

THE EURO AND THE END OF 20TH CENTURY POLITICS

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Introduction

The European crisis has been a political crisis that questions our understanding of national democracies in the new global environment. Economists and political scientists have produced extensive analyses about the European crisis. However, scholars of both disciplines have refrained from studying the interaction between economics and politics. This brief analyzes the interaction between the euro and national politics and between the national narratives of the euro crisis and the economics of the crisis itself. At first sight, the implications of a political-economic analysis of the crisis seem very compelling: national democracy as we conceive it may not be compatible with a monetary union; our concept of a nation state needs to change since it runs against the logic of an interdependent world influenced by the dramatic historical experiences of the 20th century; national politics is struggling to abandon the ideological references of closed economies; the root causes of the European crisis may be traced to the stratagems national politics have resorted to in order to minimize the political costs from the adjustment in the 2000s to the globalization of the economies unable to adjust their exchange rates.

However, the actual political lesson of the crisis remains unheeded.

Is National Democracy Incompatible with the Euro?

The European Monetary Union has developed into a political laboratory for which we do not yet have an appropriate theoretical tool at our disposal. For anybody seriously interested in European political economy, using standard economic theory in the case of a system of interdependent jurisdictions is as “if someone tried to make a jet engine operate by using the

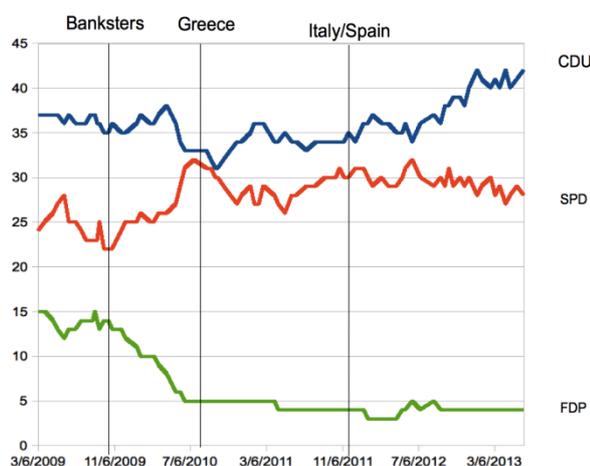
theory of the piston-driven machine.¹” Nothing is wrong with the theory. It was simply misapplied.

Transparency concerning the interaction between economic and political choice is an old and unresolved story. In 1896, Knut Wicksell noted that an individual could make an informed, rational assessment of various proposals for public expenditure only if he were confronted with a tax bill at the same time. Aware of the lack of clarity with regard to economic costs of political choices, Wicksell suggested that the total cost of any proposed expenditure program should be apportioned among the individual members of the political community. If this is still largely true, we can imagine how far we are from the transparent distribution of political and economic costs between electors that do not belong to the same jurisdiction, but to different countries.

The European monetary integration has offered a number of notable examples of interaction between politics and economics and between different jurisdictions. I will try here to draw some lessons learned, starting from the role of national narratives. Public discourse is overwhelmingly national, resulting in opportunistic policies aimed at exploiting the interdependence of European countries. National narratives of economic events have had strong domestic political impacts over the recent, crisis-marked years. However, their influence cannot be confined within national borders. In fact, narratives have also had strong effects on other jurisdictions and political systems. Ultimately, they seem able to determine the interaction between different governments, disparate public opinions, or political actors, deeply affecting the European and national responses to a common crisis.

An interesting example is the interaction between German and Greek narratives about the euro-crisis. The German narrative has changed over the years. At the beginning, German public discourse mainly highlighted the responsibility of bankers whose reckless behavior had brought the whole world to the brink. As shown in the graph below, this narrative had a strong impact on the domestic political landscape. The liberal party (FDP), generally considered the closest to the German financial milieu, lost two-thirds of its votes in a very short time. This unusual swing in consensus was mirrored by a similar increase in the polls for the social-democratic party (SPD). For the first time in years, the SPD came in a hair's breadth from the ruling party, the Cristian-democratic Union (CDU), led by chancellor Angela Merkel.

Different narratives have significant political impact...



¹ This metaphor was used by James Buchanan in his book “Deficit Democracy”

In May 2010, when the Greek crisis exploded, the narrative of the crisis abruptly changed in Germany, as well as in other countries. Once Greek Prime Minister Georgios Papandreou admitted that precedent governments had cooked the books, Greece was immediately singled out as the outlying country that had betrayed the common trust. Polls in Germany showed that the political dynamics triggered by the first phase of the crisis came to a sudden stop. The narrative maintaining that the predicaments of the economy had to be blamed on the bankers stopped working and consequently ceased benefitting the SPD at the cost of the FDP (and, marginally, of the CDU). The new narrative– “it’s all Greece’s fault” –proved almost neutral in terms of its effects on German political parties, apart from halting the precedent dynamics. Eventually, the CDU maintained and even slightly increased its lead on the SPD.

