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The Euro and the Battle of Ideas (2016)

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Book Review by

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> "Elections change nothing. There are rules."
> Wolfgang Schäuble, Former German Finance Minister, 31 January 2015
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> "We will never have a strong, sovereign Europe if it is not united and coherent in itself… Our challenge is to remain united without chasing uniformity."
> M. Emmanuel Macron, President of France, 26 September 2017

If an individual were tasked to identify the root cause of the Eurozone's response ambivalence towards addressing its crisis and the inability to formulate a shared identity, these words spoken by the then German Finance Minister, and Emmanuel Macron, currently the President of France, would not be too far off in explaining it.

Ever since its inception, the European Union has struggled unnervingly to showcase and – to a large extent – underscore the vitality of the envisioned inseparability as a base on which the Maastricht Treaty's superstructure was to be erected. The word *struggled* is there to emphasize the ironic manner in which the aspired image has not yet materialized – and may not do so at all. This is because the principal factor responsible for the lack of fruition of the aforementioned collective vision and, by effect, the enervating of the masses, stems from the stark ideological contradictions existing between the member states; and here, the core is perhaps more to blame than the periphery.

Making this argument the basis of their 2016 book "*The Euro and the Battle of Ideas*", Harold James, Jean-Pierre Landau, and Markus Brunnermeier weave a narrative of (predominantly) two uncompromising standpoints in the sphere of international political

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economy governing the functioning of the European Union: those of Germany and France.[5] The differences constitute four separate yet mutually inclusive stances.

Rules vs Discretion

The debate encapsulated in the caption above is familiar to every student and practitioner of the discipline of economics; that there always be a case for one over the other or vice versa has also become a well-established submission by now. However, preferences can become sticky once evolved, and one way of dissecting the chasm between the ideologies of Germany and France is to observe how the former stresses upon a principled approach towards the monetary union while the latter emphasizes the compensations afforded by flexibility.

According to the German economic philosophy prevalent today, there exists a genuine case of erecting rules-based institutions to insulate the economics from the politics and, more urgently, to resist as far as possible from exceptions to the laid principles lest a one-time affair morphs into a tradition of caution-lapses and moral hazard.

The French, by contrast, deem discretion as a suitable prong by which to inspect economic challenges, and champion flexibility in addressing the underlying causes, particularly in case of what they regard as "temporary liquidity problems". For in doing so, the knock on effects may as well be crucial in determining the overall stability of the union by minimizing contagion.

Solidity vs Social Solidarity

The German viewpoint emphasizes solidity of the state of an economy as a vital ingredient in limiting mismanagement and the resulting turmoil. Self-sufficiency in governance is to be strived for to ensure that the sins of resource misallocation, over or under-investment, and excessive risk taking are contained autonomously. The following words of Johann Wolfgang von Goethe, the 19th century German writer and statesman, are regarded as an aphorism and often referred to in the country's policy circles: "Let everyone sweep in front of his door and every city quarter will be clean". This has been the basis of *Haftungsprinzip* (the "liability principle") supported by the Germans: entities with the liberty to self-carve a trajectory must also be prepared to stand liable for its consequences.

France, in stark dissimilarity, advises solidarity: mistakes are imminent, and leniency coupled with a collaborative response is to be the way forward. This viewpoint takes its inspiration from the slogan of the French Revolution, which still looms large in terms of its influence on the Franco ideology: "liberty, equality, *fraternity"*.[6]

[5] The ideological standpoints of other member states (such as the UK and Italy) are also provided in the book; however, the authors deem their influence on the overall EU policies and regulations to be narrower compared to the two core states of Germany and France. For the purpose of concision, the review focuses on the latter only.

