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Public Policy Brief

THE FUTURE OF THE EURO

Is There an Alternative to the
Stability and Growth Pact?

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AND MALCOLM SAWYER

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Preface

Since the introduction of the euro, popular media attention has usually focused on the value of the currency relative to others, especially the U.S. dollar. Of course, the euro's value has been and continues to be an interesting spectacle: after trading at about \$1.16 on average for the first month after its launch, the euro bottomed out at \$0.83 near the end of October 2000 and climbed rather steadily to \$0.92 by the beginning of 2001. Predictably, the weakening of the U.S. economy and the slowdown in the flow of short-term financial capital into the United States are encouraging speculation as to how high the euro might go and the possible effect its climb might have on economies on both sides of the Atlantic.

However, once we turn our attention away from the short-run ups and downs of the exchange rate to its long-run determinants and the effects that exchange rate fluctuations have on the real economy (in terms of output growth and employment) we cannot ignore the far-reaching implications of the Stability and Growth Pact entered into by the member states of the European Union (EU). This pact underpins the adoption of the single currency and has fundamentally redefined the scope and nature of economic policy making in the member states. Yet public discussion about the pact is relatively scant, especially on our side of the Atlantic. The economic health of the EU does matter to the United States, both economically and strategically. The EU accounts for about 16 percent of our current account deficit, and 15 percent of our exports of goods are destined for the eurozone. Two EU countries—Germany and Switzerland—are major net purchasers of equity and bonds issued by American corporations.

In this brief, Philip Arestis, Kevin McCauley, and Malcolm Sawyer provide a detailed description and trenchant critique of the Stability and Growth Pact and propose an alternative policy. The critique developed by the authors focuses on the shortcomings induced by the pact's regime of mandatory fiscal austerity, the separation between fiscal and monetary policy (with the latter entrusted to the European Central Bank), the undemocratic structure and lack of accountability of the European Central Bank, and the paramount importance attached to price stability at the expense of other policy objectives. According to the authors, these shortcomings will have serious negative effects on the current and future economic performance of the member states and the material well-being of its citizens.

If the major thrust of the critique advanced by Arestis, McCauley, and Sawyer is correct, policymakers should consider reorienting immediate policy targets and, more fundamentally, the institutional structure of the European Monetary Union. The alternative pact proposed by the authors urges removing the restraints on national-level fiscal policy and developing a coherent set of labor market, industrial, and macroeconomic policies at the European level. While the unemployment rate has declined slightly in the last few quarters in the eurozone, it still remains rather high at 8.5 percent. When this level of unemployment is considered in terms of its attendant human and social costs and in light of the striking disparities in growth performance across the regions in the eurozone, it becomes clear that the current policy regime is inadequate in a profound sense.

I trust that you will find the analysis that follows insightful and thought-provoking. As always, I welcome your comments.

Dimitri B. Papadimitriou, *President*
March 2001

The Future of the Euro

The adoption of a single currency (the euro) within most countries of the European Union (EU) is underpinned by a Stability and Growth Pact. This brief critiques the Stability and Growth Pact between EU governments and proposes an alternative to it. The alternative pact we propose is based on a Keynesian analysis that differs starkly from the economic analysis (which we label “new monetarism”) that informs the Stability and Growth Pact. In our alternative pact, full employment and the reduction of inequality and regional disparities are the major objectives for economic policy. Our pact also considers growth a more important policy objective than price stability. The achievement of these objectives requires the implementation of a different set of economic policies and the construction of appropriate institutional arrangements to underpin those policies.¹

In the policy debates on the euro, the Stability and Growth Pact has received less attention than other aspects of the currency’s introduction. Yet that pact is crucial to the determination of economic policies to be pursued within the eurozone. We begin with a critical examination of the pact, followed by a discussion of its practical operation and a number of weaknesses therein. We then outline our alternative pact, discuss its rationale, and identify the institutional changes required to implement it.

The Stability and Growth Pact: Adoption and Main Features

The Stability and Growth Pact was formally adopted at the Amsterdam Summit in July 1997 after several rounds of negotiations between the EU countries. It governs the economic policies of those EU member countries that have joined the single currency and strongly constrains the policies of those EU countries that have not yet joined. Together with the Maastricht Treaty, the pact created four rules for economic policy that the pact's signatories believed would facilitate the achievement of the European Central Bank's (ECB) primary goal of price stability. The four rules are that the ECB would be independent from political influence; there would be no bailout of national government deficits; there would be no monetary financing of government deficits; and that member states would avoid "excessive" government budget deficits, i.e., deficits exceeding the equivalent of 3 percent of gross domestic product (GDP).

