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THE EUROZONE AND POLITICAL ECONOMIC INSTITUTIONS

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■ **Abstract** This review sets out a recently developed comparative political economy literature on the Eurozone, which has a basis in both varieties of capitalism and modern macroeconomics. It contrasts the export-oriented, northern European, skill-intensive, coordinated market economies with coordinated wage-bargaining with the southern European, demand-driven economies with strong public sector unions. It analyzes the Eurozone as an ongoing grouping of sovereign democratic states, each with strong concerns to remain within the Eurozone but in principle with an exit option. It argues that the origins of the Eurozone and its trajectory primarily reflected national economic concerns and not a political drive toward European integration; and its deflationary preference has been the rational choice of the export-oriented members and their bargaining power in the Eurozone, not an irrational rejection of Keynesianism. The Eurozone functioned well (comparably to the advanced economies outside the Eurozone, though with major imbalances in both) during its “dual growth model” period from inception to the Eurocrisis. The absence of flexible core labor markets suggested by the optimum currency area literature has not impeded its effectiveness; and there has been little Eurozone-generated institution building, except very partially in banking. The only important development, Outright Monetary Transactions, has made the European Central Bank the de facto lender of last resort to fiscally stable member states. A very tentative conclusion is that skepticism about the euro may be overdone.

Keywords macroeconomics, varieties of capitalism, growth strategies, Eurocrisis

INTRODUCTION

This article reviews the comparative political economy (CPE) literature on the Eurozone that has developed over the last two decades, with a focus on labor market institutions and modern macroeconomics ([Soskice & Iversen 1998](#); [Hall 2012, 2014](#); [Hancké 2013](#); [Iversen & Soskice 2013](#); [Johnston et al. 2014](#); [Johnston & Regan 2014](#)).¹ It sees economies driven---as far as fiscal and monetary policy preferences are concerned---by governmental strategies based directly and indirectly on national varieties of capitalism. The northern European, export-oriented, coordinated market economies (CMEs)², Austria, Belgium, Finland, Germany, and the Netherlands, are distinguished from the peripheral European economies of Greece, Ireland, Portugal, and Spain, and also from France and Italy. The latter six countries have major differences between them but will loosely be referred to as southern Europe.

CPE: comparative political economy

CME: coordinated market economy

Despite its basis in modern macroeconomics, the CPE approach is very different from that of the optimum currency area (OCA) literature. The OCA literature (considered critically by [De Grauwe 2012](#)) focuses on the institutions that need to be in place for a currency area to function effectively, with US institutions providing an empirical perspective. We focus on the actual institutions in place and their resilience. The CPE literature also contrasts with the large Europeanist literature, going back several decades, based on functionalism. It is less inconsistent with Hooghe & Marks's ([2009](#)) more recent definition of postfunctionalism, meaning the limits imposed on European integration by nationalist electoral politics. And it is close to intergovernmentalism, notably the work of [Moravcsik \(1998, 2012\)](#).³

OCA: optimum currency area

¹ For the modern macroeconomics of closed and open economies, covering both inflation targeting and common currency areas, see [Carlin & Soskice \(2015\)](#). Modern macroeconomics refers to simplified versions of the new Keynesian models used by central banks. [De Grauwe's \(2012\)](#) text on the Eurozone is seminal and highly accessible.

² See Hall and Soskice (2001) for discussion of coordinated market economies.

³ For a detailed discussion of the earlier theories of European integration (including functionalism and intergovernmentalism), see [Rosamond \(2000\)](#) and [Wiener & Diez \(2004\)](#). See [Niemann \(2006\)](#) and [Schimmelfennig \(2014\)](#) for more information on functionalism, [Moravcsik \(1998\)](#) for more information on intergovernmentalism, and [Hooghe & Marks \(2009\)](#) for more information on postfunctionalist theory.

We start by summarizing the three key elements of the CPE perspective (drawn from [Iversen & Soskice 2013](#)).

Northern European CMEs

The major part of the story concerns the CMEs of northern Europe (excluding France; see below). Independently of monetary policy and exchange rate systems, these economies are driven strategically by export orientation: A large proportion of high value-added employment comes directly and indirectly from the export sector. The success of the export and related high value-added sectors depends on research and development in knowledge-based companies, on close two-way links with the technical university and research systems, and on the system of vocational training at all levels, including increasingly the tertiary. Equally, the success of these systems depends on the capacity of the export sector to meet long-term profitability goals, especially as the cost of product and process innovation increases. This is a powerful and central positive feedback system in which the successful and growing knowledge base and accumulated skill formation are core drivers of exports, and where success in export growth is critical---via the resources it provides for advanced companies to make the necessary investments in the relevant systems---for high levels of research and skill formation.

Two factors underpin this positive feedback system. The first factor is a sufficient degree of real wage restraint in the export sector. Export-sector wage restraint is difficult given the power of highly skilled workforces, as well as (necessarily) profitable companies. CME governments have generally been committed to the feedback system and thus to export-sector wage restraint, and they have accomplished this in part by commitment to a tight monetary policy in which excessive wage increases are “punished” by increased interest rates and currency appreciation---or at least by firm commitment to ruling out the possibility of depreciation by fixing exchange rates. A common currency has consequently been seen as an attractive way to make such a commitment. In part, governments have also sought to underpin wage restraint by institutionally and financially supporting an extensive training system that keeps the supply of skilled workers high.

The second factor is the strict control of fiscal policy. Public sector deficits in modern macroeconomics translate in medium-term equilibrium into a *pari passu* reduction in the external balance, hence in exports. In addition, wage restraint in the export sector depends on real wage restraint in the public sector, including utilities. One political given in the northern CMEs is that employment in the public sector is highly protected. Real wage restraint in the public sector is inherently fragile because there is little danger of job loss, and wage increases imply an appreciated currency or at any rate no devaluation---a win-win situation for public sector employees. The consequence is a strong commitment by governments to tight rule-based fiscal policy as well as minimizing public sector deficits. Thus, export-oriented CMEs, with powerful companies, unions, and highly skilled workforces in the high value-added sectors of the economy as well as powerful unions in the public sector, depend on the rule-based discipline of tight monetary and fiscal policy.

The CME preference for currency unions stems from hostility to devaluation. CMEs (governments, business associations, unions) neither want the ability to devalue themselves nor for competitors to be able to do so. If CME exporters know their government is prepared to devalue it reduces their incentive to increase competitiveness through R&D and/or skill upgrading, as well as weakening the ability of unions to gain the cooperation of union members in imposing wage restraint to enhance competitiveness. And if competitors can devalue they can wipe out instantaneously any gain in competitiveness secured by CME exporters through R&D, skill upgrading or wage restraint. This explains not only the initial concern of CMEs to move to a deutsche mark (D-Mark) bloc after the inflationary chaos of the 1970s (and with the fear of the competitive devaluations of the 1930s), but also explains the strong northern CME preference to include France, Italy, and the peripheral EU members in the Eurozone. For as we discuss below, the latter are missing many of the institutions that support wage restraint, and are consequently prone to use devaluations as an alternative policy tool to counter real exchange rate appreciations when not tied into a currency union.

The export-driven CMEs are also concerned about the external value of the euro, and this explains their “deflationary” attitude across the Eurozone and not just in the CMEs themselves. Again from modern macroeconomics, holding

private Eurozone aggregate demand constant, increased public sector deficits translate in the medium term into a real appreciation of the euro and a reduction in the Eurozone's external surplus.

The Other Member States

The other Eurozone member states cannot be analyzed so uniformly. They include the peripheral economies and also France and Italy. Their motivations for entering the currency unions differ very substantially from those of the northern European CMEs. Each wanted, first, to pin itself to a low inflation currency area; and second, from that, to access low real interest rates (a pursuit that had previously been hampered by devaluation fears). Low real interest rates were seen by the southern economies as drivers of demand and keys to attracting investment. In common with the CMEs, these states (excluding Ireland) had high collective-bargaining coverage, but there was little capacity for wage restraint because of union fragmentation and division between socialist and communist unions ([Manow 2015](#)). High coverage did, however, facilitate fragile “social pacts” that secured the support of unions for fiscal restraint and restrictive monetary policies to meet the Maastricht entry conditions ([Hancké 2013](#)), including public sector cutbacks. Once these states were securely inside the Eurozone, the lack of wage restraint re-emerged ([Johnston et al. 2014](#)), with the partial exception of the export sector because of the inability to devalue to restore competitiveness after exchange rates were irrevocably fixed ([Hopkin 2015](#)).

