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Governance without government or: The Euro Crisis and what went wrong with European Economic Governance?

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Abstract

The Great Recession after 2008 did not turn out to be as deep and severe as the Great Depression of the 1930s. According to the European Commission, this positive result is due to the fact that economic policy-makers around the world learnt their lessons from the Great Depression in stabilizing their financial systems and, moreover, that particularly the European Union and its economic governance system has become a shelter against negative external shocks in coordinating stabilization policies to maintain aggregate demand.

This paper argues that the claim of the European Commission needs some qualifications: on the one hand, the lessons have not been applied appropriately in all EU and, particularly, Eurozone Member States. This is, on the other hand, not merely the result of mismanagement of individual governments but the systematic outcome of an ineffective and even counter-productive European economic governance system. Although, in the wake of the Euro Crisis some crisis control and emergency measures have been established, crisis resolution has failed as the core of the inefficient governance system – the European Stability and Growth Pact (ESGP) – has not been reformed adequately.

Key words: Euro Crisis, European Governance, Economic Policy

JEL categories: B 59, F 15, H 30, N 10

1. Introduction

The Great Depression of the 1930s is still seen both in scope (being a truly world-wide phenomenon) as well as in as in acuteness as the most severe downturn in modern economic history. It had a strong impact on the economic science in paving the way for the 'Keynesian revolution' and disavowing the idea of unfettered markets, it triggered a sharp turn in economic policy from 'laissez faire' to interventionism and it was a break-through for large-scale social policy programmes creating modern welfare states[1]. Only seven decade later, much of these ascriptions appeared outdated after a long 'neoliberal era' undermining the credibility of the Keynesian welfare state as an efficient institutional arrangement in a globalised world. Instead, retrenchment of the welfare state, de-activating fiscal policy and liberalising financial, labour and commodity markets became the unquestioned objectives of economic policy of the 'Monetarist Counter-Revolution' which took place since the 1970s (see Vercelli 2011, Bellofiore/Halevi 2011).

After the World Financial Crisis hit the global world economies in 2008 and triggered the still ongoing Euro crisis, the question immediately arising is whether policy-makers throughout the world have learned their lessons if not in preventing such a global downturn from happening in the first place[2], then at least in dealing with its consequences. Although, it certainly is of interest to compare different patterns of reaction (e.g. USA versus the Eurozone) or to inquire into the resilience or vulnerabilities of various countries or clusters of countries (such as the 'liberal market economies' or the 'coordinated market economies' of the varieties of capitalism literature), the focus here will be on the Eurozone. The reason is, on the one hand, to evaluate the European Commission's claim to have learned its lesson (see European Commission 2009a) and, on the other hand, to investigate into how the Eurozone has managed to govern a situation of utmost crisis without a unitary actor, i.e. without a government. Has the European economic governance system worked adequately or is it at the

[1] For an account from an US perspective, see Bordo/Goldin/White (1998). More general: Vercelli (2011).

[2] Hyman Minsky's 'Can it happen again?' refers to the Great Depression and his prediction that it will happen again once all the institutional precautions of the Keynesian welfare state ('big government') are razed appears to have been validated in 2008ff.; see Minsky (1982).

roots of the ongoing trouble that has been termed 'Euro crisis'? The paper is organised as follows: in the next part, a short comparison of the developments of the Great Depression (1929 – 1937) with the Great Recession (2008 – 2014) will be given in order to test the European Commission's claim. Thereafter, the European economic governance system will be briefly displayed and from the discussion of its efficiency will some conclusions be drawn that will empirically be scrutinized in the following chapter. Finally, a conclusion will be provided.

2. Great Depression and Great Recession – have we learnt our lessons?

Unsurprisingly, causes and policy effects of the Great Depression are subject to heavy debate[3]: Was monetary policy a major cause of the Great Depression or merely aggravating it? Was it too expansionary or too restrictive prior to the outbreak of the great crash at Wall Street in September 1929? And what about its stance during the Great Depression? Or was it the unduly adherence to the Gold Standard in most countries that disallowed for an appropriate countercyclical monetary policy approach? And if the most widely held conviction is correct that monetary policy at least did not succeed in stabilizing the money supply, price level and credit outlays, was that the result of personal mistakes due to wrong beliefs, systematic incapabilities or even rent-seeking behaviour of the Fed (see Wheelock 1992, Epstein/Ferguson 1984, Anderson/Shugart/Tollison 1988)?

Concerning fiscal policy, it appears to be more settled that no countercyclical policy approach existed prior to the Great Depression. That is not to say, that the public budgets were always balanced or, even, that this was the target set by governments. Clearly, public budgets often went into deficit for quite some time and at quite some magnitude. However, the reasons almost always were to finance wars, not to intentionally intervene in economic processes (De Long 1998). Effectively this meant that some 'automatic stabilizers' are traceable prior to the Great Depression due to time lacks and bureaucratic inefficiencies in pursuing a balanced budget approach but, also, that 'structural budgets' (i.e. adjusted for these cyclical behaviour) acted pro-cyclical. Moreover, the picture changed only slightly under the 'New Deal' policy of US President Franklin D. Roosevelt: Although he claimed social and economic responsibilities for the Federal Government particularly in the area of employment policies, he was merely "a decidedly reluctant and exceedingly moderate Keynesian" (Kennedy 1999: 361) when it came to fiscal policy. Although expenditure of the federal government rose quite markedly after Roosevelt took office, so did tax rates leaving the fiscal stimulus of the budget deficit rather low: "Fiscal policy, then, seems to have been an unsuccessful recovery device in the thirties - not because it didn't work but because it was not tried" (Brown 1956: 863-866).