Things changed again in 2011, when contagion spread from Greece to Spain and Italy. The euro crisis was no longer a case of one country misbehaving, but rather a deeper fracture separating fiscally profligate countries from those with a more disciplined public culture. It was the moment when a clear distinction was made between peripheral and core countries; the South and tNorth; or even, not in Germany but in the UK, notwithstanding the inclusion of Ireland in the group, between PIIGS and the rest. From this moment on, the CDU visibly gained more votes than the SPD. The gap between the two largest political parties started to widen and became very large by historical standards.

For Chancellor Merkel, the narrative that placed blame on fiscal indiscipline and exalted the well-ordered nature of German public culture represented a clear electoral advantage. The Chancellor herself adopted a policy strategy in the euro-group that mirrored the domestic narrative: ailing countries had to put their house in order, cut public deficit, and embrace austerity. Germany and other countries would help them in this painful exercise, by buying them time via low and strictly conditioned aid, with conditions scripted by Berlin.

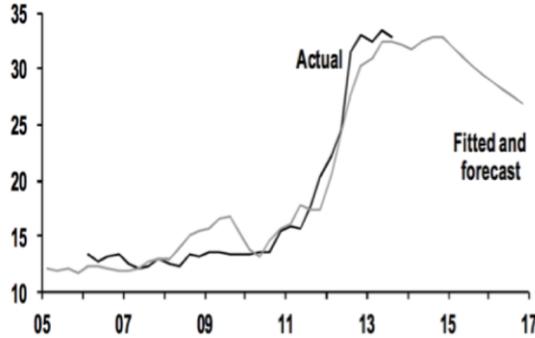
Unfortunately, the strategy aimed at keeping pressure on weaker economies via austerity and recession dramatically backfired. It weakened pro-European support in many countries, exacerbated the difficulties of enforcing painful structural reforms in the context of severe financial and political hardships. Persistent unemployment was one of the gravest symptoms of the crisis mismanagement, together with a deep recession in the real economy and increased distrust in households’.

In a statistical exercise², derived from a model first published by economists at JP Morgan, using the three aforementioned economic variables–unemployment, austerity (measured as the differential between tax revenues and government expenditures), and ‘loss of consumer confidence –one could estimate the lags through which those three variables coincide with an increase in support for non-mainstream parties. Many of those parties adopt policy platforms that are clearly critical of the crisis management conducted by European institutions. Sometimes they even endorse a strongly anti-European stance. In the following graph, the relation between dismal economics and non-mainstream parties is fitted adopting a system of lags. Although the fitted models seem to replicate changes in political sentiments pretty well, what is more important is that the lags necessary to reach this outcome are relatively short. Economic predicaments tend to reflect in the form of public disagreement with in European policies within merely 6-24 months. Consequently, the strategy of low-burn fiscal aid with austerity-oriented policy in the medium term can be self-defeating because it inevitably leads to a growing opposition to itself.

2 Economic Research Global Data Watch October 22, 2013

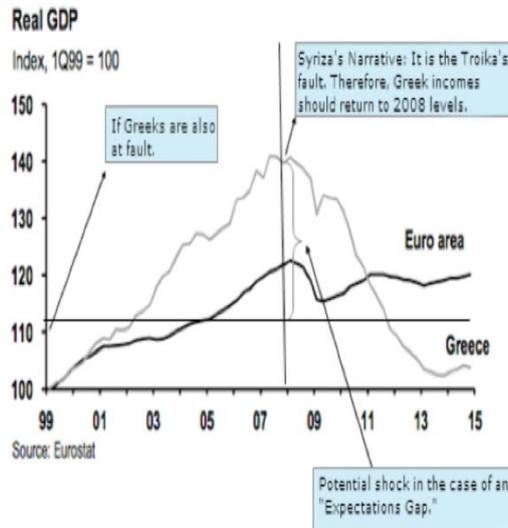
Bad interdependence among narratives: Non mainstream parties in the periphery and the delay in common policy responses

Model-based forecasts: The model is based on a 1:1 elasticity of populist parties to an increase in unemployment (2ys earlier); 2:1 to an increase in taxation over expenditures (18 ms earlier); an increase by 5% of consumer distrust (6ms earlier)



When the new euro-critical parties become strong enough to reach government levers, the consequences can be dramatic. The next graph represents the Greek situation through two different narratives describing the trend of real per capita income since the beginning of the euro. A first narrative is endorsed by the traditional parties that had governed the country when the Greek economy was growing at an exceptional speed thanks to the adoption of the common currency, the massive inflow of foreign capital, and an indiscriminate increase in private and public debt. Those parties certainly blamed the Troika for having sunk the economy after its intervention, but they accepted a portion of the responsibility in mismanaging the economy before 2008. This narrative is consistent with a shared responsibility and an objective of recovering a level of income for the Greek electorate that one could arbitrarily fix between the current Greek level and the average of the euro-area.

