July 2013

THE UNSUSTAINABLE DIVERGENCE OF NATIONAL PRODUCTIVE SYSTEMS

Seven lessons from the Eurozone crisis.

Robert BOYER, Institute of the America

Prepared for the book edited by the University of Porto

Table of content

INTRODUCTION 1

I. THE RESPONSIBILITY OF AN IRRELEVANT THEORY FOR ANALYSING THE CREATION OF A NEW CURRENCY 2
1.1 – Neutrality of money and automatic real economy equilibrium 2
1.2 – Full employment and a common model to all economies 3
1.3 - Governments are the servant of economic rationality. 4

II. THE BENIGN NEGLECT FOR MORE RELEVANT ANALYSES 5
2.1 - The Eurozone was not an Optimal Currency Areas 5
2.2 - Keynes, Schumpeter, Minsky and Krugman: useful warnings about an excessive optimism 5
III. THE EURO MADE OBSOLETE THE PAST NATIONAL ECONOMIC POLICY REGIMES, BUT POLITICIANS DID NOT CARE! 7
3.1 - Industrial and income policies were necessary to replace two lost instruments: the interest and exchange rates. 7
3.2 - The illusion of a smooth transition from the European Monetary System to the Euro 9
3.3 - The long legacy of a North/South divide in productive capacity and competitiveness 11

IV. THE POOR IMPLEMENTATION OF LISBON STRATEGY AGAINST THE STRAITJACKET OF EUROPEAN TREATIES 13
4.1 - A quite relevant diagnosis: innovation was the Achilles Heel of Europe 13
4.2 - Poor economic outcomes, but promising institutional innovation? 14
4.3 - The relevant coordination level for structural reforms: more the Nation State than European Union. 15

V. IN THE GLOBALISATION ERA, LOW INFLATION DOES NOT IMPLY FINANCIAL STABILITY 17
5.1 - Another example of dramatic underestimation of the break generated by the Euro 17
5.2 - A dramatic weakness in the epoch of globalisation 18

VI. DELEGATING TO INTERNATIONAL FINANCE EURO ZONE MONITORING: A LOSING BET . 19
6.1 - The surprising reasoning of international finance: all public debts are now equivalent from Germany to Greece 19
6.2 - Nominal convergence, but diverging economic specialisations and domestic growth regimes 20
6.3- Trade balance surpluses in the North, deficits in the South. 21
6.4 - The ambiguous blessing of Euro credibility: more trade deficit in the South 22

VII. THE ONLY DEFENSE AGAINST FINANCIAL COLLAPSE : THE CENTRAL BANKER 24
7.1 - The subprime world crisis: a brutal wakeup call by international finance 24
7.2 - The July 2012 statement by Mario Draghi stops the panic. 25
7.3 - Unequal national productive capabilities erode the effectiveness of a common monetary policy 26

CONCLUSION 28

INTRODUCTION

The Euro crisis has aroused and continues to arouse heated debate among economists and the number of interpretations is impressive and growing as time elapses. The diffusion of austerity plans assumes that excessive public deficits are the culprit and this is the mainstream explanation within contemporary new classical macroeconomics that postulates that pure market economies are self- regulating. The vision from ordo-liberalism adds that the violation of European treaties is the underlying reason for the Euro crisis, thus rules should be strictly enforced again, at odds with the free marketers recommendations. Other analysts blame the European Central Bank to have set so low interest rates that real estate bubbles and easy public deficit financing have destabilized the Eurozone. Still others reiterate that the European Union was not an optimal currency zone and thus the Euro is not viable and will collapse anyway. This list could easily be extended with an impressive list of mono-causal interpretations. At one extreme of the spectrum, the crisis is typically political and specific to Europe: no common currency without fiscal federalism; no federalism without democratic control. At the other extreme, external and quite abstract forces are dominant: the Euro crisis is the unintended consequence of Lehman Brothers collapse; the speculative nature of financial capital is the real obstacle to Euro viability; the shift in the global economy towards Asia is the deeper origin European slow growth, major obstacle to Euro viability.

The present article proposes a different approach. Firstly, the monetary and financial sources of instability should be related to the joint evolutions in the real economy, against the neutrality of money embedded in modern macroeconomics. Secondly, national economies heterogeneity has to be taken into account in order to understand the structural macro-economic unbalances that turn a speculative attack on the Greek public debts into systemic crisis of the Euro and even the whole European Union. Thirdly, such a dramatic turmoil is not up to a unique cause but it derives from the interplay of a complex web of cognitive, economic and political factors. This article deals with the following themes.

Within the leading macroeconomic thinking and models used by the Central Banks, Ministries of Finance and financiers to assess the viability of the Euro, the key variable was the relative frequency of symmetric shocks easily dealt with by a common monetary policy and asymmetric ones that would justify to maintain national monetary policies. It is an invitation to survey the debates that took place in the preparatory phase of the Euro in the 90s (I). Dissenting analyses had been developed and they were able to anticipate some, if not all, of the possible unbalances generated by the shift from the European Monetary System to an irreversible Euro: they were put aside in the public debate (II). Actually elites and politicians have dramatically underestimated the loss in the national economic policy autonomy: the interest rate, exchange rate and the interdiction of monetisation of domestic public debt should have been replaced other instruments, such as innovation, industrial, income policies and selling treasury bonds on the world market. In their absence, the shrinking of the domestic productive system is the logical outcome: this was the path followed by European periphery (III).

Precisely, along with the Euro, the European Union had launched the Lisbon strategy that aimed at a higher growth by an ambitious program fostering innovation, especially for lagging economies. Unfortunately the outcomes have been disappointing since the divergence between Southern and Northern productive systems generated by the Euro have not been balanced by the Lisbon strategy (IV). The Euro crisis came as a complete surprise for the best experts and this is puzzling for an historian of the European integration. De facto, a survey of the origins of the Rome Treaty and subsequent development hints that new European public goods, such as financial stability, or a modicum of solidarity were necessary for the long run viability of the Euro (V). The role of political factors has to be introduced to explain this lack of concern for a financial regulation that could have fostered the long run competitiveness of each national productive system: the European commission and governments delegated the monitoring of public deficit by international finance and its short termism and myopia have been fuelling cumulative real economy

unbalances, the underlying cause for the severity of the Euro crisis (VI). But then, why has not the Eurozone collapsed? Simply because the bold move of the European Central Bank. Mario Draghi announced on July 2012 that the Euro was irreversible and will be defended against speculation at any cost. This has been (transitorily) calming the storm but simply buying time since the generalisation of austerity policies is still widening the innovation and productive gap across national economies (VII).

I. THE RESPONSIBILITY OF AN IRRELEVANT THEORY FOR ANALYSING THE CREATION OF A NEW CURRENCY

The launching of the Euro coincides with the loss of influence of the Keynesian paradigm and the rise of Real Business Cycles (RBC) models that assume that business cycles can be explained by exogenous shocks hitting a pure Walrasian economy (Lucas, 1983).

1.1 – Neutrality of money and automatic real economy equilibrium

This academic school has progressively gained influence in economic policy discussions, especially when many influent Central Banks have been using this approach in the evaluation of their monetary policy. The European Central Bank has thus been developing the second generation of these models under the name of Stochastic Dynamic General Equilibrium Models (DSGE) (Smets and Wouters, 2002). This was presented as a definitive move towards a fully scientific approach to previously highly ideological discussions about monetary and fiscal policy.

Without overestimating the influence of macroeconomists upon the fate of the Euro, this conversion to pre-Keynesian conceptions has contributed to the misunderstanding of many issues at stake. The contrast between the key features of the Euro-zone and the core hypotheses of the Dynamic Stochastic General Equilibrium models is striking (table1).

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

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

	Hypotheses	Mechanisms involved	Consequences of Euro	Degree of realism
1.	Exogenous money created by Central Bank	• Typical monetarism • Neutrality of money in the long run	Price stability is the first objective of Central Bank	In modern financial system, endogenous money creation
2.	Full employment equilibrium	• Perfect adjustment by prices and wage flexibility • Only voluntary unemployment	Basically no inflation / unemployment trade off	Large and steady involuntary unemployment in many EU economies
3.	Symmetric shocks will prevail over asymmetric, country specific shocks	Thus a common monetary policy will fulfil the bulk of macroeconomic adjustments	Euro-zone can be viable even if it is not an optimum for monetary unification	Significant endogenous productivity at the national level
4.	Rational expectations for all actors: - Firms, households - Goverments	The economic policy rule associated to the Euro will affect all private and public strategies	The irreversibility of Euro is crucial for its credibility	Adaptation of firms and banks… But governments play a domestic political games
5.	The same size for all	Existence of generic economic adjustments common to all member-States	The Euro will speed up a nominal and possibly real convergence	The Single Market has generated a deeper division of labour, hence heterogeneity

1.2 – Full employment and a common model to all economies

Since wage and price are fully flexible, the unemployment is voluntary in the sense that it is the outcome of a trade off between work and leisure. Such a pattern is difficult to reconcile with the observation of millions of European willing to work for the ongoing wage but unable to have access to jobs, both in the epoch of introduction of the Euro and after 2010, the bursting out of sovereign debt crisis and its contagion to the banks. Clearly, the euro-zone is facing a wave of involuntary employment, in line with the gap between capacity of production and demand. If full-employment were prevailing, austerity policies would boost private demand…but the opposite has been observed since 2010. Nevertheless, surprisingly, leading economists and politicians continue to trust and follow a failed representation of the Euro-zone (Artus, 2012a).This does help in overcoming the euro crisis.

A third misrepresentation relates to the existence of generic mechanism: that are common to all the members of the Euro-zone and this entitles to run a common monetary policy. In a sense, this postulates the homogeneity of macroeconomic adjustments for each national economy. Quite on the contrary since 2000, quite diverging evolutions have been observed and this has enhanced the initial heterogeneity of national "regulation" modes. Therefore the EU level models loose their relevance, including for the transmission of monetary policy: very low interest rate does not convert into buoyant credit when the banks of some members of the Euro-zone are near bankruptcy. More generally, the complementarity of an innovation and export led growth in Northern Europe with a domestic demand led configuration in the South falsifies the hypothesis of a common European model. Alas the diffusion of austerity policies (Boyer, 2012) prolongs the "same size for all" illusion that has been so detrimental to past IMF programs in Asia and Latin America.

1.3 - Governments are the servant of economic rationality.

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

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

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

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

The first lesson: it was dangerous to trust an irrelevant and a-historical theory to assess the epochal change brought by the Euro.

II. THE BENIGN NEGLECT FOR MORE RELEVANT ANALYSES

A whole spectrum of more realistic analytical frameworks were available and could be used to assess the consequences of the euro and they let open the viability or the likely failure of the Euro.

2.1 - The Eurozone was not an Optimal Currency Areas

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

2.2 - Keynes, Schumpeter, Minsky and Krugman: useful warnings about an excessive optimism

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

- Imagining that the Euro-zone would constitute a Walrasian economy where adjustments take place via a complete flexibility of price and wage ignore that oligopolistic pricing is the rule in leading final goods production and that nominal wage rigidity is a common feature. Similarly, households can optimize over time their consumption only if they have access to a perfect credit market. Therefore the Ricardian equivalence principle, that states that private agents will counterbalance any public finance decision, is not an accurate representation of the majority of European economies. This brings back *the Keynesian argument*: all the European Treaties have a structural bias towards lower growth than under the previous European Monetary System regime. Somehow the most recent DGSE models for the Euro-zone recognize that their simulations become more accurate if "non-Ricardian households in the form of rule-of-thumb consumers" are introduced (Coenen & Al., 2012). This is a hidden tribute to the Keynesian consumption function, where current income is the key factor.

