

## When is it Rational to Learn the Wrong Lessons?

### Technocratic Authority, Social Learning, and Euro Fragility

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#### **Abstract:**

Why do flawed policy ideas persist over time? In this article, we trace the development of the euro's governing ideas on both fiscal and monetary policy over time and in the face of mounting evidence that continued adherence to such ideas was economically deleterious. We argue that a specific form of social learning, framed by a retrospective recoding in 2010-12 of Europe's experience with fiscal rules in 2003-05, drove European elites to pursue policies that were economically irrational but politically rational. As a result, Europe's medium-term resilience has been made possible by the European Central Bank's unconventional and loose monetary policies, which operate in direct opposition to the tight fiscal policies of the Eurozone's member states' governments. We maintain that this self-defeating macroeconomic policy mix will continue as long as the lessons learned by policymakers are driven by the need to win an authority contest rather than provide better overall macroeconomic outcomes.

**Key words:** euro, fiscal policy, ideas, monetary policy, social learning, technocratic authority.

*Introduction*

If one distinguishes between fiscal and monetary policy – on the one hand, national government decisions on the levels of taxation and spending, versus interest rate policies and open market operations conducted by the central bank on the other – and then one walks backwards over the evolution of Eurozone policy starting in the summer of 2016, a remarkable divergence reveals itself. Fiscal policy, which is today almost constitutionally *ultra vires* in the Eurozone, becomes *looser and more discretionary* the further back one travels.<sup>1</sup> In contrast, monetary policy, which in 2016 includes negative deposit rates as well as massive private and public asset purchases to suppress sovereign bond yields, *becomes tighter and more rules-based* the further back one goes, as summarized in Table 1.<sup>2</sup>

Table 1: Europe’s Changing Macroeconomic Policy Mix (1993-2016)

<b>Economic Policy Area</b>			
		<i>Fiscal Policy – Ever Tighter</i>	<i>Monetary Policy – Ever Looser</i>
<b>Timeframe</b>	1993-2003	<b>National Rules with External Targets</b> (Maastricht Criteria, Stability and Growth Pact, EDP)	<b>National/EU Rule</b> (Irrevocably Fixed Exchange Rates, Inflation Targeting, then ECB formally takes over in 1999)
	2003-2012	<b>Limited National Discretion</b> (Tax & Spending again Legitimate Domain of National Governments, all-out Fiscal Stimulus in 2008-09)	<b>EU Rule – Narrow ECB Mandate</b> (ECB Sole Mandate Price Stability, Inflation “less than but close to 2 percent,” ‘No Bailout’ Clause)
	2012-2016	<b>Strict EU Rules</b> (Balanced Budget Rules, Fiscal Compact, European Semester, Quasi-Automatic Sanctions)	<b>Large ECB Discretionary Power</b> (LTROs, “Whatever it takes,” ELA, OMTs, TLTROs, Negative deposit rates, QE, “We don’t give up”)

Source: Authors.

<sup>1</sup> While it is true that the overall macroeconomic stance of the Eurozone for 2016 is not contractionary, this is only a temporary state of affairs. Fiscal contraction is expected to be the default policy stance from 2017 onwards, as it was from 2010 through to 2015. See Timbeau (2016).

<sup>2</sup> Except for the period 2010-2012 under Jean-Claude Trichet when both fiscal and monetary policy were being tightened, as we discuss further below.

Given that the optimal ‘macroeconomic policy mix’ is unlikely to ever be found in the extreme tails of the distribution, how are we to explain both the emergence, and the persistence, of this pattern over time?

In this article, we argue that a specific politics of social learning reveals itself in the evolution of European ideas about how to govern the euro. That is, one of EU policymakers consistently learning what are – from the point of view of conducting a balanced macroeconomic policy mix – the wrong lessons from specific policy episodes. Wrong, in the specific sense that despite an ever-increasing body of evidence that argued against continuing along the same policy path, policy did not change. We justify this claim as follows.

We argue that the ideas that gave birth to the euro presupposed the completion of political institutions that never came to pass. Thus, what was ‘sovereign money *in waiting*’ in 1992 – money that governments can devalue, inflate, and default on – ended up becoming ‘non-sovereign money *in use*’ in 2002 – a currency one can use but cannot devalue, inflate etc.<sup>3</sup> That simple fact, seen as the euro’s singular strength at its inception as it would discipline national policy choices, built critical fragilities into the currency and into the institutions of the European Union that were exposed when the financial crisis hit Europe in 2008-9. As currency users rather than currency issuers, EU level technocrats and policy elites who are not directly responsive to an electorate, were forced to ask very different questions from their more democratically responsive Anglo-American colleagues about how to resolve the crisis.<sup>4</sup>

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<sup>3</sup> Blyth (2015); Matthijs (2016b): 404-5.

<sup>4</sup> We thank former Greek finance minister Yanis Varoufakis for this observation.

Specifically, the question asked by Anglo-American policymakers was ‘what can we do to save the system?’ Their answer was, broadly, ‘open the monetary toolbox, add massive liquidity, recapitalize the system, *and do fiscal policy.*’ After all, a sovereign issuer has no liquidity constraint and it can respond to an economic crisis by devaluation, inflation, and *in extremis*, by default. In contrast, the question asked by EU policy elites who were currency users rather than issuers, and whose European Central Bank (ECB) had a liquidity constraint by constitutional design was, ‘how do we keep the system we have built together when we cannot directly bail it out?’ The answer that question produced was ‘ever-stricter adherence to fiscal rules, regardless of the macroeconomic consequences.’ But following this policy path has been, especially in the face of mounting contrary evidence, economically counterproductive. So why do it?

This answer, we argue in the first part of this article, stemmed from both being a currency user and from a prior lesson learned by European policy elites in 2003-5 when the rules of the Stability and Growth Pact (SGP) were violated by the euro’s two principal members, Germany and France. This SGP ‘crisis’ episode was interpreted by European elites at that time, and crucially, during the early stages of the euro crisis, as a clear policy failure that must never be repeated. Given that framing of past experience, the brief period of fiscal activism that spread across Europe at the start of the global financial crisis (2008-09) was interpreted by euro elites as a policy error.

