew much less in these two sectors compared to tradable manufacturing. Note also that productivity increases in the manufacturing sector have exceeded the increases in the two other sectors. Finally, to increase the competitiveness of its own final products, the manufacturing sector has made increased use of trade integration with Eastern European countries through inputs imported from abroad, and far more so than other European countries. These inputs made up 14.5 percent of total output in the manufacturing sector in 1995 and 21.5 percent in 2007. Calculating the outsourcing indicator suggested by Egger and Egger (2003, p. 642) for Germany, France, and Italy regarding imported inputs from Poland, Hungary, and the Czech and the Slovak Republics, using data from the OECD Input-Output-Tables (at http://www.oecd.org/trade/input-outputtables.htm) and OECD International Trade and Balance of Payments Statistics (at http://www.oecd.org/std/its/), shows that in the year 2000, imported inputs from these four countries amounted to about 8.5 percent of inputs in Germany, compared to 2.5 percent in Italy and 1.9 percent in France (relative to GDP).

The Increase in Competitiveness and Germany’s Labor Market Institutions

The movements in German wages, within and across sectors, belie the common belief that Germany’s labor market institutions are overly rigid. Instead, we argue that the specific governance structure of the German system of industrial relations offers various margins of flexibility. In the early to mid 1990s, these institutions allowed for an unprecedented increase in the decentralization (localization) of the process that sets wages, hours, and other aspects of working conditions, from the industry- and region-wide level to the level of the single firm or even the single worker, which in particular helped to bring down wages at the lower end of the wage distribution. This decentralization took place even though the institutional setup of the dominating system of industry-wide wage bargaining basically remained unchanged.

The specific feature which we stress here is that the governance structure of the German system of industrial relations is not rooted in legislation and is not governed by the political process, but instead is laid out in contracts and mutual agreements between the three main labor market parties: trade unions, employer associations, and works councils (the worker representatives who are typically present in medium-sized and large firms).\footnote{Works councils have to be set up in establishments with more than five employees when demanded so by the employees. About 92 percent of employees in establishments that have more than 50 employees work in establishments with a works council, but only 18 percent of employees in establishments that are smaller (Addison, Schnabel, and Wagner 1997; Beckmann, Föhr, and Kräkel 2010).} For this reason, Germany was in the position to react in an unprecedented way to the challenges of the early 1990s.
The principle of autonomy of wage bargaining is laid down in the German constitution and implies that negotiations take place without the government directly exerting influence. As such, Germany has had no statutory minimum wage imposed by the political process over the period we study. Rather, an elaborate system of wage floors is negotiated periodically between trade unions and employer associations, typically at the industry and regional level.

This model of industrial relations has been very successful in Germany, where negotiation with unions and participation of work councils in decision-making processes are widely regarded as an important cornerstone in furthering common interests and even improving productivity. As a consequence, negotiations are usually far more consensus-based and less confrontational than in other countries. For example, Germany lost on average 11 days of work each year per 1,000 employees by strikes and lock-outs between 1991 and 1999, but only five days per 1,000 employees between 2000 and 2007. These figures for the earlier and later time period compare to 40 and 32 days per 1,000 employees in the United States, 30 and 30 days in the United Kingdom, 73 and 103 days in France, 158 and 93 days in Italy, and 220 and 164 days in Canada (Lesch 2009).

Germany’s culture of common interest is dissimilar to the view about worker representations commonly held in the United States. A recent US example is the attempt of the management of the German company Volkswagen to introduce a works council at its Chattanooga plant in Tennessee. While the participation of works councils in management decisions is considered by Volkswagen as a cornerstone of successful firm policy that helps furthering common interests, Tennessee Governor Bill Haslam has been outspoken in opposing any union formation at the plant, fearing that it endangers the state’s effort to attract investment (Greenhouse 2013). A key difference between US and German labor market institutions lies in the fact that a works council in Germany elected by the employees does not have to be a union representative (although in practice the majority of works councils are union representatives), while the installation of a works council in a US firm automatically involves the firm becoming unionized. Thus, works councils in Germany may act in greater independence from a union if the survival of their firm is at stake.

**Unions and Employer Associations**

In Germany, contractual agreements between unions and employer associations are negotiated either on the region-industry level or on the firm level. In addition to wages, working time regulations are an important component of the negotiations.

A distinguishing feature from US labor market institutions is that the recognition of trade unions in Germany is at the discretion of the firm, and union contracts cover only the workers in firms that recognize the relevant sectoral wage bargaining (union) contract—regardless of whether the worker is a union member (for discussion, see OECD 2004; Dustmann and Schoenberg 2009; Fitzenberger, Kohn, and Lembcke 2013). Also, German firms that once recognized the union contracts can later opt out at their own discretion. Even within union wage contracts negotiated at the industry level, there is scope for wage flexibility at the firm level through
so-called “opening” or “hardship” clauses, provided that workers’ representatives agree (for example, Hassel 1999; Hassel and Rehder 2001; Carlin and Soskice 2009; Brändle, Heinbach, and Meier 2011; Bispinck, Dribbusch, and Schulten 2010). After opting out of a collective agreement, firms still have to pay wages for the incumbent employees according to the collective agreement until a new agreement at the firm level has been reached, but they do not have to honor new negotiated wage increases and the firm need not follow the old collective agreements for new hires. Thus, over time a firm may be able to lower wage costs considerably by opting out of the union contract—provided its employees accepted this.

After 1995, there was indeed a dramatic decline in union coverage in Germany. This decline is almost entirely driven by a decline in industry-wide agreements. From 1995 to 2008, the share of employees covered by industry-wide agreements fell from 75 to 56 percent, while the share covered by firm-level agreements fell from 10.5 to 9 percent. The percentage of German workers that were not covered by an agreement in 1995–1997 was highest in the tradable services (22 percent), as compared to tradable manufacturing (9.8 percent) and nontradables (12 percent). By 2006–2007, noncoverage had sharply increased in all three sectors to 40, 27, and 32 percent in the tradable services, manufacturing, and nontradables respectively, and this share continued to rise. By 2010, according to the German Structure of Earnings Survey, 41 percent of all employees in firms with at least 10 employees in the sectors Manufacturing, Mining, and Services are not covered by any collective wage agreement (StaBu 2013).

Has this decrease in union coverage rates contributed to a reduction in wage growth and to an increase in inequality? We investigate this question in Figure 5, where we plot the observed changes in log real wages between 1995 and 2008 along the wage distribution. We also plot the counterfactual changes that would have occurred if unionization rates had remained at the same level as in 1995, using the reweighting approach developed in DiNardo, Fortin, and Lemieux (1996), which essentially reweights wages observed in 2008 with the odds-ratio that a worker with specific observed characteristics has been observed in the 2008-coverage-status in 1995 versus being observed in the 2008-coverage-status in 2008. Notice that this constructed counterfactual exercise is by no means “causal,” among other reasons because it ignores general equilibrium effects of de-unionization. The figure suggests that Germany’s wages in 2008 would have been higher if union coverage had remained the same as in 1995 throughout the entire wage distribution, but the difference is particularly large at the lower end of the wage distribution.

**Works Councils and Opening Clauses**

Wage inequality has also increased strongly among employees covered by union contracts, thus suggesting that the German system of industrial relations has allowed for wage adjustments even within the unionized sector. This pattern is illustrated in

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8 See Data Appendix A and Table A3 in Appendix C, available online with the paper at http://e-jep.org.
Figure 6, where we show the evolution of the 15th, 50th, and 85th percentile of the wage distributions, indexed at 0 in 1995, for those covered by a union (panel A) and uncovered by a union (panel B) sectors. The figure shows that wage inequality rose strongly in the covered sector both at the bottom and the top of the wage distribution, while in the uncovered sector it remained basically constant at the bottom of the wage distribution and only increased at the top of the wage distribution. However, notice that due to the indexation the figures hide the larger differentials in wage levels at specific percentiles in the uncovered sector relative to the covered sector: While the 85–50th and 50–15th differentials were on average 0.4 and 0.34 in the covered sector between 1995 and 2008, they were about 0.5 in the uncovered sector. Thus, three factors contributed to the rise in overall inequality during the time period under consideration, namely, the shift of workers from the covered to the uncovered sector (which led, due to the larger differences in wage levels in the uncovered sector, to an increase in lower tail inequality), the increase in inequality in the covered sector, and the increase in inequality at the top of the wage distribution in the uncovered sector.

Notes: The figure shows the observed wage growth by percentile between 1995 and 2008, as well as the counterfactual wage growth which would have prevailed if the share of workers covered either by industry-wide or firm-wide agreements had remained at its 1995 level. The counterfactual wage distribution is computed using the reweighting approach developed by DiNardo, Fortin, and Lemieux (1996). Calculations are based in the LIAB.
Figure 6

Notes: Calculations based on LIAB Sample for West German Full-Time Workers between 20 and 60 years of age. The figure shows the indexed (log) real wage growth of the 15th, 50th, and 85th percentiles of the wage distribution, with 1995 as the base year. Nominal wages are deflated using the consumer price index (1995 = 100) provided by the German Federal Statistical Office.
We think that the change in wage inequality in the covered sector is due to the decentralization of wage setting since the beginning of the 1990s, when industry-level collective bargaining came under increasing pressure from employers who demanded more firm-specific and differentiated regulations. Works councils accommodated this decentralization to secure jobs in Germany, which also strengthened their role in the industrial relations. As another response, the trade unions and employers' associations agreed on an increasing number of “opening clauses” in industry-level collective agreements. Opening clauses allow firms to deviate from collectively agreed industry-wide standards. At first, these opening clauses focused on hours of work, but later they also affected wages. Also, the opening clauses were initially only temporary to avoid bankruptcy, but later they were also implemented to ensure competitiveness in more general terms. Firms that use opening clauses negotiate the details concerning pay and working time agreements with the works council. Under German law, firms without a works council cannot use opening clauses, but such firms may instead decide to stop recognizing a union contract. Firms with a works council not covered by a union contract may reach an agreement on wages with the works council.

Brändle, Heinbach, and Meier (2011, Figure 1) report that opening clauses for wages only started to gain importance in 1995 (opening clauses regarding hours of work had existed before 1995). Among industry-wide collective contracts in manufacturing, less than 5 percent involved opening clauses for wages in 1995, but this had risen to about 60 percent in 2004. According to a survey of works councils in 2005, about 75 percent of all firms with collective agreements use opening clauses (Bispinck 2007; Bispinck, Dribusch, and Schulten 2010).

To summarize, the specific governance structure of the German system of industrial relations allowed for an unprecedented increase in the decentralization of the wage setting process, leading to a decrease in real wages, in particular at the lower end of the wage distribution. This was driven by two main developments: 1) a sharp decline in the share of workers covered by union agreements; and 2) an increase in opening clauses that strengthened the role of firm-based works councils in wage determination relative to trade unions. This argument is consistent with the finding that the rise in firm-level differences in wages contributes strongly to the rise in wage inequality in Germany (Antonczyk, Fitzenberger, and Sommerfeld 2010; Card, Heining, and Kline 2013).

**What Led to Greater Flexibility in the German Labor Market?**

Why were wage restraints and decreasing real wages at the lower end of the wage distribution in Germany possible after the mid 1990s but not before? After all, German firms have always had the option not to recognize a union contract and to pay wages below the union wage, provided their employees accepted this. Opening clauses had been possible before the mid 1990s. Our answer traces to the major changes in Germany’s economy in the early 1990s related to the
reunification of Germany and the opening up of the nearby central and eastern European economies.

On one hand, the extraordinary cost of German unification burdened the German economy in an unprecedented way, which is partly responsible for Germany’s dismal performance throughout the 1990s and early 2000s. The German Council of Economic Experts (SVR 2004, table 100, p. 644) estimates net transfers of about 900 billion euros from former West Germany to East Germany during the time period 1991 to 2003. The total sum of net transfers corresponds to about half of one year’s GDP in Germany during that time period. On the other hand, the opening of central and eastern European countries constituted a unique opportunity for German industry to move production abroad. They offered a stable investment climate, as well as (despite being locked away for several decades behind the Iron Curtain) a long history of trade and interaction with Germany. The structure of industry and education systems, for instance, shared many similarities, which survived the Soviet era. Vocational training plays a key role in the education system, in a way similar to Germany, in countries like Hungary or Poland. German was also widely spoken in parts of Central and Eastern Europe. At the same time, wages in these countries were far lower than in Germany, and working regulations more flexible (for example, Geishecker 2006; Marin 2006). Moving production abroad to these countries took place at a moderate pace: for example, the stock of German foreign direct investment to Poland, Hungary, as well as the Czech and the Slovak Republics amounted to about 1 percent of German GDP in 2000 and about 2.3 percent in 2010 (according to our calculations and data from http://stats.oecd.org/Index.aspx?DatasetCode=FDI_POSITION_PARTNER). However, the possibility that German firms might relocate production to these low-wage countries was very credible, and widely discussed in public (among German media outlets, see the articles in DIHK 2003; Mihm and Knop 2004; Hawranek, Hornig, and Jung 2004).

The fiscal burden of German reunification, coupled with an immediately more competitive global environment, made it increasingly costly for German firms to pay high union wages. The new opportunities to move production abroad, while remaining still nearby, changed the power equilibrium between trade unions and employer federations, and forced unions and/or works councils to accept deviations from industry-wide agreements which often resulted in lower wages for workers. In a similar vein, Burda (2000) predicted that the EU-accession of Eastern European countries would foster a reduction of labor market rigidities in the old EU member countries (including Germany). Germany’s unions and works councils realized that they had to make concessions in order not to be further marginalized, and the specific characteristics of the German system of industrial institutions allowed the trade unions to adapt to the new economic realities and to make these concessions. As a result, the German labor market appeared to be far more flexible than many would ever have expected.

Why did other continental European countries not react in the same way as Germany? One important reason is that the particularly difficult economic situation in which Germany found itself in the early 1990s was to a large part specific to
Germany, due to the reunification of Germany, which was not felt in other European countries. This was reinforced by Germany’s geographic vicinity to the countries of central and eastern Europe, which gave Germany an early taste of the challenges of globalization. This decade of economic stagnation and hardship, when Germany was the “sick man of Europe,” prepared the population for accepting agreements for the sake of economic growth, which saw inequality rise dramatically for the first time in the after-war period.

In addition, the system of industrial relations in other continental European countries does not allow for the same inherent opportunities of flexible adaptation as the German system. For example, in countries like France and Italy, union wages are often bargained at the national level and apply to all firms in the economy, regardless of whether the firm explicitly recognizes the union contract. Coverage by union wage contracts has remained remarkably stable at very high levels at about 90 percent in France and 80 percent in Italy during the 1990s and the 2000s (OECD 2004, 2012; Visser 2013). Furthermore, in contrast to Germany, union wage contracts are typically extended to all workers in an industry (OECD 2004, table 3.4, p. 148; Visser 2013, table 4, pp. 96–98). In these and other continental European countries, adding flexibility into collective agreements would require political reforms at the national level. More generally, many of the regulations which are determined by labor contracts in Germany are either legally enforced in other countries (such as the minimum wage in France) or nationally implemented (for example, union agreements extend to all firms in the economy), and therefore require consent on a much higher level (nationally, or even on the political level) to be modified and changed. There is much less scope in these countries for a decentralization of wage setting (and other aspects of working conditions) within their system of industrial relations.

In general, the decentralization of union agreements is certainly being discussed more widely across Europe, but whether or when such changes might occur more widely remains uncertain.

**Discussion and Outlook**

We have argued that the remarkable transformation of the German economy from the “sick man of Europe” to a lean and highly competitive economy within little more than a decade is rooted in the inherent flexibility of the German system of industrial relations. This system allowed German industry to react appropriately and flexibly over time to the demands of German unification, and the global challenges of a new world economy. However, this intrinsic flexibility became only evident under the extraordinary difficult economic circumstances and the extreme duress in which Germany found itself in the decade after reunification. How does our thesis fit with two other possible explanations for Germany’s increased competitiveness: Germany’s Hartz labor market reforms of 2003, or the changes brought about by the adoption of the euro?
Germany’s government under Gerhard Schröder implemented the so-called “Hartz Reforms” to the labor markets in 2003, which are often credited for spurring Germany’s economy (for example, Rinne and Zimmermann 2012, 2013; see Fitzenberger 2009 for a critical assessment of the Hartz Reforms). These reforms were extremely controversial at the time. They reduced and limited the benefits while unemployed, liberalized agency work, reformed “active” labor market policies, and reorganized the Federal Labor Agency, but did not make any institutional changes in the wage setting process.

The Hartz reforms were implemented starting in 2003, hence nearly a decade after the process of wage decentralization and the improvement in competitiveness had begun in Germany. It seems plausible that the changes already underway in Germany’s labor markets helped in preparing the political ground for the Hartz reforms. In addition, as the enumeration of the main components of the reforms makes clear, the scale of the reforms is modest enough that they seem unlikely to have triggered the dramatic increase in competitiveness or the enormous drop in German unemployment or to have led Germany’s labor market through the deep recession in 2008–2009. Further, while the focus of the reforms was on creating incentives for seeking employment, they did little to support the remarkable wage restraint witnessed since the mid 1990s, which is the key factor in explaining the gain in competitiveness.

We therefore believe that while the Hartz reforms have contributed to the recent decline in long-term unemployment and to the continued increase in wage inequality at the lower end of the wage distribution, they were not central or essential in the process of improving the competitiveness of German industry. Moreover, although one sometimes hears the argument that other continental European countries should muster the political will to adopt their own version of the Hartz reforms, we believe that such a recommendation may be misleading. In our view, the specific governance structure of the German system of industrial relations—activated under extreme duress—is what paved the way for the remarkable decentralization of wage determination from the industry level to the level of the single firm or single worker, and which together with a significant increase in productivity ultimately improved Germany’s competitiveness. Whether the political process would have been able to achieve a similar degree of wage decentralization, had the autonomy of wage bargaining not existed in Germany, is doubtful. In our view, the policy recommendation from Germany for the rest of continental Europe should not be the Hartz reforms (the advice given often by policymakers, as in a February 2013 speech by German Chancellor Angela Merkel reported in de Weck 2013), but reforms that would target the system of industrial relations by decentralizing bargaining to the firm level while keeping workers’ representatives involved to secure that employees benefit again when economic conditions improve.

