

Summary: After a coordinated initial response to the global financial crisis in 2008-09, the coordination between the major economies of the EU and the United States has since unraveled. In 2010, policy divergences between the United States and Europe have emerged and they have come to dominate the international discussion on macroeconomic policy priorities.

As often, several competing explanations are on offer. One emphasizes differentiated economic and financial structures as the origin of the dissimilar impacts of a common shock. Another view stresses differences in the policy set-up arising from institutional constraints, especially though not only, as a result of the EU's particular policy set-up. A third one puts the onus on doctrine and ideology, and how that causes different perceptions of the policy challenges and risks faced by policymakers.

This paper proposes five measures that the EU and United States could take together to help regain some form of economic coordination despite these obstacles.

Convoy Unraveled: Why U.S. and European Post-Crisis Economic Policies Differ (And What to do About It)

By Jean Pisani-Ferry

The initial response in 2008-2009 to the global financial crisis was in many ways a high-water mark for transatlantic policy coordination. The major economies of the EU and the United States came to rapid agreement on a series of measures to limit the crisis. These efforts paid off.

That agreement and common approach has since unraveled. Where the economic policymakers had been travelling in convoy in 2008-09, in 2010 policy divergences between the United States and Europe have emerged and they have come to dominate the international discussion on macroeconomic policy priorities. This is visible in the budgetary and monetary fields.

The question, then, is why the initial "London consensus" has not survived for much more than a year, making room for the "Toronto divergence." As often, several competing explanations are on offer. One emphasizes differentiated economic and financial structures as the origin of the dissimilar impacts

of a common shock. Another view stresses differences in the policy set-up arising from institutional constraints, especially though not only, as a result of the EU's particular policy set-up. A third one puts the onus on doctrine and ideology, and how that causes different perceptions of the policy challenges and risks faced by policymakers. Which of these have mattered and still matter, and which have not and do not, is what I aim to clarify in this paper.

1. Economic Developments *Demand and Output*

To start with basic facts, Figures 1a-1d compare the evolution of GDP, employment, output per hour and non-residential investment in the United States, the euro area, and the EU. Both the common character of the shock and some significant differences in later developments are apparent:

