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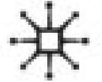

Symposium Introduction

The Euro: Manage It or Leave It!

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This symposium collects the keynote speeches delivered by Roberto Frenkel and Ugo Panizza at the workshop 'The euro: manage it or leave it!' held in Pescara (Italy) on 22–23 June 2012, along with a paper written by Andrea Boltho and Wendy Carlin, which was not presented at the workshop. The workshop was organized jointly by the International Network for Economic Research and the Department of Economics at the University of Pescara, and it focused on the economic, social and political costs of the exit strategies from the current Eurozone crisis.

At the time this introduction was written in June 2013, this issue was still timely. In most European countries the end of the recession looks now farther away than it appeared one year ago. The April 2012 edition of the *World Economic Outlook* (International Monetary Fund (IMF), 2012), forecast for 2013 a real GDP growth rate equal to 1.0% in France, 1.4% in Germany, and −0.3% in Italy. One year later, the April 2013 edition of the *Outlook* (IMF, 2013a) has revised the growth estimates downward by almost one percentage point everywhere, to −0.1, 0.6, and −1.4, respectively. Finally, at the beginning of June 2013, the growth forecast for Germany was halved by the IMF from 0.6% to 0.3%, suggesting that even the strongest and most resilient country of the Eurozone could be crushed by the recession in its most important trade partners.

A consensus is emerging that the austerity policies implemented by the peripheral countries of the Eurozone have contributed to this failure. The empirical foundations of the 'expansionary fiscal consolidation' hypothesis have been questioned recently by a number of studies, some of which were written by the same authors who had contributed to establishing the 'austerity myth' in the 1990s; compare, for instance Alesina and Perotti (1996) with

Perotti (2011). The most influential paper supporting austerity policies was probably Reinhart and Rogoff (2010), whose success among policymakers was certainly success due to its very simple message: 'median growth rates for countries with public debt over roughly 90 percent of GDP are about one percent lower than otherwise'. The causal nexus implicit in this statement was criticized by Panizza and Presbitero (2012). Nevertheless, Reinhart and Rogoff's paper was repeatedly quoted in the Eurozone media to support the view that sluggish growth in Southern countries should be cured by fiscal consolidation. As a consequence, public opinion was deeply impressed when Herndon *et al.* (2013) suggested that Reinhart and Rogoff's results were affected by coding errors and selective exclusion of data. This came shortly before the IMF (2013b) admitted 'notable failures' in the management of the Greek crisis, stressing that 'confidence was not restored', that the recession had been much deeper than expected, that productivity gains had proven elusive and so on.

The question then arises as to why wrong policies were consistently adopted during the crisis, despite many significant warnings provided by the scientific literature. The three papers presented in this special issue offer interesting insights on the possible reasons for this massive failure in macroeconomic management.

The first paper, by Andrea Boltho and Wendy Carlin, makes an interesting point: what threatens the Economic and Monetary Union (EMU) is the persistence of structural divergences in fiscal policy, competitiveness, and governance, rather than the occurrence of asymmetric shocks. This observation prompts several reflections.

First, the literature on the viability of the EMU as an optimal currency area (OCA) has focused so far on the degree of asymmetry of the shocks between member countries.[1] The analysis by Boltho and Carlin suggests that we may have overstated the contribution of this strand of research. In fact, besides the mixed results in this literature, ranging from the 'euro-skepticism' of Bayoumi and Eichengreen (1992) to the 'euro-optimism' of Kouparitsas (1999), these studies do not negate the evidence that the Eurozone countries ran into trouble after having been hit by a massive 'symmetric' shock, namely, the US financial crisis, that drove all of them simultaneously into recession.

Second, the data presented in the paper cast some doubt on the relevance of the so-called endogenous OCA theory. This theory states that, by entering a monetary union, a group of countries eliminates structural asymmetries through a number of channels such as increased factor mobility, business cycle

[1] This aspect could be analyzed formally in the elegant framework of the well-known Blanchard and Quah (1989) model, a feature that possibly contributed to the academic success of this approach.

synchronization through the enhancement of trade relations, inflation convergence through credibility effects and so on.[2] A well-known argument is that by 'tying their hands' to the policies of virtuous EU member countries, the Southern governments would gain international and internal credibility, thus facilitating the convergence of their inflation rates to those of the virtuous countries (Giavazzi and Pagano, 1988). The divergence in competitiveness and governance indicators between Northern and Southern countries documented by Boltho and Carlin disproves this view. Put in another way, even recognizing the need of essential reforms in Southern countries, one may wonder whether the straitjacket of the monetary union has significantly expedited this process, or whether it has rather hindered it, as suggested by Granville (2013) with reference to the French experience.