Some argue that the adoption of the common European currency is a main factor that has helped Germany to improve competitiveness. Again, we believe that the arrival of the euro may have been a contributing factor, but not the main one.
First, recall that Germany was shifting its labor market institutions and improving its competitiveness during the mid 1990s, and the euro did not start until 1999. Second, within the common currency area, and after 2001, Germany continued to gain competitiveness with respect to its main trading partners such as Italy and Spain. Third, the euro has persistently appreciated against the US dollar, leading to the increase in competitiveness of the United States as we illustrated in Figure 1. It seems unlikely that Germany’s deutschmark (if the euro had not been introduced) would have appreciated much more against the dollar than the euro has, at least not before the start of the global financial crisis around 2008 and the ongoing European debt crisis. Finally, it is not clear whether an appreciation of a German currency (which probably would not have taken place before 2008) would have had a dramatic impact on Germany’s overall competitiveness at least in the medium-term, because it would also have made imported inputs less costly and it would possibly have fostered even stronger labor market adjustments of the type we have described above. For example, the depreciation of the British pound by nearly 30 percent in 2008–2009 has done little to help UK manufacturing exports.

Of course, the existence of the common euro currency area raises a number of issues for countries within the eurozone. Without the possibility to depreciate national currencies, the only way for countries like France, Italy, and Spain to gain competitiveness relative to other countries of the eurozone is to reduce unit labor costs—that is, by increasing productivity relative to real wages. Whether these countries will succeed in this endeavor remains an open question. The more centralized and legally anchored nature of their labor market institutions, in comparison to Germany, does put them at a disadvantage in making such an adaptation. Boeri (2011) provides an assessment of the political economy of labor market reforms with a particular focus on countries of southern Europe. He argues that the political process often allows only for two-tier reforms (affecting only a subset of all employees) instead of complete reforms, which may not result in an increase of competitiveness.

The rise in inequality in Germany has led to an intensive debate about its social consequences, and its effect on poverty and social justice. For example, recent negotiations between employers and employee associations in Germany suggest that future wage settlements will try to make up for the loss in real wages many workers experienced in recent decades. It is also likely that certain aspects of labor and wage regulations will in the future be “put in legislative stone.” As one example, the new coalition government in Germany will introduce a nationally legislated minimum wage. Thus, the possibility for Germany to rely on its system of industrial relations to improve its competitive position by having a decentralized decision making process may be cut back, and this may restrict Germany’s ability to react in similar ways to future economic challenges. If that occurs, then future gains in German competitiveness will need to be accomplished rather through increases in productivity that outstrip wage increases. This pattern may help to bring convergence in the competitiveness of the countries in the eurozone.
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Chap 10: A transnational democracy towards a functioning governance

Key issue: We cover the debate about the lack of democratic legitimacy of European institutions and the existing initiatives for a better political governance.


CHAPTER 5

DEMOCRATIC LEGITIMACY AND INTERNATIONAL INSTITUTIONS

THOMAS CHRISTIANO*

I. Introduction

In assessing proposals for international democracy we will need to make a distinction between democracy in the sense of a set of political institutions and processes and democratic values in the sense of those values that underpin democratic institutions and processes. With the help of the underlying values, I argue, we can arrive at an assessment of the worth of democratic institutions at the global level. I will discuss two kinds of institutional system that might be thought to have democratic legitimacy: one based on the idea of a fair voluntary association of democratic states and the other based on global democratic institutions in a unified form as in proposals for a global democratic assembly. I will assess these institutions on the basis of the values I take to underpin voluntary association and democracy in the domestic setting.

I start with some brief remarks about legitimacy and the basis of what I call inherent legitimacy followed by an idealized version of the system of international institutions we already have. I examine some of the principal objections to such a system framing them within my conception of public equality. I defend what

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I call the system of Fair Democratic Association. I then discuss whether or not a case can be made for global democracy. I argue that even as an ideal, the case cannot be made. I argue tentatively that the system of democratic association is superior to international democracy. I conclude with some remarks on whether or not legitimacy can be attributed to current international institutions, at least from a broadly democratic standpoint.

The results of this study are inevitably quite messy since we are dealing with the fast-changing and polymorphous arrangements of the global order and there is so much disagreement about how it works. This is an attempt to impose some order on our understanding of international institutions while at the same time respecting the complexity of the system.

**II. The Concept of Legitimacy**

The principles that underpin democracy are primarily concerned with the grounding of inherently legitimate political institutions. In the case of the nation-state, the theory of democracy is normally meant to give us an account of legitimate political institutions. The role of considerations of inherent political legitimacy is to define a fair system of collective decision-making when there is disagreement on the substance of the decisions and fundamental interests are at stake. It answers the question: by what right has this decision been made and imposed on all? It determines who has the right to make certain decisions. If a system of decision-making is legitimate then the decisions become legitimate as well (within some clearly defined limits). Members then have content-independent reasons to go along with decisions even if they think them unjust. These reasons are grounded in the right of the legitimate decision maker.

Instrumental legitimacy grounds content-independent reasons in the fact that one is likely to do better by the reasons that apply to one independent of the decision maker by following the directives of the decision maker. This kind of legitimacy is weaker because it tends to be piecemeal and its hold varies from person to person.

A conception of legitimacy only lays down some constraints on how one may pursue justice in the international realm but it does not define justice or morality in its entirety for that realm.

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III. A Provisional Account of the Basis of Political Legitimacy

The basic idea behind the democratic conception of legitimacy is that legitimacy is a property of institutions publicly committed to the equal advancement of the interests of the persons who are affected by those institutions. This idea is based on two notions: the principle of equal advancement of interests, which is a morally cosmopolitan principle; and the requirement of publicity, which attaches to the principle once it is implemented in actual political and economic institutions. The principle of equal advancement of interests has two aspects worth bringing out: it directs us to advance the good of all persons and it constrains the pursuit of the common good by equality.\footnote{I defend this principle in ‘A Foundation for Egalitarianism’, in Holtug, N. and Lippert-Rasmussen, K. (eds.), \textit{Egalitarianism: New Essays on the Nature and Value of Equality} (Oxford: Oxford University Press, 2007), 41. Equality of advancement of interests is not as demanding as one might at first think. The institutionalist idea that the domestic institutions of a society matter a great deal to the advancement of the interests of the members combined with the idea that outsiders can do little to reform one’s institutions, suggest that equality implies mostly that one must help others escape severe poverty and disease.} Public equality implies that people can see that they are being treated as equals in the operation of the institutions even if they do not always accept the outcomes of the decision-making process. The public realization of equality is required when we try to establish justice among persons in a system of rules and institutions.

In the modern state, democratic institutions are legitimate to the extent that and because they publicly realize the equal advancement of the interests of the members of the society. Democracy is a way of publicly realizing equality when persons who have diverse interests and backgrounds need to establish rules and institutions for the common world in which they live. There is substantial disagreement on how the common world should be shaped. The diverse interests and backgrounds make persons cognitively biased towards their interests and backgrounds in the judgments they form about how to accommodate the interests of all others in a common system of institutions. And persons have interests in living in a world that makes sense to them. Consequently, persons have fundamental interests in participating in shaping the world they live in. Democracy is a way to advance the fundamental interests of all persons in a publicly equal way. In the context of biased disagreement the only way to treat persons as equals so that all can see that they are treated as equals is to give each an equal say in the shaping of the shared institutions they live under. To the extent that democracy realizes public equality, a democratic assembly has a right to rule in the sense that persons have strong reasons to go along with the decision.
just because it was democratically made and despite the fact that they might disagree
with the content of the decision. The reasons to comply are grounded in the pooled
rights of all persons to have a say in shaping the common world they live in.\footnote{3}

This idea of legitimacy as public equality is a defensible way to think about
struggles over the legitimacy of international institutions and law. The principal
type of criticism of institutional legitimacy in the international realm is that the
institution unfairly favours the interests of certain individuals or groups over others.
In particular, the interests of the members of the wealthy and powerful states prevail
over the interests of individuals in the rest of the world. They publicly treat the
interests of the members of the developing world as having less importance than
the interests of the members of the developed world.

Because democracy is the best realization of public equality in the domestic
context it is natural to think that democracy is the best way to realize public
equality in the international context. The application of the idea of legitimacy to
international institutions and law is difficult and uncertain. There are two basic
models of the legitimacy of institutions in modern democratic societies: one is the
democratic model; the other is the model of institutions as voluntary associations. I
want to explore both of these and mixtures of these as possible models of legitimate
international institutions. I will start with the voluntary association model.

IV. The Voluntary Association Model
of International Institutions

A plausible interpretation of the principles that underpin the current system is a
modified version of the traditional state consent model. Call it the \textit{voluntary associ-
ation model} of the international system. It says that the legitimacy of international
institutions and law derives from the fact that the system of international law and
institutions is a system of voluntary association among states.

The idea that international society is a voluntary association of states seems to
animate the traditional view that state consent is the main source of international
law; but it permits that some propositions of international law are valid even though
not consented to because they support a system of free association among states.

1. Some laws and institutions may be structural—or causal—prerequisites to
making the system one of voluntary association. The principle that agreements
must be performed, the norm against aggressive war, and the concern for
preserving international borders are prerequisites of this nature.

\footnote{3} See Christiano, T., ‘The Authority of Democracy’, \textit{Journal of Political Philosophy} (Sept. 2004); and
Press, 2008).
2. Some laws are necessary for the stability of such a system. That peace treaties imposed on defeated aggressors are valid can be seen to be a necessary component of a peaceful international order that respects voluntary association.

3. Some laws may specify internally grounded limits to voluntary association. The *jus cogens* norms against slavery, genocide, and aggressive war are connected with voluntary association because they are grounded in the values that underpin voluntary association.

Even customary international law can be seen as respecting a kind of tacit consent. It is a generally understood principle that a state will not be bound by a proposition of customary international law if it has made persistent and clear objections to it when it arose and that it will be bound if it has made no such objections.\(^4\) The tacit consent principle in the international context does not presuppose the authority of the candidate proposition of law over the entity whose consent is asked for, unlike the case of tacit consent to the authority of the state.\(^5\)

Finally, it is important to note that the voluntary association model is compatible with the fact that some international organizations enjoy some independence from the states that create them. The capacities of some organizations to adjudicate disputes among states, and to make the rules created by states more precise in the process, are certainly compatible with claiming that the capabilities of some organizations exist at the pleasure of the states. The capacities of organizations to make soft law and to propose hard law are also compatible with this claim. Indeed, the very limited capacities of organizations to make hard law are compatible with this model as long as states have a right to exit. In general though, even the most advanced international organizations do not allow very much in the way of making hard law without the participation of all the states that are subject to it. And in the exceptional cases where only a qualified majority is required, the most powerful states have real veto power.

V. SOME GROUNDS AND LIMITS TO THE VOLUNTARY ASSOCIATION OF STATES AS A BASIS OF LEGITIMACY OF INTERNATIONAL LAW

States should have the principal say in the making of international law. If states do not have a say and they do not want to do something, the rules of the international


system simply won’t be observed except by accident since the international system relies on their cooperation. This reason is grounded in a concern for the stability of the system of international law and organization since states are by far the most powerful players in the international system.

The moral foundation of the voluntary association model of legitimate international institutions and law consists in the importance of states to the advancement of the interests of persons. The state and, more particularly, the modern democratic state is an extremely sophisticated system for the identification and advancement of the interests of a very broad proportion of its population. It is important to understand that this is a comparative claim; the modern democratic state is far from what we want it to be. In comparison with other institutions, it is relatively successful.

The voluntary association model also suggests a very weak kind of equality among persons in the advancement of the interests of persons. Because states have equal rights of exit and entry there is a sense in which the interests of persons are being given a kind of equal weight by the system in a way that is publicly clear to the persons in the system. This will give rise to many objections but it is important to see that the equality of states could be thought to provide some kind of weakly egalitarian protection for the interests of all persons.

Now we can see why the *jus cogens* norms against genocide, slavery, torture, and some forms of radical discrimination make sense within the voluntary association conception of the international system. States that engage in these practices cannot be said to be representing the interests of their members, and so the point of voluntary association seems to be clearly defeated in the cases of states violating these *jus cogens* norms.

### VI. The Representativeness Problem

There is a natural objection to the voluntary association model of international legitimacy: the consent and lack of consent of some states does not reflect the interests of most people in those states. As a consequence, numerous individuals’ interests are not being considered in the making of international law and institutions. The *representativeness problem* comes in three variants: the authoritarian variant, the minority variant, and the secrecy variant.

The first is that many states are not democratic, or not very democratic, and so they do not even represent their majority populations very well. Generally, democratic states are likely to represent their populations reasonably well and so the states’ interests are going to be closely connected with the interests of a substantial proportion of their populations. When a democratic state agrees to undertake a duty or burden, it is doing so with the agreement of a significant proportion
of the people on whom the burden is ultimately imposed. The question is: if a state is non-democratic, do its decisions adequately reflect the significance of the duties to and burdens imposed on its population? The answer is not a simple one. Clearly non-democratic states have to be responsive to the interests of some of their populations. But in general there is reason to think that they will be much less responsive to their populations than are democratic states.6

The second representativeness problem is that even democratic states do not always represent their minorities very well, in particular indigenous peoples and insular minorities. And this could amount to a significant proportion of the world’s population.

The third source of under-representation is the fact that states have traditionally invested foreign-policy making powers in their executive branches.7 Traditionally, the branch of government most responsible for relations with other states has been the executive branch. And the exercise of its foreign policy functions has been relatively non-democratic. Such functions often occur in secret and it is often the case that citizens in democratic societies have paid less attention to foreign affairs than to domestic affairs. But now international law is expanding into the areas of trade, the environment, and human rights. And international law demands more and more reform of the internal institutions of societies. The consequence of this is that if the voluntary association model is to have any chance at being a reasonable source of legitimacy, the foreign policies of states must become more democratic.

**VII. Hard Bargaining**

The most serious problem of the voluntary association model is that it seems to allow for all forms of hard bargaining, which may not be coercive in a strict sense but allows for a great deal of unfairness. The basic idea of hard bargaining is that two states may arrive at an agreement whose benefits are highly asymmetric between those states because one state is credibly able to threaten withdrawal from the arrangement while the other is not. The development of trade law provides an instructive example. Regarding many goods, the US is capable of dictating terms of trade that are highly favourable to itself or at least to its domestic industries and exporting industries because the relative market share of the US economy is so great and the market share of many developing countries so small. It can lay down terms

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6 There is a very large literature defending this proposition, see esp. Przeworski, A., et al., *Democracy and Development* (Cambridge: Cambridge University Press, 2000).

and say to the developing country 'take it or leave it'. And this also holds true for the European Union and some other economies.\(^8\)

To secure terms of trade that are highly asymmetrically in one’s favour through the more credible threat of withdrawal, particularly against a society in dire need, seems to be a fundamental violation of norms of fair exchange. Though the agreement is voluntary there is something highly problematic about it morally.

And this impression is borne out when we think in terms of the underlying principles of the voluntary association model. It seems clear that the asymmetric outcomes, due to hard bargaining, violate an intuitive sense that the interests of all are being advanced equally. The interests of those in the developing country seem to be relatively neglected for the benefit of those of the developed country. Let us call this the problem of asymmetrical bargaining. Asymmetrical bargaining has been by far the most serious objection to the claim of international institutions to legitimacy. Complaints about the Security Council, the International Monetary Fund (IMF), the World Bank, and the World Trade Organization (WTO) are all instances of this phenomenon.\(^9\)

It should be noted that asymmetric bargaining need not be motivated by self-interest alone. The terms the IMF imposes on countries seeking relief may often be the result of well-meaning policies in accordance with neo-liberal political economy. But the fact that the countries seeking relief are in such dire need makes them capitulate quickly to the IMF demands without having much of a say in determining the terms of the loans. It is the position of asymmetric bargaining that enables the IMF to impose terms without taking into account the opinions of the society in need. This must be regarded by all as a violation of the principle that people should have some say in the things that deeply affect their lives.\(^10\)

**VIII. Fair Democratic Association**

If we take into account the above worries about the current system of voluntary association, we can give an abstract description of what it would have to be like to be


\(^10\) This is one of the key complaints of dissident economists concerning the IMF. See Stiglitz, J., *Globalization and Its Discontents* (New York: Norton Publishers, 2002) as one example among many.
a minimally legitimate system of decision making. It would have to be a fair system of voluntary association among highly representative states. I will call this a system of fair democratic association.

The representativeness problem (in all of its variations) is theoretically and partially soluble. First, one can push states to become democratic or more democratic. This has become an increasingly widespread norm in the last twenty five years.11 Second, one can insist that the foreign policy establishments of states become more transparent and more democratically controlled and that the negotiations among states as well as the institutions that arise from them be made more transparent.12 Third, one can set up special consultative or representative bodies for indigenous peoples and insular minorities in the different democratic states. At least, these are all reforms with which societies have had some experience in the past.

The representativeness problem has not been solved in practice yet. Though election monitoring has become a common norm in the international arena there are serious questions as to its effectiveness in advancing genuinely democratic values.13

The problem of asymmetrical bargaining is much harder to get a handle on. But it should be noted first that there are some mitigating factors here. First, less powerful states can group together and attempt to bargain collectively and thereby acquire more leverage over the larger economies. This is now being tried in the case of the WTO and it will take some time before we know that the collections of smaller states can actually achieve a greater degree of symmetry in defining trade law. The question is whether or not this will lead to agreement.14 Second, wealthy states may not be exclusively self-interested in their foreign policies. Developed countries have allowed developing countries to delay setting up policies to reduce carbon emissions in the Kyoto protocol; the WTO permits trading preferences to developing countries; and there is a large, influential body of opinion in the developed countries in favour of bringing down agricultural barriers in the developed countries that have been thought to harm developing countries.15 These are modest achievements, but they do give some credibility to the hope that wealthy countries will not merely press for their own interests even to the detriment of developing countries. Third,

13 See Hyde, S., Observing Norms: Explaining the Causes and Consequences of Internationally Monitored Elections, PhD thesis (University of California, San Diego, 2006) for scepticism about the association of the recent increase in election monitoring and genuine democracy.
15 See Franck, T., Fairness in International Law and Institutions (above, n. 11), 58–9, 426–7 for a discussion of these trading preferences.
relative market share is not the sole determinant of bargaining power even when coalitions do not form. Nationalistic sentiment sometimes increases the bargaining position of small, poor states. Fourth, a world in which there is more than one large society to negotiate with can give small and poor states alternatives that enhance their bargaining positions.\footnote{See the essays in Zartman, I. W., and Rubin, J. Z. (eds.), \textit{Power and Negotiation} (Ann Arbor: University of Michigan Press, 2000); and Ingebritsen, C., Neumann, I. B., Gstohl, S., and Beyer, J. (eds.), \textit{Small States In International Relations} (Seattle, Wash.: University of Washington Press, 2006).}

Still the problem of asymmetric bargaining is a large one, and it is hard to see how this problem can be avoided. There are really two main ways in which asymmetric bargaining can be held in check. First, the playing field can be levelled by greatly diminishing the economic inequalities among the parties. Second, establishing independent standards of fairness in the process of forming agreements, which are then implemented in international agreements.

