THE LEVEL PLAYING FIELDS OF FLANDERS

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Una *politeia* per un'Europa diversa, più forte e più equa

Prefazioni di Giorgio La Malfa e Giulio Sapelli

Con saggi di **Jan A. Kregel** sulla politica monetaria e fiscale e di **Alberto Heimler** sulla concorrenza nell'Unione Europea

RUBBETTINO

Document drafted by the Italian Ministry for European Affairs, to propose the creation of a high-level working group, composed of representatives of the Member States, the Parliament and the Commission, which will examine the correspondence of the current European institutional architecture and economic policy with the objectives of growth in stability and full employment explicitly foreseen in the EU Treaties.

The Level Playing Field: Single European Act

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Meant to provide a level playing field for trade among EU members

Much as Bretton Woods was created to eliminate beggar my neighbor exchange rate policies it was recognized that this would require elimination of exchange rate distortions

In a fixed exchange rate system, uniform monetary policy will have differential impact on countries with different domestic conditions

This required economic convergence criteria for introduction of the single currency spelled out in the famous protocol to Section 104c(2) of the Maastricht Treaty

If all members of the Euro had similar rates of inflation, fiscal deficits and public indebtedness, monetary policy designed to control inflation would have a similar impact across countries

However, full convergence was never achieved

Leaving substantial divergence in real interest rates across countries

(Eg Italy; Germany after reunification).

The Single Currency was novel in two respects:

- First: the adoption of an irreversible fixed exchange rate system for Euro members in the presence of an international system of floating rates,
- This eliminated national exchange rate adjustments as a remedy to correct trade imbalances among member states and non-EU trading partners,
- Shifted policy to internal adjustments via relative domestic wage and price adjustments with Eurozone and non-Eurozone trading partners.
- However, these adjustments would have a differential impact on relative competitiveness within and without the Eurozone, making their impact difficult to determine.
- Given lack of full convergence Internal adjustment became austerity policy, reducing EZ growth performance

Second: Anomalous Central Bank Design

- A Bank of Issue independent of a national government or government balance sheet, with, Single Objective of Price Stability
- *Eliminated direct coordination between monetary policy and government fiscal policy via Maastricht protocols*
- In essence, government financing of domestic fiscal policy expenditures had to be covered by fiscal revenues or by borrowing from the domestic or foreign private sector or by sale of assets to the domestic private or external sector.
- If government used borrowing to finance a shortfall of fiscal revenues then to meet debt service on the sovereign debt thus created would require governments to generate tax receipts greater than expenditures, engage in additional borrowing (debt roll over), or sell public assets.

An Institutional Omission in the Euro Architecture

- Wynne Godley early noted:
- "As the Treaty proposes no new institutions other than a European bank, its sponsors must suppose that nothing more is needed.
- But this could only be correct if modern economies were self-adjusting systems that didn't need any management at all."
- He also pointed out that "the Maastricht criteria for the establishment of 'convergence' were far too narrowly conceived. To fulfil the conditions necessary for a successful currency union it is not nearly enough that member countries agree to follow simple rules on budgetary policy …
- **They need to reach a degree of structural homogeneity such that shocks to the system as a whole do not normally affect component regions in drastically different ways**" noting that
- "if Europe is not to have a full-scale budget of its own … you will still have, by default, a physical stance of its own made up of the individual budgets of component states.
- The danger, then, is that the budgetary restraint to which governments are individually committed will impart a dis-inflationary bias that locks Europe as a whole into a depression it is powerless to lift."

But: Exchange rates still mattered

- The elimination of bilateral exchange rates for national currencies did not eliminate the differential impact of exchange rates on the performance of individual countries because variations in the Euro rate vis-a-vis the other, floating, currencies of international trading partners.
- The impact of exchange rate variations of the Euro across member states that were far from convergence, and thus variable in terms of the impact on domestic production conditions due to differences in the domestic production structure and the structure of external trade of the member states.
- These differential impacts were mediated by capital flows rather than internal wage-price adjustments.

Single Money- No Uniform Capital Market

- After the introduction of the single currency the fact that government borrowing was denominated in the liability of an external central bank appears to have led private lenders to overlook these national differentials in the first 10 years of the euro's existence.
- Thus countries with higher borrowing and debt stocks were little penalized by the market imposing higher borrowing rates leading to an allocation of private sector liquidity within the Eurozone which reinforced economic imbalances and contributed to the European financial crisis after the collapse of US financial markets.
- This market anomaly allowed many individual governments to access private market financial support at attractive interest rates to implement domestic income support measures to avoid the implementation of wage/price adjustment mechanisms compatible with the new single currency system.

