Eric Jones and Francisco Torres

An ‘economics’ window on an interdisciplinary crisis

Article (Accepted version) (Refereed)

Original citation:
Jones, Erik and Torres, Francisco (2015) *An ‘economics’ window on an interdisciplinary crisis.* Journal of European Integration, 37 (7). pp. 713-722. ISSN 0703-6337

DOI: 10.1080/07036337.2015.1079368

An 'Economics' Window on an Interdisciplinary Crisis

ERIK JONES* and FRANCISCO TORRES**

* Johns Hopkins University SAIS, Bologna, Italy, and Nuffield College, Oxford, UK

** European Institute, London School of Economics and Political Science, London, and ESC, St. Antony's College, Oxford, UK

ABSTRACT: The euro area crisis cannot be understood without combining insights from a variety of disciplines -- economics and political science first and foremost. This introduction aims at explaining how the essays in this collection map onto a number of important debates in political science. We sketch four well-known areas for the political science community: the framework for multilevel governance, the role of ideas in policymaking, the interaction between power politics and distributive bargaining, and the challenge of popular legitimation. These critical themes in the current crisis are important areas of overlap in economic and political analysis. Hence, the aim of this introduction is to show how these themes emerge in the essays that follow.

KEYWORDS: Economics and politics, multilevel governance, the role of ideas, power politics and distributive bargaining, popular legitimation

Correspondence Address: Francisco Torres, European Institute, London School of Economics and Political Science, Houghton Street, WC2A 2AE, London, UK. Email: f.torres@lse.ac.uk

Introduction

The euro area crisis cannot be understood without combining insights from a variety of disciplines – economics and political science first and foremost. Nevertheless, most conversations about European integration, and monetary integration in particular, take place within disciplinary boundaries. This is true even when the participants hope to speak to a wider audience in the public and private sectors. A few academic outlets, like the Journal of European Integration, do their best to create a forum for scholars from different disciplines to interact. Nevertheless, more often than not the contributors wind up having parallel conversations – citing the work of their disciplinary colleagues, using the same jargon, and ignoring the rest.

This lack of engagement across disciplines is a problem insofar as the different voices in the debate about the origins of and remedies for the European crisis have so much to offer one another. This is perhaps easiest to see when political scientists rely on economic analysis as in the recent debate about austerity (Blyth 2012). There are important examples that go in the other direction with economists drawing upon political science, as in the recent debates about democracy and development (Acemoglu and Robinson 2005) or income inequality (Piketty 2014). Nevertheless, it is a harsh reality that in a world indexed by Google and narrated by Twitter, the barriers to entry in any disciplinary conversation are large. There is simply too much material out there that is too accessible. Just keeping abreast with the pace of analysis and commentary within a given discipline is enough of a challenge to occupy the time of any academic, analyst or researcher. As a consequence, much value added is lost.

The purpose of this special issue is help redress the balance. In doing so, we hope to honour the memory of Max Watson, who was an academic, analyst and policymaker who showed the true value of interdisciplinary research and cross-disciplinary conversation. Organizing a series of seminars and a workshop on these very issues were among his last scholarly endeavours. We are privileged to be able to complete a project started with him and that he so generously supported.

Our contribution with this collection is two-fold. First, we make available the insights of some of the most accomplished economists and policymakers working on the crisis in the euro area to a wider research community from cognate disciplines. With few exceptions that will be easy to spot from the notes on contributors, these are not 'interdisciplinary' scholars. They work within the economics discipline, where they have achieved the highest level of recognition. We have asked these contributors to write in accessible language and to focus on questions of broad significance. They have responded with a wealth of insight about opportunities missed, flaws uncovered, data misinterpreted, experience ignored, and politics trumping economics. Each of these arguments sheds light on a different aspect of the European dilemma and each reveals an agenda for positive action. Some of this action is conceptual and shows how we can better understand the dynamics at work both in the current crisis and looking to the future; some is more practical and suggests how we can reshape European institutions to make them more resilient – and integration more sustainable – looking to the future. The abstracts to the different essays provide a quick survey of the material they contain, and so, we do not repeat that information here.

