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THE FUTURE OF THE EURO: IS THERE AN ALTERNATIVE TO THE STABILITY AND GROWTH PACT?

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In the policy debates on the euro, the Stability and Growth Pact between the European Union (EU) governments has received less attention than other aspects of the currency's introduction. Yet that pact underpins the adoption of the single currency and is crucial to the determination of economic policies to be pursued within the EU. This brief critiques the pact and proposes an alternative based on a Keynesian analysis that differs starkly from the economic analysis 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, and economic growth is considered 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 support those policies.[1]

We begin with a critical examination of the pact, followed by a discussion of its practical operation and weaknesses. We then outline our alternative pact, discuss its rationale, and identify the institutional changes required to implement it.

The Stability and Growth Pact: Underlying Theory and Main Features

The Stability and Growth Pact, formally adopted at the Amsterdam Summit in July 1997 together with the Maastricht Treaty, has

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created four rules for economic policy: The European Central Bank (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 member states would avoid “excessive” government budget deficits, i.e., deficits exceeding the equivalent of 3 percent of gross domestic product (GDP).

We have elsewhere labeled the economic analysis underlying the pact and the above four rules “new monetarism” (Arestis and Sawyer 1998b), the essential propositions of which can be described in the following terms. First, politicians in particular and the democratic process in general cannot be trusted with economic policy formulation because they lead to decisions that have stimulating short-term effects (for example, reducing unemployment via higher government spending) but are detrimental in the longer term (a notable example is a rise in inflation). In contrast, experts in the form of central bankers, who are not subject to political pressures to court short-term popularity, can thus have a longer-term perspective.

Second, inflation is seen as a monetary phenomenon that 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 an equilibrium rate of unemployment that is generally labeled the NAIRU (nonaccelerating inflation rate of unemployment) and is determined solely by supply-side factors. 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 first proposition suggests that fiscal policy, since it can be influenced directly by the political process, should be effectively constrained 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 that exists between the monetary authorities (the ECB) and the fiscal authorities (the national governments). This precludes the coordination of fiscal and monetary policies because such coordination 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. The ECB operates monetary policy in the eurozone and has been assigned the task of securing price stability without any explicit concern for other objectives, such as the level of economic activity or the exchange rate of the euro. The key decision makers on the ECB are governors of the national central banks and monetary experts.

The size of the EU budget is relatively small, around 1.3 percent of the combined GDP of EU members, and is still dominated by the Common Agricultural Policy. Also, by mandate, the EU budget must 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, nor can it 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 leads to a series of fines,the magnitude of which depends on the degree to which the deficit exceeds 3 percent.

Each country submits to the European Commission an annual update of its stability program that 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 reviews the program and delivers an opinion on the recommendation of the commission. 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.

The council must decide whether an excessive deficit exists. A country found to have breached the reference values will then have four months 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 of its identification.A country that chooses not to introduce corrective measures is subject to a range of penalties. Since the penalty clause imposes fines to be paid by the national government 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 restriction on the workings of automatic stabilizers could lead to weaker fiscal stabilization and greater fluctuations in real GDP. 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 an economic slowdown (when the deficit is most likely to exceed that limit); hence, the 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

We now propose an alternative, called a full-employment, growth, and stability pact in order 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. Our analysis involves the idea that market economies display considerable and persistent disparities in economic performance and involve significant levels of inequality between individuals, households, regions, and countries.

The second element of the alternative pact comprises the objectives of full employment and sustained economic growth, to be 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.

The third element is the creation and support of appropriate institutional arrangements at the EU and national levels. 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.

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 support full employment. Consequently, full employment may well require a budget deficit that would mop up any excess of private saving over investment. 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, would experience only small leakages abroad of any demand stimulus from fiscal policy.

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) equals zero. There is little evidence that high levels of employment would necessarily generate an equality between saving and investment. An excess of saving over investment often occurs, and must be mopped up by foreign lending and budget deficit. Because limits on budget deficits imposed by the pact would prevent this from occurring, full employment would require a trade surplus and the consequent foreign lending.

The pact's 3-percent-of-GDP limit on budget deficits is arbitrary; no good reason has been advanced for choosing the figure of 3 percent over, say, 2 or 4 percent. It has been suggested that the figure may derive 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 would be covered by tax revenue.

A 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.

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 policy acts. 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 tax revenue from richer regions to poorer ones.

The separation of monetary authorities from fiscal authorities and the decentralization of 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. 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).

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). 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 have detrimental effects on investment and the creation of productive capacity and may reduce labor force participation.

The principal instrument of monetary policy is the setting of a key short-term interest rate by the central bank. 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. This suggests that building an equitable income distribution and creating adequate productive capacity through investment should be important ingredients of antiinflationary policy.

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 be reformulated. A further change would be to increase the transparency of the ECB's operations.

European Investment Bank

The present disparities in regional unemployment and employment levels 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 could 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.

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.

Conclusions

The Stability and Growth Pact governing macroeconomic policy in the European Monetary Union draws heavily on an economic analysis that we consider invalid. The institutional arrangements inspired by this type of analysis and put in place by the pact are highly undesirable in view of the problems that we have identified.

The alternative full-employment, growth, and stability pact proposed here has four major components. First, the ECB would be reformed to make it more accountable and capable of pursuing a broader range of objectives. It should be made clear that the ECB would act as lender of last resort and participate in the coordination of monetary and fiscal policies. Second, the EU-level budget would 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 would be expanded to ensure that the less prosperous regions share in economic growth. Fourth, institutional arrangements that are conducive to low inflation would be encouraged.

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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