Keynes had already seen this problem

- "It is, therefore, a serious question whether it is right to adopt and international standard, which will allow an extreme mobility and sensitiveness of foreign lending, while the remaining elements of the economic complex remain extremely rigid.
- If it were as easy to put wages up and down as it is to put bank-rate up and down, well and good. But this is not the actual situation. A change in international financial conditions or … speculative sentiment may alter the volume of foreign lending, if nothing is done to counteract it, by tens of millions in a few weeks. Yet there is no possibility of rapidly altering the balance of imports and exports to correspond."
- Keynes: Treatise on Money, Vol II p. 336

Differential Exchange Rate impact

- While the Protocol was meant to reduce the differential impact across countries of a uniform monetary policy,
- uniform exchange rate changes would still have a differential impact across countries **with different domestic production structures (vide Godley)** and internal economic organisation.
- Thus changes in investor preferences for US dollar denominated holdings, or changes in global capital flows, could produce positive or negative impacts on EU external balances that differed across member states
- The enabling Protocol provides no mechanism to redistribute or offset this impact on productive and social conditions in individual countries.

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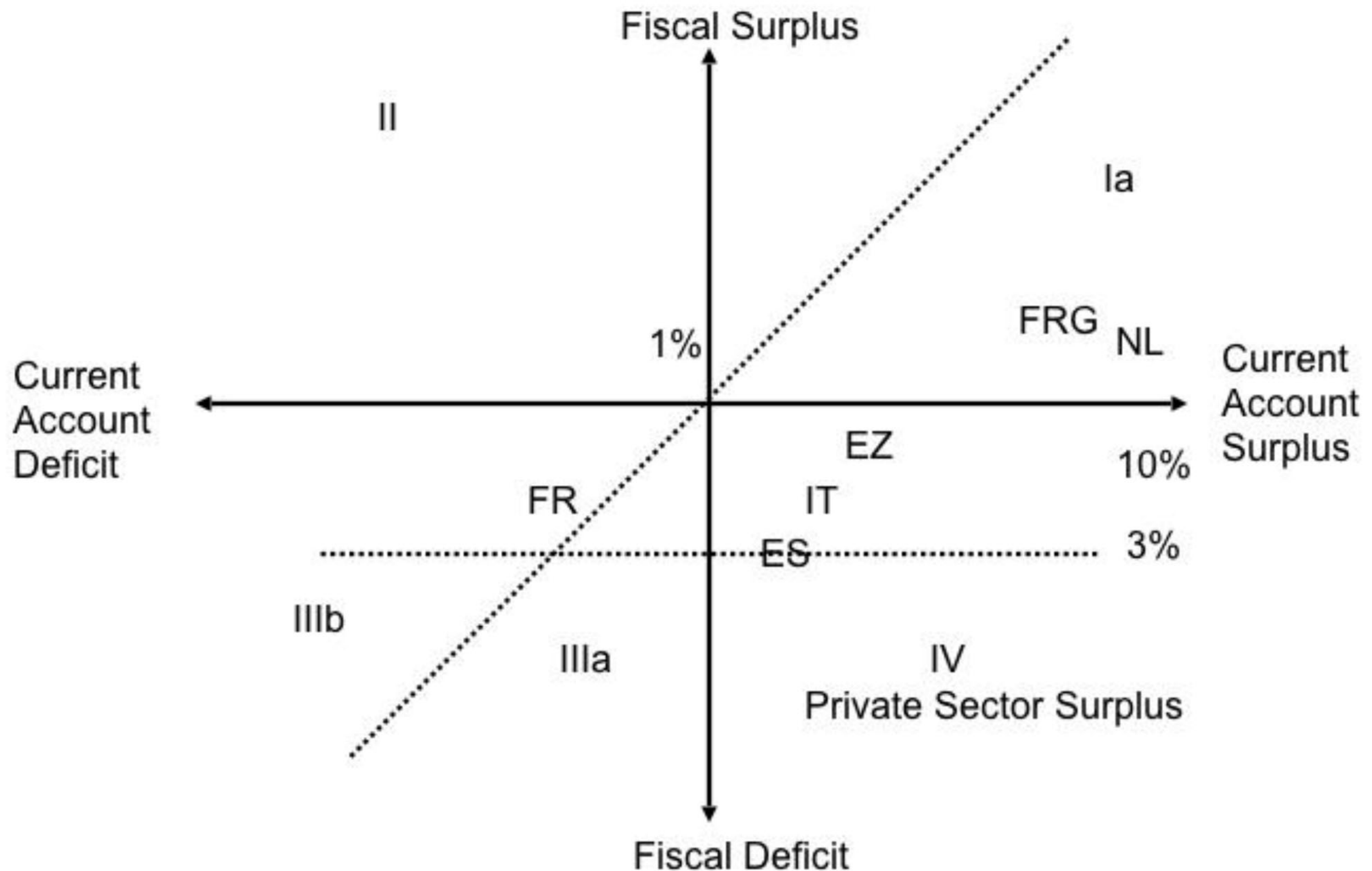
Country Government & External Balances



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