



Policy Note

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REFORMING THE EURO'S INSTITUTIONAL FRAMEWORK

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The SGP has been the focus of growing controversy within the eurozone. The ECB continues to argue that reforming the SGP by relaxing its rules would damage the credibility of the euro. The opposite, however, may be closer to reality. Relaxing the rules according to the measures already taken by the European Commission has been inconsequential regarding the euro's credibility. In our view, many more fiscal policy reforms are needed so that the eurozone can realize a true economic recovery and enhance the credibility of the euro.

IN PREVIOUS LEVY INSTITUTE PUBLICATIONS (Arestis, McCauley, and Sawyer 2001; Arestis and Sawyer 2002b), we critiqued the underlying institutional system of the European Union (EU), including the Economic and Monetary Union (EMU). Our critique focused on the mandatory fiscal austerity of the Stability and Growth Pact (SGP), the undemocratic structure and lack of accountability of the European Central Bank (ECB), the separation between fiscal and monetary policy, and the paramount importance attached to price stability at the expense of other policy objectives. We proposed removing the restraints on fiscal policy at the national level and developing a coherent set of labor market, industrial, and macroeconomic policies at the EU level. Otherwise, we argued, achieving full employment or reducing inequality and regional disparities in the EU would not be possible. Furthermore, we foresaw serious negative effects on the economic performance of the member states of the EU and the material well-being of EU citizens.

Since early 2001, the eurozone has experienced rising unemployment (from 8.1 percent to 8.4 percent in November 2002), falling output (annual GDP growth declining from 2.5 percent in the first quarter of 2001 to 0.8 percent in the third quarter of 2002), and inflation higher than the ECB's target level of 2 percent, as measured by the Harmonized Index of Consumer Prices (HICP). These statistics support our earlier conclusion that the institutional and policy arrangements governing the EU are inappropriate for combating unemployment, recession, and inflation.

The Stability and Growth Pact Revisited

The general stance of the SGP—an overall balanced budget and a maximum annual deficit of 3 percent of GDP—is deeply flawed. A balanced budget does not allow governments to borrow to fund capital investment projects, and maintaining government deficits below 3 percent of GDP during recession will likely cause economies to slump further. There is, moreover, a deflationary bias in the operation of the SGP. In 2001, for example, the European Commission condemned Ireland for cutting taxes and raising public expenditures when its output was above the trend rate of growth. In 2002 the Commission criticized Britain, which is currently outside the EMU, for proposing public expenditure increases when its output was also above the trend rate of growth. The Commission recommended further that in the event of an economic downturn in 2002, British public expenditures should be reduced from planned levels to maintain the eurozone's target public expenditure-to-GDP ratio.

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Countries differ in the extent to which their output varies during the course of the business cycle and in the sensitivity of their budget positions to the business cycle. The European Commission found that balanced budgets were negatively linked to GDP growth (Buti, Franco, and Ongena 1997) and estimated that a 1 percentage-point decline in GDP increased the deficit-to-GDP ratio on average by 0.5 percentage points at the EU level. At the national level, the effect of a 1 percentage-point decline in GDP on budget deficits was different among countries and more dramatic (e.g., budget deficits in the Netherlands and Spain increased by 0.8 and 0.9 percentage points respectively).

The SGP assumes that any level of output and employment is consistent with a balanced budget and is thus compatible with a combination of net private saving and trade that sums to zero. Although individuals and firms make decisions on saving, investment, imports, and exports, it is unlikely that the aggregation of these decisions will sum to zero. Likewise, the budget deficit will not equal zero (in order to satisfy the identity equation drawn from the national accounts). Similarly, the view that a balanced budget is compatible with high levels of employment cannot be justified. In the past, governments typically operated with budget deficits. The imposition of a balanced budget represents a major departure from the norm.

The management of the SGP is also seriously flawed. In January 2002, the European Commission predicted EU budget deficits for the coming year under the terms of the SGP. Their predictions prompted the possibility of inciting the "early warning" mechanism for Germany and Portugal, since these countries' budget deficits trended toward the ceiling of 3 percent of GDP. However, the Economic and Financial Committee (ECOFIN) ignored the Commission's recommendation to censure Germany and Portugal. It chose instead to strike a deal: no formal warning would be issued if the countries pledged to keep within the rules of the SGP.

The response of ECOFIN to the evidence of rising budget deficits in the face of an economic slowdown involved bending the rules of the SGP without removing the deflationary effects of the rules. This response therefore supports the notion that the EMU does not adhere to its own rules, which undermines its credibility. Moreover, there has not been sufficient departure from the rules to offset the pressures of recession.

