

Euroland and the World Economy

Global Player or Global Drag?

**Edited by Jörg Bibow
and Andrea Terzi**



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Introduction: Euroland and the World Economy – Global Player or Global Drag?

Jörg Bibow and Andrea Terzi

Three major developments in the global economy may be singled out as characterizing the early years of the twenty-first century. First, launched on the eve of the new millennium and meanwhile including 13 (and soon 15) European countries that have adopted the euro as their common currency, Euroland is a large and economically powerful currency area comparable to the United States, supposedly also creating a new important player in the global arena of trade and finance. Second, the rising of China and a broader South and East Asian region as a new growth centre of the world economy, in its turn shifting the world distribution of trade and investment flows. Third, an increasing polarization in international payment positions that seems at odds with conventional wisdom, with the United States under its economic and financial world leadership running mounting current account deficits that alone nearly offset the current account surpluses of the rest of the world including soaring surpluses across the emerging world.

These on-going changes point to further transformations coming in the next decades, notably with respect to foreign investment, global employment, trade and financial flows. In our minds, there is no question that one key aspect of future world developments will be the capacity of the Euro Area to live up to its own vision and potential, both in fostering Europe's economic performance as well as in enhancing the continents' global role in line with its new economic and monetary leadership responsibilities. Yet, as we are nearing the end of the euro's first decade, Euroland is still struggling on both grounds: internal and external.

On the internal dimension, while satisfactory results have been achieved in terms of average price stability across Euroland (as HICP inflation has averaged just above 2 per cent since 1999), subdued growth has disappointed the high hopes many had previously held for Europe's future under a Maastricht-style Economic and Monetary Union (EMU). One stark fact is that Euroland stands out as the only major world region that did not until very recently participate in the global boom since 2002. Even deflationary Japan has grown faster than Euroland, where recovery only started at the

end of 2005. Euroland seems to be repeating the 1990s' disappointing record, only overcome thanks to the US's 'new economy' boom, which arrived just in time to allow the euro to get off the ground by helping European countries to meet the Maastricht budgetary hurdles at the last minute. We also observe today what seems to be a repeat in the divergent trends seen at the earlier time. At that time, too, the hard currency core (Germany, the EMS's former anchor country) struggled the most to overcome stagnation and then boomed only briefly (in fact, only one year in Germany's case), while others fared better, benefiting from converging, that is, falling, interest rates that stimulated domestic demand. Today's struggling hard currency core includes Germany, Italy, and France, while the new EU member states in central and eastern Europe benefit from the prospect of joining the Euro Area through converging interest rates and capital inflows. One is tempted to comment here that the *prospect* of joining the hard currency area may be better for performance than actually *being in it*. And one may add here that the two old EU members that have continued to conduct their own fiscal and monetary policies, namely Sweden and the United Kingdom, have performed persistently and significantly better than Euroland too. In a way, Spain is the odd man out, as Spain has enjoyed a continuous boom ever since falling interest rates in the mid-1990s kicked-off a virtuous circle of rising employment and falling budget deficits. In fact, on a net basis, Spain accounts for most of the jobs created in Euroland since the mid-1990s. These observations alert us to the existing diversity in performance witnessed across Euroland, with diverging trends viewed with alarm by at least some observers. Yet, it remains unquestionable that the overall GDP and domestic demand growth has been meagre since 2001, similar – if not poorer – to developments in the prior decade.

An influential view continues to stress the need for deeper and more comprehensive structural reforms. Yet, it is not at all clear that those allegedly all-pervasive structural problems in labour and product markets have really been behind protracted domestic demand stagnation over much of the 1990s and again between 2001 and 2005. Rather, and so far, years of nudging to make product and labour markets more flexible have not been able to create a lasting pattern of growth based on home-grown demand by Euroland's own consumers and companies. It is a fact that Euroland's current recovery did not arise from within, but was – as in 1996–97 – mainly export driven. In Germany, the Euroland member country that had seen shrinking domestic demand for many years, the export boom finally boosted corporate investment, which, together with a revival in construction, explains much of the improvement in the overall situation in 2006.

We find it unwarranted to place exclusive emphasis on the need for more structural reforms when external growth stimuli can miraculously kick-start GDP to grow faster than its *estimated*¹ potential, allegedly held back by all-pervasive rigidities. Structural reforms that address market segmentation,

notably in the financial sector, are desirable; and so are reforms that enhance competition by eliminating unproductive, *rentier* positions. Yet, they have no impact upon what we consider the major issue today in the Euro Area: to make Euroland less dependent on world (namely US) cyclical demand conditions through decisive reforms of macroeconomic policy-making. We do not feel an economic giant like Euroland should, or even could, continue to freeload forever on successful demand management elsewhere in the world economy, while blaming the emergence of global imbalances, towards which it thereby handsomely contributes, on apparently inadequate policies conducted elsewhere. For these reasons, we asked our contributors to consider a macroeconomic perspective, as a more appropriate framework in assessing Euroland's economic malaise and its global ramifications.

Indeed, we hope that scholars who prefer to focus on structural reforms will find these concerns relevant to the realization of needed reforms. Lacking a coordinated set of macroeconomic growth policies, Euroland's members are facing unnecessary obstacles in carrying through with reforms. Not only is a deflationary environment quite likely to undermine the political feasibility of reforms.² It is also not clear why any willing reformers should have to wait to reap any real gains from boosting *potential* growth until some lucky export boom might accidentally (and perhaps only rather briefly) kick-start an acceleration in *actual* growth. Euroland may require a fundamental overhaul in its macroeconomic governance that ensures better overall policy coordination, a position argued by a number of contributors in this volume.

On the external global dimension, our call for contributions had stressed that the relation between Euroland's performance and trends and global imbalances has so far not been sufficiently explored. On this question, key euro policy-makers believe that because the Euro Area's current account is broadly in balance, Euroland contributes to limiting global financial imbalances.³ They also believe that supply-side structural reforms in Europe will protect Euroland from potentially adverse global developments (such as the unwinding of imbalances) and better enable it to play a positive role in the orderly correction of global imbalances.⁴

Contributions in this volume consider the global role of Euroland from a different perspective. While some pundits view financial imbalances as inevitably leading to instability, with the United States as their supposed culprit, and while other observers view the situation as reflecting a persistent and stable symbiosis between the United States and Asia that is in the interest of both, we believe the role of Euroland cannot be missed. While private indebtedness in the United States has soared over the period in which the world's largest economy often acted as sole global growth engine, the core of Euroland (namely Germany) has relied on foreign demand as its sole sponsor of growth, thereby also creating severe imbalances inside Euroland. In this context, questions to investigate include: what may Euroland's part have been in the emergence of today's imbalances? And will Euroland ever

be a growth engine of the world economy? Recall here that playing a greater global role – more on a par with the United States – is a vision that had provided one key motivation for EMU from early on. And prominent international economists like Bob Mundell welcomed ‘the euro as a stabilizer in the International Economic System’.⁵

The chapters collected in this volume compellingly question, from a variety of angles, many popular beliefs about the road to virtue of Euroland, and provide a comprehensive and fresh framework to address old and new questions. Several themes and lines of research emerge throughout the book, each in more than one chapter, and pointing in several complementary directions. These include: a critical review of the effectiveness and the strategy of monetary policy as structured by the Treaty and as implemented by the European Central Bank (ECB); a critical reading of the limits of the Stability and Growth Pact (SGP) and a search for a more effective reform of fiscal policy; a comparative analysis of the power of US and Euroland institutions in effectively steering the macroeconomy, outlining a contrast between US Keynesianism and European neo-mercantilism; an analysis of the role of Germany as a destabilizing factor within Euroland; an analysis of the dichotomy between formal institutional integration through the creation of common institutional bodies and a declining economic coordination now limited to a mutual agreement to put one’s own house in order; a set of proposals and recommendations for action in broader areas of policy coordination and structural reforms, ranging from wage policy to furthering political integration, from industrial policy to enhanced social welfare and public services; a critical assessment of the vacuum left by the Maastricht Treaty concerning exchange rate policy and the prospects of an increasing role of the euro as an international currency; and the relevance of a scenario of reflation in Europe that would contribute to reverse unsustainable world trends.

All these contributions shed light on the overarching question, which we believe is of vital importance both for the future of Europe itself and the world at large: will the single currency project contribute to world economic dynamism or will Euroland be driven by others’ vigour and vitality? Will Euroland act as a *global player* or as a *global drag*?

* * *

Early drafts of these chapters were first delivered in Lugano at a three-day conference, hosted by Franklin College Switzerland (2–4 March 2006), where participants engaged in thorough and lively discussions that helped to shape chapters into their final form. The 13 contributions have been divided for publication into four distinct but overlapping parts. Contributions in Part I set the scene by investigating some candidate causes of Euroland’s persistent failure to live up to its potential and point to a number of divergences and institutional inadequacies that have put Euroland on a collision course.

Approaching the issue of mounting global imbalances through the angle of the 'Bretton Woods II hypothesis', **Jörg Bibow** argues in Chapter 1 that the popular preoccupation with China's supposed export-led development strategy is misplaced and that, similar to Japan's depression, subdued growth in Euroland for most of the time since the Maastricht Treaty has been of first-order importance in these developments. Germany is identified as being at the heart of the European trouble, with global imbalances reflecting a clash between a highly dogmatic German approach to macro policy-making on the one hand and a very pragmatic Anglo-Saxon one on the other. Bibow argues that the low levels of interest at which the resulting imbalances have been smoothed out financially are a reflection of deficient global demand in an environment of vast supply-side opportunities; a situation to which US macro policy-makers responded appropriately by boosting domestic demand; benignly neglecting the external stimuli thereby unleashed. By contrast, apart from having acted as a notorious drag on global growth ever since the Maastricht Treaty, Bibow argues that soaring intra-Euroland divergences today represent serious dangers for European integration and the long-term viability of EMU.

One of these divergences is wage dynamics, which **Heiner Flassbeck** finds to be a far greater threat to the sustainability of EMU in Europe than any minor deviations from the SGP. Flassbeck argues in Chapter 2 that EMU can only function if wage increases in member states are in line with the inflation target set by the monetary authorities and, given the close correlation of unit labour cost growth and inflation, if real wage growth in each member state strictly follows national productivity growth. Violations of this rule will cause divergence of national real exchange rates and national levels of competitiveness, bearing serious long-run consequences for the appreciating countries. Worst of all, this could trigger deflation in the Union as a whole. Unfortunately, an aberration of this kind started right at the beginning of the currency union in 1999 (if not before) – with Germany's deflationary wage policy as the main culprit. Without fundamental changes in wage policies throughout Europe, a deflation or a 'transfer union' comparable to developments in Germany after unification is an imminent danger.

Facing these shortfalls, Euroland seems ill equipped to either adequately stimulate domestic demand or to alleviate the problem of international financial imbalances. Analysing the theoretical framework of Euro Area policymaking, **Philip Arestis** and **Malcolm Sawyer** find that in the context of global imbalances, Euroland should prepare itself for further dollar depreciation, namely by establishing better coordination of fiscal and monetary policies and more centralized wage-bargaining arrangements. Yet, Euroland's current institutional structure has no room for maneuver. In Chapter 3 Arestis and Sawyer focus on the theoretical model that is thought to prevail in the Euro Area and provide a comprehensive analysis of the current policies pursued in the areas of monetary policy, fiscal policy and

labour market reforms. They criticize various aspects of this framework, including the notions that monetary policy is ineffective to stimulate real growth, that the growth of monetary aggregates and inflation are correlated in the long run, that labor market reforms for flexibility are correlated with higher growth. Finally, they also question the 'ECB-handicap hypothesis', according to which interest rates would have less of an effect on output in Euroland than in the United States. They conclude that changes in institutions and policies are desperately needed to improve Euroland's performance in future, whereby Euroland would also contribute to reducing international imbalances.

Contributions in Part II investigate how policy coordination and increased integration could help to provide proper steering to Euroland's economy within the global context.

The intellectual roots of Euroland's macroeconomic policy regime are investigated by **James Forder** in Chapter 4, focusing on the changing conception of policy coordination, and how it has fallen prey to disinflation priority. He stresses Hamada's model where policy coordination in a fixed-rate regime is necessary to prevent countries from underexpanding and seeking to free ride on others' expansion. Forder argues that while the idea of policy coordination proper had at least some influence on the creation of the European Monetary System as an attempt to prevent Germany from diverging by carrying on deflationary policies, the EMS was later on turned into little else but a lever for strengthening the arm of anti-inflationary forces, where countries should follow the credible, price stability leader (Germany). The evolution of the EMS is thus also the story of how the 1970s conception of policy coordination was replaced by one emphasizing the benefits of disinflation and the need to enforce good policy on bad governments. With the creation of the Euro Area, coordination has taken the form of the SGP, designed to enforce 'sound finance' (based on some notion that the interests of prudent people should be protected from bad policy). Forder's chapter sheds some important light on how this policy refocusing has contributed to Europe's malaise. Transferred to the global stage, this shift in vision and corresponding policy refocusing might threaten macroeconomic stability more widely too.

The rationale and intellectual climate behind the creation of the euro and its institutions is further investigated by **Claudio Sardonì** who stresses a contradiction between the historical development of the single currency as a process primarily driven by political forces and a model of institutions based on theories that consider the political process as an unwelcome interference with the economic sphere. Sardonì argues in Chapter 5 that the establishment of a single currency area at the end of the 1990s can be seen as the final step in a long process to ensure stable exchange rates in Europe following the collapse of the post-war monetary system in the 1970s, and in view of a modified optimum currency area theory that stresses the endogeneity of

optimality conditions. The scene was set by theories that alleged the ineffectiveness of discretionary fiscal policy and suggested that giving an independent central bank with a single ('conservative') priority of price stability control over monetary policy would provide a stability anchor. While too 'cautious' monetary policies have played a role in manoeuvring Euroland into a vicious circle of stagnant domestic demand in 2001–05, in Sardoni's view the most serious flaw in regime design is identified as lying in the area of fiscal policy. Sardoni suggests that decisive steps need to be taken towards political and fiscal integration, which would require abandoning the obsession with the inflationary impact of public spending.

The importance of policy coordination is further stressed by **Alex Izurieta** and **George Irvin**, namely as a means to put Euroland securely back on a demand reflation track, as well as to correct international financial imbalances. Using a macroeconomic model of the world economy, their contribution (Chapter 6) examines the peculiar structural characteristics of global current account imbalances, which reflect financial imbalances in the personal sector rather than the public sector (as used to be the case in the past). After exploring alternative ways to adjust unsustainable global imbalances, including dollar depreciation, a US recession, or US protectionism, these are all found impracticable. Then, assessing the role of the institutional constraints on fiscal and monetary policies in Euroland, the United Kingdom and the United States throughout 1990s, Izurieta and Irvin argue that Europe's emphasis on public sector financial discipline has contributed to a new structure of global demand, which is found to be unsustainable. A number of strategic scenarios for the mid-term are then analysed, including one of demand reflation in the Euro Area that features a new emphasis on policy coordination and a more effective reallocation of global surpluses. The authors conclude that new policy coordination, highly needed in the Euro Area for its own good, is also needed globally.

Contributions in Part III then investigate how Euroland's key institutions and policies should be reformed so as to improve on current discipline rules and allow for better economic performance in the future.

Emphasizing the Euro Area's unique structure, namely its separation between a federal monetary policy and national fiscal and social policies, **Charles Goodhart** argues in Chapter 7 that this peculiar policy regime has proved responsible for numerous problems that have arisen in recent years. In Goodhart's view, the SGP has added to these problems since it leaves countries that are suffering from asymmetrically adverse economic conditions with no significant instruments of demand management once they have run up against their SGP deficit limit. Asking how monetary and fiscal issues may be brought into better balance within the Euro Area, Goodhart develops two main proposals for replacing the SGP and supporting the federal monetary policy. First, he argues that some degree of fiscal centralization is required to perform effective stabilization policies and sustain

EMU. In particular, drawing upon an earlier study undertaken in preparation of EMU in the early 1990s by an academic expert group of which he was a member, Goodhart suggests that a relatively small shift of competences from the individual nation states to a, somewhat enlarged, federal budget in Brussels could bring a significant improvement in stabilizing economic activity. Second, Goodhart argues in favour of channelling market forces in support of sound public finances through financial re-regulation. Toward this end, he proposes a redesign of prudential capital requirements of financial intermediary holders of debt of the constituent member states, so as to marshal stronger market mechanisms to deter the emergence of unsustainable fiscal policies.

Starting from the SGP's proven failure to deliver on both fronts, namely fiscal sustainability and economic growth, in Chapter 8 **Eckhard Hein** and **Achim Truger** analyse fiscal policy and its macroeconomic impact both for the Euro Area as a whole and for selected countries in comparison to US fiscal policy, with a special emphasis on the period 2001–05. The authors provide ample evidence of the largely superior macroeconomic performance in the United States, which they explain as owing to its different macro policy regime. They find that whereas US fiscal policy has acted in a strongly counter-cyclical way, stabilizing the economy, in the Euro Area fiscal policy has been both much more restrictive as well as pro-cyclical, with destabilizing effects in numerous countries. The authors provide evidence of a negative impact of fiscal contraction dictated by the SGP on economic growth, evidence corroborated by the finding that countries that undertook fiscal expansion grew more rapidly. As a possible solution for the future, Hein and Truger discuss replacing the SGP by expenditure path rules as a coordination tool that, in their view, can actually deliver stability and growth, along similar lines to those followed in the United States. Such fiscal reform would also require a parallel adaptation of the ECB reaction function and less decentralized wage policies.

Richard Werner tackles head on the conventional wisdom (or, ECB view) that weak economic performance in a number of Euro Area countries, such as Germany, has been due to structural problems that would require supply-side structural reforms. With reference to the macroeconomic experience of Japan, another large economy where this argument held sway during the 1990s, it is found that the supply-side argument is without merit and that demand-side policy is more likely to improve Euroland's economic performance. Werner emphasizes the supply of credit as the overarching budget constraint on economic activity and discusses policy options to stimulate credit supply. Given important links between monetary and fiscal policies and the crucial need to coordinate them, Werner argues in Chapter 9 that the key to higher economic performance and fiscal prudence in Euroland presently lies with monetary policy. In case of non-cooperative central bank behaviour, the author identifies ways for governments to stimulate credit supply.

The dichotomy between formal institutional integration through the creation of common EU bodies and a declining economic coordination is noted and considered by **Riccardo Bellofiore** and **Joseph Halevi**, who argue in Chapter 10 that the only true Keynesian phase in European economic policy was the 1950s when the European Payments Union scheme relieved the balance of payments constraint. Since then, major European economies have essentially shifted back to neo-mercantilism. Bellofiore and Halevi argue that the large-sized surpluses of Germany, Sweden, and Switzerland, which have no means to be recycled through the rest of Europe, prove the impossibility of European-wide Keynesianism. In contrast, the United States has adopted a financial form of Keynesianism that includes demand management, combined with de-localization, low wages, and job insecurity. Bellofiore and Halevi consider it an idealistic belief that Keynesian policies can be adopted in Euroland given the economic and political relations in which institutions are embedded. Europe and Euroland are, in this sense, non-Keynesiable. True change would only be possible if reforms of macroeconomic policies in a Keynesian style were combined with profound structural reforms including demand-side and supply-side industrial policy, a full employment goal, greater job security, better public services and a public social security system, all characteristics of what Bellofiore and Halevi consider 'structural Keynesianism', which in their view is currently far from sight.

Finally, contributions in Part IV turn more directly toward investigating the prospects and limits of Euroland as a global player, particularly from the viewpoint of the external value and the international role of the euro.

The difference between exchange rate policies in the United States and Euroland is critically assessed in Chapter 11 by **Jerome Creel** and **Fabrice Capoen**. Denying the self-defiant view that Euroland's problems may be due to external factors rather than being essentially homemade, the authors argue that the institutions that have been associated with the euro – namely limits on public deficits and a relatively conservative central bank – have actually jeopardized the efficiency of this new exchange-rate regime. They appraise the pros and cons of the European institutions in terms of macroeconomic stabilization and exchange-rate swings, drawing on different scenarios. After introducing a theoretical and empirical framework for their discussion, Creel and Capoen present a dynamic four-country model to study the effects of different policy styles on the dollar-euro exchange rate. They find that institutional differences explain why the euro has largely moved pro-cyclically, thus amplifying rather than moderating Euroland's cycle. Under current arrangements, the United States gains and Euroland loses from its supposedly 'stability-oriented' institutions. Creel and Capoen then simulate the consequences of the United States adopting European-style policymaking, namely by assigning a higher weight to the inflation target as opposed to the output growth target. Simulating a variety of shocks that hit European countries, the authors

study how European performance would differ if the United States adopted Maastricht-style macro policy institutions. Their results are remarkable: while the United States was generally made better off by Europeans adopting their more conservative policies, should US policy become more similar to current Euroland policy too, European countries would actually be even worse off. In sum, Euroland institutions seem to have more favourable effects on countries that do not adopt them than on countries that do. Their results thus underline the general tenor of this volume that Euroland's macro policy institutions should be adapted.

In Chapter 12 a different perspective is undertaken by **Sergio Rossi**, who lays down a proposal for an international role of the euro, building on its expanding regional role. The author first draws a distinction between a single supranational currency that replaces domestic currencies and a common currency that serves as an international means of payment between nations. Rossi views the aspired use of the euro in this latter sense. This would not actually require any new institutions, but simply a new function to be performed by the ECB: that of an international settlement bank. Neighbouring countries in the wider 'euro bloc' could continue to use their domestic currencies and also adopt the euro as an international means of payment, without either having to abide by the (deflationary) EMU convergence criteria or enter into an exchange-rate arrangement (the ERM II). Emerging countries in the Barcelona process could especially benefit from an international settlement institution while keeping their own independent monetary and fiscal policies. Rossi does not propose or even address the question whether the euro should rival the dollar as the world key currency. Rather, he designs a monetary architecture that would provide a system for settlement of international transactions that he finds in the spirit of Keynes's proposal for an international currency unit used to settle international transactions only.

Addressing the question whether the euro meets the conditions to count as a challenger to the dollar as the world key currency, **Andrea Terzi** responds in the negative. Moreover, Terzi argues in Chapter 13 that a dollar crisis driven by global imbalances would be more likely to result in a global rescue of the dollar than in the euro acquiring more global prominence. A fragmented capital market where sovereign bonds are not backed by either governments or the ECB, and the lack of a single decision-making body that implements effective macroeconomic governance are among the reasons that the author lists as major limits to a global role of the euro. At the same time, Terzi argues that Euroland's powerful economic and financial position as well as the quality of the euro as a stable currency that competes with the dollar in international portfolios mean that Euroland faces a much softer balance of payments constraint than the one faced by any individual pre-euro countries. This changed global position should be the premise for a coordinated action aiming at a profound change in its macro governance institutions, namely to establish a proper growth policy in Euroland without fear of running current

account deficits. Accepting its new responsibility as an important global player, Euroland would thereby also act as an engine of growth and play a balancing and stabilizing role in the world economy.

Notes

1. Needless to say, since conventional measures of potential growth are essentially averages of actual growth, such measures do not provide any evidence in support of the structural theme.
2. There is of course the view that deliberately creating or tolerating such conditions would add force to pushing through with structural reforms. This approach is not only questionable for political reasons (shedding some dubious light on the role of independent central banks in particular) but also lacking sound economic theory and evidence. See Mabbett and Schelkle (2007).
3. Cf. Stark (2006).
4. Cf. Commission of the European Communities (2006).
5. Cf. Mundell and Clesse (2000).

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Part I

Euroland on a Collision Course

1

Global Imbalances, Bretton Woods II, and Euroland's Role in All This

Jörg Bibow

1.1 Introduction

Approaching the issue of mounting global imbalances through the angle of the 'Bretton Woods II hypothesis' (BWII), this chapter sets out to investigate Euroland's role in particular. It is argued that popular preoccupations with the US's 'twin-deficit' and China's 'beggar-thy-neighbour' (renminbi) undervaluation only scratch the surface of what are really the consequences of a rather complex set of causes and developments. Systemic deficiencies in the global monetary order that induce the developing world to run current account surpluses and accumulate dollar reserves is one factor. Japan's and Germany's protracted domestic demand stagnation is another. Germany's key role somehow disappeared with the shift in focus on Euroland as a whole, and Euroland's role, in turn, was written out of the play when the oil price boom turned the area's current account surplus into a small deficit. It is erroneous to ignore the global ramifications of protracted domestic demand stagnation in an economic area similar in size to the United States. Just as it is hypocritical to bark at China's external surplus which really only attained a globally significant role over the last couple of years – while the US external deficit has built up continuously since the early 1990s.

The analysis begins with a look at some internal trends in the United States related to its soaring external deficit. After introducing BWII in Section 1.3, the analysis turns to the 'trade account region' and some prominent surplus countries in Section 1.4. Section 1.5 discusses US macroeconomic policy pragmatism, the dollar, and 'benign neglect'. Section 1.6 then focuses on Euroland's role in the global context. Section 1.7 concludes.

1.2 Mounting global imbalances

Debate about global imbalances generally focuses on the US current account. Since 1991, when, for once, the US current account was in balance, it has deteriorated persistently both in absolute terms and as a share of GDP, reaching USD 200 billion (or 2.5 per cent of US GDP) by 1998, USD 400 billion (or 4 per cent of US GDP) by 2000, USD 655 billion (or 5.5 per cent of US GDP) by 2004, and USD 857 billion (or 6.5 per cent of GDP) last year (see Figure 1.1). The OECD's projections of June 2006 (*Economic Outlook* no. 79) show a continuing rise in the deficit to 7.6 per cent of GDP by 2007.

In line with the various macroeconomic meanings of the current account, commentators either emphasize that US domestic investment exceeds national saving (with foreign saving filling the gap), or that US domestic demand outstrips US production (with imports filling the gap), or that US net foreign investment is sharply negative and the rest of the world accumulating, in one way or another, ever more claims against the United States.

As to the causes, commentators then either stress that the United States is apparently saving too little and spending too lavishly, or that the rest of the world is all too keenly exporting to, but less eagerly importing from, the United States, or that for some reason foreigners just indulge in investing in and lending to the United States. On the first view, the spendthrift United States is the clear villain behind the whole unbalanced situation. On the second view, trading partners play somewhat more of a role too in either refusing to grow faster and/or become less competitive and import more from the United States. And on the third view, the imbalance is not so much a saving

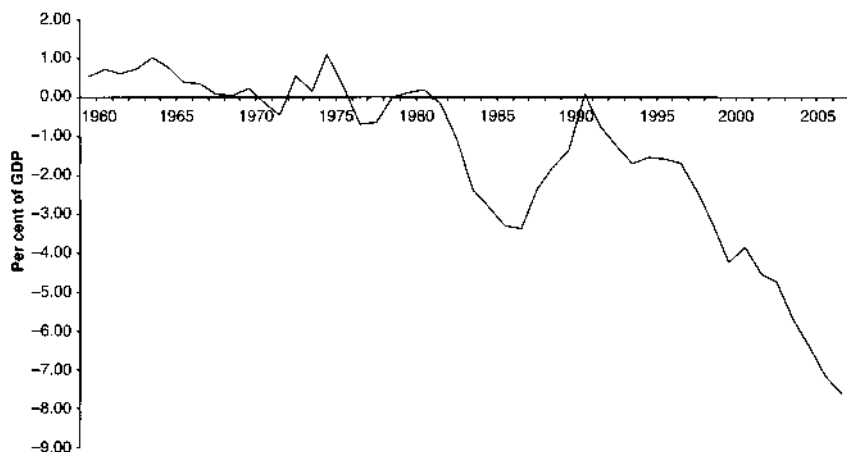


Figure 1.1 US current account balance: 1960–2007

Source: EcoWin/Reuters, OECD, *Economic Outlook* no. 79 for 2006–07 forecasts.

or trade matter, but instead driven by finance and capital flows in the first place, with foreign investors, presumably in search of higher returns, piling their money into, what would seem to be, the world's premiere investment location.

No doubt the first view is especially popular in Europe, where policy-makers and commentators alike tend to be awed by the US's apparent fiscal irresponsibility. Reviving a theme much heard of during the 1980s too, US fiscal profligacy is seen as the root cause of today's global imbalances – the so-called 'twin deficits' are back. Even more so than during the 1980s, when Germany alone was trying its luck with 'expansionary fiscal contraction', meanwhile convinced by that idea much of Europe is today saddled with a 'balancing-the-budget-no-matter-what' mindset the spirit of which was grafted into the Maastricht convergence criteria and the 'Stability and Growth Pact'.¹ To the German/European mindset, then, the twin-deficit idea is a very appealing explanation of today's global imbalances.

Empirically, the twin-deficit theme does not stand on any firm footing. The correlation between the two deficit measures as a proportion of GDP is close to zero; slightly positive over the whole period since 1960 but slightly negative (-0.15) over the relevant time since 1990 (see Figure 1.2). In particular, just as the US's current account deficit began to soar in the mid-1990s, the US budget deficit was actually disappearing and eventually moved into surplus by the end of the decade. In 2004–05 again, as the US budget deficit (as a percentage of GDP) actually shrank, and to little more than in supposedly virtuous Euroland, the US current account deficit took

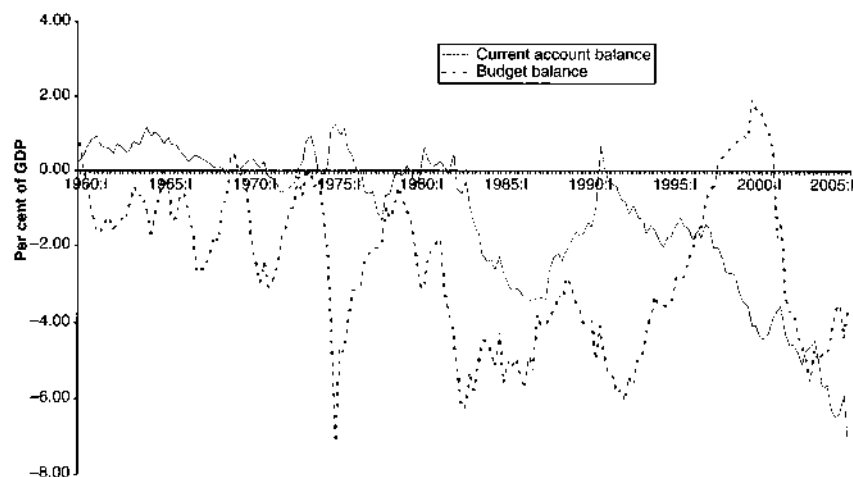


Figure 1.2 US budget and current account balances, 1960–2005

Source: EcoWin/Reuters.

yet another leap. While the twin-deficit theme is thus something of a myth, Alan Greenspan's (2005) recent observation of a more stable long-term correlation between the US mortgage market and the current account is of great interest.

The US property price boom (or perhaps bubble) of recent years is one key issue here, boosting private consumption through corresponding wealth effects. The credit market phenomenon of 'mortgage equity withdrawals' (MEWs) is another and potentially the more powerful one. Through relieving liquidity constraints, MEWs allow mortgaging properties for the purpose of financing current expenditures. After gathering some strength in the second half of the 1990s, MEWs took off in earnest after 2000 in the context of the US Federal Reserve's aggressive policy easing. As the Fed shaved some 550 basis points off its Fed funds target this boosted bank profits and bond yields plummeted, igniting a huge 'refi' (mortgage refinancing) boom (see Figure 1.3). Lower interest rates allowed households to take on rising debt levels without increasing their interest burden correspondingly. Only part of the additional borrowing actually ended up financing house purchases at rising house prices, thereby boosting construction. Another part – the home equity withdrawn – was used to supplement (weak) disposable income growth, thereby supporting general consumption expenditures (see Greenspan and Kennedy 2005²; Goldman Sachs 2002, 2005, 2006).

In the process, the US personal saving rate has declined markedly, dropping below zero by 2005. A rather neat correlation emerges here between US

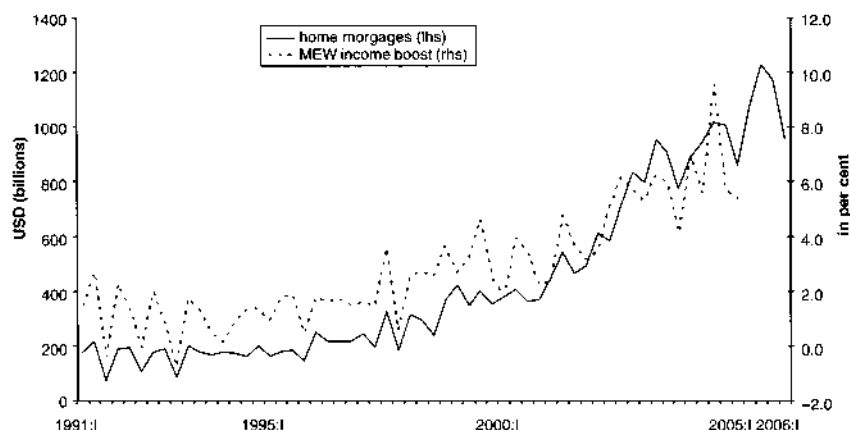


Figure 1.3 US private households on a borrowing binge

Note: 'MEW income boost' shows net equity extraction as a percentage of disposable income.

Source: FRB Flow of Funds Accounts, Greenspan and Kennedy 2005.

personal saving behaviour and the country's current account position, with the personal saving propensity on a continuous decline ever since the early 1990s (see Figure 1.4).

Of course a decline in personal saving as such does not necessarily lead to a current account worsening, as the latter reflects the overall constellation between national saving and domestic investment. The point is that in the second half of the 1990s, the United States also experienced a vigorous investment boom on top of the decline in the personal saving rate. US private spending grew so strongly as to consolidate US public finances on the way, and much more than that. Given foreign investors' keenness to invest in or lend their money to the United States, private capital inflows (in the form of both foreign direct investment (FDI) and portfolio investment) were easily filling up – accounting-wise – the rising gap between US domestic demand and production.

This situation ended with the bursting of the dot.com bubble and tanking of the US economy after the spring of 2000. And as net FDI inflows turned negative and portfolio equity investment also at times dried up, 'official lending' came to play a key role in financing the US balance of payments deficit. The shortfall in private capital inflows into the United States after 2000 would seem to put the view to rest that international finance rather than trade lies behind the country's soaring current account deficit. But the hypothesis was then put forward that official flows would just as well qualify as a candidate driving force behind these seemingly unbalanced developments.