- Nevertheless the prognosis derived from the textbook Keynesian model concerning the negative impact of the Euro and the Stability and Growth Pact (SGP) on economic activity has turned out as erroneous for the period 2000 to 2008. This period is better captured by post-Keynesian analyses about the impact of financial liberalisation and innovation upon the recurrence of financial bubbles (Minsky, 1986). Clearly the Euro was a major financial innovation with few precedents to compare with. Nevertheless, the typical pattern of liberalized markets has been observed once more: after a wait-and-see period, the Euro has been perceived as successful since the control of inflation at a low level has allowed a decline in interest rates. The dynamism of consumption and housing market has fuelled a wave of optimism and

generated a bubble in a significant part of the Euro-zone. The subsequent period 2008-2012 follows the pattern of the previous bubbles: the loss of confidence of financiers and the poor reactivity of European authorities trigger a double dip recession. After all, *Keynes and Minsky were right*: the credit money is not neutral and by changing the domestic financial systems, the Euro has shown the irrelevance of the Walrasian approach to macroeconomics.

Table 2 – A more accurate and fair assessment by other approaches

Approach	Core mechanisms	Consequences for Euro	Degree of realism
1. Keynesian Theory	Generally effective demand is the key determinant of employment	Orthodox restrictive monetary policy and limits to public deficit will imply high unemployment	Realist for the period 1993-1999, but not from 2000 to 2008
2. Neo-Schumpeterian Theory	• Innovation is the engine of growth • The knowledge based economy is the new paradigm	• Speed up innovation via RD and structural reforms • Growth is the condition for the success of the Euro	• Germany and Northern Europe, good pupils of the Euro • Lagging Southern Europe
3. New Economic Geography	Increasing returns imply geographical polarization	The Euro triggers a deeper division of labour among regions and countries, hence larger national heterogeneity	The productive unbalances put the Euro at risk, in absence of fiscal federalism / large labour mobility
4. Post Keynesian Theories	Built in instability of finance in the context of liberalisation, innovation and globalisation	Need to build the credibility of the Euro with respect to international finance, at the cost of lower growth	A typical sequence of optimism (2002-2007) and recurring pessimism (2008-2012)

- The *neo-Schumpeterian approach*, too, has not been taken seriously in the launching and management of the Euro. First, it shows that productivity increases are not exogenous since they derive from the explicit strategy of firms in order to capture more profits. Furthermore product and organisational innovations are also key ingredients in the search for oligopolistic rents. Second, neo-Schumpeterian economists have argued that Europe was affected not only by exchange rate and financial volatility but suffered from lagging in adopting the principle of a Knowledge Based Economy (KBE). This explained the slow growth of the old continent and made the sustainability of generous welfare systems problematic (Rodrigues, 2002). The Lisbon agenda intended to correct this weakness in European Systems of Research and Innovation. By the way, the Keynesian and neo-Schumpeterian diagnoses of the impact of the Euro are more complementary than contradictory: their time or horizon is different and they agree that RD expenditures are pro-cyclical, hence reactive to the nature of macroeconomic stabilization policy. Thus a long lasting conservative monetary and fiscal policy reduces productive capacity formation, innovation, in such a way that the long term growth is lower (Dosi & al., 2010).

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

- Finally, the *new economic geography* (Krugman 1991 & 1993) was able to provide an interesting prognosis, against the convergence hypothesis implicit too most European strategies and the new classical macroeconomics. Given the importance of increasing returns to scale, typical in most contemporary sectors, and the agglomeration effects that foster innovation, the stabilization of internal exchange rates had the likely consequences of polarizing economic activity around the already competitive regions, the more so, the more overvalued had been the domestic currency when it was converted into Euros. This is precisely that the evolutions from 2000 to 2012 have pointed out: the North of Europe has maintained a strong manufacturing export basis, whereas the South has specialized in domestic services (Artus, 2011a). The common currency has created the polarization of trade surplus in the North versus trade deficit in the South and such unbalances cannot be corrected by a purely financial strategy.

Clearly the structural weaknesses of the Eurozone could be anticipated and they have been detected quite early (Boyer, 1999 & 2000; Crouch, 2000) but they had no impact at all on policy debates.

Second lesson: an open debate among different economic approaches would have anticipated the present unbalances within the Eurozone.

III. THE EURO MADE OBSOLETE THE PAST NATIONAL ECONOMIC POLICY REGIMES, BUT POLITICIANS DID NOT CARE!

Whereas economists were discussing tiny details within their pet models and politicians selling the Euro as a panacea and an absolute necessity, quite nobody heard the message of few dissenters: such a structural and institutional change totally transformed the exercise of national autonomy, so much that some member States might be unable to cope with the new and drastic constraints imposed upon their past economic policy that warranted to fulfil national objectives, for instance growth and employment.

3.1 - Industrial and income policies were necessary to replace two lost instruments: the interest and exchange rates.

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

In the Golden Age, the national State could use rather freely at least four instruments to fulfil these objectives: monetary policy, budget and tax, exchange rate, industrial / innovation policy with the possible complement of tentative income policies (table 3). With the adoption of flexible exchange rate and the trans-nationalisation of finance, the autonomy of the monetary policy has been limited by the will to monitor somehow the exchange rate and public deficits have been put under the scrutiny of financial markets. Frequently, the unemployment rate has been the variable of adjustment and full employment has become more and more difficult to reach, in particular because public authorities had largely lost the full control over exchange rates.

But with the adoption of the Euro, national authorities lose a second tool: a monetary policy adequate to the national needs. The situation created by the Euro is *radically new*. It is neither the full autonomy of independent national States, nor is it a typically federalist configuration (Dehove, 1997; Boyer & Dehove, 2001)). The responsibility of economic policy is now shared at two levels and *nested* in the sense that neither the *supranational rules* nor the *subsidiarity principle* exert a dominant role. Clearly the *monetary policy* is the full responsibility of the ECB, in charge of maintaining price stability in Europe as a whole. But the credibility of the Euro and specially its exchange rate with respect to the Dollar is significantly affected by the conduct of national budgetary policies. Given the fixed exchange rate system which is irrevocably installed by the Euro between the eleven first members, the Mundell-Fleming's model implies that the *budgetary policy* becomes the only efficient instrument left to national governments in order to control the domestic level of activity (Wyplosz, 1997). Therefore each national State may have an incentive to "free ride" upon the collective good produced by the wise budgetary policy followed by other Nation-States. This is the justification for the Stability Growth Pact (SGP). This introduces still another limit in the use of the traditional tools to stabilize each national economy. Nevertheless, under the pressure of domestic demands for unemployment reduction, many governments have violated the SGP. They then agreed upon in 2005 to reform it, thus breaching one of the founding principles of the European treaties (Boyer, 2006).

Table 3 – J. Tinbergen's analysis of economic policy: the Euro means the loss of two key instruments and the ability to refinance public debt via the Central Bank

INSTRUMENTS / OBJECTIVES	THE GOLDEN AGE	THE ROUTE TOWARDS THE EURO	AFTER THE EURO
1. INFLATION	Autonomous *monetary policy* Eventually income policy	Restriction upon monetary policy (defence of exchange rate)	• Mainly the objective of the European Central Bank • Interdiction of the refinancing of national public debts
2. FULL EMPLOYMENT	Mainly *Budgetary policy* Sometimes Social Pacts	Restriction upon budgetary policy (lower public deficit)	• Budgetary policy restricted by the Stability and Growth Pact • Structural reforms (competition, labour market)
3. EXTERNAL EQUILIBRIUM	Adjustment by political decisions upon the *exchange rate*	Exchange rates become financial market variables, tentatively controlled by the Central Bank	• No more formal external constraint for Member States • The Euro/$/Yen exchange rates as pure market variables
4. GROWTH	Innovation and	Primacy of	• Enforcement of competition,

industrial policy	macroeconomic approach	as alternative of industrial policy • Complemented by the Lisbon Agenda

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

3.2 - The illusion of a smooth transition from the European Monetary System to the Euro

These last remarks point out an underestimated consequence of the Euro: it was not only implying a change in the economic policy mix, between monetary and fiscal tools, but also a drastic change in the institutional architecture of most national economies.

If one adopts the conceptual framework of "regulation" theory, the viability of any socioeconomic regime is up to the short term and long run compatibility, or even better complementarity, of five institutional forms: the monetary regime, the wage labour nexus, the nature of competition, the integration into the world economy and finally the links between the State and the economy (Boyer and Saillard, 2000). De facto, the process of European integration has progressively altered quite all these institutional forms (table 4).

The monetary regime has shifted from a large national autonomy in the Golden Age to policies largely constrained by international financial movements and finally the members of the Euro-zone accepted to pool their monetary sovereignty and create a supranational and independent European Central Bank. In theoretical terms the monetary regime becomes hierarchically superior and for sure exterior to national specific arrangements, at odds with the past Keynesian configuration where it was subordinated to support the basic capital – labour institutionalized compromise. This inversion of the institutional hierarchy means that this past compromise was no more viable and actually, the wage nexus has experienced many transformations: dis-indexing of nominal wage with respect to inflation and productivity, decentralization and individualisation of labour contracts, recurring reforms in the organization and financing of welfare. These pressures upon the redesign of post WWII domestic order were especially strong, in response also the fact that the previous oligopolistic competition at the domestic level has been challenged by the globalisation of production, the emergence of fast industrializing economies, and the loss of control by public authorities over industrial dynamics. The overcapacity in the production of manufactured goods at the world level destabilises most European economies, either because capital flows delocalize employment in search for long term competitiveness or because massive imports trigger a massive dis-industrialization in the weakest market economies.

Table 4 – The Euro meant an epochal change for national modes of "régulation"

PERIODS LEVEL OF INSTITUTIONAL FORMS	"GOLDEN AGE" 1945-1971	THE PAINFUL DECADES 1972-1999	THE HAPPY DAYS OF THE EURO 2000-2009	THE DECADE OF RECKONING 2010 - …..
1. MONETARY REGIME / CREDIT	National	More and more constraints upon national monetary autonomy	The same *European monetary policy for all members*	• The loss of efficiency of ECB confronted with national banking and sovereign debts crises • Major concern for financial stability
2. WAGE LABOR NEXUS	National	National, but transformations in reaction to fiercer competition	Still *national* but « *benchmarking* » at the European level	Labour market and welfare reforms in order to restore national competitiveness
3. NATURE OF COMPETITION	Mainly national	Growing impact of European competition policy	Stricter enforcement of competition at the European level	Overcapacity at the world level triggers fiercer competition
4. INSERTION INTO THE WORLD ECONOMY, EXCHANGE RATE REGIME	Exchange rate is the outcome of political decisions	Financial markets tend more and more to set exchange rates	A single common exchange rate set by financial markets	Promotion of internal devaluations via wage austerity and welfare slimming down
5. LINK STATE / ECONOMY	Large welfare State	Recurring public and welfare deficits	Diverging evolution of public deficits	Sovereign debt crisis, diverging trends across the Euro-zone

In the past, periodic devaluations of the domestic currency could stop these adverse evolutions but this degree of freedom progressively vanished with financial liberalization: basically the exchange rate tend to equalize the rate of return of financial capital across nations, thus generating cumulative unbalances in external trade balances. The situation becomes still more difficult with the Euro: the European currency may appreciate with respect to the dollar, even if exporting sectors and nations become uncompetitive. The only solution left is internal devaluation, i.e. reduction of indirect taxes, social contributions and finally wages.

The post WWII socioeconomic is thus over, but the new institutional architecture where monetary stability and competition are leading the macroeconomic adjustments is far from self regulating: unemployment becomes a residual variable, which hinders the domestic demand and stirs up social conflicts and potentially political turmoil when years of austerity policies only prolong the recession and exacerbate the feeling of unfairness among a large fraction of public opinion.

Lastly, the second adjusting variable is public deficit and debt that remains moderate in the economies structurally competitive, but stubbornly large for those unable to cope with the standards of the world economy. In this case, the issue at stake is not simply the restoration of a "correct" policy mix but the reconstruction of a socio-political order compatible simultaneously with the requirements of the Euro-zone and the pressing social demands of citizens. Does a viable compromise exist and can it be negotiated facing the impatience of international finance and the reluctant solidarity of the healthier members of the Euro?