Despite the general contingency with respect to the explanation of the Great Depression and the policy responses taken, the European Commission believes to be able to present "the main areas of agreement" (EU Commission 2009a: 20) by way of drawing up 5 major lessons:

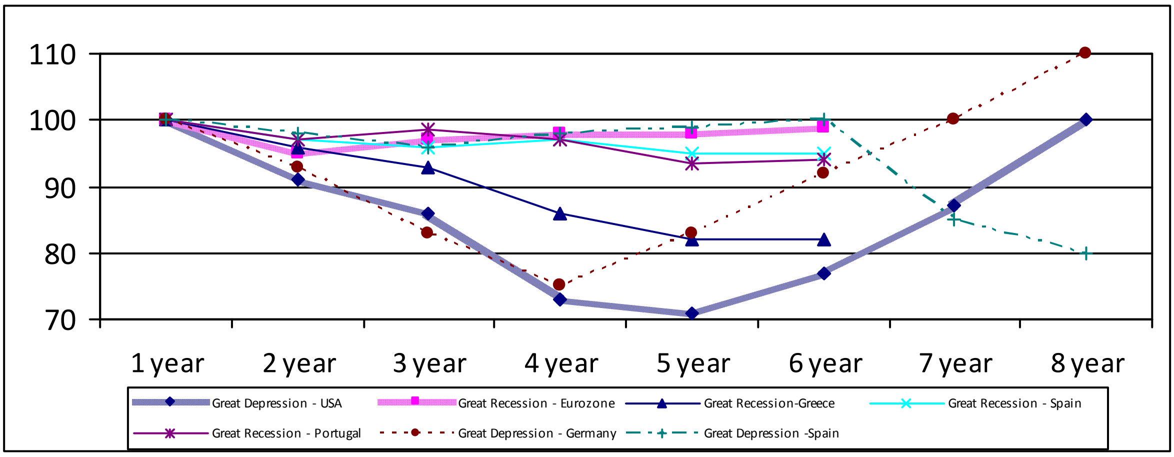
- 1st Lesson: Maintain the financial system – avoid a financial meltdown
- 2nd Lesson: Maintain aggregate demand – avoid deflation
- 3rd Lesson: Maintain international trade – avoid protectionism
- 4th Lesson: Maintain international finance – avoid capital account restrictions
- 5th Lesson: Maintain internationalism – avoid nationalism

[3] See e.g. Wheelock (1992), Meltzer (1976), Temin (1976), Eichengreen (1992), De Long (1998)

While lesson no.1 is fairly obvious and trivial, the lessons no. 3 to 5 are related to trade and globalisation policies to avoid negative consequences of uncooperative distributional games. Taking the Eurozone as a common and domestic market representing a fairly closed economy, these lessons appear to be of second order. Therefore, it is basically lesson no. 2 which is most important and it is why the European Commission in a preliminary evaluation (taking only 2008 and 2009 into account) of the development of the Great Recession draws a rather positive conclusion: “All of the above lessons from the 1930s seem well learnt today …. The financial sector in most countries are given strong support, aggregate demand is maintained through expansionary monetary and fiscal policies, protectionism is so far kept at bay, (…). Most important, the EU is now providing a shelter for the forces of depression in Europe. The EU, through its internal market, its single currency and its institutionalised system of economic, social and political cooperation, should be viewed as a construction that incorporates the lessons of the 1930s.” (EU Commission 2009a: 21 – 22).

Taking a look at comparative GDP and unemployment developments (fig. 1 and 2), this judgement needs some qualifications: While the economic downturn and unemployment shock was definitely more severe – after initially the same impact in the first year (1930 and 2009 respectively) – with respect to the major economies in the 1930s (here: the USA) as compared to the 2010s (here: the Eurozone) and the difference may be attributed to bank rescue and fiscal stimulus programmes, this is not quite true for some countries in the Eurozone: For instance Spain experienced almost the same GDP and unemployment developments now as then (over the first comparable 6 years) and Greece’s GDP development now almost parallels the GDP developments of the USA and Germany during the Great Depression: Although the decline is not as steep as it was in the USA and Germany in the 1930s, it already by now lasts longer than in these countries during the Great Depression.

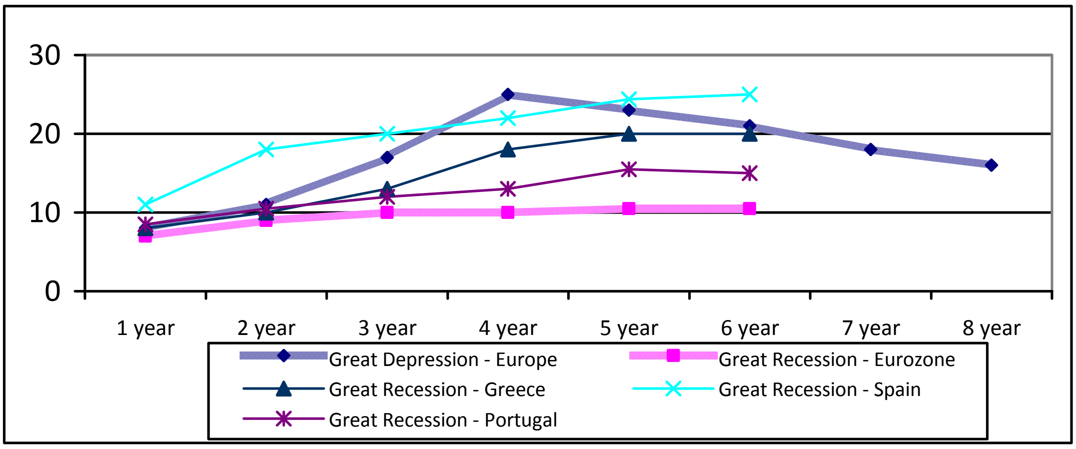
Figure 1: GDP developments in comparison



Note: Great Depression refers to data as in Maddison (2007) and Smits/Woltjer/Ma (2009) for 1929 – 1936; Great Recession refers to 2008 - 2013

Source: European Economy statistical annex spring 2012; Maddison (2007) and Smits/Woltjer/Ma (2009)

Figure 2: Unemployment developments in comparison



Note: Great Depression – Europe refers to data for Germany, France, UK, Netherlands, Belgium, Denmark and Sweden

Source: European Economy statistical annex spring 2012; Maddison (2007) and Smits/Woltjer/Ma (2009)

It appears to mean that lessons had been learned: After the insolvency of the investment bank Lehman Brothers in the USA in 2008, most countries provided unprecedented bank rescue packages in order to keep the financial system from collapsing. Moreover, most countries also provided fiscal stimulus packages to maintain aggregate demand in conjunction with a historically expansionary monetary policy stance (see e.g. EU Commission 2009: 62ff., Zhang/Thelen/Rao 2010, Prascad/Sorkin 2009). Finally, collective bargaining systems and minimum wage legislations helped the nominal unit labour cost and price levels to remain roughly constant instead of severely dropping as was the case during the Great Depression and which would have been the normal reaction if labour markets and collective bargaining systems were only as flexible as perpetually demanded by mainstream economists.