But the level playing field condition seems to require something that has eluded the international community for a long time. Not only is it not clear that the international community has succeeded in lessening inequality or even severe poverty among persons and among societies, it may have exacerbated one or both of these. When nearly 20 per cent of the world’s population lives in extreme poverty and when nearly 40 per cent of the world’s population lives in severe poverty and these populations are concentrated in particular political societies, it is hard to see how we are going to be able to set up a scheme of fair bargaining. These populations are extremely vulnerable to deeply unfair terms of association.\footnote{For contrasting perspectives, see Wade, R., ‘Is globalization reducing poverty and inequality?’, \textit{World Development}, 32 (2004), 567; and Chen, S., and Ravallion, M., ‘How have the World’s Poorest Fared Since the Early 1980’s?’, \textit{World Bank Research Observer}, 19 (2004), 141.}

On the other hand, overcoming the bargaining problem by setting outcome standards on the results of bargaining and having them implemented by international institutions would require that the results of bargaining live up to certain standards. This seems to give up on inherent legitimacy altogether. The problem here will be determining both who will set the standards and who will implement them.

Finally, we do not have a clear normative principle for the evaluation of the fairness of the system of international negotiations. A rough standard is that power in the process of negotiation should be roughly proportionate to the stake each society has in it, where the stake is a function of population size as well as the populations’ relative need for agreement. But these are very rough standards that call for significant theoretical elaboration and justification.

Nevertheless, if the agreements among states come about by a process of fair association among democratic states, they can satisfy the basic constraint of public equality. All persons are publicly treated as equals by the process that generates
these agreements. As a consequence, states have reasons to conform to treaties that are grounded in public equality. And since the grounding is in the process of coming to agreement, the reason generated is a content-independent one. Furthermore, citizens of those states have content-independent reasons, founded in the fact that the agreements are reached through an egalitarian process, to act in accordance with the provisions of the treaty and the institutional implications of the treaty. And since the requirement of public equality is a weighty requirement, the reasons generated are weighty reasons, normally outweighing contrary reasons.

My guess is that in the absence of much greater collective bargaining power on the part of developing countries or greater economic equality among societies, the system of voluntary association cannot be made legitimate. It simply cannot be seen as advancing the interests of the persons in the global order equally.

IX. Democracy as a Basis of Legitimacy of International Law

With these worries about the legitimacy of the current system of decision making in mind it is time to take a look at some proposals for democratic decision making that have been made for the international system. My focus here must be limited to the aspiration to have a global peoples’ assembly or parliament with representatives of constituencies of individuals making up the parliament, which has legislative powers. This need not involve a world state and could be connected with a federal structure of institutions. Though this institution would have formal and legal status it must be contrasted with something like the General Assembly of the United Nations in which a majority of states participates (though of course they do not have legislative power).

I emphasize the formal and legal character of the basis of democratic legitimacy due to the importance of publicity to legitimacy. It seems to me that people can see that they are being treated as equals by institutions only if these institutions have an egalitarian formal and legal character. Informally, democratic arrangements are likely to be far more opaque to their participants in terms of whether or not they realize equality, especially on a large scale.

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19 See, in contrast, Dryzek, J., Deliberative Global Politics (Cambridge: Polity Press, 2006) for a conception of democracy that de-emphasizes the formal and legal character of democracy.
X. Conditions of Intrinsic Justification of Democracy

I sketched a justification for democracy grounded in the principle of public equality in section II. But democracy can be used to realize public equality only under certain conditions. The conditions under which democracy is intrinsically justified for a community are the following:

1. A number of important issues must arise for the whole community.
2. There must be a rough equality of stakes among persons in the community concerning the whole package of issues.
3. It must not be the case that the community is divided into discrete and insular groups with distinct preferences over all the issues in the community so that one or more substantial groups always lose out in majority voting. In other words there should not be persistent minorities.
4. Democracy is justified only when it protects at least the fundamental human rights of all the persons in the community.
5. Democracy is justified when the issues with which it deals are not primarily of a purely scientific or technical character.
6. A final institutional condition for the justification of democracy is that there be a dense network of institutions of civil society that connect individuals to the activities of the democratic legislative power. A system of political parties, interest group associations, and other types of associations are necessary to give ordinary citizens an orientation among the vast array of issues that arise in a democratic polity.

XI. Interdependence and Equality of Stake

The first two conditions must be taken together. There must be an interdependence of interests among persons or groups on many issues. Since democratic decisions must be taken by majority rule, it is important that there be many issues so that
those who come up losers on some issues be winners on others. This condition enables people to trade votes between issues that are of great importance to them and those that are of lesser importance to them.\footnote{20}

But this complex interdependence is not sufficient. There must be some kind of equality of stake in the interdependence, where by ‘stake’ I mean the susceptibility of a person’s interests or well-being to be advanced or set back by realistically possible ways of organizing the interdependent group. If one group of persons has a very large stake in a community, in which there is interdependence of interests, and another has a fairly small stake, it seems unfair to give each an equal say in decision-making over this community. We can recognize this in faculty decisions. Those who are permanent members of the faculty clearly have a much greater stake in the decisions than those who are only visiting. We do not think it is fair that everyone’s vote has the same weight in decision-making. And I think we recognize this idea in many different contexts of collective decision-making. Democratic decision-making over entities in which some have a much greater stake than others, treats unequally those who have a much greater stake. The equality of stake at issue need not be on every issue. Some persons or groups may have more at stake in one set of issues and another may have more at stake in another set of issues. The key is that, in general, people have something at stake in each decision, and each has roughly equal stake in the overall package of issues.

We see some such rough equality of stake in the case of the modern state. The citizens of a modern state usually have most of their fundamental interests at stake in the decisions of a modern state. And so there is a kind of rough equality of stake. To be sure, some individuals are only temporarily or rarely residents of the state in which they are citizens. Some are wealthy enough so that they are capable of avoiding the decisions of the state by some form of emigration. But on the whole, the modern state does involve a great degree of interdependence on matters concerning nearly all of the fundamental interests of the citizens. And so there is a rough equality of stake in its decisions. This is presumably an important reason why democracy has come to be seen as an important ideal for the modern state.\footnote{21}


\footnote{21} To be sure, equality of stake does not imply equality of outcome.
XII. Are There Equal Stakes?

Many have argued that democracy at the international level is justified because there is interdependence among persons at the global level. But this thesis is extremely vague and is rarely made more precise than this. First, how much interdependence exists at the global level? And most important, is the interdependence such that the different peoples of the world have equal stakes in it?

The problem is complicated by the fact that the answer depends on the institutional capacity of the international system. The reason why the modern state seems to be a community of roughly equal stakes is because of the immense institutional capacity of the modern state. It plays a role in nearly all the main activities that human beings engage in. The same cannot be said of the set of international laws and institutions. They play a fairly small role in the lives of people throughout the world. They do not set anything but very vague standards for education or health. They do not enter into the systems of property and exchange in domestic societies except in very abstract ways. Human rights standards are quite vague; in any case the international institutions do not have the capacities to monitor human rights very effectively and have little or no chance of getting the judgments of human rights courts implemented.22

The principal sources of global interdependence in the modern world are the expansion of international trade and communications, the effects of global environmental degradation and pollution, and the preservation of peace. The prevention of the spread of some diseases has also been an accomplishment in part of the international system. No countries are left untouched by the modern system of international trade. But the system of international trade does not reach nearly as deeply into people’s lives as most domestic systems of trade and exchange. Furthermore, the capacity of international institutions to regulate the flow of trade is still quite small. And regarding global environmental conditions: most cross-border environmental effects are regional in importance, though there are some genuinely global concerns such as that of global warming.

We cannot at the moment give a very clear answer to the question of relative stakes, but here are some indicators that suggest inequality of stakes. States do not participate equally in the process of international trade. The ratios of export to gross domestic product of economies and the ratios of foreign investment vary quite a bit

between societies. In this respect societies, and plausibly individuals, do not have equal stakes in the international system. Environmental problems are still mostly regional in character so that the extent to which people are affected by these is still quite uneven.

But there may be a general argument for why individuals do not have equal stakes in international institutions: since international institutions still cover only a relatively thin set of issues (compared to the modern state) within the global order and since individuals’ interests and circumstances are likely to be quite distinct, many individuals are not likely to have as great a stake in these issues as others. The reason for this is that in general for any particular issue, individuals’ interests and circumstances are likely to be distinct and as a consequence, individuals are not likely to have as much at stake as others within that issue space. This holds in the international order—particularly if we confine the issues to what international institutions can do about the issue, which is in general quite limited.

Peoples have very different stakes in that order and so democracy would actually be a way of treating persons unequally in that context. Hence, there is substantial reason to doubt that democracy can realize equality publicly in the international order.23

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XIII. Persistent Minorities

Another connected worry about international democracy is the problem of persistent minorities. If the issues upon which a democratic international institution makes decisions are such that discrete and insular coalitions tend to form (with some forming a majority and some forming minority blocs), then there is a significant chance that some groups will simply be left out of the decision-making process. And this leaves open the possibility that their lives will be heavily determined by strangers.

As I argued in section II, democracy is justified to the extent that it is a collective decision making process that publicly realizes the equal advancement of the interests of the persons involved. Normally, democratic decision-making is determined by majority rule—resulting in some groups being winners on some issues and other groups being winners on other issues. Though there is no clear system for making interpersonal comparisons, as long as there is sufficient rotation among winners and losers, the system is reasonably fair. But sometimes a discrete and insular minority rarely if ever wins on any issue. Since the successful exercise of power is normally necessary to advance fundamental interests within a diverse and contentious polity,

23 My worry in this section is about whether or not global democracy can be legitimate. Despite this worry, Thomas Pogge has pointed out in discussion, it may still be better than what we have. But the worries that follow call that thesis into question as well.
if the minority never succeeds in making legislation, we have strong reason to think that the interests of the minority are not being advanced. If there is a minimum amount of rotation of majorities and minorities, we can think of the collective decision-making process as publicly realizing equality. But when one group never gets its way, then the collective decision-making process is no longer publicly advancing the interests of members equally. But if the collective decision-making process is not publicly advancing the interests equally, then it loses its legitimacy—at least in significant part.24

It is important to note the difference between the problem of persistent minorities and the problem of majority tyranny. Though they often go together, they need not. Indeed, it is quite possible for a dominant group to act in accordance with what it takes to be the human rights of the minority, while the minority never gets its way. This seems to me a serious problem above and beyond the violation of human rights, and may itself constitute such a violation.

The possibility of persistent minorities in the international system is very great. To the extent that this is a serious danger at the global level, it seems that there is a real risk that a global democratic institution will be illegitimate in an important way.

This conclusion must be qualified in a couple of different ways. First, we do not know that the problem of persistent minorities would occur. What could happen instead is that groups of persons around the world see common interests so that groups that are persistent minorities in individual societies could form coalitions and form majorities in some circumstances.25 Second, the problem of persistent minorities has been handled by democratic societies, with mixed success, by means of institutions that qualify majority rule such as consociational institutions or even federalist institutions. It is not obvious to me that these solutions will arise in the case of global democracy partly because of the weakness of civil society in global democracy. The idea is that because of this weakness, states will take the primary role in mediating between persons and global assembly.

XIV. Institutional Incapacity of Civil Society

The other fundamental problem with global democracy is that we do not have institutions that can mediate well between individuals and legislative institutions. In the modern democratic state, political parties, interest groups, and diverse media

outlets all provide a fairly wide representation of views and provide means by which citizens can come to understand what is at stake in collective decision-making. The institutions we know are deeply imperfect and do not represent as widely as they should, but nevertheless they do provide citizens with some sense of what is going on from a wide variety of standpoints. In my view these institutions are absolutely necessary to democracy because citizens can only devote a small amount of time to political questions so there must be intermediate institutions that enable citizens to acquire a grasp of the key political issues and alternatives.\footnote{26} Without these institutions, citizens are at sea with the great number of issues and alternatives. They become prey to demagogic politicians and the system seems to be run essentially by elites.

The trouble in international politics is that the institutions of civil society, while certainly growing quite rapidly, are not anywhere near the capacity necessary to act as intermediaries between the great majority of persons in international society and international institutions. Even in the European Union, mass political parties have yet to form and these are an absolute minimum condition for successful democracy. The consequence of this situation in the international realm, were it to be democratized, would be a state of affairs in which elites rule mostly without any serious check on their power. Some groups, mostly representing selected Western interests and concerns, would have some capacity to embarrass and shame states and international institutions.\footnote{27}

XV. \textbf{Comparisons between Global Democracy and the System of Fair Democratic Association}

Let us compare these two purported ideals. Our observations above suggest that global democracy is not currently an ideal for the global order at all. Without the condition of equal stakes in global collective decision-making, democracy cannot be intrinsically justified for the global system. But the condition of equal stakes in collective decision-making is not itself intrinsically desirable or required. Since equal stakes is not required as part of an institutional ideal, then democracy, which is justified intrinsically only if there are equal stakes, cannot be justified intrinsically under current circumstances.

\footnote{26} See Christiano, T., \textit{The Rule of the Many} (Boulder Colo.: Westview Press, 1996), chs. 5 and 7 for a discussion of the nature and role of citizenship in an egalitarian conception of democracy and of the central role of political parties, interest groups, and other associations in mediating between state and citizen.

In contrast, the system of fair democratic association can be thought of as an ideal to be pursued, though its realization is at best quite far off. The point of a scheme of voluntary association in domestic society is to deal with the reality of uneven stakes. It is designed to allow individuals to choose for themselves what ventures they wish to engage in and to tailor those ventures to their particular interests. Democratic association allows states to pick and choose what terms they enter into and so allows them to determine how important issues are to their peoples and to sub-populations within their societies. It allows for the possibility of the kinds of regional and other kinds of more particular associations that have proven to be the most effective institutions beyond the state.

The system of fair democratic association also deals with the problem of permanent minorities much better than does a global democracy because states must consent to the terms they come under. This provides protection for these states by ensuring them a say in what happens to their societies. Global democracy would have to deal with this problem by significantly qualifying majority rule.

Concerning the problem of institutional incapacity, the system of democratic association makes use of the most powerful institution in the current environment, which is the state. The democratic state is a reasonably successful mechanism for accommodating and representing the interests and concerns of its members. Many democratic societies have thriving civil societies that help ensure this function of the democratic states. The absence of a dense global civil society does not undermine the capacity of democratic states to represent the interests and concerns of their citizens.

If we compare the two ideals, I tentatively conclude that the system of fair democratic association is a superior ideal to aim at and it gives us a better picture of what inherently legitimate institutions would have to look like.

XVI. Do International Institutions and Law Have Democratic Legitimacy Now?

For the moment, it seems that we should not think of the system as a whole as legitimate because of the problems of representativeness and asymmetric bargaining. This does not entail that we need to think of it as illegitimate. The basis for saying that a system of decision making is illegitimate is that it has either produced the conditions that undermine its legitimacy or it stands in the way of improving those conditions or is failing to do what it knows it can do to ameliorate the problem. Only under these circumstances can the system be thought to be treating the worse-off as inferiors. We might think that the problems of extreme and severe poverty are problems that we currently do not have the tools to solve. There is clearly a lot
of disagreement among expertly informed persons. Furthermore, there is progress in the direction of more democracy throughout the world and greater pressure in favour of representation of indigenous and insular minorities.

We must think of international institutions and law as works in progress. We must evaluate the products of this system mostly on a case-by-case basis to make sure that it is making progress towards resolving the major problems of human rights, severe poverty, environmental degradation and pollution, and that it is advancing the common good through a process of free and fair trade, investment, and finance. And finally we must evaluate it in terms of the progress it is making towards a more inherently legitimate system of decision making.

**XVII. Conclusion**

If our aim is to realize the democratic values in the international order, then we should aim primarily at what I have called a system of fair democratic association among states. Global democracy is highly unlikely to succeed given the weakness of global civil society and it is highly unlikely to be legitimate given the unevenness of stakes in its decisions and given the high chance of permanent minorities. And since we are quite far away from a fair system of voluntary-association highly representative states, we cannot think that the current system has legitimacy overall. Nevertheless, there may be some reason for hope for progress towards a more equal and representative system of association. According a greater say to developing countries in what are the most powerful institutions in the international order may help to advance a system that is more equitable and that could eventually become legitimate.
In Defence of the ‘Democratic Deficit’: Reassessing Legitimacy in the European Union*

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Abstract

Concern about the EU’s ‘democratic deficit’ is misplaced. Judged against existing advanced industrial democracies, rather than an ideal plebiscitary or parliamentary democracy, the EU is legitimate. Its institutions are tightly constrained by constitutional checks and balances: narrow mandates, fiscal limits, super-majoritarian and concurrent voting requirements and separation of powers. The EU’s appearance of exceptional insulation reflects the subset of functions it performs – central banking, constitutional adjudication, civil prosecution, economic diplomacy and technical administration. These are matters of low electoral salience commonly delegated in national systems, for normatively justifiable reasons. On balance, the EU redresses rather than creates biases in political representation, deliberation and output.

