Ideas that Make Money:

The Euro from Maastricht to the Fiscal Compact and Beyond

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Abstract

Why and how do bad ideas persist over time? While it has been well established that ideas were crucial during the euro's foundational period, what is less appreciated is how the fiscal consensus governing the euro vacillated between rules and discretion during the 1990s and 2000s, and how the same ideas that caused the euro crisis in 2010 were also the ones used to remedy it. Since the euro's disintegration has been averted, and Greece (for now) remains a member of the Eurozone, proponents of the orthodox approach have hailed the single currency's perseverance, despite the fact that the result is an unhappy, deflationary, and low-growth equilibrium. In this paper, we trace the resilience of the euro's *ordo*liberal and *neo*liberal ideas that informed policymaking throughout the crisis, even in the face of an astounding amount of evidence that the professed cure was slowly killing the patient. We argue that Europe's medium-term resilience is mainly owed to the actions of the European Central Bank's monetary policy, which operates in direct opposition to the Eurozone's fiscal policy consensus. In the long term, we argue, the euro's tenacity is still questionable given that the solution to the crisis could only be achieved by supranational technocratic demands superseding any legitimate national democratic choice. We maintain that the euro will remain fragile as long as these contradictory underlying ideas continue to inform policy.

Introduction: A Certain Idea of Money

Ideas that make money are generally speaking a good thing. In this paper we refer to European ideas that make money in three specific senses. First, we view them as a set of ideas about how to build a common currency – literally, how to make money. Second, we conceive of a set of ideas that will earn the holder of the money, more money. That is, the money created based upon these new ideas will make the user of the money better off. And third, we consider a set of ideas that preserve the value of that money over the value of other assets, or prioritize the securing of that value over other values such as the level of output or employment. In all three senses we argue that these ideas, as they continue to exist in the Eurozone, have turned out to be less than a good thing. But is this by default or by design? Or, more poetically, is the fault in our monetary selves or our macroeconomic stars? To adjudicate why these bad ideas about money persist we analyze the evolution of European ideas about money from the early 1990s until today from the point of view of the 'policy paradigms' model of social learning.[1]

If one makes a fundamental distinction between fiscal and monetary policy, and then one walks backwards over the evolution of policy starting in the spring of 2016, a remarkable divergence reveals itself. Fiscal policy, which is today borderline illegal in the Eurozone, becomes more discretionary the further back one travels. In contrast, monetary policy, which in 2016 includes negative deposit rates as well as massive private and public asset purchases to suppress yields, is as loose as it can be. But the further back one goes, the tighter monetary policy becomes, as seen in Table 1 below. Given that the optimal 'macroeconomic policy mix' is unlikely to ever be found in the extremes of the distribution, how are we to explain this pattern?

[1] Hall (1993); Berman (2013); Blyth (2013); and Carstensen and Matthijs (2016).

Table 1: The Changing Macroeconomic Policy Mix in Europe (1993-2016)

		Economic Policy Area	
		Fiscal Policy – Ever Tighter	*Monetary Policy – Ever Looser*
Timeframe	1993-2003	**National Rules with External Targets** (Maastricht Criteria, Stability and Growth Pact, EDP)	**National/EU Rule** (Irrevocably Fixed Exchange Rates, Inflation Targeting, then ECB takes over)
	2003-2012	**Limited National Discretion** (Tax & Spending again Legitimate Domain of National Governments, all-out Fiscal Stimulus in 2008-09)	**EU Rule** (ECB Sole Mandate Price Stability, Inflation "less than but close to 2 percent," 'No Bailout' Clause)
	2012-2016	**EU Rules** (Balanced Budget Rules, Fiscal Compact, European Semester, Quasi-Automatic Sanctions)	**Large ECB Discretion** (LTROs, "Whatever it takes," ELA, OMTs, TLTROs, Negative rates, QE, "We don't give up")

We argue that a specific politics of social learning is apparent in the evolution of European ideas about money, which is *one of consistently and deliberately learning the wrong lessons, over and over, for 15 years, despite much evidence to the contrary*. We justify this claim in five steps.

Our first argument is that the ideas that produced the euro were predicated on the completion of political institutions that never came to pass. As such, what was 'sovereign money in waiting,' in 1992 ended up becoming 'non-sovereign money in use' by 2002. That simple fact built fragilities into the currency and into the European Union that exacerbated the impact of the crisis the currency faced after late 2009 because it led European elites to asking themselves quite different questions about the crisis from their Anglo-American cousins.[2]

The question asked by Anglo-American elites, because they had sovereign money, was 'what can we do to bail out the system?' The answer was 'open the monetary fire hose and throw liquidity at everything.' After all, a sovereign issuer – the US Federal

[2] We thank Yanis Varoufakis for this observation.

Reserve and the UK Bank of England – has no liquidity constraint. The question asked by Brussels-based EU officials and monetary policy elites in Frankfurt – who could only act with non-sovereign money, and whose European Central Bank (ECB) actually did have a liquidity constraint – was more like 'how do we maintain the system we have built when we cannot directly bail it out?' The answer given was never clearly expressed. As we will document below, the resulting policies refract the politics of that difference.

Second, in terms of an asset that makes the issuer better off, the euro has also been highly problematic. As we shall show, despite the credit boom of 2001-2007, European growth remained sclerotic, prompting budgetary pressures that resulted in the violation of the rules of the Stability and Growth Pact (SGP) in 2003 and 2004 by its two principal members, Germany and France. This episode was interpreted by European elites as a policy failure. We instead code it as a policy success that was interpreted as a failure, insofar as we argue that the wrong lesson was learned from that episode.

Third, building on that erroneous lesson, we focus on the brief period of fiscal activism that occurred in Europe at the start of the global financial crisis (2008-09). Rather than taking the improvements in performance that this policy levered as evidence that the policy should continue, policy was instead seen in the mirror of what was mis-learned over the prior SGP episode. As then ECB President Jean-Claude Trichet put it at the time, "stimulate no more, it is now time for all to tighten,"[3] a policy which proved to be rather calamitous for the Eurozone.

Fourth, we focus upon the compounding of this error in the period from 2010 to 2012 with a double contraction of tight fiscal and tight monetary policies, which, as we show, was exactly the wrong combination for growth, but it was a much better

[3] Trichet (2010)

combination if one's objective was saving the euro, even at the expense of ordinary Europeans. Not only did monetary policy get tighter – not looser – despite the recession deepening; in this period, efforts got underway at the level of European institutions to permanently bind fiscal policy options while steadfastly refusing to admit that the policies being followed were in fact causing the problem, despite the build up of evidence that this policy combination was self-defeating.[4]

Fifth, we examine the period from 2012 to 2016 where monetary activism, from Long Term Refinancing Operations (LTROs) to Outright Monetary Transactions (OMTs), to Negative Deposit Rates and enhanced Quantitative Easing (QE), has been facing off against fiscal parsimony, with each policy slowly dragging the other down. Here we highlight the paradox that Mario Draghi's monetary activism may be against the rules, but it works, at least insofar as it is putting a floor on the deflationary pressures that are created by the new fiscal framework. As Ben Bernanke, former US Fed chairman, once sardonically remarked: "QE…works in practice, but it doesn't work in theory."[5] Meanwhile, the EU fiscal framework in operation since 2012 is busily creating the very problems that monetary policy is trying to obviate.