However, this is only half of the story. Obviously, in some countries the general lessons learned have not been properly applied. Again, this may be due to simple policy failures of individual actors, or it may the systematic shortcomings of an institutionalized system of 'governance without government': Perhaps the European economic governance system, contrary to the EU Commission's judgement, is not that well designed as to particularly implement the lesson no.2: to maintain aggregate demand.

3. European Economic Governance and its shortcomings

The 'pre-Great Recession' European economic governance system showed a complex pattern of hard and soft forms of mechanisms to coordinate national and sectoral policies (see tab. 1): the Broad Economic Policy Guidelines (BEPG), the Employment Policy Strategy (EPS), the Cardiff Process (CP), the Open Method of Coordination in the field of social policy (OMC[Social Policy]) and the European Macroeconomic Dialogue (EMD)[4] are forms of

[4] The EMD has been marked by gray shading in tab. 1 because it is the only EU economic policy process which

information exchange not capable of imposing sanctions and, therefore, without clearly traceable coordination effects (see e.g. Deroose/Hodson/Kuhlmann 2008). The European Social Dialogue (ESD) introduced a number of EU regulations that are binding for EU member states – however, due to the very restricted area of application, the ESD had only marginal impact on EU social policy.

Table 1: Pre-Great Recession European economic governance system

Process	Policy area	Modus	Dominant actor	Theoretical basis	Outcome
BEPG	Economic and fiscal policy	Soft	France (nominally), Germany (substantially)	Economists	
EPS	Labour market	soft (OMC)	France, EU- Commission	neoclassical supply-side economics	Disappointing (see Kok-Report), Discours framing
CP	Commodity and financial markets	Soft	UK	neoclassical microeconomics	Information exchange
EMD	Monetary, fiscal and wage policy	Soft	Germany, Austria	Neokeynesian	Information exchange, marginal
ESD	Social policy	Hard by way or EU regula-tions	EU-Commission	Neocorporatism	Various EU regulations in work protection and Equal rights policies
OMC (Social policy)	Social policy (Health, pensions)	Soft	EU- Commission		Catalysator, Discours framing
ESGP	Fiscal policy	hard by way of sanction	Germany	Neoricardian Equivalence theorem	Restricting budgetary policies

Therefore, it is basically the European Stability and Growth Pact (ESGP) which is relied upon to coordinate fiscal policies within the Eurozone in order to complement the common monetary policy. After demands from the German government, the Maastricht convergence criteria on fiscal policy had been hardened and prolonged for the time of existence of EMU: Based on Domar's debt arithmetic (see Domar 1944), assuming a long-term growth trend of (nominally) 5 %[5] and a sustainable public debt level of 60% of GDP[6], the benchmark structural (i.e. cyclically adjusted) deficit level of public households has been set at 3% of GDP as one of the convergence criteria of the Maastricht treaty to be fulfilled by all potential members of the European Monetary Union (EMU)[7]. Despite the 'no bail-out clause' of the

is clearly based on a different theoretical foundation than mainstream economics. It had been introduced in 1999 when a small 'window of opportunity' opened during the very short period of Social Democratic governments holding a majority in EU members states, the newly elected German (Social Democratic-led) government took the EU presidency and Finance Minister Oskar Lafontaine was determined to change EU macroeconomic policies. This constellation changed only months later, when Oskar Lafontaine resigned as German Finance Minister and the German government changed its economic policy outlook from broadly Keynesian to supply-side economics. Although the EMD is still existing, it has never been set to work properly.

5 Allowing for 2% as targeted inflation rate of the European Central Bank (ECB) this implied a potential real GDP growth rate of 3% for the Eurozone – quite an optimistic assumption.

6 Either the 60% government debt level is entirely arbitary or, as rumor goes, was either the average debt level of the potential Eurozone member states at the time of paraphrazing the Maastrict treaty (1992) or the expected debt level of France and Germany by the time of fulfillment of the convergence criteria (1997).

7 The derivation of the 3% deficit threshold – and its debt and growth assumptions - needs to be understood in

Maastricht Treaty, which disallowed for a fiscal union in the Eurozone and kept the national governments fiscally self-responsible, the fiscal convergence criteria were put in place as selection device: only those countries that proved capable of pursuing a sustainable fiscal policy stance were allowed to join the club. As the few years of run-up to EMU could not be seen as a proof of a common fiscal philosophy of restriction and sustainability, the German government insisted on an institutional safeguard of such a fiscal policy stance after EMU had been set up[8]. The resulting European Stability and Growth Pact (ESGP) not only implemented a sanction mechanism, but also hardened the arithmetic deficit target: according to the convergence criteria, 3% of GDP was the structural (cyclically adjusted) deficit ratio, while the ESGP deliberately lowered this structural deficit 'to close to balance or in surplus' leaving the 3% benchmark as the upper threshold level of (cyclically unadjusted) total deficits that goes without sanction.