Different Narratives Different Economic Consequences



However, starting in 2008, a new political movement, Syriza, gained ground and grew stronger as the economic predicament of the Greek population worsened. Syriza's narrative is different from that of the traditional parties. After advocating leaving the euro, Syriza embraced a political platform that attributed all blame for the crisis to the Troika and the parties that underwrote the so-called "memorandum" with the Troika. Refusing any responsibility for past policies, Syriza could call for the restitution of a level of income close to what Greeks enjoyed before the Troika's memorandum inflicted overly severe doses of austerity on the country.

The first Greek narrative is determined by the cooperation between traditional mainstream parties and EU institutions. It could be defined as a narrative not distant from or even aligned with the German domestic narrative and with the crisis management that emerged from it. The second narrative, calling for full restitution of pre-crisis income to the Greeks, is entirely domestic. The two "domestic" narratives—the German and the Greek—are evidently incompatible with each other. There is only one way to make the two different levels of income called for by the two narratives compatible with each other: change the denomination of the high level of income targeted by Syriza. This would require a Grexit, a return of the Drachma, and nominal recovery of past levels of income, although only for the short period before inflation or drachma devaluations eroded those levels.

The conclusion is that national narratives in different countries sharing the same currency are not possible. National narratives indiscriminately autonomous from external conditions are possible only if one country can resort to the manipulation of its currency. Ultimately, one of the main aims of the monetary union was to prevent national governments from abusing protectionist or nationalist narratives and papering over their consequences via regular movements in the value of their currencies. During the crisis, what has emerged is that national narratives—the expression of domestic public discourse within national democracies—can be incompatible with a monetary union. Stretching this to the limit, one could even maintain that the national public discourse on which national democracies are based should be conditional to its compatibility with the narratives of other member states in the same monetary union.

A Flawed Idea of the Nation State at War

In the German and Greek experiences, decisions based on national narratives are democratically legitimated, regularly sanctioned by elections, but leading to a bad political interdependence. Both neglect externalities on other political jurisdictions. However, those externalities are incredibly relevant and eventually have repercussions on the national political systems of all countries. We could even stretch this line of thought to the limit by saying that only national currencies can accommodate wrong or partial political narratives. The euro requires more. It requires political interdependence.

In my book, *Saving Europe*, I synthesized this observation in a provocative assumption: Europe is undergoing its first war of interdependence. I am not using the word war lightly. In fact, we shouldn't abuse this loaded term, especially when speaking about financial crises where antagonists, if not enemies, are normally not in front of us but between us. Still, there are some reasons why I want to brandish this word. The first is that the size of the economic crisis, the loss of production measured against the trend, is in the ballpark of a war. It actually amounts to a higher economic cost than all the wars fought by the United States after 9/11, Iraq, and Afghanistan included.

But the real reason why I do not want to shy away from using the words conflict or war is that I really believe that the root causes at the origin of the crisis and behind its disappointing management lies in a bellicose concept of politics. Throughout the crisis, national governments have acted as if their states were or had to become self-sufficient, live within their own means, and stand on their own two feet.

The very idea of self-sufficiency is rooted in the dramatic historical experience of each European state and in the ancient concept of nation states exposed to the eventuality of war. Self-sufficiency, or being economically independent from foreign states, was necessary and even vital during the past 250 years, when European states fought approximately 150 conflicts and 600 major battles on the continent.

The concept of self-sufficiency cropped up since the very beginning of the crisis in Autumn 2008, in the midst of the financial crisis. The decision at the time was that each state had to take care of their national banking system as if they were nationally independent, even though global banks operating within each nation state were entirely interdependent. But the knee-jerk reaction was that each state had to protect its own banks, or, as Sarkozy eloquently surmised, Merkel's motto was "chacun sa merde"--to each his own mess, which clashed with the clear perception that what was happening had a global and interdependent nature.

Resorting to discipline within national borders predates the Greek crisis. When Athens admitted that past governments had cooked the books, mistrust erupted and the perimeter of the crisis started to officially coincide with political borders. When the sovereign crisis broke, new forms of self-sufficiency came to the fore under the policy prescription that inspired the economic remedy of achieving an equilibrium in both the balance of payments and public budget in each state.