This contradiction reached its apotheosis during the third Greek bailout crisis of 2015 where the ECB rationed liquidity to the Greek banking sector as a way of disciplining Greek fiscal choices while using hyper-liquidity everywhere else in the Eurozone to stabilize the euro in the face of the shocks this same policy was causing. Again we see fiscal rules getting ever tighter (one set of ideas about money) while monetary discretion gets ever wider in response (another set of ideas about money). In

[4] See Ban (2015); Blyth (2015), Postscript; and OECD (2014).
[5] Brookings (2014).

conclusion we return to the policy paradigms model to evaluate how this pattern of policymaking can, in any meaningful sense, be seen as 'social learning,' and how despite an abundance of contrary evidence, bad ideas about how to make money continue to persist.

Policy Paradigms and Social Learning Revisited

One of the most successful models that seek to understand how ideas and material factors combine to influence policy is the "Policy Paradigms Approach," developed by Peter Hall, who built upon the original model by Thomas Kuhn.[6] A reduced version of Hall's model sees policy change as a function of two discrete causes: empirical anomalies and authority contests. The former logic is rationalist. The latter is constructivist.[7] Both logics argue that policy paradigms, defined by Hall as "a framework of ideas and standards that specifies not only the goals of policy… but also the very nature of the problems that they are supposed to be addressing," are the location where social learning, defined as "a deliberate attempt to adjust the goals or techniques of policy in response to past experience and new information," takes place.[8]

Hall's model, and other similar derivations, typically has three levels of policy change ('first order' instruments, 'second order' policies, and 'third order' paradigms) and two forms of social learning (simple and complex). Here we are more interested in the social learning part. Specifically, we ask how – from a theoretical point of view – can policymaking elites consistently learn the wrong lessons?

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[6] Hall (1993); Kuhn (1962).
[7] See Blyth (2013) for further elaboration.
[8] Hall (1993): 279, 283

Recent work on this model suggests that policy change is more a function of authority contests over the *meaning* of empirical anomalies rather than 'just the facts' bringing about change, since 'facts' are always theory dependent; and in economics especially, they are paradigmatically exclusive.[9] That is, paradigm dependent empirical anomalies do not simply 'hollow-out' existing paradigms by weight of the 'facts' revealing themselves. Rather, events identified as anomalies – or not – can either add to, or subtract from, the 'authority' of those arguing for specific policies given that their authority in part rests upon appeal to these 'ruling ideas.'[10] Seen this way, social learning is then dependent upon who is institutionally authorized to learn, what their relationship to policy is (can they directly make policy or not?), and their power to define what actually counts as an anomaly, and what does not.

We hypothesize that technocratic actors – operating with non-sovereign money – who are highly insulated from politics, have the capacity to systematically skew the interpretation of anomalies in order to produce policy choices that are 'globally irrational but locally rational' since there is no democratic check upon their policies. Such choices serve to insulate actors from criticism while reproducing suboptimal policies.

The problem EU technocrats face is that lacking sovereign money, which would give them the ability to make unlimited liquidity pledges directly, they are forced to fight liquidity and solvency crises with an insufficient toolkit. Due to this constraint, and facing declining legitimacy given the lack of the effectiveness of the policies they can use, policymakers are incentivized to continue to pursue bad policies as a kind of 'second best' equilibrium outcome where what Robert Wade termed "paradigm maintenance"

[9] Matthijs (2011), Blyth (2013)
[10] Ban (2016)

trumps actual "paradigm change" through the systematic social learning of the wrong lessons.[11]

Key here is the ability of such agents to use Kuhn's notion of paradigmatic incommensurability as a political weapon to delegitimize and sideline other agents' interpretations of 'why policy is wrong,' and why 'what they are doing is right,' despite accumulating evidence to the contrary. As Kuhn put it over fifty years ago, incommensurability occurs where "parties to… debates inevitably see differently certain of the experimental or observational situations to which both have recourse. Since the vocabularies in which they discuss such situations consist, however, of predominantly the same terms, they must be attaching some of those terms to nature differently. As a result, the superiority of one theory to another is something that cannot be proved in debate. Instead... each party must try to, by persuasion, convert the other."[12]

But this also suggests that in zero sum situations where persuasion is not an option – for example, when the future of a technocratic elite project fifty years in the making is at stake and where those in charge have insufficient tools to make a 'first best' fix – incommensurability can be deployed as a defensive mechanism to deflect attention from actual performance while insulating those in power from challenges to their technocratic authority. Governments and governors may both 'power and puzzle,' as Hugh Heclo once famously put it, but they also can authoritatively dictate *what the puzzle is in the first place* and therefore define how power should be applied, which may not be to solve the puzzle that seems most pressing to others.[13]

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[11] Wade (1996), p. 3
[12] Kuhn (1996 [1962]), p. 198
[13] Heclo (1974), pp. 305-306.

Given this, those invested in saving and preserving the euro, as well as the wider European project of 'ever closer union' since the crisis began in late 2009 – those whose identities were bound up with these ideas about how to make money – can hardly be expected to turn around and declare that policy since 2009 has been an error, no matter the weight of the evidence against them. As we shall see, with so many distributed, yet mutually supportive, authorities invested in the art of 'paradigm maintenance,' social learning can lead to the persistence of bad ideas about money just as much as it can lead to positive change in policy. To see how these politics actually unfolded, we must first return to our three sets of ideas about how to make money.

How to Make a Euro: Maastricht's Ordo- and Neo-Liberal Sins

The creation of the euro is often explained as the heavy price Germany had to pay France for its unexpected reunification.[14] But the reality is that discussions to create a single currency alongside the then recently launched Single Market in Europe had been under way well before the Berlin Wall came down, at least from the setting up of the Delors Committee in June 1988, which submitted its unanimous report to replace national currencies with a single European currency in April 1989.[15] While the decision to create a common currency – the euro – was undoubtedly a political one, the ideational consensus on how to actually 'make this new money' was remarkably depoliticized.