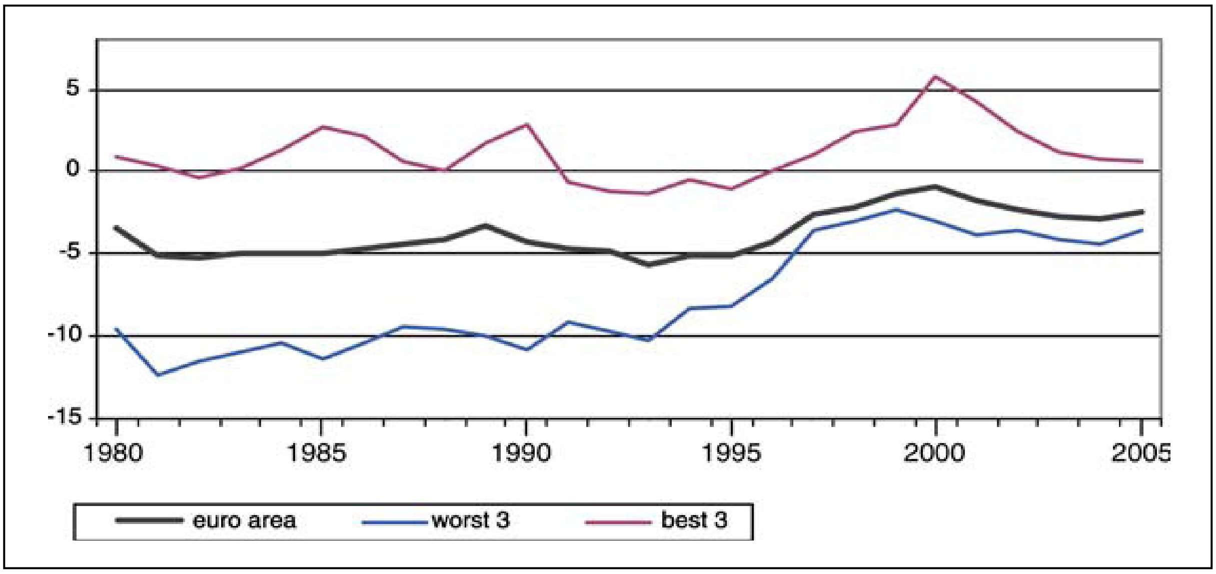
Ever since its introduction, the ESPG has drawn critique: For those, that condemned fiscal policy altogether for its 'government failure' potentials of popular governments desiring to spent but not to tax (see e.g. Buchanan/Wagner 1977; Alesina/Perotti 1995) as well as for those that expected 'free-rider behaviour' to become paramount in a monetary union without restrictive fiscal rules (see e.g. Beetsma 1999, Beetsma 2001) undermining the credibility of price-stability oriented monetary policy (see e.g. Artis/Winkler 1999), the ESGP was still far too lax and vague in its enforcement procedure (see Schuknecht 2005; Feldmann 2003). For them, the ESGP was rather a further example of 'soft' instead of 'hard' coordination without the necessary incentives to provide the desired policy behaviour and the fact that the ESGP had been breached many times by almost every single Eurozone member state without ever a sanction being imposed, served as the proof of its ineffectiveness.

Taking a look at some empirical evidence clearly disapproves this objection: There had been a marked restrictive turn-around in the fiscal policy stance within the Eurozone since the signing of the Maastricht treaty and the preparation for EMU.

order to reject the claim made by some renowned economists that there is no economic rationale for it (see Alesina/Perotti 2004: 13). This non-understanding may also be the reason why most economists have simply missed the fact that the ESGP is hardening the Maastricht convergence criteria.

[8] "Germany was about to surrender control of its currency, and feared that this would endanger its long-cherished monetary stability. As a consequence, it wanted to make sure that it would not have to share membership of the EMU with countries whose economic policy was, in some sense, grossly mismanaged. The budget deficit and government debt were the two best observable proxies for the somewhat hard to define notion of economic mismanagement" (Alesina/Perotti 2004: 13). Interestingly, the French government opposed all too strict fiscal rules as they were seen to cause economic distress – however, they only managed to change the name of the product – by including 'Growth' into the German proprosal of a 'Stability Pact' – but not the substance (see Heipertz/Verdun 2005: 993f., Heise 2005).

Figure 3: General government budget balances 1980 - 2005



Source: European Commission – Ameco database; here taken from: Schuknecht (2005)

As fig. 3 shows, from mid-1990 onwards, public budget deficits in the EU countries eventually forming the Eurozone more than halved – and this result holds as much for the Eurozone average as - and even more so - for the worst three performing countries (in terms of public debt ratio).

Table 2: Budget consolidation before the World Financial Crisis

Country	Debt ratio 1998	Debt ratio 2007	Difference
Eurozone	81,5	71,6	-9,9
OECD	74,2	73,1	-1,1
Germany	62,2	65,3	+3,1
Greece	97,7	112,9	+15,2
Italy	132,6	112,8	-19,8
Ireland	62,1	28,8	-33,3
Spain	64,2	36,2	-28,0
USA	64,2	62,0	-2,2
Japan	113,2	167,0	+53,9

Source: OECD Economic Outlook; European Commission – Ameco databank

Since the establishment of EMU and, hence, the operation of the ESGP in 1999 (see tab. 2), the public debt ratio has declined by 9.9 percentage points – far more than the OECD average

(-1.1 percentage points) or in the USA (-2,2 percentage points)[9]. Moreover, some of the countries that became known as 'PIIGS'[10] and had to resort to emergency measures provided by the EU during the recent 'Euro crisis' were among the countries consolidating their public debts most.

Table 3: Structural deficits during 1999 – 2005 cycle

Country	1999	2000	2001	2002	2003	2004	2005
Eurozone	-1,4	-0,8	-2,6	-2,8	-2,8	-2,8	-2,5
USA	0,6	1,2	-0,4	-3,1	-4,1	-4,2	-4,0
UK	1,1	3,3	0,2	-2,3	-3,9	-4,2	-4,2

Source: European Commission - Ameco database

Finally, tab. 3 provides evidence that the ESGP not only restricted the fiscal policy stance in the Eurozone over a complete business cycle but also narrowed the discretionary room to manoeuvre in times of economic downturn as, for instance, during the 'post-9/11' recession: while structural deficits in the Eurozone during that time never exceeded 3% of GDP, in the USA and the UK a much stronger fiscal stimulus was given[11].

To briefly summarize, it must be stated that the ESGP had not been fulfilled prior to the World Financial Crisis in the strict interpretation of the 'Excessive Deficit Procedure' (EDP) of the European treatise – yet, a strong restrictive behavioural effect can hardly be denied[12]. Moreover, the discretionary capabilities in Keynesian fiscal policy orientation had also been curtailed. This, of course, brings us to the other voices in the critique of the ESGP: While the above-mentioned critics argued in favour of a fiscal rule as strict and inflexible as possible and lamented their inappropriate application, the second group of critics rejected the strictness and inflexibility of the ESGP on different grounds[13]. One criticism has been on the 'one size fit's all' character of the ESGP rule being applied to countries of rather different economic development. According to the Domar arithmetic, sustainable public debt ratios may go along with varying (structural) public deficit rates if the growth rates only differ accordingly. Catching-up countries (mainly of the European south) supposed to converge to Eurozone averages in per capita GDP levels may be harmed if they are restricted in their attempt to follow a (deficit financed) 'golden rule' fiscal policy stance[14].