Introduction

Is the European Union democratically legitimate? It is an appropriate moment to pose this question. The last decade has witnessed the emergence of a stable institutional equilibrium – let us call it the ‘European Constitutional Settlement’ – that serves as a de facto constitution for Europe. The Treaties of Amsterdam and Nice failed to alter its structure significantly. Deliberations now underway, despite being turbo-charged with constitutional rhetoric, are unlikely to achieve much more. The most ambitious proposals still under serious discussion – incremental expansion of qualified majority voting or flexibility, the creation of a forum for national parliamentarians, restructuring the European Council and its Presidency, for example – consolidate decade-long

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trends rather than launch new ones. Incremental moves to deepen foreign policy, justice and monetary policy co-operation appear to require only minor centralizing reforms, and few other functional issues of significance are visible on the horizon. None of this will alter the essential trajectory of European integration. Thus we may now be glimpsing the constitutional order that will govern Europe, barring a severe crisis, for the foreseeable future.

The question of legitimacy is timely also because the last decade has witnessed nearly continuous debate over the proper constitutional structure for Europe. In a much-lauded book, Larry Siedentop asks, ‘Where are the Madisons for Europe?’ (Siedentop, 2000). Yet the more appropriate question for those who have followed European thinking is: ‘Why are there so many Madisons?’ (Moravcsik, 2001a). Hundreds, perhaps even thousands, of scholars, commentators, lawyers and politicians have analysed this problem. They have canvassed every conceivable proposal from the construction of a centralized European social welfare state to a federal commitment to English, Christianity and juridical localism. Advocates and opponents of each have mustered constitutional theories, social scientific hypotheses, everyday political anecdotes and good old-fashioned political rhetoric. Never before in history have such rich and varied intellectual resources been brought to bear on an international political process – a discourse from which we can learn much.

Both political negotiations and intellectual debates have focused, perhaps above all, on the question of whether the EU is democratically legitimate. Most politicians, scholarly commentators and members of the European public appear to agree that the EU suffers from a severe ‘democratic deficit’. There are many reasons why this perception is so widespread. An organization of continental scope will, of course, appear rather distant from the individual European citizen. As a multinational body, moreover, it lacks the grounding in a common history, culture, discourse and symbolism on which most individual polities can draw. Neither of these reasons, however, need necessarily disqualify the EU from being treated as a democratically legitimate body.

Rather, when analysts criticize the lack of democratic legitimacy in the EU, they generally point to the mode of political representation and the nature of policy outputs. Only one branch of the EU is directly elected: the European Parliament (EP). Though stronger than it once was, the EP remains only one of four major actors in the EU policy-making process. Its elections are decentralized, apathetic affairs, in which a relatively small number of voters select among national parties on the basis of national issues. Little discussion of European issues, let alone ideal transnational deliberation, takes place. For its part, the European Commission, which enjoys a powerful role as an agenda-
setter and regulatory co-ordinator, is widely perceived as a technocracy. The European Court of Justice, comprising 15 appointed judges, is unusually powerful. Most powerful of all, the Council of Ministers brings together national ministers, diplomatic representatives and administrative officials from the Member States, who often deliberate in secret. While indirectly accountable to voters, the link is too tenuous and the mode of interaction too diplomatic or technocratic to satisfy many observers.

These procedural qualms might be tolerable were it not for the perceived bias in the outputs of European policy-making. Many view the EU as a throwback to the nineteenth century – a fiscally weak, neo-liberal state. EU directives and regulations promote wider and deeper markets, while providing only a truncated range of compensating and counterbalancing policies of regulatory protection or social welfare guarantees. If – as Karl Polanyi and Joseph Schumpeter asserted – the legitimacy of democratic capitalism rests on an explicit compromise between markets and social protection, then the EU appears a dangerous exception (Polanyi, 1944; Schumpeter, 1942). The most salient task of the modern state is to equalize life chances and socialize the risk faced by individual citizens, a goal to which the EU appears indifferent or even hostile. No wonder, then, that many Europeans – and disproportionately the poor, female, economically peripheral and recipients of public sector support – view the EU with scepticism.

For these reasons, many believe it is self-evident that the EU is not democratically legitimate. Yet my central contention here is that, if we adopt reasonable criteria for judging democratic governance, then the widespread criticism of the EU as democratically illegitimate is unsupported by the existing empirical evidence. At the very least, this critique must be heavily qualified. Constitutional checks and balances, indirect democratic control via national governments, and the increasing powers of the European Parliament are sufficient to ensure that EU policy-making is, in nearly all cases, clean, transparent, effective and politically responsive to the demands of European citizens.

Mostly critics overlook the relatively optimistic conclusion to be drawn from the evidence because they analyse the EU in ideal and isolated terms. Comparisons are drawn between the EU and an ancient, Westminster-style, or frankly utopian form of deliberative democracy. While perhaps useful for philosophical purposes, the use of idealistic standards no modern government can meet obscures the social context of contemporary European policy-making – the real-world practices of existing governments and the multi-level political system in which they act. This leads many analysts to overlook the extent to which delegation and insulation are widespread trends in modern democracies, which must be acknowledged on their own terms. The fact
that governments delegate to bodies such as constitutional courts, central banks, regulatory agencies, criminal prosecutors, and insulated executive negotiators is a fact of life, one with a great deal of normative and pragmatic justification. In this regard, moreover, most analysts view the EU in isolation, and thus fail to appreciate fully the symbiotic relationship between national and EU policy-making – a division of labour in which commonly delegated functions tend to be carried out by the EU, while those functions that inspire and induce popular participation remain largely national. This gives observers the impression that the EU is undemocratic, whereas it is simply specializing in those functions of modern democratic governance that tend to involve less direct political participation. We might, of course, choose to criticize the broader trend toward professional administration, judicial enforcement of rights and strong executive leadership, but it is unrealistic to expect the EU to bear the brunt of such a critique – a point to which I return in the conclusion.

I proceed as follows. In successive sections, I analyse the constraints inherent in the European constitutional settlement that guarantee that the EU will not become a despotic ‘superstate’; the democratic procedures that prevent the EU from becoming an arbitrary and unaccountable technocracy; the legitimate reasons for shielding certain EU decision-makers from direct democratic contestation; the underlying social reasons why political participation in the EU cannot be radically expanded; and the extent to which EU policy-making suffers from an excessive neo-liberal bias. Final sections consider whether these assessments are likely to change with enlargement of the EU, and how the analysis might be generalized.

I. Constitutional Constraints: Why the EU is not a ‘Superstate’

The classic justification for democracy is to check and channel the arbitrary and potentially corrupt power of the state. Accordingly, arbitrary rule by national and supranational technocrats – ‘bureaucratic despotism’ by a ‘superstate’ in Brussels, as one formulation has it – is a widespread concern in contemporary EU politics (Siedentop, 2000; cf. Moravcsik, 2001a). This is the stuff of British tabloid articles, often fuelled by ignorance of what the EU actually does, but it underlies much legitimate concern, particularly among those on the libertarian right of the political spectrum. This concern gains plausibility from the overtly technocratic nature of much EU regulation, the open role played by non-elected officials in Brussels, and the geographical and cultural distance between those regulators and the average European ‘person in the street’.

Yet the threat of a European superstate is a myth. The European constitutional settlement imposes tight constraints on EU policy. These combine and
exceed the most extreme constraints imposed in national systems by consociational or consensus democracy (beyond, say, the Netherlands or Austria of years past), federalism (e.g. Switzerland or Canada), separation of powers (e.g. the United States), and reduced fiscal competences (e.g. the United States or Switzerland). The result is as much confederal as federal (Moravcsik, 2001b; Elazar, 2001), and almost eliminates any threat of a European superstate. A set of substantive, fiscal, administrative, legal and procedural constraints on EU policy-making are embedded in treaty and legislative provisions that have the force of constitutional law – to which we now turn.

**Substantive Constraints and the Focus on Cross-Border Economic Activity**

The EU’s current activities are restricted by treaty and practice to a modest subset of the substantive activities pursued by modern states. Its mandate focuses primarily on the regulation of policy externalities resulting from cross-border economic activity. The core of EU activity and its strongest constitutional prerogatives still lie almost exclusively in the area of trade in goods and services, the movement of factors of production, the production of and trade in agricultural commodities, exchange rates and monetary policy, foreign aid and trade-related environmental, consumer and competition policy. To be sure, there are exceptions, including a modest level of regional and structural funding of infrastructure, but even these exist primarily as side-payments for the creation of core policies. In some areas regulatory controls exceed narrow market-making functions, and immigration and foreign policies are emergent areas of action. But these tend often to be treated in more intergovernmental procedures, whereas the strongest constitutional prerogatives of the EU remain primarily economic.

Much is thereby excluded from the EU policy agenda. Absent concerns include taxation and the setting of fiscal priorities, social welfare provision, defence and police powers, education policy, cultural policy, non-economic civil litigation, direct cultural promotion and regulation, the funding of civilian infrastructure, and most other regulatory policies unrelated to cross-border economic activity. Certainly the EU has made modest inroads into many of these areas, but only in limited areas directly related to cross-border flows.\(^1\) Even within the core functions of the EU, governments are allowed to exempt themselves to maintain high regulatory protection (e.g. environmental and social policy), or to act unilaterally where the EU has not effectively legislated (e.g. air transport).

\(^1\) The scholarly literature on European integration seems to pay disproportionate attention to exceptional cases of ‘spillover’ in cases such as gender discrimination, the initial experience with environmental policy and structural funding, the jurisprudence of supremacy and direct effect, the Commission’s use of Article 90, and the possible, but as yet undocumented, effects of the open method of co-ordination (OMC). These are important trends, but atypical of the EU as a whole.
Fiscal Constraints and the Emergence of a ‘Regulatory Polity’

One might object at this point that this analysis treats the status quo as a ‘snapshot’ and thereby overlooks the future trajectory of integration. Yet the EU’s institutional capacity to act in new areas and new ways is constrained by a severe lack of fiscal, administrative and legal authority, thereby partially mitigating the imperative to maintain close and constant legislative scrutiny. At a first approximation, the EU does not tax, spend, implement or coerce and, in many areas, it does not hold a legal monopoly of public authority.

It is not coincidental that the policies absent from the EU’s policy portfolio – notably social welfare provision, defence, education, culture and infrastructure – require high government expenditure. The ability to tax and spend is what most strikingly distinguishes the modern European state from its predecessors, yet the EU’s ability to tax is capped at about 2–3 per cent of national and local government spending (1.3 per cent of GDP) and is unlikely to change soon. The disbursement of these funds, moreover, is explicitly directed to a small range of policies – the common agricultural policy, structural funding and development aid – that must periodically be renewed by unanimous consent of the Member States. The EU is thereby rendered a ‘regulatory polity’ – a polity with legal instruments but little fiscal capacity (Majone, 1996, 1998).

These fiscal constraints have important consequences. They leave little room for discretionary funding by Brussels technocrats. Funding levels in agriculture and structural funding are set by strict unanimous intergovernmental agreement. Moreover, even in areas of the EU’s greatest fiscal activity, much (generally most) public funding remains national. There is considerable evidence from the two largest areas of EU spending – the common agricultural policy and structural funds – that national governments possess the resources to counteract broad fiscal priorities set by authorities in Brussels (e.g. Pollack, 2000).

Administrative Constraints and the Decentralized Politics of Implementation

Analysts often observe that the essential politics of regulation lies in implementation, yet the EU implements very few of its own regulations. With the exceptions of monetary policy, competition policy and the conduct of, though not the ultimate control over, external trade negotiations, the powers of the EU to administer and implement are, in fact, exceptionally weak. How could it be otherwise, given the extraordinarily small size of the Brussels bureaucracy? The EU employs fewer people than a modest European city. They total about one-fortieth of the number of comparable civilian federal employees even in the United States, a jurisdiction of comparable size but noted in cross-
national perspective for the small size of its national government workforce. Except in a few areas, the task of legally or administratively implementing EU regulations falls instead to national parliaments and administrations.

Were this not enough, the EU has no police, military force or significant investigatory capacity – and no realistic prospect of obtaining any of these. Take the military. Even if the most ambitious plans currently on the table in European defence were fully realized, the EU would control only 2 per cent of European Nato forces – and these forces could be employed only for a narrow range of regional peace-keeping and peace-making tasks. Similarly, whereas the EU is co-ordinating efforts to combat international crime, the decentralized structure of national police, criminal justice and punishment systems, while externally constrained, remains in essence unchanged.

Procedural Constraints and the Politics of Checks and Balances

Of course the lack of administrative clout, and even perhaps of fiscal discretion, would be of less consequence if the EU technocracy could act unhampered by procedural constraints. Yet the EU’s ability to act, even in those areas where it enjoys clear competence, is constrained by institutional checks and balances, notably the separation of powers, a multi-level structure of decision-making and a plural executive. This makes arbitrary action (indeed, any action) difficult and tends to empower veto groups that can capture a subset of national governments. Such institutional procedures are the conventional tool for protecting the interests of vital minorities – a design feature generally thought to be most appropriate to polities, like the EU, that must accommodate heterogeneous cultural and substantive interests (Lijphart, 1990).

The most fundamental constraint lies in the requirement of unanimity, followed by electoral, parliamentary or administrative ratification, to amend the Treaty of Rome – an exceptionally high standard for any fundamental act of substantive redirection or institutional delegation. Accordingly, the EU has developed over the past two decades only by focusing on core areas of exceptionally broad consensus, backed by large financial side-payments to persuade recalcitrant Member States. Whereas judicial decisions like the celebrated Cassis de Dijon case may have helped set the agenda for initiatives like the single market, monetary union or enlargement, there is now agreement in the scholarly literature that they could not do so without nearly consensual support from the Member States (Alter, 2001). Even ‘everyday’ EU directives must be promulgated under rules that require the concurrent support of between 74 and 100 per cent of the weighted votes of territorial representatives in the Council of Ministers – a level of support higher than required for legislation in any existing national polity or, indeed, to amend nearly any national constitution in the world today.
Surmounting super-majoritarian and unanimous voting requirements is not enough, however, to pass legislation. The EU is not a system of parliamentary sovereignty but one of separation of powers. Power is divided vertically among the Commission, Council, Parliament and Court, and horizontally among local, national and transnational levels – requiring concurrent majorities for action. For legislation, the Commission must propose; the Parliament must consent; if the result is then challenged, the Court must approve; national parliaments or officials must transpose into national law; and national bureaucracies must implement. Even within each branch and level of EU governance, we encounter extraordinary pluralism. The Commission itself is a plural executive – so much so that experts disagree whether it is an executive at all. The EP requires unusually high majorities to act. As a result, consistent and effective EU policy-making tends to be possible only where there exists not just a supermajority of national representatives, but a supermajority of European technocrats, judges and parliamentarians as well. Current proposals to represent more groups, for example through another chamber representing national parliamentarians, can only exacerbate this tendency.

**Legal Constraints and the Politics of Competences**

If, after such widespread consent, legislation is nonetheless unacceptable to EU Member States, they have real alternatives to strict reliance on EU norms. This is so to a far greater extent than even the most decentralized of national federations. In core areas of trade and factor flows, to be sure, EU rules remain relatively strict and are enforced as such. Yet there are also a number of areas, even in economic affairs, in which governments can act ‘minilaterally’ – inside or outside the EU. These include issues in which a subset of EU governments can work through other international organizations (e.g. human rights, defence, border controls and some environmental policy, the UN Security Council), areas where a ‘core’ of governments can move ahead collectively inside the institutions (e.g. ‘flexibility’, ‘enhanced co-operation’ or ‘coalitions of the willing’ in social, monetary, defence and immigration policies, and areas with long transition periods, e.g. for new members in agriculture).

In still other areas, such as environmental policy, governments may opt out of EU regulations to provide higher regulatory protection. The number of such mechanisms has increased over the past decade, and their important role distinguishes the EU from national federations.²

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² There are, of course, isolated examples in other jurisdictions, such as the proliferation of ‘interstate compacts’ among states of the United States.
II. Democratic Control: Why the EU is not an Unaccountable Technocracy

We have just seen that the EU is more constrained than any national polity, in part by its own plural structure of checks and balances, and in part by its need to co-exist within a multi-level system of governance with fiscally, administratively and legally more powerful nation-states. This renders the spectre of a ‘European superstate’ absurd. Most analysts doubt the EU is a state at all; they prefer to speak of a diffuse ‘governance system’.

Still, no matter how constrained its substantive and institutional authority, there remain important areas – notably important matters of market regulation, monetary policy and other related regulation – in which EU legislation and regulation are dominant. In these areas, policy-making remains rather centralized in Brussels, Luxembourg or Frankfurt, albeit with constant Member State and interest group input. In the cases of European Court of Justice jurisprudence, the European Central Bank’s setting of monetary policy and the Commission’s handling of competition policy, moreover, such powers are wielded by semi-autonomous supranational authorities. Even where legislation and regulation remain subject, as they are generally, to super-majoritarian consent, it might be objected that the EU policy process favours national bureaucrats and ministers at the expense of national parliaments and publics. The EU, from this perspective, is an insulated cartel of supranational and national technocrats.

As a description of EU policy-making, there is some truth in this (Moravcsik, 1994). But what is the implication for democratic legitimacy? I argue in this section that the insulation of the EU from mechanisms to assure democratic accountability is easily exaggerated, particularly by those who tend to overlook the multi-level constraints embedded in the European constitutional settlement arising from democratic control over national governments. Moreover, the mode of EU delegation to its constitutional court, central bank and other semi-autonomous authorities, is consistent with the late twentieth-century practice of most advanced industrial democracies. Even if we were to reject outright the modern trend towards delegated policy-making, it would surely be normatively arbitrary as well as politically futile to expect the EU to bear the brunt of such opposition.

Direct and Indirect Democratic Accountability

Given the vehemence of the critique levelled against it, one might assume that the EU lacks any form of democratic participation and accountability at all. Yet in fact the EU employs two robust mechanisms: direct accountability via the EP and indirect accountability via elected national officials.
For over a decade, the EP has been progressively usurping the role of the Commission as the primary agenda-setter vis-à-vis the Council in the EU legislative process. It is now the EP that, late in the legislative process, accepts, rejects or amends legislation in a manner more difficult for the Council to reject than to accept—a prerogative traditionally accorded the Commission. The EP is directly elected by proportional representation within nation-states, and often acts independently of ruling national parties. Whereas one might criticize the absence of clear programmatic elections, the EP nonetheless has an effective system of party co-operation. Votes most often split along party lines and recognizable ideological cleavages shape voting patterns. Among the most relevant differences between the European Parliament and national parliaments appears to be the tendency of the EP to reach decisions by large majorities. Yet this tendency underscores the propensity of the EU to reach decisions by consensus—unsurprising given the high level of support required in the Council of Ministers—and should give us reason for confidence that it is legislating in the ‘European’ interest (Hix et al., 2002).