Rather than taking the improvements in performance that the breaking of the pact led to as evidence that expansionary policy was working, the stimulus episode was instead interpreted in the light of France and Germany’s prior violation of the SGP. The macroeconomic indicators may have been moving in the right direction, but as then ECB

President Jean-Claude Trichet admonished Europe's leaders, "stimulate no more, it is now time for all to tighten;"<sup>5</sup> a policy that would prove to be continually counterproductive for the Eurozone's overall economic performance.<sup>6</sup> Indeed, Trichet's 2009-11 tightening combined with redoubled efforts at the level of European institutions to permanently bind fiscal policy options, again via a particular framing of the SGP episode, all the while discounting mounting evidence that the policies being followed were in fact the problem, rather the solution.<sup>7</sup> This period of double tightening ended when Trichet's term at the ECB ended and Mario Draghi came to the helm in November 2011. We examine the period from 2012 to 2016 in the second part of the article, where Draghi's return to monetary discretion has increasingly faced off against ever stricter fiscal rules, with each policy slowly dragging the other down, with ECB policy acting as a stabilizer to the deflationary pressures created by a contractionary fiscal framework.<sup>8</sup>

In sum, we see policy ideas driving fiscal policy in an ever tighter direction while monetary discretion gets ever wider in response. This is a policy mix that, from a policy optimality point of view, is economically irrational, so explaining it deserves our attention. Our analysis of these episodes shows that this pattern of policymaking can be seen as 'social learning,' but of a particular type.<sup>9</sup> One that places politics above the purported economics, while reducing policy outcomes to political imperatives. What are then the conditions under which such social learning can take place?

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<sup>5</sup> Trichet (2010)

<sup>6</sup> Note that the ECB came out publicly against fiscal stimulus a lot earlier than that. In its monthly bulletin of January 2009, the ECB warned about further stimulus, "if not reversed in due time, this will negatively affect in particular the younger and the future generations." See Ban (2016), p. 196.

<sup>7</sup> See Ban (2015); Blyth (2015), Postscript; and OECD (2014).

<sup>8</sup> LTROs and OMTs also put a floor underneath the repo market greased by sovereign collateral from the Eurozone. By stabilizing a key basket of bonds, the ECB enabled the persistence of the pre-2008 financial system in Europe, which depends on well-functioning money markets. See Gabor and Ban (2016).

<sup>9</sup> Hall (1993), Blyth (2013), Beland (2006)

### *Social Learning Revisited*

One of the most prominent political science models that seeks to understand how ideas and material factors influence policy is the approach put forward by Peter Hall.<sup>10</sup> At its core, Hall's 'paradigms' model sees policy change as a function of two distinct mechanisms: empirical anomalies and authority contests. Empirical anomalies as causes views social learning as a rational process of quasi-Bayesian updating given information flows. Authority contests, in contrast, see learning as a political struggle over what the information actually means.<sup>11</sup> Both mechanisms view policy paradigms, defined 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," as the location where social learning, "a deliberate attempt to adjust the goals or techniques of policy in response to past experience and new information" takes place.<sup>12</sup> Since we are mainly interested in the social learning part rather than the paradigm change part of Hall's model, we ask the following question. From a theoretical point of view, what are the conditions under which policymaking elites can consistently learn the wrong lessons?

Recent work within this tradition suggests that policy change is as much a function of authority contests over the *meaning* of empirical anomalies rather than empirical anomalies bringing about change since 'facts' are always theory dependent.<sup>13</sup> Theory dependent empirical anomalies do not simply 'hollow-out' existing paradigms by

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<sup>10</sup> Hall (1993); Kuhn (1962).

<sup>11</sup> See Blyth (2013) for further elaboration.

<sup>12</sup> Hall (1993): 279, 283.

<sup>13</sup> See Matthijs (2011), and Blyth (2013).

weight of the ‘facts’ revealing themselves, to which policy makers neutrally update.<sup>14</sup> Rather, events identified as anomalies – such as a financial crisis and how to respond to it – can either add to, or subtract from, the ‘authority’ of those arguing for specific policies. Especially for technocratic authorities who do not have a democratic mandate, their ‘authority’ rests in large part upon appeal to the ‘ruling ideas’ of the day.<sup>15</sup> As such, social learning about what to do is dependent upon who is institutionally authorized to learn, their ability to make policy, and their power to define what actually counts as an anomaly and what does not.

Key here is the ability of such agents to use what Thomas Kuhn called “paradigmatic incommensurability” as a political weapon to delegitimize other agents’ interpretations of ‘why policy is wrong,’ despite accumulating evidence to the contrary.<sup>16</sup> In our case, this applies to technocratic governors who have insufficient tools to make a ‘first best’ policy fix and lack any ability to change policy via a democratic mandate. In such a political field, incommensurability can be deployed as a mechanism to deflect attention from actual performance while insulating those in power from challenges to their technocratic authority. In what follows we detail how the European Commission (EC), the European Central Bank (ECB), and the German government each, at particular times, played ‘incommensurability politics,’ and in doing so, socially learned the wrong lessons.

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<sup>14</sup> Best (2005).

<sup>15</sup> Ban (2016); Schmidt (2015).

<sup>16</sup> 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.” Kuhn (1996 [1962]), p. 198.

## *Hypotheses*

We hypothesize that technocratic actors, operating with non-sovereign money and highly insulated from politics, have both the capacity and the incentive to systematically skew the interpretation of policy anomalies in order to produce policy choices that are ‘globally irrational but locally rational,’ for two reasons. First, is a lack of tools. EU technocrats lack sovereign money, which would give them the ability to make unlimited liquidity pledges, devalue, and inflate their way out of trouble. As such, they are forced to fight liquidity and solvency crises with an inadequate toolkit. Similarly, domestic politicians in member states are similarly constrained in their fiscal policy options. Second, because there are no direct democratic checks upon their policies, technocratic elites are incentivized to choose policies that insulate them from criticism (politically rational) while reproducing economic policies that are suboptimal (economically irrational). Meanwhile, due to their inability to fully respond to asymmetric shocks, member state politicians cannot respond to domestic demands for alternative policies. Due to these mutual constraints, and facing declining legitimacy given the lack of the effectiveness of the policies they choose to use, policymakers in both spheres are therefore incentivized to continue to implement policies where what Robert Wade termed “paradigm maintenance” trumps actual “paradigm change” through the deliberate social learning of the wrong lessons.<sup>17</sup>

In sum, technocrats may both ‘power and puzzle,’ as Hugh Heclo once famously put it.<sup>18</sup> But key here is how they can authoritatively dictate *what the puzzle is in the first place* and can then use that authority to define how power should be applied. Social

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<sup>17</sup> Wade (1996), p. 3

<sup>18</sup> Heclo (1974), pp. 305-306.



learning can therefore also lead to the persistence of flawed ideas, just as much as it can lead to positive change in actual policy. To see how these politics actually unfolded, we must first return to the ideas underpinning the euro at its inception in the late 1980s.