Thus, both the export-oriented economies of the north and the “demand-driven” economies of the south had interests in a common currency area. For the export-oriented economies, a common currency ruled out competitive devaluations from the demand-driven economies, and especially from France, Italy, and Spain, while increasing their demand for northern products. And for the demand-driven economies, a common currency offered low and stable inflation as well as, critically, low real interest rates and inward investment. But a major issue for the export-oriented economies was whether there was sufficient fiscal discipline in the southern economies. Without fiscal discipline, the concern was that countries would run high deficits and allow too high a ratio of debt to gross domestic product (GDP) to build up, with the possibility of default and

even exit from the currency. Moreover, if fiscal discipline in the currency union as a whole was undermined, it threatened both public sector wage inflation and tight labor markets, and hence inflation in the sheltered sectors.

Financial Markets

The political-institutional conditions described above for the northern CMEs and the other Eurozone members can be thought of as relatively long-term persistent elements in a currency union, and they gave rise to concerns about discipline. But another element partially solved this problem, namely, the move in the late 1980s and early 1990s to financial market flexibility in the European Union (as set out by the Committee for the Study of Economic and Monetary Union, also called the Delors Committee after its chair Jacques Delors, in [1989](#)). This can be seen as part of the wider move to globalization and openness in the advanced world, which in turn was part of the information and communications technology (ICT) revolution. The significance of financial market flexibility for the potential development of the Eurozone is easily underestimated. First, it meant that sovereign borrowing by the southern economies would operate within the framework of implicit fiscal sustainability rules⁴, which would help reinforce the Stability and Growth Pact (SGP) rules on deficits and debt (discussed below in “The CPE Explanation for the Creation of the Euro”). Thus, open financial markets offered a powerful guarantee to the northern member states that the southern economies would need to respect fiscal discipline in terms of deficits and public sector debt to avoid being penalized by financial markets. Second, as far as the southern economies were concerned, financial market flexibility meant that external borrowing was greatly facilitated, both directly and because their commercial banks could now borrow externally (including from northern banks). Third, managed floating, as in the D-Mark bloc, was now much harder because of speculation, imposing a choice between flexible exchange rates and a common currency ([Eichengreen 1992](#)).

ICT: information and communications technology

⁴ The fiscal sustainability condition says that for the government debt to GDP ratio to be stable the existing government debt to GDP ratio must not exceed the primary government surplus to GDP ratio divided by the excess of the real interest rate over the GDP growth rate. For a detailed discussion of government debt dynamics, see Carlin and Soskice (2015, ch. 14).

Having established the CPE perspective on the Eurozone, we set out the three main points of the review: the differences in economic institutions and interests, the paradox of relative success, and the resilience of national institutions.

DIFFERENCES IN ECONOMIC INSTITUTIONS AND INTERESTS, AND THE

DEFLATIONARY BIAS. It is essential to understand the motivations for Eurozone membership and the relations between the member states. The Eurozone is a collection of independent, democratic nation-states, which can de facto and in principle leave the currency. Their governments are concerned primarily about electability, so the idea of redistribution to fellow member states in difficulty is seldom on the table. The origins of the euro were largely driven by national economic interests, not by federal political interests, and these remain the drivers of the currency union. The CME members are export-oriented and as a consequence are only prepared to accept a union with nonaccommodating monetary and fiscal policy. Their opposition to Keynesian discretionary demand management is a rational preference from their perspective; subject to that, their benefit from the union is that the peripheral economies, as well as France and Italy, are unable to use nominal devaluation. On their side, the demand-oriented non-CME members benefit from being “anchored” into a low-inflation and low-interest-rate union; “reform” constituencies within the peripheral economies benefit internally from externally imposed discipline on public sector deficits; and the European Central Bank’s (ECB’s) guarantee of low interest rates through Outright Monetary Transactions in exchange for fiscal stability solves the multiple equilibria problem posed by financial markets (as explained below in “The Eurocrisis and Institutions”).

ECB: European Central Bank

There is an asymmetry in preferences. The CMEs are in a minority, but they would prefer to leave the Eurozone rather than accept a union without strong monetary and fiscal discipline. And it has become clear that (so far) the other members are deeply opposed to leaving the currency even under the heavy weight of externally imposed austerity; in part this is doubtless because of real income losses as a result of the consequent devaluation. Thus, the CMEs, particularly Germany, have been able to maintain rule-based and disciplined macroeconomic management despite the arguable opposition of the other members, notably France and Italy.

PARADOX OF RELATIVE SUCCESS. The political-economic institutions of the Eurozone fulfill virtually none of the institutional conditions that are widely accepted as necessary for an **OCA**, and that are for many exemplified by the United States (as discussed in the next section of the review). Most notably, labor markets are far from flexible, with widespread collective bargaining, employment protection, and limited labor mobility in the northern CMEs as well as in the other initial members,. Not only was this true at the inception of the euro, it has remained the case.

Many contemporary commentators see the Eurozone as a failed experiment and explain the failure through the absence of the relevant OCA institutions. Yet on its tenth anniversary in 2008 the success of the Eurozone was widely celebrated---with little mention of absent OCA institutional conditions. We argue that a relatively successful “dual growth model” operated during the decade before the financial crisis, and that its success was not held back by the absence of the OCA conditions. In the dual growth model, the peripheral states (apart from Portugal) were able to grow rapidly because of access to low real interest rates (the low real interest rates under the euro were further lowered by expected inflation in the south exceeding that in the north) as well as CME savings generated by CME external balances; and because of low real exchange rates underwritten by the Eurozone promoting export-led CME growth. Although the difficulties of wage coordination in the south certainly contributed to north--south imbalances, large global imbalances were also produced between the United States and the major exporters with their own currencies.

RESILIENCE OF NATIONAL INSTITUTIONS. The third major proposition of the review is that even though labor markets and other institutions across the advanced world have become somewhat more flexible because of the globalization and openness that have come with the ICT revolution, their basic forms have not changed greatly in the Eurozone. There has been quite limited Eurozone-initiated change in the CMEs---where institutions are most organized. We suggest this reflects national economic interests.

The next section of the review explains the economic origins of the euro and contrasts the economic institutions of the member states with OCA institutional desiderata. In the third section, the success of the euro’s first decade is related to member state institutions in the north and south. The fourth section documents

the limits to institutional change in the first decade. The fifth discusses the role of institutions in the Eurocrisis years, and the sixth briefly concludes.

THE CPE EXPLANATION FOR THE CREATION OF THE EURO

Three decades before European leaders decided to create the euro, economists [Mundell \(1961\)](#), [McKinnon \(1963\)](#), and [Kenen \(1969\)](#) pioneered the theory of **OCA**s, which elucidated three key conditions for an effective monetary union between countries (see [De Grauwe 2013](#) for a more thorough discussion of the OCA conditions).

The first condition is that member states are not subject to divergent economic trends that may be hard to adjust to without national monetary policy autonomy and flexible exchange rates. The second is that labor and goods markets are flexible and workers are mobile between countries. The final condition is that the monetary union has a sizeable tax and transfer system at the central level. The second and third conditions are to ensure that member states are able to stabilize their economies against country-specific shocks in a timely manner.

None of these conditions applied in Western Europe in the late 1980s or early 1990s. A large empirical literature found that, outside a core of northern European economies, output fluctuations were not closely coordinated, and that Europe lacked the labor market flexibility and mobility of other monetary unions such as the United States and Canada (e.g., [Eichengreen 1991](#), [Bayoumi & Eichengreen 1997](#); see [De Grauwe 2012](#) for a review). The budget of the European Economic Community (the predecessor to the European Union) was also far too small to provide any real stabilization. Even now, the EU budget stands at only ~1% of EU GDP. Again, the contrast with the United States is stark; the US federal tax and transfer system provides 10--20% stabilization in the face of state-specific aggregate demand shocks ([Melitz & Zumer 2002](#)).