The success of that contribution should be measured in terms of the breadth of appeal – both for the individual papers and for the collection as a whole. Hence, the goal of these essays is not to push forward scientific knowledge in the 'normal' manner described by Thomas Kuhn (1970). Strict disciplinary journals would be more appropriate for such arguments. But then, our ambition to foster cross-disciplinary exchange would be thwarted. Hence, we encouraged our contributors to challenge fundamental assumptions and to look across disciplinary boundaries. In doing so, we asked them to work outside their comfort zones and to develop arguments that are more familiar to those working in other disciplines. This should create multiple avenues for engagement.

This explains our second contribution, which is to show how the essays in this collection map onto a number of important debates in political science. We use the introduction and conclusion to achieve that objective. This allows us to highlight areas we believe are of particular concern. It also makes it easy for us to show how this kind of cross-disciplinary engagement can take place. We offer a gateway not a finished product. There are other themes from political science that recur in these essays. We leave these for the reader to discover. Moreover, the value added to draw from this type of collection will always be a work in progress. If we can introduce these arguments to a new audience and show how they can be folded into existing debates with which that audience is likely to be familiar, we can begin the cross-disciplinary conversation.

The introduction sets the stage by sketching four areas for attention that are well known within the political science community: the framework for multilevel governance, the role of ideas in policymaking, the interaction between power politics and distributive bargaining, and the challenge of popular legitimation. These are critical themes in the current crisis and important areas of overlap in economic and political analysis. Hence, the aim of the introduction is to show how these themes emerge in the essays that follow.

The goal of the conclusion is to suggest how both economists and political scientists can use shared themes to foster a coherent and productive cross-disciplinary conversation. That conversation should help us move towards a two-fold objective: it should improve the quality of the answers we provide to important questions in the scholarly literature and should also help to shape recommendations for strengthening public policy. Clearly, the European Union needs to make progress on both dimensions. There is a wealth of insight and analysis out there to be exploited offering a variety of solutions to the wide array of pressing problems. At the moment, though, the interaction between economics and politics is working against effective public policymaking. The solutions that are acceptable are not effective, and many of the measures that could improve the situation are unpopular (if not simply unacceptable). It is times like these that we need to start thinking outside of disciplinary boxes.

Multilevel Governance

At its core, the euro area crisis is a crisis in the framework for multilevel governance. For political scientists, this is territory made familiar both through the study of federal systems and through analysis of the European Union itself. Liesbeth Hooghe and Gary Marks (2001) have brought together the various strands of argument in the multilevel governance literature in a synthetic framework and Fritz Scharpf (1999; 2001) has provided invaluable insights on the unique challenges that multilevel governance arrangements face in terms of decision-making and legitimation. These insights are fundamental to understanding the crisis of the euro area.

Consider, for example the theory of optimum currency areas (OCA). In abstract terms, the question is how large or small of an economy domain should be encompassed by a single currency. In more practical terms, the question is whether the currency domain and the political domain should be the same. The OCA literature exists because economists questioned the necessity of subjugating economic institutions to a political logic – one sovereign and so one currency. Yet if you break that link, then it is unclear how many governance institutions need to coordinate at the same level of aggregation as the currency and how many can be allowed to operate at levels that are either larger or smaller. This is an age-old problem and, as Vitor Gaspar shows, it lies at the heart of American experience with federal state building. Gaspar focuses on the financial system and the crucial role played by Alexander Hamilton in structuring both federal budgets and private finances. The story he tells is progressive insofar as the U.S. federal state continues to amass authority. It is a non-linear story; Hamilton's financial institutions were largely dismantled by Andrew Jackson. Nevertheless, Hamilton anticipated much of what is required in a modern multilevel financial economy like the one you find in the United States today.

The process of European integration is only very loosely analogous to the U.S. experience. Nevertheless, there are certain insights about multilevel governance in the areas of money and finance that resonate in both places. You can see this in the essay by Francesco Giavazzi and Charles Wyplosz. The story they tell is about design features that should have been included in European efforts and yet were omitted either because they were unpopular or because they were simply ignored. Fiscal union falls in the unpopular category; financial union should be filed under neglect. Implicitly, this shows the importance of learning from the experience of other cases. The United States tried to manage a currency without a financial union and nearly failed. That is why Hamilton's original insights are so important. Hamilton had a more lasting impact on federal finances. Yet if pooling finances is necessary for successful monetary integration, it is an open question why the architects of the single currency went ahead with their project without securing political support for fiscal centralization first.