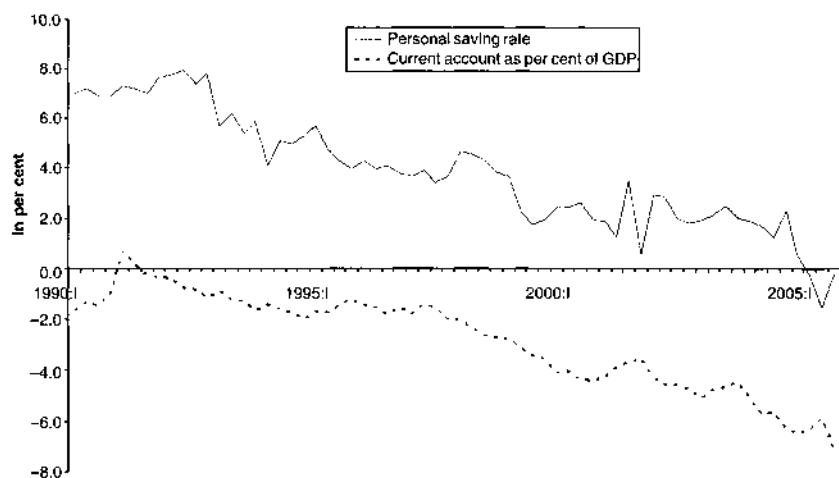


Figure 1.4 US personal saving rate and current account

Source: EcoWin/Reuters.

1.3 The Bretton Woods II hypothesis

Dooley, Folkerts-Landau and Garber (2003) deserve credit for highlighting that current account imbalances are inherently a two-sided affair. It makes little sense to focus on the US current account deficit and ignore that there must be corresponding surpluses elsewhere in the world economy. In fact, the three authors argue that surplus-seeking countries are the ultimate driving force behind the imbalance and that the whole situation, which they refer to as the 'revived Bretton Woods system' (BWII), may be far less unstable than it might seem at first. In their view, the situation is sustainable since it brings mutual benefits to both the peripheral surplus countries as well as to the deficit country at the centre.

In a nutshell, BWII states that certain Asian developing countries are today adhering to the same export-led development strategy that was followed by Western Europe and Japan a few decades ago (namely under Bretton Woods I). With the United States today reinstalled as the 'centre country', issuing the reserve currency and providing financial intermediation services to a new 'periphery', the dynamic structure of the global monetary system since the advent of Bretton Woods has remained essentially the same; except that new players have substituted the previous periphery generation since its graduation to the centre.

The periphery's export-led development strategy features: an undervalued exchange rate that yields net outflows of goods to the centre, capital controls to protect the peg, and official capital outflows that involve the accumulation of reserve asset claims on the centre. The relevant peripheral countries form the 'trade account region', whose main concern is exporting to the United States since 'exports mean growth'. According to BWII: 'When the [trade account region's] imports do not keep up, the official sectors are happy to buy US securities to finance the shortfall directly, without regard to the risk/return characteristics of the securities. Their appetite for such investments is, for all practical purposes, unlimited because their growth capacity is far from its limits.' The dollar foreign exchange reserves accumulated along the way meanwhile serve as collateral for the growing stock of FDI in countries whose own financial structures are as yet underdeveloped.

While the United States is the premiere intermediary of the system, on this view, there is also a 'capital account region' of countries that are characterized by a developed financial system and flexible exchange rates. This region includes Europe, Canada, Australia, and most of Latin America. And since it is not this region's official sector but its private investors, who presumably care about the risk/return of their international investment position, the capital account region is not an unlimited abode of claims on the United States. Continuously reassessing their US exposure, private investors are the key driving force behind net private capital flows and exchange rate movements

between the dollar block (including the periphery) and currencies issued by the capital account region, while official capital flows between these two zones play no role.

BWII paints an illuminating picture of a world of unequal players that seems to have matched the situation in 1997–2003 rather well. During the 'new economy' boom, private investors in the capital account region keenly raised their US exposure, driving the dollar up against the euro, for instance.³ As their keenness tired subsequently and they rolled back their US exposure, the euro appreciated again. At that point, the trade account region's official sectors stepped in to refill the shortfall left thereby, so as to maintain their exchange rate pegs – and exports to the United States (see also Higgins and Klitgaard 2004).

Can we conclude here that global imbalances are a sign of good health and the BWII system sustainable? Is the trade account region really bound to underwrite the United States in the long term? It seems to me that the BWII hypothesis provides a rather partial description of the underlying global constellation. Particularly since the US current account deficit today extends to almost the rest of the world, and thus includes countries that would seem to make rather strange bedfellows as members of the trade account region. The role of the supposed capital account region – featuring Euroland – in today's global system and constellation of global imbalances remains somewhat under-explored.

1.4 A closer look at the trade account region and some key surplus countries

Being the most obvious trade account region candidate, China is the second focal point in the debate on global imbalances. Certainly commentators in the United States tend to see China as the root cause of the US current account deficit, since on a *bilateral* basis the US trade deficit with China has truly surged since the mid 1990s, exceeding \$200 billion by 2005 (see Figure 1.5).

However, only after 2002 has China's overall current account position really moved sharply into a *globally* significant surplus position, attaining \$68.7 billion by 2004 and surging to \$158.6 billion (or 7.1 per cent of GDP) by 2005 (IMF 2006).

Does this then prove that China pursues a beggar-thy-neighbour policy, and what does export-led development mean anyway? A first important fact not to be overlooked in this context is China's very fast domestic demand growth. Filipe and Lim (2005) find that over the 1993–2003 period net exports contributed less than 10 per cent of overall GDP growth. In particular, domestic demand contributed 8 per cent annually to GDP growth between 1999 and 2002 while net exports were a minor drag, that is, subtracted from GDP growth, according to the IMF (2003, *World Economic*

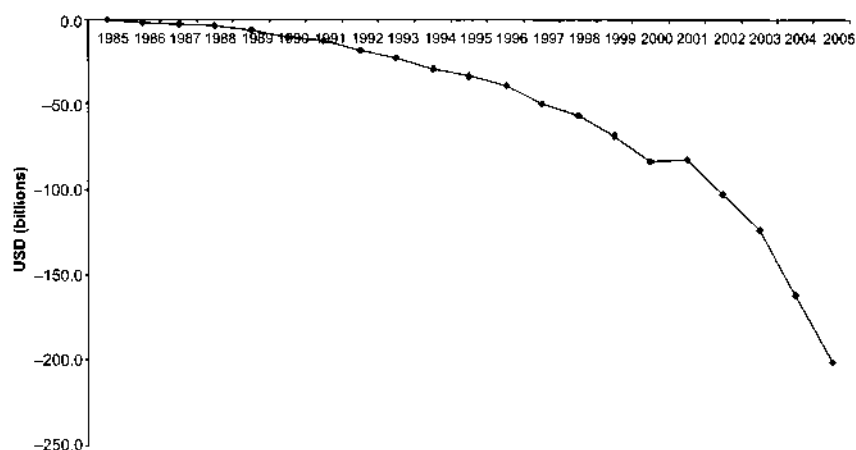


Figure 1.5 The growing US–Chinese trade imbalance, 1985–2005

Source: EcoWin/Reuters.

Outlook, September, p. 36). While domestic demand growth has accelerated thereafter, export growth accelerated even more; whereas import growth decelerated somewhat of late. China's WTO entry in 2001 may be one factor behind this. The renminbi's depreciation since 2002 in line with the dollar is perhaps another; although this also reminds us of its prior appreciation in line with the dollar between 1995 and 2001 (withstanding the Asian crises). But exceptionally high productivity growth in manufacturing seems to be the key factor behind China's export performance. Sharply decreasing unit labour costs are boosting external competitiveness while nominal wage inflation is in line with nominal GDP growth (UNCTAD 2005).

China's persistently strong domestic demand growth contrasts sharply with Germany's situation – another candidate for export-led growth. Whereas stagnant Germany features growing trade surpluses *vis-à-vis* its European partners, China actually runs deficits *vis-à-vis* some of its Asian neighbours. Reflecting an increasing degree of trade integration in the region, China has become a premiere location for final assembly of manufactures. Given its size China is an extraordinarily open economy and really the 'bazaar economy'⁴ *par excellence* today. Export-led development does not require export surpluses, only export revenues that are sufficient to prevent any constraint on imports from arising without recourse to foreign borrowing. Deliberately seeking export surpluses may be seen as a cause of imbalance. Yet, if China is seen as a main culprit of current account imbalances, this is a recent development. For until 2002–03 its role was quantitatively of third-order importance only. By contrast, the US current account deficit has gradually built up since the early 1990s.

Accordingly, until 2002 China's foreign exchange reserve accumulation was mainly the counterpart to FDI inflows – as BWII suggests. This has changed drastically in recent years, when surging current account surpluses as well as accelerating FDI and non-FDI capital inflows have contributed to a rapid build-up in China's reserve holdings (reaching \$1tn in the fall of 2006). At the same time, the People's Bank of China was seen issuing huge amounts of debt securities (in addition to increases in minimum reserve requirements of banks and other measures) to mop up the resulting domestic liquidity.

BWII interprets this constellation as reflecting China's pursuit of a deliberate policy of renminbi undervaluation to boost growth and employment via exports. At 10 per cent annual GDP growth, consumer price inflation has stayed very low up to this point despite soaring commodities prices. Asset price inflation and regional property markets, on the other hand, are giving rise to some concern. Many observers thus question the wisdom of China's policy regime focused on the US dollar (see Roubini and Setser 2005; Goldstein and Lardy 2005, for instance). They suggest that an immediate and sizeable renminbi revaluation would be in China's own best interest.

I am not convinced. China's stronghold in international trade stems from still low (although rapidly rising) wages and declining unit-labour costs, the latter owing to exceptionally high productivity growth in manufacturing. To counterbalance this advantage through the nominal exchange rate would require a very sizeable renminbi revaluation indeed. A gradually appreciating renminbi may be preferable though. The risks to China and the world related to any drastic revaluation today appear significant given that other sectors (banking and agriculture in particular) seem far more vulnerable.⁵

Reducing China's very high saving rate and boosting domestic demand seems more promising. High personal saving is a reflection of China's underdeveloped financial and social security systems, and recent reform initiatives by the Chinese authorities specifically target the latter: to reduce precautionary saving. Reforms along these lines should lead to rising imports and a refocusing of investment towards local consumption rather than exports. High public saving leaves scope to boost disposable incomes today, especially in rural areas, and it may also provide a welcome lifeline to Asia when the next recession hits (as in the wake of the Asian crisis). Through such a rebalancing of demand China will gradually cease to act as a seemingly unlimited abode of reserve asset claims on the United States.

It is far less clear that the Asian NIEs and Emerging Asia at large properly qualify for the trade account region in the BWII sense (see Kamin 2005). Recall here that – following financial liberalization – the 'Asian tigers' experienced rising current account deficits in the pre-crises years. The crisis of 1997–98, which presented a severe disruption in the region's development, and memories of this are still fresh, then caused a severe slump in investment and involved sharp exchange rate depreciations that boosted external competitiveness and led to a drastic swing in current account positions

in the region. Relying on export growth to overcome subdued domestic demand growth and deflationary pressures, the region has been eager to prevent renewed exchange rate overvaluation ever since. China was thus not alone in the region in intervening in foreign exchange markets and accumulating reserves in the process. Yet, while the US–Chinese imbalance has surged, the US's overall position with the region worsened by far less, as the US trade imbalance with some other countries in the region actually shrunk. Also, in line with economic recovery, some Asian currencies (the Korean won in particular) appreciated against the dollar in 2005. Overall, rather than being strictly in line with their supposed trade account role, the regions' behaviour probably owed more to the 1997–08 regional crisis and renewed slump in 2001.

Financial turbulences and crises have been widespread in the developing world in the era of financial liberalization. And Rodrik (2005) noted a common trend towards rising foreign exchange reserve holdings in developing countries since the early 1990s. Reminded again and again that sudden reversals in capital flows can cause severe economic disruptions, countries seem to seek protection primarily through increased liquidity. To an extent this is a financial intermediation process for which developing countries pay a handsome insurance premium (the spread of their international borrowing costs above US T-bill rates). Through running current account surpluses they safely add to their liquid (net) foreign assets. Summers (2006) referred to this phenomenon as the 'global capital flows paradox'.⁶ Arguably, building up a protective shield against financial crises whilst relying on export earnings (rather than foreign savings) for growth reflects developing countries' response to systemic deficiencies in the global monetary and financial order.

A truly odd *de facto* member of the trade account region is Japan which, according to BWII, has long graduated to the core. Yet, Japan featured prominently among countries that heavily intervened in dollar support in 2002–04, accumulating foreign reserves on a massive scale to contain the yen's appreciation. Keeping the yen competitive should best be seen in the context of the Bank of Japan's 'quantitative easing' policy that flooded Japan's fragile banking system with liquidity ('à outrance', as Keynes advised in his *Treatise on Money*) in an endeavour to escape from deflation at zero interest rates. Even more so than other Asian countries following the 1997–98 regional crisis, Japan probably considered relying on export growth as its best bet to end its long depression. Japan's bilateral trade surplus with the United States increased from \$50 billion to \$80 billion between 1995 and 2000, but has not changed much since then. By contrast, after fluctuating between \$70 billion and \$120 billion from 1991 until 2002, Japan's notorious current account surplus position has since increased to \$160–170 billion. In line with its strong international creditor position, this is mainly due to surging investment income.

There are some remarkable parallels between Japan and Germany, respectively the second and third largest economies in the world, as Germany too has experienced a persistent slump in investment and protracted domestic demand weakness since the early 1990s. By contrast, both countries grew strongly in 1991, when the US current account was last in balance. Figure 1.6⁷ shows that among today's current account surplus countries, Germany has seen the biggest absolute change in its external position since 2000: by some \$145 billion!

Suffice to mention here that current account imbalances have been markedly exacerbated by the oil price boom since 2004. One effect was to add yet another \$100 billion or so to the US deficit, another was to redistribute current account surpluses, away from Euroland and other oil importers toward oil exporters. While the group of oil-exporting countries is diverse (featuring Saudi Arabia, Russia, Norway, Nigeria, Venezuela), their combined current account surplus position has improved by around \$300 billion since 2002. Global payments imbalances would shrink if either oil prices reversed or spending propensities adjusted in line with the global income redistribution caused by this terms-of-trade shock.

In conclusion, the widespread focus on China is understandable at first sight given that on a bilateral basis the country has the largest share in the US's trade imbalance. Yet, China's contribution to global imbalances was quantitatively insignificant until recently: between 1994 and 2002 China's

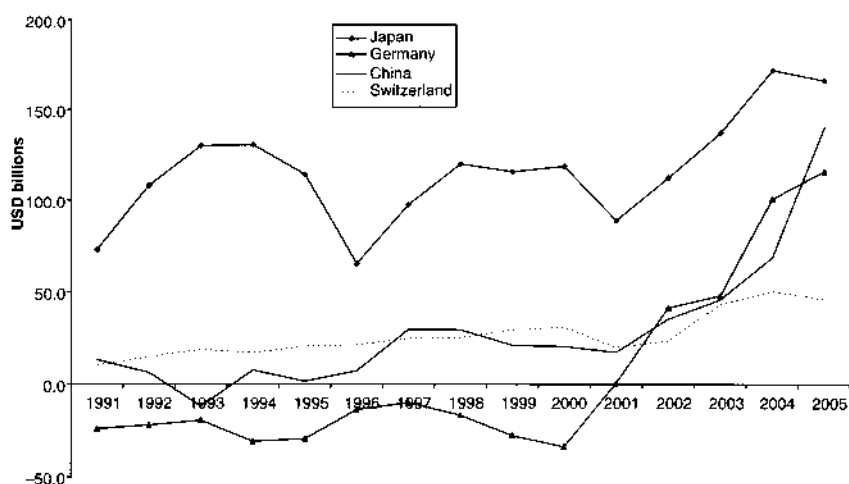


Figure 1.6 Countries with huge current account surpluses (Largest swing since 2000 occurred in Germany)

Source: Quelle: OECD, *Economic Outlook* no. 79 (June 2006).

current account surplus averaged \$20 billion, less than Switzerland's. While China matches the BWII description of the trade account region at least in some respects, other Asian economies do not. The region at large seems to have relied on export-led growth primarily as an emergency strategy to overcome domestic headwinds stemming from the 1997–98 regional crisis. In fact, a more general trend seems to be underway in the developing world to pay down external debt and accumulate dollar reserves as a protection against financial crises whilst relying on export-led growth.

BWII completely fails to account for some key industrial countries. Together Japan, Germany and Switzerland, the world's premiere laggards, make up some 40 per cent of the size of the US current account deficit. Moreover, oil exporters' lagged spending response to their terms-of-trade gains since 2004 have exacerbated and redistributed global payments imbalances; in the process of which Euroland's external surplus position has turned into a small deficit, for instance. In short, today's global constellation of current account surpluses is far more diverse, with respect also to its underlying causes, than BWII suggests. It is now time to explore the role of the core, that is, the United States.

1.5 Macroeconomic policy pragmatism and benign neglect at the core

According to BWII it is natural for the core to play by a different set of rules. As issuer of the world's reserve currency no. 1 the United States can finance current account deficits at ease, as long as its creditors are satisfied with accumulating claims on future US production – *in dollars*. So the United States can happily live beyond its means for much longer and without facing the kinds of problems that other debtor countries would normally have to fear. Some key facts about the evolution of the US current account position and certain striking internal (counterpart) trends since the early 1990s were described in Section 1.2 above. Here we need to highlight the key role of macroeconomic policy pragmatism behind the remarkable stability and strength in US GDP growth since 1992, except for the two-year pause in 2001–02.

The US's impressive overall GDP growth performance (see Figure 1.7) was achieved while significant shifts in its composition occurred. The only stable trend throughout this period was the continuous decline in the personal saving rate that accompanied strong and stable consumption growth. Investment, by contrast, has seen boom (1996–2000) and bust (2001–02), followed by gradual recovery since 2003. One might have expected the gap between US saving and investment to narrow with the 2001 recession. Just at that time though, a swing in fiscal stance occurred that turned a budget surplus of 1.6 per cent of GDP in 2000 into a deficit of 5 per cent of GDP by 2003. By luck or design, the fiscal swing was not only of unprecedented magnitude, but also well timed – filling the gap in demand left by insufficient corporate

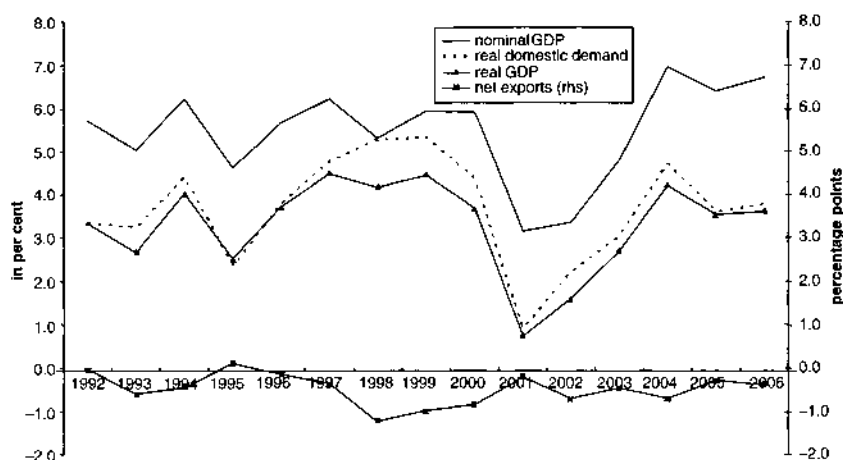


Figure 1.7 The US as global growth engine (Featuring persistent net exports drag)

Source: OECD, *Economic Outlook* No. 79 (June 2006).

investment. Fiscal expansion received great support from the Fed's fast-track monetary policy easing since 2001, crowding in private spending (both in the United States and elsewhere) as the Fed's pre-emptive strike at deflation led the way to historically low interest rates, which boosted US property prices, construction, and consumption spending.

Externally, the 'new economy' boom was accompanied by a 'strong dollar' policy, which was but one aspect of the US's benign neglect of its deteriorating trade position accompanying the flexible and pragmatic use of macroeconomic policies. In fact, the internal and external dimensions of US policy are intimately related. Applying macroeconomic policies to sustain GDP and employment growth in the United States meant tolerating significant policy spillovers from US domestic demand growth to other regions in the world, regions that for various reasons were having trouble boosting their own domestic demand and thus primarily relied on export growth instead.

BWII suggests that the dollar's status in today's global monetary order provides the motivation for the US's benign neglect of its deteriorating trade position. Analyses of the international role of a currency focus on monetary functions and the seignorage gains that stem from the international use of a currency for these purposes. A narrow interpretation of (international) seignorage estimates the central bank profit on that part of the note issue that circulates abroad. A broader interpretation includes certain benefits from trade invoicing in the international currency (for instance, oil) and certain home advantages of financial institutions. Arguably, the real issue is best illustrated by the fact that the US's net flow of investment income has stayed positive at least until 2005 despite a sizeable

negative net international investment position (with liabilities exceeding assets by some \$2.5 trillion). For this to be possible, 'the United States' must be a profitable financial intermediary indeed. The United States as a nation must hold sufficiently profitable items among its gross foreign assets, the return on which overcompensates its net debtor position (amounting to some 25 per cent of GDP).

The US's 'exorbitant privilege' just described is mainly of two kinds. One source stems from the higher yields the United States gets on its foreign assets compared to what it pays to foreigners on its liabilities; with the latter depending on domestic monetary policy and ultimately on domestic conditions and goals. The favourable yield premium reflects the asset structure of the US's balance sheet and owes to a number of factors like, for instance, the liquidity of US Treasury securities markets and risk premia on the US's equity and direct investments abroad. Gourinchas and Rey (2005) thus describe the United States as the world banker that has turned into world venture capitalist. The attractiveness of US Treasury securities is inherently related to the dollar's international status.

The other source of the US's advantage arises from valuation effects and is directly related to the dollar's status too. While the United States holds a share of 70 per cent of its foreign assets in foreign currencies, its borrowing is all in dollars. Dollar depreciation thus involves wealth transfers from the rest of the world. In fact, the greater the financial leverage in the US's gross international investment position, the greater the valuation gains obtainable in this way in case of domestic currency depreciation – a kind of 'original virtue' effect.

The US's exorbitant privilege can either be based on the financial account only, with the United States financing its high-yielding foreign investments through currency note issuance and other low-yielding Treasury securities while the current account remains in balance – as under Bretton Woods I. Or the dollar can be leveraged through building up a net debtor (and hence short dollar) position by running current account deficits – as under Bretton Woods II. When viewed as an 'ongoing business' the yield advantage helps to offset any trade deficit while valuation gains partly erase the US's external debts (see Cavallo and Tille 2006).

While this privilege may be significant, or even exorbitant, it is neither unlimited nor does it negate the laws of arithmetic, which still imply a sharply rising external-debt-to-GDP ratio. In particular, net investment income (i.e., US financial intermediation profitability) is unlikely to improve as the Fed boosts Treasury yields.⁸ Also, the prospect of recurrent dollar depreciation might damage the dollar's status and attractiveness, risking disorderly business. Higher US GDP growth *per se* would alleviate the burden of the debt, but GDP is also the driver of US import growth. In fact, a US recession, together with a falling dollar and oil price, is the surest way to reduce global imbalances. But the rest of the world might then regret what it was wishing for.

So perhaps we should better not worry too much but hope, as BWII suggests – depicting the international role of dollar liquidity rather well! – that the symbiosis between the United States and its debtors might last for quite a while longer. However, given the magnitudes of imbalances reached by now this seems an optimistic proposition since the United States may have become over-burdened as global growth engine no. 1.⁹

The US's role above as global growth engine no. 1 is reflected in Figure 1.8 in the gap between domestic demand and GDP growth. Especially during the period from 1996 until 2000 and again since 2002 domestic demand outpaced GDP growth by a large margin. This enormous stimulus to the world economy is owing to an ongoing focus of US authorities on full employment with price stability paired with benign neglect on the external front. The cumulative effects of this truly benign neglect have manifested themselves in a US current account deficit which represents a 2-per-cent-of-world GDP impulse to global aggregate demand – to which the rest of the world has become addicted.

The US's accommodating role as to weaknesses elsewhere in the world economy was noticed by Henning (2000), for instance, who observed that almost \$100 billion of the rise in the US current account deficit from 1996 to 1998 was a consequence of allowing Asian and other crises economies see their current account positions turn into surplus. Interestingly, Henning went on to observe that 'American policy-makers were clear about their desire for Europe to join in this process. [...] But rather than contributing to

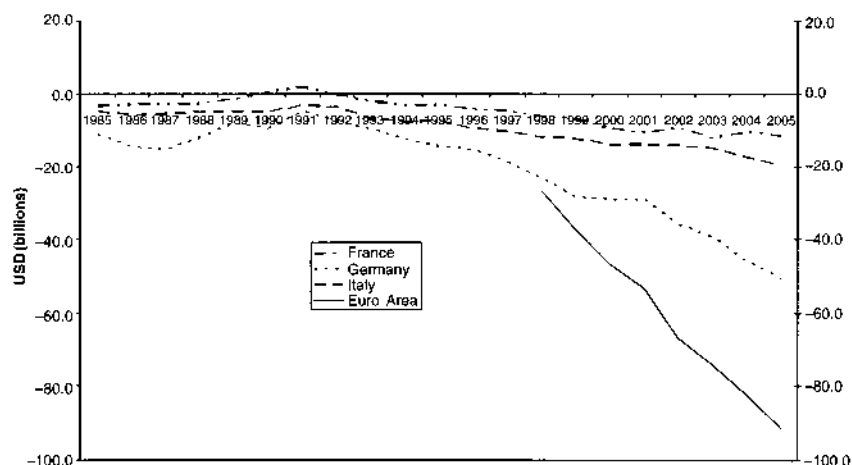


Figure 1.8 US-Euroland bilateral trade imbalance

Source: EcoWin/Reuters.

the adjustment, the euro area *increased* its surplus over the same period' (Henning 2000, p. 41).

The IMF, too, from early on stressed the role of Europe and Japan in the build-up of global imbalances. Referring to the rise in the US current account deficit of 1.5 per cent to nearly 4.5 per cent between 1995 and 2000, the Fund observed in its May 2001 *World Economic Outlook* that 'rapid US GDP growth and relatively weaker growth in other parts of the world, notably Europe and Japan, as well as a sharp increase in the real foreign exchange value of the dollar driven in large part by capital inflows, contributed to the rise in the deficit. The domestic counterpart has been a significant rise in investment,' (IMF 2001, p. 14). And in September 2002 the Fund observed that 'external imbalances across the main industrial country regions widened steadily during the 1990s' (IMF 2002, pp. 65–6), with these imbalances being 'dominated by the euro area and Japan, respectively' (p. 67).

In September 2005, the Fund then highlighted a wider dispersion in current account imbalances: 'Between 1997 and 2004, about two-thirds of the increase in the US current account deficit has been balanced by higher external surpluses in emerging market and oil-producing countries, with the rest matched by larger surpluses in industrial countries (mainly Japan)' (IMF 2005, p. 98). And in its April 2006 *World Economic Outlook* it observed that 'The US current account deficit has continued to rise, matched by large surpluses in oil exporters, China and Japan, a number of small industrial countries, and other parts of emerging Asia' (p. 5). Note, then, that Euroland's role has been silently written out of the play. And despite running the largest trade surplus in the world and after experiencing the largest current account swing in absolute terms, Germany does not even get mentioned among surplus countries either anymore. Time to scrutinize the apparent non-role of Euroland.

1.6 Ever becoming part of the solution rather than being part of the problem?¹⁰

As a 'grown-up' member of the capital account region, its natural home according to BWII, Euroland has essentially faced a choice between two strategies. The first features a primarily inward-oriented macroeconomic policy stance that aims at full employment at price stability combined with a balanced external position. As suits a large and fairly closed economy, GDP growth would be solely driven by domestic demand, and be in line with potential growth too. For an economy that aspires to be a global economic player and reserve currency issuer, a second strategy may be even more suitable. This strategy, too, features a macroeconomic policy stance aiming at internal balance, but joined by benign neglect as regards external balance. With the euro as a true rival to the dollar by more than aspiration, in today's

global monetary order Euroland would share the benefits that the United States has so far reaped alone.

In actual fact, however, Euroland has chosen not to follow either of these strategies. Instead, Euroland has *de facto* behaved more like yet another member of the trade-account region. One reason for this failure is that it is not all that clear what Euroland's aspirations really are, an issue on which the following observations by prominent policy-makers or scholars shed some interesting light. According to Padoa-Schioppa (2004, p. 139), 'the Economic and Monetary Union was not conceived to address an external challenge. The challenge was rather intra-European ... the euro came to life without program, ambition, or doctrine for its international role.' By contrast, Charles Wyplosz (1997) identified 'the international role of the euro [as] the hidden agenda of Europe's long-planned adoption of a single currency.' Finally, Henning (2000, p. 37) diagnosed that: 'EMU is in part a defensive reaction against US monetary diplomacy, as it unfolded over the post-war decades. EMU shields the Euro Area from some of the disruptive effects of dollar fluctuations.'

Although these assessments would seem to contradict each other, there is truth in all of them. Just like its EMS forerunner, the euro was intended to protect Europe – as an 'island of monetary stability' – against external shocks. By integrating Europe at the monetary front, a key hope was that an internally stabilized Europe would then be in a better position to withstand disturbances originating 'elsewhere in the world economy'. While this motivation is well in line with Strategy 1 above, hopes that the euro would make Europe more equal to the United States and give it more weight globally were always present too. De Gaulle is famous for complaining about the US's 'exorbitant privilege',¹¹ which would speak for Strategy 2 above. In light of these motivations, then, it seems truly puzzling that Padoa-Schioppa is quite right too in attesting a lack of any 'program, ambition, or doctrine' supporting the euro's international role as it was actually designed in the Maastricht regime of the EMU.

For the Maastricht regime is institutionally introverted and incomplete as regards the project's external dimension. The foremost issue here concerns external representation and responsibility for exchange rate policy in EMU. But in comparison to the dollar, the euro's lack of a fiscal backing and related financial system shortcomings, such as the absence of a lender of last resort for Euroland and non-existence of a Euroland Treasury bill traded in a deep and liquid market, are rather serious systemic deficiencies too. Not only do these shortcomings handicap the euro's potential global role. They also dilute the euro's supposed function as a protection shield against external disturbances.

The Maastricht regime's deficiencies were no accident though, but deliberate, reflecting 'Bundesbank wisdom'.¹² Essentially, Germany's famously

independent central bank was determined to replicate German monetary and exchange rate arrangements at the European level. If anything, the European arrangements to be established had to be even more 'prudent' than Germany's, and aspects which had complicated the Bundesbank's position in the past had to be corrected. Exchange rate matters had featured prominently as a cause of conflict in its history. For in this field too the Bundesbank was in an atypically – by international standards – strong position *vis-à-vis* the government. Yet, to take exchange rate policy completely out of political control in the Treaty would have been an unrealistic aim. So leaving things open *de jure* provided the ECB with the greatest possible latitude to establish its *de facto* leadership through practice and negotiation. A *de jure* vacuum would tilt the balance of power in favour of (the supposedly united front of independent) central bankers against (less united and probably insufficiently coordinated) finance ministers. Apart from asserting its 'natural competence' in financial market operations, including foreign exchange markets, the ECB can use public relations to denounce finance ministers' aspirations as an attack on its independence; a strategy that used to work rather well for the Bundesbank.

Other relevant Bundesbank views concerned short-term public debt instruments and any explicit lender-of-last-resort responsibilities, paired with a general reluctance concerning the D-mark's international role. For if a Euroland Treasury bill were to facilitate easier external financing of public debt, this would be wholly undesirable; a Euroland equivalent to the US Treasury Department, a sheer nightmare. Establishing watertight protection of the ECB's independence and stability orientation 'above all else' was the overriding issue.

It is debatable whether this kind of order may have served Germany (rather than the Bundesbank) well in the past.¹³ The resulting institutional vacuum under EMU has certainly left Euroland in a precariously exposed position: it is still not settled today who is really in charge of exchange rate policy in Euroland. When I questioned Commissioner Almunia on this point with reference to potential risks posed by global imbalances at a conference in Brussels in March 2006, he publicly confirmed this rather amazing *status quo*.¹⁴

Perhaps there would be nothing to worry about if Euroland's quite balanced external position really verified that it has 'kept its own house in order', as Otmar Issing (2005) seems to imply when he bluntly asserts that Euroland 'has not made any real contribution to the build-up of current imbalances'. In Issing's view, Euroland also has no major role to play in the global current account adjustment process but should simply continue on its well-trodden stability-oriented path. While Ahearne and von Hagen may not disagree too much with this judgment as such, they still consider European policy-makers' apparent complacency unwarranted, observing that: 'Europe may not be part of the global current account problem, but it is bound to be part of the solution' (2005, p. 1).

Of course Issing's denial is futile. Similar in size to the United States, Euroland has proved oddly dependent on external growth under the Maastricht regime. The US's 'new economy' boom proved decisive in getting the euro off the ground in the first place (allowing the members-to-be to meet the Maastricht criteria in the last minute). On average, net exports have also made a small positive contribution to Euroland's meagre GDP growth since 1999. Euroland's current account surplus has only evaporated recently, turning into a rather small deficit due to the oil price boom. Meanwhile, Euroland's bilateral trade surplus with the United States has surged (see Figure 1.8), which underlines that the euro's appreciation since April 2002 has failed to rebalance relative competitiveness positions and that Euroland remains at the mercy of the US growth engine.

The popular 'victim view' that the euro has borne the 'brunt of dollar depreciation' can thus also be put to rest. Although 50 per cent above its low point of November 2000, until November 2006 the euro had barely risen above its launching value of 1999, which many regarded as undervalued at the time. If anything, the victim view captures justified frustration about the fact that Euroland has been the only world region that managed to stagnate in the middle of the longest global boom since the 1970s. That, however, happened because Euroland *chose* not to participate in the deliberate deflation policy of the dollar bloc – which has nonetheless sponsored Euroland's ongoing recovery. Before subscribing to Ahearne and von Hagen's fears that Euroland might yet become even more of a victim should the external motor stutter, it may be time to admit that Euroland does not have any natural right to perpetually free-load on US-sponsored growth.