The Stability and Growth Pact has three components: a European Council Resolution and two Council Regulations. The resolution commits all parties, member states, the commission, and the council to "implement the Treaty and the Stability and Growth Pact in a strict and timely manner." The council regulations, unlike the resolution, have legal force and are composed of two elements. One element is preventive, aiming to strengthen budgetary positions and surveillance and coordination of economic policies. It commits member states that join the single currency to submit stability programs to the commission. These programs must be updated annually and must detail the member states' medium-term budget objectives, main assumptions about economic developments, and projected future values for both the budget deficit-to-GDP ratio and the national debt-to-GDP ratio. Non-euro members must submit a "convergence plan," which should be similar in outline to the stability program. The second element aims to speed up and clarify the implementation of the penalties imposed on countries with excessive deficits.

Theoretical Basis of the Stability and Growth Pact

The economic analysis underlying the Stability and Growth Pact has not, to our knowledge, been formally spelled out. But we argue that the rationale for the pact can be understood in terms of an economic analysis that we have elsewhere labeled “new monetarism” (Arestis and Sawyer 1998b). This “new monetarism” also underpins many of the policy propositions associated with the “third way” advocated by Tony Blair and “new Labor” in the United Kingdom (Arestis and Sawyer 2001).

We identify the essential propositions of the “new monetarism” in the following terms.

First, politicians in particular and the democratic process in general cannot be trusted with economic policy formulation because it leads to decisions that have stimulating short-term effects (for example, reducing unemployment via higher government spending) but that are detrimental in the longer term (a notable example is a rise in inflation). In contrast, experts in the form of central bankers are not subject to political pressures to court short-term popularity and thus can take a longer-term perspective.

Second, inflation is seen as a monetary phenomenon, which can be controlled through monetary policy. The money supply itself is viewed as difficult (or impossible) to control directly, but the central bank can set the key short-term interest rate to influence monetary conditions, which in turn influence the future rate of inflation.

Third, the actual rate of unemployment fluctuates around a supply-side determined equilibrium rate of unemployment, generally labeled the NAIRU (nonaccelerating inflation rate of unemployment). The level of the NAIRU may be favorably affected by a “flexible” labor market, but is unaffected by the level of aggregate demand or the amount of productive capacity.

Fourth, fiscal policy is impotent in terms of its long-run impact on real variables, such as output and employment. It should be subordinate to monetary policy in controlling inflation. It is recognized, though, that the government budget position will fluctuate during the course of the business cycle, but in the context of an essentially passive fiscal policy.

The policies and institutional arrangements inspired by the new monetarism and being put in place in the EU have serious negative consequences. The first proposition mentioned above suggests that fiscal policy, since it can be influenced directly by the political process, should be constrained effectively from doing long-term damage. It also suggests that monetary policy must be beyond democratic influence and essentially controlled by central bankers. In combination, these considerations have prompted the complete separation between the monetary authorities (the ECB) and the fiscal authorities (the national governments). This precludes the coordination of fiscal and monetary policies, for it would require the ECB to be influenced by national governments and those who can influence national governments.

The ECB and the system of national central banks are viewed as operating independently of national governments and the European Commission (EC). The ECB operates monetary policy in the eurozone and has been given the objective of securing price stability without any explicit concern over other objectives, such as the level of economic activity or the exchange rate of the euro. Article 105 of the Protocol on the European System of Central Banks (the system encompasses the ECB as well as the national central banks) states, "The primary objective of the European System of Central Banks (ESCB) shall be to maintain price stability. Without prejudice to the objective of price stability, the ESCB shall support the general economic policies in the Community" (EC 1998). The key decision makers on the ECB are governors of the national central banks and monetary experts.