### *The Euro's and the SGP's Ordo- and Neo-Liberal Instruction Sheets*

The euro's institutional design blended together ordoliberal and neoliberal ideas that reached a broad consensus among the elites of the advanced industrial world by the early 1990s.<sup>19</sup> Erik Jones refers to this set of ideas in the context of the European Union as the “Brussels-Frankfurt consensus.”<sup>20</sup> The neoliberal part of that consensus swapped full employment for price stability as the main goal of macroeconomic policy given the ‘time-inconsistency’ problem of politicized monetary policymaking.<sup>21</sup> The Bundesbank's success in fighting inflation in Germany during the 1970s was taken to show that such an approach actually worked in practice.<sup>22</sup> But it was the ordoliberal part of these ideas that was to prove the most consequential when the crisis hit.

The ordoliberal part of the Brussels-Frankfurt consensus insisted that capitalism performed best when governments set clear rules for competition in all markets and pursued sound public finances, preferably with fiscal budgets in balance or in surplus while individuals and states were held as the generators of moral hazard.<sup>23</sup> Given that moral hazard problem, the main constraint on growth, it followed, was uncertainty over

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<sup>19</sup> McNamara (1998), p. 3; Schmidt (2015), p. 93.

<sup>20</sup> Jones (2013), p. 145

<sup>21</sup> 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. See Barro and Gordon (1983); Alessina and Tabellini (1988); Lohmann (1992); and Cukierman (1992).

<sup>22</sup> McNamara (1998), pp. 150-52

<sup>23</sup> Matthijs (2016a), p. 376. See also Jacoby (2014) for an excellent overview of the multiple variants of ordoliberalism in Germany, as well as Nedergaard and Snaith (2015), which shows further evidence of ordoliberalism being at the heart of the euro, and the unintended consequences thereof. See also Stark (2015)

public finances.<sup>24</sup> Once that uncertainty was taken away from investors by governments' 'credible commitments' to pursue sound fiscal policies, which in practice meant deficit and debt control and strict adherence to an inflation target, business confidence, and thus investment, would follow.<sup>25</sup> These ideas were enshrined in a piece of European legislation, the Stability and Growth Pact (SGP) and its related Excessive Deficit Procedure (EDP). The SGP would prove to be the key mechanism through which the wrong lessons about shocks would be learned, again and again, in Europe.

Critics warned at the time of the euro's introduction that the euro's inherent bias was going to be a deflationary one, and that its governing institutions lacked the discretionary tools needed to deal with asymmetric shocks.<sup>26</sup> They did not have to wait too long to be proven correct. The first asymmetric shock hit when Germany and France slid back into recession in 2002. As unemployment rose and their automatic stabilizers put real pressure on their countries' public finances their budgetary stances came into direct conflict with the ordoliberal rules of the SGP.

Germany, who had insisted on these strict fiscal rules as a condition for anchoring the new single currency, would now come see them as a hindrance to adjustment rather than a bonus, and choose to ignore them.<sup>27</sup> In doing so Germany, followed by France, would solve their macroeconomic problem in the short term. But the unintended consequence would be for the technocratic guardians of the EU treaties, and their domestic level allies (especially in Germany and who were in opposition at the time), to learn the wrong lesson the episode provided.

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<sup>24</sup> See Praet (2012), but also Barro (1990) and King and Rebelo (1990).

<sup>25</sup> Giavazzi and Pagano (1988)

<sup>26</sup> See Eichengreen (1991) and Eichengreen and Bayoumi (1993).

<sup>27</sup> Heipertz and Verdun (2010).

### *Breaking the SGP*

The Stability and Growth Pact (SGP) was constructed at the insistence of German worries about moral hazard problems. It was feared that Eurozone member states would fall back into their old fiscal habits of running large deficits and promoting inflation once they had adopted the euro.<sup>28</sup> Germany therefore insisted that the Maastricht convergence criteria – of 3 percent fiscal deficits and 60 percent public-debt-to-GDP ratios – were written into European law.<sup>29</sup> Together with the ECB’s mandate to first maintain price stability above any other targets, the SGP thereby emerged as the ordoliberal cornerstone of the euro’s fiscal governance framework.

The SGP would quickly be criticized from an unexpected corner. Romano Prodi, then President of the European Commission, put it bluntly in an interview with *Le Monde* in October 2002: “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.”<sup>30</sup> Prodi’s comments followed earlier remarks from then EU Trade Commissioner, Pascal Lamy, that the Pact was “crude and medieval.”<sup>31</sup> Yet, despite Germany being the author of these rules, it was Germany, followed by France, that violated them in 2003 by running budget deficits in excess of 3 percent of GDP. The European Commission had to initiate an Excessive Deficit Procedure (EDP) in response. But when it became clear that the ‘big two’ would be the first ones to break the pact, it

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<sup>28</sup> Heipertz and Verdun (2010).

<sup>29</sup> McNamara (1998): 165. These numbers were actually written into an annex of the treaty as an afterthought. See Sandbu (2016)

<sup>30</sup> Prodi interview in *Le Monde* (17 October 2002) as quoted in Heipertz and Verdun (2010), p. 135.

<sup>31</sup> Osborn (2002).

also became plain that, as a matter of politics, the European Council was going to overrule the Commission and let France and Germany off the hook.<sup>32</sup>

The EU's response to this crisis of macroeconomic governance was to make the rules of the SGP more flexible. After the Pact's spurning by France and Germany, the EDP was considerably weakened in 2005 to allow the European Council, where larger member states tend to have a much stronger voice, more discretion in interpreting the reasons for violating the 3 percent rule.<sup>33</sup> Before the 2005 reforms the 'exceptional circumstances' allowing abrogation were defined as cases where a country experiences an annual fall in real GDP of at least 2 percent, which is a serious economic depression.

After the 2005 reform, a severe downturn was reinterpreted as a negative annual real GDP growth rate, or an accumulated loss of output during a longer period of very slow GDP growth.<sup>34</sup> In other words, the 2005 reform of the SGP placed a rather large Keynesian elephant in the ordoliberal tent, making fiscal policy, and the discretion on when to use it, once again the preserve of the member states. States could now almost define 'a loss of output' to their own liking, pursue their autonomous budgetary goals, and then inform the Commission once they had done so. In any ordoliberal frame, this was moral hazard run amok.

#### *What Did the EU's Ordoliberal Governors Learn from the SGP Episode?*

The SGP 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

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<sup>32</sup> See Evans-Pritchard (2003) for a summary of political events in Brussels at the time.