This was the institutional landscape in 1992 at the time of the signing of the Maastricht Treaty (on the treaty's origins, see [Dyson & Featherstone 1999](#)). And the treaty, which set out the conditions that a member state needed to fulfill in order to qualify for Eurozone membership in 1999, makes virtually no reference

to required future institutional development.⁵ The Maastricht conditions (with minor qualifications) for a candidate country were as follows:

1. The country's inflation rate had to be below the average of the inflation rates of the three countries with the lowest inflation rates plus 1.5%.
2. The country's exchange rate had to have remained within the Exchange Rate Mechanism (ERM) for the last two years before entry.
3. The public sector deficit could not have exceeded 3% of GDP for the last three years before entry.
4. The public sector debt must not exceed 60% of GDP.
5. The interest rate on 10-year sovereign bonds must not exceed the average of the corresponding rates of the three countries with the lowest inflation rates plus 2%.

The one major institutional change that accompanied euro adoption and the ceding of monetary authority to the **ECB** was the signing of a formal fiscal agreement between member states. The Stability and Growth Pact (SGP) of 1997 defined the procedures for member states to follow in relation to fiscal deficits and debt once the Eurozone had come into existence. The basic rules were the same as the Maastricht entrance criteria: public deficits should remain under 3% and public debt under 60%. The SGP set up both a surveillance, or "persuasive", system requiring monitoring of deficit and debt developments (by a body representing both the European Commission and the Council of Ministers), and a punishment, or "dissuasive", system in the event of persistent breaches ([Calmfors 2012](#)). It is worth pointing out that the SGP imposed no penalties on member states that ran public sector surpluses. It also included no formal requirements for fiscal policy coordination across member states and took no steps toward establishing a centralized Eurozone fiscal authority.

There was thus a striking discrepancy between widely accepted views of the institutional desiderata of a common currency area (and indeed how the common currency system operated in the United States) and the Eurozone, which was a grouping of independent sovereign states with differentiated institutional systems

⁵ The full text of the Treaty of Maastricht on European Union is available at http://europa.eu/eu-law/decision-making/treaties/pdf/treaty_on_european_union/treaty_on_european_union_en.pdf

where the only substantive rules were those embodied in the SGP on fiscal deficits and debt. Clearly, the reason for setting up a monetary union was not that Europe approximated the features of an OCA. In this section we seek to account for the rise of the euro, and OCA theory is of relatively little help. [Our explanation does not completely follow Dyson & Featherstone's magisterial and seminal study, *The Road to Maastricht* (1999), but the reader is referred to it for a full account.]

A commonly held narrative is that Germany and France decided to set up a monetary union for overriding geopolitical reasons and therefore paid little attention to institutions or the economics of a monetary union (De Grauwe 2013). The narrative emphasizes France's desire to wrest back some control over its monetary affairs from Germany and to tie a reunified Germany into Western Europe (Marsh 2011). It traces Germany's involvement to Chancellor Helmut Kohl's wish to take steps toward the political unification he saw as necessary to guarantee long-term peace on the continent (Szász 1999).

Although geopolitical considerations are likely to have played a part in the creation of the euro, the CPE perspective instead emphasizes the clear political-economic benefits governments foresaw from joining the monetary union. This is in line with the view of the leading scholar of European integration (Moravcsik 2012, p. 55):

Germany's main motivation for a single currency, contrary to popular belief, was neither to aid its reunification nor to realize an idealistic federalist scheme for European political union. It was rather to promote its own economic welfare through open markets, a competitive exchange rate, and anti-inflationary monetary policy.

The seeds for a monetary union had been sown long before German reunification was on the agenda. In the 1970s and into the 1980s, governments of CMEs were concerned to avoid competitive devaluations and the nominal exchange rate instability that had marked or threatened the break-up of Bretton Woods in the inflationary context of OPEC (Organization of the Petroleum Exporting Countries) price increases and the strike waves of the late 1960s. This was a period of rapid growth of intraindustry trade in Western Europe, and externally imposed price instability was seen as problematic to trade. Perhaps most important, all the CME economies had powerful union movements in these

decades, and devaluation removed the effectiveness of monetary policy in disciplining inflation. Signing up for mutual quasi-fixed exchange rate systems, limiting the temptation of devaluation, thus went in line with a move to nonaccommodating monetary policy; and, as this environment developed, wage coordination within the CMEs underwrote the effectiveness of monetary policy.

Central to all this was the role of the Bundesbank (the German central bank). With the collapse of Bretton Woods, the Bundesbank pursued a low-inflation policy, disciplining the export sector in the event of rising inflation with increased interest rates and exchange rate appreciation ([Flanagan et al. 1983](#), [Hall & Franzese 1998](#), [Iversen 1999](#), [Soskice & Iversen 2000](#), [Soskice 2007](#)). As this system evolved somewhat experimentally over time, the export-sector unions in the other northern European CMEs increasingly tied their own unit labor cost inflation to that in West Germany ([Soskice & Iversen 1998](#)).⁶ What supported this, from a political-economic perspective, was the belief that CME central banks would not restore competitiveness through devaluation.

At the same time, certain countries with weakly disciplined wage determination systems and fiscal control, which relied on inflationary demand-led growth, saw the benefits of tying themselves to a reconfigured, low-inflation, fixed exchange rate system that allowed limited realignments. These countries included France, Ireland, Italy, and later Greece, Portugal and Spain. For these economies, the benefits of low inflation were seen as lower interest rates and increased investment, as well as *vincolo esterno* (external constraints) to impose domestic fiscal discipline and tighten monetary policy. CMEs benefited because this dramatically reduced the use of southern devaluations to undercut their exports.

These related institutional developments took time. Specifically, after the collapse of Bretton Woods in 1971, the EU (then the European Economic Community) member states set up the Snake mechanism in 1972, whereby each member agreed not to move its currency by more than 2.25% against the US dollar. But the Snake proved difficult to maintain, especially after the dollar

⁶ The Scandinavian CMEs stood apart from this system because of overarching collective bargaining until the 1990s that removed the need for nonaccommodating monetary policy. When overarching collective bargaining gave way to German-type coordinated bargaining in the 1990s, the Swedish and Danish system moved to nonaccommodating monetary policy and they debated joining the Eurozone ([Iversen 1999](#)).

floated in 1973, followed by OPEC price increases in the mid-1970s. By 1977, with a number of departures, the Snake had become de facto a D-Mark zone with Germany, the Benelux countries, and Denmark (which only firmly instituted the policy after 1982). In 1979, the European Monetary System (EMS) was created, with a defined unit of account, the European Currency Unit, against which currencies could fluctuate in a narrow (2.25%) or wide (6%) band. This was the initial form of the Exchange Rate Mechanism (ERM), with the northern European CMEs and France in the narrow band and Italy, Spain, and Portugal in the broad band (Spain and Portugal having joined in 1987 and 1991, respectively, and the United Kingdom joining for just two years from 1990).

From the start, there was a clear distinction between export-oriented CMEs, which all realigned up in the ERM several times, and the inflation-prone members, France, Italy, Ireland, Portugal, and Spain, which realigned down on two or more occasions.⁷ Germany was the leading “appreciator”, imposing low inflation on the system.

As we see it, the “exogenous” change that pushed the ERM system toward a single currency was the move to capital mobility and the removal of capital controls on financial markets in the EMS area at the end of the 1980s and the early 1990s, as proposed by the (Delors) Committee for the Study of Economic and Monetary Union. We see it as exogenous to the EMS/ERM in the sense that it was taking place throughout the advanced world, notably in the United Kingdom and the United States. It was a response to the increase in sophistication and complexity of markets that had been taking place with the gradual collapse of the standardized world of Fordism as a result of the ICT revolution, and it was part of the movement toward opening markets that accompanied the Single European Act of 1986.