The elevation of monetary policy as the only policy instrument that can be exercised at the EU level, combined with the antiinflationary focus of that policy, will tend to generate a deflationary economic environment. Any signs of inflation or “overheating” of some part of the EU economy is likely to be met by increases in the interest rate. This will be exacerbated by the lack of active fiscal policy and the absence of other mechanisms (such as the promotion of investment) to stimulate aggregate demand. The existing institutional framework is not adequate to provide for a sufficiently strong fiscal policy at the EU level, and the very limited economic policy coordination provided for under Article 103 of the Maastricht Treaty is not adequate to support an EU-level fiscal policy.

The size of the EU budget is relatively small at around 1.3 percent of the combined GDP of EU members. It is still dominated by the needs of the Common Agricultural Policy, which account for about 50 percent. Yet the MacDougall Report (1997), written for the European Commission, suggested that monetary union would not be viable without a sufficiently large community budget for fiscal policy (7.5 percent of members’ GDP). Additionally, the EU budget is mandated to be balanced. Under these conditions, there is no scope for active fiscal policy (or indeed any fiscal policy). The EU budget cannot operate as an effective stabilizer or redistribute funds from richer regions to poorer ones in any significant manner.

The Stability and Growth Pact: Operational Characteristics

A central feature of the Stability and Growth Pact is the requirement that a national government’s budget deficit not exceed 3 percent of GDP. Failure to meet that requirement would lead to a series of fines, depending on the degree to which the deficit exceeds 3 percent (as indicated below). Non-euro members are also required to exercise

similar constraints on their deficits through convergence programs, though they are not subject to penalties for excessive deficits.

A country's budgetary data become available for the commission to scrutinize on March 1 of each year, when the annual updates of the stability programs are submitted. Each program contains information about the projected future values of the deficit-to-GDP ratio and the debt-to-GDP ratio. The Council of Economics and Finance Ministers of the EU examines the program and delivers an opinion on a recommendation by the commission within two months of the report's submission. If a country's stability program reveals that it is significantly diverging from its medium-term budgetary objective, the council will recommend that the stability program be strengthened. If the situation persists, the member state will be judged to have breached the reference values for the deficit-to-GDP ratio and the debt-to-GDP ratio. The pact details "escape" clauses that allow member states with excessive deficits to avoid penalties. If there is an economic downturn and output (real GDP) has fallen by more than 2 percent, the offending member states will escape penalties automatically, but their deficits are to be corrected once the recession has finished. If output falls between 0.75 and 2 percent, the council can use discretion when making a decision on an excessive deficit. Other factors are taken into account such as the abruptness of the downturn, the accumulated loss of output relative to past trends, and whether the government deficit exceeds government investment expenditure.

When the council has sifted through all relevant information pertaining to the country whose financial position is under review, it must decide whether an excessive deficit exists. In making the decision the council operates with a qualified majority voting system; under the Maastricht Treaty all EU member states have a vote, including those countries that are not in the eurozone and even the country under review. A country found to have breached the reference values will then have four months in which to introduce the corrective measures suggested by the council. If the country follows

the council's recommendations, the "excessive" deficit must be corrected within a year following its identification. A country that chooses not to introduce corrective measures will be subject to a range of penalties, at least one of which must be imposed. One penalty must be in the form of a non-interest-bearing deposit lodged by the national government. In this instance, it falls upon the European Monetary Union (EMU), meaning eurozone members, excluding the member country under consideration, to reach a decision on penalties. The non-interest-bearing deposit consists of a fixed component (0.2 percent of GDP) and a variable component of one tenth of the difference between the deficit ratio and the 3 percent reference value. If the budget deficit is not corrected within two years, the deposit is forfeited and becomes a fine. If the deficit is corrected within two years, the deposit is returned and the penalty becomes the foregone interest. Since the penalty clause imposes fines to be paid by the national governments to the EU, it adds to the deficit it is meant to cure, and therefore may generate political opposition and resistance at the national level.

The constraints imposed by the pact will severely reduce national fiscal independence and effectively preclude the use of national fiscal policy for demand management purposes. This is especially the case at present, whereby countries have entered the eurozone with budget deficits close to the upper limit of 3 percent of GDP. Organization for Economic Cooperation and Development (OECD) 1998 estimates suggest that eight of the 11 countries in the eurozone have projected budget deficits in the range of 1 to 2 percent of GDP over the next few years, which is not sufficient to allow automatic stabilizers (such as government-sponsored unemployment insurance) to work under the Stability and Growth Pact. Bayoumi and Eichengreen (1995) suggest that this restriction on the workings of automatic stabilizers could lead to weaker fiscal stabilization and greater fluctuations in real GDP. Further, von Hagen and Eichengreen (1996) argue that if automatic stabilizers cannot function fully, political pressures will build for fiscal federalism to provide them.