But searching for Euroland's problem 'elsewhere in the world economy' is much beside the point anyway. Euroland's primary problems are truly home-made. Commenting on the persistent growth differential between Euroland and the United States, Padoa-Schioppa's (2005) remarkably candid admission highlights that the 'main challenge for Europe today is: to increase its potential and actual growth. [...] Not only is potential growth relatively low in Europe; its actual growth performance is also persistently falling short of that potential.' If we trusted our textbooks, there could hardly be any clearer evidence of a macroeconomic policy failure. Indeed, the ill-designed Maastricht regime has failed dismally, seeing to it that Euroland drifted into protracted domestic demand stagnation even in the middle of a global boom. Contrary to Bundesbank wisdom, then, the mix of 'stability-oriented' monetary policy, fiscal consolidation 'no-matter-what', and notorious wage 'moderation' has caused stagnation, not growth. Excessive wage disinflation has amplified home-made demand weakness and notorious reliance on export-led growth.

As IMF assessments explicitly confirmed until recently, slow growth in Euroland and Japan have contributed markedly to the build-up of imbalances. Today, their combined bilateral trade surplus *vis-à-vis* the United

States is in the same order of magnitude as the Chinese one. Not only has Euroland paid a huge domestic cost for its self-imposed protracted stagnation. Externally, it has missed a great opportunity too: foregoing the intermediation profits that reserve currency issuance brings with it. No conflict has existed between pursuance of domestic equilibrium and benign neglect regarding the external position. Boosting domestic demand would have served both Euroland and the global economy well. In fact, failing to do so is inviting the risk of being offered an even bigger part in the reserve currency business later on, albeit abruptly.

Essentially, there is an ongoing clash of policy orientations in the global arena. Following Bundesbank wisdom, highly dogmatic policy-makers have done too little to keep domestic demand growth up in Euroland. By focusing on full employment at stable prices, highly pragmatic US policy-makers ended up doing correspondingly more to boost US domestic demand, thereby offsetting the external drain of their policy stimulus resulting from freeloading elsewhere, including Euroland. US interest rates thus had to drop, and asset prices to rise, *more than otherwise*, to induce the extra spending needed to drag along the domestic demand laggards. This order is not all that new. Traditionally, the United States has enjoyed long upswings occasionally interrupted by brief downturns. The stylized facts for Germany are the opposite: short upswings followed by long periods of stagnation – the very pattern that is today replicated in Euroland. Exporting the German model to Europe has not only undermined the model's working in Germany and brought stagnation to Euroland. Spreading the German disease to Europe is also bad news globally.

Alas, the situation has become even more complicated owing to the build-up of intra-Euroland imbalances that are hardly less spectacular than the ones much fretted about at the global level. As ever, Germany is at the heart of the problem: Germany's trade surplus with its Euroland partners reached €90 billion in 2005 and is soaring (see Figure 1.9). The imbalance owes primarily to Germany's beggar-thy-neighbour policies. Confronted with the fact that exporting Bundesbank wisdom – including wage moderation across Euroland – has caused stagnation rather than growth, Germany's response was to shift German wage 'moderation' into 'higher' gear since 2001. In terms of unit-labour-cost trends, Germany has achieved significant real 'depreciation' in this way (see Figure 1.10).

The internal consequences of deflating incomes have been disastrous too: Since 2001 the cumulative contribution of domestic demand to German GDP growth has actually been negative (Figure 1.11)! In a way, at the regional (Euroland) level Germany plays the very role that Euroland plays at the global level: domestic deflation paired with free-loading on external growth. The key difference is that inside Euroland, nominal exchange rates can no longer adjust – and tensions will thus have to be worked off in some other way (Bibow 2006b).

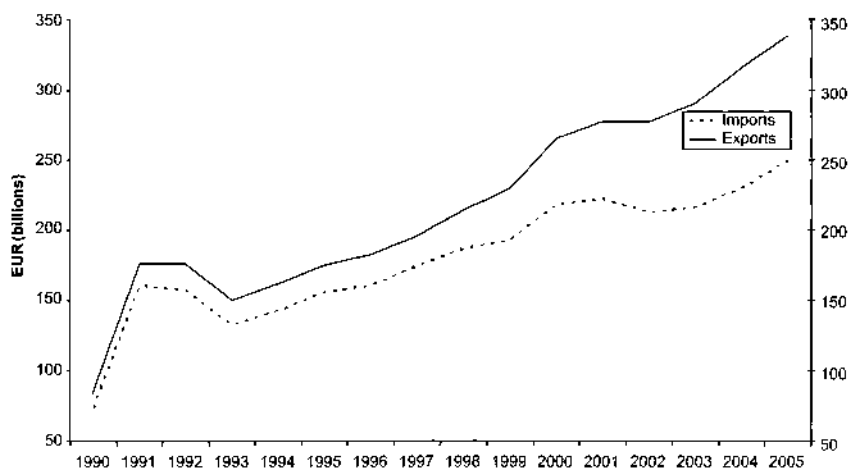


Figure 1.9 Germany pushing Eurozone apart (Germany's soaring trade imbalance with its Eurozone partners)

Source: Reuters.

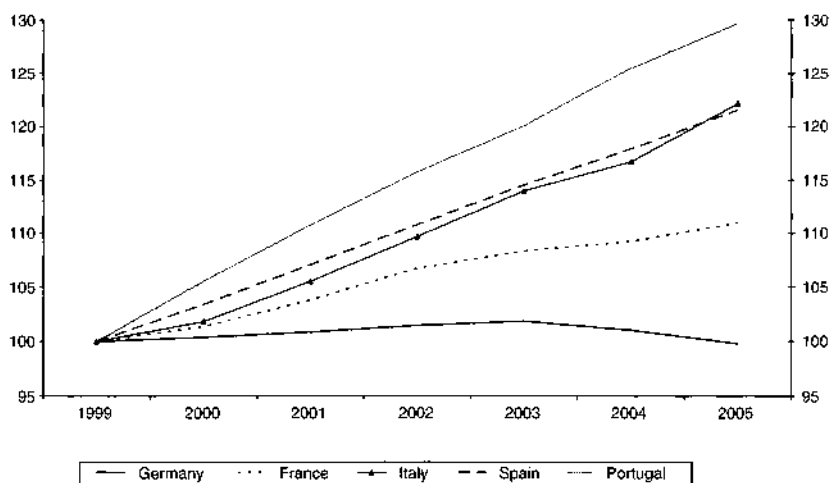


Figure 1.10 Diverging real exchange rates inside Eurozone (1999=100)

Source: OECD, *Economic Outlook* December 2005.

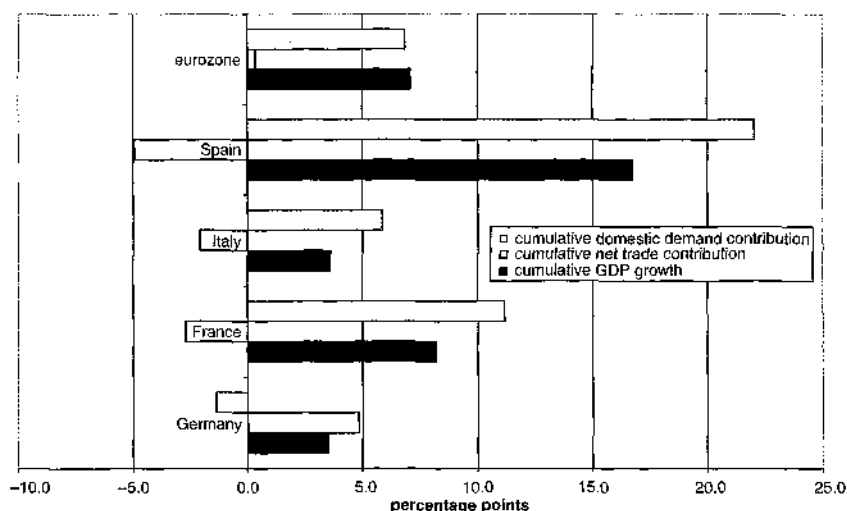


Figure 1.11 Cumulative GDP growth and its composition (2001–2005)

Source: OECD, *Economic Outlook* no. 78 (December 2005).

The upshot is that Euroland is just as unlikely to play any constructive part in the unwinding of global imbalances as it is unlikely to get away unscathed with its remarkable macroeconomic mismanagement for much longer. Problems are threefold. First, apart from the damage at the domestic front caused by the ill-designed Maastricht regime, the policy vacuum left at Euroland's external front is not conducive to constructive engagement either; chances are low, though, that the Maastricht regime might get the fundamental overhaul that it truly deserves. Second, probably no less harmful than the flawed regime itself, Euroland's key policy-makers refuse to grow up and live up to the fact that they are steering an economic giant that impacts on the rest of the world rather than being affected by it. Both Euroland's finance ministers and central bank politicians are notorious for their small-country mindset. What has worked for Ireland, Finland, or The Netherlands will work for Euroland too, remains their (mis-)guiding principle. Third, mounting internal imbalances are further undermining unity. Inquiring whether regional cooperation might help to deal with global imbalances, Wyplosz (2006, p. 1) observes on intra-Euroland imbalances that 'incentives for common action are not particularly strong'. In fact, Germany's beggar-thy-neighbour strategy brought upon Euroland what EMU was supposed to ban forever: a competitive devaluation.

1.7 Conclusion: reluctant global player and notorious global drag

The analysis here has shown that today's global imbalances are the result of a complex set of causes and developments. Twin-deficit stories, all too popular in Europe, and claims about China's beggar-thy-neighbour policy, all too popular in the United States, are just scratching at the surface. BWII partly captures the US-Asian 'symbiotic' economic relationship, but only to an extent. More than an export-led development strategy by a new periphery is involved. Following financial liberalization and recurrent financial crises there is a widespread desire among crisis-stricken newly industrialized and developing countries at large to prevent exchange overvaluation, to run current account surpluses, and to build-up massive foreign exchange reserves; rather than relying on fickle foreign savings and IMF policies. Essentially, this is a consequence of the absence of a sound multilateral global monetary and financial order; to a good extent, global imbalances reflect systemic deficiencies.

Against this backdrop, the United States has accepted playing the 'strong dollar' (benign neglect) counterpart and acted as the global economy's growth engine; reaping some sizeable real benefits from filling the above monetary vacuum along the way. No doubt flooding the global economy with dollar liquidity at historically low interest rates has worked rather well, so well that despite global (ex-US) demand weakness in product markets, oil (and commodity) prices have been pushed up to levels that are inflating current account surpluses of oil-exporting countries today. Of course interest rates are low not because of any 'saving glut' in capital markets (Bernanke (2005), but due to deficient demand in global product markets – which prompted easy monetary policies to stem deflationary pressures.¹⁵

US macroeconomic policy pragmatism – filling the vacuum left by the deficient global monetary order – represents one side of the coin of today's global imbalances. Protracted failure to properly manage domestic demand elsewhere in the world is the other. This blame can hardly be put at China's door though. Through its dollar peg (since its own earlier crisis in 1994), China has served as a kind of back boiler to the Fed's aggressive easy money policy since 2001, thereby providing important growth stimuli to the region and the world economy. In any case, the US personal saving rate is unlikely to drop another 10 percentage points. And another drastic deterioration in US public saving is unlikely to be tolerated either. Only an increase in domestic demand in the rest of the world would allow an orderly unwinding of global imbalances.

BWII completely fails to shed any light on the roles of certain other key players in all this. For one thing, Japan's current account surplus, while increasingly driven by net investment income, is still bigger than China's, which has only attained a globally significant scale since 2003 anyway. Yet,

there is no pressure on Japan to let the yen appreciate. Perhaps memories of the yen's sharp appreciation in the second half of the 1980s, the prelude to Japan's 'lost decade' that then ensued, inspire China's gradualism of today. For another, Euroland's role, aptly emphasized by the IMF until recently, has been written out of the play as the oil price boom turned Euroland's current account surplus into a small deficit.

Yet, protracted domestic demand stagnation and notorious reliance on export-driven growth by the world's second largest economic area is too important a force to be ignored; even when it is convenient for 'structural problem' story-telling. Padoa-Schioppa can again be singled out for candidly acknowledging that not all is well in the land of the euro:

In these early years neither the Eurosystem has acted as a full-fledged central bank nor euroland as a 'country'. The latter still lacks the constitutional structure to do so. The former is endowed with such structure but has not yet enlivened its charter with the necessary determination and political will. The result is that in the global arena an important player is missing from the field and another – a 'central bank without a state' – stays on the filed but does not play.

(Padoa-Schioppa 2004, 163)

The Maastricht regime's enormous stagnation damages at the domestic front have been identified elsewhere (see Bibow 2006a, for instance). Its global ramifications may be less obvious, but they are no less consequential. No doubt Euroland has had its fair share in manoeuvring the global economy into its current precarious corner. Moreover, Euroland is ill-prepared for playing any constructive part in the unwinding of imbalances; not to mention its lack of preparedness for coping with the consequences. The anti-growth bias at the Maastricht regime's domestic front is paired with an institutional vacuum at the external front: it is not clear who is minding the store. Sadly, whoever may be in charge is likely to suffer from the small-country mindset bedevilling Euroland's policy-makers. On top of all this, incentives for common action and unity of interest have been undermined by Germany's beggar-thy-neighbour wage deflation, which has caused soaring intra-Euroland imbalances. Euroland is drifting on a collision course, the euro's long-term survival not assured.

Notes

1. Cooper noted: 'my impression is that the consensus view among American economists is that fiscal stimulus (a reduction in taxes or an increase in expenditures) will increase GDP in normal circumstances. My impression is that the consensus among German economists is that a fiscal stimulus will not increase GDP and indeed may reduce it' (2005, p. 82). Summers (2004) observed on Europe: 'where policy-makers too often confuse the supply and demand elements of economic policy'.

2. Defining the extraction of equity on existing homes as the 'discretionary initiatives of home owners to convert equity in their homes into cash by borrowing in the home mortgage market', Greenspan and Kennedy (2005, pp. 5–6) quantify (net) equity extraction as: the change in regular mortgage debt outstanding minus new home originations plus scheduled amortization (less closing costs and other costs related to the extraction of home equity).
3. Bibow (2002) argues that the ECB did its best to scare private investors, both through its confused communications and transparently growth-unfriendly interest rate hikes in this period.
4. Sinn (2005) claims that Germany has no real title to be export world champion as an increasing share of its exports is no longer 'made in Germany' but imported from elsewhere; Germany's economy was transformed from a proper production location into a mere 'bazaar' on this view. A look at the growth contribution of *net* exports pays put to the bizarre 'bazaar economy hypothesis'; yet another variation on the theme that Germany cannot grow because of its alleged structural problems, and as such instrumental in the deflationists' agenda.
5. China's exchange rate regime was officially changed on 21 July 2005. Since then the renminbi has gradually appreciated from its long-standing 8.28 peg rate by some four per cent against the dollar. The declared policy is to gradually make the regime more flexible. Using the Oxford Economic Forecasting model, Park (2005) shows that a 20 per cent renminbi revaluation *vis-à-vis* the dollar would reduce the US current account deficit by a mere 0.05 per cent of GDP while risking a hard landing for the Chinese economy.
6. The new EU member states and potential future EU entrants are an exception to this global phenomenon.
7. As a tribute to the host country of the Lugano conference Switzerland was included too. Another advanced economy that has gone through a prolonged period of subdued growth since the early 1990s, Switzerland's current account surplus is among the highest in the world in relative terms (13 per cent of GDP) and quite significant in absolute terms too (\$46 billion in 2005).
8. Note that portfolio shifts by foreigners out of lower-yielding into higher-yielding US assets would shrink the privilege too.
9. See the Levy Institutes' periodic *Strategic Analyses* on this, Godley et al. 2005, for instance.
10. Credit is due here to Michael Mussa who vigilantly observed that the ECB was at the heart of the problem from early on. On 29 April 2001, the then IMF chief economist attested that 'it is time for the ECB to become part of the solution, not part of the problem, of slowing global growth' (FT.com 29 April 2001). Exemplifying the ECB's single-minded and backward-looking focus, Mr Duisenberg explained that 'with inflation above the central goal, a move in interest rates in that context would not enhance the credibility of the ECB' (FT.com 30 April 2001). It is doubtful whether this peculiar mindset, which continues to inspire the ECB's conduct until today, has really enhanced its credibility. Surely it is not all that conducive to growth and employment though.
11. Gourinchas and Rey (2005) attribute this position to Valéry Giscard d'Estaing, one of the founding-fathers of the European Monetary System (EMS).
12. The Bundesbank's decisive role in designing the Maastricht regime is well known. Dyson and Featherstone (1999) provide a thorough account of the negotiations that led to the Treaty and the national dispositions that inspired them. Essentially, Helmut Kohl could only steer Germany into EMU by getting the

- Bundesbank aboard. For Germany's European partners getting rid of German monetary hegemony required accepting a policy regime based upon Bundesbank wisdom (though under shared 'control').
13. Bibow (2005) argues that the Bundesbank model only worked for Germany because and as long as its main trading partners behaved differently, explaining why Germany got itself into trouble in the 1990s by imposing German 'stability culture' upon Euroland members.
 14. Shortly later the issue aroused a public conflict as ECB President Trichet failed to respond to a letter by the Eurogroup's Chairman Juncker and Commissioner Almunia proposing a closer dialogue between politicians and the central bank (see 'Juncker hits at ECB president', FT.com 15 June 2006.)
 15. Summers (2004) referred to a 'demand-supply imbalance abroad', judging that the 'global economy today appears to be suffering more from the deflationary pressures associated with too little demand than the inflationary pressures associated with too much demand'. The BIS identified a 'shift in supply-demand conditions at the global level' (2006, p. 17) among the factors responsible for subdued inflation pressures.

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2

Wage Divergences in Euroland: Explosive in the Making

Heiner Flassbeck

2.1 German 'Standortpolitik' and the monetary union

The European Economic and Monetary Union (EMU) faces increased international and internal scrutiny. More and more observers are asking questions about the long-run viability of a monetary system with absolutely fixed nominal exchange rates, but dramatically divergent real exchange rates. Since the start of the Union in 1999 Germany, the biggest country and the European stronghold of external stability for several decades, has decoupled from many other member countries by keeping nominal and real wage growth far below the pace expected by the partner countries and the markets. Nominal unit labour costs are the surrogate of the real exchange rate in systems of absolutely fixed nominal exchange rates: rising divergences between Germany and the rest of EMU point to an unsustainable real depreciation of the German relative cost position in a system that has abandoned the use of the exchange rate as an instrument to compensate for such divergences.

Some observers, in an attempt to defend the visible deterioration of competitiveness in Italy, Spain and Portugal, call attention to the fact that Germany has a long-standing tradition of defending undervaluation and running huge trade surpluses, reaching back to the 1950s. In their view, it is obvious that the tremendous shock of German unification only interrupted Germany's tradition of running high current account surpluses and that Germany today is in the process of re-establishing normality.

In fact, the adoption of the D-mark by Eastern Germany at an overvalued exchange rate temporarily altered the external situation for Germany as a whole. German Monetary Union was accompanied by a rapid catch-up of nominal and real wages. Despite huge investments in infrastructure and large-scale privatization, Eastern German productivity increases fell well short of nominal wage rises. The eastern region's drastic loss in competitiveness led to a current account deficit of that region (statistics were still available for the region in the early years after unification) of more than 50 per cent of GDP (*vis-à-vis* the rest of the world including West Germany). Germany's

overall current account balance turned into a deficit (of around one per cent of GDP), a situation that lasted for about a decade.

A number of factors helped to dissipate Germany's traditional current account surplus in the aftermath of the country's unification. In an environment of economic weakness in most of Europe, the Bundesbank's tight monetary response to the unification challenge strangled growth outside of Germany even before it crashed the Western German economy itself. This was followed by sharp real appreciation of the D-mark in the context of the weak US dollar after the Mexican financial crisis.

Impressed by the real appreciation of the D-mark and the implied loss of competitiveness as well as the weak economic performance, policy-makers in Germany put enormous pressure on trade unions and employer associations to forge a new consensus to regain international competitiveness through wage growth restraint. Eventually, following a tripartite agreement ('Bündnis für Arbeit') in 1996, the rate of nominal wage growth dropped lastingly below the sum of productivity growth and unit labour cost growth dropped below the 2 per cent inflation target, at least implicitly, set by the Bundesbank (and later by the ECB). Unit labour costs were set on a much lower growth path and later even declined.

Obviously, a strategy of raising international competitiveness through limiting the rise of unit labour costs to rates lower than in partner countries can only be successful as long as the domestic currency appreciates less than needed to compensate for the 'wage moderation' (the degree by which nominal wage increases fall short of the sum of productivity growth and anticipated or targeted inflation).¹ In the case of Germany, the *de facto* fixing of nominal exchange rates in the run up to the European currency union and the definite fixing of intra-regional exchange rates at the beginning of 1999 made this kind of beggar-thy-neighbour strategy possible. With the EMU, the risk of D-mark appreciation *vis-à-vis* EMU members, which are Germany's main trading partners, had been completely eliminated.

From a narrow German exporter's perspective, the strategy of wage disinflation has proved highly successful in boosting external competitiveness and net exports since attaining export surpluses became re-established as a key policy target in a strategy called 'Standortpolitik' (a policy designed to promote Germany as a site for production). Alas, the deflationary dynamics of German unit labour costs have pushed a number of EMU members into a very difficult position, experiencing a sharp and totally unexpected real appreciation. With France, Italy, Portugal and Spain as the main victims of the German strategy, the gap between unit labour cost trends in Germany and its European partners has widened sharply since 2000. As a result, Germany's current account balance has improved from -1.7 per cent of GDP in 2000 to 4.1 per cent of GDP in 2005 – while its closest trading partners suffered corresponding movements into deficit.

For instance, France's current account has swung from a 1999 surplus of \$42 billion to a deficit of \$33 billion in 2005, while Germany's 1999 deficit of \$26 billion turned into the second largest surplus in the world, reaching some \$114 billion in 2005 (IMF estimates, WEO, September 2006). By 2005 already, Germany had the third-largest current account surplus behind Japan and China. Its trade surplus is larger than Japan's. Indeed, the dramatic divergences in the current accounts are closely related to the emerging divergences in the competitive positions after the start of the European Monetary Union. They are not consistent with the fashionable view that current account swings are driven by voluntary and autonomous saving decisions of households or governments in the countries concerned.

France and Germany, for example, are fairly similar in size and degree of openness and their respective gross national saving rates have changed relatively little since the 1993 recession. Despite a rise in France's domestic investment rates after 1993 and a fall in Germany's by 6 percentage points since then, neither private households nor governments have changed their saving behaviour fundamentally. Private households have reduced their savings ratios in both countries and governments were stuck with rather high public budget deficits, violating the European Stability and Growth Pact over a number of years. Hence, it is undeniable that the swing in the current account was forced upon France by means of Germany's deflationary wage policy.

It is thus quite remarkable that Germany, the world's third largest economy after the United States and Japan, hardly features in today's intense international debate about global imbalances. This is despite the fact that between 2001 and 2005 Germany experienced the largest absolute change in the current account balance of all surplus countries. Obviously, Germany's huge surplus is hidden behind the Euro Area's overall fairly balanced current account position.²

Accordingly, on top of acting as a destabilizing factor and drag on growth from a global perspective, Germany is today also undermining the long-term viability of EMU in Europe. Even more than Japan, Germany has relied on belt-tightening policies to stimulate GDP growth through exports, but at the same time, as employment results of the wage dumping did not show up in terms of growing domestic demand, squeezed imports and boosted the trade balance.

There is only one argument that could justify the beggar-thy-neighbour policies currently pursued by Germany. This argument is used frequently to defend the undervaluation policy of the last ten years: namely, that Germany has entered the EMU at a grossly overvalued rate.³ But this argument is clearly false as a brief look at the history of the EMU in Europe demonstrates.

2.2 Was the D-mark overvalued?

After the collapse of the Bretton Woods system many smaller European countries decided to 'tie their own hands' in monetary affairs, as was the case in Austria when it later used the D-mark as an anchor for monetary policy. The 'snake' and the 'snake in the tunnel', that is, bands of fixed exchange rates around the fluctuating D-mark, were the first systemic and regional answer to the unwinding of the global system of regulated exchange rate relations in 1973. These countries sacrificed part of their economic policy power to the group as a whole or to Germany. But, at the same time, they gained autonomy *vis-à-vis* the power of markets and the influence of multi-lateral international organizations like the IMF. The German central bank *de facto* acted as a lender of last resort for the system as a whole, although this role has never been explicitly assigned to her, and, even more important, in a critical stage of the system accepted symmetrical obligations of both, the surplus and the deficit countries.

For a country, the decision to stabilize its nominal as well as its real exchange rate may formally be an autonomous national question. But *de facto* it is at least a bilateral affair. The country pegging its currency needs another country's currency to peg to, thereby forming the 'anchor' of the system. The natural anchor for many European countries at the beginning of the 1970s was the D-mark. Why? The D-mark had been consistently the most stable currency after the Second World War and Germany's economy as a market for products of its neighbouring countries was large enough to allow neighbouring countries to benefit from a stable value of their currency *vis-à-vis* the D-mark. Additionally, given the political will of all participating countries in Europe to head towards a further unification in many fields of economics and politics, Germany, from the beginning, did not just follow these moves of the smaller countries with benign neglect, but actively participated in the first steps to form a new European currency system as soon as the turbulences of the collapsing old system had been left behind.

An anchoring country, with an overall inflation performance quite similar to the anchor country, is in an easy position from the beginning. Austria, in its relation to Germany, is a good example. However, the general inflationary performance in normal times is one thing. The real test for successfully anchoring comes in time of shocks when its performance is directly compared with the anchor's reaction. Figure 2.1 reveals not only that Germany, in terms of flexibility of its labour market – mainly driven by the traditional tripartite social contract – has always outperformed most other European countries in normal times as well as in times of shocks. Only the recent, persistent pattern of growth in nominal labour unit cost consistently below the inflation target, resulting from the adoption of the 'Standortpolitik' in 1996, is new to Germany and the system as a whole.

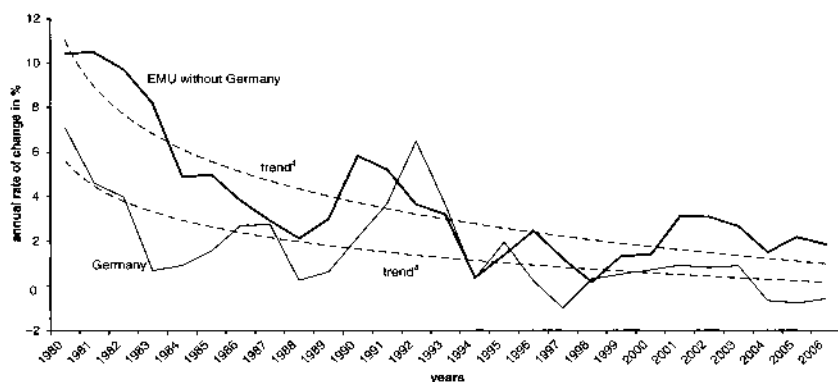


Figure 2.1 Nominal unit labour costs¹ in Germany² and other EMU-member countries³ 1980–2006

Notes: ¹ Total economy, national currency. – ² West-Germany, from 1991 Germany. – ³ EMU without Germany. – ⁴ Logarithmic trend.

Source: AMECO data base from April 2006; calculations by the author.

Germany was the best trend performer and it was clearly superior in the absorption of the inflationary consequences of the oil shocks. Consequently, it has assumed the role of the European anchor for good reasons. Only Austria was able to follow Germany very closely under all circumstances and maintain exchange rate stability all the time without a loss of overall competitiveness. The traditional high-inflation countries like France and Italy for a long time proved to be too inflexible compared to the low-inflation countries to prevail without exchange rate adjustments. The rigidity of prices and wages was higher compared to the anchor country of the system. Consequently, anchoring countries which could not follow suit with the anchor country had to depreciate time and again in order to restore the real value of their currency and their competitive position.

The most famous and most clear cut example of an unsustainable peg was the attempt of Italy and the United Kingdom to fix their currencies *vis-à-vis* the D-mark already in 1988, that is, at a very early stage on the way to the monetary union which at that time first appeared on the horizon. After the stock market crash in autumn 1987, the central banks in the United States and in Europe had lowered their interest rates to historical lows and this monetary stimulation at a rather late stage of the recovery gave new momentum to the world economy and world investment. The growth performances of the countries in Europe after the shock were more or less identical. All the countries reached growth rates of 4 per cent or more with the United Kingdom as the best performer at the end of the 1980s and West Germany outpacing the others at the beginning of the 1990s following the unification boom.

The inflation performance in this crucial period, 1987–92, was quite diverse, however. Whereas the traditional low-inflation countries including the United States were capable of keeping the inflation rate below 4 per cent despite upbeat growth, in Italy and the United Kingdom, the natural suspects for inflationary acceleration at the time, the price level jumped by 8 per cent or more. Even more pronounced were the differences in the growth rates of unit labour costs. Whereas Germany, Austria and France experienced a very slow and moderate reaction of wages to falling unemployment and rising growth, in Italy and the United Kingdom growth rates of unit labour costs hiked and reached 10 per cent, as a brief look at Figure 2.2 below reveals. Therefore, compared to the anchor country, the two newcomers in the European Monetary System (EMS), Italy and the United Kingdom lost massive ground. With fixed nominal exchange rates, the real exchange rate (calculated on the basis of unit labour costs) *vis-à-vis* Germany appreciated by 23 per cent in Italy and 28 per cent in the United Kingdom between 1987 and 1991. The loss of competitive power in these two countries was reflected in a huge swing in the current account from surplus to deficit.⁴

The United Kingdom and Italy, trapped by the choice between a deflationary threat on the one hand and the decision to quit the EMS on the other, opted for depreciation under speculative pressure (the famous fight of Mr Soros with the Bank of England). Crucial, at this stage, was the position of France. Although the country had been under the same kind of pressure from the financial markets as Italy and the United Kingdom the government decided not to give in to the pressure coming from the speculators in 1992. This was fully justified. France had been able to preserve its

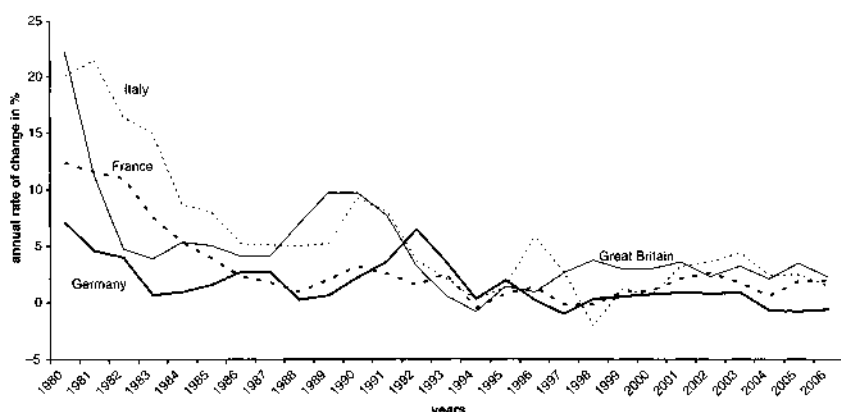


Figure 2.2 Nominal unit labour costs¹ in four European countries² 1980–2006

Notes: ¹ Total economy, national currency. – ² 1980–1991 West-Germany, from 1991 Germany.

Source: AMECO data base from April 2006.

competitive position, its relative unit labour cost position, during the whole period. France had been under pressure from the markets because its overall economic situation at that time was rather gloomy compared to Germany or Austria so that depreciation was seen by the markets as an easy way out of the recession. However, the decision of the French government – and with the assistance of most other members of the EMS including Germany – to stick to the ‘unwritten’ rules of the game, namely to use nominal depreciation only in case of a preceding real appreciation, was bold.

It is important to note that the pressure of the markets in the case of France was fully unjustified whereas in the case of the United Kingdom and Italy it was justified in view of diverging fundamentals. The willingness of the French authorities and other members of the EMS, again including the leading central bank, the Bundesbank, to challenge the wisdom of the market proved to be absolutely correct.

The lesson to be learned from this event is evident: had national authorities and their partners in the system realized at a much earlier stage that the situation of the lira and the pound would turn unsustainable, they could have reacted in a more timely fashion and they could have devalued the currencies of the two high-inflation countries and revalued the currencies of all the other in 1989 or 1990, long before the crisis loomed. With such a move they would have avoided the worst troubles of the crisis and would from the outset have prevented the danger of a country like France falling victim to the contagious effects of a general speculation against currencies with fixed exchange rates. This episode clearly shows that the D-mark was never an overvalued currency. As the Italian devaluation has been the last big devaluation inside the European Monetary System (before the leading countries were entering the monetary union at unchanged rates) and since this devaluation was the result of a preceding overvaluation, the D-mark cannot have entered the EMU at an overvalued rate.

Anchoring a small and very open country's currency has in several cases proved to be a very effective method of stabilization of the domestic price level. The main economic policy target many anchoring countries had in mind was not the external value of money, but the internal one.⁵ And it is here that the approach has proved to have its merits time and again. This is true for the small anchoring countries in Europe like Austria, the Netherlands and Belgium. In these countries inflation has been subdued for decades now in the same way as in their anchor country, Germany, and they have been able to adjust to shocks as effectively. The anchor approach has been successful in some large countries like France and Italy too. Although France fixed its exchange rate later than the smaller countries (in 1987) and the adjustment was not always as smooth as in their cases, France managed to fully catch up with Germany's inflation performance. But even a country like Italy, which was subject to many speculative attacks and many backlashes in its adjustment process, finally converged in terms of growth rates

of unit labour costs to the anchor in the final run up to the foundation of the monetary union. Hence, and again by implication of its role as anchor, the anchor's currency cannot be overvalued at the end of a long convergence process 'crowned' by the launching of a monetary union.

It would mean both to fully misunderstand the functioning of the former European Monetary System as well as the Monetary Union itself and to ignore the sheer fact of the convergence to conclude that the D-mark was an overvalued currency in 1999. By implication, if the D-mark was not overvalued, there has been no justification for an undervaluation strategy of the anchor country after fixing nominal exchange rates once and for ever. With its politically orchestrated wage restraint since the mid-1990s, Germany has not only violated its own historical rule of keeping unit labour cost growth in line with its monetary authorities' inflation target. Germany is also fundamentally undermining the very existence of the European Monetary Union (see Figure 2.3 below) – despite its own experience with a miserably failed monetary union (which is paradoxically also mainly due to wage divergences) inside Germany only a few years earlier.

To justify Germany's behaviour as a warranted restoration of previously lost competitiveness is also to ignore the mounting intra-Euro Area imbalances this policy has given rise to. Worse still, it is inviting partner countries that have found themselves on the other side of drastic changes in intra-Euro Area competitiveness positions to follow Germany's example.