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The view that fiscal policy has an important role to play is gaining ground. For example, *The Economist* argues, "The euro members need to loosen their fiscal straightjacket immediately and rewrite the stability pact to take account of the cycle. Some argue that to re-write the pact now would hurt the euro's credibility. But it is far worse to stick to a lousy policy than to admit it is wrong and change it. Ask Argentina" (September 28, 2002).

Some economists argue that a country's budget must be restrained because of externalities or spillover effects, such as government spending that puts upward pressure on interest rates (more specifically, bond rates). This spending is perceived to raise the cost of borrowing by other governments as spending increases demand, which results in higher inflation (at least in the country concerned) and spills over into other countries, causing the ECB to raise interest rates in order to dampen inflation. Without accepting that government expenditures would necessarily have these effects, we propose that increased private sector expenditures could have effects similar to public expenditures. In practice, fluctuations in the overall level of expenditures come predominantly from private expenditures, particularly investment. Thus, the logic of imposing limits on public sector expenditures in order to regulate budget deficits should also apply to private sector expenditures, and perhaps the size of the private sector deficit or the trade account should also be limited!

Recent Admissions of the European Commission

At a summer 2001 summit in Seville, Spain, all EU members signed a commitment to balance their national budgets by 2004. By September 2001, however, the European Commission admitted for the first time that the financial rules governing the adoption of the euro needed to be changed. In view of economic weaknesses in the eurozone, the Commission became more flexible and extended the balanced-budget deadline to 2006 for Germany, Italy, Portugal, and France, if these countries reduced their budget deficits by 0.5 percent of GDP per year starting in 2003. The European Commissioner for Economic and Monetary Affairs recently acknowledged the Commission's concern that the original commitment of national governments to uphold the SGP was weakening substantially (*Financial Times*, September 9, 2002). The Commission has also stated that it would pay more attention to structural deficits so that a country's fiscal deficit would be judged in relation to its economic cycle (ibid). These pronouncements came with a warning that some countries ran a high risk of breaching the conditions of the SGP.

Since the Commission's budget deficit forecast and "early warning" citation in January 2002, Portugal and Germany have breached the 3 percent benchmark (budget deficits for 2002 are forecast to be 3.4 percent of GDP and 3.8 percent of GDP, respectively) and were reprimanded by the European Commission. The Commission has criticized Italy's budget deficit because it was reaching "dangerous proportions" and has charged the Italian government with massaging the figures. It has also criticized France for its 2002 tax and spending plans and expressed its concern that France may not meet the 2006 deadline to balance its budget.¹ During his testimony to the European Parliament in October 2002, ECB president Willem F. Duisenberg actually blamed France, Germany, and Italy for the uncertainty surrounding economic recovery in the eurozone. "Three of the larger countries have not used the time . . . [of] good economic conditions . . . to consolidate their budgets. Now they bear the burden of it," he said.

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The SGP has been the focus of growing controversy within the eurozone. The ECB continues to argue that reforming the SGP by relaxing its rules would damage the credibility of the euro. The opposite, however, may be closer to reality. Relaxing the rules according to the measures already taken by the European Commission has been inconsequential regarding the euro's credibility. In our view, many more fiscal policy reforms are needed before the eurozone can realize a true economic recovery and enhance the credibility of the euro.

The Problems of Monetary Policy in the European Union

We previously outlined the ECB's adoption of a "two-pillar" monetary strategy (Arestis and Sawyer 2002b). The reference value for monetary growth is a target of 4.5 percent for the M3 definition of the money supply. There is no mechanism to correct deviations in the short term, although deviations from the reference value would normally signal "risks to price stability." Price stability is interpreted as an annual increase in the HICP within a range of 0 to 2 percent.

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Many problems have occurred in the management, operation, and potential efficacy of ECB monetary policy. The issuance of policy decisions has been very slow, and the ECB's operations have been confusing to the financial markets. In the two-pillar monetary strategy, uncertainty exists about the reference value attached to M3. Although the target value of 4.5 percent growth has rarely been met, this failing does not seem to affect policy decisions. We believe that the 0 to 2 percent annual inflation target is too restrictive and not symmetrical (i.e., the ECB's policy response is different when the inflation rate is above or below the target range). We note, moreover, that the ECB has been reluctant to manipulate interest rates when it was abundantly clear that such maneuvers were necessary (e.g., the U.S. Federal Reserve lowered interest rates four times—a total of 2 percentage points—before the ECB started to lower its interest rate). In practice, most central banks, aside from the ECB, account for economic growth and do not concentrate on inflation to the exclusion of other policy objectives. It has become obvious that the ECB's inflation target is far too low, especially now, when it "provides an inadequate cushion against the risk of deflation in the event of a serious slump in demand" (*The Economist*, September 28, 2002, p. 11).