First, flexible financial markets made periodic realignments within the EMS/ERM narrow-target-zone system very difficult as a result of speculation (Eichengreen 1992). Second, if there was a common currency, flexible financial markets could penalize sovereign bonds when the fiscal stability rules were not met and when there appeared the possibility of default. Thus, flexible financial

⁷ The only CME realignments down were Belgium in 1982 and Denmark, which had several realignments down between 1979 and 1982 before it firmly instituted the D-Mark policy in 1982.

markets gave a serious guarantee against fiscal laxness. Capital mobility therefore represented for the CMEs, especially for Germany, a critical surety for the fiscal rectitude of the demand-driven and more inflationary economies.

In our perspective, then, a CPE approach sheds considerable light on the origins of the Eurozone. This is not to say that politics plays no part. Negotiations between France and Germany certainly took place, and the shaping of the ECB around the Bundesbank's tenets of price stability and independence was undoubtedly the price France had to pay to convince the skeptical German public and Bundesbank to abandon their cherished D-Mark ([Szász 1999](#), [Marsh 2011](#)). But the argument that monetary integration would lead to a federal Europe, though ever-present and dating back to the Werner report in 1970, has not been embodied in any of the actual agreements: the Snake, EMS/ERM and the D-Mark bloc, Maastricht itself, or the establishment of the Eurozone and subsequent developments since the Eurocrisis.

The CPE approach sees the underlying logic in terms of economic incentives. The French government believed joining the Eurozone was a long-term guarantee of low inflation, and the German government believed the elimination of the use of devaluation by France and Italy was a major benefit for German exporters. Both sides had long been aware of these benefits. Critically, Germany and the northern CMEs were only prepared for a Eurozone with monetary and fiscal discipline, rejecting French demands for *gouvernance économique* (economic governance). The CMEs saw monetary and fiscal discipline as necessary for the organized systems of industrial relations and wage setting that underpinned their export-led growth model.

Moreover, the approach here makes clear why the CMEs were not concerned with the OCA conditions of flexible labor markets. At least as far as permanent workforces were concerned, they would have been inimical to export-oriented institutions.

A SUCCESSFUL FIRST DECADE: THE DUAL GROWTH MODEL AND ITS INSTITUTIONAL SUPPORTS

After its first decade the euro was declared a “resounding success” ([European Commission 2008](#), p. 3), and this appears justified. Against a target of 2%,

average Eurozone inflation between 1999 and 2008 was 2.2% (IMF 2015). The first decade also saw greater integration in trade, foreign direct investment (FDI), and banking across the Eurozone. Intra-Eurozone trade in goods increased from 26% of GDP in 1998 to 33% of GDP in 2008, and intra-Eurozone FDI as a share of total Eurozone FDI increased from 35% to 45% between 1999 and 2006 ([European Central Bank 2008](#), pp. 89--93). Eurozone banks' holdings of debt securities issued by the banks of other Eurozone countries and cross-border interbank loans between Eurozone banks both also rose dramatically ([Lane 2008](#)). Even given the effects of the single market in Europe and of the wider globalization, the empirical evidence suggests that the euro made a substantial contribution to integration in all these areas ([Bun & Klaassen 2002, 2007](#); [Barr et al. 2003](#); [Micco et al. 2003](#); [Baldwin 2006](#); [Blank & Buch 2007](#); [Petroulas 2007](#); [Baldwin et al. 2008](#); [Coourdacier & Martin 2009](#); [De Sousa & Lochard 2011](#)).

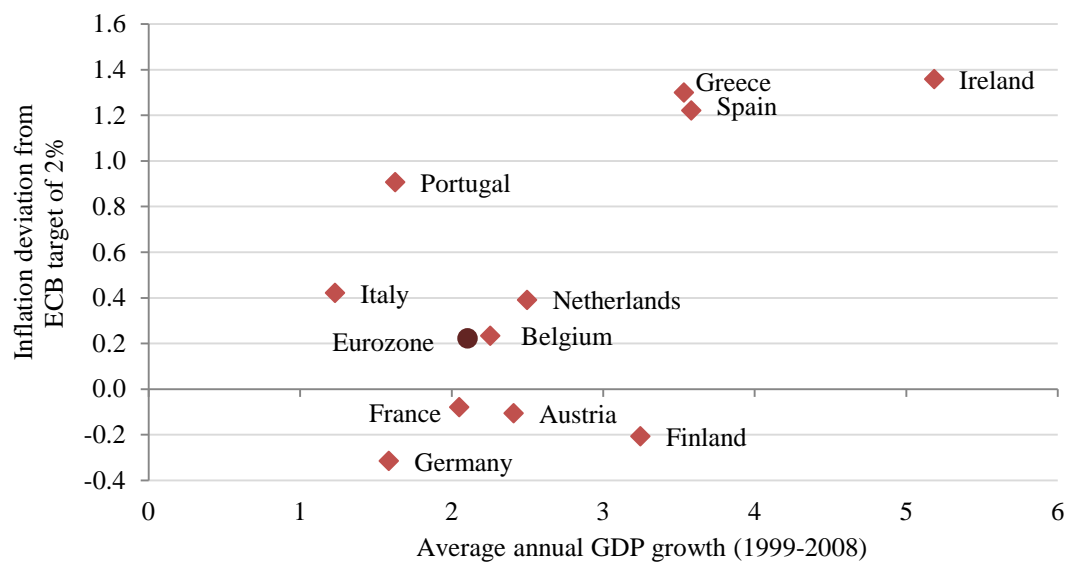
The euro also played an important role in supporting the distinct growth strategies of the northern and southern member states. A dual growth model developed, with demand-led growth in the south and export-led growth in the north ([Hall 2012, 2014](#); [Iversen & Soskice 2013](#)). The growth strategies were complementary; the north and its institutions directly benefited from the south and its different institutions over this period and vice versa.

The export-led **CMEs** of northern Europe had long possessed coordinated wage-setting institutions capable of restraining nominal wage growth and maintaining external competitiveness. The introduction of the euro entrenched this advantage by preventing their export competitors in the south from periodically devaluing to restore competitiveness. For example, in the 2000s German unions committed to several years of restrictive wage increases, and work councils representing workers in large German companies agreed to more flexible wages and working hours in exchange for increased employment security and continuing management investment in capital equipment and worker training ([Carlin & Soskice 2009](#), [Dustmann et al. 2014](#)). These policies contributed to the depreciation of the German real exchange rate; German competitiveness improved by 13% compared to the Eurozone average between 1999 and 2008 (European Commission 2015a), and German exports expanded from 27% of GDP to 44% of GDP between 1999 and 2008, far outstripping the growth of the export sector in the Eurozone as a whole (OECD 2015a).

A major reason the southern European economies joined the euro was to benefit from lower borrowing costs. They were not disappointed; interest rates in the southern European economies fell dramatically because of the euro and were close to German levels by the mid-2000s (OECD 2015b). The single currency also removed currency risk on financial transactions between Eurozone banks, increasing the willingness of northern banks to lend to southern banks. This resulted in a massive inflow of foreign credit into the peripheral economies in particular. In Ireland, Greece, and Spain, domestic demand grew rapidly, financed directly and indirectly by foreign borrowing. Nontradable sectors, such as real estate, construction, retail, and the public sector, expanded rapidly (Hall 2012, Fernández-Villaverde et al. 2013).

Figure 1 shows that the Eurozone achieved reasonable growth rates and had inflation close to target during its first decade. But this coincided with striking divergence between member states, and in particular between the northern and southern member states. Inflation was persistently above target in the southern economies compared to the north. Greece, Spain, and Ireland greatly outpaced the more modest growth seen elsewhere in the monetary union. France and Italy stand apart from the other southern economies in that they had inflation close to the Eurozone average and avoided excessive credit expansion. They are loosely grouped with the southern economies, however, because they are demand led. In addition, both France and Italy lost competitiveness against Germany during the first decade of the euro, and Italy later became embroiled in the sovereign debt crisis (see “The Eurocrisis and Institutions” below).

Figure 1. Average gross domestic product growth and inflation in the Eurozone member states for the period 1999--2008. The dark red circle shows the average growth and inflation for the Eurozone as a whole over the period.



