



Europe's Economic Crisis

Transatlantic Perspectives



ROBERT M. SOLOW AND DANIEL S. HAMILTON, EDITORS

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Edited by
Robert M. Solow and Daniel S. Hamilton

Center for Transatlantic Relations
Paul H. Nitze School of Advanced International Studies
Johns Hopkins University

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Center for Transatlantic Relations

The Paul H. Nitze School of Advanced International Studies

The Johns Hopkins University

1717 Massachusetts Ave., NW, Suite 525

Washington, DC 20036

Tel: (202) 663-5880

Fax (202) 663-5879

Email: transatlantic@jhu.edu

<http://transatlantic.sais-jhu.edu>

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Preface and Acknowledgements

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Our authors express their own views, and do not necessarily reflect views of any institution or government.

Robert M. Solow

Daniel S. Hamilton

Introduction

Robert M. Solow and Daniel S. Hamilton

When the euro was introduced, it was heralded as the symbol of a unified Europe. Not enough consideration was given at the time, however, to how member economies could adjust in response to disparate performance, or how debt crises could be avoided. Today, amidst a broader North Atlantic financial and economic crisis, many European economies face daunting challenges of debts and deficits. Governments have fallen, and the eurozone is in turmoil. Such strains and stresses could challenge Europe's very construction.

How should eurozone countries tackle their current crisis? How did it come about, and how may it be resolved? What does it mean for Europe's historic experiment in political and economic integration? Will the eurozone crisis be remembered as the moment when the EU finally cracked? Or as the spur to a more integrated and competitive Union?

We asked the authors in this volume to address these questions. Their varying perspectives complement each other and offer the reader a range of views on the continuing crisis. Martin Neil Baily, Natalie McGarry, Xavier Ragot and Hans-Helmut Kotz examine the roots of the crisis and its links to the U.S. financial crisis, evaluate European responses, and suggest solutions. David Calleo casts the eurozone crisis in the context of enduring European debates about the nature of their experiment in integration, including the role of the dollar and the rise of China. John Gabriel Goddard and Daniel S. Hamilton each look at what the economic crisis means for Europe's economic prospects in an increasingly competitive and connected world.

Given the tumultuous pace of developments, it may seem premature to present a book of this type. Yet there is considerable interest in understanding the roots of Europe's economic crisis, how the crisis may evolve, how it relates to economic difficulties in the United

States, and what it means for Europe's role in the world. We thus offer these perspectives as guide and orientation in turbulent times.

Martin Neil Baily and Natalie McGarry detail EU countries' discretionary and automatic fiscal response to the crisis as well as the accompanying monetary policy; present what they call the expansionary fiscal contraction hypothesis, and contrast it with standard approaches; and discuss the difficulties some EU countries will have repaying the debt they accumulated before and during the crisis due to their uncompetitive labor unit costs. They argue that fiscal austerity does not solve the problem of a deep recession, and that Keynesianism remains highly relevant.

Baily, McGarry and Kotz discuss the role of Europe's automatic stabilizers and why Europe's response to the crisis differed from that of the United States. While European and U.S. monetary policy responses to the crisis were similar, fiscal policies diverged significantly, largely due to structural differences between the U.S. and EU countries. The EU did not have to rely as heavily as the U.S. on stimulus packages during the recession, since European economies have more countercyclical policies built into their budgetary structures than the U.S. does. EU countries relied on automatic and discretionary fiscal policy in nearly equal proportion, while the U.S. was forced to pass a much larger temporary stimulus package.

There is considerable commentary on how to improve eurozone governance. Hans-Helmut Kotz is skeptical of proposals to make the strictures of the Stability and Growth Pact more automatic and rules-based. He argues that once the crisis is contained the euro area has to think of building a macro and financial framework that acknowledges spillovers and takes account of the aggregate impact of national fiscal policies, of financial market integration as well as regional current account imbalances. He suggests that the European Commission's Excessive Deficit Procedure is a start in that direction. He contends that European financial regulation and its implementation also have to become more effective, and that the eurozone needs a fiscal insurance mechanism in addition to responsive labor markets and enhanced labor mobility.