[9] And the UK, which is not a Eurozone member and, thus, has not to comply with the regulations of the ESGP, managed to reduce its public debt ratio only by 2,2 percentage points although the time period under investigation covers the longest growth period in the modern economic history of the country.

[10] 'PIIGS' stands for: Portugal, Ireland, Italy, Greece and Spain.

[11] In conjunction with a more expansionary monetary policy stance both in the UK and the USA, this resulted in a macroeconomic policy mix better able to cope with the recessionary shock in the UK and the USA than in the Eurozone: average growth rates (2001 – 2005) were: UK = 2,9%, USA = 2,4 %, Eurozone = 1,7%.

[12] As Schuknecht (2005: 78ff.) notes, there is a potential trade-off between complexity and enforcement of a fiscal rule. The more complex it becomes, the higher the monitoring cost will be reducing the pressure to comply. In this sense, on the one hand a simple fiscal rule such as the ESGP increases potential enforcement. If, on the other hand, simplicity reduces economic reasonability ('economic soundness') of a fiscal rule, some flexibility in its application is needed. Therefore, the performance of the ESGP may come close to an optimal solution to the complexity, enforcement, reasonability trilemma.

[13] For a good overview of the different arguments see Heipertz (2003).

[14] The 'golden rule' fiscal policy stance limits structural deficits to public investment outlays.

Another problem, and thus criticism, arises because of the intended suppression of discretionary (structural) deficits to cope with stabilization and growth problems: If the ESPG is applied according to its principles, balanced (structural) budgets leave no room for discretionary fiscal policy reactions on part of the national governments – which appears ever more harmful as the Europeanized monetary policy is also unavailable for stabilisation purposes (see e.g. De Grauwe 1998, Pisany-Ferri 1998). But if structural deficits are used in this sense[15] within the confines of the 3% margin, automatic stabilizers will have to be curtailed accordingly and fiscal policy turns actively pro-cyclical (see Eichengreen 1996, Eichengreen/Wyplocz 1998a).

Finally, and potentially the most devastating critic against the ESGP comes from the ‘coordination literature’ which argues that an appropriate policy mix in order to maximize economic growth under the constraint of public budget sustainability needs an efficient institutional setting which will give the incentives to overcome the inherent ‘prisoner’s dilemma’ (see e.g. Heise 2008, Pusch/Heise 2010, Willet 1999, Collignon 2008). A pre-determined fiscal policy rule as in the ESPG will, in the best case, either be superfluous or, in the worst case, harmful.

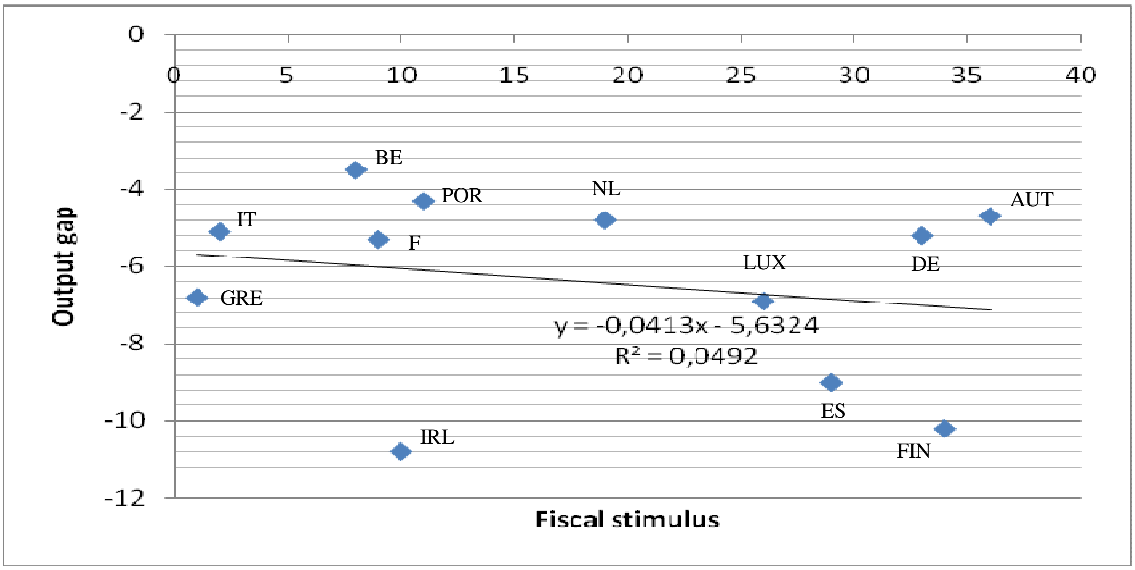
It turns out that, according to these criticism, the ESGP is not just ‘a minor nuisance’ (Eichengreen/Wyplocz 1998b), but may well be at the roots of the poor growth performance of the Eurozone prior to the World Financial Crisis as it does not allow the national governments to take appropriate action in the course of the business cycle and, moreover, does not allow for an appropriate (cooperative) policy mix.

4. European economic governance under stress

If the critics of the European governance system were right and contrary to the claim of the EU Commission, in a situation of a negative external shock one would not expect to find a policy reaction that is gauged towards the needs of the different regions of the Eurozone (i.e. the ensuing output gaps of the Member States) but a policy reaction that is led by the restrictive principles of policy coordination in the Eurozone or, by what may be termed the ‘fiscal space’.

[15] It should also be noted that the exact fulfillment of the ESGP regulations would bring the public debt ratio down to zero in the long run (realistically assuming a positive average GDP growth rate) – which can hardly be interpreted as ‘optimal’ fiscal policy stance in any sense.