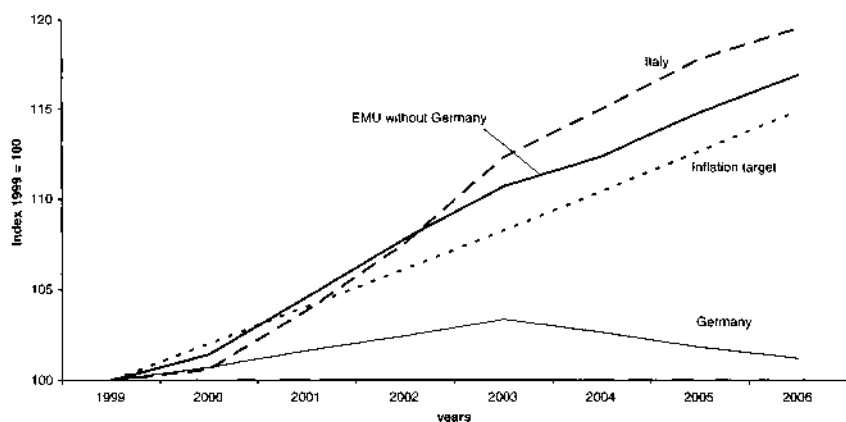


Figure 2.3 Nominal unit labour costs¹ in Germany and other EMU-member countries² since 1999

Notes: ¹ Total economy, national currency. – ² EMU without Germany.

Source: AMECO data base from April 2006; calculations by the author; data for 2006 are forecasts by the EU commission.

In fact, several economists have recently called upon Italy, in particular, to enact structural and wage policy adjustments as a solution to the malaise of persistent inflation divergence in the EMU. The point is that it is not Italy that has to change its policy, but mainly Germany. For Italy's unit labour cost growth has been fully in line with the ECB's inflation target. It was Germany's which has been much too low.⁶

There is a clear risk of pushing Euroland onto an outright deflationary path if Italy were now to follow through and adjust its wage trend (by means of political pressure on wage growth or any other measure to reduce labour costs for employers) downwards, as seems to be the intention of Mr Prodi. This would put even more pressure on others to follow the deflationary German line too. As Japan's classical example showed, monetary policy may be impotent in compensating the deflationary effects of declining unit labour costs on prices.

The irony is that, on balance, Germany has not really gained from its beggar-thy-neighbour policy. In large economies, domestic demand is more important than exports. Private consumption has stayed flat⁷ in Germany due to the fact that, since the mid-1990s, real wages have not risen while employment growth has not made up for the loss in real income per worker, thereby disproving the predictions of orthodox employment theory.⁸ Suffice to mention that following Germany's example Euroland-wide would mean to magnify the domestic demand depressing consequences of competitive wage disinflation. No doubt this is the opposite of what is required for an orderly unwinding of global imbalances.

2.3 Conclusion

The European Monetary Union can only function if nominal wage increases in all member countries stay in line with the inflation target set by the monetary authorities. Given the close correlation of unit labour cost growth (nominal wage growth minus productivity growth) and inflation, the implicit rule of the monetary union asks for real wage growth in each member state following strictly national productivity progress and for unit labour costs to neither exceed nor undershoot a 2 per cent growth path in each member state.

Violations of this rule will cause divergence of national real exchange rates and national levels of competitiveness, bearing serious long run consequences for the appreciating countries. Worst of all, this could trigger deflation in the Union as a whole. Unfortunately, an aberration of this kind started right at the beginning of the currency union in 1999 (if not before) – with Germany's deflationary wage policy as the main culprit. Without fundamental changes in wage policies throughout Europe a deflation or a transfer union,⁹ comparable to the German transfer union after unification, is an imminent danger.

Notes

1. Flassbeck (1997) raises the important point that this strategy may be viable for small countries like the Netherlands, yet is not sensible for larger ones like Germany.
2. For instance, in its World Economic Outlook of April 2006, the IMF no longer either mentions Germany or the Euro Area in assessing rising global imbalances: 'The US current account deficit has continued to rise, matched by large surpluses in oil exporters, China and Japan, a number of small industrial countries, and other parts of emerging Asia' (IMF 2006, p. 5).
3. See for example the contribution of Otmar Issing, the former chief economist of the European Central Bank, in a discussion of the topic in 'International Economy' (Issing 2006, p. 37).
4. Krugman's description of the European crisis as a case of the 'second-generation model' of financial crises is misleading, to say the least. Krugman (1998) is weighing the fiscal situation of the countries in crisis heavily, but forgets about overall competitiveness and doesn't take into account the quick turnaround in the economic performance of the countries concerned after depreciation despite high budget deficits. In my opinion there have not been several generations of models but only variations of one single theme, the theme of competitiveness of nations in a world of imperfect adjustment of exchange rates.
5. Lane (2006) points to the strong reduction in inflation differentials during 1992–98 across current EMU members.
6. Unit labour cost growth has been above the implicit European rule in Spain, Portugal and some smaller countries, which would call for some moderation on their part. Blanchard (2006) concludes that without policy changes the most likely scenario in Portugal is a competitive disinflation.
7. Ahearne and Pisani-Ferry (2006) find that domestic demand in Germany has barely grown since 1999.
8. See Flassbeck and Spiecker (2000) for a more detailed exposition of this argument.
9. See Flassbeck (1997) for a more detailed exposition of this concept.

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3

Can the Euro Area Play a Stabilizing Role in Balancing Global Imbalances?

Philip Arestis and Malcolm Sawyer

3.1 Introduction

The purpose of this chapter is to investigate the extent to which prevailing global imbalances can be reduced and removed without triggering a global depression. The President of the European Central Bank (ECB) in his monthly press conference on 6 July 2006 was very clear about the dangers posed by global imbalances. He suggested that 'The risks to the outlook for economic growth appear to be balanced over the short term, while in the longer term downside risks prevail, relating mainly to potential further oil price rises, a disorderly unwinding of global imbalances and potential pressures for increased protectionism' (Trichet 2006, p. 1). If the main imbalance is located in the United States, it is conceivable that there could be orderly private sector adjustments, which could remove the imbalances in question. In the United States, the private savings (to-GDP) ratio may rise gradually as interest rates increase and the housing market slows down. The rest of the world could move in the opposite direction, namely the savings (to-GDP) ratio decreases gradually (or the investment ratio increasing). But there is no evidence for either possibility. It is also conceivable that a sharp fall in the dollar might do the job. But the dollar has been falling for the last three years or so and the global imbalances have worsened rather than improved. If these possibilities do not materialize, then more abrupt and disorderly adjustment is possible: overshooting of exchange rates, large increases in interest rates globally, and sharp contraction in global economic activity.

The really interesting question is, then, how might economic policy help to avoid disorderly rebalancing. The US economic policy-makers could reduce the government budget deficit, so that the external deficit would be reduced – see Identity 4 below. The economic policies of the rest of the world could, of course, affect global imbalances by pursuing expansionary policies, which would increase their imports from the United States, potentially

thereby tackling the problem. Or, indeed, a combination of United States and the rest of the world economic policies would be a good way forward. This is particularly so in the case of China, whose share in the US trade imbalance is the largest on a bilateral basis (Bibow 2007). It is the purpose of this paper to examine the potential of economic policies that could be undertaken by the Euro Area economic institutions and member countries that are responsible for economic policy. The Euro Area can help to remove current global imbalances, we conclude, but not on the basis of existing institutions and economic policies.

The chapter begins with an examination of the current situation in terms of the state of the global imbalances, followed by a brief appraisal of the current situation in the Euro Area. This is followed by a discussion of the theoretical model that is thought to capture current thinking within the Euro Area. This enables us to demonstrate the economic policies that emanate from this theoretical framework. A comprehensive analysis of the current policies pursued in the areas of monetary policy, fiscal policy and labour market reforms is provided, which shows the consistency of the economic policies that follow from the theoretical framework, and those pursued in the Euro Area. The analysis concludes that while the Euro Area should be able to help, its current institutional structure and the economic policies adopted and implemented cannot be relied upon to deliver. Changes in institutions and economic policies are desperately needed.

3.2 Global imbalances

This chapter explores imbalances both in the United States and in the rest of the world. In the United States, there are the twin deficits of the US current account and of the government deficit. The US current account deficit was 6.4 per cent of GDP in 2005, projected to rise to 7.6 per cent in 2007 (Bibow 2007), a very high percentage by historical standards.¹ The general government deficit over the same year, that is 2005, was 4.1 per cent of GDP, with little change expected over the 2006–07 years (IMF 2006).

The rest of the world imbalances are to some extent the mirror image of the US current account deficit. Current account surpluses are much in evidence and this is particularly so in the case of China and the rest of the Asian economies (IMF 2005, for example). As a result there is a substantial accumulation of dollars, which in turn are invested in the US financial markets, especially so in the government bond market. This strong inflow has remained robust and has helped to finance the growing US external deficit.

The problem with these imbalances can easily be described through the usual income identities (see, for example, Higgins and Klitgaard 1998). The standard income identity provides:

$$Y = C + I_p + G + X - Q \quad (1)$$

where Y is aggregate income (GNP), C is consumption, I_p is private investment, G is government expenditure, defined as including government infrastructure expenditure (GIE), so that $G = G_1 + \text{GIE}$, and $X - Q$ includes net factor income (i.e., returns on domestic and foreign assets), where X is exports and Q imports.

$$Y = C + S_p + T + \text{TR} \quad (2)$$

where S_p is private saving and TR is income transferred abroad.

So that:

$$O = (I_p - S_p) + (G - T) + (X - Q - \text{TR})$$

and

$$(X - Q - \text{TR}) = (S_p - I_p) + (T - G) \quad (3)$$

with $(X - Q - \text{TR})$ being the Current Account (CA), implying:

$$\text{CA} = (S_p - I_p) + (T - G)$$

or

$$\text{CA} = (S_p + T - G_1) - (I_p + \text{GIE}) \quad (4)$$

This suggests that:

(i) current account balance = domestic saving – domestic investment

We may recall that:

$$S_p = I_p + (G - T) + \text{FA}$$

that is, private saving is equal to domestic physical capital, domestic government debt (net issuance of government debt, which is equal to $G - T$), or foreign assets (FA); so that, solving for FA we can have:

$$\text{FA} = (S_p - I_p) + (T - G) \quad (5)$$

Hence a country accumulates foreign assets (or equivalently, is a net lender to the rest of the world) when domestic private saving is more than sufficient to finance private investment spending plus the government balance.

Comparing (5) and (3) we have:

$$FA = (X - Q - TR) = CA$$

which means that a current account surplus is matched by an equal net outflow of investment funds overseas, while a deficit is matched by an equal net inflow of investment funds.

It is also true from (5) that:

$$FA = (S_p + T - G_1) - (I_p + GIE)$$

This is interpreted as meaning that a country accumulates foreign assets when domestic private saving is more than sufficient to finance private investment plus the government deficit.

Or equivalently:

(ii) net foreign asset purchases = domestic saving – domestic investment

This shows that a country accumulates foreign assets when domestic saving exceeds domestic investment expenditure. Such a country exports savings abroad in the form of direct investment or holdings of foreign stocks, bonds or real estate. Similarly a country without sufficient saving to finance its investment must attract surplus foreign savings in the form of capital inflows. Furthermore, the fact that the right-hand side of (i) and (ii) are identical, implies that a current account surplus is matched by an equal net outflow of investment funds overseas, while a deficit is matched by an equal net inflow of foreign investment funds. Consequently, a country with a CA surplus is in effect lending to the world. Such a country accepts foreign IOUs in the form of increased holdings of foreign assets to bridge the difference in the CA. Similar effects prevail in the case of a CA deficit country. Such a country offers IOUs in the form of increased foreign holdings of domestic assets to bridge the difference in the CA. It is thus the case that the CA and FA expressions are simply two ways of looking at the same underlying phenomenon. In no way does this suggest a causality that goes from savings to the CA, while the accounting identity cannot establish causality.

There is an interesting implication, relevant to the focus of this chapter, of these identities worth exploring. A high current account deficit may hurt employment through an increased volume of imports. However, the current account deficit is matched by an equal inflow of foreign capital. This finances a higher volume of investment spending, which otherwise would not occur, thereby increasing employment. It is the case that the recent behaviour of the US economy fits in nicely with this implication. The US current account deficit has been associated with an increase in investment and a fall in saving as percentages of GDP, but with increased employment,

and with a 25-year low-unemployment rate. Foreign saving in the form of capital inflows to the United States has made this possible. The trouble is, of course, that a continuation of these large deficits causes foreign indebtedness to rise rapidly as a share of GDP. Regardless of whether this represents a policy concern, the point remains that the United States would have to rely on foreign capital to maintain adequate levels of employment and investment. This, of course, would depend on the willingness of foreign investors to oblige. Thereby the problem with global imbalances and the focus of this chapter are both highlighted. More precisely, though, we are concerned here with the possibility of the Euro Area expanding its economic activity, and in the process the United States reducing its trade deficit, thereby helping towards alleviating the global imbalances to which we have alluded.

3.3 The Euro Area theoretical framework

In an attempt to highlight the economic policies pursued by the Euro Area authorities, we begin by referring to the theoretical framework from which the Euro Area economic policies emanate. It is unlikely that economic policy pursued by any government or institution is fully consistent either internally or with some theoretical paradigm. However, in view of the approach adopted by the Economic and Monetary Union (EMU), and the theoretical positions put forward by its officials (see, for example, European Commission 2000; Issing 2003), it can be thought of as embedded in the 'new consensus' macroeconomics paradigm (see, for example, Arestis 2007; Arestis and Sawyer 2003a, 2003b, 2004, 2006; Sawyer 2007). We argue that the approach can be viewed as 'new consensus' through its emphasis on the supply-side-determined equilibrium level of unemployment (the 'natural rate' or the non-accelerating inflation rate of unemployment, the NAIRU), its neglect of aggregate or effective demand in the long run, and the elevation of monetary policy at the expense of fiscal policy.

The most relevant to the EMU theoretical construct can be highlighted under the following seven propositions.

- (i) The market economy is viewed as essentially stable, and that macroeconomic policy (particularly discretionary fiscal policy) may well destabilize the market economy. Markets, and particularly the financial markets, make well-informed judgements on the sustainability of economic policies, especially so in the current environment of open, globalized capital and financial markets.
- (ii) Monetary policy is taken as the main instrument of macroeconomic policy, with the view that it is a flexible instrument for achieving medium-term stabilization objectives: it can be adjusted quickly in response to macroeconomic developments. Indeed, monetary policy is the most direct determinant of inflation, so much so that in the long run the

inflation rate is the only macroeconomic variable that monetary policy can affect (see, for example, ECB 2003). Fiscal policy is no longer viewed as a powerful macroeconomic instrument (in any case it is subject to the slow and uncertain legislative process). It is recognized that the budget position will vary over the course of the business cycle in a counter-cyclical manner (i.e., deficit rising in downturn, surplus rising in upturn), which helps to dampen the scale of economic fluctuations (i.e., act as an 'automatic stabilizer'). But these fluctuations in the budget position take place around a balanced budget on average over the cycle. The budget (at least on current account) can and should be balanced over the course of the business cycle. Fiscal policies 'based on clear mandates and rules reflect a macroeconomic policy design that is generally preferable to the ad-hoc discretionary coordination of day-to-day policy action in the face of shocks' (ECB 2003, p. 37). Monetary policy has, thus, been upgraded and fiscal policy has been downgraded.

- (iii) Monetary policy can be used to meet the objective of low rates of inflation (which are desirable in this view, since low, and stable, rates of inflation are conducive to healthy growth rates).² However, monetary policy should not be operated by politicians, but by experts (whether bankers, economists or others) in the form of an 'independent' Central Bank (ECB 2003, pp. 40–1). Indeed, those operating monetary policy should be more 'conservative', that is, place greater weight on low inflation and less weight on the level of unemployment than the politicians (Rogoff 1985). Politicians would be tempted to use monetary policy for short-term gain (lower unemployment) at the expense of long-term loss (higher inflation). An 'independent' Central Bank would also have greater credibility in the financial markets and be seen to have a stronger commitment to low inflation than politicians do.³
- (iv) Credibility is recognized as paramount in the conduct of monetary policy to avoid problems associated with time-inconsistency. This is an argument that reinforces the requirement of central bank independence. It is argued that a policy that lacks credibility because of time inconsistency is neither optimal nor feasible (Kydland and Prescott 1977). The only credible policy is the one that leaves the authority no freedom as to how to react to developments in the future, and that even if aggregate demand policies matter in the short run in this model, a policy of non-intervention is preferable. It is precisely because of the time-inconsistency and credibility problems that monetary policy should be assigned to a 'credible' and independent Central Bank. Such a Central Bank should be given price stability as its sole objective.
- (v) The ECB pursues a monetary policy strategy with 'clear commitment to the maintenance of price stability over the medium term' which 'implies a stable nominal anchor to the economy in all circumstances' (ECB 2001, p. 49). The ECB, however, does not pursue an inflation

targeting policy (Duisenberg 2003; Issing 2003). Duisenberg (2003) was adamant that the ECB approach does not entail an inflation target: 'I protest against the word "target". We do not have a target ... we won't have a target.' The ECB, though, views the demand for money in the Euro Area as a stable relationship in the long run – most central banks would suggest the opposite in the case of their economies.⁴

- (vi) The level of economic activity fluctuates around the NAIRU, and unemployment below (above) the NAIRU would lead to higher (lower) rates of inflation. The NAIRU is a supply-side phenomenon closely related to the workings of the labour market.⁵ The source of domestic inflation (relative to the expected rate of inflation) is seen to arise from unemployment falling below the NAIRU, and inflation is postulated to accelerate if unemployment is held below the NAIRU. However, in the long-run there is no trade-off between inflation and unemployment, and the economy has to operate (on average) at the NAIRU if accelerating inflation is to be avoided. In the long run, inflation is viewed as a monetary phenomenon in that the pace of inflation is aligned with the rate of interest. Monetary policy is, thus, in the hands of central bankers. Control of the money supply is not an issue. This is so for two reasons. Money supply is endogenous and, also, because the demand for money is unstable, which clearly implies that the impact of changes in the money supply is a highly uncertain channel of monetary influence.
- (vii) The essence of Say's Law holds, namely that the level of effective demand does not play an independent role in the (long-run) determination of the level of economic activity, and adjusts to underpin the supply-side-determined level of economic activity (which itself corresponds to the NAIRU). Shocks to the level of demand can be met by variations in the rate of interest to ensure that inflation does not develop (if unemployment falls below the NAIRU).

It follows from this description of the main ingredients of the theoretical framework that three types of policies can potentially be utilized: monetary policy, fiscal policy, and labour market reforms. There are a range of policies, notably industrial, structural/regional, and technology ones, which do not readily fit into this framework and which have been down played in recent years. The policies, which are admissible, are discussed in Section 3.4.

3.4 The Euro Area economic policies

We discuss and assess the Euro Area economic policies in this section. In doing so, we are mindful of the problems that might be tackled by these economic policies, these being of course the world imbalances. The main actors in this game are the United States, China, Japan, and the Euro Area. The US external deficit has been building up ever since the early 1990s, while

China's surplus as an important global imbalance has only emerged over the last few years. It was actually after 2002 that China's surplus emerged as a significant dimension of global imbalances. Japan's and the Euro Area's protracted domestic demand stagnation are two further important dimensions to the problem. We concentrate in this chapter on the Euro Area, and seek to examine whether economic policies can initiate a demand-led growth that would help to mitigate, if not eliminate, global imbalances as smoothly as possible, and at the same time avoiding, if not minimizing, negative effects on global economic growth. It is true that eliminating global imbalances requires changes in both prices and quantities. Exchange rate changes alone would not be sufficient. Growth differentials should also adjust. This is exactly where the EMU comes into the scene. Increases in both potential and actual growth are necessary if the world economy is to be helped and global imbalances removed.

The current situation in the Euro Area is characterized by two main relevant facts. There had been a current account surplus since its creation in January 1999, although it has turned into a small deficit recently (in 2006 and only 0.2 per cent of GDP) due to increases in energy prices; Euro Area's bilateral trade surplus with the United States has actually surged in recent years (Bibow 2007). A further relevant Euro Area characteristic is a protracted shortage of aggregate demand. The last decade has been disappointing for the Euro Area. It has only grown by less than 2 per cent per year, while the United States has well exceeded the 3 per cent growth rate. Furthermore, '[a]s the value of the United States imports currently represents roughly 180 per cent of its exports, the latter will have to grow much faster than imports for a considerable time for the trade deficit to follow a downward trend' (UNCTAD 2005, p. 15). This makes it imperative that the rest of the world does expand. This chapter considers such a possibility emanating from the Euro Area and argues that the latter can help a great deal in this endeavour.

It clearly is the case that in the Euro Area growth has been disappointing over the period 1999 to the present, although short periods of growth have been observed (the first half of 2006 is an example). Unemployment remains very high,⁶ while the external position is not problematic at all. The Euro Area would, thus, benefit greatly from higher demand and absorption. Consequently, policies designed to increase demand within the EMU would not only foster economic growth but also tend to boost imports and reduce the current account surplus, perhaps moving it into deficit, with the latter helping to reduce global imbalances to the extent that the US current account deficit were thereby reduced. Since the object of the exercise is to examine the possibility of expansion in the Euro Area, active economic policies are needed for this purpose. Can the Euro Area model deliver, however, if the available policies were to be implemented? This is the question to which we wish to provide an answer in what follows in this section. In this attempt we discuss the three economic policies referred to above as

emanating from the theoretical framework discussed in Section 3.3. Three such policies emerge as important: monetary policy, fiscal policy and labour market reform type of policies. We begin with monetary policy.

3.4.1 Euro Area monetary policy

The ECB is independent from political, though not ideological, influence, with price stability as its primary objective. This is articulated so as to maintain inflation 'close to 2 per cent from below'. Without prejudice to price stability, the ECB should help achieve according to its constitution, 'a high level of employment ... sustainable and non-inflationary growth, a high degree of competitiveness and convergence of economic performance'. Ever since 1999 when the ECB was established, the only objective that has been fervently pursued has been that of price stability. In the pursuit of this objective, the ECB has a two-pillar system of evaluating the prospects of achieving price stability: economic analysis and monetary analysis.

The economic analysis is an assessment of price developments and the risks to price stability over the short to medium term. A number of indicators are utilized with a list that includes: 'developments in overall output; aggregate demand and its components; fiscal policy; capital and labour market conditions; a broad range of price and cost indicators; developments in the exchange rate; the balance of payments and global economy; financial markets; the balance sheet positions of euro area sectors'. Then there is the monetary analysis. This is to analyse monetary developments for the information they contain about future price developments over the medium and long term, exploiting the long-run link between money and prices. A 4.5 per cent reference value for the M3 monetary growth has been imposed. Deviations from the reference value would 'signal risks to price stability'. Monetary analysis is utilized by the ECB as a 'cross-check' for consistency between the short-term perspective of economic analysis with the more long-term perspective.

The really interesting question is to ask whether this approach to monetary policy can achieve the desired expansion. Clearly, the answer must be in the negative since the only objective on this score is the achievement of price stability, but not output stabilization. To the extent, of course, that a negative relationship exists between inflation and output growth, achieving low and stable inflation rates can potentially provide high growth rates. However, the available evidence suggests that the relationship between inflation and growth is non-linear: at low levels of inflation the relationship is positive and it is only at relatively high levels of inflation, say around 10 per cent, would the relationship become negative (see, for example, Ghosh and Phillips 1998).

Further problems emerge when the conduct of monetary policy is examined over the period since the birth of the ECB. Following Arestis and Chortareas (2006), we distinguish three periods. The first is the period 1999

to mid-2001. There was a decrease in the rate of interest in April 1999, only to increase back to the same level by the end of the same year. A period of increasing interest rates followed, which peaked at 4.75 per cent in October 2000 and remained at that level until May 2001. The period was characterized by concerns over price stability, emanating essentially from strong economic growth, increasing import prices, declining euro exchange rate and high growth in the money supply (M3). Over the period mid-2001 to mid-2003, the second period, official ECB rates were reduced, and rapid monetary growth was evident. That was explained (see the monthly *Bulletin* of the ECB over the relevant period) by a shift from the uncertain stock markets into cash; it was felt that there was no risk to inflation since credit growth was not increasing rapidly; the ECB decreased the interest rate over that period. In the third period, mid-2003 to 2006, the official ECB rates remained unchanged until the end of 2005 (but has increased since). Since the mid-2003, though, fast monetary growth has been associated with equally fast lending. The slack in the real economy has not convinced the ECB to decrease interest rates; the fear is that monetary developments can be inflationary this time. But since the beginning of 2006, signs for improved real activity have been accompanied with increases in the official ECB interest rates. In some way the ECB has been caught between the economic analysis that suggests lower interest rates and the monetary analysis that implies higher interest rates. The two-pillar approach is sending different and contradictory signals. The credibility of the strategy is obviously at stake (see also CEPS 2005, p. 29, which reaches a similar conclusion). One might also add at this juncture that the 2003 ECB clarification on the two pillars did not help either.

3.4.2 Euro Area fiscal policy

Moving on to examine fiscal policy, we note that its main ingredients, as it is expected to operate within the EMU, are characterized by the principle of the Stability and Growth Pact (SGP). The main ingredients of the latter can be succinctly summarized. The EMU members countries should, in principle, aim for a government balanced budget in normal circumstances, preferably aiming for surplus during 'good' times, so that if a 'deficit' is necessary during 'bad' times, this can easily be dealt with, but under no circumstances should this exceed 3 per cent of GDP. Another important dimension of the SGP is that the public debt/GDP ratio should not exceed 60 per cent.

National fiscal policy is subject to the requirements of the SGP (with no fiscal policy at the level of the European Union (EU) with a balanced budget requirement and EU expenditure at a maximum of 1.24 per cent of EU GDP). The official rationale for the SGP is twofold. The first is that a medium-term balanced budget rule secures the scope for automatic stabilizers without breaching the limits set by the SGP (see below for more details). Second, since a balanced budget explicitly sets the debt ratio on a declining trend, it

reduces the interest burden and improves the overall position of the government budget. Underlying the approach to SGP, though, is the notion of 'sound' public finances (see, for example, Bibow 2003). The European Commission is emphatic on this issue:

Achieving and sustaining sound positions in public finances is essential to raise output and employment in Europe. Low public debt and deficits help maintain low interest rates, facilitate the task of monetary authorities in keeping inflation under control and create a stable environment which fosters investment and growth ... The Maastricht Treaty clearly recognizes the need for enhanced fiscal discipline in EMU to avoid overburdening the single monetary authority and prevent fiscal crises, which would have negative consequences for other countries. Moreover, the loss of exchange rate instrument implies the need to create room for fiscal policy to tackle adverse economic shocks and smooth the business cycle. The stability and growth pact is the concrete manifestation of the shared need for fiscal discipline.

(European Commission 2000, p. 1)

It is further argued that these views spring from experience in that both emphases on fiscal prudence and stability in the founding Treaty of the EMU spring from the firm conviction that

the deterioration of public finances was an important cause behind the poor economic performance of many EU countries since the early 1970s. The subsequent decades taught Europe a salutary lesson of how economic prosperity cannot be sustained in an unstable economic policy environment. Inappropriate fiscal policies frequently overburdened monetary policy leading to high interest rates. On the supply-side, generous welfare systems contributed to structural rigidities in EU economies and fuelled inappropriate wage behaviour. The net effect was a negative impact on business expectations and on investment, thus contributing to a slower rise in actual and potential output. As a result, employment stagnated.

(European Commission 2000, p. 9)

Between January 1999 and March 2005, the SGP did not work in the manner it had been designed to function; nor, following some modifications to the SGP, has it worked since March 2005 either. A number of countries allowed their deficits to exceed the upper 3 per cent limit in the face of an economic slowdown, which was worsened by the inability of national governments to use fiscal stimulus. It is not surprising, then, that the SGP has been seriously criticized and calls for abandoning it or modifying it significantly have been plenty. So much so that in an interview with the French newspaper *Le Monde*

in 2002, the then President of the European Union, Romano Prodi, claimed that the SGP was 'stupid', essentially because of the requirement to apply its rules too mechanically.

Following intensive and highly controversial discussions among EU officials on revisions of the SGP suggested by the EU Commission and by member states, the ECOFIN (the body that comprises of the EU Economic and Finance Ministers) Council adopted on 20 March 2005 a proposal on improving the implementation of the SGP. The European Council endorsed those proposals subsequently. The ECOFIN Council's report now forms part of the SGP. Interestingly enough, during the process of reforming the SGP the ECB consistently insisted on the need for a sound fiscal framework in EMU. In a statement of the Governing Council on 21 March 2005, ECB stated that 'Sound fiscal policies and a monetary policy geared to price stability are fundamental for the success of Economic and Monetary Union. They are prerequisites for macroeconomic stability, growth and cohesion in the Euro Area. It is imperative that Member States, the European Commission and the Council of the European Union implement the revised framework in a rigorous and consistent manner conducive to prudent fiscal policies' (ECB 2005, p. 61).

The new proposals that were introduced in March 2005, were designed to improve the functioning and implementation of the SGP. The main points of those changes can be briefly summarized:

- more budgetary consolidation in good times and more flexibility in reducing deficits in bad times;
- more focus on cutting the debt to GDP ratio and more room for manoeuvre for countries carrying out structural reforms;
- countries with sound finances are allowed to run small extra (beyond 3 per cent) deficits to invest, provided it is a small breach and appears temporary.

These changes are rather cosmetic and cannot be expected to be of much help in introducing a major impact on the operation of the SGP. The changes to the SGP in March 2005, introduced some flexibility but did not address the underlying issue, namely the imposition of arbitrary arithmetic limits on budget deficits with the pursuit of balanced budgets over the business cycle.

3.4.3 Euro Area labour market reforms

We may now turn to the third type of policies, that is labour market reforms. Such policies, it is argued, would encourage firms to expand and in the process the Euro Area will achieve higher aggregate growth rates. Interestingly enough there is a problem in the EMU in terms of labour-market reforms. In France minor labour-market reforms have met with opposition and sent crowds onto the streets.⁷ In Germany high taxes have become a political asset

in that it helped the current coalition to gain in recent elections. It would appear that extensive labour-market reforms in the EMU are impossible, but there is barely any protest against even quite big tax rises. This is precisely the opposite to what happens in the United States, where there is no problem with labour-market reforms, but politicians who dare propose tax increases have a huge problem on their hands.

It is the case that the EMU model lacks even macroeconomic policies to support labour market reforms. In terms of budget policy, the Stability and Growth Pact (SGP) constrains fiscal policy to the 3 per cent of GDP deficit ceiling. EMU members have no independent monetary policy, since interest rates are set by the ECB to achieve price stability. Reforms are in the hands of national governments, and they are expected to boost growth. Even if the ECB decided to ease interest rates to help in the process of reforms in one country, say France or Germany, it might in the process damage other members of the EMU that may need higher interest rates, say Ireland or Finland, which experience higher growth rates than other members, signalling higher inflation and thus higher interest rates in the eyes of the ECB. In any case, new member countries would have to meet targets for macroeconomic stability, not improve flexibility. EMU countries, therefore, seem to have to choose between fiscal and monetary stability on the one hand, and reforms to boost growth and achieve stability on the other. EMU countries often choose to deal with public finances first. But why can they not achieve both?

A recent study by Coats (2006) shows that there is no European employment problem caused by labour market rigidities. Countries like Denmark, Sweden, Austria, and the Netherlands have more 'inflexible labour markets' (i.e., tight labour laws, strong trade unions and collective bargaining, and generous unemployment benefits) than other countries like the United Kingdom and the United States, and still have at least as strong, if not stronger, employment performance as the latter countries. Quite obviously, different models of employment can yield equally satisfactory outcomes; regulation of labour markets does not seem to be the enemy of jobs! It would appear that the EMU does not have 'an employment problem' of the type suggested by, for example, the ECB (2003).

Be that as it may, reforms have been implemented and a recent OECD study (Brand, Burniaux and Duval 2005) has produced a score and a ranking of labour market reforms in a number of OECD countries. Table 3.1 below has been compiled from the OECD study to which we have just referred. Table 3.1 reproduces the relevant scores and rankings of the 12 Euro Area countries. These are based on quantitative indicators of the reform process, which have been constructed in the form of Reform Intensity Indicators. This method provides a broad-brush picture of policy reforms over the period 1994–2004. We have also cited in the fourth column of Table 3.1 the average growth rates of the 12 Euro-Area countries over the period 1999–2005, along with the relevant GDP rankings. The two rankings do not correspond at all actually. At face

value, Table 3.1 produces the conclusion that countries that have managed well in terms of GDP growth rates have not done well in terms of their score on labour market reforms. Similarly, countries with relatively low GDP growth rates over the period under scrutiny, have managed high scores in terms of labour market reforms. Furthermore, we calculated a simple Spearman correlation coefficient on the relationship between scores and GDP growth for the period 1999–2005, under the hypothesis that scores and GDP growth are independent. Using the STATA package and ranking tests, the Spearman correlation coefficient is -0.58 , indicating a negative relationship, while the p -value of 0.048 clearly indicates that the hypothesis postulated is accepted within the normal confidence threshold. This implies that the variables in question are independent. This simple exercise is rather revealing in that it shows that no relationship is evident between GDP growth and the degree of labour market reforms.⁸

The analysis in this subsection suggests that inflexible labour markets do not appear to be as important as the notion of insufficient aggregate demand in explaining the Euro Area's inability to increase income and employment. It may very well be the case that labour market reforms by themselves increase the power of employers to resist increases in wages or even lower wages. This may very well result in lowering aggregate demand, thereby exacerbating the already existing shortage in this all-important variable.

3.4.4 The ECB-handicap hypothesis

Further support to the conclusions reached in Section 3.4.3 is provided by examining the so-called ECB-handicap hypothesis. This hypothesis suggests that monetary policy in the Euro Area is ineffective in influencing output

Table 3.1 Ranking of labour-market reforms and GDP in the 12 Euro Area countries

Country	Score	Ranking	GDP	GDP
Netherlands	25.7	2	1.48	9
Finland	25.0	3	2.73	5
Germany	23.9	4	1.26	12
Italy	21.7	5	1.28	11
Belgium	21.4	6	2.13	7
Austria	17.8	8	2.02	8
Ireland	17.4	9	6.25	1
Portugal	15.9	12	1.32	10
Luxembourg	14.4	15	4.48	2
France	14.5	16	2.16	6
Greece	13.8	17	4.27	3
Spain	10.5	24	3.59	4

since its effect is transmitted quickly and completely into prices. This is explained by the existence of labour-market rigidities, which 'limit the pace at which an economy can grow without fuelling inflationary pressures' (ECB 2004, p. 21). Thus, if the ECB lowered the rate of interest in an attempt to expand economic activity in the Euro Area economy, this would merely translate into higher prices with only limited effects on real economic activity. By contrast, in view of the United States being less rigid, the Fed can actually stimulate the economy without causing inflation. In fact, an ECB study (Angeloni et al. 2003) concludes that a one-percentage point increase in the short-term interest rate tends to have a substantially significant stronger output effect in the United States than in the Euro Area. Their explanation rests on the view that Fed monetary policy has a stronger impact on US consumption than the ECB monetary policy has on Euro Area consumption. This latter conclusion concerning the ECB monetary policy has been labelled as the ECB-handicap hypothesis (De Grauwe and Costa Sorti 2005).