Still, if European elections were the only form of democratic accountability to which the EU were subject, scepticism would surely be warranted. Yet a more important channel lies in the democratically elected governments of the Member States, which dominate the still largely territorial and intergovernmental structure of the EU. In the European Council, which is consolidating its position as the EU’s dominant institution, elected heads of state and government wield power directly (Ludlow, 2002). In the Council of Ministers, which imposes the most important constraint on everyday EU legislation, permanent representatives, ministerial officials and the ministers themselves from each country act under constant instruction from national executives, just as they would at home. Here the bonds of accountability are tight: these representatives can be re-instructed or recalled at will, often more easily than parliamentarians in national systems. In addition, national parliaments consider and comment on many EU policies, though their de facto ability to influence policy fluctuates greatly by country.

Broad representation also encourages transparent policy-making. In contrast to the widespread impression of a cadre of secretive gnomes of Brussels, supranational officials in fact work under intense public scrutiny. The legislative process works slowly, with no equivalent to ruling by executive decree or pushing legislation swiftly through a friendly parliament, and information appears more plentiful about the EU political and regulatory process, at least at the Brussels level, than about similar processes in nearly all of its Member States. With 20 Commissioners and their staffs, 15 national delegations, over 600 parliamentarians, hundreds of national ministers and thousands of national officials, ex ante parliamentary scrutiny in some countries and ex post
parliamentary scrutiny in nearly all, and finally the need for domestic administrative implementation, there can be no such thing as a monopoly of information in the EU. And whereas it is true that certain aspects of the system, such as early discussions in the lower levels of Coreper, tend to take place in relative secret, the same might be said of the de facto preparation of legislation in national systems. Recent research seems to reveal that the EU regulatory processes are as open to input from civil society, and as constrained by the need to give reasons, as the (relatively open) systems of Switzerland and the US (Zweifel, 2001). Discussions within comitology appear to take due account of public interest considerations, though the precise reasons for this – socialization, insulated expert discussion, external pressure by Member States, structured deliberation, anticipated non-compliance – remain to be fully analysed (Joerges and Vos, 1999; Majone, 1998).

The Legitimacy of Semi-Autonomous Judges and Technocrats

It might be objected that the EU sometimes bypasses comitology and relies overly on autonomous technocrats in the Commission or constitutional court judges to resolve essentially political questions involving the apportionment of cost, benefit and risk. Yet there is little that is distinctively ‘European’ about the pattern of delegation we observe in the EU. The late twentieth century has been a period of the ‘decline of parliaments’ and the rise of courts, public administrations and the ‘core executive’. Increasingly, accountability is imposed not through direct participation in majoritarian decision-making, but instead through complex systems of indirect representation, selection of representatives, professional socialization, ex post review, and balances between branches of government (Majone, 1996).

The critical point for the study of the EU is this: within the multi-level governance system prevailing in Europe, EU officials (or insulated national representatives) enjoy the greatest autonomy in precisely those areas – central banking, constitutional adjudication, criminal and civil prosecution, technical administration and economic diplomacy – in which many advanced industrial democracies, including most Member States of the EU, insulate themselves from direct political contestation. The apparently ‘undemocratic’ nature of the EU as a whole is largely a function of this selection effect.

Insulation is not simply an empirical fact; it has normative weight. To understand why, we must address the justifications for the apparently ‘counter-majoritarian’ tendency of political institutions that are insulated from direct democratic contestation. Most such insulated institutions arise out of the logic of commitment; that is, as efforts to enforce or embed the impartial implementation of prior bargains. Three normative justifications, often found in combination, are most common.
First is the need for greater attention, efficiency and expertise in areas where most citizens remain ‘rationally ignorant’ or non-participatory. Universal involvement in government policy would impose costs beyond the willingness of any modern citizen to bear. Insulated institutions reduce decision-making costs by encouraging specialization. They thus permit efficient and consistent decisions to occur in areas of weak or intermittent citizen involvement and interest, most importantly where scientific, legal or administrative expertise is expensive to acquire, yet expert, informed decision-making is desired. As such expertise has come to play a greater role in policy-making, delegation to specialized authorities in areas from environmental policy to food and drug authorization has become more common.

Second is the need impartially to dispense justice, equality and rights for individuals and minority groups. It is common to delegate to insulated authorities, such as constitutional courts, responsibility for the enforcement of individual or minority prerogatives against the immediate ‘tyranny of the majority’. Such delegation is often justified where citizens seek to reduce the risk of contracting into an uncertain future. This tendency has spread in recent years as increasing numbers of governmental functions have been recognized as basic or human rights that are judicially or administratively enforced, often at the international level, against political authorities.

Third is the need to provide majorities with unbiased representation. Insulated institutions offer one the means of redressing underlying biases in national democratic representation. The most common distortion is the capture of open political processes, and thus government policy, by powerful particularistic minorities with powerful and immediate interests, who oppose the interests of majorities (often treated as ‘the median voter’) with diffuse, longer-term or less self-conscious concerns. The classic understanding of trade policy, for example, sees the broadly liberal interests of consumers and firms trumped by pressure from powerful, self-conscious sectorally-organized protectionists. To the extent that this is so, the EU may be more ‘representative’ precisely because it is, in a narrow sense, less ‘democratic’.

Given these prima facie justifications, the burden of proof rests on critics of the EU. We may debate whether the EU’s central bank, constitutional court, or competition authorities are properly constructed, but any such criticism must first concede the legitimacy and general acceptability of a greater measure of insulation and autonomy in precisely these areas than elsewhere in modern political life.
II. Democratic Deliberation: Why the EU Cannot Expand Participation

Radical democrats might nonetheless be tempted to reject the entire trend toward insulated decision-making, domestic and international, because the cost in terms of political participation is too high. Such critics might observe that the European constitutional settlement has failed to promote the transnational political parties, identities and discourses that might help render European political participation meaningful and effective for citizens. A number of analysts propose to employ European institutions to induce social co-operation in pursuit of common interests. This in turn, they expect, will generate legitimacy.

Unless entirely grounded in an ideal preference for participation, however, these criticisms and proposals rest on the questionable premise that greater participation in European political institutions will generate a deeper sense of political community in Europe or, at the very least, greater popular support for the EU. There are at least three reasons to doubt that this is the case.

First, insulated institutions – constitutional courts and administrative bureaucracies, for example – are often more popular with the public than legislatures. Internationally, institutions like the European Court of Human Rights (ECHR) in Strasbourg command great legitimacy, despite their near total lack of direct democratic legitimacy. The EU’s position in the institutional division of labour involves such political functions, as we have just seen, and it is unclear whether more participation in such functions would legitimate them. Whereas a greater sense of common identity might indeed increase support for the EU, this does not bear on the case for democratic reform but on the question of how extensive European integration should be (Gibson and Caldeira, 1993).

Second, EU legislative and regulatory activity is inversely correlated with the salience of issues in the minds of European voters, so any effort to expand participation is unlikely to overcome apathy. Among the most significant consequences of the limitation of the substantive scope of the EU, discussed above, is that the issues handled by the EU – and even more so second-order institutional choices about how to manage them – lack salience in the minds of European voters. Of the five most salient issues in most west European democracies – health care provision, education, law and order, pension and social security policy, and taxation – none is primarily an EU competence. Among the next ten, only a few (managing the economy, the environment, alongside the anomalous issue of Europe itself) could be considered major EU concerns, none exclusively so.3 In contrast, the issues in which the EU special-

3 I am indebted to Bonnie Meguid for access to her systematic data on issue salience in European countries.
izes – trade liberalization, the removal of non-tariff barriers, technical regulation in environmental and other areas, foreign aid and general foreign policy co-ordination – tend to be of low salience in most European polities. Lack of salience, not lack of opportunity, may impose the binding constraint on European political participation. This would explain why European citizens fail to exploit even the limited opportunities they have to participate. Monetary policy lies somewhere in the middle: whereas citizens in advanced industrial democracies focus on macroeconomic performance, its link to the institutional design of a central bank remains unclear in the minds of many, thereby depoliticizing the issue.

It follows that reforms, referendums, parliamentary elections, or constitutional conventions based on EU issues encourage informationally impoverished and institutionally unstructured deliberation, which in turn encourages unstable plebiscitary politics in which individuals have no incentive to reconcile their concrete interests with their immediate choices. The typical result is a debacle like the 2001 Irish referendum on the Nice Treaty. Not only does this demonstrate the existence of significant substantive constraints on EU policy-making, but it implies – as we shall see below – that even if a common European ‘identity’ and the full panoply of democratic procedures existed, it would be very difficult to induce meaningful citizen participation.

Of course this could change in the future. But the proposals to construct greater citizen involvement in EU politics that are most plausible in theory are patently implausible in practice. In order to give individuals a reason to care about EU politics, it is necessary to give them a stake in it – a fact that many discussions of a *demos*, ‘we-feeling’, ‘community’, and ‘constitutional patriotism’ elide. The most compelling (and historically grounded) schemes for doing so rest not on the creation of new political opportunities, but the emergence of entirely new political cleavages based on interest. Philippe Schmitter proposes, for example, that agricultural support and the structural funds be replaced by a guaranteed minimum income for the poorest one-third of Europeans, national welfare systems be rebalanced so as not to favour the elderly, and immigrants and aliens be granted full rights (Schmitter, 2000). With the EU acting as a massive engine of redistribution, individuals and groups would reorient their political behaviour on whether they benefit or lose from the system. This is a coherent scheme targeted at precisely those groups most dissatisfied with European integration today – broadly speaking, the poorer, less well-educated, female, and public sector populations – but it is utterly infeasible. In search of legitimacy, Schmitter breaks with the European constitutional settlement, divorcing the EU entirely from its ostensible purpose of regulating cross-border social behaviour, which would thereby

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4 For an exception, see Weiler (1999).
undermine the legitimacy of almost everyone currently involved with it. The result would almost certainly be a higher level of political dissatisfaction, domestic and interstate, than Europe has seen in several generations.

IV. Social Democracy: Why EU Governance is not Substantively Biased

Some, finally, maintain that the EU lacks democratic legitimacy not so much because it stifles political participation, but because its policies are biased against particular interests consensually recognized as legitimate. Such accounts tend to be social democratic, that is, they tend to argue that the EU systematically biases policy-making in a neo-liberal direction.\(^5\) It does this, so the argument goes, by excluding from the agenda particular issues, notably social welfare and some public interest regulation, while facilitating common liberalization of trade and factor flows. The entire arrangement is locked in by the European legal order. Opposition does not form because it is kept off the agenda by the ‘European constitutional settlement’, which leaves social welfare provision to the national governments, and by the ignorance of less fortunate individuals and groups about their own interests.

Fritz Scharpf offers just such a critique.\(^6\) Following Karl Polanyi and other social democratic theorists, Scharpf argues that the most important element in a democratic polity is to maintain the balance between market liberalization and social protection. Most Europeans favour maintaining current levels of welfare spending, as demonstrated by the decentralized tendency of Member States to spend increasing percentages of GNP on welfare as per capita income increases. Yet the status quo cannot be maintained today because of the tendency of decentralized market competition to generate an interstate ‘race to the bottom’ in regulatory protection. Trade, immigration and especially foreign investment and capital flows create strong incentives for countries to reduce welfare expenditure. The EU cannot respond effectively to this tendency, despite overwhelming support for the maintenance of welfare systems, because of a neo-liberal bias in the constitutional structure of the EU and the rhetoric that surrounds it, which favours market liberalization (‘negative integration’) over social protection (‘positive integration’). This argument is outlined elsewhere in this issue, so I need not explain it further.

Scharpf’s argument is without a doubt the most empirically and theoretically nuanced criticism of the EU democratic deficit that currently exists. Yet

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\(^5\) Yet they need not be so. Many libertarians believe that policy in the EU, as well as in Europe as a whole, is biased in a social democratic direction (see, e.g., Rabkin, 2001).

\(^6\) Scharpf (1999). For a more detailed critique, from both positive and normative perspectives, see Moravcsik and Sangiovanni (2002).
there is good reason to qualify his formulation of the argument, above all since these qualifications are acknowledged in Scharpf’s own empirical analysis.

There is little evidence of a race to the bottom. Scharpf himself concludes ultimately that there can be such a race in only a few areas, there is relatively little evidence that it has yet occurred, and the effects have been limited. The level of social welfare provision in Europe remains relatively stable. National welfare systems are no longer moving strongly in the direction of greater redistribution, but neither are they imploding. Recent OECD analyses report that fiscal consolidation over the past 20 years has almost always led to increases in government revenues as a percentage of GNP, and in most cases the burden of consolidation is placed primarily on revenue increases. Much recent research, moreover, suggests that the adverse impact of globalization on standards in the major areas of social spending in Europe (pensions, medical care and labour market policy) is easily exaggerated. The most important factors behind increasing social spending are instead domestic: the shift to a post-industrial economy, lower productivity growth, shifting demand for less skilled workers, and rising costs of health care, pensions and employment policies, exacerbated by increasingly unfavourable demographic trends. These factors fuel welfare deficits and fiscal strains, yet any reform is opposed by entrenched constituencies (the elderly, medical care consumers and the full-time unemployed) well placed to resist it. No responsible analyst believes that current individual social welfare entitlements can be maintained in the face of these structural shifts. In this context, the neo-liberal bias of the EU, if it exists, is justified by the social welfarist bias of current national policies (Pierson and Leibfried, 1995; Rhodes et al., 2001; Iversen et al., 1999).

Nor is there much evidence that the EU is driving social protection downward. By contrast, the EU has often permitted high standards and supportive institutional reform, and thus has tended to deregulate at a high level (Vogel, 1995; Joerges and Vos, 2000). Anecdotal evidence and poll data suggest that the EU is responsive to public and interest group concerns in a way quite similar to national polities. For reasons set out in Scharpf’s article in this issue, there is far less reason for a social democrat to fear the piecemeal evolution of European law than might have been the case five years ago (see also Scharpf, 1999). Whatever consequences there may be lie largely in the future. The major difference between apparently intractable issues of EU discussion such as social and tax harmonization, and similar issues where European regulation is effective, such as worker health and safety, appears not to lie in con-

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7 The life-cycle of an issue like mad cow disease is just as it would be in any western democracy: some bureaucracies are captured; a crisis emerges; and reforms are put in place that place greater emphasis on the broader public interest (Joerges and Vos, 1999).
stitutional structure but in the precise nature of conflicts of interest among national governments. In the case of taxation, some governments remain deeply opposed to the harmonization of taxation and social welfare, whereas there are few die-hard defenders of unilateralism in matters of worker health and safety or pollution abatement. In this sense, the EU reflects patterns of consensus and contestation within European publics.

From the perspective of democratic theory, finally, it is important to note that Scharpf’s proposals are concerned primarily with maintaining social protection in richer Member States. They are quite conservative in that they favour domestic redistribution over transnational redistribution; the defence of German welfare standards takes precedence over schemes for transnational redistribution. Scharpf’s justification lies in the subjective perceptions of identity of national citizens in countries like Germany, which do not support a heavy commitment to redistribution. Yet this is likely to be perceived very differently in poorer Member States, and in particular among the new members from central and eastern Europe. This leads us to the most significant challenge facing the EU over the next decade: enlargement.

V. The Challenge of Enlargement: Why the EU is Likely to Remain Legitimate

Will enlargement alter this generally optimistic assessment of democratic legitimacy in the EU? Given that expansion of such intensive international cooperation to include such a varied group of countries is unprecedented, any assessment must remain more speculative than scientific. Yet there is good reason, nonetheless, to be hopeful.

The above analysis suggests that the most fundamental source of the EU’s legitimacy lies in the democratic accountability of national governments. There is little reason to doubt that, on balance, the prospect of enlargement and the practice of membership of the EU bolsters domestic democratic institutions in applicant countries. The ‘power of attraction’ is perhaps the most powerful instrument of democratization that European governments possess, and indeed perhaps, next to trade policy, their most powerful foreign policy instrument overall. There is compelling evidence that the prospect of enlargement has significantly strengthened centrist democratic parties in central and east European countries (Vachudova, 2001). As long as the domestic governments of these countries remain liberal democracies, there is no reason to doubt that their interactions with the EU will remain as firmly subject to democratic accountability as national policies. To be sure, the EU runs the risk of admitting countries that could subsequently vote in anti-democratic parties. The recent debacle of EU pressure on Austria, which is widely perceived as hav-
ing been counterproductive, has demonstrated the difficulty (if not futility) of EU efforts to micromanage the domestic democratic practices of Member States. Still, a wholesale challenge to democracy, as opposed to an ideologically unattractive right-wing minority party, might generate a more credibly effective response. This is certainly the lesson many learned from the Spanish experience. In this sense, EU enlargement is almost certain to promote democracy in the region.

A more significant threat stems from the greater diversity and heterogeneity of interests within an EU of 20–25 (Moravcsik, 1998; Nello and Smith, 1997). The most common argument about this diversity is, however, not the most convincing. One often hears that the EU will become gridlocked as a result of the increase in the number of EU Member States. This folk wisdom is based on the rather primitive notion that the probability of gridlock is an exponential function of the number of potential national vetoes, which is itself a direct function of the number of members (Petite, 1998). Certainly the conclusion has a Cartesian clarity, but is it correct? Whereas individual vetoes may impose a binding constraint in a limited number of cases of unanimity voting, as with the role of Greece in foreign policy or Luxembourg in banking, there is little reason to believe that this is generally the essential concern. Most issues involve compromises between opposing coalitions, whereby the total number of countries matters less. In any case, there are relatively few remaining issues where co-operation is promising but unanimity is the norm. It is perhaps more likely that greater heterogeneity of interests would undermine the cohesion of parties within the EP, making effective legislation more difficult. Yet the most recent analyses suggest that, as long as countries have similar parties, cohesion is not narrowly dependent on the precise range of ideological differences (Hix et al., 2002).