<sup>33</sup> Heipertz and Verdun (2010).

<sup>34</sup> See Matthijs (2016a), p. 381.

economic situations of both countries improved significantly.<sup>35</sup> It was also a political success insofar as the 2005 SGP reform handed national governments back a critical tool to fight the deleterious impact of a ‘one-size-fits-none’ monetary policy, thereby putting the euro on a politically more sustainable footing. But crucially, the reform clashed with the ruling ideas of the EU, whereby such discretion can only be seen as moral hazard and therefore an accident waiting to happen.

The breaking of the pact marked a significant weakening of the “Brussels-Frankfurt consensus” and opposition to this move from the European Commission, the ECB, the German Bundesbank, and the German opposition parties (CDU/CSU and FDP at the time) was both swift and stern. Pedro Solbes, the European Commissioner for Economic and Monetary Affairs, said after the Franco-German compromise that “the Commission deeply regret[ted] that these proposals [were] not following the spirit and the rules of the [EU] treaty.”<sup>36</sup> The Governing Council of the ECB expressed serious concerns in an official press release in March 2005, pointing out that the changes to the corrective arm of the SGP could, “undermine confidence in the fiscal framework of the European Union and the sustainability of public finances in the euro area Member States.”<sup>37</sup> Jean-Claude Trichet, who had just taken over the reins of the ECB from Wim Duisenberg in November 2003, warned that “[t]he conclusions adopted by the ECOFIN Council carr[ied] serious dangers.” He added that “the failure to respect the rules and

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<sup>35</sup> Real GDP growth rates in France and Germany in 2002 and 2003 were a lackluster 1.1% and 0%, and 0.8% and -0.7% respectively. The four years following their breach of the SGP – 2004, 2005, 2006 and 2007 – France grew at 2.8%, 1.6%, 2.4% and 2.4% respectively, while Germany recorded growth rates of 1.2%, 0.7%, 3.7% and 3.3%. (Data: World Bank).

<sup>36</sup> BBC News (2003), “Budget attracts EU ire,” November 25. Online available at: <http://news.bbc.co.uk/2/hi/business/3235436.stm>

<sup>37</sup> ECB (2005), “Statement of the Governing Council on the ECOFIN Council’s report on Improving the implementation of the Stability and Growth Pact.” 21 March. Online available at: <http://www.ecb.europa.eu/press/pr/date/2005/html/pr050321.en.html>

procedures foreseen [in the SGP] risk[ed] undermining the credibility of the [euro's] institutional framework.”<sup>38</sup>

But the strongest opposition to the reform of the fiscal rules came from within ordoliberalism's German *Heimstadt*. The Bundesbank lamented that the pact would be “decisively weakened,” and that “the incentives for sound fiscal policies and the binding effect of the rules [had been] reduced.” Furthermore, the German central bank feared that the new rules were “not transparent, [were] complicated, and ultimately [would be] more difficult to enforce” and worried that the next move would be that “the ceiling for the government deficit of three percent of GDP [would] be softened.”<sup>39</sup> The German opposition was even more scathing in its critique. Friedrich Merz, deputy CDU leader in the German Bundestag, called it a “black day for the whole of Europe,” adding that “one of the most important rules was in fact being laid to rest in the grave... with a significant impact on interest rates and monetary stability in the long term.”<sup>40</sup> Karl Ludwig Thiele of the liberal FDP agreed that the reforms set “a bad example for possible further stability sinners among the euro countries.”<sup>41</sup>

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<sup>38</sup> ECB (2003), “Testimony before the Committee on Economic and Monetary Affairs of the European Parliament, with the President of the European Central Bank, in accordance with Article 113(3) of the Treaty on European Union.” December 1. Online available at: <https://www.ecb.europa.eu/press/key/date/2003/html/sp031201.en.html>

<sup>39</sup> As translated from Spiegel Online (2005), “EZB äußert sich bestürzt über Stabilitätspakt-Reform.” 21 March. Online available at: <http://www.spiegel.de/wirtschaft/furcht-vor-verschuldung-ezb-aeussert-sich-bestuert-ueber-stabilitaetspakt-reform-a-347590.html>

<sup>40</sup> As quoted in Frankfurter Allgemeine Zeitung (2003), “Merz: Schwarzer Tag für ganz Europa,” November 25. Online available at: <http://www.faz.net/aktuell/politik/kompromiss-zum-stabilitaetspakt-merz-schwarzer-tag-fuer-ganz-europa-1129526.html>

<sup>41</sup> Ibid. Another good example of this was a statement by the BGA, the Organization of German Exporters, which had argued that “the softening of the stability pact [was] also a nail in the coffin for the European Growth Pact.” It referred to the 2005 reforms of the SGP as a “Pyrrhic victory” that would prove very expensive as European growth would grind to a halt. The BGA argued that “higher debt would not bring growth and prosperity, but eventually lead to more inflation and higher interest rates.” See BGA (2005), “Aufweichen des Stabilitätspakts ist unsozial.” Online available at: <http://www.presseportal.de/pm/6564/660631>

Yet despite all this *Sturm und Drang*, the core of the Eurozone returned to rapid growth between 2004 and 2007.<sup>42</sup> The SGP's new flexibility did not seem to have brought about the collapse of trust in the euro. Instead, it was delivering the goods. But rather than accept the episode's positive lesson, the global financial crisis and subsequent Eurozone debt crisis would allow a radical 'recoding' of this moment by the EU policy elite – the proof that many had been waiting for.

### *Recoding the SGP: From Stimulus to Austerity Through the SGP Episode*

The turn to fiscal stimulus in 2009 in Europe was made possible by the fact that the ideas that lay behind Europe's money – ever deeper integration, market efficiency, policy credibility, and a single currency – effectively denied that such a crisis could ever arise in the first place. Given this rather obvious failure of ruling ideas, "governments quickly came to believe that monetary policy was insufficient on its own to help the real economy."<sup>43</sup> As a result, 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 1.6 percent of GDP, the biggest program in Europe.<sup>44</sup> But that the Germans did so did not mean that they liked doing so. Neither did the Commission nor the ECB.

On the monetary policy side, and unlike the US Federal Reserve or 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

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<sup>42</sup> Annual Eurozone growth in 2004, 2005, 2006, and 2007 was 2.3, 1.7, 3.2, and 3.1 percent respectively (Data: World Bank, <http://data.worldbank.org/indicator/NY.GDP.MKTP.KD.ZG?locations=XC>). See also footnote 35.

<sup>43</sup> Farrell and Quiggin (2016), p. 21.

