Afterward

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When we wrote this article ten years ago, our underlying objective was to show that the economic impact of institutional arrangements in one sphere of the political economy often depends on the character of institutional arrangements in other spheres of the political economy. Therefore, attempts to assess the impact of potential institutional reforms in one sphere, such as those frequently proposed for labor or capital markets, produce valid estimates only if they take such interaction effects into account. Other scholars have explored similar interactions between other institutional spheres, and we continue to regard the point as one of the fundamental contributions the field has made to understanding the political economy.

With respect to European monetary union, our core point was that the movement to a common central bank, highly independent from political influence, would have effects across the member states that vary according to the institutional arrangements that organize the political economy in each of those states. This contradicted the conventional wisdom that all would gain equally from each unit of increased independence entailed by the shift from a national to the European central bank. We argued that shifting monetary authority to a single European bank would have effects in each European economy not only because it changed the monetary signal-sender and potentially its credibility, but because it also shifted the relevant audience from one in each domestic political economy to one in a wider European political economy. Because that shift alters the coordinating capacities of the wage/price bargainers who respond to the monetary signal-sender, it changes the terms of the strategic interaction we emphasized.[1]

Because our empirical data was drawn from an era marked by relatively high rates of inflation and low rates of unemployment, we focused our analysis on one of the central

[1] Working with a small 11-country sample on the first 3 years post-ECB (1999-2002), and assuming Europe-wide bargaining coordination of .25 on the Hall-Franzese 0-1 scale and ECB credible conservatism of 1.0 on their CBI scale, Franzese (2004) managed some rough estimates of the terms of these trades, concluding that, in general, "those Euro members who bought more credible conservatism by delegating to the ECB paid some real [growth] cost, and greater real cost the higher their domestic bargaining coordination had been that this delegation swapped for the European level" (p. 30).

economic dilemmas of that era, namely, on the ways in which a central bank's efforts to contain inflation generate levels of unemployment that vary with the organization of wage bargaining. As we note at the end of the article, however, EMU was established in an era of high unemployment when the relevant interaction effects are somewhat different, because the bargaining power of even the strongest trade union confederations is more limited. Therefore, although the organization of national political economies has conditioned the impact of EMU in each country, the relevant interaction effects have sometimes been different from those we stressed. Three types of interaction effects are worth noting.

First, an independent central bank can lower the rate of inflation not only by controlling the money supply but also by influencing the fiscal policies pursued by national governments. As we have noted, threats by the Bundesbank to raise interest rates if the government adopted overly expansionary fiscal policies were once crucial to containing inflation at relatively low cost in terms of unemployment in the Federal Republic of Germany. When the government contains fiscal expansion in response to warnings from the central bank, there is no need for the latter to impose punitive rates of interest that depress the economy in order to contain the inflation that can flow from such expansion.

However, as we emphasized with respect to wage bargaining, this type of signaling mechanism works best where the central bank is responding to a single government. The new European central bank faced many such governments. It could not punish some of them for overly expansionary policy without simultaneously punishing all the others. Therefore, the smaller states, in particular, knew that they could expand without much fear of retaliation, thereby free-riding on the fiscal restraint of the others. Concern that they might do so inspired the Stability and Growth Pact that accompanied monetary union, but the fiscal targets it offered proved at best loose guidelines that many member states could evade for periods of time. As a result, the European Central bank has been less effective than the Bundesbank at containing expansionary fiscal policies and rates of inflation in some parts of the Union.

Institutional differences in the organization of wage bargaining have exacerbated cross-national variation. The member states of EMU with well-developed systems for coordinating wage bargaining, such as Germany, the Netherlands, and Belgium, have been able to contain the rate of growth of wages and the advent of a common currency gave them

added reasons to do so, since depreciation of the national currency could not be used to offset the effects of high wage settlements on the competitiveness of their traded goods. Where unions are relatively powerful and wage bargaining is not well-coordinated, however, in the presence of expansionary conditions linked to fiscal policy or local asset booms, national rates of inflation have been higher.

As a result, substantial variation in national rates of inflation has persisted across the EMU despite the common monetary policy pursued by the European central bank. Therefore, gaps opened between the nominal interest rate governed by the ECB and the real interest rate present in each country. This has worked to the disadvantage of countries such as Germany, where national rates of inflation have been low and real rates of interest high. In such settings, the impact of the common monetary policy of the ECB has been more contractionary than in the member states running higher levels of inflation, such as Ireland and Greece.

Soskice (2006) has argued that other features of the national political economy exacerbate such effects. Building on a varieties-of-capitalism analysis (Hall and Soskice 2001), he notes that the savings rate varies substantially between coordinated market economies where workers typically invest in relatively high levels of industry-specific skills and liberal market economies where workers normally seek general skills. If they lose their jobs, workers with industry-specific skills find it more difficult to find new positions commensurate with their levels of skill. Therefore, when economic conditions are not buoyant, typical workers in these types of economies will tend to save at rates in excess of those in liberal market economies. That in turn depresses aggregate demand and makes it more difficult for such economies to recover from recession without levels of fiscal expansion higher than those countenanced by the Stability and Growth Pact.