The easy answer is to assume that monetary policy could operate at the European level while fiscal policy could operate at the national level. This assumption works under certain conditions. But it does not work when national economies are allowed to accumulate essentially unlimited public or private sector liabilities. This is the point made in the paper by Russel Kincaid and Max Watson. What it reveals are the externalities of policy action (or inaction) at the mid-range of a multilevel governance structure. Their point is that these externalities accumulate to such an extent that they can threaten the viability of the multilevel governance framework as a whole. Moreover, there are strong incentives at the Member State level to allow these imbalances to accumulate into a source of systemic stability. As Scharpf (and many others in the political science community) anticipated, there are gaps in the decision-making framework that no level of government and no specific actor have the authority to fill. The consequences can be seen in the essay by Lorenzo Bini Smaghi. He shows how attempts to impose conditionality on governments in distress have failed to achieve a desired reaction. Worse, they have engendered widespread discontent – both among those countries that have been subjected to conditionality and among those countries that have provided resources for European bailouts against what they now perceive as 'empty' promises of 'meaningful' reform. This is a challenge that Iain Begg and his colleagues recognize as well. In fact, an alternative to an improbable full-fledged fiscal integration would be to improve both the current model of conditionality and make it more sustainable (Bini Smaghi) and complementing it with an integrated economic policy framework (Begg et al., Kincaid and Watson and Sapir and Wolff, 2015).

The problem of imbalances focuses on the negative interaction between a large currency union and smaller fiscal authorities. A further concern is the interaction between policymakers in the monetary and fiscal domains that does not take place because they are not working at the same level of aggregation. Here, the issue is not perverse incentives that give rise to excessive indebtedness, it is the lack of coordination necessary for effective macroeconomic adjustment. This theme would be anachronistic in the paper by Gaspar; macroeconomic demand stabilization was not a consideration for the founding fathers of the American Republic. It was not anachronistic for the founders of the euro area. Indeed, the importance of coordinating makes an appearance in Giavazzi and Wyplosz and features prominently in the essays by Paul De Grauwe and Yuemei Ji and by David Vines. Implicitly, the contributors appeal to a set of economic models where macroeconomic policy coordination is useful in stabilizing the evolution of inflation and unemployment. Such models assume a level of aggregation – both for policymaking and for data collection. Hence they also assume some connection between the domains for political control and for relevant economic activity. This creates an important tension in the theory of optimum currency areas – and hence also a tension in the architecture of the euro. A currency should encompass efficient markets (Mundell 1961) but it should also encompass effective macroeconomic demand stabilization (McKinnon 1963), and where the scale for effective macroeconomic demand stabilization is larger than the domain of market efficiency, then appropriately designed fiscal institutions can make up the difference through automatic flows in taxes and transfers across regions within the currency area (Kenen 1969). In other words, multilevel governance is both the problem and the solution.

The Role of Ideas

Of course, it is also possible that the shared assumption about the importance of coordinating macroeconomic policy instruments is flawed because aggregate demand stabilization is not a valid policy objective. Economists do not all accept models derived from the neoclassical synthesis. Indeed, those models are hotly contested in Europe. This observation is fundamental in the political science literature. It lies at the heart of virtually every major contribution to the role of ideas in comparative political economy from Peter Hall's (1989) edited volume on Keynesianism across nations to Kathleen McNamara's (1998) study of monetary integration and Mark Blyth's (2002) work on the monetarist revolution. Economists are more comfortable trying to assert their own ideas in the policy process than trying to understand how ideas influence policy more generally. Nevertheless, they are well aware that such influence exists and that contestation has an impact on policy outcomes. This is clearly shown in the collection of papers on joining Europe's monetary club, which we published in the phase of convergence towards EMU (Jones et al. 1998).