The starting point of any new single currency was the view, much in vogue among economists at that time, that one could not and should not trust politicians with one's money. The euro's institutional design hence sprang from a mixture of ordoliberal

[14] See Katzenstein (1997), Calleo (2001), or James (2012).
[15] The first real concrete proposals for a common currency in Europe go back to the 1970 Werner Report.

and neoliberal ideas, the result of a long gestation process of ideational convergence in the 1970s and 1980s that reached a broad consensus among elites in the advanced industrial world by the early 1990s.[16] Erik Jones referred to this set of ideas as the "Brussels-Frankfurt consensus."[17] The neoliberal part of that consensus traded full employment for price stability as the main goal of macroeconomic policy.[18] In theory, the best way to achieve price stability was for an independent central bank to directly target inflation as a rule, given the time-inconsistency of politicized monetary policymaking.[19] The Bundesbank's success in fighting inflation in Germany during the 1970s was given as the main example that such an approach worked in practice.[20]

The ordoliberal part of the Brussels-Frankfurt consensus hailed from the German understanding that capitalism performed best when governments set clear rules for competition in all markets and pursued sound public finances, preferably with fiscal budgets in constant balance or in surplus.[21] The ordoliberal tradition also insisted that both individuals and states should be the sole bearers of the risks of their decisions so as to avoid problems of moral hazard.[22] Rather than under the Keynesian view of macroeconomic management where full employment was the target and policy discretion was the norm, ordoliberals argued that the main constraint on growth was uncertainty about public finances. Once that uncertainty was taken away from investors by governments' "credible commitments" to pursue sound fiscal policies (which meant in

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[16] McNamara (1998), p. 3; Schmidt (2015), p. 93.
[17] Jones (2013), p. 145
[18] Unemployment could only be lowered by 'microeconomic' policies, such structural reforms to bring about more flexible labor markets and a weakening of the power of trade unions.
[19] Barro and Gordon (1983); Alessina and Tabellini (1988); Lohmann (1992); and Cukierman (1992).
[20] McNamara (1998), pp. 150-52
[21] Matthijs (2016a), p. 376. See also Jacoby (2014) for an excellent overview of the multiple variants of ordoliberalism in Germany.
[22] See Stark (2015)

practice deficit and debt reductions and adherence to an inflation target) business confidence would receive a much-needed boost.[23]

It was acknowledged at the time that the single currency would entail a serious loss in macroeconomic sovereignty. Without national currencies, either devaluation or inflation would be firmly off the table, while default would become all but forbidden under the new euro rules. But the efficiency gains from an irrevocably fixed exchange rate – through lower transaction costs, the vanishing of foreign exchange rate and inflation risk, as well as the assumed benefits from soon being an international reserve currency of choice – carried the day.

Enshrined in the Maastricht convergence criteria of 1992, adherence to these new ideas was believed to create a virtuous circle of fiscal austerity and tight monetary policy that would be rewarded by the markets in terms of lower bond yields and inflation rates. The result would be faster growth, higher standards of living, and greater stability in the financial markets. Europe's common money would then make all of its members ever more money. And as long as the member states did their microeconomic homework by reforming their sclerotic labor markets through liberalization while staying out of the economy by resisting any temptation at macroeconomic discretion, they would pick the fruits of lower unemployment as well.

Words of Warning

At the time of convergence, much of America's and a fair bit of the UK's economics establishments warned that Europe did not represent the 'optimal currency

[23] Giavazzi and Pagano (1988)

area' that such theories presupposed.[24] For them, the euro's inherent bias was going to be a deflationary one, and its governing institutions clearly lacked the discretionary tools to deal with asymmetric shocks since they had sacrificed them at the euro's ordoliberal altar.[25] One prominent economist at Harvard even predicted war and international conflict would break out as a result.[26] Nonetheless, the European Commission's technocrats viewed 'one market – one money' as the sensible sequel to the 1987 Single European Act (SEA) and were quick to dismiss such fears.

Initially, the facts seemed to support the EU technocrats over the euro skeptics. The strong convergence among Eurozone economies in the mid-to-late 1990s, good growth rates in the early 2000s, and the super-convergence in bond yields in the period 1999-2007 all seemed to prove the euro's critics wrong. In reality however, the convergence in nominal interest rates would overshadow the continuing differences in national inflation rates, with German and French real interest rates going up as Greek, Spanish and Irish real interest rates were turning negative. As a result, the effect of the euro's introduction was one of large capital flows from Northern core to Southern periphery, which fueled intra-EMU macro imbalances.[27] And here the critics had a point.

Policy Inactivism

The ECB in this pre-crisis period faced a classical 'goldilocks' problem. Its interest rates were too high for the Northern core countries experiencing lackluster growth, and too low for the booming Southern periphery. But since Frankfurt was mainly

[24] See Matthijs and Blyth (2015), p. 1-3.
[25] See Eichengreen (1991) and Eichengreen and Bayoumi (1993).
[26] Feldstein (1997).
[27] See Matthijs (2014), Wolf (2014), Jones (2015), and Blyth (2015).

worried about maintaining price stability, defined as close to but lower than 2 percent in the medium term, and with earning the markets' credibility, they persistently erred on the side of higher rather than lower rates. And while the European Commission in Brussels could recommend fast growing 'Celtic tiger' Ireland to run ever-larger budget surpluses, it could not allow 'sick man' Germany or feeble France to stimulate domestic demand by running bigger deficits because political discretion had no role to play in an ordoliberal world.

Hence lay the euro's original sin. As Germany and France were sliding back into recession in 2002 and suffering from ever-higher rates of unemployment, their automatic stabilizers quickly put real pressure on their public finances. This came into direct conflict with the very ordoliberal rules of the Stability and Growth Pact – with its Excessive Deficit Procedure (EDP) – that all future euro member states had signed onto in 1997. Germany, the euro's indispensable member state, which had insisted on strict fiscal rules as a condition for anchoring the new single currency, would now see those rules a hindrance rather than a bonus. In doing so Germany, followed by France, would solve a macroeconomic problem but would mis-learn the lesson the episode provided.

How to Make a Mistake: The Breaching of the SGP and Learning the Wrong Lesson

The Stability and Growth Pact (SGP) – a misnomer as critics have argued that its deflationary effects only create social instability through higher unemployment as well as no growth[28] – was constructed at the insistence of Germany. The Germans, more than anything, were worried that EU member states would fall back into their old fiscal habits

[28] See Driffill and Miller (2003), p. 42. See also Vail (2015), p. 157.

of running large deficits and promoting inflation once they adopted the euro. It therefore enshrined the Maastricht convergence criteria – of 3 percent fiscal deficits and 60 percent debt-to-GDP ratios – into European law. Together with the ECB's mandate to maintain price stability at all cost, the SGP was the ordoliberal cornerstone of the euro's fiscal governance framework. Discipline would be demanded – but would it be supplied?

The SGP would quickly be criticized from an unexpected corner. As it was clear that not just France and Germany, but also Portugal, would thumb their noses at the pact, Romano Prodi, then President of the European Commission, admitted in rather spectacular fashion that it was not working. In an interview with *Le Monde* in October 2002, Prodi stated: "I know very well that the stability pact is stupid, like all decisions which are rigid. The pact is imperfect. We need a more intelligent tool and more flexibility." [29] Prodi's comments followed earlier remarks from then EU trade commissioner, Pascal Lamy, that the Pact was "crude and medieval."[30] Despite Germany being the author of these ordoliberal bindings, it was Germany, and then France, that violated the Pact's rules in 2003 by running budgetary deficits well in excess of 3 percent of GDP. It immediately became clear that since the 'big two' were the first ones to break the pact, while the Commission had to initiate an excessive deficit procedure (EDP) in response, the Council was likely to overrule it.