In short, the impact on national economic performance of the move to EMU has been conditioned by variations in the institutional structure of national political economies. Some countries have benefited more than others from entry into EMU. Against the expectations of those who observed that Germany already had a Bundesbank similar to the new ECB, Germany has found the transition especially difficult. Although our article focuses on the problems that would arise in an inflationary era, analogous problems have developed in an era when rates of growth and inflation have been relatively depressed. Faced with high real

interest rates and a workforce inclined to save rather than to spend, the German government has been unable to pursue fiscal policies expansive enough to reflate an economy experiencing high levels of unemployment. Instead, Germany has had to find a more difficult route out of recession, one based on increasing exports, rather than domestic demand, by improving labor productivity while holding real wages down.

This analysis underlines another difference between a political economy perspective and mainstream economic approaches of the sort frequently associated with analyses of central bank independence. Mainstream approaches tend to treat national differences in the organization of the political economy as aberrations – deviations from best practice – that are destined to disappear as international markets become more open and competitive and that should disappear if economies are to become more efficient. For the case of EMU, the advantage of the mainstream perspective is the attention it focused on the ways in which the advent of monetary union would inspire 'structural adjustment' in the member states. Since national monetary policy could no longer be used to cushion the economy of a member state from the effects of asymmetric shocks, entry into EMU was expected to force the member states to change their regulatory practices to make labor markets more competitive, so that adjustment could occur through market processes. Indeed, EMU has pushed its members in this direction.

However, a political economy perspective explains why that movement has been less rapid and monolithic than mainstream perspectives expect. The speed of market reform is not determined solely by political resistance, important though that can be. Economic tasks that might be accomplished in some countries by processes of market-led adjustment are achieved in other countries by forms of strategic coordination that entail negotiation among firms and produce groups, and one of the points of our article was to suggest that this kind of strategic coordination can have other efficiencies relative to market coordination. Therefore, developments that pressure modern economies to become more efficient do not always have to force those economies to abandon strategic coordination. Instead, they may lead the actors in those economies to seek ways of enhancing the efficiency of strategic coordination, and that is what has happened in many of the northern European economies.

In the face of EMU, it would not be practical for Germany to dissolve its powerful union movement in favor of American-style industrial relations. Instead, the country has had

to find ways of improving coordination among employers, works councils and unions to cope not only with the economic problems created by German reunification but also the problem of creating jobs in the context of monetary union. The result has been some loosening of nation-wide coordination that accommodates greater diversity in work practices and wage rates without entirely undermining the strategic capacities implicit in producer-group organization (Martin and Thelen 2007). Much the same can be said for other nations, where structural adjustment in the wake of EMU has taken many forms. As we noted in 1998, EMU has been only "the first step in a more extensive process of institution building" that takes different forms in line with national varieties of capitalism.

That process of institution building has rarely been smooth. On the one hand, it entails experimentation with different types of reforms before ones that work well are found. On the other, it is invariably a political process marked by resistance wherever it imposes losses on some groups of workers. However, political economies with different types of institutional structures have all found ways to accommodate to monetary union.

In the course of that process, contemporary views about the value of monetary union and of central bank independence have also changed. When we wrote in 1998, mainstream analysis was highly optimistic about both types of reforms. Central bank independence was said to be an unmitigated advantage and most European countries moved toward it. In the ensuing years, however, it has become clear that the stance taken by the central bank is at least as important as its level of independence from the political authorities, and attention has turned to the differences between a central bank like the American Federal Reserve Bank that is relatively sensitive to problems of unemployment and the European Central Bank which has been more exclusively attentive to issues of inflation. Some now argue that the stance of the ECB would be more conducive to the overall growth of the economy if there were structural arrangements that forced it to have a more even-handed dialogue with a body representing the political authorities in the member states, thereby rendering it more responsive to the concerns about employment that politicians have.

In much the same way, the advantages of monetary union now seem more ambiguous than they appeared to be in the 1990s. We continue to think that the overall economic and political advantages of monetary union are substantial. However, we also notice that many of the nations that did not join the new union have continued to enjoy high levels of economic

performance. Among these, Britain and Sweden are notable cases. Each has used its capacities to control monetary policy at the national level to run more expansionary macroeconomic policies when faced with potential economic downturns than many of the members of EMU were able to sustain, and each has secured higher rates of growth and employment over the past decade than many might have expected. As readers of our article will understand, however, we would argue that their success turns not only on their monetary independence but also on the character of wage coordination (and the broader political-economic institutional configuration) in each country. Britain has a liberal market economy and a relatively weak union movement. Sweden has a powerful union movement but retains significant capacities for strategic wage coordination. Whether countries without equivalent means of controlling wage pushfulness would benefit as much from independent monetary policies remains uncertain (Iversen 1999).

In sum, after almost a decade of experience, we regard EMU as a work in progress. As a bulwark against inflation, this monetary union has been a success. With respect to employment, its record has been mixed at best. On both fronts, however, at the national level, its impact has been mediated by the structure of the political economy, and the processes of institutional adaptation that it set in motion remain some of the most fascinating developments in Europe today.

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