Decisive instead is whether conflicts of interest, particularly those involving the redistribution of resources, will place undue strain on EU governance. In particular, whose interests are to be represented by EU budgetary transfers? Nearly every country that has entered the EU – most notably Britain, Greece, and Spain – received a relatively unfavourable financial settlement, to which the response of each, once a member, has been to obstruct EU legislation until they received a financial side-payment. EU regional policy was a response to the British referendum of 1975. In the 1980s, structural funding was established and expanded as the result of pressure from Mediterranean countries. Financial transfers contributed to the legitimacy of the EU in a number of countries. This will be far more difficult a strategy for future entrants to pursue, due to the larger number of core members, the larger size of the *acquis communautaire*, the lack of major issues on the horizon, and the recent introduction of flexibility provisions that might well permit rich coun-
tries to react to such a situation by opting out and moving together as a sub-group. Structural and agricultural funding is unlikely to be extended at the same level as in the past (Nello and Smith, 1997, p. 28). Labour movement is likely to have some *de facto* transition period. This, in turn, may reduce the popularity, and thus the *perceived* democratic legitimacy, of the EU. Yet even in this context, the current arrangement, in which small countries can block unanimity votes, may offer a better prospect of forcing continued redistribution than any type of decision-making reform.

**Conclusion**

When judged by the practices of existing nation-states and in the context of a multi-level system, there is little evidence that the EU suffers from a fundamental democratic deficit. That is not to say that there is no cause for concern. There are a few areas where the EU departs modestly from existing national practices with no compelling substantive justification. The most important is the structure of the European Central Bank, which is more independent of political pressure than any known national example (Herdegen, 1998). One need not draw an analogy with the 1930s to view overly independent central banks with caution. Another is the rights of immigrants, where EU standards are evolving but could move in a direction more restrictive than the European norm. Still another area is administrative procedure, where the formal rights enjoyed by residents of the US under the Administrative Procedures Act surpass those formally guaranteed in Europe. Finally, Scharpf is correct in drawing attention to the possibility that, in the future, European administrative and constitutional law might move in a direction inimical to social welfare provision. Yet up till now there is little evidence that these specific examples add up to a structural democratic deficit in the EU. Any mature polity could point to areas in which such democratic protections are stronger or weaker; in this regard the EU is hardly exceptional.

So, we might reasonably ask, why then is there such public and scholarly concern about the democratic deficit? Concern appears to result, above all, from a tendency to privilege the abstract over the concrete. Most critics compare the EU to an ideal plebiscitary or parliamentary democracy, standing alone, rather than to the actual functioning of national democracies adjusted for its multi-level context. When we conduct the latter sort of analysis, we see that EU decision-making procedures, including those that insulate or delegate certain decisions, are very much in line with the general practice of most

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8 Whether this in fact does so depends, of course, on which standard we adopt. A rise in nationalism and a decline in European feeling is also possible and, again, the democratic legitimacy of such an outcome is unclear (Nello and Smith, 1997, p. 47).
9 For a more detailed analysis, see Moravcsik and Vachudova (forthcoming).
modern democracies in carrying out similar functions. This overall trend toward insulation of certain functions is in turn driven, most analysts believe, by considerations that should be given normative weight, such as the complexity of many policy issues, the rational ignorance and apathy of many publics, the desire to protect minority rights, and the power of certain special interests in situations of open political contestation. These constraints cannot be assumed away; they must be acknowledged on their own terms. As long as political procedures are consistent with existing national democratic practice and have a *prima facie* normative justification, I conclude, we cannot draw negative conclusions about the legitimacy of the EU from casual observation of the non-participatory nature of its institutions – a dictum that could usefully be applied in many contexts outside the EU.

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Why There is a Democratic Deficit in the EU: A Response to Majone and Moravcsik

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Abstract

Giandomenico Majone and Andrew Moravcsik have argued that the EU does not suffer a ‘democratic deficit’. We disagree about one key element: whether a democratic polity requires contestation for political leadership and over policy. This aspect is an essential element of even the ‘thinnest’ theories of democracy, yet is conspicuously absent in the EU.

Introduction

The fate of the Constitutional Treaty for Europe after the French and Dutch referendums will no doubt prompt further volumes of academic books and articles on the ‘democratic deficit’ in the European Union (EU). The topic already receives huge attention, with ever-more convoluted opinions as to the symptoms, diagnoses, cures and even side-effects of any medication. However, two major figures in the study of the European Union, Giandomenico Majone and Andrew Moravcsik, have recently focused the debate, by disentangling the various forms of dissatisfaction authors have expressed. Not only have these intellectual heavy-weights entered the fray, they have attempted to argue against much of the current received wisdom on the subject – and argue, in a nutshell, that the EU is in fact as democratic as it could, or should, be.

What we do in this article is assess some of the contributions of Majone and Moravcsik together. We start by articulating a contemporary ‘standard version’ of the democratic deficit, before reviewing how far these two scholars are
able to refute the various elements of the received wisdom. We then highlight our points of agreement and disagreement with the positions of Majone and Moravcsik as expressed in some of their articles. Specifically, we disagree about one key element: whether a democratic polity requires contestation for political leadership and argument over the direction of the policy agenda. This aspect, which is ultimately the difference between a democracy and an enlightened form of benevolent authoritarianism, is an essential element of even the ‘thinnest’ theories of democracy, yet is conspicuously absent in the EU. We then discuss what we think can be done to reduce the democratic deficit in the EU, and whether the Constitutional Treaty would go some way to achieving this goal. Other issues that Majone or Moravcsik raise also merit attention, but must await later occasions. These include the status and implications of federal or multi-level elements of the EU, and of various non-majoritarian democratic procedures (Majone, 1998; Moravcsik, 1998b, 2002).

I. The ‘Standard Version’ of the Democratic Deficit, circa 2005

There is no single meaning of the ‘democratic deficit’. Definitions are as varied as the nationality, intellectual positions and preferred solutions of the scholars or commentators who write on the subject. Making a similar observation in the mid-1990s, Joseph Weiler and his colleagues set out what they called a ‘standard version’ of the democratic deficit. This, they said, was not attributable to a single figure or group of scholars, but was rather a set of widely-used arguments by academics, practitioners, media commentators and ordinary citizens (Weiler et al., 1995).

Weiler’s contribution did not lay the debate on the democratic deficit to rest – in due course it become ever more diverse. An upgraded ‘standard version’ of the democratic deficit, supplemented by a more substantive yet ‘thin’ normative theory of democracy helps assess the valuable contributions of Moravcsik and Majone, and indicate remaining issues of contestation for further research. The democratic deficit could be defined as involving the following five main claims.

First, and foremost, European integration has meant an increase in executive power and a decrease in national parliamentary control (Andersen and Burns, 1996; Raunio, 1999). At the domestic level in Europe, the central structure of representative government in all EU Member States is that the government is accountable to the voters via the parliament. European parliaments may have few formal powers of legislative amendment (unlike the US Congress). But, the executive is held to account by the parliament that can hire and fire the cabinet, and by parliament scrutiny of the behaviour of government ministers. The design of the EU means that policy-making at the European
level is dominated by executive actors: national ministers in the Council, and government appointees in the Commission. This, by itself, is not a problem. However, the actions of these executive agents at the European level are beyond the control of national parliaments. Even with the establishment of European Affairs Committees in all national parliaments, ministers when speaking and voting in the Council, national bureaucrats when making policies in Coreper or Council working groups, and officials in the Commission when drafting or implementing legislation, are much more isolated from national parliamentary scrutiny and control than are national cabinet ministers or bureaucrats in the domestic policy-making process. As a result, governments can effectively ignore their parliaments when making decisions in Brussels. Hence, European integration has meant a decrease in the power of national parliaments and an increase in the power of executives.

Second, and related to the first element, most analysts of the democratic deficit argue that the European Parliament is too weak. In the 1980s, some commentators argued that there was a direct trade-off between the powers of the European Parliament and the powers of national parliaments, where any increase in the powers of the European Parliament would mean a concomitant decrease in the powers of national parliaments (Holland, 1980). However, by the 1990s, this position disappeared as scholars started to see European integration as a decline in the power of parliamentary institutions at the domestic level relative to executive institutions. The solution, many argued, was to increase the power of the European Parliament relative to the governments in the Council and the Commission (Williams, 1991; Lodge, 1994).

Successive reforms of the EU treaties since the mid-1980s have dramatically increased the powers of the European Parliament, exactly as many of the democratic deficit scholars had advocated. Nevertheless, one can still claim that the European Parliament is weak compared to the governments in the Council. Although the European Parliament has equal legislative power with the Council under the co-decision procedure, a majority of EU legislation is still passed under the consultation procedure, where the Parliament has only a limited power of delay. The Parliament can still amend only those lines in the EU budget that the governments categorize as ‘non-compulsory expenditure’. And, although the European Parliament now has the power to veto the governments’ choice for the Commission President and the team of Commissioners, the governments are still the agenda-setters in the appointment of the Commission. In no sense is the EU’s executive ‘elected’ by the European Parliament.

Third, despite the growing power of the European Parliament, there are no ‘European’ elections. EU citizens elect their governments, who sit in the Council and nominate Commissioners. EU citizens also elect the European Parliament. However, neither national elections nor European Parliament
elections are really ‘European’ elections: they are not about the personalities and parties at the European level or the direction of the EU policy agenda. National elections are fought on domestic rather than European issues, and parties collude to keep the issue of Europe off the domestic agenda (Hix, 1999; Marks et al., 2002). European Parliament elections are also not about Europe, as parties and the media treat them as mid-term national contests. Protest votes against parties in government and steadily declining participation in European elections indicate that Reif and Schmitt’s famous description of the first European Parliament elections – as ‘second-order national contests’ – is as true of the sixth European elections in June 2004 as it was of the first elections in 1979 (Reif and Schmitt, 1980; van der Eijk and Franklin, 1996; Marsh, 1998). Blondel, et al. (1998) provide some evidence that at the individual level participation in European elections is related to citizens’ attitudes towards the EU. However, this effect is substantively very small, and more recent research has shown that, if anything, the main second-order effects of European elections – whereby governing parties and large parties lose while opposition and small parties win irrespective of these parties’ EU policies – have increased rather than decreased (Mattila, 2003; Kousser, 2004; Hix and Marsh, 2005).

The absence of a ‘European’ element in national and European elections means that EU citizens’ preferences on issues on the EU policy agenda at best have only an indirect influence on EU policy outcomes. In comparison, if the EU were a system with a genuine electoral contest to determine the make-up of ‘government’ at the European level, the outcome of this election would have a direct influence on what EU ‘leaders’ do, and whether they can continue to do these things or are forced to change the direction of policy.

Fourth, even if the European Parliament’s power were increased and genuine European elections were able to be held, another problem is that the EU is simply ‘too distant’ from voters. There is an institutional and a psychological version of this claim. Paradoxically, both may have given rise to the frustration vented in the referendums on the Constitutional Treaty. Institutionally, electoral control over the Council and the Commission is too removed, as discussed. Psychologically, the EU is too different from the domestic democratic institutions that citizens are used to. As a result, citizens cannot understand the EU, and so will never be able to assess and regard it as a democratic system writ large, nor to identify with it. For example, the Commission is neither a government nor a bureaucracy, and is appointed through an obscure procedure rather than elected by one electorate directly or indirectly (see, for example, Magnette, 2001). The Council is part legislature, part executive, and when acting as a legislature makes most of its decisions in secret. The European Parliament cannot be a properly deliberative assembly because of the multi-lingual nature of debates in committees and the plenary without a common political backdrop
culture. And, the policy process is fundamentally technocratic rather than political (Wallace and Smith, 1995).

Fifth, European integration produces ‘policy drift’ from voters’ ideal policy preferences. Partially as a result of the four previous factors, the EU adopts policies that are not supported by a majority of citizens in many or even most Member States. Governments are able to undertake policies at the European level that they cannot pursue at the domestic level, where they are constrained by parliaments, courts and corporatist interest group structures. These policy outcomes include a neo-liberal regulatory framework for the single market, a monetarist framework for EMU and massive subsidies to farmers through the common agricultural policy. Because the policy outcomes of the EU decision-making process are usually to the right of domestic policy status quos, this ‘policy drift’ critique is usually developed by social democratic scholars (Scharpf, 1997, 1999).

A variant of this ‘social democratic’ critique focuses on the role of private interests in EU decision-making. Since a classic representative chamber, such as the European Parliament, is not the dominant institution in EU governance, private interest groups do not have to compete with democratic party politics in the EU policy-making process. Concentrated interests such as business interests and multinational firms have a greater incentive to organize at the European level than diffuse interests, such as consumer groups or trade unions, and the EU policy process is pluralist rather than corporatist. These features skew EU policy outcomes more towards the interests of the owners of capital than is the case for policy compromises at the domestic level in Europe (see, e.g., Streeck and Schmitter, 1991).

II. Defence of the Titans: Majone and Moravcsik

Giandomenico Majone and Andrew Moravcsik, two of the most prominent scholars of European integration, have recently struck back at the flood of articles, pamphlets and books promoting one or more of the elements of the standard version of the democratic deficit.

Majone: Credibility Crisis Not Democratic Deficit

Majone’s starting point is his theoretical and normative claim that the EU is essentially a ‘regulatory state’ (Majone, 1994, 1996). In Majone’s thinking, ‘regulation’ is about addressing market failures and so, by definition, is about producing policy outcomes that are Pareto-efficient (where some benefit and no one is made worse off), rather than redistributive or value-allocative (where there are both winners and losers). The EU governments have delegated
regulatory policy competences to the European level – such as the creation of the single market, the harmonization of product standards and health and safety rules and even the making of monetary policy by the European Central Bank – deliberately to isolate these policies from domestic majoritarian government. From this perspective, the EU is a glorified regulatory agency, a ‘fourth branch of government’, much like regulatory agencies at the domestic level in Europe, such as telecoms agencies, competition authorities, central banks, or even courts (Majone, 1993a).

Following from this interpretation, Majone asserts that EU policy-making should not be ‘democratic’ in the usual meaning of the term. If EU policies were made by what Majone calls ‘majoritarian’ institutions, they would cease to be Pareto-efficient, insofar as the political majority would select EU policy outcomes closer to its ideal short-term policy preferences and counter to the preferences of the political minority and against the majority’s own long-term interests.

In this view, an EU dominated by the European Parliament or a directly elected Commission would inevitably lead to a politicization of regulatory policy-making. Politicization would result in redistributive rather than Pareto-efficient outcomes, and so in fact undermine rather than increase the legitimacy of the EU (Majone, 1998, 2000, 2002a, b; Dehousse, 1995). For example, EU social policies would be used to compensate losers or supplement the market rather than only correct its failures (Majone, 1993b).

For Majone, then, the problem for the EU is less a democratic deficit than a ‘credibility crisis’ (Majone, 2000). The solution, he believes, is procedural rather than more fundamental change. What the EU needs is more transparent decision-making, ex post review by courts and ombudsmen, greater professionalism and technical expertise, rules that protect the rights of minority interests, and better scrutiny by private actors, the media and parliamentarians at both the EU and national levels. In this view, the European Parliament should focus on scrutinizing the European Commission and EU expenditure, and perhaps increasing the ‘quality’ of EU legislation. It should not try to move EU legislation beyond the preferences of the elected governments or try to influence the policy positions of the Commission through the investiture and censure procedures.

Majone consequently holds that, if the EU could increase the credibility of its policy-making by introducing such procedural mechanisms, then the public would or should accept the EU as legitimate and concerns about the democratic deficit would disappear.
Moravcsik: Checks-and-Balances Limit Policy Drift

Moravcsik (2002, 2003, 2004) goes further than Majone, and presents an extensive critique of all main democratic deficit claims. Moravcsik objects to four different positions in his writings on this subject: libertarian, pluralist, social democratic and deliberative. Rather than repeat his arguments as they relate to these four viewpoints, let us reconstruct his arguments against the five standard claims identified, above. Moravcsik has explicit answers to four of the five standard claims.

First, against the argument that power has shifted to the executive, Moravcsik points out that national governments are the most directly accountable politicians in Europe. As he states (2002, p. 612):

if European elections were the only form of democratic accountability to which the EU were subject, scepticism would surely be warranted. Yet, a more important channel lies in the democratically elected governments of the Member States, which dominate the still largely territorial and intergovernmental structure of the EU.

He goes on to argue that national parliaments and the national media increasingly scrutinize national government ministers’ actions in Brussels. Hence, while the EU remains a largely intergovernmental organization, decisions in the European Council and the Council of Ministers are as accountable to national citizens as decisions of national cabinets. In other words, his argument that the EU ‘strengthens the state’ (meaning national executives) also challenges claims of a democratic deficit, since the democratically controlled national executives play dominant roles in the EU institutions – underscoring the democratic accountability of the EU.

Second, against the critique that the executives are beyond the control of representative institutions, and hence that the European Parliament needs to be strengthened, Moravcsik points out that the most significant institutional development in the EU in the past two decades has been the increased powers of the European Parliament in the legislative process and in the selection of the Commission. In other words, he might grant that national governments no longer dominate outcomes where significant independent agenda-setting power has been delegated to the Commission, for example under the co-decision procedure and qualified majority voting in the Council. Hence, indirect accountability via national executives in the Council is weak under these ‘supranational’ policy mechanisms, as particular national governments can be on the losing side on an issue-by-issue basis. However, the EU has addressed this potential problem by significantly increasing the powers of the European Parliament in exactly these areas.
The European Parliament now has veto-power over the selection of the Commission and is increasingly willing to use this power against heavy lobbying from national governments, as was seen with the Parliament’s veto of the first proposed line-up of the Barroso Commission in October 2004. Also, the reform of the co-decision procedure in the Amsterdam Treaty means that legislation cannot be passed under co-decision without majority support in both the Council and the European Parliament. So, if a party in government is on the losing side of a qualified majority vote in the Council, it has a chance of ‘winning it back’ in the Parliament – as Germany has done on several occasions (such as the takeover directive in July 2001).

Third, against the view that the EU is too distant and opaque, Moravcsik argues that the EU policy-making process is now more transparent than most domestic systems of government. The growing paranoia inside the EU institutions about their isolation from citizens and the new internal rules in response to public and media accusations, have made it much easier for interest groups, the media, national politicians and even private citizens to access documents or information about EU policy-making – easier indeed than access to information from national policy processes. Furthermore, EU technocrats are increasingly forced to listen to multiple societal interests. Both the European Court of Justice and national courts exercise extensive judicial review of EU actions, and the European Parliament and national parliaments have increased scrutiny powers (as in the European Parliament’s censure of the Santer Commission in May 1999). Also, the introduction of an ‘early warning mechanism’, as envisaged in the Constitutional Treaty, would increase the power of national parliaments to scrutinize and block draft EU legislation before it even leaves the Commission.