3.3 - The long legacy of a North/South divide in productive capacity and competitiveness

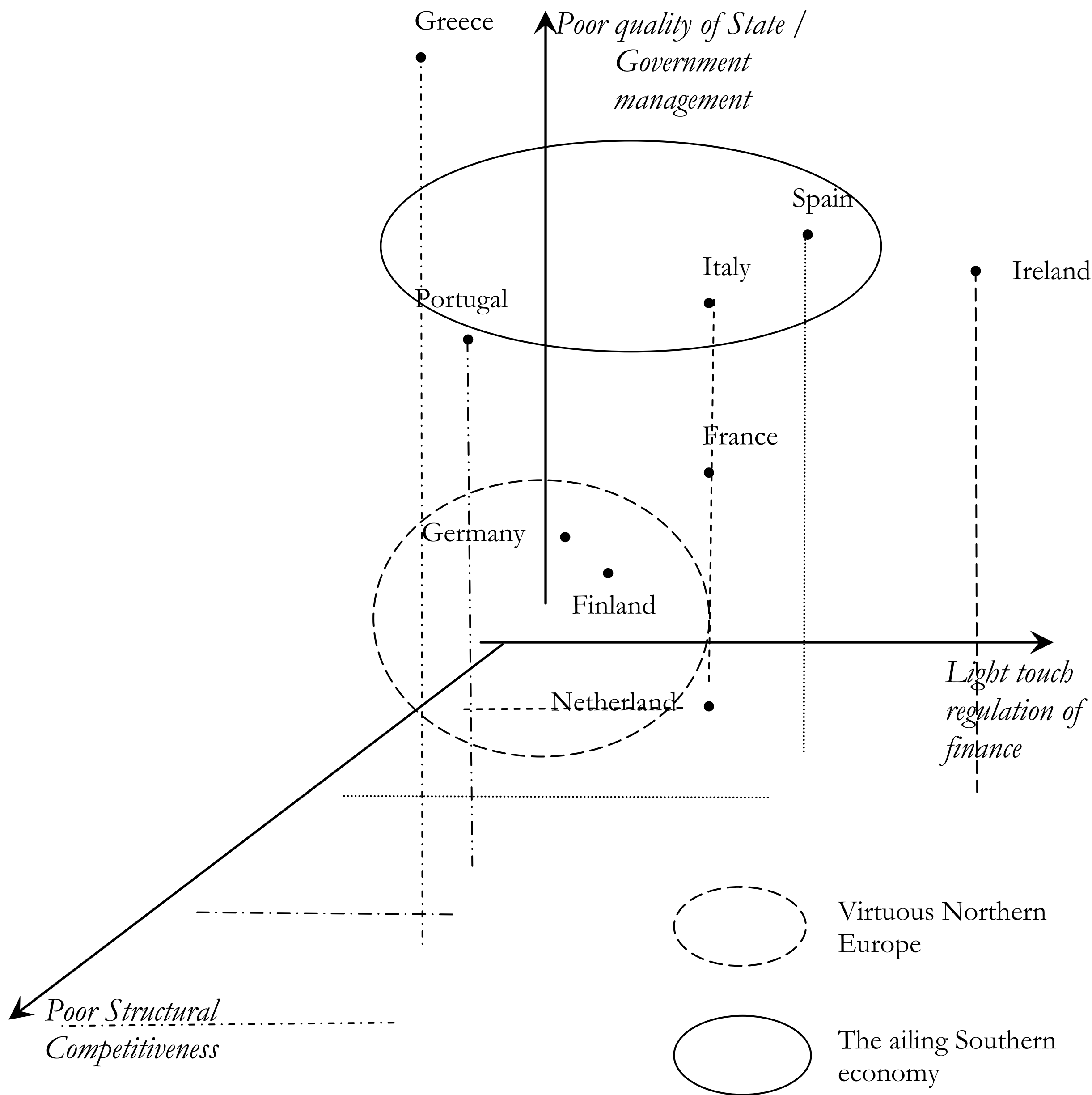
Clearly, the various societies have reacted quite differently to the pressures associated to their Europeanization because they display contrasted innovation systems (Amable & al. 1997; Boyer, 2010) and belong to different brands of capitalism (Amable, 2003). This heterogeneity might be the source a grand divide.

- On one side, small open economies and Germany had a long experience in designing and managing domestic institutions that foster their competitiveness and successful integration into the world economy. An open social dialogue, the dynamism of entrepreneurs and the political stability, were the key ingredients of these "negotiated capitalism" and their export and innovation led growth. For them, joining the Euro is not so difficult since large continuities prevail: organise collective bargaining in order to sustain competitiveness, put the emphasis upon education, training and innovation, turn welfare into an asset in world competition by well designed and patient reforms. In most cases, the reforms are anticipatory and not triggered by a dramatic and unexpected crisis. Still more, the actors do not think that deficit spending can solve major macroeconomic unbalances. Consequently, economic is attributed the role to shape stable expectations.

- On the other side, medium size or less industrialized economies used to rely more on the monitoring of the domestic market, industrial relations are more conflicting than prone to durable compromises, Schumpeterian entrepreneurs are more the exception than the rule, recurring political conflicts make the coherence and continuity of economic policy quite difficult. All unsolved macroeconomic disequilibria – high youth unemployment, specialization in the services, obsolescence of past industrial specialization, lagging innovation, tax evasion, inadequate welfare system – are translated into a large and permanent public deficit. For these configurations, joining the Euro implies a complete redesign of most domestic institutions. The impossibility to devaluate means the implementation equivalent of a permanent income policy-or to use unemployment as a painful disciplinary device-, a definite upgrading of industrial specialization…but these are long term strategies that deliver their benefits only after one or two decades of efforts. The impossibility to monetize the domestic public deficit implies that the governments have to convince international finance that they can reimburse by generating both a trade and public surplus. In some cases. This is an impossible task given the legacy of the pre-euro configuration.

The present analysis concludes that the North/South divide might be one of the major threats upon the current configuration of the Euro-zone (figure 1).

Figure 1 – How the factors of crisis differ across the Euro-zone



THE GREEK EXCEPTIONALISM

FRANCE AS A BARYCENTRE BETWEEN NORTH AND SOUTH

IRELAND VICTIM OF AN UNWISE FINANCIAL LIBERALISATION

Three main characteristics explain why the crisis takes different profile and severity within the same Euro-zone: the quality of State organization and government handling of the crisis, the degree of structural competitiveness and the ability to control and monitor finance.

- Northern economies (Netherland, Finland, Germany) enjoy a good fit with the evolution of the world economy with an effective and reactive State and relative, even imperfect, control over finance. They fare relatively well in terms of external surplus, ability to reduce their public deficit and thus they can comply with the EU and Euro-zone rules rather easily…and ask to their partners to do so….

- Unfortunately, Southern economies suffer from a structural lack of competitiveness, a limited ability of the State to intervene efficiently and some of them have suffered from real estate speculative bubbles generated by financial liberalization. Given the persisting public deficits and the deterioration of their trade balances, it is very difficult from them, to stick to the adjustment programs negotiated with the EU and IMF. The international finance is the referee and it is largely unconvinced that the decisions of the June 2012 European Council can be rapidly and successfully implemented and it doubts that a form of fiscal solidarity will finally prevails before a sequence of defaults.

The heterogeneity of the Euro-zone is still larger when one takes into account three hybrid configurations: France is the intermediate case between North and South, Greek is an exceptional case of clear and largely irreversible insolvency and Ireland is a failed tiger perverted by a careless financial liberalisation but with a large capacity to rebound back to a viable export led regime.

***Lesson three: In the weakest economies, policy makers have not perceived the radical institutional changes required by a durable integration into the Eurozone*.**

IV. THE POOR IMPLEMENTATION OF LISBON STRATEGY AGAINST THE STRAITJACKET OF EUROPEAN TREATIES

At the very same period when the Euro was launched, technical change experts (Soete, 2002) pointed out a structural limit to growth revival in the old continent: the diverging trends observed between the United States and European innovation systems were putting at risk the Welfare State that had to cope with new ageing, obsolescence of workers competences, persisting mass employment. Furthermore, the emergence of China and India as major players of the world economy and recurring demands by citizens for more security added other strains upon the so-called "European Social Model".

4.1 - A quite relevant diagnosis: innovation was the Achilles Heel of Europe

This diagnosis convinced the European Commission to launch a special program, that was adopted by the Heads of States during the March 2000 European Council held in Lisbon on March 2000 . The so-called *Lisbon strategy* displayed three major components. Its objective was to promote growth and employment by maintaining a highly competitive European economy. Its originality was to couple innovation along with the preservation of social cohesiveness, as a compromise between a market liberalisation and a social democratic approach under the umbrella of a Schumpeterian vision of innovation. Since this was not explicitly prescribed by the European Treaties, a new intergovernmental procedure was invented. The Open Method of Coordination (OMC) was conceived as a device in order to overcome the present distribution of competences between member-states and Brussels and promote at the national level the structural reforms required to fulfil the Lisbon objectives.

No surprise if the more severe critiques of the Lisbon strategy recognised that the general diagnosis was, and still is, relevant and the overall strategy goes in the good direction (Kok & al., 2004; Pisani-Ferry and Sapir, 2006; Aghion & alii, 2006) and technical change scholars continue to support the Lisbon Strategy

(Lundval &Lorenz, 2011) . Since the mid2000s, before the euro crisis, the common feeling was nevertheless that the strategy had basically failed and it is why it had to be redesigned .Actually, the 2005 Spring European Council made of the reformed Lisbon strategy a key component of its policy (Rodrigues, 2004).

4.2 - Poor economic outcomes, but promising institutional innovation?

. Generally speaking, economists tend to diagnose a clear failure, whereas political scientists and sociologists have a far more positive assessment. After all, they do not consider the same components.

> The economists focus upon outputs and inputs. Actually the European growth has been sluggish and job creation disappointing, and the gap with the US has been widening. The picture is not satisfactory either in terms of input. The RD/GNP objective of 3 % in 2010 is probably out of reach for Europe as a whole and the reforms of welfare have been difficult, and partial, especially in France, Germany and Italy. They are also the countries that failed to increase their efforts for innovation.
>
> Other social scientists (Zeitlin, 2005; Zeitlin & Pochet, 2005) are more interested by the method and they find a significant learning/experimenting process that, potentially, could overcome for instance some veto points in the reform of national welfare states (Obinger & alii, 2005). On one side, they recognize that National Employment Action Plans are frequently formal exercises of window dressing but on the other side they note a significant transformation of the cognitive maps and agenda of decision makers, by national interactions at national and European levels. For the authors under review, the OMC is a very promising institutional innovation that could be quite helpful, at least in the long term, to overcome some of the deadlocks, exemplified by the fate of the European Constitution. By contrast, economists regret the weak enforcement of the Lisbon strategy, the lack of clear methodology in assessing the National Reform Programmes and generally the poor involvement of national stakeholders (Pisani and Sapir, 2006).

The mid-term review in 2004-2005 had clearly pointed out some limits of the actual organisation and triggered a reform of the Lisbon agenda (Rodrigues, 2006). Basically, it was recognized that strategic objectives were blurred, the inflation of measures and priorities was detrimental some basic mechanisms as well as financial incentives were missing concerning the implementation of the agenda. But, the more fundamental one is a return to a "one size for all approach" (table 5).