This system of financial penalties for breaches of the budget deficit criterion implies that deflationary fiscal policies will continue, and indeed intensify, as those countries that just met the 3 percent requirement in conditions of cyclical upswing will have to tighten their fiscal stance to meet the 3 percent requirement in times of cyclical downswing. The European Commission has estimated that a 1 percent fall in GDP will increase the deficit-to-GDP ratio by 0.5 percent (Buti et al. 1997, 7). The extent to which the Stability and Growth Pact permits a country to have a larger deficit in the face of recession is some formal recognition that automatic stabilizers and active fiscal policy can be hampered, but it may not be sufficient to prevent the Stability and Growth Pact from exacerbating recessions.

A government that aims to avoid at all times an excessive budget deficit would have to ensure that the 3 percent limit is not breached during economic slowdown (when the deficit is most likely to exceed that limit); hence, the average deficit during the course of the business cycle would have to average considerably less than 3 percent of GDP.

A Full-Employment, Growth, and Stability Pact

In this section we propose an alternative pact that we label a full-employment, growth, and stability pact to emphasize the change of policy objectives involved. The alternative pact draws on three elements: a Keynesian analysis of the workings of the economy, the articulation of a specific set of policy objectives that include full employment and growth, and a consideration of appropriate institutional arrangements.

A Keynesian analysis of the economy (Arestis and Sawyer 1998a) views fiscal policy as a crucial ingredient in the achievement of the high levels of aggregate demand required to sustain high levels of economic activity. In addition to the broad stance of fiscal policy, governments can

affect the level of aggregate demand through their choice of the composition of taxes and public expenditure and their influence over investment expenditure. It should be clearly understood that we are not advocating any form of “fine tuning” involving frequent (more often than annual) changes in tax and expenditure policies. Instead we are advocating “coarse tuning” under which budget deficits are used to support aggregate demand as necessary, given the prevailing levels of private demand.

Our broadly Keynesian analysis involves the idea that market economies display considerable disparities in economic performance and involve significant levels of inequality between individuals, households, regions, and countries. These disparities and inequalities are exacerbated by the forces of cumulative causation with little, if any, tendency for market forces to reduce these disparities (Myrdal 1957). The euro has been launched in the face of substantial regional disparities (in terms of unemployment rates and per capita income levels), and it is difficult to think of comparable examples of a single-currency zone in which the disparities of economic performance were on anything like the scale of those within the EU. For example, unemployment in April 1998 varied from 2.1 percent in the central region of Portugal to 2.6 percent in the Aaland region of Finland, 27 percent in Calabria, Italy, and 29.9 percent in Andalusia in southern Spain. Unless appropriate policy action is taken at the EU level there will be little tendency for those initial disparities to decline.

The second element of the development of an alternative pact is the articulation of a set of objectives for economic policy, the pursuit of which should influence the design of the institutional arrangements and the instruments of economic policy. These objectives are full employment and sustained economic growth achieved in an environmentally friendly manner. The achievement of full employment necessarily includes a substantial reduction in the disparities of unemployment between different EU nations and the creation of sufficient productive capacity (Sawyer 1999).

The third element is the creation and support of appropriate institutional arrangements at the EU and national levels. The only new institution created so far in connection with the single currency has been the ECB. Our view is that a range of other institutions should be established by the EU or encouraged by the EU and the member governments. There is clearly a need for coordination of economic policy among the member countries and the emergence of appropriate institutional arrangements and policies at the EU level.

We now turn to a closer look at the three areas of economic policy covered by our alternative plan: fiscal policy, monetary policy and the ECB, and the role of a European Investment Bank in redressing regional disparities.