A range of reservations have been expressed about the ECB's efficacy.

1. The Governor of the Bank of England noted the problem of the "one-size-fits-all" approach during an interview on German television (December 20, 2001). This approach was risky, he said, and for a diverse economic area "the same monetary policy is not necessarily the best for every country at the same time." The Governor also suggested on BBC radio (December 21, 2000) that setting monetary policy in a country in which mitigating factors such as labor migration and fiscal redistribution exist was different from setting monetary policy in the eurozone, where those factors are not present to any significant degree. A single currency can do little to offset the undesirable effects of interest rates that are set too high or too low by the ECB.
2. Regarding the transmission mechanism of monetary policy in the eurozone, ECB president Duisenberg conceded, "Relatively little is known as yet about it. One important challenge for the eurosystem is to obtain better knowledge of the structure and functioning of the euro-area economy and the transmission mechanism of monetary policy within it, so that policy actions can be implemented accordingly" (Duisenberg 1999).
3. We have considerable doubt about the effectiveness of monetary policy in responding to recession and controlling inflation. Governments are reluctant to cut interest rates in the face of recession (with the notable exception of the United States). The ECB, moreover, has failed to meet its inflation target for the past three years and has presided over a wide range of inflation rates within the eurozone.

4. The magnitude and timing of the impact of interest rates on private and public expenditures are unclear.
5. Interest rate policies affect a range of economic variables (e.g., aggregate demand) and have distributional effects.
6. We expect that exchange rate adjustments will have little effect on the EMU economy. In terms of international trade, imports and exports in the eurozone represent less than 10 percent of GDP, so changes in the exchange rate of the euro with other currencies will impact prices far less than exchange rate adjustments in more open economies.

Monetary policy in the EU suffers from three major defects. First, if inflation is induced by a demand shock (i.e., higher demand causes more inflation), then a policy that influences aggregate demand may have some validity. Such a policy, however, is powerless to deal with cost inflation or supply-shock inflation. A supply shock, for example, would lower (raise) output and raise (lower) inflation. The extent to which domestic interest rate adjustments can influence inflation rates is limited not only by exchange rate considerations, but also the time required for any adjustment to affect aggregate demand. For example, monetary authorities in Britain expect a two-year lag between interest rate adjustments and their impact on aggregate demand and the inflation rate.

Second, although changes in interest rates affect investment and the exchange rate, they have a limited impact on aggregate demand. Our survey of the effects of monetary policy, based on research undertaken for the ECB and the Bank of England, showed that a percentage-point change in interest rates may change inflation by 0.2 to 0.3 percentage points after two years (Arestis and Sawyer 2002a).

Third, the "one-size-fits-all" approach to EU monetary policy may address average inflation, but it cannot address national differences in inflation. In November 2002, for example, the annual inflation rate ranged from a high of 4.7 percent in Ireland to a low of 1.0 percent in Germany. In addition, many eurozone countries (e.g., Ireland, Portugal, Greece, Spain) do not satisfy the inflation convergence criteria of the Maastricht Treaty (inflation within 1.5 percent of the three best-performing member states). The impact of any interest rate adjustments by the ECB is therefore likely to differ markedly among EU countries.

Despite the major defects of EU monetary policy, ECB president Duisenberg defended interest rate levels in the eurozone when he testified before the European Parliament in October 2002. Comparing the euro-area economy with other major economies that have followed more aggressive interest rate policies, he claimed that the ECB policy stance was worth valuing "highly." The policy he referred to related to the 1.5 percentage-point interest rate reduction since the beginning of 2001 (when the global slowdown began) to 3.25 percent (effective November 9, 2002). By contrast, the Federal Reserve in the United States cut its interest rate by 4.75 percentage points, to 1.25 percent, during the same period.

The claim by the ECB president that the economic results of the ECB's interest rate policy are favorable cannot be sustained.