Source: IMF 2015

A key driver of the inflation differential between the north and the south was the behavior of wages in the sheltered sector, especially the public sector (Johnston et al. 2014, Johnston & Regan 2014). In the northern European economies, coordinated bargaining tied sheltered sector wage growth to the restrained wage growth in the export sector. In southern Europe (excluding Ireland), high collective-bargaining coverage facilitated fragile social pacts that were able to hold down sheltered sector wages during the 1990s to meet the Maastricht inflation condition and secure euro entry. However, the southern economies possess little capacity for medium-term wage restraint because of union fragmentation and division between socialist and communist unions (Manow 2015). Once these economies were in the Eurozone, the mechanisms tying wages in the sheltered and export sectors therefore broke down, and public sector unions (and other sheltered sector workers) were able to secure inflationary wage settlements (Hancké & Rhodes 2005, Hancké 2013). This divergence was magnified by tight public sector spending policies in the north, underwritten by disciplined political parties, whereas in the south weak parties allowed greater influence to public sector unions and other “insider” groups in the formal sector (Featherstone 2011).

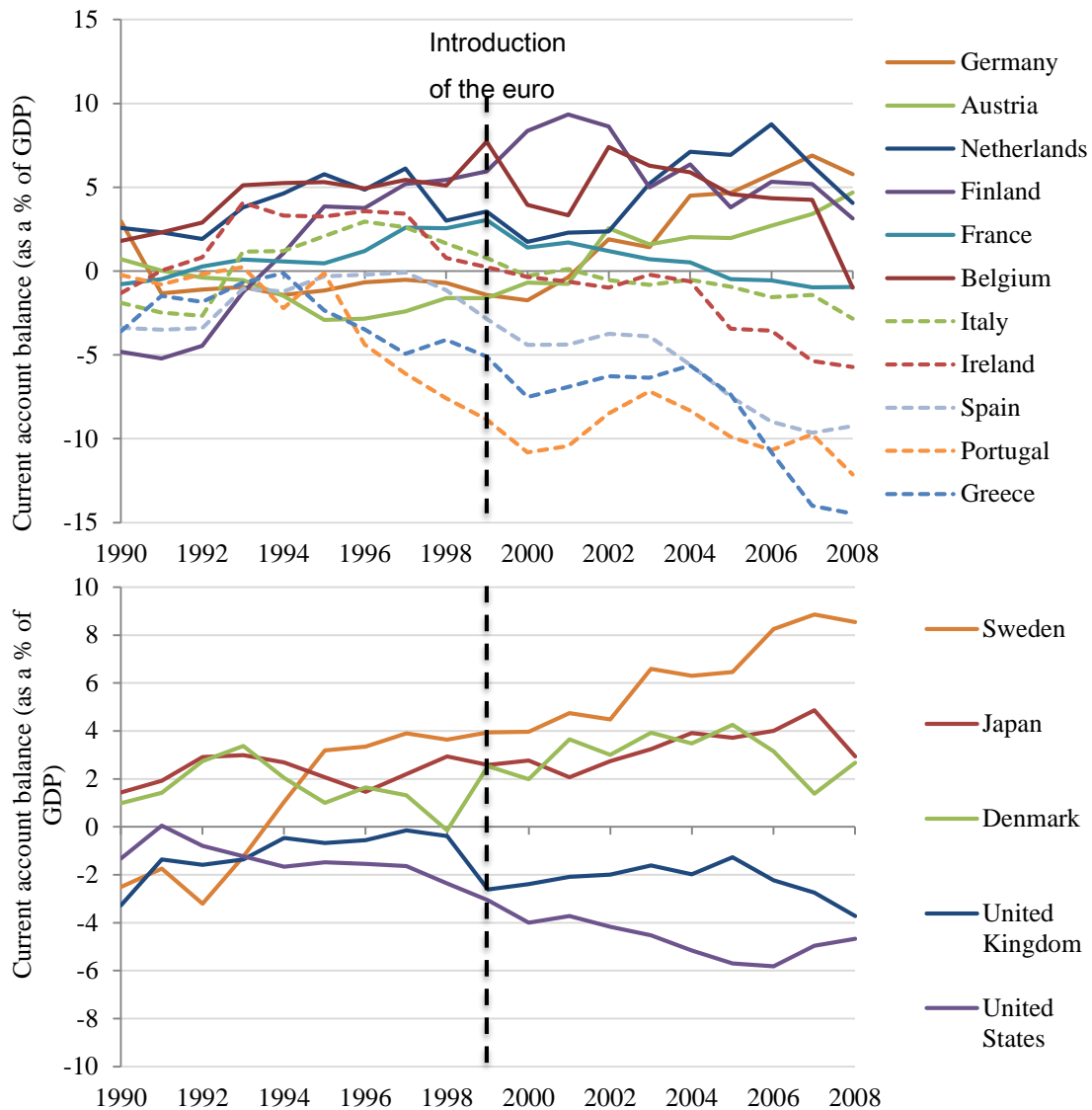
As a result of differences in inflation between north and south within the common currency, two automatic economic mechanisms come into play. First, lower inflation in the north than in the south reduces the north's real exchange rate against the south. This real exchange rate mechanism explains why the north gained relative competitiveness against the south over this period. For example, Spain lost 14% competitiveness against the rest of the Eurozone between 1999 and 2008, whereas Finland's competitiveness improved by 22% (European Commission 2015a). Second, high inflation in the south lowers the real interest of the south against the north (the so-called Fisher equation states that real interest rates are equal to nominal interest rates minus expected inflation). Due to this real interest rate mechanism, short-term interest rates were actually negative on average in Greece, Ireland, Portugal, and Spain between 2001 and 2007 (European Commission 2015b).

These mechanisms reinforced the dual growth model. The wage restraint and competitiveness-inducing institutions of the CMEs, underpinned by tight fiscal policies, generated low inflation, and the northern real exchange rate fell against that of the south; this underwrote an export-oriented growth strategy and a corresponding external balance within the Eurozone (as well as more widely against the rest of the world). The higher inflation in the south, encouraged by less-restrained wage bargaining in tight labor markets in the sheltered, formal sectors and especially in the public sector, produced very low real interest rates and hence high rates of investment. This was reinforced by investment from the north. The sizeable external surpluses amassed in the north gave the northern banks scope to increase lending to the south, both to individuals and companies and to southern banks. The flow of capital from north to south increased the growth rate in the south and put upward pressure on southern inflation, which further reduced the real interest rate in the south, and so on. The faster growth rate in the south boosted northern exports. The competitiveness advantage of the north was reinforced further by the real depreciation associated with higher relative inflation in the south. (For a more detailed explanation of the economics behind these channels, see [Carlin & Soskice 2015, ch. 12.](#))

Figure 2a shows the macroeconomic consequences of the north and south following different growth strategies under the euro in terms of the buildup of external imbalances. A distinct geographical pattern emerged in current account

balances during the period 1990--2008. The north amassed substantial surpluses while the south amassed substantial deficits. The distinction between export- and demand-driven economies also became markedly more pronounced over this period. In 1999, Greece, Italy, Portugal and Spain exported 25% of their combined GDP, whereas the figure for the five northern European countries was 49%, implying a gap of 24% (Ireland and France are not counted in either category). In 2008, the export share had only slightly increased for the four southern economies (28%) but had ballooned for the north (63%), increasing the gap to 35% (OECD 2015a).

Figure 2. Current account balances as a percentage of gross domestic product during 1990--2008, (a) in the Eurozone and (b) in selected noneuro countries. Balances are defined as exports minus imports plus net interest and profit receipts from abroad.



Source: IMF 2015

A country in external deficit is a net borrower from the rest of the world. In the Eurozone's opening decade, the southern economies were primarily borrowing from the northern economies, which reinvested part of their large trade surpluses (the excess of exports over imports) into the fast-growing southern economies ([Hall 2012](#)). Without devaluation risk, the only barrier to such investment was default risk, but this was thought to be minimal given healthy growth and perceived fiscal discipline under the Maastricht rules.