[6] As stated in the book, Paragraph 21 of the 1793 Declaration of the Rights of Man and the Citizen—the ultimate statement of the ideals of the French Revolution—states that "Public relief is a sacred debt. Society owes

Solvency vs Liquidity

Extending the narrative further, the German policy makers discourage intervention to address the temporary fluctuations in an economy. According to their viewpoint, it is the solvency that is the holy grail of stability and, therefore, deserving of protection. As the authors state, Germans remain fearful that facilitating other nation states against short-term problems may foster an environment where a “bad habit” is developed to regularly cede mishap-control missions to the supranational authority. This is unadvisable on two accounts: a) avoiding the development of homegrown policies would increase the dependence of nation states on supranational assistance; and b) the development would violate the doctrine of self-sufficiency, without which for the Germans, the monetary union would not survive.

Again, the French regard intervention as necessary and adhere to the concept of liquidity support administration. Here, the notion of multiple equilibria is of particular importance. At a certain point of time, there exist two broad trajectories for the economy in light of an economic event: a good one and a bad one. Given the costs are not excessively high (or in other words, the “bail-out multiplier” is positive and greater than one), intervention by monetary and fiscal authorities may help attain the better of the potential economic outcomes. The higher the credibility of the institutions, the more akin multiple equilibria theory becomes to self-fulling prophecies.[7]

Austerity and Reforms vs Economic Stimulus

Capturing the hitherto debate are the for and against stances of the Germans and French towards austerity. The German tradition, as we have seen, stresses upon the probability of unsustainable economic growth resulting from a stimulus and hence advises self-correction. In other words, austerity in times of economic stress to push for unpopular reforms so that resilience is breathed into a nation state. The French school of thought, meanwhile, recognizes active demand management as the way forward and skewing reform implementation towards economic upswings when conditions are more conducive in order to make the economy capable of withstanding the winds of the next downturn.

The historical roots of the ideological conflict and its repercussions in the European sphere

The authors trace back the origins of the distinct ideological standpoints between the two countries in the events of World War II. The unprecedented scale of human misery that was witnessed during the war led Germany to believe that strict adherence to rules must become the precondition to any restructuring of the economy so as to avoid another violent and arbitrary government formation. Meanwhile, the fall of France in 1940 led the policy makers

maintenance to unfortunate citizens”. It is the attempted application of this stance by France *across* national frontiers that the German ideology cautions against.

[7] The opposite is also true. For example, Brunnermeier and Oehmke (2013) argue that issuing long-term debt can become relatively fruitless for a government if investors over time become aware that previous long-term obligations are being diluted by the issuance of short-term debt. Hence, the “maturity rat race” ensues and ultimately only short-term instruments remain in demand, with long-term financing becoming increasingly impossible for the government.

of the country to conclude that perhaps too little flexibility in their ruling structure was the deciding factor in the outcome of the war.

To be clear, the federal and central models of the states of Germany and France, respectively, since well before the advent of the Second World War, are proof that ideologies are shaped and entrenched over time. The authors put it aptly that "federations are mechanisms for preserving differences while minimizing conflict, while central states repress conflict by overriding differences through the assertion of authority. Federations thus need rules as a way of dealing with substantial differences in outlook".[8]

This necessitation of the ruling structure – *the rule of rules* – also surfaces in the domain of monetary and fiscal. The efforts to limit the centrist activism, particularly with regards to fiscal affairs, gave rise to the *Finanzuasgleich* in Germany: a dense set of regulations governing the inter and intra government transfers which are so complex that revisions or renegotiations become very difficult. On the other hand, in France, the passing of legislations can be, and often has been, enforced by means of a decree. The authors highlight how this constitutional provision (Article 49-3) on *vote bloqu*e has been used fifty times since 1958.[9]

Pillars too fundamentally different to be parallel shoulder the European Union. This makes its foundations weak

According to the authors, the Maastricht Treaty of 1992 – the base of the European Union – "assumed too simply that price stability was sufficient to ensure financial stability and that fiscal policy had no role to play in the provision of price stability". Disagreements over the subject along the Rhine Divide is evident across every element of the European (mis)management.