Vines' essay is perhaps the strongest expression of concern about the role of ideas in European policymaking. He focuses his attention on the German economic establishment, but his real concern is not 'Germany' but what he brands as poor thinking. Hence, his essay is both an attempt to diagnose the problem at the heart of the European crisis and to explain how we might think about it more fruitfully. Erik Jones has a similar agenda in his essay. Ironically, the two disagree on both the most appropriate set of ideas for addressing the crisis and the appropriate strategy for choosing between them. There is a certain reassurance that emerges from the debate between them. No view has a monopoly on the truth. Hence, the contestation over ideas is not without reason.

That is not the same as saying that all ideas deserve equal merit. Some ideas work better than others – in helping policymakers to influence the world around them, but also in helping politicians to mobilize political support. This is one of the fundamental insights in the political science literature and it is on full display here as well. It connects the stories about institutional design features adopted and ignored by the architects of the single currency in the Giavazzi and Wyplosz essay to the conditionality and reform debates in the Bini Smaghi and Begg et al. papers and to the macroeconomic policies analysed by De Grauwe and Ji.

Ideas can take us further as well. As Blyth (2002) argues, ideas are a focal point for coordination. What De Grauwe and Ji show is how this coordination expresses in European financial markets. What they reveal is the extent to which actual financial market performance is inconsistent with what we would expect from ideational constructs like the efficient markets hypothesis. Instead of responding smoothly and consistently to assessments of fiscal solvency and sovereign creditworthiness, markets tend to ignore fiscal variables until suddenly they find them to be of interest. Ideas do not fit the rationality of perfect information, in that sense. They are heuristic or signalling devices used by market participants. (As an aside, there is a growing literature on voters and elections that comes to similar conclusions in a more explicitly political context.) Moreover, market participants are not the only economic agents who are fickle in their treatment of fiscal ideas. Zsofia Barta and Waltraud Schelkle show similar inconsistencies in the behaviour of credit ratings agencies and supranational institutions. These organizations do not have a monolithic sense of what is good and what is bad in the fiscal domain; rather, they operate with contested concepts and changing conventions.

Differences in ideas within a multilevel governance framework make for an added complication. This is another insight that Barta and Schelkle reveal. Once again, moreover, we are confronted with the disjuncture between the policy domain and the scope of relevant economic activity. This time, however, the supranational institutions are smaller than the economic actors (credit ratings agencies) that are the focus for attention. Hence, at least part of the challenge is to bring the credit ratings agencies into the policy domain. This challenge is not straightforward. Having validated the credit ratings agencies as sources of policy relevant data by writing ratings requirements into European legislation, European policymakers may have made matters worse rather than better.

Striking an appropriate balance is not easy. This is true partly because of the influence of unintended consequences and partly due to the lack of adequate measurement. Francesco Mongelli and his colleagues tackle the measurement problem by creating an indicator for capturing the evolution of the European Union as a framework for multilevel governance. The indicator they develop tracks the four unions that are central to the 'Five Presidents Report' (2015) to improve the architecture of the European Union. We return to this report in the conclusion. For now, what Mongelli et al. reveal is how much judgement is involved in assessing progress in institution building. Ideas factor into every aspect of the measurement process and so weave contention into the very fabric of our understanding of European integration.

Distributive Bargaining and Power Politics

Contention over the nature of European integration cannot be resolved through reference to objective principles. The European federalists recognized that early on. Worse, there are no iron clad or ineluctable causal mechanisms underpinning the process of institution building. Early neo-functionalists like Ernst Haas (1968) were disillusioned. Their historical institutionalist successors have been no more successful. This is not to say that neo-functionalist spillover or historical path dependence have no relevance. On the contrary, each of the essays in this collection shows how the crisis 'spills' across discrete policy areas, they illustrate the need for more coordinated intervention, and they highlight the challenge of working with and through those institutions that actually exist (as opposed to imagining some alternative universe). Nevertheless, even the most elegant framework for understanding European integration – or economics – has to allow space for distributive bargaining and power politics.