Fiscal Policy

Two specific considerations inform our approach to fiscal policy. The first is that there is no strong reason to believe that the private sector will generate sufficient aggregate demand to underpin full employment. Consequently, full employment may require a budget deficit that would mop up any excess of private saving over investment. This is not to say that budget deficits are inevitable or in some way desirable in themselves, but rather that they may be a necessary element in the achievement of full employment. The second is the potency of fiscal policy in stimulating aggregate demand. Fiscal policy at the EU level would be more effective than fiscal policy at the national level. At the national level, especially for small open economies, much of the stimulus from expansionary fiscal policy goes abroad in the form of higher demand for imports. But the EU is a relatively closed economy and, as such, there would only be small leakages abroad of any demand stimulus from fiscal policy. It is ironic to note that fiscal policy is being downgraded at a time when it may become more potent.

At both the national and EU levels, the Stability and Growth Pact favors balanced budgets (or even budget surpluses) over the course of the business cycle in order to meet the 3 percent constraint on the budget deficit during recession. A balanced budget implies (as a matter of accounting identity) that the sum of private saving minus investment plus the trade deficit (borrowing overseas) is zero. There is little evidence that high levels of employment would necessarily generate an equality between saving and investment. It is often the case that there is an excess of saving over investment that needs to be mopped up by foreign lending and budget deficit. The limits on budget deficits imposed by the Stability and Growth Pact would prevent this from occurring, and hence full employment would require a trade surplus and the consequent foreign lending. At present, the EU runs a significant trade surplus with the rest of the world, but the counterpart is, of course, that other countries run a trade deficit and are borrowing from the EU. It is doubtful whether such a trade pattern is sustainable in the long term, given the consequent buildup of debt burden on the countries running the trade deficit.

The pact's 3-percent-of-GDP limit on budget deficits is arbitrary, and no good reason has been advanced for the figure of 3 percent, rather than, say, 2 percent or 4 percent. It has been suggested that the figure may have come from a combination of the average German experience over the past two decades or so and the share in GDP of public capital expenditure in many countries (Buiter, Corsetti, and Roubini 1993). The logic behind setting the budget deficit-to-GDP ratio equal to the public capital expenditure-to-GDP ratio is that under such a scenario, current expenditure will be covered by tax revenue.

The 3 percent level of deficit seriously impairs an economy's ability to absorb macroeconomic shocks and sustain high levels of aggregate demand and is therefore highly inappropriate. In the absence of

an EU-level fiscal policy, national governments should be allowed to pursue budget deficits as they deem appropriate. The extent to which national governments can borrow may well be constrained by financial markets, in which different governments may face different credit ratings (as do different states within the United States). But we advocate that national governments use fiscal policy, within those constraints, in pursuit of high levels of employment. A set of coordinated fiscal policies between countries, together with an EU-level fiscal policy, should be the aim, and the policies themselves must be geared to achieving high levels of economic activity.

Rules that specify a fixed limit on government borrowing fail to recognize that such borrowing serves as a mechanism for spreading the cost of adjustment to macroeconomic shocks and the tax burden associated with public investment over a number of years. Moreover, the motivation behind the adoption of fiscal constraints by the Maastricht Treaty and their strengthening through the Stability and Growth Pact is questionable. Borrowing restrictions are not present in existing monetary unions (Eichengreen 1997). In fact, it could be argued that borrowing constraints would be justified only if government borrowing increases the risk of a bailout. This would be the case if such a government had little or no tax-raising powers and was dependent on a central EU government for most of its income. However, because national governments in the EU still retain tax powers with a large tax base and use this as a means to finance borrowing, government borrowing restraints should not be imposed on them.

It is often pointed out that most single-currency zones involve a central or federal government with a tax and public expenditure program of substantial size relative to national GDP and the ability to run significant deficits. A tax and public expenditure program generally involves redistribution from richer regions to poorer ones, whether as an automatic consequence of a progressive tax and social security system or as specific acts of policy. The redistribution acts as

a stabilizer with negative shocks, leading to lower taxation and higher social security payments in the region that is adversely affected. In the absence of such a mechanism, it could be expected that economies would adjust to differential shocks and uneven economic performance through a variety of other routes. In response to a negative shock, these would include declines in economic activity, reductions in living standards, and outward migration. There is thus a need for the development of a larger EU tax base within a progressive tax system and redistribution of the tax revenue from the richer regions to the poorer ones (Fatas 1998).