Figure 4: Fiscal policy reactions during the Great Recession in the Eurozone



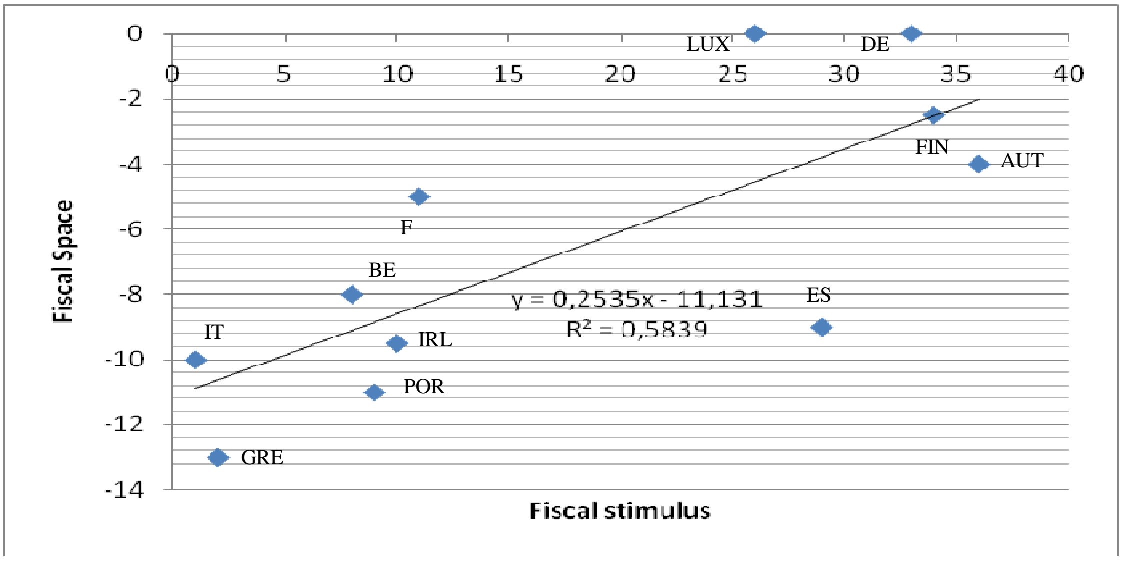
Note: Output gap measures the (aggreagte) difference of actual from potential output 2009 and 2010, Fiscal stimulus in 0,1 % of GDP: 10 = 1% of GDP

Source: European Commission – Ameco data bank and European Commission (2009b)

Fig. 4 and 5 provide evidence that this is exactly the policy pattern that can be traced in the Eurozone: There is almost no correlation between the external shock of the World Financial Crisis (measured by the output gaps in 2009 and 2010) and the size of the fiscal stimulus packages being implemented in the Member States of the Eurozone – and this appears to contradict the result published by the EU Commission with respect to the entire EU, where "(t)he analysis (...) suggests that, overall, Member States whose negative output gap (i.e. their degree of economic slack) is largest, are also those that pursue the strongest fiscal stimulus – and *vice versa*" (EU Commission 2009a: 67f.). Taking the EU Commission's result for granted, there must be a marked difference in the governance of the Eurozone and the non-Eurozone EU member states. This becomes more obvious when 'fiscal space' as a measure of the room to manoeuvre of national governments is considered: Using the composite index 'fiscal space' created by the EU Commission (see EU Commission 2009b) which covers ESGP-criteria and, therefore, institutional pressure (such as the debt ratio) as well as criteria that may capture market pressure (such as contigent liabilities to the financial sector and external imblances)[16], a clear (positive) correlation between 'fiscal space' and the size of the fiscal stimulus package is discernable – a result very much in line with the 'European Economic Recovery Plan' (EERP) which had been agreed upon by the European Council in December 2008 and which was based *expressis verbis* on the restrictions of the ESGP (see European Commission 2008).

[16]The variables defining the composite indicator 'Fiscal space' are: a) the gross debt ratio, b) contingint liabilities in the financial sector, c) medium term tax shortfalls, d) current account balance and e) non-discretionary expenditure ratio. The market pressure of 'fiscal space' works via influencing risk premia on government bonds: The smaller the 'fiscal space', the higher the risk premium and the dearer it will be for governments to finance their deficits. Correlations between governments bond spreads and the 'fiscal space' indicator imply such market pressure. However, the weakness of this correlation and the fact, that the correlation of both indicators in non-Eurozone-countries (not restricted by the ESGP) is even weaker appear to hint to the presumption that the institutional restrictions of the ESGP work directly and also indirectly via inducing extra market pressure; see EU Commission (2009b: 186ff.).

Figure 5: Fiscal policy stance and fiscal space during Great Recession in the Eurozone



Note: Fiscal space is measured as a composite indicator provided by European Commission (2009b). The Netherlands is omitted here as a strong outlier (not using its fiscal space for fiscal stimulus. If the country was included, R-square would drop to 0,3336

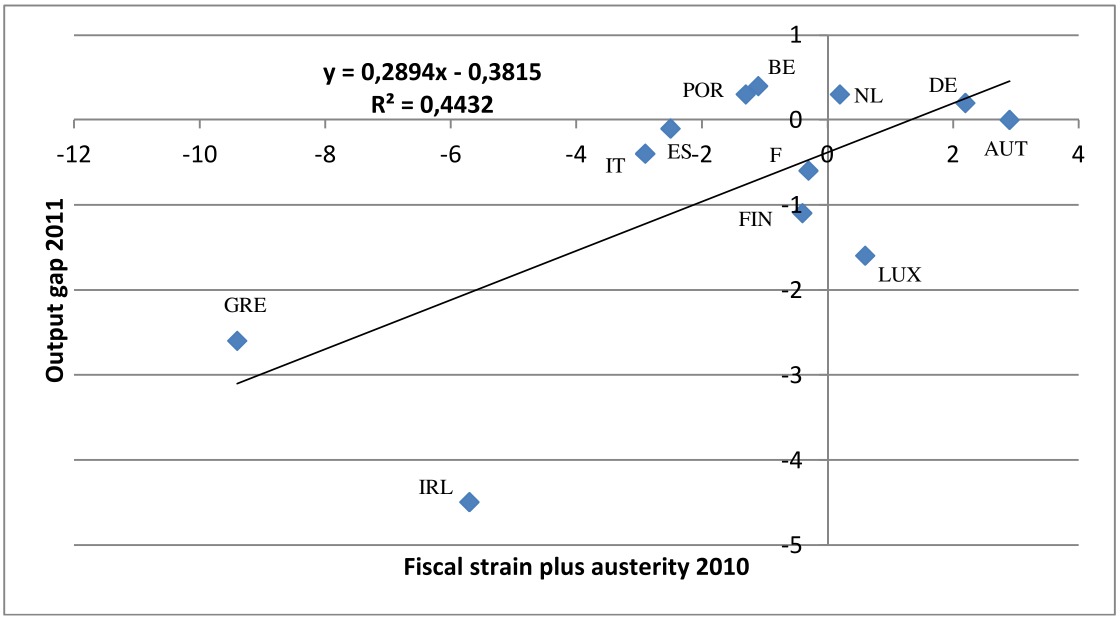
Source: European Commission (2009b)