The accumulation of current account imbalances might be thought of as a problem of the Eurozone model. But imbalances were not unique to the Eurozone; they were mirrored across other major advanced economies during the euro's first decade ([Figure 2b](#)). The fact that comparable imbalances emerged outside the Eurozone means that global economic forces, such as financial liberalization and globalization, are likely to have been partly responsible for the Eurozone accumulating external imbalances. Indeed, the United States and United Kingdom experienced credit-fueled housing and consumption booms similar to those of Ireland and Spain during the 2000s. Although imbalances in the Eurozone were most likely exacerbated by euro-induced terms of trade shifts that benefited the north, and by the euro's part in reducing borrowing costs in south, the pursuit of growth strategies that led to external imbalances was a common feature of the global economy in the 2000s ([Iversen & Soskice 2012](#), [Baccaro & Pontusson forthcoming](#)). In the Eurozone, as in other advanced economies, external imbalances were of little concern to policy makers during this period as the dominant macroeconomic regime of inflation targeting focused almost exclusively on price stability ([Iversen & Soskice 2013](#)).

Put slightly differently, demand-driven economies in the 1990s and 2000s that could access financial markets with credible inflation-targeting independent central banks were likely to end up as global borrowers, just like the United Kingdom and United States. The Eurozone put the peripheral economies in a functionally equivalent position; in that sense, membership enabled global borrowing.

INSTITUTIONAL CHANGE DURING THE DUAL GROWTH PERIOD

In the pre-euro period, many economists and policy makers expected that the competitive pressure of the euro and the single market would force institutional change on member states, specifically a convergence on competitive or liberal institutions ([Hall 2001](#)). This did not happen. The limited national institutional adaptation that took place during the first decade of the euro sought to strengthen rather than undermine existing growth strategies and was more in response to wider global trends than to euro adoption.

The world economy was evolving rapidly in the 1990s and 2000s, driven by a number of secular developments such as globalization, market competition, and financial liberalization, which in turn were driven directly and indirectly by the **ICT** revolution combined with the rise of emerging economies (particularly in low- and middle-tech manufacturing). These broad global trends forced advanced economies, including but not limited to the Eurozone countries, to adapt their institutions in order to find a viable path to growth in a highly competitive international marketplace.

Table 1 shows how labor and product market institutions changed between 1998 (the year before the euro was introduced) and 2008 (its tenth anniversary). In column 1, we show employment protection legislation for temporary contracts, which indicates the level of difficulty employers encounter when trying to employ workers on flexible, fixed-term contracts. There has been a general trend toward less regulation, particularly in southern Europe, where regulation was strictest in the late 1990s. The change over this period provides a snapshot of a longer-term process that began in the 1980s, in which regulation of temporary and part-time workers in Continental Europe and Scandinavia converged toward the low levels seen in liberal market economies such as the United Kingdom and United States ([Iversen & Soskice 2015](#)).

[INSERT TABLE 1 here]

The same pattern was not observed in employment protection legislation for permanent workers, which remained high in CMEs to encourage acquisition of the firm-specific skills necessary to pursue an export-led growth model. These changes in employment protection have contributed to the dualization of labor markets in much of the advanced world, dividing the labor force into “insiders”,

who enjoy secure employment, and “outsiders”, who do not ([Rueda 2005](#), [Emmenegger et al. 2012](#)). The deregulation of the low end of the labor market extends beyond the Eurozone. It is a “structural trend that affects all advanced postindustrial economies” ([Häusermann & Schwander 2012, p. 30](#)).

The second and third columns of [Table 1](#) show union density and coverage. Column 2 shows the proportion of the workforce that are union members and column 3 shows the proportion of the workforce that are covered by collective wage-bargaining agreements. In nearly all advanced economies, union membership is in structural decline, largely reflecting the shift from Fordism to service-based knowledge economies ([Iversen & Soskice 2015](#)). But the coverage of union wage agreements has not fallen in line with membership. In fact, bargaining coverage remains very high in much of Continental Europe and Scandinavia. Wage coordination is essential to an export-led growth strategy, so it has remained a prominent feature of these economies, even as union membership has fallen and firms have acquired more power over wage setting.

The last column of [Table 1](#) shows that product market regulation, such as barriers to entrepreneurship and international trade, fell across all advanced economies during the 2000s (see also [Conway et al. 2005](#)). Regulation was reduced by a greater amount in the Eurozone than elsewhere, but it also started at a higher level. Again, the trend toward deregulation was wider than the Eurozone and was driven by governments seeing a need for firms to compete in a highly globalized marketplace, in part to promote innovation and growth and in part to accommodate the desire of voters (as consumers) to have access to a wide range of goods produced in foreign markets.

The [CPE](#) literature finds long-term structural trends at the heart of institutional change in the Eurozone, and more generally across advanced economies. It is still possible that the euro accelerated the ongoing process of reform in labor and product markets, but the empirical literature gives no clear answer to this question ([Duval & Elmeskov 2005](#); [Alesina et al. 2010](#)). In fact, [Fernández-Villaverde et al. \(2013\)](#) argue that the introduction of the euro retarded reform in southern Europe because the easing of credit conditions loosened governments’ budget constraints and made politicians less accountable to voters. What is clear is that it did not lead to any kind of institutional

convergence between the north and south, let alone wholesale deregulation as envisioned by **OCA** theory.

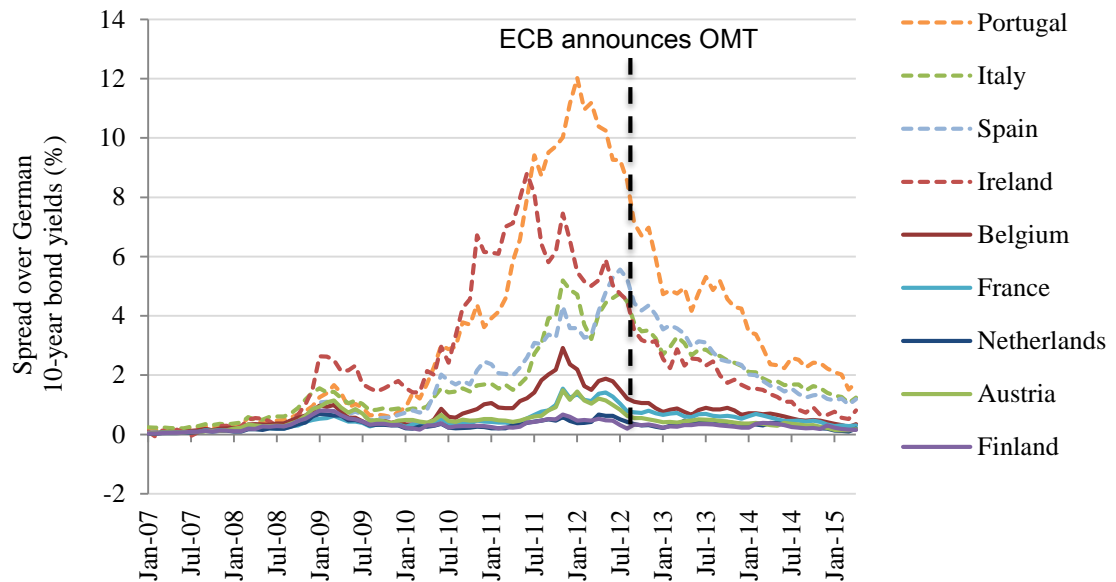
Fiscal policy also saw no movement toward the institutional setup that OCA theory would recommend. Tax-and-spend powers remained firmly in the hands of national governments. The EU budget stayed far too small to provide any stabilization against asymmetric shocks, and the Eurozone member states did not move toward a more federalized system with a sizeable centralized budget.

THE EUROCRISIS AND INSTITUTIONS

The global financial crisis, which originated in the US subprime mortgage market, had economic repercussions around the world. The Eurozone economies were no exception; the Eurozone economy as a whole contracted by 4.5% in 2009 (OECD 2015c). The crisis adversely affected the growth strategies of both the northern and southern economies. The export-led north suffered from the contraction in global trade and the demand-led south from the sudden stop of foreign capital. The downturn in the Eurozone was of a similar magnitude to that across the advanced economies; the OECD economies as a whole contracted by 3.4% in 2009 (OECD 2015c).