The EU's response to this macroeconomic governance 'crisis' was to make the rules of the SGP a lot more flexible. After the Pact's spurning by France and Germany, the EDP was considerably weakened in 2005 to allow the Council – where larger member states tend to have a much stronger voice – more discretion in interpreting the actual

[29] Prodi interview in Le Monde (17 October 2002) as quoted in Heipertz and Verdun (2010), p. 135.
[30] Osborn (2002).

reasons for any violations of the 3 percent rule. Before the 2005 reform of the SGP, 'exceptional circumstances' had been defined as cases in which a country experiences an annual fall in real GDP of at least 2 percent. After the 2005 reform, a severe downturn was understood as a negative annual real GDP growth rate or an accumulated loss of output during a longer period of very slow GDP growth.[31] In other words, the 2005 reform of the SGP placed a rather large Keynesian elephant in the ordoliberal tent by making fiscal policy once again the preserve of the nation states as they defined "a loss of output" to their liking, acted, and then informed the Commission once they had done so.

Learning from the SGP

This episode, what EU (and German) officials were to later describe as a policy 'failure,' was actually a success economically. Once the pact was broken, the economic situations of both countries improved. It was also a political success insofar as the 2005 SGP reform handed national governments back a critical tool in fighting the adverse impact of a 'one-size-fits-none' monetary policy by the ECB, thereby putting the euro on a politically more sustainable footing. But under neo- and ordoliberal ideas, such discretion can only be seen as anathema: a structural weakness and an accident waiting to happen. Indeed, most EU officials continued to lament that the episode marked a significant weakening of the "Brussels-Frankfurt consensus" and that the breaking of the pact had sawed the strict fiscal leg off EMU's macroeconomic governance stool.[32]

Therefore, while the core of the Eurozone returned to growth between 2005 and 2007 as private capital flows from North to South continued to bridge the widening intra-

[31] See Matthijs (2016a), p. 381.
[32] Add citations.

EMU balance of payments disequilibria, those who saw the SGP reform as a mistake waited for proof. In the short term the SGP's new flexibility did not seem to have brought about the collapse of trust in the euro and instead was delivering the goods. But rather than accept that this episode provided a positive lesson, events would soon come to pass that would allow a radical 'recoding' of this moment. This would in turn set the stage for a series of ideological reinforcements to the EU's ideas about making money, despite the persistent swelling of evidence to the contrary.

Compounding the Mistake: The SGP, Austerity, and the Recoding of a Crisis

Crisis is, as the cliché has it, an opportunity. The global financial crisis first hit Europe in August 2007 when a Düsseldorf-based lender called IKB, had to be rescued after suffering losses on its US subprime investments. From then, until the rescue of Hypo Real Estate bank in 2008, Europe thought it had survived the worst of the meltdown in 'Anglo-Saxon banking' that, as then German Finance minister Peer Steinbrück put it, was (correctly) seen as the cause of the crisis.[33] A banking crisis was then, at this point, rightly seen as the problem facing Europe: not over-spending or a lack of credibility, or anything else. Given such an understanding there was no need to turn the money pumps on to fuel recovery. Little wonder then that the Germans looked on in horror, as the United States and the United Kingdom seemed to do just that, especially after they bullied Berlin to join in this avalanche of political discretion.[34]

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[33] As German Finance Minister Peer Steinbrück put it at the time, the "irresponsible overemphasis on the 'laissez-faire' principle, namely giving market forces the most possible freedom from state regulation, in the Anglo-American financial system," which had led to a crisis of over lending. See Mangasarian (2008).
[34] As German Chancellor Angela Merkel put it in late 2008, "cheap money in the US was a driver of this crisis…I am deeply concerned…[with]…reinforcing this trend…[and wonder]…whether we could find ourselves back in five years facing the same crisis." As quoted in Newman (2010): 158.

Europe's Keynesian Moment

The turn to Keynesianism in 2009, even in Europe, was made possible, in part, by the fact that the ideas that lay behind Europe's money – integration, market efficiency, credibility, etc. – pretty much denied such a crisis could arise in the first place. Given this rather obvious failure of ideas, "governments quickly came to believe that monetary policy was insufficient on its own to help the real economy."[35] The results of this realization were both immediate and dramatic as countries as diverse as Brazil, China, and the United States, as well as many European economies, lined up to stimulate their economies. Even Germany stimulated to the tune of just under 3 percent of GDP. But that they did so did not mean that they liked doing so.

On the monetary policy side, and unlike the US Federal Reserve and the Bank of England, both of whom were extremely active in deleveraging and recapitalizing their banking systems, the ECB sat on the sidelines and did very little in the initial stages of the crisis, for two reasons. First, Fortis and Dexia apart, there did not appear to be much of a European banking crisis until 2010, so there was nothing to fix. Second, given that its job was by statute to fight an inflation that clearly was not there, there did not seem to be all that much to do on that front either. But despite the supposedly "Anglo-Saxon" nature of this crisis, yields on European bonds became more volatile in early 2009 and spreads began to widen.[36]

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[35] Farrell and Quiggin (2016), p. 21.
[36] Jones (2010); Matthijs (2014, 2016).

In response, the ECB under Jean-Claude Trichet decided to cut rates and intervene to the tune of 60 billion euros in the market for what are known as 'covered bonds' under the guise of a program euphemistically called 'credit easing.'[37] More important than the program was what Trichet said during the ECB press conference 'question and answer' session at the time of the announcement. When asked if this program was the ECB's equivalent to the US and UK quantitative easing schemes, he replied, "we are not at all embarking on quantitative easing."[38] What Trichet said that day was hugely significant. In saying that QE was not on the cards for Europe, the ECB president had just told global financial markets that the European Central Bank did not stand behind banking-book asset values, even of AAA sovereign assets, and they would not act as a traditional lender of last resort. The only way periphery bond yields would move from that point on was up.

The timing of events here is very important. The ECB eschewed QE in May 2009 and in September 2009 Germany's general election saw the CDU's grand coalition with the SPD fall and a new CDU-FDP coalition arise that was to take a much harder line on fiscal policy discretion going forward. The ordoliberals who objected to the SGP's 2005 modifications were back in power. They were resolutely, but silently, against the Keynesian turn of 2009, and they were being strengthened by events.[39] When in mid-2009 a slow motion bank run began "spreading first to Ireland and Portugal, then in increasingly severe waves to Spain, and Italy," these forces in Germany and at the ECB began to gain the upper hand.[40]

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[37] Hansen (2009).
[38] Trichet (2009).
[39] Matthijs (2016a)
[40] Lonergan (2014), p. 23

The slow motion bank run that had been triggered by Trichet's remarks in May 2009 gained strength when the incoming Greek Papandreou government revealed in October 2009 that the officially reported fiscal deficit of 6.5 percent of GDP was in fact closer to 13 percent of GDP. Piling on the pressure, the ratings agencies downgraded Greek bonds from A to BBB-, which compounded their debt burden by lowering prices and spiking yields further. As a result the Greek economy began to contract such that outstanding debt increased, GDP collapsed, and insolvency loomed.