The inherent logic of the European economic governance system – decried by its critics – is that who has ‘messed around’ with its public finances in the past, will not be able to react appropriately to external shocks and, thus, suffer economic hardship. Whether one subscribes to this logic – which may work as a pedagogical device only if it is executed in due course – or not (as it does not discriminate between different possible reasons for fiscal inordinateness in the past such as external shocks or internal misbehaviour[17]), it needs to be scrutinized in the light of deep recessions such as the World Financial Crisis as it may become an institutional device denying the above-mentioned lessons to be learnt: if the fiscal stimulus fails to spark off a cyclical turn, a country may easily find itself in a vicious circle of unsustainably high and illicit budget deficits, consolidation efforts, economic impairment and persistent or even growing budget deficits[18]. Again, there is empirical evidence that some Member States of the Eurozone are caught in such a vicious circle or, to put it differently, that the European economic governance system may systematically aggravate instead of contain initial economic slacks.

[17] Cafiso (2012: 72) highlights the importance of this disctinction.

[18] Moreover, the likelihood of such a vicious circle to happen increases if austerity programmes are run under the conditions of overall economic slack, i.e. if the shortfall of domestic demand is not likely to be compensated for by foreign demand by way of a mercantilist strategy.

Figure 6: Fiscal strain, austerity measures and output gaps 2010-2012



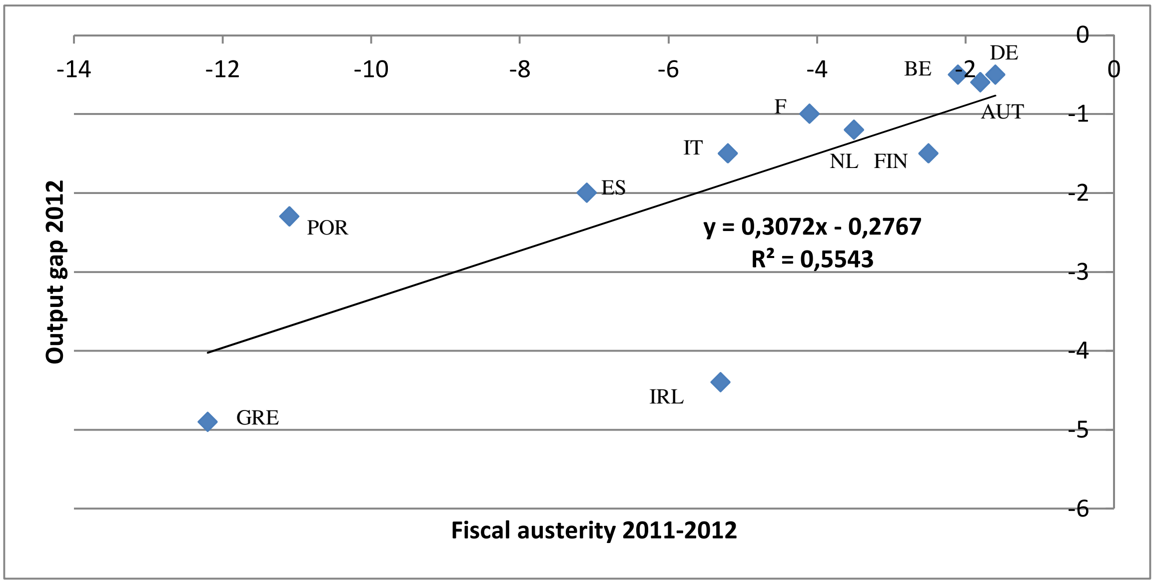
Source: Ameco database, IMK Report No. 71, 2012, European Economy statistical annex spring 2012; own calculations

It has been pointed out before that – partly due to the lack of 'fiscal space' – the fiscal stimulus given in 2009 and 2010 by the national governments under the 'European Economic Recovery Programme' was not appropriately dimensioned to meet the requirements of the Great Recession. The difference between an appropriate stimulus[19] and the actual (realized) fiscal stimulus may be termed 'fiscal strain'. As fig. 6 – 8 suggest, there is a mounting correlation between initial fiscal strain, austerity policies[20] to bring down high deficits in line with consolidation programmes as part of the ordinary Excessive Deficit Procedure (EDP) of the ESGP or measures agreed upon with the 'troika' consisting of representatives from the IMF, the EU Commission and the European Central Bank (ECB) and ensuing output gaps.

[19] To simplify the analysis, an 'appropriate stimulus' has been calculated in the following way: (GDP_{2009} – [-2]) x 3/5. A fall in GDP by -2% is supposed to be handled within the rules of the ESGP, i.e. the automatic stabilizers will not surpass the deficit threshold of -3% of GDP. Assuming a trend GDP of 3% at which the public budget is supposed to be balanced, this implies a fiscal multiplier of roughly 3/5.

[20] In most Eurozone Member States, fiscal stimulus programmes and consolidation programmes overlapped in 2010!