Table 5 – Lisbon strategy and OMC: clearly recognized limitations, not really corrected

CRITICISM	REPLY	POSSIBLE REFORMS
1. Too many guidelines	1. A response to the complexity of modern economies. The expression of political compromises	1a. Reduce the number of guidelines 1b. Replace by mechanisms combining items
2. Lack of policy instruments to implement the strategy	2. On the contrary a promising method for overcoming institutional and political deadlock	2a. Design explicit hard rules at the community level 2b. "Blame and share" as incentives to reform
3. Lack of political will, a technocratic exercise	3. Unequal across countries, Common to many European issues	3a. Better marketing, repackaging of the Lisbon strategy 3b. Explicit more clearly the political objectives
4. Low democratic accountability	4. More involvement of diverse stakeholders than for other European policies (ECB, competition)	4a. Extend the diversity of stakeholders at the national level 4b. Develop another concept of democracy
5. Few justification of an euro zone dimension of benchmarking	5. Benchmarking as a learning process, a method to overcome institutional deadlock	5a. Either an unambiguous re-nationalisation of reforms 5b. Or taking into account the Lisbon strategy in the re-design of European instruments (for example SGP reform)
6. Fuzzy criteria in the assessment of National Reform Plans	6. This is only the first stage of a learning process	6a. Use the employment/growth diagnostics 6b. Build a genuine methodology
7. The same reform might have different, sometimes opposite, effects in different countries	7. It might be an exceptional case	7a. Contextual benchmarking 7b. Take into account national diversity

Nevertheless the reforms have been mild, partial and to marginal to overcome the original sin of OMC (Boyer, 2009) : this soft intergovernmental governance could not overcome the dominance of domestic polity in the design of difficult reforms and still less reduce the innovation gap between Northern and Southern Europe that opposes highly and poorly competitive productive systems (see figure 1 supra).

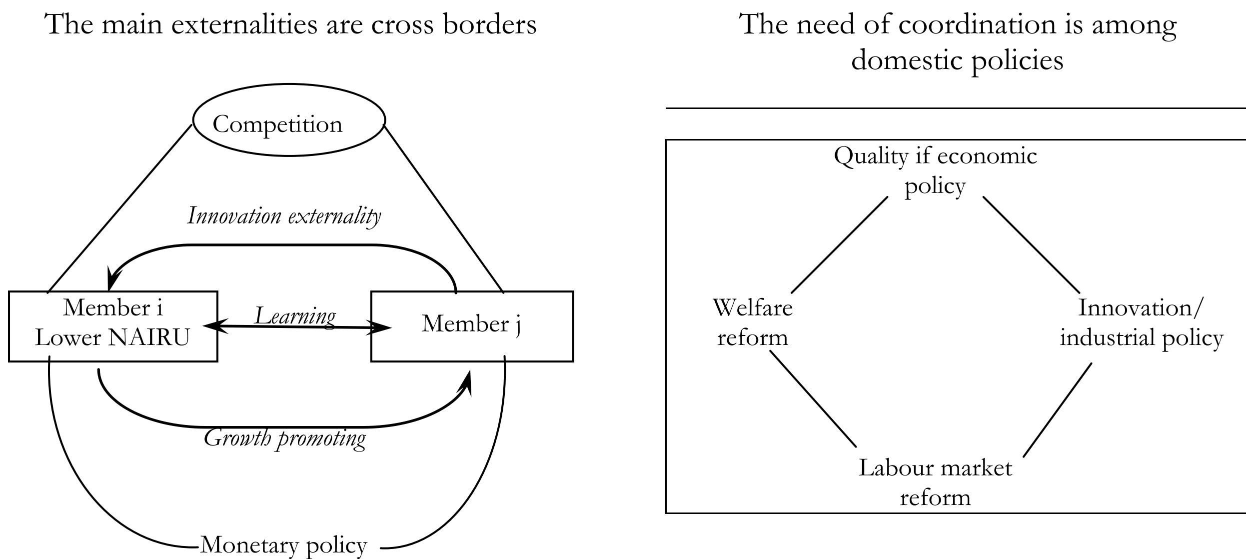
4.3 - The relevant coordination level for structural reforms: more the Nation State than European Union.

The Lisbon strategy raises another central issue concerning the level of governance that is appropriate in order to foster the institutional reforms required to fulfil its main objectives. The OMC assumes that the

coordination among member States is an important factor in the redesign of economic institutions. If for instance, it is assumed that part of the macroeconomic problems are related to a rather restrictive monetary policy that takes into account the fact that labour markets are perceived to be too rigid, then a successful reform reducing the structural employment in one country may induce a change in the European policy mix, especially if such a reform take place in a large country. There are other forms of *cross border externalities*. Actually, a successful redesign of a national system of innovation is expected to benefit to the other economies, via the conventional positive spill-over associated to technical change. From a theoretical standpoint, this would mean that in the long run, the related competences should be at least shared between the national and the European level. According to this view, the Lisbon process would be a method in order to overcome the present distribution of competences as stated by existing European treaties.

The experience of recent years suggests that these externalities, even if existing, are quite weak and unable to trigger the emergence of a virtuous circle according which the lagging countries would be emulated by the more successful ones, and this process would induce a progressive acceleration of European growth and job creation. Quite on the contrary, the abundant literature on capitalist diversity is now confirmed by the researches about the complementarities between labour market reforms and welfare, innovation policy and the conduct of the policy mix. The problem is that these complementarities are mainly if not exclusively national. Hence, a major le difficulty of the Lisbon process: the will to cope with *cross border externalities* neglects the fact that the crucial issue is frequently the coordination and the sequencing of *domestic reforms* (figure 2).

Figure 2 – The need for coordination: across member states or among domestic policies?



One of the major failure is thus to have fed an illusion: benchmarking would be sufficient to enhance an easy catching up of lagging national innovation and production systems. Quite on the contrary, Northern economies have thriven and improved their structural competitiveness, whereas Southern ones have been anesthetized by the inflow of credit and confusing bubbles with productive modernisation.

Lesson four: The polarisation of specialisations across the Eurozone has not been alleviated by an active innovation and industrial policy and this is the underlying origin of the crisis.

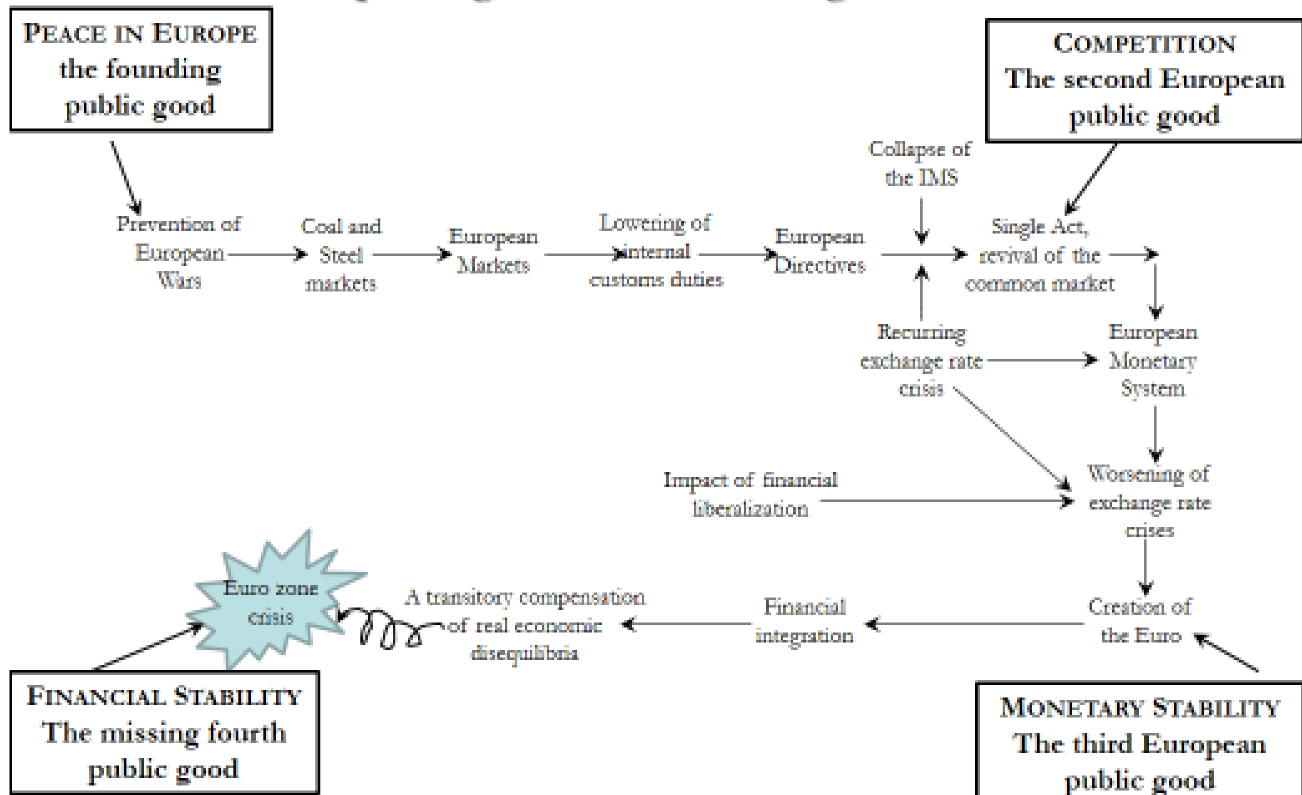
V. IN THE GLOBALISATION ERA, LOW INFLATION DOES NOT IMPLY FINANCIAL STABILITY.

It has been already mentioned: the cognitive maps of the architects of the Euro was not considering how much financial innovation and globalisation had changed the objectives, instruments and effectiveness of Central banks. For monetarists the only source of financial crises was inflation and this conception has hindered the viability and resilience of the Euro zone.

5.1 - Another example of dramatic underestimation of the break generated by the Euro

The policy-makers have worked for eliminating the previous sources of crisis – i.e. internal exchange rate volatility –, and they even tried to anticipate and overcome some of the most likely fragilities of the new institutional design, for instance by forbidding free rider national fiscal policies. Nevertheless, they seemed to ignore that public mismanagement is not the only factor of financial fragility of the Euro-zone: the private sector and especially the banks might adopt quite risky strategies, such as fuelling a real estate boom, pushing securitization or using huge leverage effects, thus provoking a typical Minsky's financial crisis. It is precisely that happened in Spain and Ireland. Back to 1997, the Asian crisis had already shown that very sound public finances were not a protection against massive entries of capital and then their brutal stop. Paradoxically, the cognitive reference of the builders of the Euro was more the German hyperinflation of 1923 or the 80s and 90s Latin American sovereign debts that the new risks associated to financial globalisation and its hype effects on the "animal spirits" in the private sector. Again the basic postulate of a "naturally" stable market economy – a convenient hypothesis for model builders – has hidden the perception of the dangerous path followed by the Euro-zone after 2003. By the way, on October 2011, the European Council has recognized the need for a set of macro-economic indicators capturing the unbalances generated within the private sector – trade balance, real estate prices, deterioration of competitiveness, excess of credit….but it was a little late.

In retrospect, in the mid-2000s, the European policy makers had convinced themselves that the European Union has finally reached its purpose and that no new initiative was necessary (figure 3). The founding fathers had the project to prevent the repetition of the two world wars that had meant the self-destruction and afterwards the decline of the old continent. Peace was the primary public good to be searched for: if it was impossible to get it by a Europe of the Defence, the other road was the organization of orderly economic relations between Germany, France and all other nations involved in these recurring conflicts. But a common market supposed rules of the game in order to maintain fair competition: it was, elevated to the statute of basic European public good justifying a progressive and patient extension of European level competences (Boyer & Dehove, 2006).



5.2 - A dramatic weakness in the epoch of globalisation

But the process has to be re-launched with the rise of exchange rate volatility and its impact over the fairness of the competition on the Single Market. After a long period of experimentation, a growing fraction of European elites has been convinced that a common currency was necessary to continue to benefit from the deepening of inter-European trade. Quite anybody was conscious that it could be a jump into a radically new configuration. It was the merit and the strength of German representatives to propose to extent the approach of ordo-liberalism into the relations between Brussels and national entities: the viability of a monetary integration, without fiscal solidarity and political union, could be warranted by the respect of a set common rules in order to prevent any opportunist national behaviour that could bankrupt the Euro-zone. This was the victory of German conceptions for organizing the European Union, but not at all a transposition of the German federalism, since an institutionalized redistributive system, equivalent to the one created among *Länder*, was not proposed.