<sup>44</sup> The Guardian (2009) <https://www.theguardian.com/world/2009/jan/27/germany-europe>

the crisis, for two reasons. First, *Fortis* and *Dexia* banks in Belgium aside, there did not appear to be much of a European banking crisis to address until 2010.<sup>45</sup> Second, given that its job was to fight an inflation that was absent, there did not seem to be all that much to be done on that front either for the ECB. But despite the policy passivity, yields on European bonds became more volatile in early 2009 and spreads began to widen.<sup>46</sup>

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 a program called ‘credit easing.’<sup>47</sup> More important than the program itself 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.”<sup>48</sup> What Trichet said that day was hugely significant. In saying that QE was going to happen in Europe, the European Central Bank did not stand behind banking-book asset values, even of AAA-rated sovereign bonds, and they would not act as a traditional lender of last resort. Lacking their own sovereign money, the only way periphery bond yields would go from that point on was up.

The timing of events here is very important. The ECB eschewed QE in May 2009. In September 2009, Germany’s general election saw the CDU’s grand coalition with the SPD fall and a new CDU-FDP center-right coalition arise that was to take a much harder

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<sup>45</sup> By 2010, Europe was looking at a full-fledged financial crisis, with both bank and non-bank financial institutions in the periphery locked out of money markets, while selling their own governments’ bonds as they were quickly turning into worthless collateral. See Gabor and Ban (2015).

<sup>46</sup> Jones (2010); Matthijs (2014, 2016a).

<sup>47</sup> Hansen (2009).

<sup>48</sup> Trichet (2009).



line on fiscal policy discretion going forward.<sup>49</sup> The ordoliberals who objected to the SGP's 2005 modifications were now back in power, and they were soon strengthened by events.<sup>50</sup> Wolfgang Schäuble, the staunchly ordoliberal CDU grandee who had opposed any weakening of the SGP, was promoted to finance minister and replaced the SPD's more pragmatic Peer Steinbrück.<sup>51</sup> Also, Jens Weidmann, who had been head of economic and financial policy in Merkel's chancellery since 2006, was promoted to President of the Bundesbank in 2011. When in mid-2009 a slow motion bank run began, spreading first to Greece (spring 2010), then to Ireland (fall 2010) and Portugal (spring 2011), then in increasingly severe waves to Spain and Italy (summer 2011), ordoliberal forces in Germany and at the ECB began to gain the upper hand and repeatedly analogized ongoing events to the SGP episode.<sup>52</sup>

### *The Umpires Strike Back*

With the bank run through the bond markets of Europe gathering pace the ordoliberals had thus started to strike back.<sup>53</sup> Major German politicians had begun to join forces with the ECB to send a common message. ECB Chief Jean-Claude Trichet fired

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<sup>49</sup> Matthijs (2016a). On the ECB learning different lessons from Japan on QE compared to the BoE or the Fed, see Gabor (2014).

<sup>50</sup> Schelkle (2007). While both SPD and CDU can be described as 'ordoliberal' in economic terms, the SPD follows a 'softer' version compared to the CDU, especially when in power. See Young (2014).

<sup>51</sup> Other people close to Schäuble, who entered the finance ministry with him, included Hans Bernhard Beus (Staatssekretär, 2009-13), Thomas Steffen (Director of European Department, 2010-12), as well as CDU politicians who served as Parlamentarische Staatssekretäre Steffen Kampeter and Hartmut Koschyk. The two exceptions were Jörg Asmussen and Werner Gatzert: both were Staatssekretäre in the finance ministry under Steinbrück and are associated with the SPD, but Schäuble kept them in the Finance Ministry after he took over.

<sup>52</sup> Lonergan (2014), p. 23.

<sup>53</sup> See also, for example, see Greenspan (2009).

the opening salvo in his “stimulate no more”<sup>54</sup> 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. Schäuble wrote the following: “it is an undisputable fact that excessive state spending has led to unsustainable levels of debt and deficits that now threaten our economic welfare. Piling on more debt now will stunt rather than stimulate growth in the long run.”<sup>55</sup> But he put his thinking at the time most clearly in a later speech in Berlin in April 2014: “We are not just the warning voice of others, without first turning to our own house and show that we adhere to the rules. It was a serious mistake for Germany and France to be the first to break the Stability Pact. *Exactly from that episode we have learnt our lesson.*”<sup>56</sup>

Volker Kauder, leader of the CDU/CSU faction in the Bundestag, amplified this lesson in a speech in June 2011: “With the softening of the Stability Pact, you have sent a crucial wrong signal, so that the train has arrived on the wrong track. That was the exact opposite of what was needed. This government coalition will bring the train back on the right track.”<sup>57</sup> Rainer Brüderle, FDP party leader, put it only slightly more colorful in the same Bundestag debate: “You [the SPD/Green coalition] have deviated and ultimately destroyed the Stability Pact [in 2003-5] until it could no longer function properly. That is the ultimate cause of our current misery. You punched through the fundamentals [of the

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<sup>54</sup> Trichet (2010).

<sup>55</sup> Schäuble (2011)

<sup>56</sup> Authors’ italics. Schäuble (2014), Speech on April 8 in Berlin. Available online at:

<http://www.bundesfinanzministerium.de/Content/DE/Reden/2014/2014-04-08-bundestag-einbringung-bundeshaushalt-textfassung.html>

<sup>57</sup> Volker Kauder (2011), speech in Bundestag on June 10. Available online at:

<http://dip21.bundestag.de/dip21/btp/17/17115.pdf> (page 13222)

euro] and now they no longer hold. Your policy was misguided [...] That is why we are now creating a sort of Stability Pact II.”<sup>58</sup> Finally, Theo Waigel, the influential CSU finance minister during much of the 1990s and who negotiated the original Pact, also observed that it had been a mistake to water down the SGP after Germany and France broke it, and that “no one should be surprised that eventually serious problems arose in a difficult situation.”<sup>59</sup> In short, German political elites’ ability to appeal to existing ordoliberal rules, as inscribed in the institutions of European monetary governance, allowed them to contest and recode the economic lessons of the 2005 revisions to the SGP. Given this authority contest, sympathetic EU actors at the Commission and the ECB increasingly appealed to the same ordoliberal ideas to strengthen their hand.