The recession caused by the global financial crisis escalated into a full-blown sovereign debt crisis (the Eurocrisis) in southern Europe in 2010 and 2011. As a result of the Eurocrisis, Greece, Portugal, Ireland, and Spain all received financial assistance (i.e., bailouts) from the Troika---the European Commission, the **ECB**, and the International Monetary Fund ([Hall 2014](#)). Italy avoided a bailout, but its bond yields also came under pressure (see [Figure 4](#)), whereas France escaped relatively unscathed.

Figure 4. The difference between long-term government borrowing costs in the other Eurozone member states and Germany for the period January 2007—April 2015. Greece is purposefully excluded. The evolution of Greece bond yields is just an exaggerated version of the other southern European economies, peaking at >27% in early 2012.



Source: OECD 2015d

It is true that the behavior of the Greek government during the first 10 years of the euro made the country vulnerable to a sovereign debt crisis. The government took advantage of lower borrowing costs to increase public sector employment in a clientelistic manner (Featherstone 2011). However, this argument holds little water elsewhere. In fact, Spain and Ireland ran budget surpluses for most of the 2000s. Beyond Greece, we argue that the sovereign debt problems arose because of two institutional deficiencies in the Eurozone (neither of which concerns the conditions of OCA theory): namely, the lack of a banking union and the absence of a credible lender of last resort in government bond markets. This fits closely with Schelkle's (2014) view that it is not a movement toward OCA institutions, but rather a strengthening of insurance (or risk-sharing) mechanisms, that is the main institutional change required to safeguard the Eurozone against further crises.

When the single currency was set up, responsibility for banking regulation, dealing with bank failures, and insuring depositors all remained at the national level. This is in contrast to the United States, where a large proportion of banking regulation is at the federal level, bank failures are the responsibility of the federal

government, and there is a federal deposit insurance scheme. The Irish and Spanish governments (and to a lesser extent the Portuguese government) faced illiquidity problems when they had to step in to rescue their overextended banking systems, which operated across national borders and were often large relative to national GDP ([Carlin & Soskice 2015](#)). The collapse of house price bubbles in Ireland and Spain that accompanied the global financial crisis reduced the assets of the banks and brought them near to bankruptcy, forcing the government to step in and make taxpayers liable for the debts of the banks ([Hardiman 2012](#), [Lane 2012](#)). This led to financial markets pushing down the prices on sovereign bonds (raising their yields relative to the German 10-year sovereign bonds) to reflect a possibility of default, as shown in **Figure 4**. The situation was compounded by falling bond prices further weakening the capital positions of banks, as a high proportion of the peripheral nations' sovereign bonds were held by domestic banks ([De Grauwe 2012](#)). A banking union sharing the burden of cross-border bank resolution across Eurozone countries (and/or private investors) would have limited the deterioration in the public finances that occurred in Spain, Ireland, and Portugal following the financial crisis.

The second institutional deficiency of the Eurozone that contributed to the Eurocrisis was the absence of a credible lender of last resort in government bond markets. In a monetary union of sovereign states without a central bank guaranteeing that the cash will always be available to pay off bondholders at maturity, two market equilibria for sovereign bonds can arise. One is a low-yield equilibrium, in which the government has a sustainable fiscal path to its target debt level; the other is a high-yield equilibrium, in which markets attach a positive probability to default and euro-exit, and the problems associated with higher government borrowing costs further reinforce the probability of default (i.e., a vicious cycle of rising bond yields). In the latter case, market fear can create a self-fulfilling prophecy, pushing otherwise solvent countries into default ([De Grauwe 2011](#), [2012](#), [2013](#)).

The **ECB**'s inability to play the role of a credible lender of last resort during the early part of the Eurocrisis contributed to contagion in bond markets, where rising bond yields in Greece increased default fears (and bond yields) in Ireland and Portugal, and later in Spain and Italy. This constituted a major problem of instability for the operation of the Eurozone. In response, the ECB acted in a

quasi-unilateral way---as the only actor in the currency area that could make decisions without the approval of the member states. Arguing that it would “do whatever it takes” to save the euro, the ECB set up the Outright Monetary Transactions (OMT) procedure in mid-2012, which enabled it to buy unlimited sovereign bonds in second-hand markets to keep yields close to the German rate as long as a member government had a credible fiscal plan to ensure the medium-term sustainability of government debt.⁸ As we can see from **Figure 4**, the markets viewed OMT as credible, and bond yields in southern Europe slowly fell back toward northern levels. OMT was particularly important in changing the trajectory of bond yields in Spain and Italy. Italy’s relatively high public debt was at the root of initial bond market pressure, but the turnaround after OMT suggests they were stuck in a bad equilibrium and did not have an underlying solvency problem.

If the Eurozone did not have these two institutional deficiencies, then it is much less likely the negative demand shock of the global financial crisis would have escalated into the Eurocrisis (outside of Greece). The Eurocrisis focused on the southern European economies for two reasons: First, their high level of total (public and private) debt made them a greater default risk, and second, their sizeable current account deficits made them a greater devaluation risk. When fears of euro-exit materialized, the latter contributed to the interest rate premium just as it had done in the pre-EMU (Economic and Monetary Union) period of fixed but adjustable exchange rates. After OMT was announced, euro-exit became much less likely, and bond yields fell as devaluation risk receded (**Iversen & Soskice 2013**).

Outside of the ECB, any Eurozone-level institutional changes required the consent of member governments. Eurozone governments have taken tentative steps toward a banking union, transferring supervision of the Eurozone’s 130 largest banks to the ECB and setting up a Eurozone-wide bank-financed resolution mechanism to deal with bank failures.⁹ The banking union has been criticized on many grounds, however. The biggest hole is the absence of a pan-

⁸ For more information on OMT see the ECB website:

http://www.ecb.europa.eu/press/pr/date/2012/html/pr120906_1.en.html.

⁹ For more information on the Eurozone banking union, see the European Commission website:

http://ec.europa.eu/finance/general-policy/banking-union/index_en.htm.

Eurozone fiscal backstop for the bank resolution or deposit insurance schemes, meaning that national governments are ultimately still responsible for cross-border banks headquartered in their territories ([Hellwig 2014](#)).

Institutional change has been limited in the fiscal arena as well. Member governments choose to tighten existing fiscal rules via the Fiscal Compact rather than move toward the OCA condition of a more centralized tax-and-spend system.¹⁰ Supranational institution building has been held back by national politics. Voters across member state borders simply lack the solidarity necessary to agree to the burden sharing and loss of sovereignty that comes with further political or fiscal integration or a full-fledged banking union ([Hall 2012, 2014](#); [Carlin & Soskice 2015](#)). In an analytically persuasive piece, [Beramendi \(2015\)](#) shows that fiscal union is made even less politically feasible by the markedly different growth strategies and levels of wealth in the north and south of the Eurozone; the richer, investment- and export-oriented northern economies in particular have little incentive to pursue further fiscal integration.

At a national level, institutions in the northern CMEs have not been fundamentally altered in response to the crisis. Under no pressure to change their institutions, these countries would not do so unless they believed it would improve their export competitiveness, and would in particular resist changes in core institutions (collective bargaining, corporate governance, research and skill formation systems, and so on). The situation is more complicated in the south (excluding France), where the Troika and financial markets have forced governments to undertake austerity (i.e., spending cuts and tax increases) and structural reform, typically as a condition of their bailout packages. Although the OECD figures show that employment protection for permanent workers has fallen slightly across the south since the Eurocrisis (OECD 2015e), the political difficulty of implementing sweeping reforms and the lack of change in the north means there has not been a convergence toward liberal labor markets along OCA theory lines.