These goals became the cornerstone of crisis management and the European system of economic governance that later emerged. Once a country achieves those virtuous targets, internal and external equilibria, it has no need to borrow other countries' savings, is financially sterilized, and is, in a way, a modern form of a "closed economy" or potentially a "closed state". Yet, the idea of a closed state goes back to the reality and political philosophy of the eighteenth century. German philosopher Joachim Gottlieb Fichte spoke of a *Geschlossener Handelsstaat*—a state closed to trade. Actually, he coined the concept with pacifist intentions, but wound up being accused for militarism instead. After two centuries, this condition of financial self-sufficiency runs against any rationale for an economically integrated area where capital must be free to flow in search of the best returns in the most productive investments, wherever they may be, and achieve the best resource allocation.

I wish to be clear: being self-reliant is not an absolute negative per se. I have a lot of sympathy, particularly for the German emphasis on self-sufficiency as a moral compass. Germany's insistence on self-sufficiency at both the individual and collective level stems from an effort to avoid repeating a past of excesses—a past of military crimes, poverty, debts, and hyperinflation. The country's laudable desire to avoid former excesses has inspired a strong ethic of living even below their own means. But expecting all other Europeans to adopt the same ethic has produced a somewhat paradoxical exercise of "collective self-sufficiency." Once this moral exercise of living below our means extends to a whole interdependent area, then it backfires in the form of misallocation and takes us toward recession and deflation.

The preference for self-sufficiency over interdependence was not the only analogy with actual conflicts.

- Offering domestic deflation or outright recessions as solutions for every country in crisis, cutting GDP by 20 or 30%, bears a strong analogy with shrinking the territory of a country defeated in war.
- Moreover, the management of the euro crisis called for weaker countries to be governed de facto through a foreign-led task force (the “troika”) rather than by a cooperative European government.
- Initially, loans to indebted countries carried punitive terms, as if they were war reparations, even though the loans actually saved banks in the creditors’ own countries.
- The leaders of Europe also established a hierarchy among themselves based on the balance of power, with decisions made first by the creditors, then imposed on the debtors, although both were sources of imbalance.
- Prevention of Moral Hazard seemed inspired by the strategy of pre-emptive dissuasion that characterized the Cold War nuclear tension.
- In addition, the prevailing narrative of the crisis was from the point of view of fiscally stronger countries, just as when history is written by the victors.
- Often leaders resorted to war-like secret diplomacy, working through unaccountable bodies and making decisions sheltered from public scrutiny.
- Finally, in some cases, parliamentary democracy was undermined by suspended elections and repeated referenda⁴⁴; in a way, economic inferiority became the equivalent of a political minority.
- More significantly, the countermeasures necessary to tackle the crisis were disavowed by the countries in need and sold by their national governments to their electorate as an imposition by a malevolent occupying force, although they were generally accompanied by generous funds.

Once the principle of each state being isolated when coping with its own crisis prevailed, even the institutional setting of Europe changed. The euro-area distanced itself from the practices of shared democratic decisions, which were put on back-burner, and turned into an intergovernmental, sometimes even a hierarchical, system, working through technical and judicial practices rather than democratic features characterized by solidarity.

I would like to try to give an interpretation of why interdependence is neglected in the current economic analyses of the euro area. The main reason is that our standard OCA theories are chiefly interested in real economy indicators. On that front, we do not see the euro as a factor behind a pronounced increase in economic interdependence. Factor mobility may have increased a bit more out of desperation as far as labor is concerned, but, for the rest, cross-border investments have declined. FDI declined in the past years. Trade between euro area member states has not increased as expected and imbalances were reined in mainly as a consequence of asymmetries in the economic cycles. Fiscal spillovers are not self-evident and

so on. Overshadowed by globalization, interdependence probably did not seem to be very important.

What we missed, again as a consequence of old political and cultural throwbacks, was financial interdependence. One example of the predominant role of financial interdependence vis-a-vis real economy interdependence acquired after the adoption of the euro is that, if you add up the net financial external positions of the three largest creditor countries (Germany, the Netherlands, and Belgium) and measure their difference with the three largest debtors (Greece, Spain, and Portugal), you see that this distance increased by a factor of four in the last ten years and is now equivalent to 40% of the euro area's GDP. There is no single region in the global economy that is so interdependent, where creditors and debtors are so closely interdependent.