In such a situation the ideal interventionist policy back in late 2009 would have cost around fifty billion euros, less than the covered bond program. It would have required either the ECB, or the European Investment Bank acting as its surrogate, to buy the secondary market Greek debt that was subject to near-term rollover risk and bury it somewhere deep in its balance sheet and walk away, much as the US Fed had done with its banks in 2008 with programs such as TALF.[41] So why did they not do so?[42]

The popular answer of the time was 'German politics.' With a regional election coming up and a new more austerity-inclined coalition, it was politically easier to blame the Greeks for being lazy and profligate than it was to explain to the German electorate that the ECB needed to bail international holders of Greek debt for reasons of systemic risk. But an alternative answer lies in the strengthening of the German and ECB ordoliberals by recent events, and their ability to appeal to existing ordoliberal rules, as inscribed in the institutions of European monetary governance, to firmly shut the interventionist door that the 2005 revisions to the SGP had opened once and for all.

[41] Blyth (2015)

[42] Ironically, the ECB ended up using hedge funds as its hidden toxic balance sheet a year later when it sold Greek debt at cents on the dollar to the hedge fund community. In 2012, one of those funds made half a billion dollars on the trade. See Financial Times (2012).

The Umpires Strike Back

With the bank run through the bond markets of Europe gathering pace these elements began to strike back.[43] In the realm of public discourse major German politicians began to join forces with the ECB to send a common message. ECB Chief Jean-Claude Trichet fired the opening salvo in his "stimulate no more"[44] broadside in the *Financial Times*, explicitly rejecting Keynesian demand deficiency arguments in favor of the debt reduction as the sine qua non of a 'confidence led' recovery. Two days later German Finance Minister Wolfgang Schäuble published an extended opinion piece in the same *Financial Times* stressing the need for "expansionary fiscal consolidation," stating that Germany will not respond to the crisis by "piling up public debt."[45]

And in the realm of institutional warfare these same actors increasingly appealed to the ordoliberal rules that underpinned Europe's money to strengthen their hand. Article 127 of the Treaty on the Functioning of the European Union says that, "the primary objective of the European System of Central Banks (hereinafter referred to as 'the ESCB') shall be to maintain price stability." Further, it continues that "without prejudice to the objective of price stability, the ESCB shall support the general economic policies in the Union with a view to contributing to the achievement of the objectives of the Union as laid down in Article 3 of the Treaty on European Union." And what does Article 3 say? It says, *inter alia*, that: "The Union shall… work for the sustainable development of Europe based on balanced economic growth and price stability… aiming at full

[43] For example, see Greenspan (2009).
[44] Trichet (2010).
[45] Schäuble (2010).

employment and social progress, and a high level of protection... It shall promote economic, social and territorial cohesion, and solidarity among Member States."[46]

The inclusion of the goals of growth, full employment, protection and solidarity, leaves substantial room for intervention beyond maintaining price stability. That the ECB chose not to do more given its statutes can be sustained. That it was somehow 'unable' to do more given its statutes is simply unsupportable.[47] The decision under Trichet for the ECB to turn against these goals and focus on the narrow mandate of price stability, despite a recession going on all around them, was a political decision in the end. It slammed the interventionist door shut and recoded the 2005 SGP moment as 'exactly what not to do' going forward.

It is once again worth noting the timing of events here. Opposition to Keynesian policies intensified in the spring of 2010 just as the Greek crisis really became newsworthy. In the UK, Germany, and the United States, politicians in favor of austerity zeroed in on the Greek crisis as a metaphor for the perils of Keynesianism in general and interventionism in particular. George Osborne, the new Conservative British Chancellor of the Exchequer, made repeated comparisons to the fiscal situation of Greece and the UK as soon as he was elected.[48] Congressional Republicans in the United States leapt upon such comments with undisguised glee, while media outlets picked up and amplified the story throughout the spring of 2010. In Europe, the ECB repeatedly honed in on Greece as the future of all European states unless fiscal budgets were cut.[49]

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[46] Need exact European Union Treaty Cites – difference between Maastricht and Lisbon
[47] We thank Marco Capitão Ferreira of Lisbon Law School for this key insight into the crisis.
[48] "You can see in Greece an example of a country that didn't face up to its problems, and that is the fate that I want to avoid." (Reuters 2010).
[49] Wise (2010); Atkins, Hope and Oakley (2010).

The offensive against Keynesianism at a global level was thus married to the discovery of the Greek debt crisis and amplified via the threat of bond market contagion to establish fiscal austerity as only 'reasonable' way forward. What the 2005 SGP reform augured, a better balance between fiscal and monetary policy and between rules and discretion, was 'actively forgotten' in the rewriting of the crisis as a crisis of state spending rather than private lending. The wrong lesson had been learned.

How to Dig a Ditch: From Mis-Learning to Actively Discounting Contrary Evidence

The closing of the interventionist door opened by the 2005 SGP reform and the 2008 financial crisis led European policy down a particularly destructive path. As bond spreads between core and periphery continued to widen while seemingly endless EU crisis summits did nothing to abate financial markets fears, a manageable Greek fiscal problem morphed into a full-fledged crisis of sovereign debt in 2011. The European economy as a whole fell into a deep recession, and despite this, the ECB actually raised interest rates in April and July 2011, further compounding the situation. If the ECB's only job in an ordoliberal world is to fight inflation, it will continue to do that, even if the problem it faces is one of deflation.

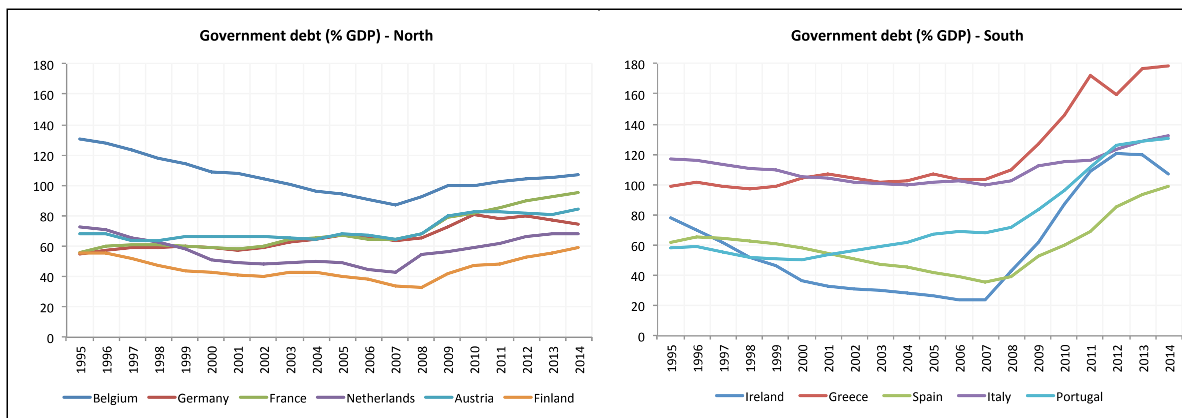
The policy response of the Eurozone authorities – led by Germany's ordoliberals and their allies in the Commission – ignored the private sector and systemic origins of the crisis and insisted that the periphery's 'irresponsible borrowing' was to blame.[50] The periphery countries, it was argued, needed to implement strict budgetary austerity

[50] After all, one cannot have over-borrowing without over-lending. See Blyth (2015), and Matthijs and McNamara (2015).

measures and enact far-reaching structural reforms to restore fiscal balance.[51] This thinking resulted in the consecutive 'troika' bailouts of Greece, Ireland, and Portugal.