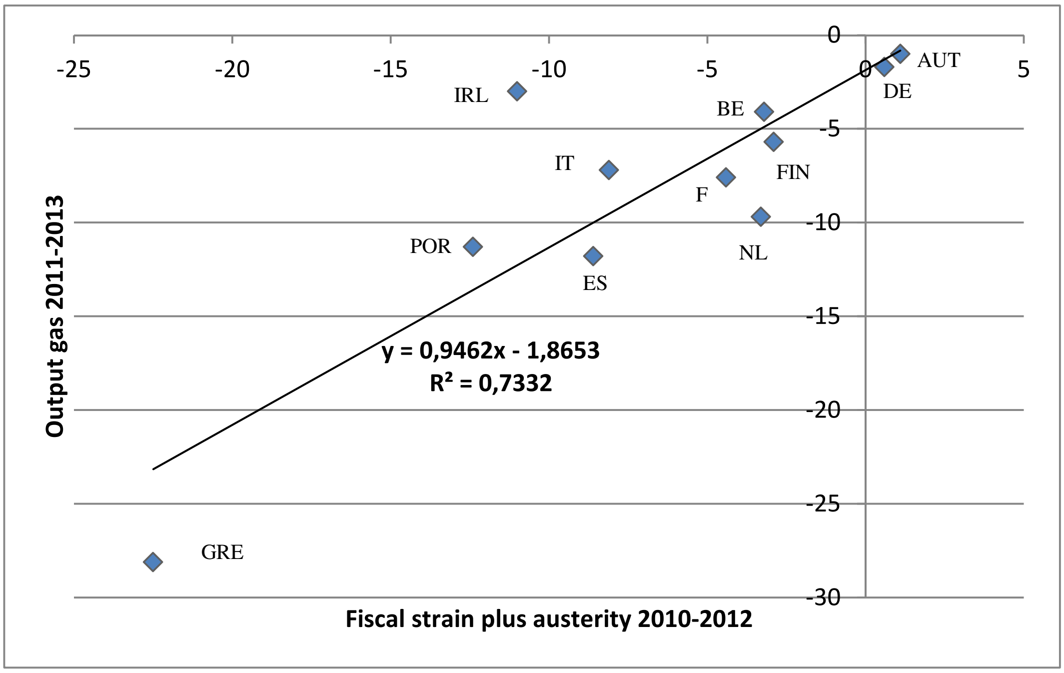
Figure 7: Austerity measures and output gaps 2011 – 2012



Source: Source: Ameco database, IMK Report No. 71, 2012, European Economy statistical annex spring 2012; own calculations

The reaction of international financial markets to sanction such governments which find themselves unable to reduce deficits and debts as desired by raising interest rates to unprecedented levels only adds to the stress. For some, the immense increase in government bond risk premia are the main cause of the ongoing 'Euro crisis', requiring fiscal adjustments impossible to be achieved without adverse growth effects. Yet, although the short-run liquidity and the long-run solvency of governments are surely much affected by adverse financial market reactions, the evidence provided here is to argue that the 'Euro crisis' is not fundamentally based on such market reactions (see also Cafiso 2012). And others regard goverment bond risk premia merely as the consequence of unsolid fiscal behaviour in the past. However, new empirical evidence (see Pusch 2012) shows that the risk premia on Eurozone government bonds are determined by 'fiscal fundamentals' (such as past public debt and deficit levels for which national governments bear some responsibility) only to a minor degree – leaving explanatory space for 'fundamental uncertainty' in a Keynesian sense about financial market deveopments, the economic future of the Eurozone in general and some Member States in particular (for which national governments bear only limited responsibility). In this case, there is a good rationale for a common responsibility to access to financial markets at affordable interest rates (i.e. the working of the European Financial Stability Facility or the European Stability Mechanism).

Figure 8: Fiscal strain, austerity and output gaps 2010 – 2013



Source: Source: Ameco database, IMK Report No. 71, 2012, European Economy statistical annex spring 2012; own calculations

5. Conclusion

The Great Recession at the end of the first decade of our century has not turned out to be as severe as the Great Depression of the 1930s – and this is surely also due to the swift monetary and fiscal policy reactions of most governments and central banks. It is in this sense that the EU Commission's claim that lessons from the Great Depression have been learnt, must be acknowledged. However, what is true in general, is not necessarily true for any particular country. Our study suggests that it is the institutional frame of economic policy coordination in the EU (and, particularly in the Eurozone) – the European economic governance system – which systematically prevents the application of the policy lessons and, thus, puts some Eurozone Members States on a course which very much resembles that of the Great Depression: not only is economic slack in these countries almost as bad as during the 1930s and its duration even potentially longer, also the uncompromising defence of institutional structures – the Gold Standard and its deflationary mechanism then, the monetary union and its austerity bias now – appear to aggravate the problems: the reform of the European economic governance system, hastingly pushed through during dozens of special or emergency summits of the European Council has managed to create crisis control and emergency measures such as the European Financial Stability Facility (and later: the European Stability Mechanism) which were not in place before the crisis. However, crisis resolution has not worked – neither in terms of overcoming slack economic conditions, nor in overcoming budgetary problems or in terms of tranquilizing financial markets – as the treatment basically used the same medicine and just increased the dosing: the 'fiscal pact' not only hardened the ESGP further by strengthening both the preventive as well as the corrective arm of the EDP but also ordered all Eurozone Member States to make a balanced budget a constitutionally based and implemented target. Moreover, the 'Euro Plus Pact' adressing regional trade imbalances is bound to keep up pressure on governmental (social) spending and wage increases – most likely harming aggregate demand in the longer run and, in the worst case, initiating a wage-price deflation which has been prevented so far.

The European economic governance system is politically based on mistrust which is nourished by the pre-crisis politico-economic mainstream of the economic science: it not only denies systematic and positive long-term effects of active stabilizations policies, but also boils down the complex budgetary decision making process in democratic societies to rent-seeking and moral hazard behaviour which, then, needs to be contained by strict and restrictive rules. The failure of this system becoming evident during the World Financial Crisis and being responsible for the ensuing 'Euro Crisis' presupposes as much radical reform as a fairwell to its supporting ideational basis – a situation which resembles that after the Great Depression. This is not the place to speculate about the exact features of a more appropriate and effective governance system but as the Great Recession has demonstrated the limits of 'governance without government' (yet with several goverments being tied in their national constituencies) in an institutional set-up created in neoliberal times, it stands to reason that a 'Gouvernement Economique'[21] based on modernized (post) Keynesian principles is a necessary step to be taken in order to avoid a final break-up of the European integration project.

[21] Clearly, 'Gouvernement Economique' is an opaque political term that needs to be filled with institutional contents. What is meant here is the historical lesson that monetary unions only survived under the condition of forming a unitary political actor, i.e. a nucleus of what became a political union eventually; see e.g. Heise/Heise Görmez (2011).

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