The separation of the monetary authorities from the fiscal authorities and the decentralization of the fiscal authorities will inevitably make any coordination of fiscal and monetary policy difficult. Since the ECB is instructed to focus on inflation, while the fiscal authorities will have a broader range of concerns, considerable grounds for conflict will arise. This suggests a need for the evolution of a body charged with the coordination of these monetary and fiscal policies. In the absence of such a body, tensions will emerge when monetary policy and fiscal policy pull the economy in different directions (Begg and Green 1998, 131). The Stability and Growth Pact in effect resolves these issues by establishing the dominance of the monetary authorities (ECB) over the fiscal authorities (national governments).

To summarize, our proposals concerning fiscal policy include three elements. First, the present constraints on national budget positions should be removed, and national governments should be allowed to set fiscal policy as they deem appropriate in the light of economic circumstances and their perceptions of the costs and benefits involved. Second, institutional arrangements for the coordination of national fiscal policies must be strengthened. Third, institutional arrangements at the EU level must be developed for the operation of an EU fiscal policy and to ensure that monetary authorities of the ECB do not dominate economic policy making.

Monetary Policy and the European Central Bank

Much of the Stability and Growth Pact focuses on the achievement of low inflation through the use of monetary policy (that is, interest rate policy). It should be recognized that monetary policy through the manipulation of interest rates may not be an effective way of guiding the economy; the effects of interest rate changes on economic performance are highly indirect and uncertain and, as such, difficult to predict. Insofar as interest rate policy can influence the pace of inflation, it does so through suppressing aggregate demand, which in turn may well have detrimental effects on investment and the creation of productive capacity and may reduce labor force participation.

It is now clear that the principal instrument of monetary policy is the setting of a key short-term interest rate by the central bank, rather than directly (or even indirectly) controlling the stock of money. But industrialized economies use credit money, which is created largely through the banking system and the granting of loans. In an endogenous (credit) money system, the control of the stock of money (and other monetary aggregates) is problematic, and in effect the stock of money is set by the amount of money that people wish to hold. Further, in a credit money economy inflation is not a purely monetary phenomenon. Instead, inflation arises from the operation of real phenomena, mainly conflicts over the distribution of national income and a lack of adequate productive capacity (relative to the level of aggregate demand). Inflationary pressures lead to the creation of money by the banking system (see, for example, Arestis 1997). This suggests that building an equitable income distribution and creating adequate productive capacity through investment should be important ingredients of antiinflationary policy. In contrast, the use of interest rates—the sole policy instrument prescribed by the Stability and Growth Pact—to control inflation can have detrimental effects on the future course of inflation. Unnecessarily tight monetary policy will have detrimental effects on the future growth of productive capacity, and thereby on the ability of the economy to reach high levels of employment without inflationary pressures.

Apart from this, there are additional problems that emerge from the fact that the interest rate policy is formulated by the ECB for a group of countries, rather than an individual country. Banking systems and financial institutional arrangements vary widely within the eurozone. The responsiveness of economic activity to a given change in interest rates will also be different in different national economies. For example, the use of longer-term financial contracts that insulate the borrower from the fluctuations in the short-term interest rates is more common in some countries than others, and such differences in the structure of financial markets will retard the impact of monetary policy on aggregate demand in those countries (Begg 1997). This consideration reinforces the difficulties of the one-instrument approach to economic policy, which is embodied in the use of interest rates for macroeconomic management. The varying impact of monetary policy from country to country may also exacerbate regional disparities.

It should also be noted that the emergence of the euro will lead to a novel situation in which two or three currencies dominate at the global level: the dollar, the euro, and possibly the yen. Associated with each of these major currencies will be several other currencies whose values are virtually fixed relative to it. Because the setting of the euro interest rate will be heavily conditioned by the dollar and the yen interest rates, there is the threat of instability as one set of interest rates responds to the setting of the others. For example, the pursuit of inconsistent exchange rate targets through interest rates would lead to a form of interest rate war, as countries compete against each other for flows of global financial capital.

Our view of inflation is that it is not essentially caused by a monetary expansion, but rather that a monetary expansion, mainly in the form of an upsurge in bank lending, occurs to finance increased expenditure. The major sources of inflationary pressures are conflicts over the distribution of national income and a deficiency in productive capacity relative to high levels of demand. This leads us to favor a two-pronged approach to inflation that does not use monetary policy to control it.