Despite good adherence to the programs, this ordoliberal policy of austerity backfired badly in the euro periphery. Because of, rather than despite, cuts to spending, as well as the collapse in private sector activity, the periphery countries saw *rising* levels of national debt after 2008 as the 'denominator effect' kicked-in (figure 1). In fact, if one looks at the evolution of gross debt figures between 2007 and 2014, Portugal's debt-to-GDP ratio has doubled, Spain's has nearly tripled, and Ireland's has nearly quintupled.

Figure 1: Government Debt (Percent of GDP) – 1995-2014

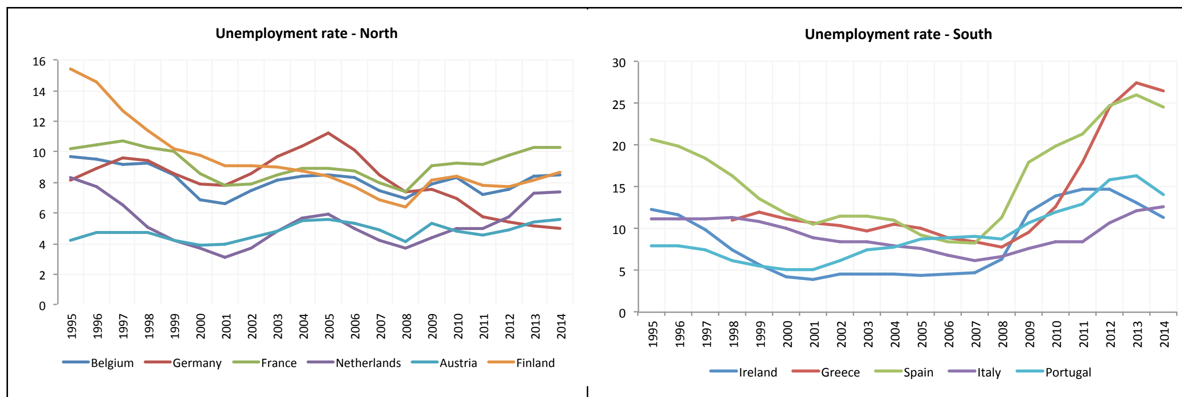


As a consequence, by 2014, the standards of living of Greece, Spain, and Italy vis-à-vis Germany had fallen below their levels in the mid-1990s, to 50 percent, 67 percent, and 75 percent respectively.[52] Unemployment in Greece and Spain rose rapidly while countries like Germany and Austria saw record-low levels of unemployment (figure 2). And "the Spanish and Italian economies had shrunk by almost 10 percent

[51] Matthijs (2014)
[52] Matthijs (2016b).

[from their 2007 levels] by 2013."[53] This made a farce of any EU claims of 'ever closer union.'

Figure 2: Unemployment Rates in the Eurozone (1995-2016)



As Martin Sandbu reports, Eurozone GDP in 2013 was "7.7 percent lower than it would have been without (ordoliberal inspired) fiscal consolidation."[54] Meanwhile, monetary conditions further contracted throughout 2011 such that the real interests rates in the periphery shot up further, compounding already deep distress. Unsurprisingly, the bond market crisis went from bad to worse in the midst of this self-inflected recession.

Super Mario's Monetary Keynesianism

When Trichet was succeeded at the ECB by the decidedly non-ordoliberal Mario Draghi in November 2011, some respite was at hand.[55] But that respite was to push further along the extreme divergences in the stances of monetary and fiscal policy noted at the beginning of this paper. Early on in his tenure Draghi introduced the Very Long Term Refinancing Operations (VLTROs) in December 2011 and February 2012, totaling

[53] Sandbu (2015), p. 114.
[54] Ibid. p. 111.
[55] Despite being a consummate euro insider and former Goldman Sachs investment banker, Draghi is a US trained macroeconomist under those consummate Keynesians Modigliani and Solow at MIT.

over 1 trillion euro worth of 1 percent loans to Eurozone banks at a maturity of 3 years. He then reduced reserve requirements from 2 to 1 percent while increasing eligible collateral by allowing national central banks to accept additional credit claims and widened the range of eligible asset-backed securities (ABSs).

Despite these initiatives, during the summer of 2012, fear over the potential break-up of the Eurozone reached all-time highs when interest rates on Italian and Spanish bonds peaked at 7 percent. In response, Draghi made a speech in London on July 26, 2012 where he promised: "Within our mandate, the ECB is ready to do whatever it takes to preserve the euro." He followed up on his words in early September 2012 by rolling out a program of conditional Eurozone-wide bond buying, called Outright Monetary Transactions (OMTs).

Due to OMT and VLTROs banks in the periphery were now incentivized to buy lots of local bonds, banking the spread between the VLTRO loan rate and the bond yield, using the cash earned to improve balance sheets while using the purchased bonds to shore up bank capital. Bond yields plummeted as a result and Europe got some much-needed breathing space. Unfortunately, while Draghi was giving Europe room to breathe, the ordoliberals at the helm in Berlin and Brussels were designing new instruments of suffocation.

The Ordoliberal Packs and Compacts

At the same time as monetary policy was becoming looser, fiscal policy was about to get even tighter. As well as putting the fiscal squeeze on Greece, Ireland, and Portugal in 2010 and 2011, the European Union next introduced a new series of laws and

regulations to more actively monitor the budgetary decisions of all the other EMU member states going forward.

Given the emphasis on supposed periphery profligacy, and the lesson mis-learned from the SGP reform period that discretion was the root of all evil, the focus of EU policymakers through 2013 fell mainly on correcting the perceived 'national' causes of the crisis (i.e. fiscal profligacy, lack of competitiveness) rather than the 'systemic' ones (a central bank that was not a full lender of last resort, the lack of a common debt instrument, as well as national banking supervisory and resolution powers with continent wide banks).[56] As can be seen in table 2 below, there are three sets of ever-tightening fiscal measures that de facto, if not de jure, make fiscal policy illegal in the Eurozone.

Table 2: EU Fiscal Crisis Measures

Measure	Entry into Force
The Six-Pack (5 regulations + 1 directive)	December 2011
The "Fiscal Compact" or TSCG (Treaty on Stability, Coordination and Governance)	January 2013* (16 EU members, early ratification) April 2014 (all except UK and Czech Republic)
The Two-Pack	May 2013

Source: European Commission (2016)

The Six-Pack, five EU regulations and one EU directive, was designed to ensure a much stricter application of the EMU fiscal rules by defining quantitatively what a "significant deviation" from the country-specific "Medium Term Objective" (MTO) meant. The Six-Pack basically sets out under what conditions an Excessive Deficit

[56] Matthijs and McNamara (2015).

Procedure (EDP) can be initiated against a member state, and stipulates which financial sanctions will be imposed if it is so designated.[57]

The "Fiscal Compact" – or Treaty on Stability, Coordination, and Governance (TSCG) – is an intergovernmental agreement (not EU law) concluded in Brussels in December 2011, which went into force in January 2013 after early ratification by 16 EU member states. The Fiscal Compact requires EU member states to respect and ensure convergence towards the country-specific MTO, *with a lower limit on the structural deficit of 0.5 percent of GDP*.