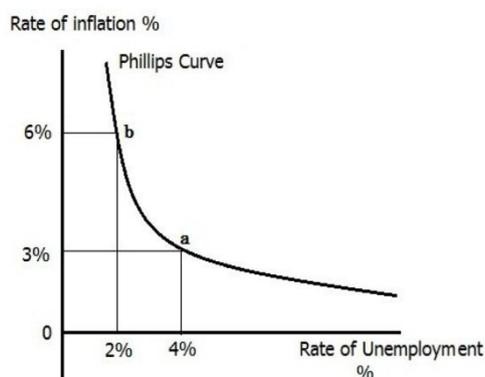
We are not used to considering this kind of interdependence as a domestic political factor. However, financial connections have acquired some new and striking features. One, for instance, is that they are enormous in size. Secondly, they change faster than any parliamentary decision. Thirdly, they have an incredibly powerful political impact because they affect the financial vulnerability of states, going right to the core of the state's internal degree of coexistence, taxation and public expenditures.

But why are we fixated on real economy interdependence? We are all concerned with the direct variations in the levels of wages and capital returns, which are references of political categories in the European public discourse. Traditionally, leftwing and rightwing parties define themselves according to the privileges that they devote to wage increases or employment levels, rather than to the preservation of the value of capital and of its returns.

The Old Political Categories

A reflection of the importance of "old" categories—labor vs. capital—in the political dialectics of the past century can be exemplified through a "popularity and Vote function" as expressed by Douglas Hibbs. Resembling a Phillips curve, it was interpreted by scholars of the Public Choice Theory as a powerful synthesis of political preferences of leftwing and rightwing parties.

The Vote and Popularity Function



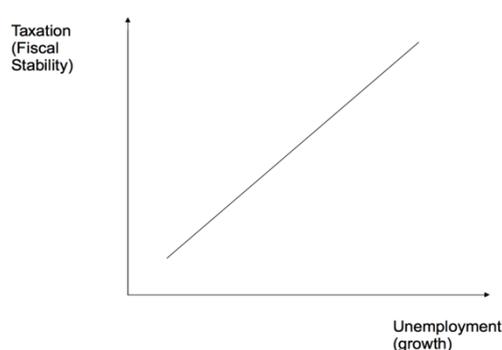
Leftwing parties tended to privilege the political goal of lowering unemployment even at the cost of a higher level of inflation and, consequently, an erosion of real wage increases. This preference was famously staged by former German Chancellor Helmut Schmidt who asserted,

at the end of the 70s, that he would rather have 5% inflation and 5% unemployment than 2% inflation and 8% unemployment. A rightwing party could maintain the opposite view, saying that it would rather ensure a stable inflationary environment in order to grant a stable return for capital investments even at the cost of a higher unemployment.

The dialectic tension between labor and capital mirrored a world where dialectics was deeply entrenched and far from confined in the ideological domain. The confrontation between the West and the Soviet Union was in the background of the capitalism vs socialism dialectics. Against this backdrop, Conservative policies coincide with stability and Progressive policies with growth. In what were mainly closed economies, labor and capital conducted redistributive conflicts that determined the destiny of governments and political powers. Interestingly, the external disequilibria, normally mirrored in the current account of the balance of payments, when provoked by unbalanced combinations of labor and capital, could ultimately be compensated through currency depreciations or appreciations meant to re-align the level of wages or the excess in capital returns.

The new Political Divide Stability and Growth Pact

(once Monetary policy is no longer national)



This led me to investigate if the function described above, representing the political dialectics in the European countries of the 50s-80s, would be affected by monetary union. Once the process of monetary convergence was kicked off by the Maastricht Treaty after 1992, with powerful hiccups along the road, monetary policy slips out of the domestic policy toolbox. Monetary authority is delegated to a non-national institution, the European Central Bank, which by statute cannot compromise monetary stability in the pursuit of other goals, not even higher growth or full employment, and not even at the non-national level.

Once monetary stability is no longer the domain of political antagonism, the political dialectics between stability and growth resorts to a new antagonism, one between fiscal stability and low unemployment. In political terms, it can be reduced to a choice between lower taxes and higher investments. The graph shows a fundamental change relative to the one describing politics before the euro. The rate of substitution of the new dialectical terms is not negative anymore. Rightwing parties can maintain that by lowering taxes, they can support employment as well, as if there were no contradiction between the two goals. Similarly, leftwing parties can claim that bringing more people to work would automatically produce more fiscal revenues and create room for lowering taxes per capita.

The post-euro world is not an environment for clear cut political distinctions. In fact, political scientists start to discuss the confusion between leftwing and rightwing parties in the 90s.

Paradoxically, this happens once the currency tool was no longer available, cleaning the slate anytime political confrontation produced excessive economic imbalances, effectively making the political ideological confrontation of the 20th century harmless. After the euro, misallocation of capital and labor cannot be compensated via currency movements (the currency is no longer national) and thus have permanent consequences on the economy and the affected productive factors. Political confrontation between labor and capital carries deep distributional consequences after the 90s just as its ideological underpinnings blur into the more confused distinction between left and right.