This genuine "prudential federalism" was supposed to make unnecessary fiscal, financial and political federalism. But when unanticipated sources of fragility appeared, what to do? Quid if the rules are not followed by all? Should policy makers accept a financial meltdown just to better enforce the rules that have been violated and thus prevent moral hazard to generate another crisis? But will the European Union still exist? European had to recognize painfully that is an evidence for North Americans: it is difficult to defend the Euro in the absence of a Lender of Last Resort, with a tiny balanced European budget and no clear political leadership.

The dangerous path followed from March 2010 to July 2012 shows that financial stability was the next public good in order to preserve the cohesion of the EU…But it was quite late. So late that now the next step is a form of fiscal federalism, however limited, just in order to guarantee the European Stability Mechanism and the European Financial entity in charge of the management of the direct bailing out of some ailing European banks

Lesson five: Monetary stability may be associated to financial instability and a major crisis: specific financial regulations were required to sustain the Euro.

VI. DELEGATING TO INTERNATIONAL FINANCE EURO ZONE MONITORING: A LOSING BET

It was to support the Single European market in reaction to the large volatility induced by financial globalisation that were first stabilized the exchange rate and then a number of countries have pooled their monetary sovereignty with the creation of the euro. For their part, the European treaties instituted an independent European Central Bank and entrusted it to the goal of maintaining low inflation, as monetary stability was perceived as the sine qua non condition for the credibility, therefore the viability of the euro. The fixing of the irrevocable exchange rates between member countries of the euro area was designed to promote trade between Member States and promote the diversification of financial portfolio

6.1 - The surprising reasoning of international finance: all public debts are now equivalent from Germany to Greece

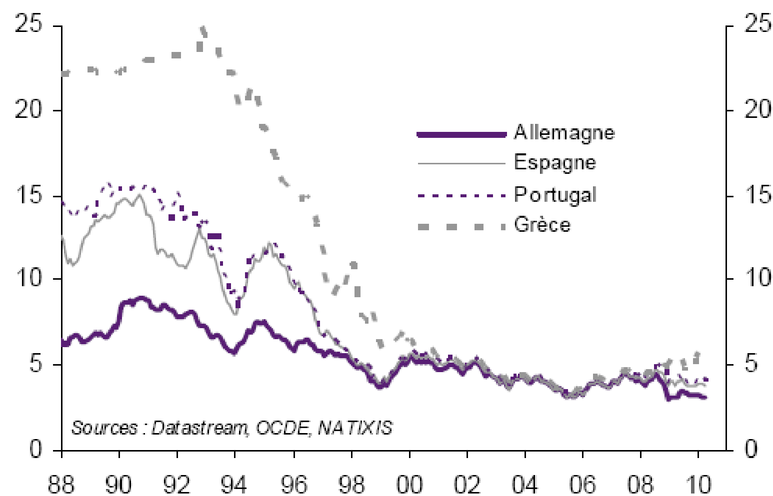
In a sense, after the introductory period marked by great uncertainty, the single currency has reached its objectives as to convince the international financial community to consent, from 2002, the same interest rate for all national public debts within the Euro-zone. While Greece, Portugal and Spain had to pay very high very high interest rates until the late ninety, their accession to the euro granted them the same favorable treatment than that accorded to Germany (graph 1). But this complete convergence of interest rates on all public debts is due to an error of economic analysis and a misreading of the European treaties.

- A priori the Euro membership eliminates a first factor of risk since parity is fixed once and for all as soon as the drachma, escudo and peso are replaced by the euro. However, it was prudent to consider that under the EU treaties some members of the Euro could face the impossibility of maintaining the economic competitiveness of their economy, in the absence of periodic devaluations, while this was the preferred instrument in earlier decades. In this regard the experience of Argentina, establishing a currency board with an irreversible and complete equivalence between the peso and the dollar, collapsed dramatically in 2001. It showed that a constitutional guarantee had not the effective power to contain macroeconomic imbalances accumulated during a decade, precisely because the rigidity of the rate exchange had severely penalized national competitiveness.

- A second consequence was expected and it turned to be wrong: the accession to the euro would bring a quasi-convergence of inflation rates across the area. But the statutes of the European Central Bank only involve maintaining a low inflation for Europe as a whole. This does not preclude that, because of their specialization in sectors sheltered from international competition, some countries, particularly those of southern Europe, are experiencing higher inflation than average. Actually during the period 2001-2007, the yearly average inflation rate spanned from 1.1% in Germany to 4.1% in Spain and 3.2% in Greece (Sapir, 2012). As a result, over time the production costs of southern economies and Ireland diverge compared to the rest of Europe, leading to a deterioration of their trade balances (see Graph 2, infra). But this is not initially an obstacle to their growth as the redeployment of the portfolio of European banks throughout the euro area has compensated this imbalance of trade until 2007 at least. Yet over the years,

this divergence of inflation rates is not corrected and it manifests itself through a contraction in manufacturing and tradable services, and this builds a systemic dependence upon a permanent and large entry of credit from abroad and to a minor extent of capital from surplus countries of northern Europe, especially Germany.

Graph 1 – A convergence of 10 years Treasury bonds interest rate



Source : Patrick Artus (2010), « Quelle perspective à long terme pour la zone euro ?, *Flash Economie,* n° 158, 12 Avril, p. 4.

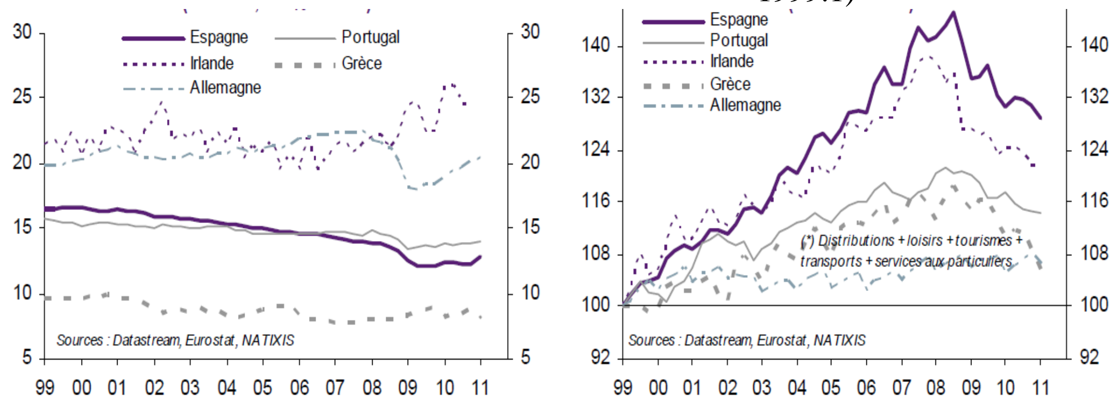
- However a third error in the analysis of international finance is still more puzzling since it affects allegedly quite rational actors: traders do not take into account the prohibition by the European treaties of any fiscal or financial solidarity between member countries of the euro area. Furthermore, joining the euro does not mean that public finances, for example in Greece, became as strong and well managed than those of Germany. Not taking into account this feature is all the more surprising that it was common knowledge that the Greek political authorities had to resort to various accounting tricks and sophisticated financial instruments in order to remove from the balance sheet of the state part of the public debt. Moreover, the admission into the Euro-zone of the Mediterranean countries was the subject of considerable controversies because many analysts and politicians stressed that some of these countries had not built a production system and an institutional structure that could support their long term integration in the euro area. Finally the decision was based on a more political than economic argument: the European Union could not exclude Greece, birthplace of democracy

6.2 - Nominal convergence, but diverging economic specialisations and domestic growth regimes

Still another erroneous analysis and prognosis is noteworthy to be stressed again: many opponents to the euro anticipated that the uniqueness of a monetary policy only focused on price stability in interaction with the constraint implied by the SGP would result that Europe would become a slow growth zone and the least competitive countries, namely those of southern Europe, would grow still more slowly than the European average. It's actually the opposite that was observed from 2001 to 2008 because of plummeting interest rates stimulate home purchases, durable goods, therefore the demand in these countries. In parallel, the North specializes in manufactured goods it exports to the South but also to emerging economies, thus contributes to the balancing of euro-zone external trade with a positive impact on the credibility of the Euro. By contrast, other economies specialize in domestic services, generally not tradable (graph 2).

Graph 2 – A deepening of intra-European specialization: manufacturing in the North, service in the South

A – Share of manufacturing in total value added B – Employment in domestic services (100 in 1999.1)



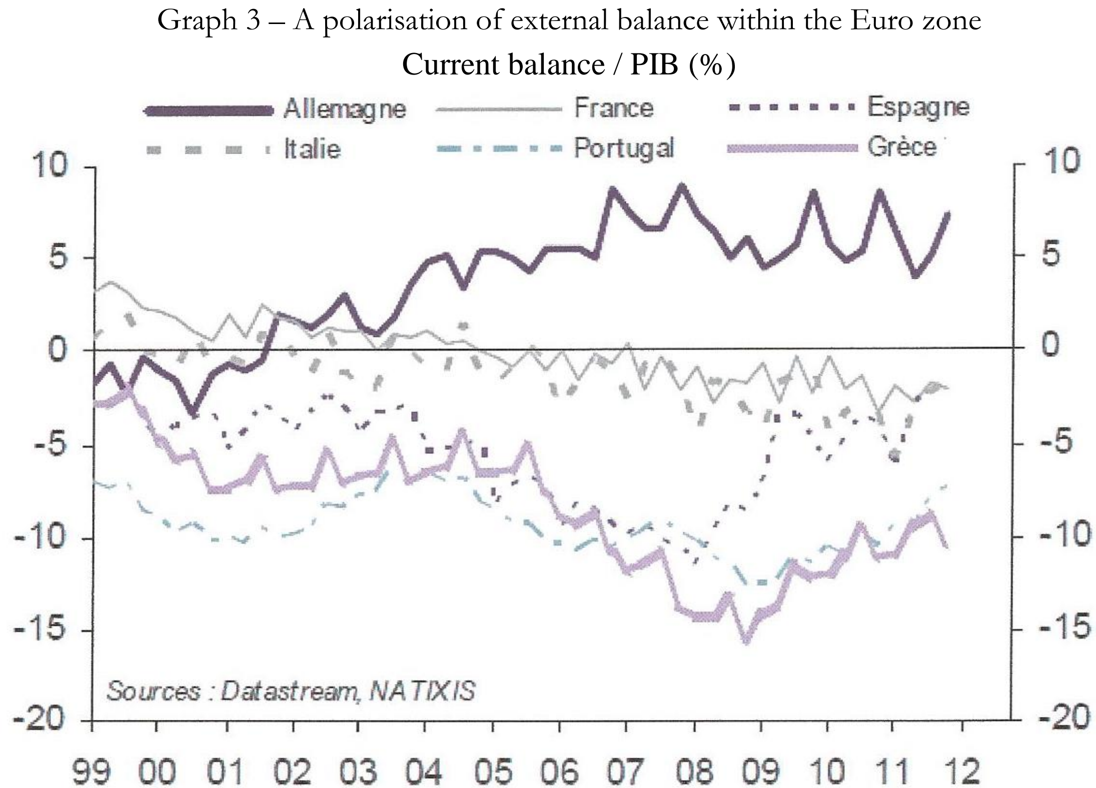
Source: Patrick Artus (2011) "Pourquoi n'a-t-on pas vu, de 1999 à 2007, les problèmes de l'Espagne, du Portugal, de l'Irlande, de la Grèce? »", *Flash Economie*, n° 534, 9 juillet, p. 5.

6.3- Trade balance surpluses in the North, deficits in the South.