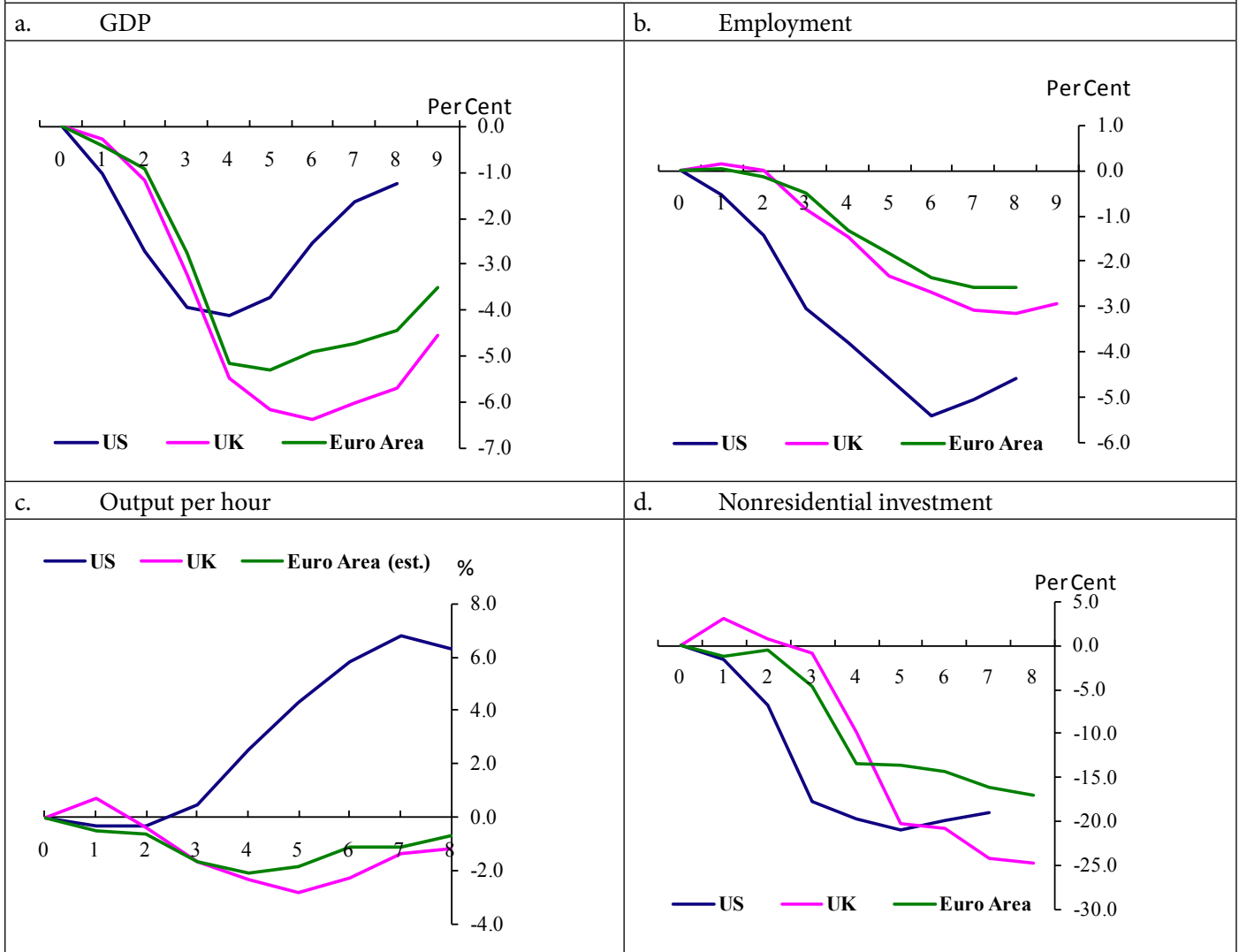
- First, U.S. GDP declined less and recovered faster than either in the euro area or the United Kingdom;

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- Second, U.S. employment declined much more than European employment and did not start exhibiting feeble signs of recovery until early 2010;
- Third, as a result, productivity developments have been strikingly divergent. Eight quarters after the start of the recession, output per hour had increased by about 7 percent in the United States whereas it was still below the initial pre-crisis level in the euro area and the United Kingdom; and
- Fourth, there are no major differences regarding the behavior of investment, despite the differences in growth and in the financial system.

It is not entirely clear why a large divergence in employment and productivity can be observed between the United States and Europe (where the evolutions in the euro area and the United Kingdom are remarkably similar). Part of the explanation is that U.S. companies, which are less constrained by firing restrictions, traditionally adjust their payrolls faster than European counterparts. But if this was the only reason, the evolution in the United Kingdom, where the labor market is traditionally deemed flexible, should mimic that of the United States. The strength of the post-recession U.S. productivity boom and the subdued productivity response in most part of continental Europe (Spain being an exception) both remain puzzling.

Figure 1: Impact of the Crisis on GDP, Employment, Output per Hour and Nonresidential Investment in the United States, the Euro Area, and the United Kingdom (Movements in quarters from pre-recession output peak)



Source: National data, ECB.

Note: pre-recession output peak is 2008Q1 for euro area and the United Kingdom, 2008Q2 for the United States

Turning to the outlook, the strength of domestic demand in the short- to medium-run largely depends on the extent to which private agents have to engage in deleveraging. In the 2000s, households went much more into debt in the United States and the United Kingdom than in the euro area. The contrast is striking, with the 1999-2007 rise in household indebtedness as a share of GDP in the United States and the United Kingdom almost three times larger than for the euro area – and in 1999 the initial levels of household debt in the euro area was already significantly smaller.

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Balance sheet data do justify more concern about the risks of sluggish demand and recovery in the United States and the United Kingdom than in continental Europe, while also underlining the greater unsustainability of borrowing patterns on the American side of the Atlantic.