For instance, the no bailout rule that Germany so passionately fought to be included in the treaty of integration is the backdrop of the Stability and Growth Pact (SGP). Under the agreement, every fiscal authority is advised to practice solidity and not breach the 3 percent budget deficit rule for the fiscal year. However, market participants and financial institutions did not take the concept of no-bailout too seriously and leaned towards the French ideology of fraternity. Accordingly, under the Basel framework, banks are required to cushion up against risky positions; however, all euro-area government debt carries a zero-risk weight. Similarly, the ECB allows all euro-area government debt as acceptable collateral deposit without any risk-associated interest rate differentials. Brunnermeier et al are right in stating that, "Both rules were in direct contradiction to and undermined the principle of the no-bailout clause". This contradiction played into the euro crisis, as essentially the no

[8] The authors give an example of the railway track structures of both the countries to observe the aforementioned governance contrast. In Germany, there exist multiple "nodes", all interconnected, while the French railway tracks have Paris as the overarching central node from which all other tracks are connected.
[9] On the finance front too, France is home to a very concentrated banking market, within which the banks were also nationalized to facilitate in the careful construction and tweaking of the country's economic planning.

differential rule was incentivizing financial institutions to lend to other member states after incorporating credit and liquidity risks plus the inflation levels.[10]

On the international economics front, too, the two ideologies collide. The German philosophy explicitly supports free trade, undistorted competition and frictionless capital markets, with controls being considered as a form of potential lobbying that may result in moral hazard down the road. French, on the other hand, favor a relatively Keynesian position of "fixing exchange rate, controlling capital flows, and fostering multilateral adjustment via inflationary policies in surplus countries".

In other words, if one considers the *trilemma* or the *impossible trinity*, the two countries are on the opposite sides of the triangle, with Germans picking the capital flow side and France preferring the fixed exchange rate one. This is important as the third side of the triangle – with fixed exchange rates and free capital mobility – puts a significant constraint on the formulation of the monetary policy, especially when country's debt is denominated in foreign currency and is exactly what most economists refer to about what happened during the brink of the European crisis.

The foundations of this trilemma standoff between the two countries date back to the gold standard era (when the "price species" flow mechanism led to an inflow of gold into surplus countries and, given the gold inflows were not sterilized, increase in the prices) and continued into the Bretton Woods period (which was also essentially a gold-backed mechanism as the benchmark currency, the US dollar, was pegged to gold). With Germany accumulating trade surpluses on the back of increased labor productivity and contained wage inflation, the deficit countries were feeling the heat. As capital controls were present, financing even small deficits was becoming difficult. The only recourse left to the deficit countries was hence the application of fiscal brakes. The preferred alternative for the deficit countries, particularly France, was German growth and inflation expansion, which Germany was against given the legacy of hyperinflation and the presence of a strong and independent central bank.[11]

During the 1970s, the capital flows from creditor to debtor countries started increasing substantially. On the face of it, it was a welcome development for the French and other deficit countries. This is why the insistence of such countries to enforce tighter controls and even "penalize" the inflows may seem as counterintuitive. However, what was happening was that the cross border flows were financing mostly domestic focused sectors rather than export-oriented ones. This was resulting in increased wage differential without the

[10] A common narrative in most periphery-origin (and even international) books is indeed the surplus liquidity vs deficit borrower countries. Taking the case of Greek, for example, Yanis Varoufakis (2016) stresses how excess liquidity with the core countries' banks, coupled with the higher interest rates and low credit penetration in the deficit countries, led to a fueling of first the private and then the public debt of the periphery countries amidst a "frenzy" of inflows.

[11] For a long time in France until the mid-1990s, central bank independence was considered undesirable in a "unitary republic' as it could break free of the political oversight. The book cites Christaian Noyer, a former governor of the Banque de France, as stating that the French republic was "one and indivisible" and hence monetary independence is incompatible with the political system in place.

accompanying improvement in competitiveness of the products in the international market. Adding to this was the phenomenon referred to as the Walter's critique: with a fixed exchange rate regime and an expansionary demand shock fueling inflation, real interest rates in deficit countries were becoming lower relative to the debtor countries, thereby exacerbating the skewed credit flow situation. Notably, a similar development was also witnessed during the euro crisis with the periphery countries piling up debt from the core countries and disguising their weak economic situation in the "miracle" debt-fueled import-fed growth during the years prior to the crisis.