Consequently, a structural complementarity emerges between these two sub-area in terms of specialization, supply/demand equilibrium and flows of credit but this means divergence between high value added and skills economies and those limited to more traditional production. This internal unbalance is barely noticed in the early 2000s, whereas the competition with new industrializing countries makes still acute this productive divide. Lastly, the real estate and stock market bubbles, observed for instance in Ireland and Spain, artificially accelerate, transiently, national growth. As domestic production systems, whose competitiveness is deteriorating, cannot meet the boom of domestic demand, trade deficits are widening for all these countries, especially when the euro appreciates against the dollar and other currencies. Indeed, Germany, the Netherlands and other countries of northern Europe generate a growing trade surplus, which ensures the viability of the euro as an emerging international currency, but accentuates the internal imbalances within the area (graph 3).

Graph 3 – A polarisation of external balance within the Euro zone

Current balance / PIB (%)



Source: Patrick Artus (2012), *Flash Economie*, n° 347, 21 mai.

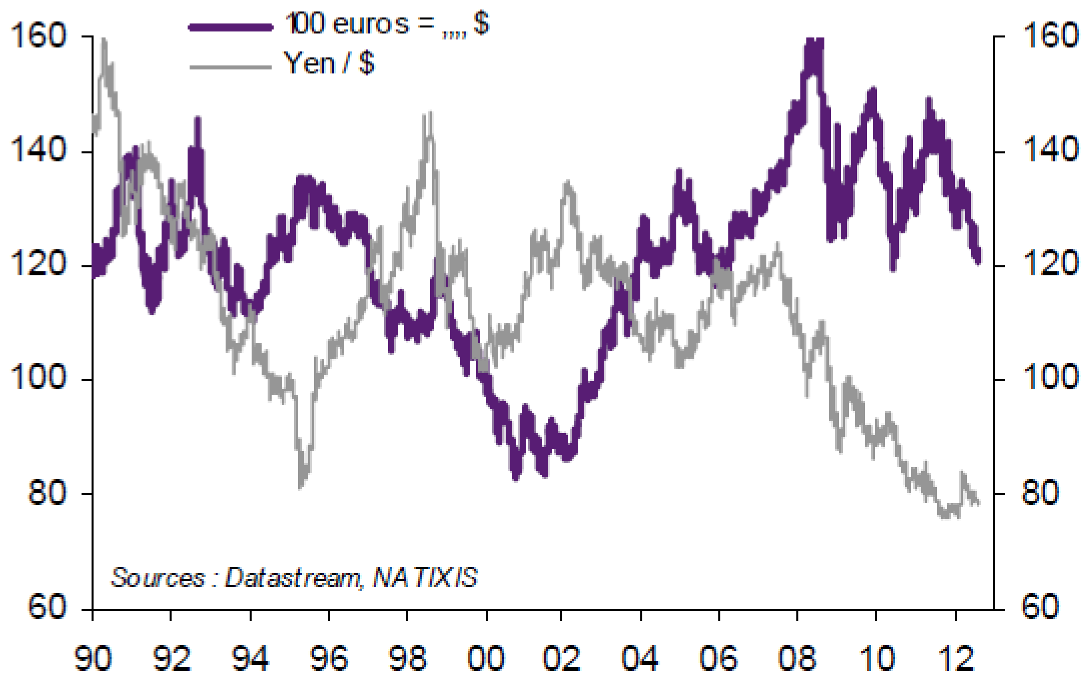
6.4 - The ambiguous blessing of Euro credibility: more trade deficit in the South

The Euro solves internal exchange volatility but does not deal with the issue of the exchange rate regime. In the context of external and internal liberalisation of capital flows, the ECB cannot monitor the Euro / Dollar / Yen exchange rate and simultaneously control inflation, its primary objective.

Initially, the adhesion to a rather simple monetarism led to a rather optimist assessment : if European inflation is under-control, then the equivalent of a Purchasing Power Party equilibrium exchange rate will prevail and warrant, quasi-automatically, the competitiveness of the Euro-zone.

Unfortunately, since the 80s the gross trans-border flows of capital have grown far faster than world trade and even Foreign Direct Investment (FDI). Consequently, the external capital account position tends to lead the evolution of the exchange rate, far away from rate that would warrant a medium-long term trade balance equilibrium and competitiveness of each domestic specialisation. Two years after the launching of the Euro, began on 2002 a long period of its appraisal against the Dollar, with a quasi- doubling of its value just before the crisis (graph 4).

Graph 4 – The evolution of Euro/dollar/yen exchange rates.



Source: Artus (2012c), Flash marches n°535, page 6.

This move contributed to moderate European inflation, in a period of fast rising natural resources prices and it allowed to maintain a neutral or slightly expansive monetary policy. But beneath the surface of this clear success, the over all competitiveness of the Euro-zone has been adversely affected with a negative impact upon the employment in the tradable goods sectors, especially in manufacturing. The high Euro has triggered the delocalisation of productive capacities mainly outside and no more within the EU. The legacy has been a very slow potential growth.

But the strong Euro has exacerbated the large productive heterogeneity that was already the Achilles heel of the old continent (Boyer, 2010).

- On one side, the economies that follow an innovation and export led growth pattern could cope relatively easily since many sectors and firms, being at the technological frontiers, were price makers and thus could develop clever strategies of delocalisation that maintained the high value activities at home. Germany and most Nordic countries have long been following this path. After implementing significant reforms, they fared quite well in the 2000s.

- On the other side, other economies rely more upon the domestic market and develop mainly via their sheltered sector (construction, services to household, distribution) and their export sector is generally small and highly sensitive to price competition given the nature of their specialisation in standardised production in mature industries. Their deindustrialisation speeds up with the appreciation of the Euro (see graph 2, supra).

Here are the germs of the present European crisis: public finance difficult sustainability reflects largely the weaknesses of the domestic productive potential. The Euro has not been devoid of influence in this deterioration of Southern Europe competitiveness.

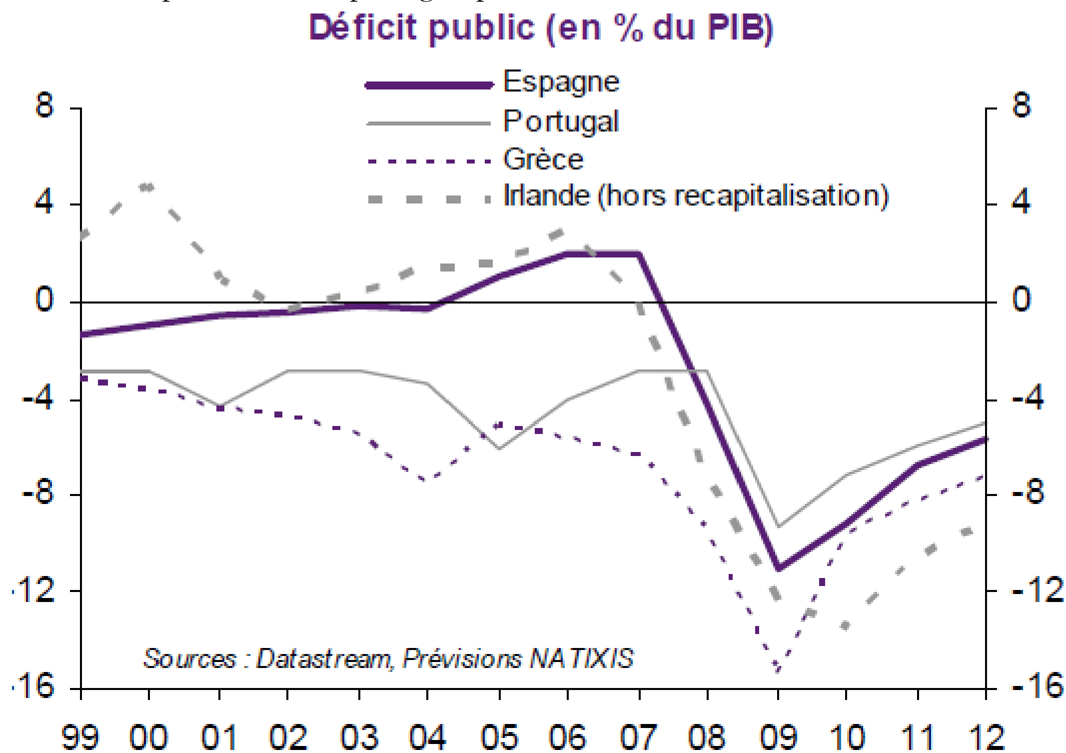
Lesson six: The Euro, along with capital full mobility, has exacerbated the productive unbalances across member states that leads to the present crisis.

VII. THE ONLY DEFENSE AGAINST FINANCIAL COLLAPSE : THE CENTRAL BANKER

7.1 - The subprime world crisis: a brutal wakeup call by international finance

As from 2002 to 2007 the world economy grew at a high rate, under the combined impact of the housing boom in the U.S. and the rapid development of China, the deepening of the internal imbalances in the euro area remained largely unnoticed by European authorities, even worse Spain and Ireland for instance were presented as promising models to be emulated, and they did not raise the concerns of international financiers who extrapolate the observed boom, according to their typical pro-cyclical expectations formation. The reversal occurred only after the collapse of Lehmann Brothers in September 2008. The sharp contraction of world trade and the radical uncertainty that block financial systems are forcing public authorities, whatever their political orientation, to launch programs to sustain economic activity and give their full support to banks and bail them out. The governments definitely wanted to avoid a dramatic depression equivalent to that of 1929-1932 and thus they let the automatic stabilizers play: public deficits have soared. In this context, the level of public debt to GDP reached high levels that were considered as alarming in the eyes of international financiers, as soon as a modest recovery seemed to prevent the repetition of the 1930s. The global crisis has the effect of making visible previously neglected unbalances: from the spring 2010 on, the long-term sustainability of Greek, Portuguese and Irish public finances has been scrutinized by financiers and their assessment has been negative (Graph 5).

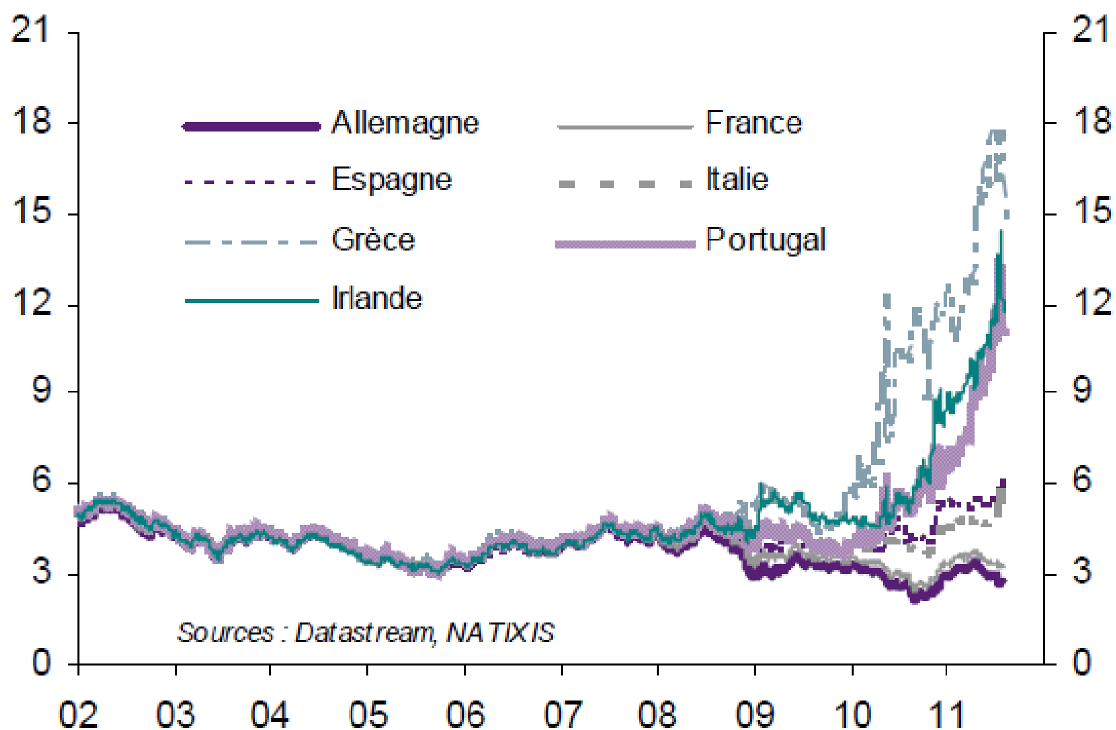
Graph 5 – The deepening of public deficits after 2008: selected countries.