Supply-Side Optimism vs. Supply-Side Pessimism

A key factor underlying policy reactions is the size of the negative supply-side shock resulting from the crisis – or at least the perceived size of this non-observable shock. It is a stylized fact that financial crises affect the underlying productive capacity – because of forgone investment, the discarding of capital, withdrawal from the labor force and skill losses, for example. If policymakers believe – rightly or wrongly – that the GDP decline essentially results from a demand shock, leaving potential output unaffected, they will be naturally inclined to advocate further stimulus. In this situation, a stimulus simply would activate excess capacity into production. If policymakers tend to believe that the supply-side damage has reduced output capacity, they will have less appetite for monetary or fiscal policy interventions. Policy interventions in the

context of damaged supply conditions could create inflationary pressures.

Both official policy statements and available estimates from policy institutions suggest that supply-side optimism prevails in the United States whereas the opposite holds in Europe. In the United States, the administration does not consider that the recession resulted in lowering potential output. The Federal Reserve is more cautious in its assessment and does not rule out the possibility of an increase in structural unemployment, but it still regards the increase in unemployment as mostly cyclical.

In Europe, by contrast, official statements indicate much more concern about the supply-side effects of the crisis. For the euro area, the European Commission asserted both that pre-crisis potential output had been overestimated and that the crisis would result in a permanent lowering of potential output. In addition, it expects post-crisis damages to potential output, and it therefore assesses the permanent output reduction to be of the order of magnitude of 4 percent of GDP. These very large numbers, if determining policy, would significantly reduce the scope for demand-side policies and add to the urgency of consolidation.

Is this difference justified? The reduction in potential output arises from a combination of three main factors:

- A lower capital stock. Foregone investment and a higher cost of capital negatively affect capital deepening, and hence output per employee.
- Unemployment hysteresis (hangover effect) impacting both equilibrium unemployment and labor force participation.
- Reductions in Total Factor Productivity resulting from sectoral reallocations from high- to low-productivity sectors, skill mismatches, and lower research and development expenditures.

Taking these three factors into account, the OECD assesses potential output losses to be about 3 percent in the United States, between 3 and 4 percent in the United Kingdom, France, the Netherlands, and Germany, and a little more than 4 percent in Italy – thus, importantly, comparable for most major Western economies. Some more supply-side optimism seems to be warranted in the United States, given both the recent productivity numbers (even heavily discounted) and a history of full recovery following shocks – but there is little evidence-based justification to rule out permanent effects alto-

gether in the U.S. economy. Conversely, European pessimism may well be exaggerated.

Mismatch between perception and reality arises from a comparison of the U.K. and U.S. situations since 2008. In the United Kingdom, unemployment has gone up and job vacancies have gone down accordingly, and there is no evidence of a change in the relationship between the two variables. In the United States, vacancies declined initially but have started to increase again, at a high level of unemployment. This would suggest that structural unemployment has not increased in the United Kingdom while it has increased in the United States – contrary to what policymakers believe. In both cases, however, the policymakers' beliefs may in the end be self-fulfilling, as an active demand-side policy can help contain hysteresis and stimulate investment while a policy that starts from the opposite assumption may be vindicated *ex post*.

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Political Economics

A last reason why policies may differ is that political economy constraints are not identical. This especially applies to the political cost of mass unemployment:

- First, unemployment in the United States is back to levels not seen since the early 1980s, close to post-war highs. In Europe, however, the employment recession is by no means exceptional, and unemployment rates in the euro area or the United Kingdom are essentially back where they were in 1996-1997, significantly below post-war highs.
- Second, U.S. unemployment insurance does not cover long-term unemployment while schemes to supplement the income of the long-term unemployed

are widespread in Europe, making unemployment more tolerable.

In these conditions, U.S. policymakers hear a strong call to action for job creation. In Europe, by contrast, the political urgency of action is much less, and neither monetary nor fiscal policymakers consider they have a responsibility to keep unemployment at a low level.