As early as December 2008, Trichet warned against breaking the SGP, claiming in a revealing interview with the *Financial Times* that “we would destroy confidence if we blew up the stability and growth pact.”<sup>60</sup> In that same interview he also cited “Ricardian effects” insisting that “one might lose more by loss of confidence than one might gain by additional spending.”<sup>61</sup> President of the European Commission, José-Manuel Barroso, echoed German and Trichet’s sentiments in his ‘2010 State of the Union’ in Strasbourg in front of the European Parliament: “Unsustainable budgets make us vulnerable. Debt and deficits lead to boom and bust. [...] Our proposals will strengthen the Stability and Growth Pact through increased surveillance and

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<sup>58</sup> Rainer Brüderle (2011), speech in Bundestag on June 10. Available online at: <http://dip21.bundestag.de/dip21/btp/17/17115.pdf> (page 13215)

<sup>59</sup> Theo Waigel (2011), June 14 interview with Der Tagesspiegel. Online available at: <http://www.tagesspiegel.de/politik/theo-waigel-im-interview-der-stabilitaetspakt-wurde-verwaessert/4284640.html>

<sup>60</sup> Financial Times (2008), “In the Face of Fragility,” December 15. Online available at: [http://www.ft.com/cms/s/0/7ec1ac1c-ca48-11dd-93e5-000077b07658.html?ft\\_site=falcon&desktop=true#axzz4M7xyYoNu](http://www.ft.com/cms/s/0/7ec1ac1c-ca48-11dd-93e5-000077b07658.html?ft_site=falcon&desktop=true#axzz4M7xyYoNu)

<sup>61</sup> Ibid.

enforcement.”<sup>62</sup> Barroso had plenty of ordoliberal ideas to appeal to in his attempt to strengthen the Pact, and thereby, the Commission in this moment of crisis. But he also had many other ideas he could appeal to. Why did he choose to side with the German interpretation of what the crisis meant and what to do about it?

Indeed, article 127 (1) and 282 (2) of the Treaty on the Functioning of the European Union (TFEU), the EU’s most basic law, 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 [TEU].”<sup>63</sup>

But 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 employment and social progress, and a high level of protection... It shall promote economic, social and territorial cohesion, and solidarity among Member States.”<sup>64</sup> In its Declaration on Article 126 of the TFEU, the Lisbon Treaty, as signed in 2007, elaborated on what those objectives were: “The Union aims at achieving balanced economic growth and price stability. Economic and budgetary policies thus need to set the right priorities towards economic reforms, innovation, competitiveness and strengthening of private investment and consumption in phases of weak economic

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<sup>62</sup> Barroso (2010), State of the Union. Online available at: [http://europa.eu/rapid/press-release\\_SPEECH-10-411\\_en.htm](http://europa.eu/rapid/press-release_SPEECH-10-411_en.htm)

<sup>63</sup> TFEU: <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:12012E/TXT&from=EN> (page 56 and page 121)

<sup>64</sup> TEU: <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=OJ:C:2016:202:FULL&from=EN> (See article 3 on page 19)

growth. This should be reflected in the orientations of budgetary decisions at the national and Union level.”<sup>65</sup>

The inclusion of the goals of balanced economic growth, full employment, and social progress leaves substantial room for intervention beyond maintaining price stability, especially, as the treaty says, during economic downturns or periods of weak growth. 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 unsupportable.<sup>66</sup> The decision under Trichet for the ECB to ignore these goals and to focus on the narrow mandate of price stability, despite a recession deepening around them, was a political decision. The decision by Barroso’s Commission to follow suit slammed the interventionist door shut.

This recoding of what the crisis was, where it stemmed from, and what to do about it, spilled over into the wider international context. 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 and interventionism. 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.<sup>67</sup> Congressional Republicans in the United States leapt upon such comments with undisguised glee, while media outlets picked up and amplified the story

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<sup>65</sup> TFEU: <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:12012E/TXT&from=EN> (page 304)

<sup>66</sup> We thank Marco Capitão Ferreira of Lisbon Law School for this key insight into the crisis.

<sup>67</sup> “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).

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.<sup>68</sup>

The offensive against Keynesianism at a global level, and at the EU level via the recoding of the SGP episode, was then linked to bond market contagion to establish an ordoliberal tightening of policy as the only ‘reasonable’ way forward. What the 2005 SGP reform augured – a better balance between fiscal and monetary policy, and between rules and discretion – was thus actively recoded in the rewriting of the crisis as “a crisis of state spending rather than private lending.”<sup>69</sup> The right lesson had been learned in terms of political sustainability. But the wrong lesson had been learned in terms of economic sustainability, as the next several years would show all too well.

#### *Contesting the Authority Contest: From Re-Coding to Actively Discounting Evidence*

The closing of the interventionist window led European economic policy down a particularly destructive path. As sovereign bond spreads between core and periphery Eurozone members continued to widen, a manageable Greek fiscal problem quickly morphed into a full-fledged crisis of sovereign debt in 2011. The European economy as a whole fell into a deep recession, despite which the ECB actually raised interest rates in April and July 2011, further compounding the situation.<sup>70</sup> The policy response of the Commission and the ECB – encouraged by the ascendant ordoliberals in Berlin – ignored

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<sup>68</sup> Wise (2010); Atkins, Hope and Oakley (2010).

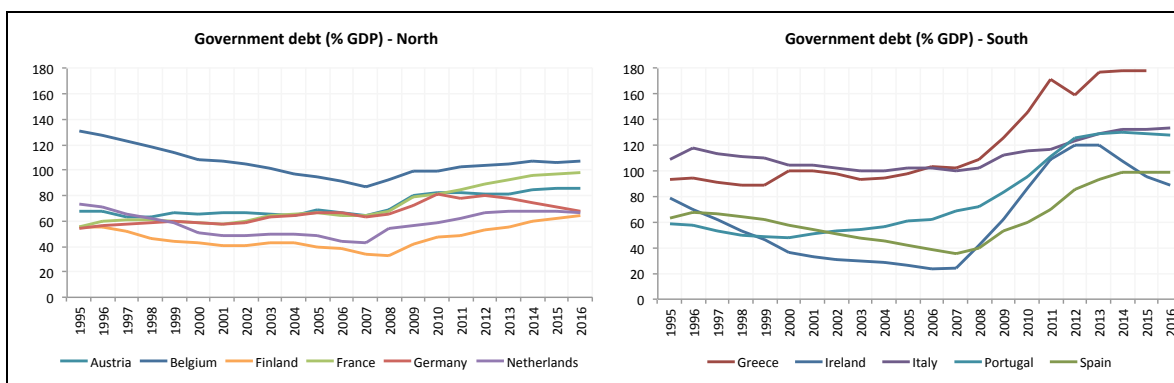
<sup>69</sup> Blyth (2015), p. 5.