This becomes even more critical because of the positive rate of substitution described in the new post-euro Vote and Popularity function. Once the curve's slope is positive, increases in one variable do not come at the cost of the other. A politician can actually promise everything to everybody: lower taxation *and* lower unemployment. During the 90s, political leaders as different as the former trotskyist Lionel Jospin and the conservative media-mogul Silvio Berlusconi could both campaign under the same slogan: lower taxes and more jobs. This specific configuration of politics under reinforcing and not compensating dialectic terms is conducive to the mechanism of over-promising: campaigning through ever-increasing promises, which is a definition of populist politics.

Inadvertently, the introduction of the euro seems to have produced a perfect environment for populists, who gained footholds in all European countries during the 90s and later on.

Partisan Protectionism

While populists were exploiting all the advantages of the new political discourse, mainstream parties had to resort to a change of strategy that allowed them to keep their identification with the traditional categories of left and right alive. In order to do this, they resorted once again to the identification of the left with labor and the right with capital.

A few years ago, I identified the pattern behind it as “partisan protectionism”, and the political strategy behind it as one determined by the fact that national partisan politics in Europe defines itself in terms of its protective stance with respect to globalization. The protection of the constituency—labor for the left wing and capital for the right wing—responded to the partisan ideologies of the past two centuries, but was now staged through vigorously exposing the other constituency to the full duress and dynamics of global competition.

This duplicity is strengthening the grip of national ideologies on the imagination of the citizens of each European country. Traditional, national politics become a structural hurdle with respect to coordination. The euro, for its many merits, has been the catalyst of the contradiction between an open economy and closed politics.

I will give here a few examples for the protectionism or liberalization of capital markets under rightwing or leftwing parties after the Maastricht Treaty was signed. In France, neo-Gaullist Prime minister Edouard Balladur launched French privatizations, but he did it upholding golden share control, while Lionel Jospin's socialist government went on to privatize capital through a stock exchange reform that impacted corporate governance and stressed the need for transparency in asset ownership. Conservative Nicolas Sarkozy protected national champions and de-penalized corporate crime. Consistently, he opposed granting European antitrust constitutional status.

In Germany, Kohl's government launched financial market reform, but protective networks, the real hallmark of German relational capitalism, were dismantled by Gerhard Schroeder's

socialist government. The same occurred in Italy, where a left-wing government, traditionally devoted to nationalizing companies, focused on privatizing and overhauling corporate governance. On the other end of the spectrum, the right-wing governments halted the process of market liberalization, increasing the opaqueness of proprietary asset markets by passing legislation that favored false accounting.

The opposite happened in relation to the labor market. In France, the 35-hour work week legislation adopted by left-wing governments was eroded by right-wing majorities introducing flexibility in starter job contracts and in tax regimes applicable to overtime, plus limitations on trade union rights to strike in public services. In Italy, the so-called 'Biagi legislation' liberalizing the labor market was the battle-horse for the center-right government and its amendment was the focus of a harsh conflict, within the left-wing, between reformists and radicals. In Germany, labor market reform was reluctantly planned by Helmut Kohl, but it had to wait six years until a 60% increase in unemployment allowed it to wend its way onto the political agenda of the center-left.

Looking into individual economic policy measures clearly yields a more subtle picture, but partisan protectionism was fairly prevalent in the rhetoric of both right/left-wing European politics.

With the opening of borders to the global economy, national governments soon realized that opting for isolation vis-à-vis the rest of the world, and closing up borders, was impossible or counterproductive. The sophisticated response has been to protect only prioritized segments of the electorate and economy in which vested constituency-based interests lie, while opening up the rest of the economy to the pressures of globalization and making them bear the brunt of the adjustment.

In so doing, both the right and left have ended up reverting back to traditional 20th century categories: capital for the right, labor for the left.