The idea was for these budget rules to be implemented in national law through clear-cut provisions of "binding force and permanent character, preferably constitutional."[58] It also introduced reverse qualified majority voting (RQMV), making it harder for big countries to band together, as France and Germany did in 2003 – again, a 'social learning' reaction to the SGP reform episode. Finally, the "Two-Pack," which came into force in May 2013, set out simplified rules for the enhanced surveillance of member states facing financial instability, those receiving financial assistance, and those exiting a financial assistance program.

In the end, all that this elaborate legal apparatus of fiscal monitoring achieved by the spring of 2016 was to make growth outside of Germany, with the partial exception of Spain and Ireland, even more sclerotic. More importantly for our purposes, they mark the institutional instantiation and reconsolidation of the ordoliberal ideas at the heart of the

[57] The Six-Pack also included measures for macroeconomic surveillance, including a new 'Macroeconomic Imbalance Procedure,' where 'excessive' balance of payments imbalances are defined as 4 percent of GDP for deficits and 6 percent of GDP for surpluses.

[58] The Fiscal Compact also reinforced EU surveillance and coordination of economic policies, with prior coordination of debt issuance plans among member states, as well as detailed structural reforms needed for an effective and durable correction for any excessive deficit.

European monetary project. But building these new institutions confirmed one bias and opened up another problem. The bias was to ignore any and all contrary evidence that binding fiscal policy so tight was making the situation worse rather than better. The problem was that doing so required, and indeed necessitated, an ever looser monetary stance to offset the fiscal tightening, which was driving fiscal and monetary polices in opposite directions.

Not Listening, Not Learning

The standard reading of social learning demands that policymakers alter their stance when *anomalies* (also known as obvious and large policy failures) appear. Given the plethora of such failures discussed above one could look to find acknowledgement, and thus positive social learning, in the research documents of the Troika (the European Commission, the ECB, and the IMF). Given how large the forecast errors were in the policy estimates of the Troika, regarding what tight policies were supposed to do in the periphery, and what they actually did, one would think that some new thinking might have occurred in response to these errors. And indeed, as we shall see, this has indeed happened with one third of the troika, the IMF. With the other two thirds however, the ECB and the Commission, while we see a shift in emphasis, the underlying ideas remain largely the same, despite all the evidence to the contrary.

For example, the Bruegel Report on the three troika bailout programs commissioned by the European Parliament in 2014 usefully analyses the language of Troika documents over time and notes the shift from the use of terms such as ‘fiscal,’ ‘consolidation,’ and ‘reform,’ which dominated the initial reform documents to a greater

emphasis on terms such as 'growth' and 'employment.'[59] This is perhaps unsurprising given the lack of growth and high unemployment produced by the implementation of these policies.[60]

Alongside this shift however is another shift, associated with terms such as 'structural reform' and 'privatization,' which increase in use over this same period. This perhaps suggests that in highly stressed economies where confidence effects failed to show up, other revenue and growth strategies had to be found? But most tellingly, as far as admitting error is concerned, acknowledgement is in short supply. As the Bruegel report notes, "since greater economic and social cohesion is a major EU objective… we study how often issues such as poverty, fairness and inequality are discussed in the documents," and they note that "except for Greece, the issue received practically no attention in the Commission program documents."[61] Taken together, such inter-temporal shifts hardly suggest a paradigm shift in thinking among two thirds of the relevant policymakers.

The one part of the Troika that has substantially shifted their ideas is the IMF. As Cornel Ban details, the IMF's policy ideas have shifted substantially over the course of the crisis across multiple positions.[62] But the ideas of the other two members of the Troika have barely moved at all. The so-called "Battle of the Boxes," between the Commission and the IMF in 2013 showcased this lack of positive social learning.[63] By 2012 a series of IMF studies had shown negative fiscal multipliers greater than one for the periphery countries of Europe, which meant that a one percent cut in public expenditure led to a

[59] Sapir et al (2014), pp. 17-23.
[60] Ibid. pp. 19-21.
[61] Ibid. p. 22.
[62] Ban (2015).
[63] See Blyth (2015), postscript.

greater than a one percent cut in GDP, with no offsetting confidence effects.[64] Negative multipliers also imply positive ones, as the reciprocal demands, and as such the IMF's challenge was not limited to the technical boxes of IMF reports since making the point about negative multipliers effectively argued *for* fiscal expansion, which is precisely what the new fiscal institutions discussed above were designed to obviate. In putting this challenge out there the entire ordoliberal edifice of the ECB and EC approach to the crisis was challenged directly from within the Troika itself.

Unsurprisingly, the EC hit back at the end of 2012 with its own version of multiplier estimates to counter the IMF's. The Commission argued that, in essence, Troika policies were fine, and that the multipliers would have been less than one, had it not been for a lot of people talking about the break up of the euro, which made things worse.[65] In other words, *ceteris paribus*, fiscal contraction would have had a positive effect after all.

The IMF has however continued with its new line despite this attempted refutation by the EC, which was quickly enjoined by the ECB.[66] It is also worth noting that the other great booster of fiscal tightness and credibility, the OECD, authored a report in February 2016, which admitted that developed country growth prospects have "practically flat-lined" and that "a commitment to raising public investment would boost demand and help support future growth."[67] Neither the Commission, nor the ECB, nor the German government had any response to the OECD report. If social learning is going on in Europe, it is one where the wrong lessons seem to be constantly reaffirmed.

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[64] For a summary see OECD (2014).
[65] See European Commission (2012).
[66] See ECB (2012), box 6, pp. 82-85.
[67] OECD (2016a, 2016b).

How to Work at Cross Purposes: Ultra Loose Money Meets Ultra Tight Budgets

As bond markets rallied due to the 'Draghi VLTRO and OMT put,' the Eurozone was struggling through a recession and an economy on the brink of deflation. In July 2013, Draghi added 'forward guidance' to his toolbox, stating that "the Governing Council expects the key ECB interest rates to remain at present or lower levels for an extended period of time." Another year later, with deflationary conditions pressing further, in June 2014, the ECB introduced so-called Targeted Long-Term Refinancing Operations (TLTROs) to further fight deflation by allowing banks to borrow an amount equivalent of up to 7 percent of a specific part of their loans with promises of more depending on the evolution of banks' eligible lending activities in excess of bank-specific benchmarks. In other words, the ECB was trying to force banks to lend more in an environment where potential borrowers were instead paying back debt because of low rates, low inflation, and low growth.

June 2014 also saw the ECB introduce negative deposit rates, which led to European banks buying US dollar assets rather than parking their cash reserves directly in the ECB, and resulted in a significant fall in the value of the euro. While the euro/dollar rate was 1.36 at the time of Draghi's introduction of negative deposit rates, by January 2015 the euro was trading at 1.06 to the dollar.[68] But with practically all emerging markets starting to put downward pressure on their currencies, this 'exchange rate channel' for recovery by exports was exhausted by early 2015. With deflation still ongoing (and with four short-term euro sovereign bonds trading negative by the fall of

[68] At the time of writing the euro/dollar rate is 1.13.