First, institutional arrangements should be developed for collective wage determination that would minimize conflicts over the distribution of income. Wage determination within the EU is currently undertaken on a decentralized and fragmented basis, even where it is (or has been) centralized within a particular national economy. Institutional arrangements for collective wage determination at the EU level do not currently exist, which effectively rules out any possibilities for the operation of EU-level incomes policy for the next few years. There are a number of countries in Europe (within and without the EU) with centralized institutional arrangements that have been conducive to relatively low inflation. Examples include Austria, Germany, and, perhaps the most successful, Norway.

Second, it is necessary to build a well-functioning economy that is conducive to combining low inflation with high levels of economic activity. A major element in building such an economy is the construction of a level and location of productive capacity that is capable of providing work to all who seek paid employment. This would require the general level of productive capacity to be raised, especially in less prosperous regions of the EU. To achieve this goal, the functions of the European Investment Bank (or a similar institution) must be redefined to ensure high rates of capital formation, appropriately located across the EU.

The construction of EU-wide institutional arrangements for wage determination and investment would be a long-term project. The EU, however, might be able to act as a facilitator through appropriate legislation on the role of trade unions and employers' organizations, and the encouragement of the operation and growth of such organizations at the EU level.

However, any discussion of antiinflation policy must acknowledge that inflation has generally reached low levels recently, not just in European economies but nearly worldwide. The greatest present danger is deflation, in terms of both low levels of demand and falling prices, rather than inflation. Because of its undue emphasis on price

stability, the Stability and Growth Pact has not addressed some fundamental issues regarding the structure and role of the ECB—a task to which we turn next.

Central banks usually have a range of roles linked with the regulation and stability of the financial system, but these appear to be lacking in the case of the ECB. In particular, there is no specific requirement for the ECB to act as lender of last resort, though the ECB can decide to do so (see, for example, Articles 17 and 18 of the Statute of the European System of Central Banks and of the European Central Bank). Under a single currency there is no proper framework for crisis management. The traditional role of a central bank has been completely decoupled, with the ECB assuming monetary control and the national central banks retaining supervisory roles. It has been argued that in the event of a banking crisis these two roles would overlap and the national central bank, acting as lender of last resort, would wish to inject liquidity into the financial system; however, it would be constrained, given that money supply control falls under the remit of the ECB (*Financial Times*, September 23, 1998). This argument should be qualified in an important way. The ECB's main objective is the pursuit of price stability, but it is also responsible, along with national central banks, for banking surveillance, though in this respect it can only offer a non-binding opinion (Article 105[5] of the Statute of the European System of Central Banks and of the European Central Bank). The ECB's potential role in surveillance could be enhanced considerably, and there is scope for an expansion of its current supervisory role subject to the approval of the Council of Economics and Finance Ministers of the EU (Article 105[6]). Furthermore, prevention can play an important role in reducing the possibility of financial crisis. Higher capital and liquidity reserve requirements than those currently in operation can, in principle, reduce the severity of crises and strengthen banking supervision, which would lessen the risk of bank bankruptcies.

The ECB at present stands as the only body that can implement economic policy at an EU level. In its present form, the ECB suffers from

two major shortcomings: its undemocratic and unrepresentative nature, and the objective it has been assigned. Hence, we propose that the ECB be changed in two significant ways: the membership of its board of directors should be broadened and the directors made answerable to the European Parliament, and the objectives set for the ECB should also be reformulated. A further change would be to increase the transparency of the ECB's operations.

Many seem to regard the setting of interest rates as a technical matter. Indeed, part of the rationale for an independent central bank is that it takes decisions on interest rates out of the hands of politicians (though this does not necessarily mean that the decisions become depoliticized). However, changes in interest rates often have distributional consequences and differential impacts on regions and industries. In such instances, those who face the possible consequences should influence the setting of interest rates. The board of directors of the ECB should be broadened through the explicit representation of different industrial sectors and workers and consumers. An alternative would be for the European Parliament to appoint the board of directors in a way that would represent a much wider range of interests, certainly much wider than is the case at present.

An alternative full-employment, growth, and stability pact would thus involve major changes in the operations of the ECB. We have argued for a change in the objectives set for the ECB and a recognition of the channels through which monetary policy influences economic activity, with due regard for the distributional effects of interest rate changes. Further, there is a need for a reformulation of the ECB's regulatory role. In this respect, the ECB's most important function is to ensure that orderly conditions prevail in the money market. In order to achieve this, the restructured ECB should be required to act as lender of last resort, not merely to possess the potential to do so. Moreover, the ECB should adopt a more proactive stance on bank surveillance and supervision. The interest rate policy of the ECB should encourage full employment and growth rather than merely fight inflation.