<sup>70</sup> See Matthijs (2014) for an overview of the main events of the euro crisis between 2009 and 2012.

the private sector origins of the crisis and insisted, against mounting evidence, that the periphery’s ‘irresponsible borrowing’ was to blame.<sup>71</sup>

The periphery countries, it was argued, needed to implement strict budgetary austerity measures and enact far-reaching structural reforms to restore fiscal balance.<sup>72</sup> This thinking resulted in the consecutive ‘troika’ bailouts of Greece, Ireland, and Portugal. Despite good adherence to the programs, this 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 examines the evolution of gross debt figures between 2007 and 2016, Portugal’s debt-to-GDP ratio has doubled, Spain’s has nearly tripled, and Ireland’s has almost quadrupled.

Figure 1: Government Debt (Percent of GDP) – 1995-2016



Source: IMF (2016), World Economic Outlook Database (Washington, DC).

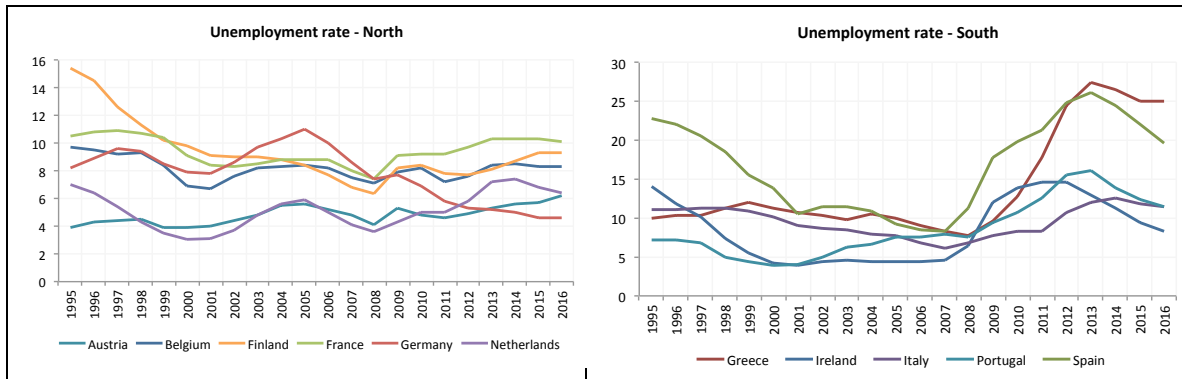
As a consequence, by 2015, the standards of living of Greece, Spain, and Italy vis-à-vis Germany had fallen roughly to their levels in the mid-1990s, to 57 percent, 74

<sup>71</sup> After all, one cannot have over-borrowing without over-lending. See Blyth (2015), and Matthijs and McNamara (2015).

<sup>72</sup> Matthijs (2014)

percent, and 76 percent respectively.<sup>73</sup> Unemployment in Greece and Spain rose rapidly while countries like Germany and Austria saw record-low levels of unemployment (figure 2).

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



Source: IMF (2016), World Economic Outlook Database (Washington, DC).

Meanwhile, monetary conditions further contracted throughout 2011 such that the real interest rates in the periphery rose, compounding already deep distress. Unsurprisingly, the bond market crisis went from bad to worse in the midst of this self-inflicted recession. When Trichet was succeeded at the ECB by the decidedly less ordoliberal Mario Draghi in November 2011, some respite was at hand.<sup>74</sup> But that respite, which was designed to effectively counter the economic contraction *caused* by adherence to these ordoliberal ideas, was to push further the extreme divergences in the stances of monetary and fiscal policy noted at the beginning of this article.

<sup>73</sup> IMF(2016), *World Economic Outlook Database* (Washington, DC). Online available at: <https://www.imf.org/external/pubs/ft/weo/2016/01/weodata/index.aspx>

<sup>74</sup> Despite being a consummate euro insider and Goldman Sachs alumnus, Mario Draghi is a US trained macroeconomist under those consummate Keynesians Franco Modigliani and Robert Solow at MIT.



*“Doing Whatever It Takes” – But to do what Exactly?*

Very early on in his tenure Draghi introduced the Long Term Refinancing Operations (LTROs) in December 2011 and February 2012, totaling over 1 trillion euros at a maturity of 3 years. He then reduced reserve requirements while increasing eligible collateral by widening 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).

It is vital to note that Draghi was not fighting external events – asymmetric shocks – in the language of economics. Rather, he was forced to fight a recession brought on by adherence to economic ideas that made political sense in a transnational authority contest – they strengthened German ordoliberals and EU level technocrats – but made no sense as economic policy. Unfortunately, while Draghi was giving Europe room to breathe, the ordoliberals at the helm in Berlin and Brussels were busy designing new instruments of fiscal constriction. These instruments, imposed by the member states themselves, only further distressed the economies of the euro periphery, as the European Union introduced a new series of laws and regulations to more actively monitor the budgetary decisions of all EMU member states going forward.

Given the recoded focus on periphery profligacy via the lesson learned from the SGP reforms, the focus of EU policymakers through 2012 fell mainly on correcting the

perceived ‘national’ causes of the crisis (fiscal profligacy and a 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 the missing joint banking supervision and resolution powers in dealing with continent wide banks).<sup>75</sup> As can be seen in table 2, the EU ‘turbo-charged’ the SGP with three sets of ever-tightening fiscal measures.

Table 2: EU Fiscal Crisis Measures

<b>Measure</b>	<b>Entry into Force</b>
<b>The ‘Six-Pack’</b> (5 regulations + 1 directive)	December 2011
<b>The ‘Fiscal Compact’</b> or TSCG (Treaty on Stability, Coordination and Governance)	January 2013* (16 EU members, early ratification) April 2014 (all except UK and Czech Rep)
<b>The ‘Two-Pack’</b>	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 Procedure (EDP) can be initiated against a member state, and stipulates which financial sanctions will be imposed if it is so designated.<sup>76</sup>

The “Fiscal Compact” – or Treaty on Stability, Coordination, and Governance (TSCG) – is an intergovernmental agreement (not EU law) concluded in Brussels in December 2011 that went into force in January 2013 after early ratification by 16 EU

<sup>75</sup> Matthijs and Blyth (2015); Matthijs and McNamara (2015).

<sup>76</sup> 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.

member states. The Fiscal Compact requires EU member states to respect and ensure convergence towards the country-specific Medium Term Objective (MTO), *with a lower limit on the structural deficit of 0.5 percent of GDP.*

The idea was for these strict budget rules to be enshrined into national law through clear-cut provisions of “binding force and permanent character, preferably constitutional.”<sup>77</sup> It also introduced reverse qualified majority voting (RQMV), making it harder for big countries to band together, as France and Germany had done 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.