The crisis has revealed the key weakness at the heart of the eurozone, namely the uneasy coexistence of a unified monetary policy with

disparate fiscal policies. Many have questioned this split system and have suggested that either a European fiscal union is needed to complement the monetary union, or that the common currency itself should be dissolved. The status quo seems untenable, and yet either alternative course is fraught with economic and political difficulties. Kotz and Xavier Ragot argue that Europe must agree on fiscal governance. Eurozone leaders have in fact set in motion a process that could lead to a fiscal union as a next historic step in European integration. It is unclear whether European voters and taxpayers will go along. Yet Kotz goes even further, arguing that effective macro policies must go hand-in-glove with supply-side policy—a two-handed approach that not only deals more effectively with labor market conditions but extends to appropriate policies in infrastructure, education, innovation, and European networks.

Ragot, David Calleo and Daniel Hamilton also underscore the central point that Europe's crisis is as much political as economic. As Calleo notes, it is the failure to control budgets and supervise banks—two fundamental tasks of government. In addition, there is growing concern that EU institutions are too weak to provide the leadership necessary to navigate the shoals of today's financial crisis. Calleo places the current economic and monetary crisis in the context of decades-old debates between rival 'federal' and 'confederal' visions for Europe, or what he calls Europe's 'constitutional dilemma.' He argues that European efforts to reconcile those differing visions has resulted in a hybrid construction, part supranational and part confederal, the inner contradictions of which are facing renewed strains due to the eurozone crisis, the gyrations of the dollar, and the rise of emerging powers, particularly China.

As a result, Europe is paying a high economic price for its inability to decide politically what the European experiment means today, and to make difficult decisions that would either take the EU along a path of deeper integration, with all that means for the sovereignty of individual countries, or down a road of far looser arrangements, which carry the risk of fragmentation as well as eroding competitiveness for a substantial number of European economies. Voters and markets are uncertain whether the EU can evolve institutions and habits strong enough to constrain states, firms and markets from the runaway accumulation of ailments characteristic of recent years.

Hamilton and John Gabriel Goddard put the current economic crisis in the context of Europe's broader economic challenges. Hamilton offers a summary analysis of the EU's economic strengths and weaknesses, while keeping Europe's tremendous diversity in mind. He argues that Europe is stronger in more areas than its critics acknowledge, but also weaker in more areas than its proponents are prepared to admit. He argues that European leaders cannot afford to focus only on the economic crisis itself, no matter how absorbing it has become; they must simultaneously lay the foundations for continued European competitiveness in an increasingly interconnected world. He urges that priority attention be given to boosting European productivity; capitalizing on European strengths in services and energy economics; and completing the Single Market. He discusses the rather severe challenges Europe faces in terms of demography. Europe has become a magnet for the unskilled, and has trouble attracting and retaining high-skilled migrants. He argues that the EU needs to develop a pan-European talent strategy that attracts skilled foreign labor; ensures the free movement of people among member states; facilitates better links between business and education; improves access to and harmonizes key features of the labor market; promotes higher education and training in key enabling technologies; and boosts overall skills training and re-skilling across the Union.

Both Hamilton and Goddard argue that the EU's Europe 2020 Strategy is taking Europe in the right direction in terms of innovation policies, but that it needs to be developed with far more specific strategies to ensure effective implementation. Such strategies, they argue, must be based on firm expenditure commitments by individual countries that can turn the Strategy's goals into reality. They must reinforce links between overall R&D targets and national and European innovation policies; draw on best practice in basic research, and dispel the lingering aversion to risk-taking and entrepreneurship, which could boost much-needed private sector R&D.

For fifty years, the European project was about internal reconciliation and reconstruction following the collapse of an earlier era of globalization into war and depression. It was a grand experiment in harnessing closer economic integration to build prosperity and peace. Over the past twenty years it has extended those benefits to more of

the European continent than ever thought possible. Today, Europe's deep economic crisis is again raising fundamental questions about the nature and future of its grand experiment. We believe this set of essays add light to those debates.