European Investment Bank

The present disparities in regional unemployment levels (and in labor market participation rates) within the EU would suggest that even if full employment were achieved in some regions, substantial levels of unemployment would persist in many others. In the presence of such disparities, the achievement of a low level of overall unemployment (not to mention full employment) would be well nigh impossible. Inflationary pressures would build up in the fully employed regions even when the less prosperous regions were still suffering from significant levels of unemployment. Interest rates would then be raised in an attempt to dampen the inflationary pressures in the prosperous regions without consideration for the continuing high levels of unemployment in other regions.

A European Investment Bank (EIB) that is given a much wider purview can supplement the activities of the ECB, with the specific objective of enhancing investment activity in those regions where unemployment is acute. Enhanced investment activity would thus aim to reduce the dispersion of unemployment within the framework of reducing unemployment in general. This could be achieved through encouraging long-term investment whenever this is necessary by providing appropriate financing for it.

We suggest an overhaul of the EIB's purview because of the changing environment. As noted by Honohan (1995), the EIB was established at a time when national capital markets were less developed than at present. Now, however, many lenders compete with the EIB, and in this respect its public policy role is shrinking. Despite this trend, there is still room to extend the EIB's public policy role. The case for a revamped EIB is based on three considerations. First, there is a need for differentiated policies, which will enable the less prosperous regions to catch up with the more prosperous ones by promoting higher levels of employment and economic activity. Second, the forces of cumulative causation in the context of a single currency and market

will tend to stimulate investment in the more prosperous regions rather than in the less prosperous ones. Third, the high setup costs of venture capital projects and the disproportionate number of small firms in the EU peripheral areas (which generally experience higher levels of unemployment) provide a rationale for subsidies aimed at venture capital activities because setup costs are largely independent of the scale of borrowing (Honohan 1995).

Summary and Conclusions

The Stability and Growth Pact governing macroeconomic policy in the European Monetary Union draws heavily on an economic analysis that we have labeled “new monetarism.” An important ingredient in that analysis is the idea that a clear separation can be made between the real side and the monetary side of the economy. The equilibrium unemployment rate (effectively the NAIRU) and output are determined on the supply side of the economy, and the level of prices (and hence the rate of inflation) is set by the rate of expansion of the money supply. We do not accept this as a valid framework of economic analysis. The institutional arrangements inspired by new monetarism and put in place by the Stability and Growth Pact are highly undesirable in view of the problems that we have identified above. Therefore, we have suggested an alternative pact that we call the full-employment, growth, and stability pact.

The full-employment, growth, and stability pact proposed here would have four major elements. First, the ECB must be reformed to make it more accountable and capable of pursuing a broader range of objectives. It should be made clear that the ECB will act as lender of last resort and participate in the coordination of monetary and fiscal policies. Second, the EU-level budget must be extended to become more redistributive (across countries and time) and to provide much more discretion for national governments to pursue expansionary fiscal policy. Third, the role of the EIB must be expanded to ensure

that the less prosperous regions share in economic growth. Fourth, institutional arrangements that are conducive to low inflation must be encouraged.

Consideration of an alternative to the Stability and Growth Pact is urgent and pertinent now, in view of the recent pronouncements by ECB officials. The ECB's president stated at a press conference (October 13, 1998) that "the structural budgetary positions in several member states are still far from being close to balance or in surplus as required by the Stability and Growth Pact. Therefore, these member states are not yet sufficiently prepared to enable automatic stabilizers to function in the event of a slowdown in real GDP growth, while still respecting the 3 percent reference level set out in the treaty and ensuring a decline of debt ratios at an appropriate pace. Moreover, in a number of member states, against the background of a still favorable and partly better than expected growth performance, short-term budgetary targets appear not to represent structural improvements." Surely, a healthy future for the EU cannot be foreseen when economic policies are based on such pronouncements.

Notes

1. This brief is based on another study by the authors (see Arestis, McCauley, and Sawyer 2001). It also has important links to a forthcoming book (Arestis, Brown, and Sawyer 2001).

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