In actual fact, Partisan protectionism was bound to misfire and generate distrust in politics. The reasons can be summarized as follows:

- Left-wing politics can lead to right-wing results (exposing capital to competition increases its relative productivity as compared to that of labor) and vice versa;
- Partisan protectionism strengthens ideological confrontation because political discord is exacerbated if only one constituency bears the brunt of adjustment;
- It also challenges the credibility of politics (with one production factor flexible and the other rigid, the economy operates sub-optimally);
- It strengthens the populist rhetoric of isolation; favors non-political solutions (politically disfavored production factors end up in the 'black' economy or resort to tax evasion) or solutions that are not constituency-based (technical or broad coalition governments);
- all of which encourages the rhetoric of isolation or of 'domestic,' constituency-based interest protection

With the adoption of the euro, biased decisions in terms of income allocation of capital or labor, which generate payment imbalances, are no longer offset through currency management, resulting in devaluations in Italy and revaluations in Germany. We assume that

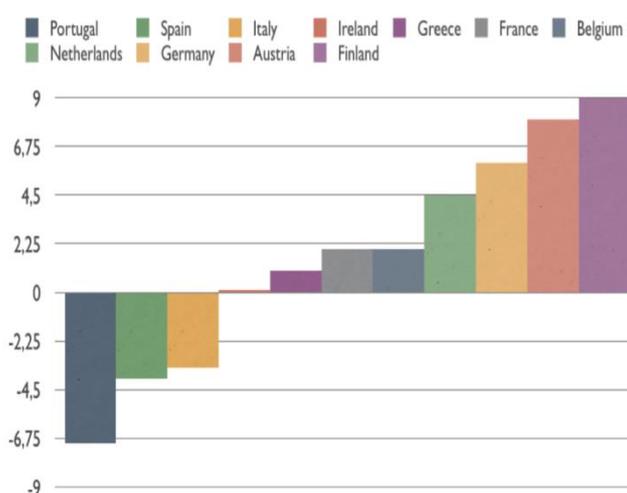
we live in a post-ideological world, and that we are therefore sheltered from political conflict, whereas the conflicts implicit in right and left-wing policy decisions (both on the supply and demand side) are far more loaded in terms of sustained consequences on social justice today than was the case in the age of ideological confrontation when monetary illusions prevailed.

Protecting the interests of voter constituencies has taken on a much more concrete meaning, becoming more effective from the point of view of both distribution and advocacy for constituency-based policies. In other words, the adoption of the euro did mark the blossoming of partisan protectionism into an attractive electoral strategy for short-term national politics, while it proved negative in terms of consent and support for Europe insofar as it opposed the protective effectiveness of domestic policies to the claims of openness voiced by Europe.

Against this backdrop, not all countries behaved the same. Some of them responded promptly to the challenges imposed on politics by the global environment. Others remained mired in the ideological mindset that flourishes if capital and labor are viewed as antagonists in a perennial distributional war.

One way to exemplify the distinction between ideological and adaptive politics is to watch the changes in how the two productive factors epitomizing the ideological confrontation have combined constructively rather than antagonistically. I have chosen to adopt changes in the levels of Total Factor Productivity as a symptom of how capital and labor have been made to work together.

Changes in Total Factor Productivity during the Euro



The graph showing changes in TFP between 1998 and 2008 seems to predict which countries arriving at a crisis is more vulnerable. Portugal, Spain, Italy, Ireland, and Greece all feature as countries that have been losing the capacity to combine labor and capital in the context of changing technologies and heated global competition, while Germany, Austria, and Finland appear among the countries that have managed to adapt their economic system to the challenges of the new century.

This can be interpreted either as proof that the European crisis was a political one, caused by asymmetric adjustment to an economic environment transformed by globalization and the

more difficult changes in countries where ideological politics prevailed, or as another example of the Varieties of Capitalism theory whereby countries with more intense and productive social dialogue performed better when adjusting to a new challenge.

Stratagems

Although each country adjusted differently to the new highly competitive global environment, which coincided exactly with the introduction of the euro, each of them was subject to the pressure of new populist tensions mirroring either the dialectical change in politics (the blurred distinction between left and right) or the new cleavage between pro- and anti-Europeans. In fact, the European rules on political economy, particularly the ones concerning the stability of the fiscal budget and the limits to public expenditures or tax cuts, represented the main bastion against populism.

Europe became an enemy of populists and an obligation for the mainstream parties. The latter had to defend and legitimate the European project or they would have been booted out by more populist anti-European movements. However, just like they had done in the 90s with “partisan protectionism,” in the 2000s mainstream parties looked, more or less consciously, for political stratagems allowing them to lower the political costs of policies aimed at adjusting to the global environment.

I will start with Italy as an example of what happened. Between 2005 and 2008, when global competition was more immediate, Italy’s unobserved economy—a euphemism for black, tax-evading, or outright illegal activities—increased by a substantial amount, about 6.6% of its GDP. This coincided with a marked increase in the number of migrants that were more or less officially employed in the economy and who bore the brunt of the flexibility intrinsic in a productive system becoming less “formal” and observable while the rest of the economy remained spared from flexibility and preserved past privileges. Shifting the political cost to migrants, effectively exploiting them, was a very efficient way of lowering it since migrants are rarely citizens and therefore cannot vote.

