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The policy consensus ruling European political economy: its attractions, flaws and possible departures

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Summary

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Since 2008, crises in financial markets have forced governments in OECD countries to unprecedented monetary and fiscal intervention. In previous such situations, namely the Great Depression and stagflation in the 1970s, the economic policy consensus of the time came under close scrutiny and eventually shifted. Today, criticism of academic economics is not in short supply but a straightforward alternative is not in sight either. This seems to be particularly troubling for governments in Europe, desperate for advice on how to stop contagion spreading from a small peripheral economy to the core of the European Union. But then, the lessons that especially European governments seem to draw from the crisis suggest that the economic policy consensus of the last two decades, with its heavy emphasis on structural reforms and inflation-targeting monetary policy, is less obsolete than the critics suggest.

Our contribution first assesses what the consensus until recently has been and how it could have been implicated in the crisis. We identify as the elements of the consensus that are potentially flaws responsible for the crisis the notion of a fundamental equilibrium that is determined independently of financial markets, the focus on micro foundations that neglects issues of systemic stability and an obsession with structural reforms of labour markets. The incremental shift of economic theorizing towards self-regulation of markets and macro-stabilisation assigned to central banks left governments the task of restoring the role of the price mechanism in labour and product markets. A stronger role of price adjustments increased the flexibility of nominal prices but not necessarily real adjustment.

Second, we argue that the policy consensus continues to persist because it is politically attractive. Following Hall (1989) who suggested that 'the political power of economic ideas' requires, at a minimum, their economic, administrative and political viability, we identify the attractions of the policy consensus as directly following from its theoretical flaws. In monetary policy, agencification of monetary policy – i.e. the creation of independent central banks -- freed fiscal authorities from dealing with issues of macro-stabilisation for which they typically get more blame than praise. The assurance that there is a full-employment equilibrium determined by real economic factors enabled governments to turn a blind eye on overheating credit markets that allowed households to finance rising consumption while real incomes stagnated for most. Finally, the focus on labour markets and structural reforms suited particularly centre-left parties and governments targeting changing electoral constituencies, due to a decline in industrial employment and the inequality of employment conditions in services.

We end the paper with observations of potential departures from the policy consensus that could indicate a significant shift for the political economy of Europe. The crucial question is whether political support can be mobilized for the shift from structural reforms of labour markets to the containment of risks in financial markets. Welfare state building in the 20th century depended on the active support of firms for welfare state expansion in the employment relationship. Similarly, robust re-regulation of financial markets is likely to emerge as a response to political demand by 'capitalists against markets' (Swenson 2002). One cannot take this demand for granted. But we argue that there is a prospect for the formation of politically cross-cutting coalitions that aim at defending the real economy against financial havoc by protecting the financial system from itself.

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