The study by De Grauwe and Costa Sorti investigates further the ECB-handicap hypothesis and reaches different conclusions. The authors of this study utilize a 'meta-analysis', widely used in medical sciences but not so frequently in economics. The way meta-analysis is employed by the study is 'first to statistically analyse the estimated effects of monetary policy shocks on output and prices, and second to identify the factors that can explain the differences in these estimated effects' (2005, p. 4). They employ 83 studies, which report on the impact of interest rates on inflation and output. Four different parameters that measure the effect of monetary policy are examined: short-term effects on prices and output; and long-term effects on prices and output (effect after one year measures the short term; effect after five years measures the long term). Since many of the 83 studies employed report results for more than just one country, 278 parameters that measure the short-term and long-term effects on output are obtained, while only 185 parameters are possible to obtain for the short-term and long-term effects on the price level. An econometric equation explaining these different parameters is employed. The purpose is to control for a number of variables that can affect the size of the estimated coefficients (different estimation methods, different time periods, etc.). It is concluded that the Euro Area and US coefficients are of the same order of magnitude, that the short-term effect on the price level is very small, while the long-term effect on prices is significant. Short-term and long-term effects on output are significant. The ECB-handicap hypothesis is, thus, not upheld. This conclusion tends to support the results reached in Section 3.4.3 above. It is, thus, simply not true that the ECB cannot affect output because of the existence of rigidities, especially in the labour markets. There may be good reasons why monetary policy might not be an effective means of affecting output. But rigidity in the labour markets is not one of them.

3.5 Summary and conclusions

On the basis of the analysis conducted for the purposes of this chapter, a number of conclusions follow. The first is that the Euro Area could potentially help in removing the global imbalances referred to above. However, on the basis of the current institutional and policy framework this is highly restricted. Institutional changes are thus required to enable policy to work. The required changes should target both monetary and fiscal policies designed to reformulate the objectives of the ECB and drop the 'stupid' SGP. Proper coordination of fiscal and monetary policies which are themselves designed to stimulate growth rather than suppress it should be undertaken. Changes in the labour market and its institutions could make a contribution, but these would not be designed to make the labour market 'more flexible' in the way that term is generally used, but rather should be designed so as to produce more efficient central wage-bargaining arrangements. The required changes are urgent for both the Euro Area member countries to enable them to achieve higher growth rates and to enable world imbalances to be tackled. The removal of the US current account deficit will involve some depreciation of the dollar, including against the euro. The consequent rise in the value of the euro would tend to depress external demand, and as the Euro Area has tended to rely on the growth of external demand, measures are needed to offset any reduction in external demand.

There is, however, another scenario, the effects of which would neutralize any EMU adjustments following active economic policies designed to remove global imbalances. Under this scenario the United States and China adopt the right policies and act in tandem. The United States increases its national net savings ratio through some combination of increases in private sector savings, reduction in investment and reduction of the budget deficit, while China, and possibly other emerging countries, allow their currencies to appreciate against the dollar as appears to be required for the correction of the pattern of current account deficits and surpluses. It appears unlikely that there would be any prospect of agreement between the United States and China on this, and that China and other emerging economies would be able to absorb the corresponding decreases in their net savings ratio. The effects of the increase (or attempted increase) in the US national net savings would in themselves be deflationary, and anyway require decreases in net national savings elsewhere. If the Euro Area responded to this by insisting that budget deficits do not rise or by raising interest rates, then the prospects for global recession rise.

Notes

1. UNCTAD (2005) suggests that the US deficit is 'the counterpart of almost 70 per cent of the aggregate surpluses in the world economy' (p. 12).

2. Issing (2003) puts it in the following way: 'Widespread consensus: even low inflation entails significant costs'. This statement should be judged against evidence provided by Ghosh and Phillips, where a large panel set that covers IMF countries over the period 1960–96 is utilized, to conclude that 'there are two important nonlinearities in the inflation-growth relationship. At very low inflation rates (around 2–3 per cent a year, or lower), inflation and growth are positively correlated. Otherwise, inflation and growth are negatively correlated, but the relationship is convex, so that the decline in growth associated with an increase from 10 per cent to 20 per cent inflation is much larger than that associated with moving from 40 per cent to 50 per cent inflation' (1998, p. 674). However, the point at which the nonlinearity changes from positive to negative is thought to deserve a great deal more research. The statement of Issing (2003) should also be judged in terms of statements like 'there is an optimal rate of inflation, greater than zero. So ruthless pursuit of price stability harms economic growth and well-being. Research even questions whether targeting price stability reduces the trade-off between inflation and unemployment' (Stiglitz 2003).
3. See Forder (2000) for an extensive discussion and critique of the notion of credibility.
4. Our own empirical work (Arestis et al. 2003) suggests that the demand for money differs between the component countries of the EMU and that the demand for money is unstable in a number of those countries and throughout the Euro Area.
5. The March 2003 issue of the ECB's Monthly Bulletin puts it as follows: 'the outlook for the euro area economy could be significantly improved if governments strengthen their efforts to implement structural reforms in labour and product markets. Such reforms are important to ultimately raise the euro area's production potential, improve the flexibility of the economy and make the euro area more resilient to external shocks' (ECB 2003, p. 6). A point repeated in a number of issues of the Monthly Bulletin of the ECB subsequently.
6. In fact, Eurobarometer reports that 'Unemployment remains the key issue' amongst the main concerns of European citizens (2006, p. 8). Interestingly enough, according to the Eurobarometer, concerns about inflation have been downgraded from 17 per cent to 13 per cent in 2006 as compared to 2005 (Autumn).
7. A recent poll reported in the Guardian newspaper (10 April 2006) suggests that only one-third of French citizens believe in the system of free market forces.
8. A study that assesses the labour market flexibility agenda in the cases of the United States and the Netherlands concludes that although such policies may lead to higher job growth, they are likely to do so at the expense of innovation and labour productivity growth (Kleinknecht and Naastepad 2005). A social pact, it is argued, between trade unions and employers becomes an important policy recommendation.

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Part II

Policy Coordination and Increased Integration as Means to Properly Steer Euroland

4

Whatever Happened to 'Policy Coordination'?¹

James Forder

4.1 Introduction

One often neglected aspect of the process leading to Economic and Monetary Union (EMU) in Europe is that when the European Monetary System (EMS) was created, the promotion of 'policy coordination' was seen as an important condition of its success. The issue of just what one means by 'policy coordination' might be debated, but I suggest that the relevant connotation of it at the time included demand-expanding policy and that lying in the background, were the theoretical arguments of Hamada (1974) and Hamada (1976) which formalized, amongst other things, the idea that there are circumstances where, if each country sets policy independently, deficient demand results. What distinguishes Hamada's treatment from earlier consideration of similar issues is that his case for coordination arises from a positive sum game with a clear-cut free rider incentive – it is Hamada who gives these issues their properly 'game theoretic' aspect.

This perhaps accounts for some of the interest shown in these ideas in the late 1970s and early 1980s, but it certainly became a crucial characteristic of the development of them later. Indeed, the prominence given to game theoretic problems – or supposed problems – was to grow out of all proportion to their intrinsic interest. As a result, by the time the European Central Bank began its operations, it was still possible to praise the idea of 'policy coordination', but it had come to mean something quite different from what was under discussion in the early stages of the EMU process – and something which, it is to be feared, is very much less pertinent to the real problems of the European or the world economy.

4.2 Economics and 'policy coordination' before the European Monetary System

In some sense, issues of policy coordination were under discussion from a very early stage in the development of economics, but an early contribution

along the lines that Hamada was to develop was that of Keynes (1936, ch. 23). He noted that although they might try, countries cannot all increase their gold reserves at the expense of each other, but the effort to do so can produce unemployment. The implication there, of course, was that the central bankers had not understood the nature of the process determining employment and it was this misunderstanding that led them astray in their international policy. Similarly, Robinson (1937/1969) said of a number of countries:

Each one claims excuse for maintaining the rate of interest at a level which causes unemployment in the fact that none is free to act alone. But a cautious spirit in each individually is damaging to all collectively.

She may have felt the failing was more a moral than an intellectual one, with 'the cautious spirit' being a manifestation of conservatism. If that were eradicated, then nothing would stand in the way of achieving the cooperative, expansionary outcome. But still, the problem is not treated as involving any particular difficulty in coordination *per se*. Rather, it is treated merely as a matter of recognizing the collective interests.

Early post-war treatments – not least Meade (1951) – moved beyond the implicit presumption that a worldwide deficiency of demand was the only problem requiring a collective response. And Mundell (1968) clearly realized that the assignment problem had an international dimension, since he noted the possibility that the appropriate target for one country's policy tool might be an outcome in another country. Even so, the problem under consideration was merely that of understanding policy optimization.

The difficulties of the Bretton Woods era led to a rather more specific focus on what was required in order to maintain the system. Cooper (1968) noted that there is a tendency to competitive policy of various sorts and – drawing an analogy with the theory of externalities – that this can be sub-optimal for the world as a whole.² And Niehans (1968), considering the matter more formally, noted that the case clearly exists where world demand is kept deficient as a result.

Neither of these authors seemed to take the view that there would be any great difficulty in inducing nation states to play by cooperative rules if it could be settled what those rules were. Cooper was perhaps the first to contemplate some common policy-making. But his idea seems to have been simply that policy coordination was a convenient way of implementing the globally optimal policy, rather than a means to restrain the pursuit of national interest. And Niehans, although he explicitly drew an analogy with the theory of duopoly, settled simply for saying that the problem would call for 'some conscious coordination' to resolve it.

Hamada (1974), however, presented the problem much more as an authentic piece of game theory. He considered a wider variety of circumstances

and objectives than earlier authors had. But one of his central cases was, in its basic form, not all that much more than the early Keynesians' reflections on the Gold Standard, and certainly no more than Niehans had modelled. If each country in a fixed exchange rate system values growth in reserves, then (so long as the sum of reserve growth targets exceeds the exogenous increase in world reserves), policy will be excessively deflationary in the sense that all countries would be made better off if they adopted a more expansionary policy. That particular presentation perhaps seems to overweigh the importance of reserves *per se*. But the argument carries through *mutatis mutandis* to any case where there is a benefit from relative deflation. One candidate would clearly be the promotion of exports and employment by deflationary policy in a fixed exchange rate regime.

Perhaps it was just the contemporaneous developments in economic theory, or otherwise a characteristic of the tenor of the times, that led to Hamada seeming to emphasize – or anyway, his work to lead to more emphasis on – the difficulties in reaching a common policy response in such a case. The game theoretic issue that has always lurked in these kinds of arguments was that even if 'agreement' on expansionary policy could be reached, it would still be in each country's interest to renege on that agreement and set a non-cooperative policy. And if that idea is given too much prominence, then it can easily come about that the crucial issues seem to be those of monitoring, commitment, and enforcement.

4.3 Policy coordination and the creation of the EMS

The historical outline of the creation of the EMS is well known. The Werner Plan went nowhere, although it continued to be fairly seriously discussed up to at least 1974. It led to the creation of 'the snake in the tunnel' with the intention of bringing greater stability than was required by Bretton Woods to the European currencies' cross-rates; but hardly was it in operation before the Bretton Woods System failed. The snake remained, minus its 'tunnel', but all the large countries except West Germany left it and allowed their currencies to fall. As a result there was no possibility of acting on Werner's idea of achieving monetary union by gradually narrowing the bands of fluctuation.

However, Commission President Jenkins determined to revive the idea and made two significant speeches on it. One was the first Jean Monnet lecture, delivered in October 1977,³ and the second, clearly designed for a West German audience, was his speech to the German Council on Foreign Relations delivered in Bonn on 8 December.⁴ Scholars dispute the practical significance of these particular contributions, but it is clear that West German Chancellor Schmidt's support was crucial to the project. He and French President Giscard d'Estaing, with, at least on Schmidt's side, some effort to avoid involving central bankers, constructed the outline of the deal, then presented it first to the British and Italians, and later to the other EEC

members. After detailed negotiation, agreement was reached in 1978 for the system to begin operating in 1979. At that stage, further developments, most notably the creation of a European Monetary Fund holding a large share of the members' foreign exchange reserves, were clearly planned, but nothing ever came of them. (That is to say – nothing came of them until the Delors Report. But that requires a separate explanation.)

It is clear that there were many motives for creating the EMS. They range from the most ideological, or even emotional, in the form of promoting European integration, and perhaps even snubbing an unrespected American administration, to the most pragmatic in small neighbouring countries seeking exchange rate stability. But what is much less widely noted is the role that ideas like Hamada's had in the development of policy. Indeed, just at the time when Jenkins was seeking to revive the EMU project, those ideas were gaining prominence in the G5/G7 summitry process. Coordinated policy had been discussed earlier, but gradually moved to prominence and became, as Putnam and Bayne (1987) put it 'a standard item on the international agenda' of economic policy. Certainly, it was seriously discussed at the London Summit of 1977. And the following year, at Bonn, an agreement on coordinated expansion by West Germany and Japan and reduced fuel consumption by the United States was actually reached.

Furthermore, this process played a particular role in the internal politics of West Germany. In that country there was ongoing tension between the government and the Bundesbank which was apparent throughout the 1970s.⁵ As Putnam and Bayne and others have noted, this tension formed the background against which Schmidt negotiated at London and Bonn. They have argued that he used the international process to help him manoeuvre West German policy in the more expansionary direction that he desired, and which was contrary to the predisposition of the Bundesbank and others. On their account, there are a number of indications. As early as October 1976 he hinted that he 'would not mind being pushed into additional expansion'; at London he committed West Germany to an ambitious growth target of 5 per cent – perhaps deliberately making it easier for others to put more pressure on him to expand the following year when, unsurprisingly, the target was not met; and by early 1978, they say, he had certainly decided to accept reflation.

The way Schmidt put it only slightly later clearly invokes Hamada-like ideas. He said:

We are of course willing to contribute to the expansion of the world economy ... [those who] see the Federal Republic as a locomotive ... exaggerate the economic strength of our country. Together with others something might be done, but alone? This is to grossly overestimate our significance.^{6,7}

From all these considerations it seems clear that Schmidt wished to pursue a more expansionary policy; that he faced a difficulty in bringing the

Bundesbank into agreement; and that he utilized the international summitry process and the idea of policy coordination to guide West German policy in the direction he desired. So much is fairly well established and understood.

What should also be clear is that Jenkins's way of putting the case for monetary integration, particularly to his West German audience, was adapted to appeal on the same kind of basis. In the first of his speeches, he drew attention to, amongst other things including the importance of containing inflation, the urgent need to reduce European unemployment. He said rather little with any analytic content as to how monetary union would contribute to that, but he did say that there needed to be a 'strengthening of demand with a wide geographical base'. When he returned to the issue in West Germany, he made his economic outlook clearer. He noted that the long period of successful export-led growth of the West German economy naturally led to a disinclination to adopt policies of domestic demand expansion; but also that the deficit countries could not expand for fear of a sharp fall in their exchange rates. This resulted in what he called 'a sort of economic stalemate'. Consequently he was led to advocate the creation of a 'hard-core integrated Community economy' which would allow expansion on the basis of the economic strength of the Community as a whole. This would seem to be based on an informal and intuitive, but nevertheless clear-sighted account very much along the lines of the Hamada argument. Again, he emphasized the importance of acting to reduce unemployment.

It is not only in the motives for its creation, but also in the design of the EMS, that the influence of ideas like Hamada's can be seen. That design included a conventional 'parity grid' stating permissible bands of fluctuation of each currency against each of the others; but there was also an innovation called the 'divergence indicator'. This device in principle limited the degree of fluctuation of any currency against an average of the others.⁸ It had the effect, therefore, of identifying a single currency as 'divergent' whereas the parity grid could only ever see two currencies simultaneously reaching the limits of permitted fluctuation. The point, clearly, was that if one currency diverged, the burden of adjustment would fall uniquely on it. If that currency were the strong currency, ultimately, this obligation would presumably involve more expansionary policy. The divergence indicator should therefore certainly be seen as an attempt to overcome the problem (or perceived problem) that as a matter of market practicalities, in conventional parity-grid systems, the burden of adjustment tends to fall on weak currencies even when obligations are in principle equal. As Ungerer, Evans, and Nyberg (1983) put it 'the [divergence] indicator has a built-in tendency to promote convergence not necessarily toward monetary stability but rather toward some average level of monetary and price developments.'

One could simply say that the creation of the divergence indicator was a response to the failure of the snake. In a sense the unfortunate thing about that system had been that the D-mark remained in it whilst the

pound, franc, and lira all left – and all left in a downwards direction. If the objective was moving towards a common policy, it would have been preferable either for West Germany to move towards the policy of the other three, or for those three to remain in the system whilst West Germany left. In such a situation, a device like the divergence indicator, by identifying the single divergent currency would have at least pushed in the right direction from the point of view of maintaining the system.

It is, however, appropriate to go a little further than this. If one has ideas like Hamada's under consideration, the issue of whether each country is contributing properly to an expansion of demand that might be agreed is essential to effective policy. In that case, the objective is not merely a matter of avoiding a recurrence of the fate of the snake where countries seeking to expand demand are forced out of the system one by one. Rather, it is a question of designing a system which actually promotes coordination in expansionary policy.

One can, I think, readily see that if all members but one are embarking on demand expansion, that one might well experience a currency appreciation. In the event that this triggers the divergence indicator it would be identified as the non-cooperating country. In terms of the game theoretic problem, the problem of monitoring compliance with an agreement to a common policy is addressed. A country which triggers its divergence indicator (or does so persistently) is one which is not pursuing a policy sufficiently close to the average.

One could probably go a step further. If the currency arrangements, including the divergence indicator were sufficiently effective, they might promote a collective expansion even in the absence of an actual agreement to one. The reason is that subject to its being understood that each country feels an obligation to the exchange rate system, no country has the opportunity to gain by free-riding on the others' expansion. This is because an attempt to free-ride sees the currency appreciate and the divergence indicator is (presumptively) triggered. As a matter of common sense (even if not strictly of ordinary game theory), if the possibility of free-riding is diminished, the likelihood of cooperation is increased. Furthermore, if enough members of the group simply prefer an expansionary policy even without active cooperation from the rest, their actions will 'force' the rest at least partly to follow them.⁹

These things might be taking the matter too far – certainly there is no suggestion that any of those involved in creating the EMS articulated such ideas. But the speculation that this general direction of thinking was operative is, I suggest, very reasonable. All it really takes is, first, the sense that a problem of the snake had been that one country – West Germany – was divergent from the rest, and that as a matter of practicality, there was nothing very much that the rest could do about it. The result was the failure of the system. Second, there is the general sense that policy coordination is primarily about

coordinated expansion, and that it involves inducing all the relevant countries to take part in the expansion notwithstanding their selfish reasons not to do so. Third, it requires the understanding that the EMS generally and the divergence indicator in particular were about inducing a more or less common policy amongst the members. And furthermore, of course, there is no doubting that policy coordination was very much under discussion amongst policy-makers at the relevant time. Perhaps most surprisingly, but nevertheless, quite clearly, it requires that one recognize that the objectives of the West German negotiators were not straightforwardly the control of inflation in their own country or elsewhere.

One would not, of course, wish to go down the road of suggesting that Schmidt was in any sense in favour of an inflationary policy, nor that the West German position when the detailed negotiations began was not rather more hostile to the divergence indicator than that of some of the small countries. It is apparent from Ludlow (1982) that it was. The existence of the so-called 'Emminger letter', by which Schmidt agreed that if inflation posed a threat the Bundesbank could withdraw from the system, clearly shows some limits of the argument. But it is not, I suggest, going too far to suppose that Schmidt had a more relaxed attitude to the existence of a danger of inflation, and a more acute sense of the dangers of unemployment than the Bundesbank; and certainly not that he sought to advance the negotiations of the EMS without involving them, and nor really that they opposed its creation. And certainly there is no denying that in this confrontation, the Bundesbank lost.

I think, therefore, that it is reasonable to say that ideas of policy coordination, which were clearly very much in the air in 1977 and 1978 influenced the design of the EMS and gave rise to a particular aspect of the perception of the benefits it might bring. From the point of view of non-Germans, the 'coordination' aspects of the plan related to preventing a repeat of the snake experience by inducing a more consensus-based policy on the part of West Germany. And from the West German point of view, the same objectives affected that part of the government which felt the Bundesbank was permitting too much appreciation of the D-mark and consequently too much unemployment.

None of this, it should be noted, amounts to a denial that it could have been hoped that the EMS would assist in reducing inflation, particularly for the non-Germans. In the first place, it could be exchange rate volatility *per se* that is inflationary – presumably because depreciations cause more price increases than appreciations cause cuts. And in any case, it is a mistake (although an extraordinarily common one) to suppose that policy-makers of the mid-1970s presumed that there was any particular trade-off (in the short run or the long run) between inflation and unemployment. Rather, inflation was often seen as a problem which could emerge and become hard to control, but once defeated would not necessarily re-emerge as a result of any fall

in unemployment. It was reasonable enough, given the conceptions of the time, to suppose that if inflation was controlled, demand could then be expanded without restarting it.

4.4 Loss of interest

Clearly, nothing much ever came of any ideas of 'policy coordination' in Hamada's sense that were part of the story of the creation of the EMS. The explanation of why that is so is, in large part, the explanation of how the EMS progressively came to be seen as an arrangement for controlling inflation.¹⁰ Many factors contributed to this – the second oil shock threatened inflation, and naturally turned policy-makers to a concern with it. As a result the idea that there might be a coordinated expansion in 1980 was clearly a non-starter. Indeed, the rise in inflation afforded the opponents of the Bonn summit the opportunity to blame it, thereby casting policy coordination in an altogether unfair light.

The appointment of Volcker to the Federal Reserve provided an example for the rest of the world of determined inflation-fighting. With the dollar no longer falling, the pressure for revaluation of the D-mark was, in the early days of the EMS, very much reduced.¹¹ This, perhaps, contributed to the fact that respect for the divergence indicator failed to take hold in the early years. It was also plain that the indicator itself suffered significant faults in the details of its design, with the result that it could hardly command true respect. As it happens, those design faults had the effect of promoting independent action by West Germany.¹² No doubt the fact that Schmidt lost power in 1982 did no harm to the same cause.

The two turns of French policy also helped the Bundesbank. The first of these was the expansionary policy adopted by Mitterrand. That led to a sharp fall in the value of the franc and a rise in inflation. In this phase, it must have been rather clear that French policy was divergent (although inflation also rose in Italy). Common sense would hardly have permitted any other view. Indeed, in 1983 there was some discussion in the French government of an effective withdrawal from the customs union as a means of protecting the balance of payments.¹³ It is hardly possible to explain that discussion except on the hypothesis that theirs was the divergent policy. West German policy could hardly be expected to be constrained by the French in these circumstances.

The failure of the French reflation – clearly accepted by the government by 1983 – put them in the position of feeling an urgent need to reduce inflation. Although some of the problem was that the policy had been conducted in an environment of contraction elsewhere in the world, and its failure was therefore in part a demonstration of the existence of the problem that Hamada's approach was meant to solve, the change of attitude in France also helped to remove policy coordination from the agenda. Thereafter, European

policy-makers embarked on the rather more solitary activity of seeking to control and reduce inflation.¹⁴

Later – at the Plaza Hotel in 1985 and the Louvre in 1987 – the G7 again embarked on what they described as 'policy coordination', but this turned out to be exclusively a matter of seeking to control the value of the dollar.¹⁵ No doubt it came to seem rather natural to regard 'international policy coordination' simply as meaning exchange rate coordination. That would have reduced the EMS to, as it were, a simple fixed exchange rate system with none of the extra connotations arising from the divergence indicator or the perceived need to control West German policy.

In fact, as the EMS 'hardened', it became accepted wisdom that it was the example set by the Bundesbank that the other members wanted to follow, and their comparative credentials were determined by some rather vaguely understood notion of the 'credibility' of their determination. It was still just barely possible to describe the result as 'coordination', but it was strictly a matter of following the leader, not of collective policy setting, and therefore had essentially no relation to the original version of the plan. No wonder, Karl Otto Pöhl was led to remark that the Bundesbank had 'turned the original concept on its head by making the strongest currency the yardstick for the system'.¹⁶

A further consideration is that the case for policy coordination may have appeared to come rather unstuck as discussion of it advanced. The great complexities of establishing the appropriate manner in which to coordinate policy slowly became apparent, as did the dangers of harming policy by miscoordinating it. Feldstein (1988) deprecated it (and it is to be noted that his main target was simple exchange rate coordination, so far down the agenda has Hamada-style coordination slipped), but perhaps more famously Frankel and Rockett (1988) suggested that disagreement about the 'true model' made policy coordination very dangerous. That argument seemed so pertinent because discussions of coordination, when they occurred at all, so readily descended into a dispute over how to understand the current circumstances that it seems apparent that there was insufficient agreement at a theoretical level. Certainly, after Bonn, it is hard to see that there have been any successfully concluded agreements on Hamada-style actions, notwithstanding the urgent necessity for them sometimes asserted, for example by Bergsten (1982).¹⁷

Whilst it is relatively easy to explain the disappearance of Hamada's ideas from European policy-making, it is not immediately so apparent why the attitudes of economists should have changed so much as well. They have changed, it should be noted, not merely in respect of questions such as which is the appropriate theory of employment, or what the current policy objectives should be, but in their attitude to the nature of the interaction of economic agents.

Hamada (1979) thought that the issue of policy coordination 'naturally leads us to the interdisciplinary realm of politics and economics'. And

Corden (1986) considered the difficulty raised by the collective action problem, noting that it involves a 'sort of game' but said, 'presumably, it is the task of diplomacy to extract some benefits from the existence of potential mutual gains', and passed on to other points. Empirical work confirmed this outlook. Putnam and Henning (1989) found 'little evidence that the negotiations were hampered by mutual fear of reneging' and that the participants 'behaved as if they assumed their counterparts would act in good faith'. And yet, within a few years, out of the interdisciplinary area had come nothing but economic imperialism, and Corden (1994), changing his tune, sums up the new position. Having presented much the same theoretical case as he did in 1986, he says: 'Hence, a bargain must be struck and there must either be an enforcement mechanism or a concern with reputation that creates a high probability that the bargain will be adhered to.'

4.5 Coordination in the Euro Area

Clearly, it was the 'hard EMS' that was developed into the euro and at the same time, the concerns of Hamada were not only dismissed, but replaced by an alternative notion of 'coordination' which, I suggest, has nothing to do with collective benefits at all. The issue concerns the rationale for the Stability and Growth Pact (SGP) and although externality-based arguments are frequently advanced, they are extremely hard to maintain under critical appraisal.

One is that one government's borrowing raises the interest rate faced by others and for that reason should be restrained. Apart from an evident failure to comprehend Keynes (1936) Chapter 13; and a disconcerting willingness to see governments undertake collusive restriction of the market that would be illegal if attempted privately; the question arises as to why each country should face the same limit on its borrowing. Is a German or a French deficit in excess of 3 per cent thought to impose only the same burden on the other governments than a Portuguese one of the same size? Surely not. And in the light of that, one can hardly accept the rationale as a serious one.

Another argument holds that if there were to be a default, in the context of the euro, the other member states would be forced to organize a bail out. One wonders what they would have done in the absence of the euro. Clearly, the issue is why it would be that sovereign nations before the euro needed no externally imposed fiscal rule, but the not-so-sovereign ones inside it apparently do.

And one should note that the case of fiscal policy coordination in the Euro Area introduces an ironic twist since it was precisely the question of coordination in a fixed exchange rate regime that was the issue raised by Hamada. His thought, of course, was that the normal case would be for independent governments to tend to underexpand as they seek to free-ride on the expansion of others, and what we need, consequently, is an arrangement to promote more expansionary fiscal policy. As Allsopp, Davies, and Vines (1995)

have noted, the presumption of those who designed the SGP is just the opposite, although it is not apparent there is much answer to Hamada in their arguments.

One could seek the explanation of this *volte-face* in some abstruse area of the policy coordination literature, because certainly there are cases where fiscal restraint is required – that sort of complication, I suggested, was one of the things which undermined the idea of policy coordination in the 1980s. But there is rather little real sign of any of the relevant arguments having been adopted by the European Union.¹⁸

I suspect, however, that the operative explanation should be found in the clearly apparent change in economists' presumptions. Just as there developed a presumption against willing cooperation; so there has developed a presumption that elected government is not to be trusted. This is perhaps most clearly visible in the central bank independence literature, but can surely also be seen in the design of the SGP. It is not theoretically problematic interest rate effects, nor stories about growing incentives to bail out that drive opinion, but rather the presumption that given the chance, governments will mismanage financial affairs. It is a difficult problem to argue that the political incentives are to high taxes and low spending, so a presumption of mismanagement is next to a presumption of laxity. It is not the collective interest of separate nation states which is secured by 'coordination', but rather the interests of the prudent masses against their imprudent, untrustworthy, and indeed, quite possibly malign, governments.

One can perhaps see an analysis making use of this kind of idea in a later paper by Allsopp and Vines (1998). In that, they suggest that the SGP might be defended on the basis that a firm commitment on the part of the member state governments to fiscal consolidation is required in order to induce the ECB to lower interest rates. Without it, the ECB will presume that a monetary loosening will result in an increase in government expenditures or lower taxes and hence much the same fiscal position at a higher level of employment, and hence, more inflation. That, it cannot tolerate. So in order to see the monetary loosening, the member states must first commit to an offsetting fiscal tightening. With the question of 'commitment' brought to the fore, we have a genuine game theoretic problem and a rationale for collective action.

It is surely the case that the Euro Area would have been better served in its early years by tighter fiscal and looser monetary policy than by what it had. The actual policy is then part of the price of central bank independence, but the point is suggestive that the Allsopp-Vines argument has a second-best validity. More in question, however, is the presumption that fiscal policy will be poor. The argument is, first of all, that it would be proper policy to have lower interest rates and tighter fiscal policy. Second, the ECB is presumed to believe that if it were to lower interest rates, this would certainly not result in tighter fiscal policy. And third, it is apparently presumed that the ECB is

right to take this view. Why should all these things be simultaneously presumed? Only because, as far as I can see, it is presumed that democracy makes bad policy.

This, I fear, reveals the true face of 'coordination' in many areas of European policy. Dressed as a response to an externality problem, 'coordination' cannot stop at monitoring and a presumption that willing parties will abide by the rules. Nor can it be content with commitment, since there is in truth no game theoretic dilemma of commitment. It is concerned most of all with enforcement. But once we reach that point, it becomes apparent that many of the cases are not game theoretic ones at all. They are merely what those in power take to be problems of enforcing good policy on bad governments.

The process by which the European Union determines the position to be enforced is notoriously complex and opaque, but is also laced with historical contingency. So it is, I suggest, with 'policy coordination' itself in the Euro Area. There was once a serious case made – along the lines of Hamada – for the existence of relevant externalities. That had to be jettisoned if the Bundesbank was to seize control of the EMS. But it was far from necessary to jettison the rhetoric of 'coordination'. That word always has useful connotations to the integrationist. As the process of monetary integration developed, tight-money policy became the norm, and that was usefully called 'coordination', not least by governments who very much welcomed the appearance that international obligations were served by their otherwise unpleasant policy. And when fiscal policy came to be considered, the same forces as had promoted the dominance of sound-money ideas also came to welcome the possibility of using the rhetoric of international harmony to promote what may well in fact be a mutually destructive fiscal conservatism.

4.6 Coordination in the world

One cannot go too far down the road of insinuating that the anti-democratic presumptions of the proponents of central bank independence and the SGP have deformed European policy-making and yet altogether still deplore the fact that at least some countries now enjoy the euro. But the issue of world-wide policy coordination is also one that should be addressed. And a detrimental influence of the euro on the rest of the world must be a concern. Apart from anything else, many of the earliest proponents of EMU saw in it a 'monetary personality' for Europe and presumably intended it to be an adult, sophisticated, and civically aware personality. But in any case, the Euro Area is plainly large enough for its policy to be a meaningful determinant of macroeconomic outcomes in the world as a whole.

As should be readily apparent, the particular position in which the world found itself towards the end of the euro's first decade, gives every appearance of needing a reassignment of policy instruments. That there is at least a

concern about the American deficit is, I take it, not disputed. Whether there is also a proper macroeconomic concern about European unemployment is, of course, a more controversial issue, but I take it there is not even a small minority that would favour more unemployment in the Euro Area. The question for those not altogether enthralled by the free market must therefore be, at least, what is to be done about the American deficit which will not raise unemployment in Europe?

If it is agreed that either American exports must rise or their imports must fall, the question is how this is to be achieved without unemployment elsewhere. Plainly, a fall in American imports is unlikely to be so achieved. But who controls the policy tools that might make their exports rise?

To the extent that the relevant policy tool is the value of the dollar, the difficulty of achieving both a fall of the required, but not precisely known, size and a soft-landing should be clear enough. And the other policy tools are in the hands of non-American policy-makers, suggesting, clearly, a need for coordination.

Many difficulties stand in the way of worldwide coordination of policy. The attitude of the ECB is, as in so much else, taken over or copied, however inappropriately, from the Bundesbank.¹⁹ They make little comment on world policy at all. But one small sample, clearly confirming that there is no possibility of policy coordination, is this:

from a policy perspective, the ECB's main contribution to international cooperation consists in the exchange of information and views with non-euro area policy-makers ... These cooperation activities do not impinge on the independence of the ECB and are without prejudice to its primary objective, which is to maintain price stability.²⁰

In the form of the SGP, the European Union makes a distinctive institutional contribution to the difficulty of achieving global coordination of fiscal policy as well. Given the will, that could easily be changed or discarded, but a further difficulty arises, I suggest, from the fact that it is no easy matter for European policy-makers, who have been trained, and trained themselves, to think in the way they have about fiscal coordination in the Euro Area, to take an ideologically separate and indeed opposite view of the needs of the world as a whole.

The doctrine that the demands of 'coordination' are limited to enforcing 'sound finance' makes it impossible to escape the view that the service of the community requires only, as they say, that one put one's own house in order – nothing, in other words, to do with policy coordination at all. That doctrine is in part simply the outcome of the re-emergence of classical presumptions in economics generally. But as I have also suggested it may be in part the outcome of the particular construction that had to be put on theoretical language to advance the integrationist interests.