Fourth, Moravcsik argues against the so-called ‘social democratic critique’ that EU policies are systematically biased against the (centre-left) median voter. The EU’s elaborate system of checks-and-balances ensures that an overwhelming consensus is required for any policies to be agreed. There are high thresholds for the adoption of EU policies: unanimity for the reform of the treaties; then either unanimity in the Council (in those areas where intergovernmental rules still apply), or a majority in the Commission plus a qualified majority in the Council plus an absolute majority in the European Parliament (where supranational rules apply); and then judicial review by national courts and the European Court of Justice. Also, no single set of private interests can dominate the EU policy process, as the Commission consciously promotes the access of diffuse interests, and diffuse interests have access via those parties of party groups (on the left) in the Council and European Parliament (see, e.g., Pollack, 1997; Greenwood, 2003).
As a result, EU policies are inevitably very centrist: the result of a delicate compromise between all interest parties, from all Member States and all the main party positions. Only those on the political extremes are really excluded. So, free market liberals are just as frustrated with the centrist EU policy regime as social democrats.

Just as Majone’s views of the EU democratic deficit are logical extensions of his general ‘regulatory politics’ theory of the EU, Moravcsik’s views of the democratic deficit are extensions of his liberal-intergovernmental theory (Moravcsik, 1998a). Basically, because the governments run the EU and there is ‘hard bargaining’ in the adoption of all EU policies, the EU is unlikely to adopt anything which negatively effects an important national interest or social group. Also, because the Commission is simply an agent of the governments, there are no significant unintended consequences of the intergovernmental bargains. Hence, there is little gap between the preferences of the elected governments and final EU policy outcomes; so, the EU is not undemocratic.

Finally, Moravcsik does not address the claim directly that there are ‘no European elections’. But, his position would justify at least two answers to this concern. First, Moravcsik thinks that European Parliament elections do not really work and will not be genuine ‘European’ contests for some time, since the issues the EU tackles are simply not salient enough for voters to take an interest. ‘EU legislative and regulatory activity is inversely correlated with the salience of issues in the minds of European voters, so any effort to expand participation is unlikely to overcome apathy’ (Moravcsik, 2002, p. 615). Voters care primarily about taxation and spending and these issues are still the responsibility of Member States and tackled overwhelming at the national level. Hence, it is rational for voters to treat European elections as largely irrelevant contests.

Second, Moravcsik (2004) likes the idea that EU policy-making is largely isolated from majoritarian democratic contests. He agrees with Majone that it is a good thing that regulatory policy-makers are isolated from democratic majorities. He cites three normative reasons. Firstly, ‘universal involvement in government policy would impose costs beyond the willingness of any modern citizen to bear’ (Moravcsik, 2002, p. 614; 2004). Secondly, isolating particular quasi-judicial decisions is essential to protect minority interests and avoid the ‘tyranny of the majority’. Thirdly, and above all, isolated policy-makers can correct for a ‘bias’ inherent in majoritarian democratic contests. Here, Moravcsik argues that particularist (concentrated) interests can more easily capture majoritarian electoral processes than isolated regulators or courts. From this perspective, ‘the EU may be more “representative” precisely because it is, in a narrow sense, less “democratic”’ (Moravcsik, 2002, p. 614).
III. Points of Agreement and Disagreement

The contributions of Majone and Moravcsik have greatly enhanced the democratic deficit debate, and raised it from the largely impressionist and descriptive contributions in the 1980s and early 1990s to a new level. Arguments are presented more fully, based on careful theoretical analysis backed up by empirical evidence. This analytic clarity is a welcome improvement, not least because it facilitates assessment and further improvement. Some of their theoretical arguments and empirical evidence are valid, while others are questionable.

**Majone: Most EU Policies are Redistributive**

Majone’s main theoretical assumption, that purely Pareto-improving policies with no redistributive effects may, on normative grounds, be isolated from majoritarian democratic process, is surely correct. If policies reliably are, and are meant to be, purely Pareto-improving (with no losers) then decision-making in these areas via the usual democratic mechanisms, of electoral and parliamentary majorities, may well not produce the desired outcomes. The problem comes, however, at an empirical level, when trying to identify those policies that produce purely Pareto-improving policy outcomes with one unique solution. Majone would agree that many decisions would challenge a strict efficiency–redistributive dichotomy. This article questions the centrality of this distinction, when the empirical reality of decisions is a continuum between policies that are predominantly efficient and policies that are predominantly redistributive, with many mixes.

For example, almost everyone would accept that judicial decisions, such as court adjudication of property rights, and certain technical decisions, such as consumer product standards and safety protection, are at the ‘efficient’ extreme of a potential continuum: there is a very limited number of correct outcomes, where the distribution of benefits and burdens is largely settled in the process of deciding on the legal and technical standards. Courts and agencies, such as a food safety agency, might best be isolated from political interferences once the laws and other standards are identified.

Next on an efficiency–redistributive continuum are interest rate policies and competition policies. The aim of delegation to independent institutions in these areas is the time inconsistency of preferences and the need for trustworthiness, rather than the fact that these policies by definition are purely about the correction of market failures and the production of collective benefits (Beetham and Lord, 1998, p. 20). Even though a majority of economists and political scientists believe that central banks and competition regulators should be independent from majoritarian institutions, these views are not universally held (e.g. McNamara, 2002). And there may be reasons for immediate action that
outweigh the loss in trustworthiness: trade-offs that may best be handled by majoritarian, political accountable, agents.

Next are the bulk of policies at the European level which relate to the construction and (re)regulation of a market. A larger market and harmonized national regulatory standards to secure market integration certainly have Pareto-improving elements, in that much of EU single market, environmental or social regulation aims to make the free market work more efficiently or to correct particular market failures, such as negative externalities of production (such as pollution), collectively disadvantageous practices of trade barriers, or information asymmetries in employment contracts such as rules on minimum health and safety at work. However, many EU regulatory policies have significant redistributive consequences. Private producers for domestic markets are losers from the liberalization of trade in a single market (e.g., Frieden and Rogowski, 1996). Similarly, producers tend to suffer from environmental ‘process’ standards, such as factory emissions standards. On the other hand, some workers benefit from social policy ‘process’ standards, such as equal rights for part-time and temporary workers.

At the predominantly redistributive extreme are EU expenditure policies. It may seem that all Member States benefit in some way from EU expenditure policies. Yet, the identification of ‘net contributors’ and ‘net beneficiaries’ from the EU budget has always been a highly contested game in the negotiation of every EU multi-annual framework programme. Moreover, winners and losers are even more apparent at the individual level. Beneficiaries from EU expenditure policies, such as farmers, depressed regions, or research scientists, tend to be concentrated groups who receive large amounts from the EU budget as a percentage of their income. On the other hand, the consumers and taxpayers who pay into the EU budget are highly diffuse, with widely varying net benefits of larger markets.

Majone might wish that all EU market regulation or reregulatory policies are or should be purely Pareto efficient. The current reality is rather different. Many EU regulatory policies have identifiable winners and losers (Pierson and Leibfried, 1995, pp. 432–65; Joerges, 1999). At an empirical level, Majone’s argument that EU policy-making is or should primarily be about Pareto-improving outcomes is thus either implausible, or requires a drastic reversal of many competences back to the Member States. Majone provides good reasons why certain EU policies, such as competition policy or food safety regulation, should be delegated to independent, non-majoritarian, institutions. But his arguments do not apply to policies which allow choices with distributive or even redistributive effects. He offers no reason why they should be isolated from democratic contestation. Where there are short- and long-term winners
and losers, Majone’s argument does not diminish the need for democratic, responsive and accountable decision-makers.

Moravcsik: Democratic Contestation Would Produce Different Policies

In Moravcsik’s view:

Constitutional checks and balances, indirect democratic control via national governments, and the increasing powers of the European Parliament are sufficient to ensure that EU policy-making is, in nearly all cases, clean, transparent, effective and politically responsive to the demands of European citizens. (2002, p. 605)

Much of this we agree with. Essentially, because of the requirement of over-sized majorities in multiple institutions, EU policy outcomes are invariably ‘centrist’.

Yet, this response to the social democratic concern is insufficient insofar as the status quo of no-agreement does not secure ‘centrist’ but rather right-of-centre outcomes, as the near-constitutional status of market freedoms suggests. Moravcsik must then go on to argue that this no-agreement point is not skewed against the political parties on the left. On this issue the jury still seems to be out. On the one hand, as Paul Pierson (2001, p. 82) finds: ‘the available evidence casts doubt on the claim that in the absence of growing economic integration welfare states would be under dramatically less pressure, and national policy makers markedly more capable of addressing new public demands’. Signs of cut-backs and retrenchments may have other causes. On the other hand, the demographic changes may otherwise have entailed increases rather than stand-still in public expenditures. Thus, Anton Hemerijck (2002) notes that: ‘The empirical evidence … suggests that tax competition has so far been limited … But this may be misguided. For one, when we consider increasing unemployment, rising poverty, expanding pensions and health care costs, we would have expected that taxation should have risen. Instead, during the 1980s most welfare states turned to deficit spending’.

Indirect control via national governments certainly provides some control over EU policy outcomes, although it is greater in those areas where intergovernmentalist decision-making rules operate (such as police co-operation, foreign and defence policies, and some aspects of monetary union) than in areas where supranational decision-making rules operate (such as the regulation of the single market and now asylum and immigration policies). Increasing the powers of the European Parliament has certainly improved the legitimacy of policy outcomes in precisely those areas where the indirect control of governments over outcomes has been weakened by the move to qualified majority voting and the delegation of significant agenda-setting power to the
Commission. Essentially, the authors are willing to accept, both theoretically (because of the design of representation in the Council and Parliament and the rules of agenda-setting and decision-making) and empirically (the balance between the neo-liberal and ‘social market’ elements of the EU policy regime), that policy outcomes from the EU may be relatively close to some abstract European-wide ‘median voter’. The social democratic critique of the EU is insufficiently defended and argued; it is also quite possibly incorrect.

There are still two problems for Moravcsik’s theory, however, concerning the link between voters’ policy preferences and the policies of the EU. First, the match between preferences and policies should not only occur as a matter of fact, but there should be mechanisms that reliably ensure that this power will indeed be so used. Democratic accountability is one such mechanism that sometimes at least serves to kick rascals out and sometimes serves to prevent domination and disempowerment (Shapiro, 1996). The defence of institutions as legitimate must thus not only show that present outcomes are acceptable. Proponents must also show that these institutions can reliably be expected to secure more acceptable outcomes in the future than the alternatives considered, for instance because they are sufficiently responsive to the best interests of voters. These are the problems with benevolent but non-accountable rulers: their subjects have no institutionalized mechanisms that make them trustworthy. And, there are no reliable selection processes for selecting their benevolent successor – at most, the processes ensure selection of the next ruler, who may turn out to be much less benevolent (Rawls, 1999; Follesdal, 2005).

Second, voters’ preferences are not fixed or purely exogenously determined. If voters’ preferences over policies are completely exogenous to the political process and permanently fixed, then there would perhaps be no difference between a fully-democratic majoritarian policy and an ‘isolated’ policy regime – a form of regulated benevolent authoritarianism – that produces policies that ‘voters subjectively want’ in some interesting sense of that phrase. Both democratic and (enlightened) non-democratic regimes would produce policy outcomes close to the median or otherwise decisive-voter (assuming a single dimension of preferences).

A key difference between standard democratic and non-democratic regimes, however, is that citizens form their views about which policy options they prefer through the processes of deliberation and party contestation that are essential elements of all democracies. Because voters’ preferences are shaped by the democratic process, a democracy would almost definitely produce outcomes that are different to those produced by ‘enlightened’ technocrats. Hence, one problem for the EU is that its policy outcomes may not be those policies that would be preferred by a political majority after a debate.
This leads to a weakness in Moravcsik’s argument that the issues on the EU agenda are simply not salient enough for voters to want to have a debate about the policies, and hence allow their preferences to be shaped on these issues. The problem is that the salience of a policy issue is also endogenous to the political process. Schattschneider (1960) famously called this the ‘mobilization of bias’. With no articulation of positions on several sides of a policy debate, it is no wonder that a debate over a particular policy area does not exist and that issues lack voter salience.

Moravcsik would still contend that such a democratic contest is more likely to be captured by private particularist interests than the EU’s current system of checks-and-balances and isolated regulators, who can more easily consider diffuse and long-term interests. As it stands, this argument is incomplete. Reasons must also be provided for believing that regulators will indeed reliably use their discretion in such ways rather than for less legitimate objectives. Indeed, many democratic theorists and empiricists would actually think the opposite. Independent regulators are highly prone to capture, primarily because they are heavily lobbied by the producers who are the subjects of the regulation (Becker, 1983). Furthermore, constitutions with multiple checks-and-balances (or veto-points), as opposed to more majoritarian decision-making rules, allow concentrated (single-issue) interests to block policy outcomes that are in the interests of the majority – as has been the case in the US system of government, where the gun lobby has repeatedly blocked more restrictive gun control and private healthcare companies have repeatedly blocked provisions to introduce some form of universal health coverage, despite overwhelming public support for both these policies (Tsebelis, 1999, 2002).

Majone and Moravcsik extol the virtues of ‘enlightened’ bureaucracy against the dangers of untrammelled ‘popular’ democracy, or ‘majoritarian’ rule in the current parlance. For Majone, the technocrats in the Commission, the Council working groups and the EU agencies are more likely to protect citizens’ interests than the majority in the European Parliament or a hypothetical majority in an election of the Commission President. Moravcsik, less enthusiastic about technocratic rule, still sees no need for fully-blown electoral democracy since the design of the EU already guarantees that any policies passed are in the interests of the majority of EU citizens. We argue in the next section that there are good reasons to be slightly less optimistic about the comparative advantages of technocratic rule over constrained forms of democratic rule.

IV. Why Constrained Democracy is Better than Pareto Authoritarianism

One plausible defence of democracy is comparative, in the tradition of Winston Churchill’s quip that democracy is the worst form of government except
for all the others that have been tried from time to time. Forms of democratic rule in terms of competitive elections to choose policies and leaders, is better than enlightened technocracy and the alternatives favoured by Moravcsik and Majone.

We build the case for democracy from premises that we believe are shared by a broad range of democratic theorists. The main features of democracy are (see, for example, Follesdal, 1998):

1. institutionally established procedures that regulate,
2. competition for control over political authority,
3. on the basis of deliberation,
4. where nearly all adult citizens are permitted to participate in
5. an electoral mechanism where their expressed preferences over alternative candidates determine the outcome,
6. in such ways that the government is responsive to the majority or to as many as possible.

This is not intended as a complete definition, but rather as a statement about virtually all modern political systems that we would normally call ‘democratic’. The perennial dispute about the definition of democracy seems largely fruitless to us, and we hope to avoid it altogether. This sketch of democracy is robust in the sense that many theorists would agree to many of its components, though specifying them differently.

Features 1, 2 and 3 are especially relevant for assessing Moravcsik’s and Majone’s arguments. These are held in some form by most theorists. As an example, for Charles Beitz (1989, p. 17), democracy is conceived as:

a kind of rivalry for control over the state’s policy-making apparatus, with an electoral mechanism at its center in which all citizens are entitled to participate … There is considerable room for variation in both the manner in which the rivalry itself might be regulated and the details of the electoral mechanism that determines its outcomes. The generic idea of democracy is indeterminate about these matters, but because not all of the possibilities are equally acceptable, some criterion is needed for selecting among them.

For Schattschneider (1960, p. 141), modern democracy is ‘a competitive political system in which competing leaders and organizations define the alternatives of public policy in such a way that the public can participate in the decision-making process’. And for Brian Barry (1991, pp. 24–61), a democratic procedure is ‘a method of determining the content of laws (and other legally binding decisions) such that the preferences of the citizens have some formal connection with the outcome in which each counts equally… [and] allow for the formulation, expression, and aggregation of political preferences’.
These first three components merit elaboration to identify the weaknesses of Majone and Moravcsik’s arguments. Regarding the first component, the primary issue is institutional design, not policy outcomes. Many, though not all, democratic theorists would hold that the outputs matter when assessing such institutions. We hold that, in order to assess institutions, more must be known about whether they can bring about certain outputs. We cannot accept Majone’s argument that EU institutions provide unbiased representation without further defence. That such institutions may prevent capture by powerful minorities opposing the majority’s more diffuse, longer-term or less self-conscious concerns may be correct, but this is not enough. Indeed, much more must be known than their current output. We also need to know about the likely, least likely or typical outcomes, including the formative and strategic effects of institutions on strategies and preferences.

Thus we cannot appeal only to present policy outcomes, but must also consider their tendency to reliably be sufficiently responsive over time, compared with alternative arrangements. Their track record so far is not sufficient. We must also know whether there are mechanisms that will reliably continue to ensure acceptable outcomes in ways that provide crucial trustworthiness. This is of course not to argue that constitutions determine everything, but that the choice of constitutional rules affects the bargaining positions within the democratic decision procedures.

For example, an essential feature of the practice of democracy is an institutional design that allows for an ‘opposition’ to the current leadership elites and policy status quos (Dahl, 1971). Providing incentives and arenas for oppositions to organize and articulate their positions is important to ensure that citizens understand differences between the present government and the (democratic) political order (Shapiro, 1996). If citizens cannot identify alternative leaders or policy agendas, it is difficult for them to determine whether leaders could have done better or to identify who is responsible for policies. Active opposition parties in parliament with many affected parties represented, and media scrutiny, are crucial for such fact-finding, attention and assessments. These benefits require freedom of association and information, and real opportunity spaces for formulation and contestation of the agenda and policy choices.

Consider those who favour an alternative set of policy outcomes to the current policies of the Commission, the Council and the Parliament. As the EU is currently designed, there is no room to present a rival set of leadership candidates (a government ‘in waiting’) and a rival policy agenda. This is different from the growing ‘anti-EU’ sentiment in many Member States, which often presents itself as the opposition to the EU establishment. But, such anti-EU parties and movements do not simply oppose the current policy balance at the European level, but advocate root-and-branch reform, or even abolition, of
the EU system – rather like the Anti-Federalists in the early years of American
democracy. Indeed, it is precisely because there is no visible quasi-official
‘opposition’, that citizens cannot distinguish between opposition to the current
EU policy regime and opposition to the EU system as a whole.