2014), Draghi introduced a third “Covered Bonds Purchase Program” (CBPP3), followed by an Asset-Backed Securities Purchase Program (ABSPP), before announcing the long-awaited “Public Sector Purchase Program” (PSPP) in January 2015. With PSPP, which is all-out ‘quantitative easing’ (QE), Draghi committed the ECB to buy up a total of 60 billion euro of ‘mainly’ public sector securities every month for a period of at least 18 months. PSPP has now ben extended through 2017.

In other words, the ECB’s main job has become countering the deflationary expectations that have become embedded in large parts of Europe, mainly due to the excessive fiscal contractions that the European Union had thrust upon itself via the Six-Pack and the Two-Pack, etc. Seen in this way European QE is not primarily, as is often held, an attempt to lower the exchange rate and spur growth via exports. That is a growth strategy to be sure for Germany and Central Europe in particular (where the weaker euro has helped boost its export sectors). It is not however a growth strategy for the whole of Europe. As such, Draghi’s primary concern is, and remains, avoiding a self-inflicted deflation.

The Pain in the Athens

These tensions in policy (between extra tight budgets and extra loose money) and ideas (between ordoliberal and neo-Keynesian) came to a rather spectacular head in Athens in the summer of 2015. Five years of ‘fiscal waterboarding’ (in the colorful words of then Greek finance minister Yanis Varoufakis) had resulted in a massive electoral rout of the centrist and pro-bailout parties Pasok and New Democracy in January 2015. The freshly elected Greek government was determined to use its popular mandate to change

Europe's fiscal consensus away from austerity towards growth via getting rid of Greece's debt overhang and excessively tight fiscal stance. One of Prime Minister Alex Tsipras' main demands in his efforts to negotiate the terms of Greece's third bailout was comprehensive debt relief, which had largely been a taboo subject thus far.

As the standoff between Tsipras and Varoufakis in Athens on the one hand, and 'the institutions' in Brussels and Frankfurt on the other (the IMF would refuse to sign onto the third bailout) continued in the spring of 2015, Greek savers – unsurprisingly – started to withdraw their deposits. This triggered a new run on Greece's banking system, which had been kept afloat thus far by 'emergency lending assistance' (ELA) of the ECB. As it became clear that the Greek government was unwilling to bend to the bailout demands of the troika, the ECB for its part made it clear that it would no longer provide the Greek banking system with ELA if they were not taking part in an official bailout program. In short, despite their mandate being to make sure that the payments system of the EU functions well, they were willing to 'bung up' the payment system in Greece in order to make a political point.

At the same time, the ECB was buying up Eurozone member government bonds to the tune of 60 billion euros per month. As well as providing offsets to deflation as described above, such a policy has the effect of lowering contagion risk in the case of a Grexit (or Greek exit from the Eurozone) since the yield curve of any bond became determined by central bank policy rather than market interest rates. The European Commission could therefore play hardball with Greece over its new bailout program because the threat of a Grexit was no longer as credible as it had been in the summer of

2012. Once the ECB started to actively ration liquidity to Greek banks in the summer of 2015, it was only a question of time until Tsipras caved in.[69]

Despite these policies being rejected by over 61 percent of the Greek electorate, the technocratic demands of Brussels and Berlin – together with Frankfurt's chokehold on Greece's financial system – beat the popular democratic wishes of the Greek people as the ECB acted overtly and politically to starve member banks of liquidity in order to bring a democracy to heel.

The lesson learnt from this episode was that fiscal policy was to remain as tight as ever – fitting the ordoliberal ideas on how to make money – but only at the price of ultra loose money – fitting a very different set of ideas about money. Draghi's policies were justified as temporary 'deflation fighting' policies, not as a new consensus, but that is what they have become. With fiscal policy ruled ultra vires and monetary policy consigned to fighting a self-inflicted deflation, it does seem to be the case that social learning has indeed occurred in Europe. It is just not the lessons one would have expected the EU to learn from the evidence at hand.

Conclusions: Ideas, Social Learning and the Rational Persistence of Bad Ideas

This paper is an attempt to show how social learning can lead to paradigm maintenance as well as paradigm change. It did so in five stages. First, we argued that states that are currency users rather than currency issuers cannot credibly bail their financial systems when they get into trouble. As such, users of 'non-sovereign money' face a different set of incentives from users of sovereign money when a crisis hits. While

[69] This outcome was not strictly necessary if Tsipras had been willing to either default on any bonds that the ECB held – some 23 billion euros worth – or redenominate. Varoufakis had plans for both. Tsipras was not willing to countenance those plans. (Source: Mark Blyth interview with Yanis Varoufakis, March 3rd 2016.)

the UK and the US, and even Iceland, followed the sequence of ‘bail, fail, recapitalize (and occasionally) send to jail,’ the EU’s sequence was one more akin to ‘retreat to first principles, worry about inflation, and panic about moral hazard,’ none of which addressed the fundamental problems EU states were facing.

We argued in the second and third parts of the paper that this was due to the wrong lessons being learned in 2005, when the SGP was revised, and in 2010, when the Keynes-inspired recovery of 2009 was chocked-off by a rather abrupt turn to austerity. The original misreading of the SGP episode combined with the ordoliberal meta-rules inscribed in the architecture of the EU’s governing institutions to give authority to those claiming homology with these rules, despite evidence that doing so was self-destructive.

The fourth section showed how these ideas were both re-inscribed and reinforced in the new EU institutions of fiscal governance – the two pack, six pack and fiscal compact – effectively making fiscal policy illegal at exactly the moment when a more active fiscal stance was needed, in 2012. This turn to an ‘ever closer squeezing’ of budgets paradoxically necessitated ‘ever looser money’ from the central bank to both cushioning the recession that fiscal tightening was causing and to counter the deflationary expectations that were being sown. This section also documented how disconfirming evidence from the IMF and other organizations was challenged by the other troika institutions, despite current policy failing to restore growth and reduce unemployment throughout Europe.

The fifth section detailed how these cross-pressures came to a head in Athens in the summer of 2015 when the ECB violated its own statutes at the behest of its governing council and rationed liquidity to Greek banks as a way to discipline Greek demands for

debt relief and a change in the general fiscal policy stance of Europe. That the ECB was able to do so was paradoxically only possible because of its own ultra-loose liquidity provision elsewhere, which offset contagion risk in the bond market, thereby proving that what works in practice (a looser policy) is not as important as what trumps practice in theory.

What remains to be discussed is the one question that we opened with – why continually learn the wrong lessons despite the evidence? Our answer is simple. Non-sovereigns with sovereign responsibilities, but without sovereign capacities, rule by appeal to authority. In the case of the EU that authority is drawn from adherence to a set of ideas and institutional rules that, while utterly dysfunctional for the environment for which they are employed, are the only ones the actors can draw upon to maintain their authority when under pressure since they have no democratic mandate.

Seen in this way 'doubling down' on bad policy, as the EU has repeatedly done since 2010, is neither irrational nor purely ideological. It is instead locally rational but globally irrational. And so long as authority is produced and contested via appeal to these ordo- and neo-liberal ideas, a completely unbalanced macroeconomic policy mix will be the result. Just how long Europe can stand this policy mix remains the big open question.

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