Third, the paper by Boltho and Carlin has important political implications. An often invoked solution for the current problems of the Eurozone is a 'big leap forward' towards a full fiscal union, with the example of the United States being frequently mentioned, more or less appropriately, in this respect. If the problem were the random occurrence of asymmetric shocks, a fiscal union could actually work as an insurance mechanism for member countries, where each country would hold in the long run a zero net present value position. However, as the Eurozone features persistent structural divergences, an obvious consequence would be that the fiscal transfers would flow for a very long time in one direction: from North to South. As Boltho and Carlin point out, the Eurozone 'macrocosm' would therefore replicate the disappointing experience of most member countries' 'microcosms', where transfer policies between North and South in Italy and Spain or West and East in Germany have hardly compensated for the structural divergences and have proven politically sustainable only because of a deep sense of national identity whose construction has taken many centuries. The political viability of a 'transfer union' at the Eurozone level is therefore questionable, both because it would cost the Northern constituency too much[3] and because the construction of a European identity is hindered by the euro crisis, with the likely consequence of an increase of the mistrust between Northerners and Southerners and among Southerners.[4]

[2] This is as old as the OCA theory itself. Mundell (1961) in his seminal paper quotes the controversy between Meade (1957) and Scitovsky (1958), where the latter advocated the 'endogenous' point of view.

[3] Sapir (2012), has estimated that, in order to compensate for the gaps in infrastructure, education and R&D expenditure, the transfers from Germany to Southern countries should reach 9% of its GDP.

[4] As predicted by economists as different as Kaldor (1971) and Feldstein (1997).

In the second paper, Roberto Frenkel compares the Eurozone crisis with the emerging market crises that have occurred over the last three decades within the framework of the Minskyan 'boom and boost' cycle. This comparison provides many useful insights.

First, much in the same way as the adoption of 'credible' exchange rates in a typical emerging market crisis, the adoption of the euro, with the 'credibility' associated with it, triggered the boom phase of the cycle in Southern countries, encouraging increased private indebtedness towards the other countries of the Eurozone. In other words, Frenkel's analysis takes the view that the euro, instead of reducing the structural divergences documented by Boltho and Carlin, as would happen under the 'endogenous OCA' hypothesis, may have fostered them. With the benefit of hindsight, this seems to be a very natural explanation. After all, the purpose of the single money was to facilitate capital movements.[5] As Blanchard and Giavazzi (2002) pointed out, this outcome could have been beneficial for the Eurozone, where sizable disparities among member states left significant scope for catching-up. However, lax financial regulation transformed these potential benefits into an actual disaster along a pattern experienced before by many emerging countries.

Second, Frenkel addresses the issues of why the right macroeconomic policies are so dramatically underprovided during financial crises. According to Frenkel, this unfortunate outcome results from the rational behavior of governments operating in a situation very similar to a Keynesian beauty contest. As the sustainability of their debts depends on 'a self-fulfilling prophecy of the average opinion of the market' (in Frenkel's words), governments, rather than choosing the policies that they find right, adopt the policies that they expect the average opinion of the market will find right. In this context, the austerity measures are rational, as they issue a reassuring signal to the average market opinion. Nevertheless, they are bound to fail because the ideal policy, as Boltho and Carlin put it, would be for the government to continue to run deficits while the private sector reduces its indebtedness.

The third paper, by Ugo Panizza, provides further intuitions on the political economy of financial crisis resolution by addressing two different questions: why are policies designed so poorly? Moreover, why is the resolution of the crisis, possibly in the form of a sovereign default, invariably postponed, even when this increases the social costs as was the case in Greece?

The answer to the first question builds on the informational asymmetries between the governments and their constituencies. Bad economics may become good politics because, as Krugman (2012) says, 'it is normal to think

[5] The impact of the single money on trade was anticipated to be little *ex ante* (eg, Eichengreen, 1993) and proved negligible *ex post* (eg, Berger and Nitsch, 2008).

of economics as a morality play'. The morality play is easy to explain to the public, but puts a huge political pressure on the governments that tell it, constraining them to adopt a procyclical fiscal stance that exacerbates the crisis. Another interesting point raised by Panizza is that, in many cases, the poor design of fiscal policies may depend simply on the fact that they address the wrong cause of a debt crisis. In fact, empirical evidence demonstrates that public debt dynamics are significantly affected by a stock-flow reconciliation component whose origins are still largely unexplained and whose management lies mostly outside the scope of fiscal policy.

The answer to the second question, why politicians postpone defaults, is twofold: on the one hand, self-interested politicians may fear the political costs of their decision; on the other hand, well-intentioned politicians may wait until a market consensus has emerged that the default is unavoidable, rather than strategic.

The same arguments could apply to the exit of a country from the Eurozone. The papers in this symposium have different views in this respect. Frenkel considers the euro to be irreversible, a view shared by those who believe that the huge political capital invested in the project, to quote Draghi (2013), will prevent self-interested politicians from dismantling the Eurozone. In his views, therefore, the solution of the crisis will sooner or later involve debt restructuring and possibly the evolution of the European Central Bank into a credible lender of last resort for the Eurozone governments. Boltho and Carlin have a more pessimistic view: as the divergences in competitiveness are very costly to reduce by 'internal devaluation', the perceived costs of Eurozone membership are likely to overcome those of the exit from the single currency. History teaches us that many other ambitious political projects had eventually to reckon with the stark logic of economic reasoning. The USSR is a good case in point, as the political capital invested in its creation and continued existence was possibly larger than that invested in the Eurozone, but the returns to this political capital were apparently not large enough to prevent the system from collapsing (see Kawalec and Pytlarczyk, 2013, for other examples). This simple fact suggests that in the near future the study of optimal exit strategies may become less speculative than it appears now.

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