Notes

1. I appreciate the comments of Jörg Bibow, Andrea Terzi, and participants at the Franklin Conference on the Future of Europe, March 2006, on an earlier draft.
2. Most of this discussion is in Chapter 6 of Cooper (1968), where the author makes a reference to Pigou and, perhaps more controversially, makes the claim that it was the 'central underlying message' of the General Theory that individually rational decisions need not make for a social optimum.
3. Jenkins (1978a).
4. Jenkins (1978b).
5. On which, see Katzenstein (1987) and Goodman (1992).
6. Quoted from Ludlow (1982, p. 76), citing Deutscher Bundestag, *Stenographischer Bericht*, 65 Sitzung, 19 January 1978, p. 4970.
7. There is perhaps room for confusion as to the exact connotation of the expression 'locomotive theory'. In some of the economics literature it became a label for Hamada's idea. Schmidt, however, distinguished 'locomotive theory' from 'policy coordination' on the basis that the former meant one or a small number of countries expanding to pull the world out of recession, while the latter connoted a joint expansion. Jenkins was to treat the matter the same way in his December 1977 speech, but later commentators have perhaps lost sight of the distinction.
8. The details of the design are just a little complicated. See European Commission (1979).
9. It could be said that the same would apply to contractionary policy. That is true but it was not the pertinent point late in the 1970s when the problem was seen to be one of coordinating expansion.
10. Which – except for the specific issues relating to policy coordination – is considered more fully in Forder and Oppenheimer (1996).
11. The D-mark always had a tendency to appreciate against the Europeans when the dollar was weak – see Forder and Hurn (2003).
12. The very high weight of the D-mark in the calculation made it hard for West Germany to trigger it; and the fact that the lira, operating in wide bands, and the pound in none were both part of the calculation meant that their variability could distort the calculations by very large amounts. The appreciation of the pound in 1980 and 1981 contributed to keeping the D-mark from reaching its divergence threshold.
13. The various contributors to Machin and Wright (1985) discuss many aspects of policy.
14. The global imbalances resulting from the contemporaneous American policy leading to 'twin deficits' is another matter on which Hamada's concerns throw light.
15. On these events, see Destler and Henning (1989).
16. Quoted by Marsh (1992), p. 233.
17. 'Versailles and Toronto [the G7 and central bankers' meetings of 1982] must have set new records for failing to discharge effectively the responsibilities supposedly exercised by the major countries' – Bergsten (1982, p. 2).
18. Emerson et al. (1988, p. 115) even seem to admit that expansion in one country has positive spillover effects in others, although, precisely what is being suggested is none too clear.
19. On which subject: Forder (2001).
20. European Central Bank, *Monthly Report*, January 2001.

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5

The Economic Rationale of the EMU and the Euro

C. Sardonì

5.1 Introduction

The realization of the European Monetary Union (EMU) with the creation of the euro and the European Central Bank (ECB) are important events with relevant economic as well as social and political implications. To fully reconstruct, explain and evaluate the complex long process that led to these outcomes is far beyond the scope of this chapter. The chapter is an attempt to explain why the EMU took the peculiar shape it has today, that is to say, a monetary union with a single independent central bank without a counterpart at the fiscal level. Why the EMU took the present form can be explained by looking at the historical experience of European economic cooperation and integration as well as at some developments in economic theory and analysis that took place during the same period the EMU was being planned.

The relation between the development of ideas and historical events is, of course, complex and never straightforward. However, it appears quite clearly that the European experience of monetary integration was influenced by, and found support in, some aspects of the evolution of macroeconomics and the theory of monetary unions after the pioneering works of Mundell and others in the 1960s. This chapter concentrates on three main topics: the European attempts to realize a regime of stable exchange rates and the decision to proceed to the creation of a currency area; the development of a new approach to optimum currency areas (OCAs) and the design of the European monetary union; the role of fiscal policy in a currency area and the European decision to proceed to monetary integration without fiscal integration.

Section 5.2 looks at some of the economic ideas that favoured the adoption of a common currency as the response to the European quest for stable exchange rates and the failure of the previous regime of fixed, though adjustable, exchange rates. When, in 1992, the EMS failed, the decision on the single currency had already been taken. The adoption of a common

currency by a number of countries was seen as the only viable alternative to floating exchange rates. The European decision-makers obviously opted for this alternative.

The creation of a currency area raises the problem of its optimality. The original theory of OCAs of the 1960s clearly led to the conclusion that a European currency area was far from satisfying the criteria for its optimality. However, the evolution of macroeconomics in general, and of the approach to currency areas in particular, which took place between the 1970s and 1990s, produced a 'change of climate' that offered a number of theoretical arguments that make the requisites for a viable currency area less restrictive than those originally established. Section 5.3 deals with these problems and, in particular, pays attention to the debate on the endogenous nature of the criteria for an optimum currency area. If the fulfilment of the criteria for an OCA is largely an endogenous process, it is no longer crucial that countries adhering to a currency area respect them *ex ante*, that is to say, at the time they decide to enter or to form a monetary union.

Section 5.4 looks at some aspects of the political dimension of a process of economic and monetary integration. In general, the process of European integration cannot be fully understood and evaluated without taking due account of the political and historical factors, which played an important role in 'forcing' individual countries toward growing economic integration. In this perspective, the idea of the endogeneity of the criteria for an OCA is important. To acknowledge the endogenous nature of these criteria implies that the process of convergence among countries can be significantly favoured and accelerated by 'external' intervention, that is, by the political decision to proceed toward integration despite the initial heterogeneity of the countries involved.

From this it should follow that fiscal integration be given the same importance as monetary integration. Fiscal policy at the federal level can be a powerful instrument to deal with the effects of asymmetric shocks hitting heterogeneous countries. In Europe, however, fiscal integration has received far less attention than monetary integration. Also this aspect of the European experience finds support and justification in the prevailing intellectual climate in the debate on fiscal policy, in which the negative effects of public budget deficits and the benefits of fiscal discipline are emphasized. The Maastricht Treaty and the Stability and Growth Pact (SGP) reflect such positions.

As a result, the European process of integration took on a unique 'asymmetric' character: the European monetary authority has no counterpart in the fiscal domain, something totally new in history. Some of the implications and consequences of the way in which the EMU is currently organized are briefly considered in the concluding section.

5.2 From the end of Bretton Woods to the euro: the quest for exchange rate stability

The decision at the end of the 1990s to create a currency area in Europe is related to the European quest for a regime of stable exchange rates, regarded as the most suitable to favour the expansion of trade, as it reduces the degree of uncertainty in international markets and, hence, enhances the process of economic integration through the development of a European common market. The creation of the euro and the ECB can be seen as the final step in a long process to ensure stable exchange rates for European countries, after the collapse of the post-war monetary system in the 1970s. In this sense, the creation of a common currency is the realization of an extreme form of a fixed exchange rates regime.¹

The European Community began to plan for exchange rate stability and monetary integration after the end of the Bretton Woods regime of fixed exchange rates. Until then, stable exchange rates had been guaranteed by the international monetary order.² The decision to realize an economic and monetary union, the main objective of which was to narrow the members' exchange rates fluctuations, was made in March 1971 by the EEC member countries. In April 1972, the system known as the 'snake' was put into operation.³ However, the 'snake' involved only a few countries (Germany, Benelux and Denmark), while the currencies of other countries of the Community entered the snake later, or never entered it.

The process of monetary integration gained new momentum in 1979, when the European Monetary System (EMS) was created. The EMS, which involved most currencies of the member states, was based on a system of fixed but adjustable exchange rates. Moreover, with the EMS, the Community introduced the European Currency Unit (ECU), a basket of fixed quantities of the members' currencies used as a unit of account. The EMS was also involved in the adjustment of single members' policies in order to achieve stability of their exchange rates.⁴

The EMS was not very successful in promoting the economic convergence of the member countries. In particular, its failure has been explained by the participating countries' inability to make their fiscal policies converge. The countries with large budget deficits underwent severe exchange rate crises at the beginning of the 1990s. Italy and Britain abandoned the system of fixed exchange rates in 1992. The band was raised to ± 15 per cent, but it was clear that the EMS had failed. In the same year, the Maastricht Treaty was signed, even though the treaty should not be seen as a direct and immediate response to the crisis of the EMS.⁵

After the collapse of the EMS, there was not much room to defend a regime of fixed exchange rates as the way to ensure stability. The prevailing opinion among economists was that fixed exchange rates were less efficient than

floating rates. To try to go back to fixed rates was seen as a 'folly'. The only viable alternative to floating exchange rates was the creation of a common currency. For example, for Obstfeld and Rogoff: 'there is little, if any, comfortable middle ground between floating rates and the adoption of a common currency' (1995, p. 74).⁶ Europe chose the second alternative: to pass as fast as possible to a single currency.

5.3 Optimum currency areas and the 'macroeconomic consensus' of the 1980s

Creating an area with a single currency and a single central bank, which implies the end of autonomous monetary policies for member countries, raises the problem of optimum currency areas (OCAs). The debate on the criteria to establish whether it is optimal for an economic area to adopt a common currency began in the early 1960s, with pioneering contributions by Mundell (1961) and McKinnon (1963), followed by Kenen (1969). Mundell concentrated on factor mobility between nations or, more precisely, between areas: the more mobile the factors of production are, the closer an area is to an OCA. McKinnon pointed out the importance of the openness of an economy: the more open an economy is, the less costly it is to adhere to a monetary union; only relatively closed economies can use the exchange rate tool. Finally, Kenen considered the degree of economic diversification among countries: a higher degree of diversification of the economic structure makes monetary union less costly. In diversified economies, sectoral shocks and fluctuations tend to cancel out, so that the flexibility of the exchange rate is less necessary.

While Europe certainly does not qualify as an OCA according to Mundell's criteria, the developments by McKinnon and Kenen already offered some arguments in favour of a European currency area: European economies are very open and have diversified economic structures. In the following years, the approach to monetary unions further evolved. While the earlier analyses essentially concentrated on the costs of monetary unions, later contributions paid much more attention to their benefits.⁷ In general, such developments have led to less stringent conditions in order to establish whether it is efficient for a group of countries to give rise to a currency area.⁸ The works of the European Commission in preparation for the creation of the EMU have been influenced by these developments at the theoretical and analytical levels.⁹

The evolution of the approach to monetary unions took place in the context of a more general evolution of economic theory and, in particular, of macroeconomics with respect to economic policy and its efficacy. The earlier analyses of optimum currency areas were developed in an intellectual environment where the (old) Keynesian paradigm was still largely dominant. For the Keynesians of the 1960s, monetary policy was argued to be effective,

capable of affecting the economy's level of output and employment in a permanent way. In such a context, the cost of giving up monetary policy could be high for a country entering a currency area.¹⁰ With the coming to dominance of Monetarism and New Classical Macroeconomics, the cost of giving up monetary policy, or policy altogether, became of course less relevant. In so far as policy cannot affect the economy in any permanent or systematic way, the cost for a country of giving up its monetary autonomy is not high.¹¹

Here it is not possible to enter into a more detailed examination of the evolution of the analysis of currency areas or the problem of the efficacy of economic policy. It is important, however, to give attention to a specific aspect, which is of particular relevance for the European experience. In the 1990s, there emerged the idea that the criteria for an OCA are, to a large extent, endogenous. It is true that some criteria must be fulfilled in order to realize an optimum currency area but, it is argued, the adoption of a common currency by a number of countries, which *ex ante* do not qualify to belong to an optimum area, is a significant factor in the process of integration.¹² For example, the optimality of a currency area requires a high degree of trade integration, but the adoption of a common currency helps the countries increase their trade integration.

The debate on the endogenous nature of the OCA criteria largely concentrates on trade integration, but it is evident that this approach can be generalized. If it is possible that the criteria for optimality are realized *ex post*, the decision to proceed to create a currency area made of significantly heterogeneous countries may prove to be correct and efficient. The establishment of the Maastricht convergence criteria followed this kind of logic. Countries that wanted to adopt a common currency were 'forced' through policy decisions to converge with respect to some parameters, seen as the necessary prerequisite to begin a process of further integration by way of belonging to a monetary union. The fulfilment by the single countries of the Maastricht criteria did not represent the realization of the criteria for an OCA, but only the starting point of a process to generate an optimum currency area *ex post*.

The idea of the endogeneity of the OCA criteria is important. It allows a discussion of the process of monetary and economic integration that goes beyond the idea that the convergence of countries to the degree of homogeneity required for an efficient currency area is a spontaneous process, independent of 'external' intervention. The idea of endogeneity creates a more general context within which the roles of the state and policy in the process of integration can be discussed.

5.4 The political dimension of economic integration

The idea that an efficient currency area can be realized *ex post* through political intervention rather than by simply being the spontaneous outcome of the working of the economy is supported by historical evidence: no currency

area, like for example the United States, emerged spontaneously, without a significant role being played by the state. The same can be said about European integration, which cannot be fully understood without taking due account of historical and political factors.

The political dimension of the European process of integration is important in several respects. First of all, many influential protagonists of the European economic and political arena were convinced that European integration is much more than just an economic issue.¹³ Since the 1940s, important European figures saw the political and economic unification of Europe as the way to end centuries of European wars and not to repeat the tragic experiences of the two world wars (Padoa-Schioppa 2004, pp. 23–6). This Europeanist ideal has always inspired most of the advocates of Europe's integration.

In more recent years, politics has played a significant role in promoting and accelerating the creation of the EMU. Jabko (1999), for example, provides an accurate and detailed description of the role played by the European Commission in the late 1980s and 1990s. The Commission adopted a political strategy that induced France and Germany, in particular, to espouse the idea of proceeding to monetary unification in a relatively short span of time. In the Commission's strategy, acknowledging the discontent of several countries (France and Italy above all) at the German monetary supremacy in the EMS, the EMU was presented as the way for these countries to regain monetary sovereignty. At the same time, to offset Germany's reluctance to discard the EMS, the Commission became a strong advocate of monetary orthodoxy (policies rigorously committed to fighting inflation), as expressed by the Bundesbank.

The European experience confirms the idea that political factors are of great relevance in the process of economic and monetary integration. Integration can, and in fact must, rely on and be promoted by political intervention. However, the way in which this idea has been put in practice raises several problems. While recognizing the importance of the political dimension, Europe has at the same time largely overlooked important aspects of the state's role in the process of integration; in particular the role of fiscal policy.

In the original approach to OCAs, fiscal policy was given a relevant role to play in dealing with the effects of asymmetric shocks hitting the countries of a monetary union. In a situation in which the countries that adopt a common currency are heterogeneous and characterized by low flexibility of prices and wages as well as low mobility of the factors of production, the risk of asymmetric shocks can be dealt with by the creation of a fiscal counterpart to the single central bank. A federal fiscal authority can compensate for the effects of asymmetric shocks through its policy. Kenen (1969), building on Mundell's and McKinnon's previous contributions, stressed the importance of fiscal policy in a monetary union, a policy that must be implemented at

the federal level.¹⁴ Through a centralized (federal) budget, an insurance system can be created, with countries hit by a negative shock benefiting from redistribution of income through transfers from countries not subject to the same shock.

Starting from this viewpoint, there are several works that compare the US experience with the EMU. While in the United States the federal government, through fiscal policy, can mitigate the negative effects of having a common currency on single states, in Europe nothing exists comparable to the US federal authority and, hence, the European currency area is significantly more vulnerable to the impact of asymmetric shocks.¹⁵ In the design of the EMU, a different position was taken. In its 2000 Report, the European Commission acknowledges that the Community's budget is too small to play any significant macroeconomic role (2000, p. 101), but shows little concern about such a limitation and it rather concentrates on the need for some degree of states' fiscal autonomy and, above all, on the need for fiscal discipline.

In a 'perfect world' the compensation for asymmetric shocks would be provided by wage and price flexibility; however, since 'nominal rigidities hamper market adjustments, fiscal policy measures can alleviate temporary country-specific disequilibria' (European Commission 2000, p. 102). In order for fiscal policy to play such a role, single states have to retain some autonomy in the fiscal domain. But such autonomy has to be qualified. Fiscal measures must be such as not to prevent or delay market adjustments (e.g., real wage changes). Because of the lack of flexibility of budgets, fiscal policies must be medium-term oriented rather than short-term oriented (fine-tuning) (European Commission 2000, p. 103). With such premises, the Commission turns to discuss fiscal discipline, which is narrowly defined by the fact that 'the government has to ensure that it does not become insolvent'. In fact, budgetary sustainability is regarded as a major concern for monetary policy (p. 106).¹⁶

Behind the Commission's arguments there are the mainstream's views of fiscal policy and budget deficits. These views are well expressed by De Grauwe (2005, pp. 220–45). The thrust of De Grauwe's argument is that the creation of deficits poses a problem of sustainability: 'A budget deficit leads to an increase in government debt which will have to be serviced in the future. If the interest rate on the government debt exceeds the growth rate of the economy, a debt dynamics is set in motion which leads to an ever-increasing government debt relative to GDP. This becomes unsustainable, requiring corrective action' (De Grauwe 2005, p. 224). Unless, from a certain point on, the high-debt government creates primary surpluses, the debt–GDP ratio grows indefinitely and is unsustainable.¹⁷ De Grauwe then concludes: 'fiscal policies are not the flexible instrument that the optimum currency theory has given us to believe' (2005, p. 228).

De Grauwe's argument is contingent on the two crucial assumptions that the interest rate on the debt is higher than the growth rate of GDP and,

above all, that budget deficits have no effect on the growth rate of GDP. If the latter assumption is removed, public deficits can be associated with a higher rate of growth and with a stable, or even decreasing, debt-GDP ratio. Sardonì and Palazzi (2000) show that if the government's 'propensity to consume' (the ratio of current to total public spending) is lower than the private sector's propensity to consume, an economy with a public sector grows at a higher rate than one with no public spending and taxes. Sardonì and Palazzi study only cases of balanced public budgets, but it is easy to see that if the deficit, and hence the debt, rises because the public sector increases its capital expenditure (investment) in such a way to reduce its propensity to consume, the economy grows at a higher rate.¹⁸ As a consequence, the debt to GDP ratio can remain stable or even decrease.¹⁹ If the budget deficit has a negative or no effect on the growth of GDP, this means that a wrong fiscal policy has been implemented, *not* that fiscal policy in general is ineffective and conducive to a continuously increasing debt to GDP ratio. It is a problem concerning the quality of public spending. A budget deficit policy, which stimulates the growth of GDP through the growth of public investment, is not unsustainable.²⁰

So far, attention has been focused on fiscal policy, but there is more than fiscal policy to look at when considering the role of the state in a monetary union. On the one hand, the existence of a federal government makes it possible to deal with the problem of inflationary pressures also through incomes policy and not only through the monetary tool. In the 1980s and 1990s, several European countries implemented incomes policies that allowed them to achieve lower inflation rates and higher levels of employment. In most cases, these policies were characterized by the active role played by the governments, also through the implementation of specific fiscal policies.²¹ A European federal government could implement similar policies on a wider scale.

On the other hand, the existence of a federal government increases, so to say, the endogeneity of the criteria for an OCA. Goodhart points to some important aspects of the role of the state in a process of economic and monetary integration:

the acts and existence of a sovereign government in a particular geographical domain may serve to make that domain an OCA, whereas had there been several governments in the same domain, it would not have been an OCA. For example, if the existence of a unified-governmental fiscal system should be helpful in mitigating asymmetric shocks affecting regions in that domain, then, it would be more likely to be an OCA. Again, a sovereign government is likely to impose laws and to encourage behaviour ... that usually serve to make (labour) markets far more flexible within, than between, such countries.

(Goodhart 1998, p. 423)

Goodhart looks at the European experience of monetary integration from a cartalist point of view, according to which the creation of money (and of a common currency) is inherently related to the state(s).²² Therefore, politics preceding economics in the European process of monetary integration is not exceptional. With money, the state always 'comes first'.²³ The state, in all its connections, is an inherent component of the social and economic organization, not a merely external body that interferes with the spontaneous working of markets. If the state is seen in the latter perspective, its intervention, at the best, is justified only by its vicarious nature. A state intervention in the economy is required to the extent that, for some reasons, markets do not work perfectly and temporary corrections are needed. State interventions should be limited and 'neutral', such as to disturb markets as little as possible.

5.5 Conclusion

European history, politics and ideals have 'imposed' that the political dimension played a relevant role in the process of economic and monetary integration of the continent. At the same time, however, the European experience relied on, and looked for support, in theoretical approaches that do not see the relation between the state and the economic sphere as inherently necessary. Quite to the contrary, state interventions are seen as distortions of the economy's working. More particularly, fiscal policy is regarded as more distorting than monetary policy, provided the latter is implemented by an independent central bank, concerned only with price stability.

As a result, Europe has given rise to a unique process. The strong link between the state, with fiscal authority, and the creation and administration of money has been weakened to the point of having a central bank that is totally independent of national states, with no federal counterpart to it.²⁴ The ECB is independent both with respect to the quantitative fixing of its (given) objectives and with respect to the strategies to realize them. The creation of the ECB and its present strategy find their theoretical support in the same economics that has inspired the European approach to fiscal policy and integration. In the basic conviction of the long-period neutrality of money, the ECB is almost exclusively concerned with price stability and has implemented monetary policies that are essentially restrictive, in order to acquire credibility and 'anchor' expectations.²⁵

The ECB's anti-inflationary stance coupled with the European governments' attempt to be 'fiscally responsible' did not produce a virtuous circle of growth, but rather the opposite result of substantial stagnation, with the characteristics of a vicious spiral: the ECB's cautious, or altogether restrictive, monetary policy slows down aggregate demand and investment in particular, with negative effects on the endogenous component of national public budgets. As a consequence, to stay in line with the fiscal parameters of the Stability and Growth Pact (SGP), national governments must implement

more restrictive policies and, hence, produce a further negative impact on demand. In the same way as the possible positive effects of fiscal deficits on the GDP growth are overlooked, no or little attention is given to the fact that budget deficits are, to a large extent, determined by a country's economic performance and that the large deficits in some European countries are not discretionary, but rather have resulted from high unemployment and low growth.

In this situation, the members states of the European Union seem to rely on foreign demand as the engine of economic growth. Each member state tries to increase its net exports both to other EU nations and to the rest of the world. The increase in net exports is partly achieved by trying to lower costs of production. As exchange rates are fixed with the rest of the EU, this can be achieved by maintaining or reducing wages and prices in each country and this adds more pressure for fiscal austerity and slow growth.

So far, faster US growth has made this European strategy feasible though costly in terms of employment, but a situation in which an area grows while the other lags behind and relies on exports rather than domestic demand is untenable. The European policy choices are damaging to its own members as well as to the world economy. Europe is behaving as if it were a small open economy that relies on exports for its growth, but Europe is a large economy and its slow growth negatively affects the rest of the world, which must run a growing external deficit that can become unsustainable.

The way out from the present European impasse must be found in furthering economic integration. Decisive steps should be taken toward fiscal integration, abandoning the European obsession with the risks of inflationary pressures produced by policy impulses. Indeed, restrictive policies can produce inflationary pressures by negatively affecting investment and productivity growth.

To proceed to further integration at the fiscal level is obviously a political decision, which requires a number of conditions. In particular, it requires a widespread consensus among the governments of member countries, backed by the convinced support of major political and economic actors. Unfortunately, the current European scene appears to be far from favourable to taking important further steps toward integration beyond the monetary sphere.

Notes

1. Obstfeld and Rogoff point out: 'Much of the enthusiasm for monetary unification within the European Union (EU) stems from the belief that locked exchange rates maximize the gains from a unified market and that exchange-rate-induced shifts in competitiveness within the EU can undermine the political consensus for free intra-EU trade' (1995, p. 76). There are, of course, differences between a regime of fixed exchange rates and a currency area; the absolute irrevocability of exchange rates within a currency area is seen as the most important. See the European Commission Report (2000, pp. 34-6) for more details.

2. The ECB sets the beginning of the process of monetary integration in the 1960s (Scheller 2004, pp. 15–39), but the most significant decisions concerning monetary integration were made only in the 1980s and 1990s.
3. In 1973, the European Monetary Cooperation Fund was created; it was seen as the starting point of a future community organization of central banks.
4. In the ECB's view, 'the exchange rate constraint greatly helped those participating countries with relatively high rates of inflation to pursue disinflation policies, in particular through monetary policy' (Scheller 2004, p. 19).
5. The works for the revision of the European Community Treaty had started in November 1990, with an Intergovernmental Conference; see Scheller (2004, pp. 20–1).
6. See also Mussa and others (2000), Fisher (2001) and Padoa-Schioppa (2004, pp. 31–5).
7. In particular, attention is given to microeconomic benefits, like the elimination of transaction costs. For De Grauwe, 'the costs of a common currency have much to do with the macroeconomic management of the economy, the benefits are mostly situated at the microeconomic level' (2005, p. 65).
8. Hallwood and MacDonald (2000, pp. 371–87) offer a useful survey of the theory of monetary unions and its more recent developments; see also De Grauwe (2005, pp. 24–64); and Tavlas (1993).
9. See, for example, the Commission's Report of 2000, where it is argued that the theory of OCAs is outdated with respect to important aspects and has not kept up with the evolution of economic theory (European Commission 2000, pp. 45–52).
10. McKinnon, for example, discusses OCAs in terms of their ability to provide the best realization of three objectives, among which there is the maintenance of full employment (1963, p. 718).
11. De Grauwe (2005, ch. 4) contrasts the 'Keynesian' position with the 'monetarist' position in terms of costs and benefits of a monetary union.
12. See, for example, Frankel and Rose, who conclude: 'a country is more likely to satisfy the criteria for entry into a currency union *ex post* than *ex ante*' (1998, p. 1024). See also Fidrmuc (2001) for an empirical test of the hypothesis of endogeneity.
13. Padoa-Schioppa states: 'readers only interested in economics would not understand the euro if they ignore the political dimension' (Padoa-Schioppa 2004, p. 21).
14. 'Fiscal and monetary policies must go hand in hand, and if there is to be an "optimum policy mix", they should have the same domains ... the domain of fiscal policy ought to coincide with the currency area ... It is a chief function of fiscal policy, using both sides of the budget, to offset or compensate for regional differences' (Kenen 1969, pp. 45–7).
15. Some empirical studies show that the benefits of US federal interstate transfers have been considerable. See, for example, Bayoumi and Masson (1995). It has been held, however, that the benefits of the US federal integration are not as large as is commonly believed (Fatás 1998).
16. For more details, see Chapter 5 of the Report (pp. 100–35). Carlin and Soskice (2006, pp. 193–200) deal with the problem of fiscal prudence and discipline. With regard to the EMU, they point out the necessity to avoid the single states' fiscal irresponsibility, but they also observe that the European fiscal rules are not necessarily coherent with the principle of fiscal prudence, that is, the government's solvency in the long run.
17. De Grauwe refers to the cases of Belgium, the Netherlands and Italy in the 1980s and 1990s. While Belgium and the Netherlands succeeded in stabilizing their debt-GDP ratios, Italy failed because it could not generate primary budget surpluses.

18. The growth rate of the economy is $g = \sigma[(1 - t)s + t(1 - a)]$, where σ is the average productivity of investment, t is the average tax rate, s is the private propensity to save and a the government's propensity to consume. Sardoní and Palazzi's model is a generalization of a Domar growth model.
19. In order that the debt-GDP ratio (b) be stable ($db/dt=0$), $(r-x)b = t-g$, where r is the interest rate, x is the GDP growth rate, t is the tax to GDP ratio and g is the public spending (net of debt service) to GDP ratio. When $r > x$, and x is independent of the public deficit, ($db/dt=0$) if $t > g$, that is, the public sector runs a primary surplus. However, when x is an increasing function of the public deficit, with the above qualifications, the condition for a stable debt-GDP ratio can also be fulfilled if there is a public deficit. It is possible to find a public deficit such that the growth rate x is higher than the interest rate r .
20. De Grauwe, by recalling the Italian experience, does not prove that fiscal policy is unsustainable, but only that the fiscal policies implemented in Italy were wrong, in the sense that they did not generate a significant and persistent growth of the country's GDP.
21. For some more details on these experiences, see for example, Carlin and Soskice (2006, pp. 111–13 and 747–63).
22. For the cartalist theory, 'the spatial determination of separate currencies has almost nothing to do with ... [the] economic cost minimisation and almost everything to do with considerations of political sovereignty' (Goodhart 1998, p. 400).
23. Goodhart sees the mainstream OCA paradigm as the counterpart of the dominant concept of money, which is seen as emerging from spontaneous market processes. The OCA approach is an extension of the Mengerian theory of money into the spatial domain (Goodhart 1998, p. 400).
24. 'What, of course, is remarkable and unique about the move to EMU and the Euro is the absence of an accompanying federalisation of governmental and fiscal functions' (Goodhart 1998, p. 424).
25. For the official view of the ECB's monetary strategy, see European Central Bank (2004). For a criticism, see Sardoní and Wray (2006).

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6

Righting Global Imbalances: Recession, Protection or Reflation?

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6.1 Introduction: 'What if the wolf is coming?'

As highlighted in other chapters in this book, current global imbalances are unprecedented, with the United States running the biggest deficit ever seen, to the tune of an annualized USD 900 billion in the fourth quarter of 2005. Contributors to this book agree that US overseas indebtedness cannot continue growing indefinitely and that a global collapse could ensue in the absence of a change of policy.

However, not everybody agrees with this sombre assessment. 'Critics of the critics' are persuaded that those crying wolf should be disregarded because the wolf has not shown up. *In extremis*, such confident analysts are rather like those who, in a twist of Aesop's fable, cry: 'the wolf is *not* coming!; the wolf is *not* coming!.' The more frequent the cry, the more reassuring it becomes and the more credence it is given. The end result, however, is the same as in the original fable: as time passes, the village becomes less likely to adopt a positive plan for averting calamity.

Nevertheless, for the majority of international observers the question 'what if the wolf is coming?' seems quite legitimate since it is difficult to see how current global imbalances can continue to grow *ad infinitum*. In this chapter we examine various reasons why this is the case. Thus, in the next section we discuss the 'global savings glut' argument and set out what we consider to be a better explanation: the disarray of global aggregate demand. Subsequently, in Sections 6.3 and 6.4 we set out this argument in more detail (for the United States and Europe). In Section 6.5 we look at policy implications of our observations.

In subsequent Sections 6.6 and 6.7 we analyse two hypothetical policy-driven scenarios which we believe could emerge from the present impasse. In Section 6.6 we deal with trade protection, implemented originally by the United States and likely to give rise to retaliation in Europe. The orthodox response in Washington to 'protection' is one of concern because of the threat posed to the 'free trade globalization' project. Our analysis reveals that

protection would be a sub-optimal solution for the stronger blocs able to impose protection on others, and detrimental for the weaker ones. In Section 6.7 we present a more congenial alternative in which Europe would take a leading role in pursuing a pro-reflation agenda with considerable pro-development virtues such as promoting infrastructure and industrial investment in Africa and Eastern Europe. Although there is much talk of 'making poverty history', little has been said about its importance as a trigger of global economic linkages, which is precisely where the notion of reflation becomes meaningful. The last section condenses our main findings and their policy implications.

6.2 The problem: global savings glut or global demand disarray?

It has recently been suggested that global financial imbalances are caused by a global savings glut and that the US deficit merely accommodates this state of affairs. In its simplest version, the argument suggests that there is nothing US authorities can do about global imbalances since the crux of the problem lies in the excessive saving of the Asian countries, and of China in particular (*The Economist* 2005). A more sophisticated version (Dumas and Choyleva 2006) holds that the Asian savings glut is indeed the culprit, but that it must be seen as part of Asian countries' determination to avoid a repetition of the 1997 financial crisis by ensuring that they run a current surplus. Both versions of the story focus emphatically on the supply of savings and the need for exchange rate adjustment by the major Asian capital exporting nations (Wolf 2006).

At one level, the argument is tautological since the US deficit must be offset by a similar surplus elsewhere if world financial flows are to balance. The point typically missed by both proponents and opponents of the savings glut thesis is that the root cause of the current crisis is not illuminated by asking whether Asians save too much or Americans too little. While it is clear that somewhat slower US growth will help curtail absorption, it is equally clear that higher growth abroad will be needed to absorb additional US exports if a recession is to be avoided. As argued below, exchange rate changes alone cannot be relied upon to bring about expenditure switching on the required scale within an acceptable time frame. What is central to our argument is that the extra growth cannot come entirely or even chiefly from Asia (where resources are already stretched to the limit), but must come from a combination of renewed EU growth and growth-inducing policies towards the rest of the developing world, particularly Eastern and African neighbours.

At another level, the global savings glut argument is misleading since it entirely ignores changes in the structure of aggregate demand in the United States and the rest of the world over the past 15 years. Current macro-financial imbalances are quite different from the usual 'balance of payments problem'.¹

First, measured in terms of current account deficits (or counterpart surpluses), they are amongst the largest recorded. Second, they are geographically more concentrated. Third, they are not transitory but rather have been building up for a long time. Fourth, instead of resulting from the failure of trade and financial liberalization reforms, the current imbalances have emerged as part of the process of trade liberalization and the globalization of finance. Finally, instead of reflecting financial constraints, they appear to reflect a high degree of international financial liquidity and, what is more, an unprecedented accumulation of portfolio assets in global markets. An in-depth analysis of these unique characteristics is beyond the scope of this chapter. However, we would suggest that useful insights can be obtained by looking more closely at the interactions between public and private sector behaviour and the impact that these had in the composition of aggregate demand in the United States and Europe.

6.3 Aggregate demand and the public-private sector divide in the United States

Since the early 1990s, the US economy has enjoyed a relatively favourable growth record, more so than Europe. However, unlike previous periods of sustained growth, current US growth has been largely fuelled by an extraordinary expansion of credit to the private sector. The net additions to aggregate demand by the private sector – measured as the increases of total expenditure over the increases of disposable income, or net dis-saving – from the first quarter of 1992 to the third quarter of 2003 was equal to 12 per cent of GDP (the equivalent of USD 1575 billion at today's prices). Put another way, the net saving of the private sector moved from *plus* 6 per cent of GDP in 1992 to *minus* 6 per cent of GDP in 2000. Not only did net saving move systematically away from the historic norm of about a + 2.5 per cent of GDP but it also turned negative for the first time in post-war history. This process was paralleled by growing current account deficits.