The northern economies---led by the Eurozone's largest economy, Germany---were the main creditors in the Eurocrisis and insisted on imposing austerity

¹⁰ For more information on the Fiscal Compact, see the European Commission website: http://ec.europa.eu/economy_finance/articles/governance/2012-03-14_six_pack_en.htm.

policies on the south. Germany could do that because of its credible threat to leave the euro if southern countries could default (or borrow) at will. Austerity has been politically unpopular in the south, with electorates punishing mainstream parties at the polls. So far, however, southern voters have ultimately chosen to accept painful government cutbacks in order to remain in the euro ([Hassel 2014](#), [Hopkin 2015](#)). Beyond wider concerns about the financial market credibility of a southern country outside the euro, an explanation for the reluctance of southern voters to leave the euro is that euro-exit would likely entail a currency depreciation that would adversely affect living standards. The German government has imposed austerity abroad in part because the German electorate would not accept bailing out southern members without strict conditionality ([Newman 2015](#)). More important from a CPE perspective, the whole Eurozone pursuing tight fiscal policy is key to keeping the external euro exchange rate low and to maintaining CME export competitiveness.

The insistence of Germany and the other CMEs on imposing austerity on the south (as well as maintaining fiscal discipline in the north) has led some economists, notably [Krugman \(2013a,b\)](#), to suggest that German policy makers have intellectually misunderstood macroeconomics. Krugman is correct that Germany's behavior contributes to slower growth in the south. But the critical point that we believe the CPE analysis brings out is that Germany and the other CMEs are rationally pursuing their self-interest: the safeguarding and promotion of the export-led growth model. Fiscal discipline is seen as a critical component of CME export success. Germany would not choose to be part of a monetary union where it became accepted wisdom that governments and the central bank could intervene in the economy with the aim of creating employment and growth ([Iversen & Soskice 2013](#)). Indeed, it is the combination of that implicit CME threat to leave the euro and the choice of the south to stay in the Eurozone (despite their dislike of austerity) that enables Germany to continue to impose austerity.

We can briefly compare this CPE account of the Eurozone to standard approaches to European integration. Neofunctionalists are right that there are unintended consequences of integration. No one foresaw the Eurocrisis, although governments by and large did correctly predict the beneficial medium-term economic consequences. The ECB filled a policy void by taking on a more

activist role, and there were modest moves toward a banking union. Unlike [Schimmelfennig \(2014\)](#), we do not see these as major steps toward integration, and “spillovers” are completely lacking where they matter the most, in domestic institutional reform. Here governments lack incentives to implement them, and this turns governments into defenders of national interests at the European level, as predicted by intergovernmental approaches ([Moravcsik 2012](#)).

Postfunctionalists are right that the constraints are often rooted in domestic electorates’ opposition to greater integration ([Hooghe & Marks 2009](#)), but the CPE approach shows how both governments and electorates are driven to such opposition by rational incentives to sustain and entrench national institutional frameworks.

CONCLUSION

We are not foolhardy enough to predict the future of the Eurozone. Nor is it easy to be optimistic. Nonetheless it may be useful, in the face of much skepticism, to suggest that the Eurozone has three important sources of resilience. First, differences in labor markets and wage-setting systems between **CMEs** and other member states may indeed generate imbalances, but imbalances themselves are problematic largely because they may lead to asset bubbles. In macroeconomic models they do not imply continuing inflation differences, nor growing differential unemployment. And although, despite some progress, the Eurozone is nowhere near a common banking system (and is unlikely to establish one because of its redistributive consequences), the **ECB** and individual member states are now much more sensitive to the consequences of a bank failure in the absence of a common Eurozone banking system. In this respect, they mirror the rest of the advanced world. Second, there is no fiscal union, nor is that likely; but (aside from Greece) member states are likely to maintain the conditions for fiscal stability, both because they have shown themselves capable of doing it and because the political costs of euro-exit are evidently very high: Voters are aware of real income losses if they leave the euro and fear the wider dangers. Third, the Eurozone solves macroeconomic problems for the peripheral economies (low inflation, low interest rates); it does not answer fundamental questions about innovation, skill systems, entrepreneurship, low productivity or competitiveness-

--nor did it contain institutional mechanisms to do so. In these senses, some of the skepticism about the euro is misplaced.

It goes without saying that the euro system has made a splendid mess of the Eurocrisis, reflecting the rational pursuit of the national concerns of the member states rather than irrational behavior. Equally evident, the ease of operation of the Eurozone will depend on whether the world economy starts to grow at a normal rate again, and the debates both about secular stagnation and about the Chinese economy---as well as skepticism about endogenous growth in the Eurozone---may cast some doubt on the likelihood of that in the near future. The Eurozone is thus unlikely to function smoothly in the short term, but equally unlikely to break up.

We conclude with a methodological point. The **CPE** analysis of this article is based on understanding the bargaining power of the relevant actors and the interests they take into account. From a policy or normative perspective, it is far from evident that the northern CMEs in the Eurozone would want to adopt the current macroeconomic policies of austerity if they took into account the interests of the southern member states as well. But from their own self-interest in maintaining the institutional frameworks of successful export-oriented economies, the insistence on monetary and fiscal discipline in the Eurozone is rational if they can get the southern member states to go along with it.

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Table 1 Institutional change in the Eurozone and other advanced economies:,1998--2008

Country	EPL for temporary workers (1)			Trade union density (2)			Bargaining (or union) coverage (3)			Product market regulation (4)		
	1998	2008	Change 1998--2008	1998	2008	Change 1998--2008	Early 2000s	Late 2000s	Change over 2000s	1998	2008	Change 1998--2008
Northern Eurozone												
Austria	1.3	1.3	0.0	38.4	29.1	-9.3	98.5	99.0	0.5	2.1	1.4	-0.8
Belgium	2.4	2.4	0.0	52.2	54.4	2.2	96.0	96.0	0.0	2.3	1.5	-0.8
Finland	1.6	1.6	0.0	78.0	69.6	-8.4	86.5	89.5	3.0	1.9	1.3	-0.6
Germany	2.0	1.0	-1.0	25.9	19.1	-6.8	68.9	63.9	-5.0	2.2	1.4	-0.8
Netherlands	1.4	0.9	-0.4	24.6	18.8	-5.7	84.7	85.0	0.2	1.8	1.0	-0.9
Southern Eurozone												
France	3.6	3.6	0.0	8.2	7.6	-0.6	92.0	92.0	0.0	2.4	1.5	-0.9
Greece	4.8	2.8	-2.0	27.4	24.0	-3.4	65.0	65.0	0.0	2.8	2.2	-0.5
Ireland	0.3	0.6	0.4	40.2	31.9	-8.3	44.4	42.2	-2.2	1.9	1.4	-0.5
Italy	3.6	2.0	-1.6	35.7	33.4	-2.3	85.0	85.0	0.0	2.4	1.5	-0.9
Portugal	2.8	1.9	-0.9	23.4	20.5	-2.9	92.0	90.0	-2.0	2.6	1.7	-0.9
Spain	3.3	3.0	-0.3	18.7	17.4	-1.4	83.4	80.2	-3.2	2.4	1.6	-0.8
Non-Eurozone												
Denmark	1.4	1.4	0.0	75.2	66.3	-8.9	83.0	85.0	2.0	1.7	1.4	-0.3
Sweden	1.4	0.8	-0.6	81.3	68.3	-13.0	94.0	91.0	-3.0	1.9	1.6	-0.3
United Kingdom	0.3	0.4	0.1	30.4	27.1	-3.4	36.4	33.6	-2.8	1.3	1.2	-0.1
United States	0.3	0.3	0.0	13.4	11.9	-1.5	14.9	13.7	-1.2	1.5	1.1	-0.4

Source: (1) and (2) OECD Labor Force Statistics; (3) ICTWSS Database 4, April 2013; (4) OECD Indicators of Product Market Regulation (PMR).

Notes: (1) Strictness of Employment Protection Legislation for temporary contracts (0--6 scale, higher scores represent stricter regulation); (2) Number of wage and salary earners that are trade union members as a percentage of the total number of wage and salary earners; (3) Employees covered by collective (wage) bargaining agreements as a proportion of all wage and salary earners in employment with the right to bargaining, expressed as percentage, adjusted for the possibility that some sectors or occupations are excluded from the right to bargain. Early 2000s data is for 2000 for all countries except France (2001), Greece (2002), Portugal (1999) and Denmark (2001). Late 2000s data is for 2008 for all countries except Austria (2007), Finland (2009), Ireland (2010), Italy (2010) and Denmark (2007); (4) Product Market Regulation (0--6 scale, higher scores represent stricter regulation).