Ultimately, the Bretton Woods system collapsed, giving rise to free capital flows and flexible exchange rate regimes in line with the neo-liberal Washington Consensus. Within Europe, however, quasi-Bretton Woods structure by the name of European Exchange Rate Mechanism (ERM) was erected, and the ideological clashes persisted. Germany obstinately called for routine realignments and France insisted instead on wage growth regulation in the surplus countries. In 1986, the associated single currency market also got established, with France battling hard but eventually acquiescing to the demands of Germany to liberate the capital flows. In the end, the authors note, this development partly resulted in the two big exchange rate crisis of 1992 and 1993 leading the UK and Italy to withdraw from the ERM. The German and French policymakers had to resort to firewall efforts to rescue the free-falling system by strengthening the franc, lowering German interest rates, and widening the ERM exchange rate corridor from 4.5 percent to 30 percent.

Optimum Currency Area (OCA) without Fiscal Union – Is there a way forward?

Chapter 6 of *Euro and the Battle of Ideas* is perhaps the most interesting, as it strives to gauge the resilience of a monetary union without the presence of a complementary fiscal coordination. Debating first on the notion of free labor mobility within the union as a panacea for the vicious debt trap for the deficit countries, the authors then structure the debate towards its eventual futility. Echoing the US scholars from the 1990s, Brunnermeier et al state that free worker mobility of the scale of the US is impossible given the different cultural, linguistic and societal barriers amongst the EU countries. Furthermore, the so-called "brain drain" leaves the burden of the debt to be borne by a "smaller, less productive and aging population" as the young and skilled depart to the core.

On the capital front too, the same conclusion is reached via the *volatility paradox* (referred to above as the selective investments made by surplus countries' capital in the deficit states). Excessive capital, particularly of a smaller horizon, can potentially reverse just as quickly (if not more). Resultantly, discretionary/distortionary taxes on inflows to certain sectors are not effective, given that political lobbying may prevent this on the domestic level; while on the EU level, this may be seen as against the whole spirit of having a union.

Even if one allows for free capital and labor mobility, the reduced trade barriers would lead to increased specialization amongst the member states, making the absence of diversity within an economy a stress signal in the face of asymmetrical, industry-specific shocks. Furthermore, the deficit countries would have to face a trade-off between fading competitiveness and swelling debt – the undesired outcome of the "original sin" of having a greater share of foreign currency denominated debt in the country's total debt stock.

As mentioned earlier, for peripheral countries, excessive public debt and higher increases in prices and wages relative to core countries would leave no choice but to "internally devaluate" (as exchange rate flexibility is absent in this scenario). This may be achieved via low wage growth and economic slowdown; however, this would make more difficult for the workers to service debt obligations, which may turn into additional financial stability problems for the union. The only alternative is higher wage inflation in the core, which Germany would never agree to given its hard stance on self-sufficiency.

In sum, after presenting an adequately disinterested assessment of the (mainly) two ideologies governing the intricacies of the European Union, the authors conclude the inevitable as expected from economists: it depends whether rules, solidity and self-sufficiency are better or whether discretion, solidarity and flexibility pave the way forward. "For extreme adverse events, excessive emphasis on individual liability is counterproductive; in such circumstances, the solidarity principle should dominate". However, a threshold "needs to be identified, agreed upon, clearly communicated, and enforced in future crises". Furthermore, cries for common liability may only be heeded to when budget discipline in the euro area can be enforced credibly. Lastly, debt restructuring should occur only in extreme events, and must follow clear rules in order to limit economic disruption. The authors here are less convincing (or at times, silent) about *how*, if at all, these objectives may be achieved.