2. Monetary Policy

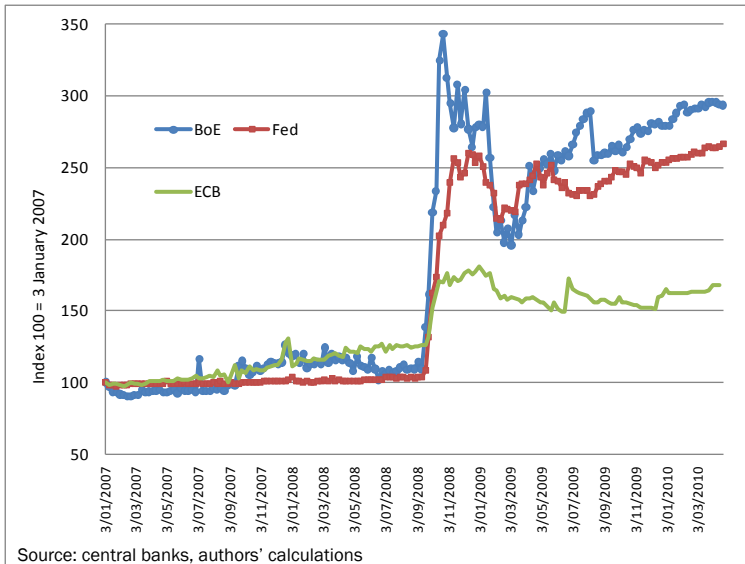
I now turn to comparing the actual policy responses, starting with monetary policy.

There were several reasons for the U.S. Federal Reserve (Fed) and the Bank of England (BoE) on one side, and the European Central Bank (ECB) on the other, to respond differently to the crisis. To start with, they had (and still have) different mandates, most clearly regarding output stabilization and financial stability. Second, there were significant differences in the three central banks' relationships with their respective national governments and regulatory authorities. Third, the central banks' monetary policies followed different strategies and had different priorities going into the crisis. Fourth, the three central banks' operational frameworks for providing liquidity to their respective banking systems differed as well.

Against this background, the monetary and financial stability policies pursued by the three central banks have been in some respects remarkably similar, indicating that shared assessments of the risks to the financial system and the economy were strong enough to overcome institutional constraints. Interest rate policies were broadly identical, at least from the Lehman shock in September 2008, and responses to outbreaks of acute interbank market illiquidity were also remarkably parallel.

There have, however, also been significant differences in the response, which have grown more important over time. Starting in early 2010, there has been markedly more emphasis on exiting from exceptionally supportive interest-rate policy on the part of the ECB, and at the time of writing it is likely that the pace of interest-rate increases will differ markedly between the two sides of the Atlantic. But probably the most notable difference among the three central banks is that the BoE and the Fed have undertaken significant quantitative easing (asset purchases aiming at affecting the yield curve beyond the traditional short-term horizon), but the ECB has not undertaken any.

Figure 2: Central Bank Balance Sheets, 2007-2010



The BoE and the Fed indicated in early 2009 that they considered it necessary to supplement interest rate cuts with loosening through unconventional instruments – they both believed that the interest rate cuts were an insufficient response to the scale of the shock. To borrow from Clausewitz, quantitative easing is seen by these two central banks as the continuation of interest rate policy through other means.

At the same time, the ECB has consistently rejected the ideas that it either had to go beyond the provision of liquidity to banks to overcome the zero bound through purchasing government bonds, or to attempt to influence the shape of the yield curve. Its stated doctrine is that it operates under a principle of “separation” between monetary policy and liquidity policy, which implies that exceptional liquidity provision measures can be carried out at any level of interest rate. Its stance throughout the crisis has been that from a monetary policy standpoint, there was no need to go beyond the lowering of the policy rate to near-zero level. Consistent with this approach, the ECB’s balance sheet increased less than those of the two other central banks (Figure 2).

Such marked differences merit understanding. I regard the lesser degree of activism on the part of the ECB as first and foremost a matter of doctrine. The ECB could relatively easily embark on wholesale liquidity provision to the banking sector, but not on wholesale purchase of government bonds, because the former was not perceived as contradicting the spirit of the EU treaty, whereas the latter was seen as running against a fundamental treaty

provision, the strict separation between monetary and budgetary policy. In the United States, however, management of the yield curve by the Federal Reserve is merely a return to the early 1950s when the Fed had an explicit mandate to ensure the stability of the long-term rates at low level. Fiscal-monetary coordination is not alien to the U.S. policy tradition, nor does it evoke dreadful times.