The emergence of private sector dis-saving was associated with the rise of a public sector surplus. In essence, the weakening of aggregate demand caused by fiscal tightening was fully offset by the accelerating pace of private sector spending made possible by growing indebtedness. As explained elsewhere, this process could not last indefinitely (Godley 1999, 2000; Godley and Izurieta 2001a and 2001b; Godley and Martin 1999; Martin 2001; Papadimitriou et al. 2003, 2004). When the US corporate sector (though not the household sector) experienced tighter credit and was compelled to restore the balance sheet to health by cutting spending, the resulting shortfall in aggregate demand triggered the beginning of a recession.

To avoid a lasting recession, the fiscal stimulus administered was the most aggressive since the Second World War. But to conclude from this that the

external deficit is a consequence of the public sector deficit is misleading and conveys a potentially fatal policy prescription.

Throughout recent decades, the government budget has played a strong counter-cyclical role, compensating for fluctuations in corporate sector spending, and it is this which has helped the United States to sustain growth and prosperity. Figure 6.1 shows contractionary and expansionary movements of the public and corporate sectors estimated as increments of net saving over two years, measured as a percent of GDP. Positive numbers represent the size of the 'leakages' over such period (i.e., withdrawals from aggregate demand) while negative numbers represent the size of 'injections' (i.e., net additions to demand).² Phases of the cycle in which the corporate sector was withdrawing from the spending stream (positive numbers of the solid line) were systematically countered by public sector injections (broken line). In the final years of the 1990s, at the peak of the previous economic expansion, the cyclical contribution of the corporate sector to aggregate demand was about 2 per cent of GDP, while throughout the first two years of this decade corporations withdrew about 4 per cent of GDP from aggregate demand. Conversely, the public sector was in tightening mode during the previous expansion but as soon as the corporate sector shifted to net savings the public sector's net additions to demand were unprecedentedly high (5 per cent of GDP).

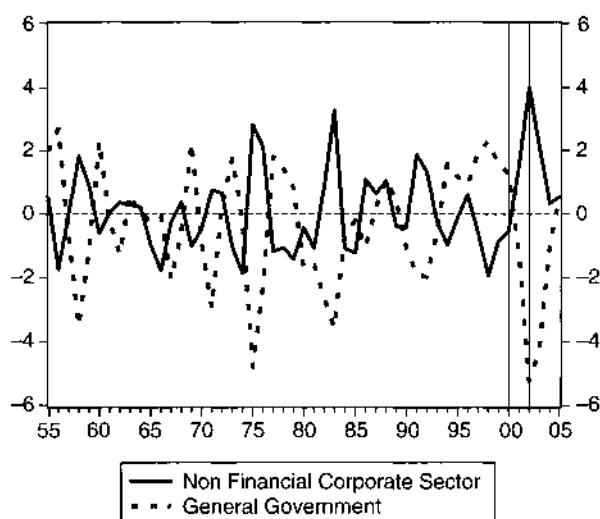


Figure 6.1 Aggregate demand leakages: US Corporate and Public Sectors (Increments of expenditure net of income over two-year cycles as per cent of GDP)

Source: National Income and Production Accounts (NIPA) (Bureau of Economic Analysis, BEA) and Flow of Funds of the United States (Federal Reserve). Author's calculations.

This interaction between the public and corporate sectors has two main implications. First, under conditions of low corporate sector spending, the injunction to rein in the public sector deficit is a recipe for recession. This is a major problem at present, since the corporate sector keeps withdrawing from aggregate demand. Such conduct suggests the corporate sector is sceptical of the ability of a financially over-stretched personal sector to step up spending.³

The second implication of the correlation between fiscal stimuli and business cycles is that there is a positive relationship between the personal sector financial balance and the current account balance. From the basic rules of national accounting we know that the external account is identically equal to the sum of the financial accounts of the three domestic sectors: personal, corporate, and public. A negative correlation between the financial balances of the latter two implies a positive correlation between the financial accounts of the external and the personal sector. In other words, to the extent that fluctuations of net spending of the government compensate for the fluctuations of corporate spending, the fluctuations in the personal sector will be a mirror image in the external account. This is shown in Figure 6.2.

The economic meaning of the relationship between the financial performance of the personal sector and the current account can be seen in two ways. First, changes in the current account, determined by the forces of economic

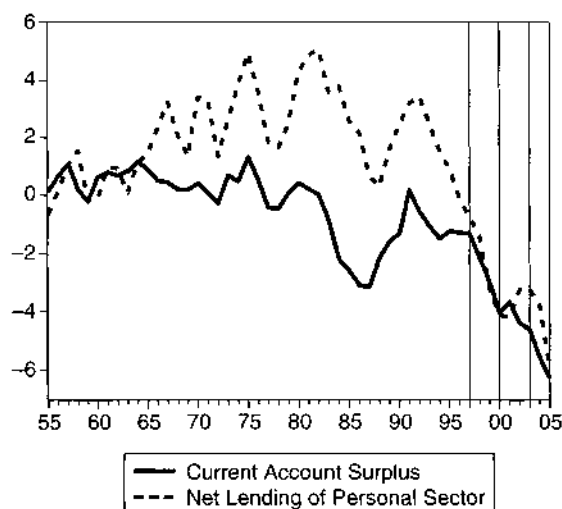


Figure 6.2 Financial balances of the external and personal sectors in the United States (per cent of GDP)

Source: NIPA, BEA and Flow of Funds of the United States (Federal Reserve). Author's calculations.

growth abroad, are injections into (or leakages from) the flow of national income. The changes in the flows of income that arise from the current account affect the disposable income of the personal sector and, *ceteris paribus*, its net saving position. Second, the current account is also determined by changes in domestic flows. Increases in total spending of the personal sector triggered by credit growth (or by income flows, given that the elasticity is greater than one) translate into current account deficits.⁴ Both directions of causality are relevant; the implied mechanisms of adjustment are explored in the following sections.

The state of global imbalances as manifested in the structure of aggregate demand in the United States can be resumed as follows:

- The current account imbalance in the United States is closely related to the personal sector imbalance. *Ceteris paribus*, weaker household expenditure may help improve the current account but would be deflationary. A non-deflationary change would result where net export injections (triggered by changes in global demand or prices) improved the financial balance of the personal sector.⁵
- Changes in the fiscal budget act to offset net spending patterns of the corporate sector. A fiscal tightening in the absence of sustained corporate investment would be deflationary. Conversely, a boost of net spending of the corporate sector would most likely allow for fiscal tightening without jeopardizing economic growth.
- These two points taken together convey the notion that the performance of the US economy ultimately depends on what happens to the personal sector and to the strength of global demand. We turn to this matter in the next section.

6.4 Aggregate demand and the public-private sector divide in Europe

In the Euro Area member states, as in most other OECD economies and in many emerging countries (particularly those prone to external shocks and subject to IMF-style reforms), achieving a current account surplus is considered a desirable policy goal. The conventional view is that Government needs merely to pursue prudent fiscal and monetary policies to bring the external account into surplus.⁶ However, it is quite illogical to suggest that all countries should aim at achieving a current account surplus since, to the extent some run savings surpluses, others must run savings deficits. What is more, countries longing for 'healthier balances' in all accounts (personal, corporate and public sectors) can only escape from outright recession if they are pulled by strong and sustained net external demand. This seems the logic underlying economic policy-making in much of Europe.

The spending behaviour of the fiscal and corporate sectors in the EU-15 for the few years of available data is illustrated in Figure 6.3.⁷ The lines represent changes over two years in the financial balance of the (consolidated) 'corporate' and 'public' sectors of the EU-15 and are shown as per cent of consolidated EU-15 GDP. Just as in Figure 6.1, positive numbers are 'leakages' because they are additions to net saving, while points under the zero line are net expenditure 'injections'. By 1997, for example, the 'consolidated fiscal sector' of the EU-15 had withdrawn about 4 per cent of GDP from aggregate demand in only two years – the dash to the Maastricht finish line. The corporate sector had been adding to demand to the tune of about 2 per cent of GDP. Both sectors taken together had a negative effect on aggregate demand of nearly 2 per cent of GDP. Similar patterns were observed until the first years of this millennium, when both sectors taken together ceased to have a negative effect on demand, but did not add to it either. And even in 2002–03 when the 'consolidated public sector' contributed to aggregate demand, it did little more than compensate for the rise in savings of the corporate sector.

Leakages of the corporate and public sectors in the major EU countries (United Kingdom, Italy, Germany and France as per cent of each country's GDP) are shown below in Figure 6.4; these show a more mixed pattern. While counter-cyclicity prevails in Germany and the United Kingdom, there have been some notable cases of fiscal tightening – shown as points of the

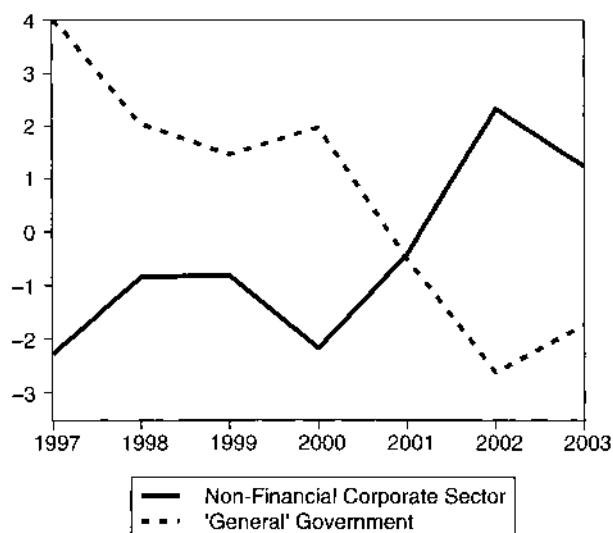


Figure 6.3 Aggregate demand leakages: 'EU-15' corporate and public sectors (Increments of expenditure net of income over two-year cycles as per cent of EU-15 GDP)

Source: Eurostat; Authors' calculations.

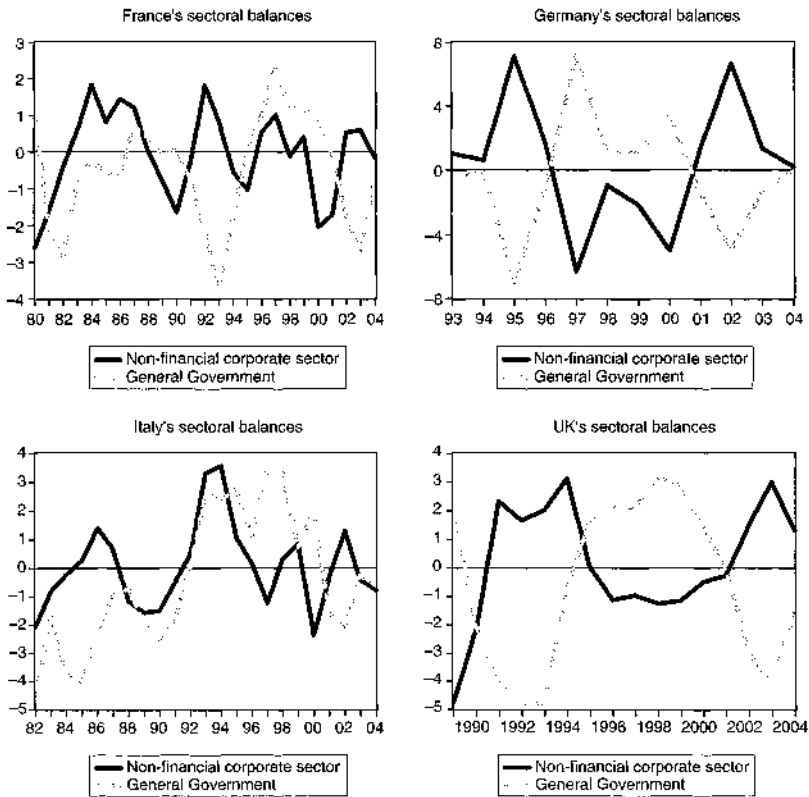


Figure 6.4 Leakages in France, Germany, Italy and the United Kingdom: corporate and public sectors (Increments of expenditure net of income over two-years cycles as per cent of GDP)

Source: Eurostat. Authors' calculations.

General Government balance above the zero line – such as Italy in the first half of the 1990s and France in 1987–88 and 1995–99, even if corporations were in net-saving mode.

Importantly, during the Maastricht era (i.e., the run-up to EMU), the net expansionary movement of the two sectors combined was generally negative in the countries shown. Fiscal contractions were strong enough to fully offset net additions to aggregate demand by the corporate sector and it is this which helps explain sluggish growth during the 1990s.⁸ The apparently anomalous growth pattern in the United Kingdom can be explained, as in the United States, by the debt-fuelled spending behaviour of the personal sector.

The above well illustrates what makes the orthodoxy in Brussels so counter-productive (see Irvin 2006, for example). The cost of Brussels

orthodoxy is twofold. First, low growth and persistent unemployment threaten the EU's political cohesion and social stability. Second, the success of tight fiscal and monetary policies has become entirely dependent on export demand from the United States and a few other deficit countries. Since this pattern is concurrent with the accumulation of dollar assets in surplus countries (which are liabilities for the United States) and with the accumulation of personal sector debt in the United States, the world economy becomes increasingly vulnerable to a potential dollar crisis or credit tightening in deficit countries.

Thus, the public-private sector divide in Europe corresponds to the following patterns, which in turn seem to be aligned with patterns observed in the United States:

- The 'public sector' in the EU exhibits, to a much more limited extent than in the United States, a counter-cyclical role to the spending patterns of the corporate sector.⁹ But the net effect of both sectors together is generally negative or neutral at best.
- Since the net effect of these sectors together tends to be negative, the orthodoxies of the Stability and Growth Pact and the Golden Rule place further pressure on the relation between the external sector and the personal sector. If the personal sector opts for a cautious, pro-saving financial strategy, as in the Euro Area, the configuration of demand is deflationary. By contrast, if the personal sector opts for stronger spending, as in the United Kingdom, this may compensate for the negative effect on demand of the other two sectors, but it will be accompanied by mounting current account deficits.
- Effectively, Euro Area countries in particular rely heavily on sustained net export demand from the United States, in part because of their own deflationary fiscal rules, and perhaps too because they cling to the belief that net export demand will always be buoyant.

6.5 Can this situation be sustained for much longer?

The world economy has entered a precarious period indeed. The main deficit country, by spending 6-7 per cent a year more than it earns, continues to increase its net liability position. By the same token, the personal sector in the United States, whose excess of total spending over income is nearly 9 per cent of its income, continues to increase its debt burden. Moreover, surplus countries are becoming increasingly dependent on the United States as consumer of last resort and continue to accumulate dollar assets. Why has this process continued unchecked for so long?

Paradoxically, the net indebtedness of the United States has not increased as much as one might imagine over recent years, despite its growing current

account deficit. Indeed, two factors have affected the *value* of the external position. First, the dollar devaluation over the period 2002–04 (17 per cent against trade partners, 30 per cent against major capital markets, and 50 per cent against the euro) increased the value of assets abroad of US residents by an amount nearly equal to the accumulated current account deficits. Second, even disregarding currency movements, the huge appreciation of assets in stock and bond markets abroad added more than 1.5 trillion dollars to US investors' wealth, even if during the last four years there was a net outflow (see Oxford Analytica 2006). Were it not for such dramatic valuation changes, the net liability position of the United States would have increased from USD 2340 billion at the end of 2001 (23 per cent of US GDP) to USD 4795 billion at the end of 2005 (37.5 per cent of US GDP).¹⁰ This should have been a cause for concern and triggered decisive action to turn around the current account deficit. But because of holding gains, the net liability position of the United States at market value at the end of 2005 was a comfortable 20 per cent of GDP.

A very similar phenomenon can be observed for the main debtor in the US economy: the personal sector. Unprecedented asset appreciation in both the stock market and real estate markets since the mid-1990s has increased the sector's wealth (Izurieta and McKinley 2006). Despite the stock market decline in 2000–01, the net worth of the personal sector increased from about 4.75 times its income in mid-1990s to about 5.75 times its income at present, mainly due to the housing boom. *Unlike debt*, net worth deteriorated dramatically during the 2000 crash, but since then the ratio of net worth to debt has hardly changed even though the growth of household indebtedness has accelerated over recent years.

For the surplus economies, likewise, the landscape appears less bleak than one might expect. Export performance is continuously improving; surplus countries accumulate dollar-denominated assets; their domestic sectors feel richer because (as noted above) their stock markets are appreciating at a nearly unprecedented pace, and neither their governments nor their private sectors appear to be in danger of falling into a debt trap.

Such mechanisms, however effective they have proved to date for keeping the imbalances in check, could easily turn perverse. First, as most economists would agree, asset markets bubbles end up bursting (or at least deflating). The high degree of internationalization of financial markets and their incredible size – about five times global GDP – means that a serious market crash in one of the world's financial centres would in all likelihood spread rapidly, with unforeseen consequences.

Second, the holding gains described above do not just affect balance sheets; they also influence behaviour (Izurieta 2005). From the point of view of the United States, debt-fuelled household spending can only continue to be the main driver of growth if total asset appreciation of the order of 5–6 per cent a year *in real terms* (only seen at the peak of past stock market bubbles) is

assured so that households net worth runs at least at par with debt accumulation. But such spending patterns, by sucking in more imports, would cause an ever deeper current account deficit and increase the net liability position of the United States as a whole. Such a process makes the United States increasingly vulnerable to a major correction in asset prices.

Third, holding gains partially offset the traditional effect of exchange rate depreciation in helping to restore trade balance. A dollar devaluation, for example, increases the wealth of US households who hold assets abroad, thus increasing consumption and imports. This is one reason why many observers believe that rebalancing cannot occur solely by means of exchange rate adjustment.

Fourth, in order for the United States to avoid a deterioration of its net debt position, US-owned assets in the main capital markets abroad must appreciate faster than assets in the domestic capital market. This implies an asset price bubble in global markets.

Fifth, were this to occur then global investors would increasingly move away from markets in the United States and towards the main centres in Europe, Japan, and perhaps in emerging markets. A shift out of the US market might precipitate a dollar collapse and a chain of stock market crises, which brings us back to our first point.

In sum, the processes that have made possible a painless continuation of global imbalances – namely credit expansion and asset appreciation – are making the world economy increasingly vulnerable to sudden credit tightening or asset deflation. A wobble in one part of the world could easily have global ramifications.

6.6 Washington's plausible responses: from benign neglect to trade protection

The response of the Bush administration to growing external debt has been confused. Both the outgoing Treasury Secretary and his successor appear to believe in a 'strong dollar' solution sustained by increases in productivity that result from a synergy between the foreign capital keen to invest in the United States and the 'resilience of corporate America'. The Federal Reserve appears keener on market-led exchange rate adjustment. This response is best represented by the recent efforts led by the IMF towards achieving 'international coordination'. The IMF does not mean 'coordination' of the 'Plaza Accord' variety; rather, what the IMF wants is for Asian countries to cease intervening in foreign exchange markets.¹¹ Such an option is attractive in orthodox circles because it is consistent with the view that the best policy is no policy at all. In this context, coordinated action would allow market forces to operate smoothly so as to bring about an orderly dollar devaluation enabling global balance to be restored.

Various commentators have questioned whether devaluation alone can bring about a meaningful correction of current imbalances (Brittan 2005; Dodge 2005; Dooley, Folkerts-Landau and Garber 2003, 2005; Genberg et al. 2005; Persaud 2005; Truman 2006). It is not surprising that the devaluation argument has been unpersuasive. A number of US trading partners, like China, Malaysia, and Hong-Kong, have effectively pegged their currencies to the dollar and are unlikely to be persuaded to accept the slowdown in export-led growth that currency revaluation would entail. Meanwhile, the real fall in the dollar relative to the 1990s (17 per cent effective depreciation on trade weighted basis and significantly more against major currencies) has not led to an external account improvement (Cripps, Eatwell and Izurieta 2005).

Finally, the trade gap is simply too large. On our estimate, exports would need to grow 3 per cent faster than imports for 15 years merely to bring US exports and imports to balance. Such a turn-around could not be engineered by price-adjustment alone, but would require constraining import growth via a slowdown in economic activity, or by protectionist measures.

Meanwhile, a strategy gaining ground in some circles in Washington is trade protection. 'Keeping out cheap foreign imports' is a slogan which mobilizes support on both sides of the political spectrum and is seen as legally defensible.¹² The prospect of trade protection in the United States is considered by many to be undesirable, not least because of the potential for retaliation, political discrimination and the breakdown in the free-market globalization project. Political-economy considerations aside, we find it useful to construct a plausible 'protection scenario' and explore its macroeconomic implications. As will be shown, even though protection might be considered preferable to a recession, such a strategy falls short of delivering sustained improvements in the US deficit because of its adverse effects on long term growth, both in the United States and the rest-of-the-world (RoW).

The protection scenario (like the reflation scenario discussed in the next section) is constructed using a revised and expanded version of the Alphametrics World Model of Income and Trade (1987), developed at Cambridge (now called CAM – Cambridge Alphametrics Model) and described in Cripps, Izurieta and McKinley (2007). The solutions are obtained as follows. The model is anchored in a fully consistent global accounting framework. The world is divided into 13 countries and/or blocs, and all trade accounts add up. Four types of commodities are specified: food, raw materials, energy, and manufactures. Demand per bloc is disaggregated into domestic expenditure (public and private) and net export demand. Stylized patterns of spending and import demand are obtained by econometric estimation; residuals are adjusted when it is evident that the variables drift away from the norm.

The model is calibrated by simulating recent history. The projection of the current situation into the future is achieved simply by projecting trends in the exogenous variables, and this projection constitutes a 'baseline'. Policy-driven

scenarios are obtained by target-instrument iterations. For each desired target an instrument is chosen. The value of the instrument should be that which assures that the target is achieved. When various pairs of targets and instruments are part of a single scenario, the model is resolved all at once to ensure that interactions and feedbacks are fully taken into account.

The protection scenario can be described as follows. Protectionism takes off in the United States with the aim of reducing the trade deficit ('target'), measured in constant dollars, at about 2 per cent per year in volume terms. This is a very moderate target, but it implies a drastic change with respect to recent years since the trade deficit has been growing at about 10 per cent per year on average. The growth of imports ('instrument') is constrained to the extent required to reach the target. Spending and National Income will take time to rise because of the lags involved in substituting domestic production for imports.

We assume that it will be in the best interests of the United States to grant exemption from protection to its neighbour and main trading partner, Canada (which in the current model structure is part of the bloc 'other developed').¹³ Thus, while total imports are reduced, imports from this bloc remain at par with the trend, which implies that all other countries experience a relatively sharper fall of their exports to the United States.

Another important component of the 'protection scenario' is to allow for policy responses by blocs affected by this hypothetical 'unilateralist' agenda of the United States. We reckon that blocs which have significant political or economic leverage could sustain a defensive response. To keep things simple, we assume that the only bloc to intervene explicitly will be Western Europe (WE),¹⁴ where macroeconomic performance has become heavily dependent on demand from the United States (at present, exports of manufactures of WE represent 24 per cent of manufacturing imports of the United States and slightly more than 10 per cent of WE exports).

The protectionist measures described above will reduce WE exports to the United States to only 16 per cent of US imports and 5 per cent of WE exports. In retaliation, WE is assumed to replace imports from the United States by goods made within the European bloc. The share of trade internal to the WE bloc rises to the extent necessary to secure a trend rate of economic growth of about 3 per cent per annum.¹⁵ It is assumed that, just as in the case of the United States and Canada, WE will give preferential treatment to its Eastern European neighbours (EE),¹⁶ some of which already belong to the European Union. A moderate but acceptable economic growth rate of about 4 per cent is the target for Eastern Europe induced by allowing these countries a greater share of Western European imports, especially in manufacturing, supported by FDI.

It ought to be clear that this scenario is driven by an attempt by the United States to reduce its deficit by protection, triggering off trade retaliation in Europe and not necessarily a 'paradigm shift' towards fiscal expansion. As will

become clearer below, under the stipulated conditions retaliation by Europe (intensifying internal trade) may compensate for the effect of US protectionism, but will not lead to performance improvement beyond Europe itself.

A direct implication of both sets of conditions (protection in the United States and retaliation in WE) is that growth in rest of the world (RoW) – excluding the United States, Other Developed, Western and Eastern Europe – will be significantly affected because their export performance will deteriorate.¹⁷ In addition, the previously strong income and trade linkages between the United States and WE will be diffused into indirect and weaker linkages via the blocs left out. In other words, exports of North America partners (the United States and Canada) will depend less on economic growth in WE than before and more on growth from other blocs (and vice versa). Thus, sluggish growth performance in the RoW countries resulting from the protectionist agenda will inevitably affect both the United States and Europe, as will later rounds of iterative interaction.

Turning to the quantitative results, economic growth in the United States will initially rise to about 6 per cent a year because the improvement in the external balance is tantamount to an improvement in the net flow of national income. But as growth in other blocs slows, US export demand can no longer be sustained at 10 per cent per annum and must slow to about 5 per cent per annum. In consequence, US economic growth needs to slow to less than 2 per cent per annum to achieve the targeted reduction of the trade deficit. As US growth slows from its peak of 6 per cent per year, in a few years' time the relative loss compared with the continuation of current growth patterns will be around 1.5 per cent per year.

The rate of economic growth of the world as a whole will be increasingly affected. Amongst the countries most affected will be Japan (with growth declining again to near zero rates) and developing America (from about 5 per cent per annum to 2.5 per cent). The rest of developing areas in Asia and Africa (including China and oil exporting countries in those regions respectively) will lose between 1.5 to 2 per cent in growth rate compared with current trends.

Growth rates in WE and EE in principle are not affected because these variables are treated as targets. But the implied changes in the 'instruments' required to compensate for both US protection and sluggish growth elsewhere turn out to be implausible. This is particularly the case for the share of internal WE trade, which is the instrument used to secure targeted growth in WE. The model's solution indicates that internal trade will need to rise sharply from about 66 per cent of WE total trade at present to nearly 80 per cent within few years.¹⁸

In sum, in our trade protection scenario the United States will not win, Europe's much-needed changes are implausible, and the world will definitely not be a better place. Indeed, it may be worse than what our model outcome suggests if more complex retaliatory measures are devised. The persistence of

macro-financial imbalances, combined with the increasingly integrated state of the global economy of today, makes an adjustment via protection and 'beggar my neighbour' policies as painful and uneven as a market-led crisis resulting from benign neglect.

6.7 Rejecting fiscal orthodoxy: a Europe-driven reflation scenario

The question then arises of what type of policy response can be implemented which would be both politically feasible and appropriate to the nature of the problem. The possibilities explored above (US recession, dollar devaluation, protection) seem impracticable and suggest that there is little that the United States can do. While it seems clear that the United States 'needs the world's help', it is also true that the current state of global imbalances was not caused by the 'extravagance' of deficit countries like the United States alone. Their import oriented predisposition would not have materialized if it was not to other blocs' advantage to devise export-oriented strategies and preach prudence. 'This basic principle is often forgotten in comparing the US and EU growth records' (Irvin 2006: 43). Moreover, from the analysis of the structure of aggregate demand in the United States and Europe posited above, one can identify another convergence of interests emerging in the early 1990s that helps explain the current impasse; namely orthodox fiscal tightening at the *global* level.

US Congressional insistence on the desirability of public sector surpluses was a familiar theme during the 1990s. Of course, US policy-makers might have reverted to fiscal deficits as soon as the first signs of a slowdown appeared in response to fiscal tightening. But such was not necessary because the US economy, instead of slowing down, started to grow relatively quickly on the back of asset appreciation and the rapid increase in credit to the private sector. By spending in a 'deficit-prone' fashion, private agents filled the gap left by the fiscal sector. Policy-makers, implicitly adhering to the 'Lawson doctrine' (according to which current account deficits that result from a shift in private sector behaviour should not be a public policy concern) were satisfied. The 'ideal' structural conditions were set for continuing economic growth: buoyant demand, high productivity, low inflation, wage moderation, low unemployment, high profits, stock market (and other asset) appreciation and ... public sector discipline. The model, described by some as the 'Goldilocks Economy', was ready to be copied by other industrialized nations.¹⁹

So it was. With the exception of Japan – where the recession of the early 1990s (caused in part by a similar model, with emphasis on property appreciation) was still being countered with fiscal policy and monetary easing – many other economies incorporated, with variations, the US model. For Europe, the success of the Goldilocks economy seemed to guarantee that the

principles laid down in the Stability and Growth Pact (and subsequently the 'Golden Rule' in the United Kingdom) would deliver prosperity if applied with rigour.²⁰ But the performance of the fiscal tightening experiment in the Euro Area turned out to be disappointing, and in some cases actually triggered recessions.

A number of authors have pointed out 'gaps' in the institutional setting as main causes, like the absence of a meaningful 'federal' budget for the EU, or the rigidity of the 'inflation targeting' model (Bibow 2004; Irvin 2005). In addition, except for the United Kingdom,²¹ Ireland and few other continental countries (Spain, Italy, Denmark, Finland, Greece, and France), the personal sector did not shift to a spending pattern strong enough to compensate for fiscal tightening, as had happened in the United States. As regards diverging performance since the 2001 global slowdown, policy-makers in Europe have not sufficiently appreciated that fiscal policy in the United States came to the rescue at the first signs of failure of aggregate demand, (which was caused, indeed, by fiscal orthodoxy in the first place; see Godley and McCarthy 1998).

At this stage, it is crucial to emphasize the need to avert a weakening of aggregate demand in the global system. But sustaining world aggregate demand cannot be based on credit expansion of the kind seen in the United States, the United Kingdom, Spain, and elsewhere. Further growth in the personal sector debt burden of these countries seems hard to imagine – and an adjustment can be expected at any time. Personal sector net saving in the United States is already less than *minus* 6 per cent of GDP per annum (see Figure 6.2). It is now evident that domestic demand management in the United States alone cannot bring about a correction to its historic norm of about a *positive* 2 per cent of GDP. If a 'US-led global slowdown' is to be avoided, the obvious solution seems that of a sustained reflation outside the United States – with Europe playing a pivotal role!

Izurieta and McKinley (2006) present a global reflation scenario which addresses such concerns. Arguably, their solution requires a very high degree of global macroeconomic policy coordination. To achieve such coordination, either a severe crisis would have to occur, or else a more modest experiment which is more easily implemented would need to be attempted. Such an experiment with encouraging global implications can be built around a Europe-led reflation. Why Europe? An important reason is that, given the poor performance of domestic demand in the 1990s, the region might have run into severe and lasting recession had it not been for buoyant net export demand from the United States. And an even more convincing reason is that '[while] belt tightening in the United States will mean slowing US demand and thus growth – a policy which risks slowing the world economy – [reflation in Europe] means faster world growth and particularly faster euro area growth' (Irvin 2006, p. 44). Furthermore, as the CAM simulation described below confirms, the global impact of a

Europe-led reflation is re-enforced by the strong income and trade linkages with middle-income and poor regions of the world (e.g., Eastern Europe, Latin America, and Africa).²²

An EU-led reflation supposes a set of demand-management instruments aimed at improving growth and income distribution and requiring coordination between Europe, Eastern Europe, and – for reasons explained below – low income regions such as Africa. In addition, some degree of success in negotiating energy-saving measures on a global scale can be expected (otherwise, with practically all blocs growing steadily under current rates of energy utilization, energy prices may be destabilizing). We reckon that the key assumptions made in our simulation are very much in line with the proposals advanced, amongst others, by the UK Chancellor, Gordon Brown (see, for example, Brown 2006).

Just as in the previous scenario, a target rate of economic growth for Europe is posited. But instead of trying to achieve this by protection or by faster export growth, the critical instrument is domestic absorption. Net additions to aggregate demand required to achieve the desired target are of the order of 3 per cent of GDP. To put things in perspective, the average net increment in domestic absorption during the 1990s was about 2 per cent of GDP. In other words, the proposed scenario is perfectly realistic.

To be sure, such a result can be achieved not just because domestic absorption accelerates by about one per cent of GDP with respect to the norm in recent years. Official development assistance and foreign direct investment aimed at improving manufacturing capacity and raising income in Eastern Europe and Africa (AE, henceforth) are critical components of this policy package. Injections of about one-third the net increments of domestic absorption posited above (i.e., one per cent of the EU-15's GDP) would be sufficient to help Eastern Europe to achieve rates of economic growth of around 6 per cent and – some years from now – as much as 10 per cent for several African countries.²³ The aid target implied is roughly equivalent to the 0.7 per cent of GDP that G-8 nations committed themselves to at the 2005 Gleneagles summit.

As far as domestic demand management is concerned, the final component of this scenario requires tuning domestic absorption in Eastern Europe to ensure that external balance is achieved within a few years. Balance could be achieved by postulating that an increasing share of the injection – from half to about two-thirds or three-quarters – would be invested in export-oriented industries and in closely related infrastructure and public investment projects.

The other important component of this scenario is the pressure on resource utilization, particularly energy. The model on the basis of which we constructed this scenario can be used to assess the demand for energy and raw materials (and derived prices) for given rates of global economic growth, assuming similar trends of energy efficiency improvements as in the recent past. A non-recessionary scenario would imply that energy use increases at a

rate of about 5 per cent per annum on average, while the rate at present is about 2 per cent per annum (Izurieta and McKinley 2006). The resulting price increases, in real terms, will be far higher than the current rates (which are already at record levels). Such an outcome would involve headline inflation numbers that are unacceptably high for central bankers and thus prompt tight money and hence derail the growth scenario.

Thus, in this scenario, we incorporate the restriction that energy demand should not rise any faster than 2 per cent per annum. There are various ways of achieving this outcome, our preferred alternative being a 'green tax' on energy use, to be substituted for either social/development-related expenditure or tax rebates on employment creation. To avoid implications of such a 'tax' on headline inflation (see Bibow 2006), the principle is that any chosen package of restrictions and incentives in use should be 'fiscally neutral' with respect to the underlying conditions of this scenario (which are indeed expansionary).

Meeting the energy saving constraint may be the most ambitious component of this scenario. Policy-makers in Europe will need to place this issue at the top of the policy agenda – a logical follow-up to the commitment to Kyoto which addresses such concerns.²⁴ To maintain the current rate of energy utilization and still allow for global economic growth will require far more energy saving measures than have so far been contemplated. In short, Europe has a leading role to play in promoting not just growth, but energy-efficient growth.

The overall results of this scenario are instructive, particularly considering that apart from the postulated conditions for WE, EE, and AF, no other bloc is required to implement adjustments. In the Europe-driven reflation scenario, the world economy will be growing about one per cent faster than the projected baseline and more than 2 per cent faster than in the previous 'protection' scenario.