Comparing the effect of ECB and Federal Reserve policy is not complimentary to the president's argument. The seasonally adjusted annual growth rates of GDP in the eurozone for the first three quarters of 2002 were 0.3 percent, 0.6 percent, and 0.8 percent, respectively (*Eurostat*, January 2003), while the corresponding growth rates in the United States were 5.0 percent, 1.3 percent, and 4.0 percent (Bureau of Economic Analysis 2003). By the third quarter of 2002, the unemployment rate had risen to 8.4 percent in the eurozone and to 6.0 percent in the United States. Furthermore, the dollar did not decline, but rose relative to the euro following the president's statement. Traders expressed disappointment with the outlook for eurozone growth (*Financial Times*, October 9, 2002). The president's comments dampened hope that the ECB would support growth by cutting interest rates. Clearly, the claim by the ECB president that the economic results of the ECB's interest rate policy are favorable cannot be sustained. Although the U.S. dollar has recently declined, we note that the current strength of the euro against the dollar is not due to the ECB's interest rate policy, but, rather, to the weakness of the dollar as a result of the high deficit-to-GDP ratio in the United States, the indebtedness of the U.S. corporate and public sectors, and the uncertainty about war.

A New Constitutional Treaty?

We are concerned about the ongoing policy position of the ECB in light of its argument that "it is natural for an economic slowdown to have adverse effects on member countries' budget positions. However, for countries with a budget position still not close to balance or in surplus, it is important to adhere to . . . medium-term consolidation plans. A short-lived slowdown should not significantly change the scope for reaching the targets set in the countries' stability programmes." Furthermore, the ECB adds, "As adjustment needs are likely to become more visible in periods of less vigorous economic growth, policy makers must now step up the reforms rather than allowing efforts to abate" (*ECB Monthly Bulletin*, October 2001, p. 6).

An interesting set of proposals has been recommended by the European Convention, a working group with the task of firming up a "basic constitutional treaty" for the EU (European Convention 2002). The group proposes that "the Union's economic and social objectives should be included in a new constitutional treaty. Some members of the group have emphasized the importance of including a reference to sustainable growth and productivity. Others attach more importance to highlighting full employment, social and regional cohesion, and a better balance between competition and public services in a social market economy" (ibid, 2). Drawing on these premises, the Convention agreed that "there is a need for improved coordination between the economic policies of the Member States" (ibid, 3). Furthermore, some members of the group believe that growth and development objectives should be included in the ECB mandate, although "a large number of the group consider that the tasks, mandate and statute of the European Central Bank should remain unchanged, and should not be affected by any new treaty provisions" (ibid, 3). The Convention also recommended increased ECB transparency and accountability, improved ECB reporting to the European Parliament, and publication of the minutes of ECB meetings. It did not suggest much change in the SGP.

Inflexible interpretation of the SGP and adherence to the balanced budget requirement . . . would turn the SGP into the "Instability and No Growth Pact."

Scrap the SGP and Reform the ECB

Some of the proposals made by the European Convention would improve the institutional system of the EU, but the proposals are incomplete. They do not go far enough in proposing cures for the system's fundamental problem—its inherent deflationary bias. Other problems associated with the operation and management of the ECB remain, apart from attempts to enhance the bank's accountability and transparency. In the case of the SGP, the ECB's stance is essentially to accept the current arrangements, although it makes the point in a number of its monthly bulletins that fiscal and monetary coordination of the Member States is important for monetary stability and sound economic growth.

We believe that the economic slowdown in the eurozone has exposed serious fault lines in the SGP, so that policy based on SGP rules is untenable

in the long term. We observe that in spite of official EU policy, national budget deficit limits have been relaxed and some countries have been granted four years rather than two to meet the balanced-budget requirement. Shifting the goalposts each time the ball comes near is not sustainable policy.

In our view, inflexible interpretation of the SGP and adherence to the balanced budget requirement would be disastrous and would turn the SGP into the "Instability and No Growth Pact." Our object response therefore is to "scrap the SGP!" Remove the artificial limits on budget deficits, permit borrowing for capital investment, and stop imposing a "one-size-fits-all" policy on EU countries. In the absence of a significant EU budget capable of providing automatic stabilizers and stimulating the EU economy, remove any political constraints on national budgets, so that EU members can set appropriate fiscal policies for themselves. Institutional arrangements for the coordination of national fiscal policies should be strengthened and new EU institutional arrangements should be designed specifically for the operation of EU fiscal policy.

The objectives and operation of the ECB must be changed to consider growth and employment alongside inflation. As suggested by the European Convention, EMU institutional arrangements and fiscal policy must ensure that monetary authorities do not dominate economic policymaking and that there is a serious coordination of monetary and fiscal policy.

Note

1. In fact, France refused to adhere even to the 2006 deadline, arguing that it was not affordable. This disputes the wisdom of a "one-size-fits-all" policy, either fiscal or monetary. France's defiance prompted the European Commission to consider issuing a formal letter of reprimand. If France is reprimanded under these circumstances, dogma will have triumphed over sound economics (*Financial Times*, October 10, 2002).

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