The same can be said of targeted asset purchase programs like the one undertaken by the ECB in May 2010. Although this program was explicitly framed as qualitative rather than quantitative (and as all operations carried out within it were entirely sterilized), its adoption was controversial even within the ECB because it was regarded by some influential parties as implying the transformation of the ECB into a quasi-fiscal agent.

In the end, central bank policy reactions to the crisis demonstrated both remarkable initial convergence in view of dissimilar traditions and institutional constraints, and significant once the worst had passed. I posit that divergences are likely to grow larger in the aftermath of the recovery.

The European Central Bank’s stance throughout the crisis has been that from a monetary policy standpoint, there was no need to go beyond the lowering of the policy rate to near-zero level.

My reading is that two factors dominate. First, as documented in the previous section, central banks exhibit different stances regarding the desirability of stimulating demand. Analyses of supply-side developments and the assessment of the extent of slack that remains in the economy weigh significantly.

The second main difference has to do with relationship with government. Where this relationship was unproblematic (in the United States and the United Kingdom), the central bank was much freer to go beyond its usual

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mission than where it was problematic (in the euro area). This structural difference is likely to continue weighing on the willingness to embrace non-conventional policies in continental Europe, even if the ECB is expanding its mandate on the financial stability side.

3. Fiscal Policy

Institutional constraints matter considerably in the field of budgetary policy. Three are especially relevant to the transatlantic comparison.

To start with, U.S. budgetary policy is carried out by the federal government, but in the EU, it is only the states whose budgets have a macroeconomic role. As sub-federal budgets tend to behave pro-cyclically, automatic stabilizers are markedly weaker in the United States than in the EU. Furthermore, euro area national governments are subject to common rules within the framework of the Stability and Growth Pact (SGP). These constraints, which tend to make European discretionary budgetary policy less counter-cyclical than in the United States, matter considerably because of the diversity of situations within the EU – in spite of a comparable pre-crisis aggregate budgetary. Taken together, institutional constraints therefore imply stronger automatic stabilizers in Europe and a stronger discretionary role for the U.S. federal budget.

For 2009, the IMF produced estimates of the discretionary stimulus delivered by the G20 countries, which are broadly consistent with estimates produced independently. They indicate that consistent with what could be expected from institutional constraints and past record, the United States delivered more discretionary stimulus than the United Kingdom and eurozone countries, but that the broad gist of policies was similar. As far as the fiscal stance is concerned, 2010 was a broadly neutral

year in most countries, but debates have been taking place regarding the appropriate stance for the years ahead. The pace of exit was accelerated by bond market tensions affecting Southern Europe and Ireland in spring 2010. In other euro area countries (especially Germany and France), moderate consolidation measures are on the agenda for 2011. Overall, a fiscal contraction amounting to one percentage point of GDP is expected in the euro area in both 2011 and 2012, and in the United Kingdom, the Cameron government announced in June a major consolidation program over four years.

In the United States, however, the Obama administration agreed only reluctantly to the G20 June commitment to halve budget deficits between 2010 and 2013 and to stabilize public debts by 2016. The budgetary package of December 2010 can be assessed as implying a broadly neutral fiscal stance in 2011, instead of the contraction that would have automatically resulted from the expiration of the Bush tax cuts. Regarding the medium-term, the Bowles-Simpson bipartisan Commission on Fiscal Responsibility appointed by President Obama has proposed reducing the federal debt-to-GDP ratio to 50 percent by 2030, but its recommendations are controversial.

Several explanations can be given for this difference in attitudes:

- A first motivation is that economic situations, and the perception of them, were different;
- A second explanation has to do with the differences in the fiscal space governments enjoy. Clearly, many smaller European countries “felt the heat” sooner and more distinctly than the United States because of the fragmentation of national budgets and the privileged status of U.S. government securities;
- Third, policy doctrines may differ. Confidence in the Keynesian effects of counter-cyclical fiscal policy is far from universal in the United States, but it is more widely accepted than in Europe;
- Finally, political economy matters. Disagreements over the distribution of the budgetary adjustment burden are probably more significant in the United States than they are in the typical European countries.