Regarding the second component, *competitive elections are crucial to make policies and elected officials responsive to the preferences of citizens* (see, for example, Powell, 2000). Electoral contests provide incentives for elites to develop rival policy ideas and propose rival candidates for political office. This identification of new alternatives is crucial: ‘the definition of the alternatives is the supreme instrument of power’ (Schattschneider, 1960, p. 68). Competition between parties with different platforms that express alternative, somewhat consistent, conceptions of public interest and public policies helps voters realize which choices may be made and give them some alternatives (see, for example, Manin, 1987, pp. 338–68).

Where the EU is concerned, policies might be in the interests of citizens when they were first agreed, but without electoral competition there are few incentives for the Commission or governments to change these policies in response to changes in citizens’ preferences. For example, EU policy-makers are trying to grapple with the structural reform of the European economy, which everyone seems to agree needs to be addressed at the European level. At the moment this is not salient for Europe’s voters, even though the distributive and redistributive consequences of any structural reforms are potentially huge. The EU has policy instruments to introduce labour market reform in Europe. For example, the Commission could propose a directive harmonizing rules on the hiring and firing of workers for small and medium-sized enterprises. However, such a proposal would be politically explosive, as this would involve a radical shift from the policy status quo for most Member States. As a result, governments have tried to encourage each other to introduce labour market reforms through the ‘softer’ process of the ‘open method of co-ordination’ (OMC). But, faced with entrenched vested interests against labour market reform, domestic political parties have no incentive to follow the informal agreements made through OMC or to act unilaterally.

The problem for the EU, in this case, is that there are few if any vehicles for encouraging a European-wide debate about structural reform of the European economy that can feed off and mobilize political opposition. In a ‘normal’ democracy, rival groups of elites (parties) would have incentives to develop and promote competing policy positions, a majority would form in favour of a particular policy package, and a mandate for action would be established. Without such democratic contestation, the EU is simply less capable of assessing and addressing one of the central issues facing European policy-makers.
Regarding the third component, political competition is an essential vehicle for opinion formation. Competition fosters political debate, which in turn promotes the formation of public opinion on different policy options. Policy debates including deliberation concerning the best means and objectives of policies are an inherent by-product of electoral competition. Without such debates, voters would not be able to form their preferences on complex policy issues. Electoral contestation thus has a powerful formative effect, promoting a gradual evolution of political identities.

For example, in the history of American and European democracies, the replacement of local identities by national identities occurred through the process and operation of mass elections and party competition (Key, 1961; Lipset and Rokkan, 1967). Political parties appear to play particularly important roles in fostering and maintaining dual political loyalties in multi-level polities to one’s own sub-unit and to the polity as a whole (McKay, 2004, pp. 23–39, 2001). Likewise in the EU, rather than assuming that a European demos is a prerequisite for genuine EU democracy, a European democratic identity might well form through the practice of democratic competition and institutionalized co-operation.

Our concern that Moravcsik and Majone ignore the role of preference formation in the EU does not stem from a greatly contested philosophically esoteric version of deliberative democracy. These effects of political discourse for ‘identity formation’ are widely acknowledged, not only among ‘communicatively’ oriented deliberative democrats – though they sometimes seem to ignore that much of this is a shared democratic heritage (Weale, 1999, p. 37). Where different theorists disagree is instead in their assessment of the risks, possibilities and best institutions for regulating such preference formation and modification in a normatively preferred direction (Schumpeter, 1976; Riker, 1982; Schmitter 2000; Follesdal, 2000).

As has also been argued by many other scholars, it is not necessarily the case that all such formation and modification is reliably for the better (Przeworski, 1998, pp. 140–60; Follesdal, 2000, pp. 85–110; Elster, 1998, pp. 1–18; 2003, pp. 138–58).

We deny that more – and less constrained – deliberation always makes for better democracy. We are prepared to defend constitutional constraints on democratic decisions (Dryzek, 1990), and we accept a constrained rather than populist account of democracy. We accept the delegation of authority to regulators where policies should be Pareto-improvements with few distributive options or when needed to build trustworthiness. We are also prepared to consider checks and balances, for example, drawing on the US federalist tradition or the European consensus-democracy tradition (Lijphart, 1999). And, we are prepared to welcome human rights constraints on parliaments to
protect minorities and Member States, rather than exposing them to avoidable risks of unfortunate deliberations and resultant policy mistakes.

Against this background, consider Moravcsik’s claims that expanding participation is unlikely to overcome apathy, since ‘EU legislative and regulatory activity is inversely correlated with the salience of issues in the minds of European voters’ (Moravcsik, 2002, p. 615). We would object that perceived salience is partly endogenous, a consequence of lack of political contestation. Thus, for instance, this apathy is likely to change if media and political parties start to claim that EU decisions impact on high-salience issues such as health care provision, education, law and order, pensions and social security policy, and taxation.

The links between domestic policies and EU institutional design may well be ‘unclear in the minds of many, thereby depoliticizing the issue’ (Moravcsik, 2002, p. 616). But, increased political contestation would probably address – and contest the nature of – such links or lack thereof. Moravcsik holds that the formal list of EU competences is highly significant for assessing whether democratic contestation is appropriate. Surely the relevant terms of normative assessment are not the formal list of competences but the impact on citizens. Such claims about impacts is the stuff of democratic contestation – and hence salience. Moravcsik may be correct that the EU’s activities are limited to a policy agenda focused on cross-border economic activity, with a small budget to boot. Yet national politicians sometimes claim that their hands are tied, leaving much room for two-level diplomacy. Such claims and others emerge and are tested largely within democratic institutions. The links may well remain unclear, but are hardly uncontested or not salient.

Moravcsik dismisses some ways to give citizens reason to care about EU politics: Schmitter’s or Van Parijs’s suggestions regarding minimum income with massive redistribution may well be infeasible schemes, especially in the short run (Schmitter, 2000; Van Parijs, 1992). But other, politically more realistic, agenda topics may also capture voters’ interests. The current implausibility of Schmitter’s and Van Parijs’s proposals are irrelevant for assessing claims that political contestation is important for enhancing democratic legitimacy.

V. Why the EU is Undemocratic and What Could be Done About It

Central weaknesses in Moravcsik’s and Majone’s denials of the EU’s democratic deficit are that EU policies currently have large distributive consequences, rendering a purely unique Pareto-improvement argument insufficient. The low current salience about policy issues is not a justification for no democracy, as long as it may equally well be the result of a lack of democratic arenas for
contestation. Currently there are several constitution-like and institutional features that insulate the EU from political competition.

Most fundamentally, there is no electoral contest for political leadership at the European level or the basic direction of the EU policy agenda. Representatives at the EU level are elected, and so can formally be ‘thrown out’. However, the processes of electing national politicians and even the members of the European Parliament are not contests about the content or direction of EU policy. National elections are about domestic political issues, where the policies of different parties on issues on the EU agenda are rarely debated. Similarly, as discussed, European Parliament elections are not in fact about Europe, but are ‘second-order national contests’. They are fought by national parties on the performance of national governments, with lower turnout than national elections, and hence won by opposition and protest parties. At no point, then, do voters have the opportunity to choose between rival candidates for executive office at the European level, or to choose between rival policy agendas for EU action, or to throw out elected representatives for their policy positions or actions at the EU level.

Referendums on EU issues, such as membership of the EU or EMU or ratification of a new EU Treaty, do better than national elections or European Parliament elections in terms of allowing voters to express their preferences about the EU. National politics, such as the popularity of the government, still play a role in EU referendums (Franklin et al., 1995; Hug, 2002). However, referendums on EU issues are considerably less ‘second order’ than European elections (Siune et al., 1994; Garry et al., 2004). The problem with referendums, however, is that they only allow voters to express their views about isolated fundamental constitutional issues and not on the specific policy content within a particular constitutional status quo. Referendums are hence ineffective mechanisms for promoting day-to-day competition, or contestation between policy platforms, or indeed articulation and opposition in the EU policy process.

Interestingly, there is increasingly ‘democracy at the European level’, in terms of party organization and competition in the European Parliament. The political parties in the European Parliament are now more cohesive than the Republicans and Democrats in the US Congress, and what determines coalition formation between the parties in the Parliament is their distance from each other on the left–right continuum – in other words, parties that are ideologically closer together vote together more often (Hix et al., 2005). Moreover, the powers of the parties in the European Parliament have evolved – in terms of their influence over policy outcomes – as the powers of the Parliament itself have grown, as has their control of resources inside the European Parliament (such as committee and rapporteurship assignments). As a result, the members of the European Parliament (MEPs) are increasingly likely to vote with their
European party colleagues and against their national party leaderships when these two sets of interests are in conflict (Hix, 2002a). This tendency came into the open in October 2004, when a coalition of parties and MEPs in the European Parliament for the first time refused to support the proposed line-up for the new Commission, despite heavy lobbying by many national governments from both right and left for their MEPs to break from their European party positions.

Similarly, there is increasing policy contestation inside the Council of Ministers. There are a growing number of ‘roll-call’ votes and what explains the number of times a government either abstains in a vote or votes against the winning qualified majority is the left–right and pro- or anti-Europe position of the government relative to the other governments (Mattila and Lane, 2001; Mattila, 2004). But, without full transparency of amendment procedures, agenda-control rules and even the recording of roll-call votes when votes fail, it is very difficult for academics or the media, let alone the general public, to follow meaningfully what goes on inside the EU’s primary legislative chamber.

A bigger problem, however, is the lack of a connection between the growing democratic politics inside the European Parliament and EU Council and the views of the public. The parties in the European Parliament and the governments in the Council may well reflect the various positions of the voters they represent on the issues at stake. However, without an electoral contest connected to political behaviour in these EU institutions it is impossible for voters to punish MEPs or governments for voting the ‘wrong way’. Government responsiveness suffers.

What is encouraging from the early seeds of democratic contestation in the European Parliament and Council, nevertheless, is that there really is potential for battles over the EU policy agenda. Opening the door for further contestation, to allow a greater connection between voters’ preferences and coalitions and alignments in the EU institutions, may not require massive constitutional overhaul. We argue that these problems may be temporary, and may not require massive constitutional overhaul—tinkering, time and controversies may engender Europe-wide debates, possibly spurred by parties and party families who see opportunities for votes.

Nevertheless, we would point to some details of institutional design that seem important. For example, the Council of Ministers needs to be more transparent. This not only means publishing voting records, which has been the demand of many democratic deficit commentators for some time. It also means allowing the public, via the media, to see who proposed what, what coalitions formed, which amendments failed, and who then was on the winning and losing side. Now that the EU has expanded to 25 Member States, the Council will be forced to become ever more like a classic ‘legislature’, with
standard rules of procedure determining the division of labour, agenda control and amendment rights. What needs to happen is that who gets what, when and how as a result of these rules, becomes public knowledge.

Furthermore, the Commission’s designated role regarding the European interest should not be formulated in such a way as to imply that the content of this term is uncontested, or that the Commission is the only institution able and willing to identify and pursue it. Now that the basic policy-competence architecture of the EU has been confirmed – in terms of the regulation of the market at the European level and the provision of spending-based public goods at the national level – the role of the Commission is not fundamentally different from other political executives. The purely Pareto-improving functions of the Commission, such as the merger control authority or the monitoring of legislative enforcement, could easily be isolated in new independent agencies. Then, the expressly ‘political’ functions of the Commission, in terms of defining a work programme for five years, initiating social, economic and environmental laws, and preparing and negotiating the multi-annual and annual budgets, should be open to rigorous contestation and criticism. Such criticism should not be interpreted as euroscepticism or anti-federalism, but rather as an essential element of democratic politics at the European level. Majone may well agree with this suggestion, though it remains to be seen how and where he would distinguish between purely Pareto-improving and other, (re)distributive, functions of the Commission (Dehousse and Majone, 1994).

Related to these two ideas, an institutional mechanism needs to be found for generating debate and contestation about politics in, not only of, the EU. The most obvious way of doing this is contestation of the office of the Commission President – the most powerful executive position in the EU. For example, there could be a direct election of the Commission President by the citizens or by national parliaments (Hix, 2002b). Alternatively, a less ambitious proposal would be for government leaders to allow a more open battle for this office without any further treaty reform. Now that the Commission President is elected by a qualified-majority vote (after the Nice Treaty), a smaller majority is needed in the European Council for a person to be nominated. This led to a dramatic increase in the number of candidates in the battle to succeed Romano Prodi and a linking of the nomination of a candidate to the majority in the newly elected European Parliament. However, the process could have been much more open and transparent – with candidates declaring themselves before the European elections, issuing manifestos for their term in office, and the transnational parties and the governments then declaring their support for one or other of the candidates well before the horse-trading began.

The Constitutional Treaty, if ratified, would be an improvement on the institutional status quo in terms of the possibility and likelihood of more
democratic contestation. The Constitutional Treaty would increase transparency of the legislative process, increase the powers of the European Parliament and formally link the choice of the Commission President to European elections. The Constitutional Treaty would also give several new powers to national parliaments, underscoring that we are not witnessing a ‘post-national’ order, but rather a complex new multi-level polity, with some classic federal features and some completely new institutional innovations. National parliaments would be able to monitor the application of the subsidiarity principle, giving ‘yellow cards’ when violations are suspected. This arrangement may well bolster political debate and contestation, since national parliaments are to get copies of legislative proposals, Commission consultation documents, copies of suggested Treaty reforms and European Council suggestions of when unanimity is not required by Council.

The increased transparency and powers of the European Parliament and national parliaments may foster political contestation. This is not to deny that transparency also may carry costs regarding the quality and efficiency of agreements, for instance by foreclosing the creative exploration of new options (Elster, 1998, p. 98; Naurin, 2004). This loss of efficiency in individual cases does not outweigh the benefits of political contestation and more trustworthy institutions.

Our arguments for increased democratic contestation also withstand Dahl’s pessimism about enlightened decisions in large-scale democracies. We agree that it is difficult, if not impossible, to determine the ‘general good’ within a heterogenous population, even with contestation (Dahl, 1999). And there seems to be a trade-off between citizen effectiveness in smaller units and system capacity which sometimes favours larger units. Surely, the relationship and division of functions between units in a complex polity requires careful and theoretically informed decisions (Dahl and Tufte 1973, pp. 139–42). Dahl and Tufte’s arguments underscore an argument that this article shares: democratic contestation of these issues is not a perfect procedure. However, their arguments do not support non-democratic solutions, where these important decisions about subsidiarity and competence allocation should be taken by non-accountable authorities without public contestation. Such non-democratic modes of decision-making would paper over such controversies and obscure the political choice. They are therefore over time likely to yield even less ‘effective’ solutions than democratic mechanisms.

EU decisions have contested effects, distributive and otherwise, and there are reasons to believe that several choices are arguably good faith specifications of ‘the European interest’. A worry about the efficiency loss of politicization therefore seems ill-founded.
However, the Constitutional Treaty was a missed opportunity to be rather more bold in trying to promote contestation of the EU agenda. For example, there was considerable support in the Convention on the Future of Europe for allowing the majority in the European Parliament to nominate the Commission President instead of the European Council. This would have established a much clearer link between the outcome of European elections and the formation of government at the European level. But a minority of governments, led by France and the United Kingdom, vetoed this change, fearing that this was too ‘federalist’. This was a mistake, as the potential impact of more democratic competition could be more or less policy from the EU, depending on the type of contest that develops and the candidate who wins.

Such a reform would also have captured the public’s imagination. With all the other Treaty reforms, the governments promised their voters a significant policy ‘carrot’ if they ratified the Treaty: the Single European Act would produce a single market; the Maastricht Treaty would lead to EMU; the Amsterdam Treaty would create an area of freedom, security and justice; and the Nice Treaty would allow enlargement. In contrast, there is no major new policy project that would be achieved if the Constitutional Treaty is ratified. As a result, the potential costs of not ratifying the Constitutional Treaty are not obvious to most citizens. Hence, the governments should have been bolder in promising something new for the European public, such as a genuinely more democratic set of institutions.

Conclusion

If democracy is only about matching the present preferences of voters to policy outputs, it is difficult to explain what is wrong with the EU. However, there is broad agreement between democratic theorists that the citizens’ preferences that do matter are those that have a chance of being created or modified within arenas of political contestation, and that what matters are institutions that reliably ensure that policies are responsive to these preferences, rather than matching by happy coincidence. Thus, one important challenge is to create institutions that provide such opportunities and responsiveness. The endogeneity of voters’ preferences, while recognized and indeed a premise across many normative democratic theories concerned with the legitimacy of democratic arrangements, seems to be handled less acceptably at the European level than at the domestic level. In particular, we suggest that the lack of party competition and other lacunae concerning a political public sphere should make us more wary of Moravcsik’s and Majone’s optimistic conclusions. It will be much more difficult to assume that EU policies are only – or should only be – concerned with Pareto-improvement to a unique solution if such claims are subjected to
public political scrutiny by different political parties that have something to
gain by convincing voters otherwise.

All is not lost though, as change is on the way. Democratic contestation, in
terms of trans-national alignments and coalitions along left–right lines have
started to emerge in both the EU Council and the European Parliament. What
is still missing, though, is the connection between these developments and the
divisions in the EU’s society at large, in terms of the potential winners and losers
of potential policy agendas. This may not even require fundamental reform of
the EU treaties. All that may be needed is for the political elites to make a com-
mitment to open the door to more politicization of the EU agenda, for example
via a battle for the Commission President, with governments and national and
European parties backing different candidates and policy platforms. European
Parliament elections would continue to be primarily ‘second-order’ for some
time. But, if there are new incentives for national party leaders to compete in
these contests on European-level issues rather than purely national concerns,
over time EU-wide coalitions and alignments between national and European
actors would begin to solidify.

Overall, Majone and Moravcsik’s contributions should be welcomed. We
do not agree with all their claims and assertions. However, we share their
enthusiasm for ditching abstract normative assertions in favour of careful
normative reasoning and the assessment of empirical evidence. The proverbial
‘bar’ has been ‘raised’ to a new level of analytical rigour in the debate about
the democratic deficit in the EU and what should be done about it.

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WHY THERE IS A DEMOCRATIC DEFICIT IN THE EU