In many of the essays collected here, these forces show up as a kind of political hidden hand. They explain why the architects of the single currency did not pursue fiscal federalism and how they came to ignore the advantages of pooling financial market supervision. On a deeper level, they explain how macroeconomic imbalances arose, why they were allowed to grow to unsustainable dimensions and why national politicians have been so reluctant to undertake the reforms necessary to prevent their recurrence. Distributive bargaining and power politics explain the very negative dynamics at work in the application of 'conditionality', they explain the suspicion that often greets the promulgation of German ideas about the virtues of fiscal austerity and the ineffectiveness of macroeconomic demand stabilization, and they explain the difficulty of forging some kind of effective European discretion in responding to crisis imperatives.

The question is whether any pattern lies buried in all this negativity. If that pattern is 'might makes right', then the goal should be to persuade the most powerful or influential policy actors. If the pattern is 'right makes might', then the goal should be to speak truth to power. It is interesting in this sense to look at the tone of the different essays to see where they fall in that spectrum and what this implies about underlying assumptions. Here again, the contrast between Jones and Vines is of interest. There are, however, many more than just two points on the spectrum. Hence, it is useful to look at each of the essays to assess both the audience and the objective of the authors. It is also useful to judge which is likely to have any measure of success in influencing either the scholarly community or the policy process.

Popular Legitimation

By considering these contributions as part of a larger conversation, it becomes easier to fold them into the mechanism of European integration itself. That is an important step in the process of engagement. The point here is not that these essays will revolutionize how we understand Europe or how Europe is organized. Rather it is that each in its own way tackles a problem of multilevel governance, offers an idea about how that problem can be resolved and addresses that idea to a particular audience that hopefully will have some influence over the situation. Whether that influence is whispered directly into the ear of the most powerful person in the room or filters its way up through the cacophony of contemporary academic discourse is irrelevant. In the long run, 'Keynes' long-defunct economists' have as much influence as Keynes himself. Indeed, Keynes worries (not unreasonably) that he is outmatched.

For such a broad assessment to work, however, it must take questions of popular legitimation into account. These questions are front and centre in the chapter by Begg and his colleagues. That explains why they are so focused on the sustainability of integration as a multi-dimensional problem. If we are to take the long term into account, it is not enough simply to address the current crisis; it is not even enough to avoid the dilemma where the solutions of today become the problems of tomorrow. Here, it is worth recalling that Tommaso Padoa-Schioppa et al. (1987) foresaw irrevocably fixed exchange rates as the first-best response to the challenge of currency market volatility even as politicians in France and Germany believed that monetary union would cement the reconciliation of their two countries (Dyson and Featherstone 1999).

Hence, the key to long-term sustainability requires doing more than just addressing the current crisis; it depends upon policymakers developing institutions and practices that will make it easier to address other future crises as well. The solution to the current problems of the euro area must help us deal with population ageing and climate change. This may seem far-fetched; once we take into account the impact of current reforms on public expenditures and market structures, however, it is easy to see how they are all connected. These connections exist in the eye of the public as well. Policymakers are not alone in having ideas about how the world works, and they are not unique in realizing the multilevel structure of governance. The people are active participants in politics as well as in the markets. Moreover, their actions play a critical role in validating or vitiating the assumptions that underpin

European institutions. When De Grauwe and Ji focus their analysis on the behaviour of markets, this is what they mean.

The challenge for analysis is to understand how people are organized and what are the relevant levels of aggregation. That notion of relevance hinges on the principle of legitimacy. Where legitimacy is greatest, policymakers have the most effective control over collective action. This is what Begg and his colleagues reveal. Drawing upon the work of Kalypso Nicolaïdis (2010; 2013), they show how units of political legitimation – *demoi* – operate as the political equivalent of optimum currency areas. These units are not equal in scale or scope to the currency itself. That is the fundamental challenge. Hence, it is necessary for these different units to engage in power politics and distributive bargaining in order to influence how their common currency is governed. Along the way, they fight over different ideas about how the economy works and what institutions offer the most control over economic performance. And they reserve the right to act as sovereign even within a multilevel governance framework. This political analysis is not so different from the economic analysis in other chapters. Nevertheless, it operates at the other end of the prism with economic rationality on one end and political legitimation on the other. In fact, as put by Begg et al. and Mongelli et al., economic integration would have to be pursued along the lines of creating stronger incentives for structural reforms in low-productivity countries, thereby improving the overall stability of EMU to macroeconomic shocks by making the Eurozone better meet the economic requirements for a currency union.