France’s parties adopted a different strategy by simply shifting the burden onto future generations, increasing the country’s public debt much more than what was justified by a strongly growing economy. Increasing public expenditure helped its citizens preserve or improve their living conditions, as if a new competitive global environment was irrelevant, leaving an as yet non-voting future generation to bear the cost.

In the South of Europe, costs have been regularly diverted to minorities or nonvoters. Like Italy, Spain adopted a dual labor market structure where 68% of the labor force was entirely protected and all the flexibility was provided by a 30% minority. That minority represented the social buffer absorbing all the shocks: unemployment, which was high before the euro, plunged from 24% to 8% in the good years before 2008, but lurched back to 24% after the crisis and remained there.

Shifting the cost to minorities or “invisible citizens” also occurred in Germany, which experienced a clear increase in low income “mini-jobs” or *Schwarzarbeit*. In France, as said, costs were deferred to future generations. Similarly, capital inflows allowed Portugal to increase the public sector wage-bill by 13% of GDP between 2001-2008. Similarly the public sector wage bill increased by 11% in Greece, Ireland and Spain.

Ireland, Luxembourg, Austria, and the Netherlands went for beggar thy neighbor strategies, using tax and regulatory regimes to attract capital from the other countries. Greece adopted an all-encompassing strategy of cooking the books.

Germany enacted a more comprehensive strategy, equally aimed at lowering the political costs of the transition to the global economy. The first was to adopt a mercantilistic strategy. In 1995, the sum of imports and exports in Germany relative to GDP was lower than in France and slightly lower than in Italy. Between 1991 and 2008, it grew from 52% of GDP to more than 90%. It became 1.5 times higher than the French or Italian ratios and around 3 times that of the Japanese and U.S. In the critical transformation of the 90s, In this way, Germany accumulated huge trade surpluses. Keeping its public deficit in balance, Germany wound up accumulating huge savings surpluses as well.

Between 1997 and 2008, Germany exported two-thirds of its surplus in domestic savings and injected one trillion euro into the rest of the euro area, which offered higher yields at no apparent currency risk. Those yields represent a transfer of income from the recipient countries to Germany amounting annually to more than 0.75% of German GDP. This helps explain why German growth reached 3-4% while its potential was estimated as declining to 1-1.5%. Although the savings were intermediated across the borders by the banking system, the incomes deriving by the financial investments were not visible in the banks' balance sheets. According to Bundesbank, 87% of the German banking system is subject to some kind of public interest, and profit constraints make banks transfer excessive profits to German firms through long term loans or to local political interests through infrastructural funding to regional authorities. It is another way of obtaining political consensus funded by other countries' taxpayers.

The Euro-Crisis as a Political Crisis

Monetary policy had a political role in the management of national economies before the euro. It helped soften both cyclical and structural adjustments at relatively low political costs. It corrected misallocations, making political confrontation innocuous. Once monetary policy was non-national, governments resorted to other stratagems to minimize the political costs of globalization, unloading them on non-voters.

When the crisis broke, the system was strained along fault-lines created by the political strategies aimed at shifting political costs onto the non-voting sector of the population. German and Dutch banks found themselves on the brink after having misallocated their domestic savings surplus into higher yielding foreign assets. French fiscal policy had no margin to absorb the shocks of the crisis. Italy's growth proved more fragile than expected and tanked rapidly. Spanish unemployment skyrocketed, with temporary employees and occasional workers hit the hardest. Greece collapsed.

None of these fault-lines have been mended. We are still pursuing the policy responses of the 2000s. German current account surplus could reach 10% of GDP; France's public debt could exceed 100%. Italy's "South-problem" and low productivity have worsened. We have not learned the political lesson of living in an interdependent area.

In my remarks, I raised a number of questions. Is today's national democracy ultimately compatible with monetary union? Is the value of interdependence neglected because we are still clinging to an outdated, bellicose vision of the nation state? Has 20th century politics, based on the confrontation between labor and capital, outlived itself? Is populism, indirectly,

an offspring of the openness of economies? Have all national governments, confronted by a more competitive global environment, shifted the burden of the adjustment onto the shoulders of non-voters? Combined, have all these factors played a major role in causing the euro-crisis?

My ambition ends with raising these questions. Reaching for definitive answers at this stage would require hubris. We need a new institutional setting at the euro-area level that crosses the threshold of political union—one that takes interdependence into account, exposing opportunistic national stratagems and enhancing the principle of multilateral cooperation. Such a political environment needs to overcome old categories of political distinction that have made pro-capital policies incompatible with pro-labor ones. Issues of this nature can be daunting, but questions are destined to remain and should continue to be posed until somebody finds an answer.