Source : Artus Patrick (2011b), L'introduction du fédéralisme dans la zone euro : les avantages et les risques, *Flash économie*, 18 avril 2011, numéro 284, p. 7.

International financiers operate then a sudden readjustment of their criteria for assessing the financial health of the various members of the Euro-zone. Greece and Portugal polarizes first their concern when they realize-at last- that these two countries have steadily accumulated deficits above those permitted by the SGP quasi each year since joining the euro. The repercussions of the world crisis make visible a characteristic already observable long ago. This is not the case for Spain and Ireland, but they are also hit by a second wave of suspicious evaluations and down grading by rating agencies, in spite the fact that since their accession to the euro, the governments of both countries had maintained a prudent public finance policy, reflected by some surpluses during the years preceding the crisis. If a slimming-down of the public sector might seem adequate for Greece, it is much more dubious for Spain and Ireland since their crises derive largely from a private credit fuelled speculative boom. Maintaining such a low nominal interest rates has spurred massive housing bubbles, when they burst out government deficits have been widening, since tax revenues fall and spending to rescue banks and welfare transfers explode. Again, one is struck by the crudeness of the models used to evaluate the financial strength of various countries. In the case of Ireland and Spain, the soaring costs of refinancing their debt are falsely attributed to mismanagement of the state whereas their crisis is largely the consequence of the errors of private actors, embarked in the hype of a bubble. Capital flight to quality translates into lower interest rates on German debt. This divergence of interest rates is the more acute, the longer had been the period of their total convergence from 2002 to 2007 (graph 6).

Graph 6 – The brutal explosion of the cost of refinancing of public debt of Southern Europe economies



Source: Artus Patrick (2011), "La crise de la zone euro nous apprend beaucoup sur le fonctionnement des Unions Monétaires ; l'euro est-il sauvé?", *Flash Economie*, n° 599, 9 août, p. 5.

7.2 - The July 2012 statement by Mario Draghi stops the panic.

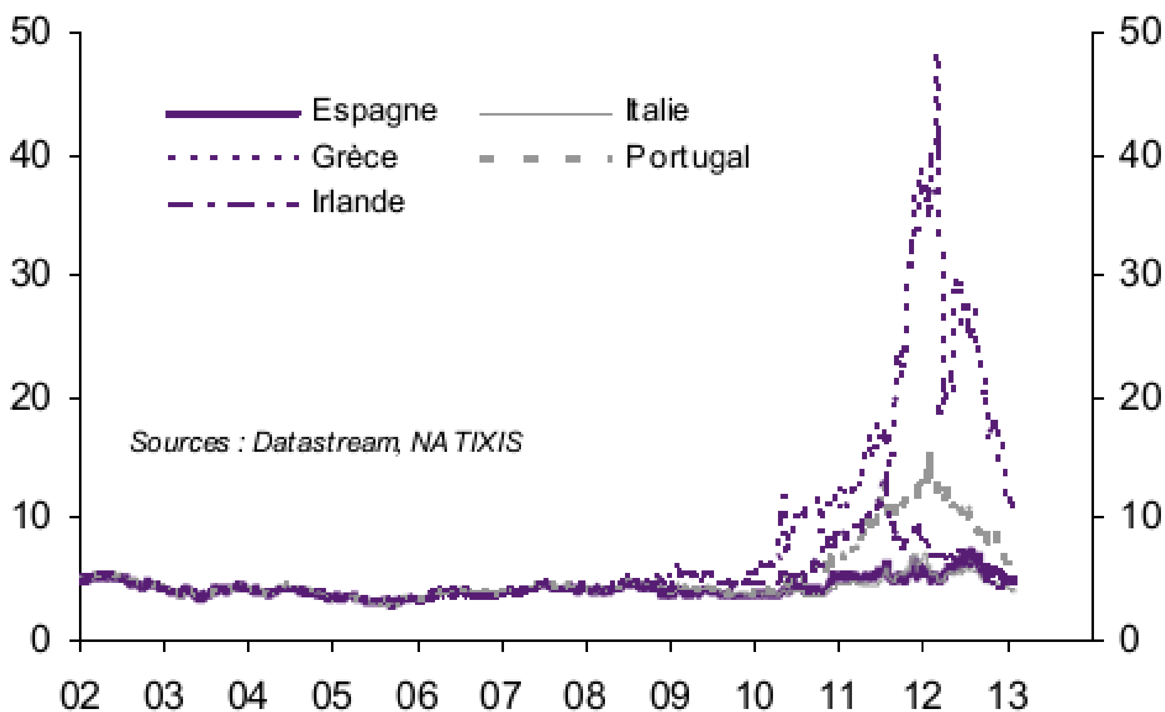
The interest rates were so high compared with growth outlook that, if they persisted, they implied the default for Greece, Portugal and Ireland. In early June 2012, the most likely scenario was a victory of international finance and the breaking-down of the Euro zone since the various European authorities had

shown recurrently their inability to design any relevant policies in response to the everyday pressure of financial markets.This pessimist scenario is brutally reversed by the bold words by Mario Draghi on July *"Within our mandate, the ECB is ready to do whatever it takes to preserve the Euro. And believe me it will be enough [...] To the extent that the size of the sovereign premium (borrowing costs) hamper the functioning of the monetary policy transmission channel, they come within our mandate [...] We think that the Euro is irreversible"."*

The ECB had to argue to defend this unorthodox monetary policy. He stated that the threat of bankruptcy of banks (and governments) was blocking the credit channel in the transmission of monetary policy to economic activity. Therefore, the ECB was ready to buy Treasury bonds from Greece, Portugal, Spain, and Italy. This creative interpretation of the Lisbon Treaty was threatened by the protests of the Bundesbank and the inability to get a unanimous support within the ECB Council. But the aura of ECB prevailed over the sceptics and the impact on interest rates was spectacular and prevented the default of Greece and Portugal (Graph 7). A remarkable calm has been observed on financial markets at least until the spring 2013.

Graph 7: A rapid decline in the cost of refinancing the public debt of the weakest European Economies

Of Greece



Source: Artus Patrick (2013), *Flash Economie*, n° 118, 6 février., p. 5

7.3 - Unequal national productive capabilities erode the effectiveness of a common monetary policy

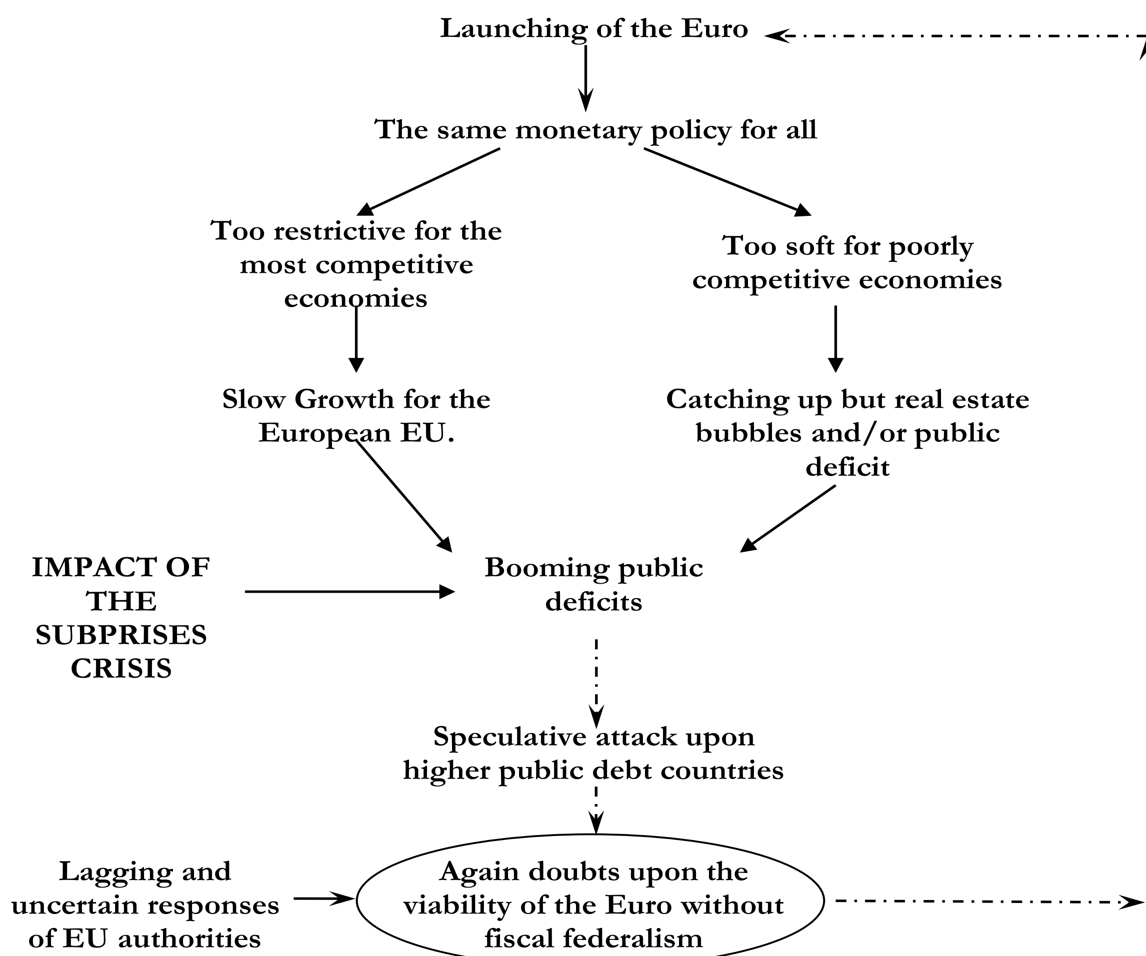
Nevertheless credit to the ailing banks might buy time, but it is not an alternative to difficult institutional reforms of European governance, the more so the more adverse the impact of the diffusion of austerity policies. Consequently if all the entities involved into the governance of the Euro stick to their traditional objectives, past strategies and instruments, no way out the Euro crisis will emerge. Basically there no European commissioner who could defend and implement the required industrial and innovation policy.

Two general lessons can be derived from the observation of this brusque reversal of fortune, concerning the nature of European integration and the logic of liberalized financial markets.

Firstly this "the same size for all" approach to crisis resolution shows how difficult is it for financiers and public authorities to take into account the heterogeneity of socio-economic regimes that coexist within the EU (Boyer et *ali.*, 1997; Amable, 2003) and how serious this handicap is in the redesign of European institutions and the compliance with democratic principles as well (Höpner et Schäfer, 2012).

Secondly a key characteristic of financial markets has to be stressed upon: their evaluations, far from being based on an analytical model that seeks to understand all the factors that determine the probability of default, are built upon highly ad hoc and subjective perceptions that oscillate between overly optimistic in good times and completely pessimist when the economy turns around. This pattern is typical of stock markets (Shiller, 1999): they display a mimetic logic that leads to this instability, the more so, the higher the degree of uncertainty is (Orléan, 2004; 2011). Consequently, it has been quite detrimental to European integration viability to have delegated to the financial markets the task of disciplining member states public finances, after failing to decide and implement a community based process, political in nature, able to enforce the SGP(figure 4). It was especially dangerous since the Euro was conceived as a rampart against the world instability of finance led capitalism (Boyer, 2011).

Figure 4 – Financial speculation reveals the institutional unbalances of European governance in response to national differences in competitiveness



There is another irony: the euro was designed to prevent the liberalization of capital from derailing the construction of the Single European market, in response to the succession of speculations on national currencies exchange rates. One decade later, global finance is now playing one national public debt against another and it has thus destabilized the very foundations of the Euro. If its power remains unchallenged, there is a growing risk that the euro area, at least in its present configuration, comes to an end. This is the cost to be paid for abandoning a community approach: financial stability should have been the next European public good to be implemented, failing to establish it at the world level, even after the G20 summits that followed the Lehman Brothers bankruptcy, when world leaders contemplated the possibility a complete collapse of capitalism.