Yet all that this tightening of fiscal monitoring and further constriction achieved by the spring of 2016 was to make growth outside of Germany, with a few partial Eastern European states tied into its export supply chains, even more sclerotic.<sup>78</sup> More importantly for our purposes, they mark the institutional reconsolidation of the ordoliberal ideas at the heart of the European monetary project, all of which stemmed from the authority contest over the original SPG episode. Building these new institutions confirmed one bias and opened up another problem, however. The bias was to ignore any and all contrary evidence that binding fiscal policy so tight required an ever-looser monetary policy and that ever-looser monetary policy was causing its own problems.

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<sup>77</sup> 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.

<sup>78</sup> Blyth 2016

Fiscal and monetary policies were being further driven in opposite directions, which would open up a further authority contest on what the economic evidence actually meant.

### *The Intra-Troika Authority Contest*

As noted above, the social learning literature argues that policymakers alter their stance when *anomalies* such as large policy failures appear. Given how large the forecast errors were in the policy estimates of the Troika (the European Commission, the ECB, and the IMF), 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, this happened with one third of the troika, the IMF, even though the big shift there on fiscal multipliers was in the research department rather than among its leadership team.<sup>79</sup> With the other two thirds however, the ECB and the Commission, while we see a shift in emphasis, the underlying ideas remained largely the same, despite any and all evidence to the contrary. The reason why, we suggest, was not the efficacy of these policy ideas. Rather, it was the authority that they gave to those who wielded them.

For example, the Bruegel Report on the three troika bailout programs commissioned by the European Parliament in 2014 usefully analyzes 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,’<sup>80</sup> which is perhaps unsurprising given the lack of growth and high unemployment produced by the implementation of

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<sup>79</sup> See Henning (forthcoming), unpublished manuscript, p. 311

<sup>80</sup> Sapir et al (2014), pp. 17-23.

these policies.<sup>81</sup> However, 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.”<sup>82</sup>

The one part of the Troika that has substantially shifted their ideas was the IMF. As Cornel Ban details, the IMF’s policy ideas have shifted substantially over the course of the crisis across multiple positions.<sup>83</sup> 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.<sup>84</sup> 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 greater than one percent cut in GDP, with no offsetting confidence effects.<sup>85</sup> Since negative multipliers also imply positive ones, as any reciprocity demands, the IMF’s seemingly technical challenge effectively argued *for* a political shift towards fiscal expansion, which is precisely what the new fiscal institutions discussed above were designed to obviate. In making this challenge the entire ordoliberal framework 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 the right policies, and that the multipliers would have been less than

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<sup>81</sup> Ibid. pp. 19-21.

<sup>82</sup> Ibid. p. 22.

<sup>83</sup> Ban (2015).

<sup>84</sup> See Blyth (2015), postscript.

<sup>85</sup> For a summary see OECD (2014).

one, had it not been for a lot of people talking about the break-up of the euro, which made things worse.<sup>86</sup> 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, in which the EC was quickly supported by the ECB.<sup>87</sup> It is also worth noting that that other great booster of fiscal tightness and credibility, the OECD, authored a report in February 2016 that argued developed country growth prospects have “practically flat-lined” due to misapplied austerity policies and that “a commitment to raising public investment would boost demand and help support future growth.”<sup>88</sup>

Neither the Commission, nor the ECB, nor the German government had any response to the OECD report. In sum, if social learning, as it is understood in the literature, is going on in Europe, it has to be understood as a process where the wrong lessons seem to be constantly reaffirmed as a part of an authority contest over what a crisis means, and who gets to dictate how to respond.

### *How the Wrong Policy Mix Became the ‘New Normal’*

Despite bond markets rallying due to Draghi’s LTRO and OMT policies, the Eurozone struggled through a recession and found itself on the brink of deflation in 2013. 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.” A year later, with deflationary conditions pressing further, the ECB introduced so-called Targeted Long-Term Refinancing Operations (TLTROs) in

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<sup>86</sup> See European Commission (2012).

<sup>87</sup> See ECB (2012), box 6, pp. 82-85.

<sup>88</sup> OECD (2016a, 2016b).

June 2014, allowing banks to borrow up to 7 percent of a specific part of their loans to get cheap credit into the system. 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, low growth, and above all, diminished demand conditions. The ECB was by now, de facto, counteracting the costs of the recoding of the SGP episode, nearly half a decade later.

June 2014 also saw the ECB introduce negative deposit rates. This led to European banks buying US dollar assets rather than placing their cash reserves with the ECB, which 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.<sup>89</sup> 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, 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 been extended through March 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

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<sup>89</sup> At the time of writing the euro/dollar rate is 1.10.

the Six-Pack and the Two-Pack, etc., which was itself made possible by the ordoliberal recoding of the 2005 SGP episode.

*Conclusions: Ideas, Social Learning, and the Rational Persistence of Irrational Ideas*

We have attempted to show in this article that social learning can lead to paradigm maintenance as well as paradigm change. 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 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 for political reasons and stick to them despite the evidence.’ The EU was able to do this due to the wrong lessons being learned from the 2003-5 episode when the SGP was revised. This recoding 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 increasing evidence that doing so was self-destructive.

We next showed how these ideas were both re-inscribed and reinforced in the new EU institutions of fiscal governance – the six-pack, two-pack and fiscal compact – in 2012. This turn to an ‘ever closer squeezing’ of budgets paradoxically necessitated ‘ever looser money’ from the ECB to both cushion the recession that fiscal tightening was causing, as well as to counter the deflationary expectations that were being sown. Disconfirming evidence from the IMF and other organizations was discounted by the other troika institutions as this authority contest continued. 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 governors, that authority is drawn from adherence to a set of ideas and institutional rules that, while irrational 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. In the case of those that have a domestic democratic mandate, the appeal to such rules allows them to expand their claims to authority beyond their electorate, into the institutions of supranational governance. Without appeal to such ideas, their authority, like their capacity, would stop at the border.

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, as Keynes said about the adherence to deflation in the 1930s, locally rational but globally irrational. And so long as authority is produced and contested via appeal to these ordo- and neo-liberal ideas, and through contested readings of past events, a rather unbalanced and ineffective macroeconomic policy mix will be the result. Just how long Europe can stand this policy mix remains the relevant question. But what our analysis suggests is that so long as the answer is framed in ordoliberal terms, those in authority will not be compelled to give an alternative answer.

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