Between these two points is a large and complicated set of dynamics. Currently, those dynamics are in crisis. Any attempt to resolve that crisis must take account of both the economic and political forces at work. The purpose of this collection is to shed light on the economic side of the problem. Doing so, however, only reveals the political dimensions that warrant complementary analysis. We hope that readers will use these essays as a source of inspiration to generate new questions. We cannot anticipate how those questions will be answered but we can imagine that the answers will operate across traditional academic disciplines.

Acknowledgements

This special issue benefited a lot from the very helpful comments of an anonymous referee and from the willingness of the authors to take up the challenge to engage with the other

chapters and domains. We are also grateful to the editors of JEI for their comments and suggestions and the patience with which they accompanied the making of this special issue.

References

Acemoglu, Daron and James Robinson (2005), *The Economic Origins of Dictatorship and Democracy*, Cambridge: Cambridge University Press.

Blyth, Mark (2002*), Great Transformations*, Cambridge: Cambridge University Press.

Blyth, Mark (2012), *Austerity: The History of a Dangerous Idea*. Oxford: Oxford University Press.

Dyson, Kenneth and Kevin Featherstone (1999), *The Road to Maastricht: Negotiating Economic and Monetary Union*, Oxford: Oxford University Press.

Hall, Peter ed. (1989), *The Political Power of Economic Ideas: Keynesianism across Nations*, Princeton: Princeton University Press.

Haas, Ernst (1968), *The Uniting of Europe: Political, Social, and Economic Forces 1950-57*, Stanford, CA: Stanford University Press.

Hooghe, Liebeth and Gary Marks (2001), *Multilevel Governance and European Integration*. Lanham: Rowman & Littlefield.

Jones, Erik, Jeffry Frieden and Francisco Torres (1998), *Joining Europe's Monetary Club: The Challenges for Smaller Member States*, New York: St. Martin's Press.

Kenen, Peter (1969), "The Optimum Currency Area: An Eclectic View", in R. Mundell and A. Swoboda (eds) *Monetary Problems of the International Economy*, Chicago: University of Chicago Press, 41-60.

Kuhn, Thomas (1970), *The Structure of Scientific Revolutions, Second Edition, Enlarged*, Chicago: University of Chicago Press.

McKinnon, Ronald (1963), "Optimum Currency Areas", *American Economic Review*, Vol. 53, 717–25.

McNamara, Kathleen (1998), *The Currency of Ideas: Monetary Politics in the European Union*, Ithaca, NY: Cornell University Press.

Mundell, Robert (1961), "A Theory of Optimum Currency Areas", *American Economic Review*, 51, 657–65.

Nicolaïdis, Kalypso (2010), "Sustainable Integration: Towards EU 2.0?" The JCMS Annual Review Lecture, *Journal of Common Market Studies*, Volume 48, pp.21-54.

Nicolaïdis, Kalypso (2013), "European Demoicracy and Its Crisis", JCMS: *Journal of Common Market Studies*, 51 (2): 351–369.

Padoa-Schioppa, Tommaso, Michael Emerson, Mervin King, Jean-Claude Milleron, Jean Paelink, Lucas Papademos, Alfredo Pastor and Fritz Scharf (1987), *Efficiency, Stability and Equity: A Strategy for the Evolution of the Economic System of the European Community*, Oxford: Oxford University Press.

Piketty, Thomas (2014), *Capital in the Twenty-First Century, Cambridge, MA:* Harvard University Press.

Sapir, André, and Guntram Wolff (2015), "Euro-Area Governance: What to Reform and How to Do It", Bruegel Policy Brief 2015/01, February.

Scharpf, Fritz (1999), *Governing in Europe. Effective and Democratic?*, Oxford: Oxford University Press.

Scharpf, Fritz (2001), "Notes toward a Theory of Multilevel Governing in Europe", *Scandinavian Political Studies*, 24, 1, 1-26.