> ***Lesson Seven: the ECB has become the leader in the rescue of the Euro but no other actor has the legitimacy and tools to develop an offensive industrial policy at the continental level, a necessary condition for the viability of the Euro in the absence of fiscal federalism***.

CONCLUSION

This article argues against the principle of parsimony if the causes and specificity of the euro crisis are to be enlightened. The structuring of academia, the retrenchment of polity with respect to the collective control over national economies, the progressive domination of global finance over the allocation of credit and capital jointly shape first the rise and then the near collapse of the Euro.

The new classical macroeconomics has convinced a majority of economists and politicians about the built in stability of a market economy. Thus the related economic models, used to assess the impact of the Euro were built upon hypotheses that make impossible any crisis: structural stability of macroeconomic equilibrium only moved by exogenous real shocks, neutrality of high powered money, full rationality of expectations, no involuntary unemployment no bankruptcy, and last but not least, the same model for all. This exclusive emphasis upon market pure and universal adjustments discarded two major stylized facts featured by contemporary capitalisms: the geographical polarisation of innovation and productive capabilities on one side, the primacy of financial globalisation on the other.

Actually, it was a rather poor starting point for analysing a complete change in the economic policy mix and in the degree of autonomy of national "regulation" modes. The loss of monetary and exchange rate policies called for mobilising other instruments such as innovation and industrial policy, social pacts or income policy. Some Northern countries had previously developed these instruments and they went through the Euro crisis rather smoothly. Nevertheless others could not forge such a strategy in the eye of the storm. This gap makes the cohesion of the Eurozone problematic in the absence of solidarity and fiscal federalism.

Thus, politicians and macroeconomics have down played the heterogeneity of euro-zone Members in terms of productive specialization, economic policy styles, political and legal conceptions. Still more the deepening of the social divide between groups that gain from the internationalisation and the euro and those who are fearful to loose from it imperils the governability of domestic democratic systems by referring to rules negotiated at the European levels that are to be implemented whatever the expression of domestic public opinion, for instance via referendum on the European treaties.

Financial deregulation and globalisation responsibility are deeply involved in the present turmoil. Most governments have been happy to remove away from the political arena unpopular decisions in terms of capital allocation and economic restructuring. Initially they feared that product and labour market liberalisation would strengthen the economic constraints and consequently imply a slower growth and social protests, but the innovative dynamism and internationalisation of finance have removed the inter temporal income constraints for households, firms and States. Furthermore finance has entitled poorly

competitive economies to enter the Euro, providing instruments to hide and/or transfer the related risks. By lack of political authority and will to enforce Excessive Deficit Procedure, the European entities (the Council, the Commission) have been happy to delegate this task to international finance. Hence the irony concerning the sequence of first an extreme permissive finance then a highly overly pessimist appraisal of the viability of the Euro. This pathological pattern, typical of liberalised finance, has turned a local / limited crisis (Greece) into a radical uncertainty about the future of the Euro and it has revealed the political and institutional limits of the European Union itself.

REFERENCES

AGHION Philippe, COHEN Elie, PISANI-FERRY Jean (2006), "Politique économique et croissance en Europe", *Rapport du Conseil d'Analyse Economique*, n° 59, Paris, La Documentation Française

AMABLE Bruno (2003), *The diversity of capitalism*, Oxford University Press, Oxford.

AMABLE Bruno, BARRE Rémi, BOYER Robert (1997), *Les systèmes d'innovation à l'ère de la globalisation*, Economica, Paris.

ARTUS Patrick (2011a), "L'ajustement demandé aux pays périphériques de la zone euro est-il réalisable? Une comparaison avec l'ajustement réalisé en Allemagne », *Flash Economie*, n° 268, 11 avril.

ARTUS Patrick (2012a), « En situation de sous-utilisation des capacités, les entreprises concentrent leurs productions dans les pays où elles sont les plus profitables, d'où l'accélération des pertes d'emplois dans les pays où la profitabilité est faible », *Flash Economie*, n°515, 25 juillet.

ARTUS Patrick (2012c), « Liquidité mondiale, taille des flux de capitaux, taille des fluctuations des taux de change : pas d'amélioration en vue », *Flash Marchés,* n°535, 9 août.

BOYER Robert (sous la présidence) (1999), *Le gouvernement économique de la zone euro*, La documentation française, Paris.

BOYER Robert (2000), "The Unanticipated fallout of European Monetary Union: The Political and Institutional Deficits of the Euro", Colin Crouch ed., *After the Euro*, Oxford University Press, Oxford, 2000, p. 24-88.

BOYER Robert (2006), "The institutional and policy weakness of the European Union: the evolution of the policy mix", in CORIAT Benjamin, PETIT Pascal, SCHMÉDER Geneviève*, The Hardship of Nations*, Edward Elgar, Cheltenham, p. 161-187.

BOYER Robert (2009), « The Lisbon Strategy: merits, difficulties and possible reforms », in Maria Joao RODRIGUES, *Europe, Globalization and Lisbon Agenda*, Edward Elgar, Cheltenham UK, Northampton (MA), 2009, p. 149-187

BOYER Robert (2010), "From the Lisbon agenda to the Lisbon treaty: national research system in the context of European integration and globalization", in Henri DELANGHE, Ugur MULDUR and Luc SOETE (Eds) *European Science and Technology Policy*, Edward Elgar Publishing Limited, Cheltenham, UK, 2010

BOYER Robert (2010), "Integracion productive y financiera en la Union Europea. De la sinergia al conflicto", *Puente@Europa*, *Dinamicas productivas de la integración: comercio, moneda, trabajo e industria*, Ano VIII, n° 1, Abril, p. 31-47.

BOYER Robert (2011), *Les financiers détruiront-ils le capitalisme ?*, Economica, Paris.

BOYER Robert (2012), "The four fallacies of contemporary austerity policies: the lost Keynesian legacy", *Cambridge Journal of Economics*, 2012, 36, p. 283-312..

BOYER Robert, DEHOVE Mario (2001), « Du « gouvernement économique » au gouvernement tout court. Vers un fédéralisme à l'européenne », *Critique internationale*, n° 11, Avril 2001, p.179-195.

BOYER Robert, DEHOVE Mario (2006), *Political goals, legal norms and public goods: the building blocks of Europe,* Prismes, n° 8 Center Cournot for Economic Studies, Paris.

BOYER Robert, DEHOVE Mario, Dominique PLIHON (2004), *Les crises financières*, Rapport du Conseil d'Analyse Economique, n° 50, La Documentation française, Paris.

BOYER Robert, SAILLARD Yves (Eds) (1995), *Théorie de la Régulation. L'Etat des Savoirs*, La Découverte, Paris.

.

COENEN Günter, STRAUB Roland and Mathias TRABANDT (2012), "Fiscal policy and the great recession in the Euro Area", *American Economic Review*, 102 (3), May, p. 71-76.

CROUCH Colin (ed.) (2000), *After the Euro*, Oxford University Press.

DEHOVE Mario (1997), 'L'Union Européenne inaugure-t-elle un nouveau grand régime d'organisation des pouvoirs publics et de la société internationale ?', *l'Année de la Régulation 1997*, 1, (Paris: La Découverte), 11-83.

DOSI Giovanni, FAGIOLO Giorgio and Andrea ROVENTINI (2010), Schumpeter meeting Keynes: A policy (friendly model of endogenous growth and business cycles, *Journal of Economic Dynamics and Control*, doi:10.1016/j.jedc.2010.06.018.

DRAGHI Mario (2012), "Introductory statement to the Press Conference, 2 August. http://www.ecb.int/press/pressconf/2012/ html/is120802.en.html

HÖPNER Martin, Armin SCHÄFER (2012), "Integration among unequals. How the heterogeneity of European varieties of capitalism shape the social and democratic potential of the EU", *Discussion Paper* 12/5, Max Planck Institute for the Study of Societies. Kohln.

KOK W. and alii (2004), "Facing the challenge. The Lisbon strategy for growth and employment", *Report from the High Level Group*, Luxemburg, November.

KRUGMAN Paul (1991), Increasing Returns and Economic Geography, The Journal of Political Economy 99(3) : 483-499

KRUGMAN Paul (1993), Geography and Trade, Leuven: Leuven University Press, Cambridge: The MIT Pres.s

LUCAS Robert E. (1983), *Studies in Business Cycle Theory*, The MIT Press, Cambridge MA, USA.

LUNDVALL Bengt-Ake, Edward LORENZ (2011), From the Lisbon Strategy to Europe 2020, Mimeograph Forthcoming in MOREL, N., PALIER Bruno and PALME James (eds), *Social Investment*, Policy Press.

MINSKY Hyman (1986), *Stabilizing an unstable economy*, Mc Grow-Hill, New York.

MISHKIN F. and T. ERBERTSSON (2006), *Financial stability in Iceland*, Reykjavick Iceland Chamber of Commerce.

MUNDELL Robert A. (1961), "A Theory of Optimum Currency Areas", *American Economic Review*, 51 (4), p. 657-665.

OBINGER Herbert, LEIBFRIED Stephan, CASTLES Francis (2005), "Bypasses to a social Europe? Lessons from federal experience", *Journal of European Public Policy*, June, p. 545-571.

ORLEAN André (2004), « Efficience, finance comportementale et convention : une synthèse théorique », in Robert Boyer, Mario Dehove et Dominique Plihon (dir), *Les crises financières,* rapport du Conseil d'Analyse Economique, n° 50, octobre, La Documentation Française, Paris, p. 241-279.

ORLEAN André (2009), *De l'euphorie à la panique : penser la crise financière*, Editions de la rue d'Ulm, Paris.

ORLEAN André (2011), *L'empire de la valeur,* Paris, Seuil.

PISANI-FERRY Jean, SAPIR André (2006), "Last exist to Lisbon", *Bruegel Policy Brief*, March.

PORTES Richard, BALDURSSON F. (2007), *The Internationalisation of Iceland's financial sector*, Reykjavick Iceland Chamber of Commerce.

RODRIGUES Maria Joao (ed.) (2002), *The new Knowledge Economy in Europe. A strategy for international competitiveness with social cohesion*, Edward Elgar, Adelshot.

RODRIGUES Maria J. (2004), *European policies for a knowledge economy*, Cheltenham, Edward Elgar Publishing..

SAPIR André and alii (2004), *An agenda for a growing Europe*, Oxford, Oxford University Press.

26, p. 25

SHILLER Robert J. (1999, 2006), *Irrational Exuberance*. Princeton University Press, Princeton.

SMETS Franj and Raf WOUTERS (2002), "An estimated Stochastic Dynamic General Equilibrium Model of the Euro Area", *Working Paper Series*, n° 171, European Central Bank (International Seminar on Macroeconomics), August.

SOETE Luc (2002), "The Challenges and the Potential of the Knowledge-Based Economy in a Globalized World", in RODRIGUES Maria Joao (ed.), *The new Knowledge Economy in Europe. A strategy for international competitiveness with social cohesion*, Edward Elgar, Adelshot..

Bruno, B. (1992) *Régimes économiques de l'ordre politique. Esquisse d'une Théorie régulationniste des limites de l'état*. Économie en liberté, Puf, Paris

TINBERGEN Jan (1952), *On the theory of economic policy*, North Holland publishing.

WYPLOSZ Charles (1997), 'EMU: Why and How it might Happen', *Journal of Economic Perspective*, 11, Autumn.

ZEITLIN Jonathan (2005), "Social Europe and experimentalist governance: Towards a new constitutional compromise", European Governance Paper C05-04.

ZEITLIN Jonathan, Pochet Philippe (eds) (2005), *The open method of coordination in action. The European Employment and social inclusion strategies*, Brussels, Peter