4. Events, Politics, Doctrines, or Institutions? Summary of Findings

I started from the question why post-crisis policy responses have started to diverge while the crisis response was remarkably symmetric. I have identified four nonexclusive explanations.

First, economic developments in the United States are in some respects more worrying than those in Europe, and warrant more aggressive policy action. The same policy-makers approaching the situation with the same preferences would conclude that the U.S. economy is in need of more support.

Second, political economy factors add to this objective assessment. For reasons that have to do both with its history and with its limited institutions for social protection, the U.S. polity clearly has a lower tolerance to unemployment than European polities. The pressure to stimulate is bound to be more significant.

Third, an important source of divergence could be laid to fundamentally different beliefs about the nature of the recovery from the common shock. The U.S. government and the Federal Reserve believe that U.S. growth trends and potential output have not been lastingly damaged by the shock to a significant extent; the EU governments (including the United Kingdom) hold the opposite view. As a result, the U.S. government and Federal Reserve officials are far more inclined to maintain aggressively expansionary macroeconomic policies than their European counterparts.

Fourth, institutional factors play a major role as well. The absence of a central fiscal authority, the dispersion of national situations, and the lack of global currency status make the euro area economies much more vulnerable to market attack for their fiscal situation than the

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United States. The uneasy relationship between the fiscal and monetary authorities, where testing the limits has reaffirmed mutual suspicions, has also contributed to limiting the euro area central banks' margin of maneuver.

5. How Transatlantic Divergence Matters

If the major economies in the EU and the United States are in genuinely different situations – in terms of demand growth, of unemployment, of adverse supply shocks, and of fiscal space – it is not only likely, but desirable, for macroeconomic policies to differ across the Atlantic. The same to a large extent applies to the consequences of institutional. So why worry about divergence between the EU and United States following the initial joint crisis response?

We see five reasons why macroeconomic policy divergence may still matter in the current phase more than usual. First, the common policy principles that embody the need for policy consistency across the Atlantic offer little guidance in the current context. Second, spillover effects between countries' policies, particularly through capital flows, are still not what they are in normal times. Third, there is the possibility of international commercial strife coming out of divergence during a period of austerity – that is, a spiral of protectionism or competitive depreciation. Fourth, transatlantic divergence could exacerbate imbalances globally, not just bilaterally across the Atlantic. Fifth, there remains the risk of a self-fulfilling low-growth or even deflationary scenario that may arise through premature withdrawal of policy stimulus, which coordination could diminish.

Given this assessment of the reasons for transatlantic divergence in macroeconomic policies since the initial crisis response, I would suggest a few measures to maintain what could be termed a critical quantum of policy coordination:

- The euro area, the United Kingdom, and the United States should agree not to intervene unilaterally against each others' currencies, making explicit what is already understood, and avoid other policies geared toward deliberate depreciation of their own currencies;
- The monitoring of the consistency of actual monetary and exchange-rate policies with this commitment should be delegated to the IMF, while the G20 should serve as the venue for coordination;

- Comparative assessment of the fiscal room – including of potential growth – should also be assigned to an independent multilateral assessor, like the IMF;
- All countries should adopt and submit to parliament medium-term fiscal consolidation objectives and guidelines that ensure the sustainability of public finances under prudent economic assumptions;

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- The EU and United States should agree that the Chinese undervaluation problem has to be dealt with in a multilateral framework but commit to undertaking joint action under the terms of such a framework.

I have little illusion, however, that these measures will be adopted in the near-term. Rather, I fear that the longer that policies diverge across the Atlantic, the more justified each policy stance will seem to their originators. I would wish to warn policymakers that while relaxation from the exceptional intensity of transatlantic coordination that provided the backbone of the crisis response in 2008-2009 is advisable, it is definitely too early to claim that time has come to focus again, and exclusively, on putting all houses in order.

About the Author

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