Importantly, external balances would be more in harmony with rates of economic growth and financing too. Of particular interest in this regard is the evolution of WE and the United States. Western Europe will show a (manageable) external deficit of the order of 1–1.5 per cent of combined GDP. This reflects stronger economic growth than in the recent past, and also the fact that injections are largely driven by domestic reflation rather than being dependent on US demand alone. In consequence, the US balance will gradually improve as a proportion of (growing) GDP; that is, there is no recession in the United States and neither dollar devaluation nor protection are required.

Economic development linkages are worth mentioning as well. While WE increases its foreign investment in its neighbours, it also imports more from them.

The two sets of plots shown below in Figures 6.5 and 6.6 compare the rates of growth and the current account balances of the main blocs concerned

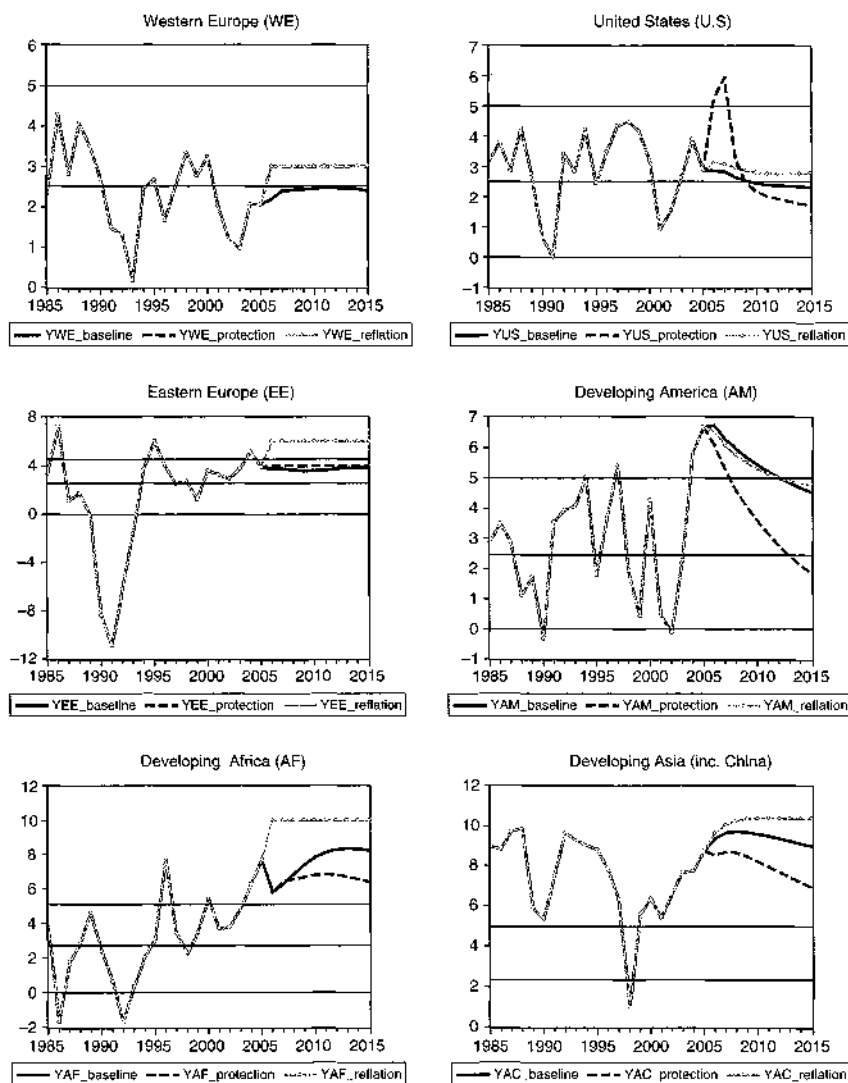


Figure 6.5 Rates of economic growth in main blocs (Three scenarios compared: baseline, protection, reflation)

Source: Historic period: compilation from UN and IMF statistics. Projection: (CAM) model simulations.

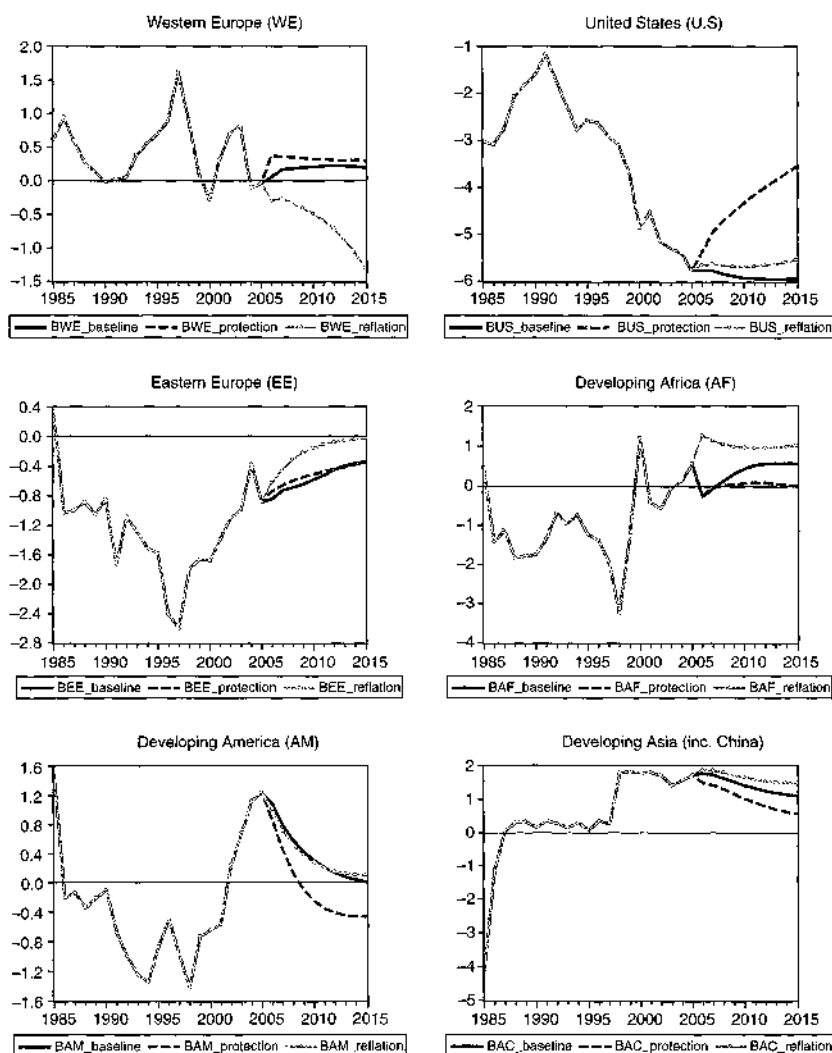


Figure 6.6 Trade balances in main blocs as per cent of GDP (Three scenarios compared: baseline, protection, reflation)

Source: Historic period: compilation from UN and IMF statistics. Projection: (CAM) model simulations

under three scenarios: 'baseline', protection, and reflation.²⁵ Admittedly, growth in WE, EE, and AF follows from the set target, and in this sense economic growth and external balances are altogether superior than in the baseline case. The central difference is that the instruments used to trigger growth in the reflation case are preferable to those used in the protection case. Both reflation in WE and investment in EE and AF are pro-growth in their own right; equally, reflation implies that the linkages with other blocs, including the United States and developing regions, will become stronger.

With regard to the United States, it is evident from Figures 6.5 and 6.6 that the 'protectionist solution' is unpersuasive compared with the reflation scenario. The US current account adjustment results more from the economic slowdown triggered by slower global growth than from the 'trade-switching' effect of protection. In this scenario, the detrimental effect on world growth would be even greater with more aggressive retaliatory measures adopted than those assumed in our model. Conversely, growth of the world economy – and US growth as well – would be significantly higher if pro-development policies are adopted not just by WE, but by other developed regions, by oil exporters, and so on.

In assessing the merit of this scenario, it should be recalled that our concern is not to create a 'best' or 'dream' solution, but rather to focus on measures that are plausible and within the reach of policy-makers in Europe and in neighbouring blocs. It should be self-evident that countries in Eastern Europe and Africa are themselves keen to embark on a development agenda leading to more balanced and sustainable growth. Western Europe will benefit as well. In fact, the Europe-driven reflation scenario simulated here is in Western Europe's own best interest. Not only would faster domestic demand growth in Western Europe raise employment and living standards at home. It would thereby also make a real contribution to the problem of global imbalances. Reflation in Western Europe could potentially reverse the trend of growing US external deficits and thus foreclose the risk of a more malign unwinding (the protection scenario, for instance). Moreover, many of the policy principles have already been agreed (raising official development assistance) or else are envisaged as part of the longer term expansion of the EU. In this sense, the model yields results which are 'modest' and 'realistic'. The only ambitious component relates to achieving energy efficiency, but we think it plausible that R&D in Europe should privilege such a crucial aspect of policy.

6.8 Conclusion

In this chapter we have explored the structural conditions under which the world economy is operating in the light of historic trends and apparent changes which have occurred in the past 15 years. During this period, the US experienced a reasonable rate of economic growth and the Euro Area has adopted measures to promote fiscal and monetary harmonization between member states. However, economic growth in the United

States has been accompanied by unprecedented external and internal imbalances. Growth in Europe (and other blocs) has generally been disappointing and has relied excessively on external demand, thereby contributing significantly to the build-up of global imbalances. These developments are largely the result of economic policies based on prevailing economic orthodoxy; namely that the critical thing to be concerned about is public sector discipline since private sector behaviour is subject to market discipline and by definition is self-correcting.

Such a framework is critically limited. Public sector prudence may end up being severely contractionary, as Euro Area experience shows, unless private spending accelerates to unprecedented and potentially hazardous rates. In turn, private sector driven growth has come to be correlated with excessive debt burdens, both internally and externally, as the experience in the United States confirms. In sum, 'more of the same' is not an option for the mid-term future.

For this reason, we use a parsimonious model framework capable of capturing key structural conditions of the world economy in order to explore a number of plausible scenarios. We have chosen to discard two potential outcomes resulting from no policy at all, namely a severe global economic slowdown and a market-driven adjustment based entirely on exchange rate realignment. The former is obviously unattractive; the latter is unrealistic.

The emphasis on financial, portfolio, and market liberalization as a panacea, with its focus on contractionary policies in the name of prudence, has actually led to a sub-optimal situation. If current imbalances are left to work themselves out through market forces alone, the result could be quite literally calamitous.

An alternative solution to current global imbalances is the recourse to protection. Such a course of action, controversial as it may be, is considered attractive by a number of leading policy-makers in the United States. In consequence, we devise a plausible protectionist strategy originating in the United States, with a minimum set of potential retaliatory measures in Europe. The macroeconomic implications of such a scenario, we conclude, are very disappointing.

A more congenial scenario does exist for the world economy; notably Europe, the United States, and the developing regions. Such a scenario requires moderate shifts in the composition of aggregate demand aimed at kick-starting Europe-wide economic growth accompanied by income generating effects in developing regions, particularly Africa.

In sum, this chapter shows that a Europe-led reflation scenario, although involving a mild deterioration in the EU's own external position, would stop current unsustainable trends from getting worse. This is a significant contribution, but it should be clear, too, that EU-led reflation will require a major change in the orthodoxy prevalent in Brussels and Frankfurt. Moreover, our scenarios amply demonstrate the potential offered by the income, trade, and investment linkages embedded in the structure of the world economy. The model simulations presented here and elsewhere suggest that the full reflationary potential of these linkages can only be realised if policy-makers

incorporate both the developmental and sustainability dimensions included above and explored elsewhere in this book.

Notes

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1. In the earlier literature, three broad categories seemed to cover all the ground: the 'elasticities approach' which focused on the determination of the market clearing level of equilibrium exchange rate; the 'absorption approach' that emphasized changes in real domestic income and the exchange rate; and the 'monetary approach' that treated the problem as essentially a monetary phenomenon (Isard 1995). In all these cases, market forces (at times helped by monetary fine-tuning) would restore balances in relatively short time without excessive pain.
2. It is customary to represent injections of leakages over two-year cycles. Had we expressed the same phenomena in terms of three-year cycles it would be apparent that the fiscal expansionary shift in the United States during 2001–03 was the most important in the last six decades.
3. In emphasizing the macroeconomic relevance of public sector deficits as counter-cyclical policy measures, we do not deny that the nature of the deficit matters; i.e., that the multiplier associated with infrastructure or social spending and tax breaks for low-income earners is far greater than that of tax breaks for the high-income earners. A change in the structure of the US deficit could raise the multiplier and thus achieve a greater stimulus; alternatively, a smaller but better targeted deficit could have the same countercyclical effect.
4. It may be useful to recall the derivation of the balances of domestic institutions from the basic national accounting identity.
5. In order for an improvement in net exports to result in a healthier financial position of the personal sector, various conditions need to be met: the improvement has to be relatively permanent; not all the additional income can be spent, and there must be room to increase output capacity without inflationary frictions, etc. Under normal circumstances these conditions would be satisfied.
6. Amongst the most influential views is the 'Monetary Approach to the Balance of Payments', MABP (Polak 1957, 1995) which is at the core of Financial Programming of the IMF. The MABP asserts that at the root of external imbalances lies an excess of domestic credit creation. The resulting acceleration of inflation makes it impossible to bring the economy back to balance. The model singles out public sector deficit as the critical variable for reining in domestic demand and reducing inflationary pressures. It is in this sense that many proponents consider MABP to be in effect a 'fiscal approach to the balance of payments'. Another influential view is the so-called 'Lawson Doctrine'. The former UK Chancellor of the Exchequer, Nigel Lawson, argued in the late 1980s that the emergence of a large current account

deficit should not be a cause of concern as long as the public sector was running a surplus. If the private sector was in deficit it must have judged that it was optimal to invest more than it saved (Williamson and Mahar 1998). The Stability and Growth Pact and the 'Golden Rule' that govern fiscal policy in the Euro Area and in the United Kingdom respectively are more sophisticated views of these doctrines, providing limited 'room' for public sector deficits. In the Euro Area the cap is in the form of a per cent of national income; in the United Kingdom it is accounting conventions separating government investment from current spending. Further, in the SGP there is a maximum of three years in which the fiscal budget can exceed the agreed limit (implicitly adhering to some notion of cycles). Meanwhile, in the United Kingdom the notion of the cycle is more explicitly recognized as a macroeconomic phenomenon affecting the public budget. But in essence, all this programmes postulate controlling the size of the governments and moderating private spending as the ultimate recipe for stability and growth.

7. The figure plots Eurostat consolidated accounts of the EU-15 members. Complementary plots are reproduced underneath for the main four European countries over a longer period.
8. The exception is Italy in the 1980s and France in the post-recession of 1991, where fiscal cycles were more extreme than their corporate sector counterpart.
9. It is worth noting that the plotted budget deficits are not adjusted for the impact of growth on tax revenues. Thus, equal values of opposite sign of fiscal deficits and corporate surpluses should most probably be interpreted as a net *ex-ante* leakage of the two sectors taken together. Conversely, public sector surpluses larger than corporate deficits in expansions should not be counted fully as an overall tightening on the demand side. As a rule of thumb, mild downturns (defined as a one percentage point decline in GDP growth) may add about half of a per cent of GDP to the fiscal deficit.
10. Obtained by a straightforward addition of current account deficits of USD billion. 470, 530, 655 and 790 (years 2002 to 2005 respectively) to the net liability position of USD 2340 billion at the end of 2001.
11. The *Plaza Accord* was signed on September 22, 1985 by the then G5 nations (France, West Germany, Japan, the United States and the United Kingdom). The G5 agreed to intervene in currency markets in order to trigger a US dollar devaluation *vis-à-vis* the Japanese yen and the German deutschmark (and other European currencies in turn). Such unusual support for government intervention was seen as the right response to an unusual situation: a US current account deficit of about 3.5 per cent of GDP, combined with a slowdown which many feared could end up as a 'triple-dip' recession which might be transmitted to the other G5 nations. Implementation in terms of dollar devaluation was effective but the correction of the US deficit was slow and, more importantly, uneven (mostly absorbed by European economies). Thus, on 22 February 1987, the *Louvre Accord* was signed by the then G6 (France, West Germany, Japan, Canada, the United States, and the United Kingdom), aimed at stabilizing the international currency markets and halting the decline of the US Dollar.
12. Article XIX of the GATT agreement, Round 1994 (prevailing at the WTO) includes a safeguard provision that allows protectionist measures to be taken in order to deal with emergencies, unlawful practices elsewhere or in general export practices elsewhere that injure domestic producers and have significant effects on welfare and employment. As far as the United States is concerned, Section 301 of the 1974 Trade Act authorizes the US President to enforce unilaterally perceived US rights under international trade agreements to respond to 'unfair' foreign practices

(Schwartz 2003). So far, US manufacturers have filed a petition with the US Trade Representative's Office to get the WTO to apply trade sanctions against China because of its widening bilateral trade surplus with the United States.

13. The other members of this bloc are Australia, New Zealand, Israel, and South Africa.
14. In the current model, the WE bloc encompasses the most developed countries of the region; namely Austria, Belgium, Denmark, Finland, France, Germany, Greece, Iceland, Ireland, Italy, Luxembourg, Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, and United Kingdom.
15. As such exercise, it would have seem futile that Europe as a whole embarks on such a trade-war with the United States to get less than trend growth to warrant employment creation.
16. EE comprises the European states formerly under the influence of the USSR (except Eastern Germany which is part of WE). This includes: Albania, Bulgaria, former Czechoslovakia (Czech Republic, Slovakia), Hungary, Poland, Romania, Slovakia, and former Yugoslavian states (Bosnia and Herzegovina, Croatia, Macedonia, Serbia and Montenegro, Kosovo, Slovenia).
17. We have not assumed that the other countries which would be affected by trade protection in the United States and Europe would in turn implement measures to retaliate and intensify intra-regional agreement. There is no end to the amount of successive runs of complications in such a setting and thus we have taken the most parsimonious, yet plausible, approach.
18. Such level of 'integration' was last achieved in the 1970s; returning to such a level seems incompatible with the effects of globalization.
19. Developing countries, meanwhile, were imbued into the fiscal orthodox doctrine since the early 1980s at least. Since such time, external debt crises brought many to their knees and creditors, aid donors and multilateral organizations conditioned their support on the strict application of the 'monetary approach to the balance of payments', a doctrine centred on fiscal tightening (see note 5).
20. For a full historic account and institutional analysis of the macroeconomic model governing fiscal policy (and the management of domestic demand by large) in Europe, see Irvin (2006).
21. The striking similarities in the macroeconomic picture in the United Kingdom and the United States vindicates William Keegan's observation that: 'Gordon Brown and Ed Balls studied the US system before election and had the usual Treasury official stationed in the Washington Embassy from mid-1997, one of whose principal tasks was to study the US experience, learn the lessons and pass them on' (2003, p.239).
22. It is worth emphasizing that the design of the world model currently in use has a fixed bloc structure which in particular aggregates all the countries of Western Europe (WE) into a single bloc (see note 16). In this context, a Europe-led reflation is broader than reflation in Euro Area countries alone. Furthermore, the model simulation described here envisages reflation in EE countries as well.
23. The fact that net injections of about one per cent of Europe's GDP targeted at manufacturing and extraction capacity in Europe and Africa could achieve such results should not be surprising. The combined national income of Eastern Europe and Africa is about one quarter of Western Europe's. The injections in those blocs will initially encounter incremental capital output ratios (ICOR) of about four to five (diminishing over the years by a half). Considering employment and demand

linkages, plus the synergies and the trade linkages within each bloc and with Europe itself, the initial effects will be magnified.

24. At present 164 countries have ratified the 'Kyoto Protocol', which all together encompass about two-thirds of global carbon emissions. Amongst the most heavy users of energy which have not ratified are the United States and Australia.
25. As noted earlier, the baseline represents projected trends in the exogenous model variables and generates solutions by considering structural conditions obtained from the econometric results. A further qualification worth mentioning concerns 'structural conditions'. As explained in Izurieta and McKinley (2006), expenditure functions depend on both income and accumulated wealth, following the tradition of econometric modelling in the Cambridge Economic Policy Group (CEPG). Since the model at its current stage of development does not yet generate financial wealth per country/bloc, the stock-flow restriction typical of the 'CEPG expenditure function' is introduced by considering a 'mean lag adjustment'. In other words, domestic expenditure as a whole is constrained by the recurrence of accumulated external deficits, in the same way as private expenditure may slowly reach a plateau when net worth deteriorates due to the growing debt burden. In this regard, our baseline can be considered a 'structurally conditioned' baseline. A totally unrestricted baseline would merely follow the trends and would be consistent with what 'consensus forecasts' would postulate. Such an unrestricted baseline would lead to ever-growing current account deficits in the United States, of the order of 10 per cent of GDP within a decade.

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Part III

Reforming Euroland's Institutional Framework and Macroeconomic Policy Governance

7

Replacing the Stability and Growth Pact?

C. A. E. Goodhart

7.1 Introduction

The Euro Area is unique in its structure, whereby a single, *federal monetary* system coexists with separate *national fiscal* and labour market management. Central federal competences in Brussels in these latter fields are *much* weaker than in other federal systems, such as the United States, Australia, Canada, Germany, and so on.

This separation, between a federal monetary policy and national fiscal and social policies, has caused numerous difficulties. With the member nation states unable to manage (to stabilize) their own economies from (asymmetric) shocks by the use of monetary and exchange rate policies, there would be a natural tendency for them to rely more on fiscal policy for that purpose. But there is then a danger that, in the absence of market discipline causing interest rates and exchange rates to move against, and punish, a country within the Euro Area when its fiscal policy is perceived by markets as imprudent and unsustainable, there would be a systemic temptation towards excessive fiscal deficits. That was the justification for the Stability and Growth Pact (SGP), now firmly established in the Amsterdam Treaty (1997).

But this latter constraint implies that countries within the Euro Area which are suffering from asymmetrically adverse economic conditions are left with *no* significant instruments of demand management to attempt to improve their economy once they have run up against their SGP deficit limit. What then remains are market mechanisms of wage/price adjustment, fostered where possible by structural reform. Sometimes such market mechanisms work reasonably successfully, as they appear to have done in Germany, where competitiveness has been restored by keeping down the growth of unit labour costs, though such deflation of wage costs has now continued for too long.¹ Sometimes such market mechanisms have not worked sufficiently, as appears to be the case now in Portugal, Greece, and Italy. In either case there will be an overpowering temptation for such, relatively impotent, Ministers of Finance to blame the ECB for having 'excessively tight' policies,

whether, or not, this is the case overall for the Euro Area. The consequent public wrangling has, at times, been unseemly.

Some academics, for example Padoan and Rodriguez (2004), have applauded the overall constraint on government demand management policies on the grounds that, when private sector agents have their 'backs to the wall', then structural reforms and greater labour (product) market flexibility will be encouraged. Others, for example Mabbett and Schelkle (2007), doubt whether structural reforms, and flexibility, are promoted in conditions of economic uncertainty and distress.

It is not the purpose of this chapter to discuss either the general issue of what economic conditions may be most conducive to such structural reform, or the more pressing particular question of how Italy may escape from its current economic difficulties. Instead, this study adopts the more limited remit of asking how monetary/fiscal issues may be brought into better balance within the Euro Area.

In some part the move to monetary union may have been influenced by much the same 'backs to the wall' argumentation. There were some who realized that the adoption of the euro would introduce tensions between (federal) monetary policy on the one hand and (national) fiscal and other policies on the other, but who believed that such tensions might be creative, in the sense that they could hasten the transition to much wider political union. Some of the French 'monetarists' took this line.

Indeed one possibility had been that further progress towards closer political union would have brought with it greater fiscal (and other policy) harmonization and centralization, but such hopes seem to have been dashed by the negative votes on the referendum on the Constitution by two key founder members of the EU. Moreover, the Stability and Growth Pact itself is in disarray. Its applicability in future to any large country is in doubt and its asymmetric implementation on small countries is deeply resented by those same countries.

The Stability and Growth Pact was almost bound to fail. It was not in the self-interest of governments, at least in the larger countries, to abide by it, once they had become members of the Euro Area. Moreover, the penalties for persistent infringement were neither credible nor politically acceptable. In other large federal countries, such as the United States or Australia, it is easier to strike a bargain between the federal centre and the subsidiary states. The states agree to abide by some version of balanced budget commitment, and in return the federal centre provides both stabilization and redistributive functions. Moreover, the scale of expenditure and revenue flows passing through the federal centre, as compared with the constituent states, means that the federal authority has the clout, though sometimes – as in Argentina – it lacks the political will, to force the constituent states to abide by their side of the bargain.

The size of the federal centre in the European Union is, however, *much* smaller relative to the constituent nation states than in other Federal

countries. Moreover, the remaining wide differences in stages of development, and in real income levels, plus the lack of political harmony between countries, and concerns about the possible establishment of dependency cultures, make the allocation of any redistributive function to the federal centre, beyond the present schemes, such as the Cohesion and Structural Funds, doubtful.

In Section 7.2 of this chapter, I shall argue that the federal monetary policy needs to be supported by some, relatively small, shift of competences from the individual nation states to a, somewhat enlarged, federal budget in Brussels. This returns to earlier exercises that the European Commission put in motion in prior decades to examine what were the (minimum) fiscal changes necessary to support a single currency. The first of these exercises was the MacDougall Report (1977). The second was the EC's Report on 'Stable Money-Sound Finance', in which I served as an external expert, (see Goodhart and Smith 1993). This latter initiative was shelved by the EC after widespread hostility was expressed by the nation state members to the transfer of *any* further competences to the federal centre. Given the present problems of the euro regime (of governance), it would seem a good time to dust down this past work.²

The main, but not the only, purpose of this transfer is to allow the federal centre to undertake partial stabilization services within the Euro Area. It has been argued (Melitz and Vori 1993) that the individual countries, or at least the larger ones amongst them, can undertake such stabilization services internally. Even insofar as this is the case, and it is far from self-evident that it is, especially now that the SGP is in place, one of the purposes of the transfer of stabilization functions would be simultaneously to give the asymmetrically and adversely affected recipient country more reason to be grateful for membership of the zone, and more concerned about potential penalties in exiting the zone. In other words, the point of the exercise is to shift the political economy balance in favour of (continued) membership of the euro. An even simpler proposal, which I owe to Melitz (2003), is just to limit penalties for countries overstepping the SGP deficit limit to those which *also* have a debt ratio in excess of 60 per cent.

It may seem odd, and against the temper of the times, to react to the defeat of the referendums on the Constitution by arguing for some further fiscal centralization. But in my view, it provides the minimum necessary to hold the Euro Area together in the longer term. I shall also note that the financial integration of the Euro Area provides an argument for some centralization of possible fiscal measures for resolving a cross-border European financial crisis.

One of the key structural problems is that all the main institutions in the EU, Commission, Parliament, and so on, contain *all* the member states, both those in the Euro Area and those outside it. But the need for federal centralization is much more acute for Euro Area members, than for non-members. That raises a question whether some institutions, and some functions, can

be focused on Euro Area member states alone, particularly since the entry of the United Kingdom into the Euro Area now seems to have been postponed to an indefinite future.

Nevertheless the scale of fiscal transfers from the federal centre in the Euro Area to the constituent nation states during asymmetric downturns is unlikely to be large enough to persuade them to abide by any self-denying ordinance on budget deficits. So, there is a need to support further federal stabilization funding, when needed, by stronger market mechanisms to deter the emergence of unsustainable fiscal policies in the guise of a large, and growing, debt burden. What this requires is a complete rethink of the proper prudential capital requirements on financial intermediary holders of the debt of the constituent nation states. This is the subject of Section 7.3.

This paper brings together two previously separate strands of my own work. The first, from Goodhart and Smith (1993), argues for a transfer of stabilization functions to the federal Euro Area centre. The second, from Goodhart (2005) on 'The Links between Fiscal and Monetary Policies on the one hand and Financial Stability on the other', proposes a market mechanism to replace the Stability and Growth Pact (also see Goodhart 1992). Taken together, as proposed here, this outlines a programme that could help to replace the SGP. I doubt, however, whether these proposals will be found acceptable. So I remain pessimistic.

7.2 Stable money – sound finances

As the Maastricht Treaty (December 1991) on European Union, which paved the way towards the European System of Central Banks and a single currency, was drawing to its conclusion, the European Commission set up a joint EC/academic expert group to explore what changes, if any, needed to be made to Community public finance to underpin the prospective monetary union. The Directorates-General for Economic and Financial Affairs and for Budgets invited some nine independent academic experts, including myself, to contribute to this study. It was chaired by Horst Reichenbach, then acting Director of the Economic Service of Community Policy, and Marc Vanheukelen was its *Rapporteur*. The main Report, drafted primarily by the EC participants, entitled 'Stable Money – Sound Finances: Community public finance in the perspective of EMU' was published, after a considerable delay, in *European Economy*, no. 53 (1993), and the supporting papers, both by the academic experts and the EC economists and officials, were published, more or less simultaneously, under the title, 'The Economics of Community Public Finance' in *European Economy*, 5 (1993).

It is, perhaps, worthwhile recalling the background to this report. As the Report noted, p. 13:

In 1977, the MacDougall report undertook a pioneering effort to assess in a systematic way the role of public finance in European integration.

Building on an analysis of the role of the central budget in several federal and unitary States and on the insights from the available 'fiscal federalism' literature, the MacDougall report formulated a number of policy recommendations, in particular towards strengthening the capacity of the EC budget. Following these recommendations, the budget would need to grow to a minimum of 2 to 2.5 per cent of GDP. Although it did not elaborate the matter at any length, given the breakdown of the first EMU attempt, the MacDougall group deemed that the budget had to be raised to 5 to 7 per cent of EC GDP for it to be compatible with monetary union.

Despite the fact that little has come in the way of concrete execution of its policy recommendations, the MacDougall report can be seen as a benchmark for thinking about the EC budget because it took a far-sighted view and large parts of its analytical underpinnings remain valid. However, the normative economics of EC integration since the end of the 1970s have undergone appreciable changes as a result of, on the one hand, a better analytical grasp of, and longer experience with, the integration process itself, and of the altered views on the role and effectiveness of public economic intervention on the other. The debates on the contents and design of, first, an internal market, and, afterwards, an economic and monetary union, and the associated benefits and costs, have enabled a clearer insight into what EMU entails. The poor economic performance of most European countries between roughly 1975 and 1985 has prompted strong doubts about the usefulness of discretionary policy activism in the macroeconomic domain. Instead, the emphasis has come to lie more on the need for structural adjustment in goods and factor markets, leading to a reappraisal of the microeconomic responsibilities of government by way of the provision of public goods, deregulation or reregulation and incentives related to taxes and transfers.

These final sentences are, in some part, bureaucratic short-hand for a political appreciation that the member states of the EU would not countenance an expansion and an extension of the fiscal competences of the federal community on anything like the scale that the MacDougall Report has advocated as the minimum necessary to support EMU. Indeed, one reason for the temporary suppression of our own Report was to allow time for the Edinburgh agreement (1992) to be achieved on the medium-term development of EC public finances, without scaring the assembled Ministers of Finance that yet more would shortly be asked of them.

So there was a need for the Report to cut its coat to suit its cloth. As noted in the Summary and Conclusions in pp. 6 and 7:

The central message of the report is that a small 'EMU budget' of about 2 per cent of Community GDP is capable of sustaining European economic and monetary union, including the discharge of the Community's growing external responsibilities [see Table 7.1].

Table 7.1 EC expenditure in the early years following the introduction of a single currency and comparison with the 1992 budget

Expenditure categories	Indicative % of EC GDP	% share	1992 budget as % of 1992 GDP	% share in 1992 including EDF*
1. Agricultural expenditure	0.4 to 0.5	23	0.67	56
2. R&D, infrastructure, energy, education, environment	0.15 to 0.2	10	0.06	5
3. Structural expenditure (including Cohesion Fund)	0.4 to 0.5	23	0.32	27
4. External aid (including EDF*)	0.5 to 0.55	27	0.07	6
5. Expected outlays under regional stabilization mechanism	about 0.2	12	-	-
6. Other	0.1	5	0.07	6
Total	1.75 to 2.05	100	1.19	100

* EDF = European Development Fund.

This is clearly contrary to much of the conventional economic wisdom, reflected in the MacDougall report as well as in the literature on economic and monetary union. Three distinctive features of this report compared to previous analyses explain the difference in the group's conclusions:

- (i) The principle of subsidiarity is applied rigorously.
- (ii) No explicit role is foreseen for the Community budget in Community-wide macroeconomic stabilization.
- (iii) While recognizing that strong political forces are at play and that the reduction of regional disparities is an important Community objective, the economic case for a permanent and substantial increase in interregional redistribution, as a direct consequence of EMU, is found to be weak.

In my view the most important, and possibly original, feature of the Report was that tailor-made stabilization mechanisms, to mitigate the effect of asymmetric shocks hitting individual countries, could be designed relatively inexpensively. Thus again in the Report (same pages), it was noted that:

In existing federations, central governments are responsible for fiscal policy, with their budgets regarded as a potential union-wide stabilization instrument alongside the single monetary policy. For Community-wide stabilization the monetary policy of the European system of central banks

at EC level will be available in the same way as in existing federations. The group considers that, in addition, attention needs to be paid to the aggregate budgetary stance through the coordination of national budgetary policies. Making such coordination effective will thus be one of the main challenges in the future management of EMU. Nevertheless, the group concludes that no explicit role in Community-wide stabilization needs to be foreseen for the EC budget.

In existing federations, the central budget has a significant regional stabilization effect. This takes place mainly through automatic stabilizers via budgetary flows principally serving other purposes, for example social security. There are very few explicit instruments designed to help regions in the case of economic difficulties.

The group shares the view of much of the literature on EMU that there is a strong case for a Community role in assisting Member States to absorb severe specific shocks. This is in order to compensate for the loss of the exchange rate as an adjustment instrument and for the loss of an independent monetary policy, and should help to prevent longer lasting economic deterioration which could increase the pressure for greater redistribution. It should also make it easier for Member States to respect fiscal discipline rules.

Moreover, the group's confidence in this unconventional conclusion rests on one of its main findings. Inexpensive and effective mechanisms can be operated for assisting Member States hit by adverse economic developments (shock absorption) if they are explicitly designed for this purpose rather than being the automatic implicit consequence of much larger budgetary flows serving mainly other purposes as in existing unions. Such a shock-absorption mechanism would provide a cushion against adverse developments in the Member States to a similar degree as automatic stabilizers do, for example, in the United States. For a shock absorption scheme based on changes in unemployment rates, the group estimates that the average annual expenditure might be of the order of 0.2 per cent of EC GDP.

The background to this central plank to the Report was Section V of the accompanying papers on 'The Economics of Community Public Finance', incorporating the following:

C. A. E. Goodhart and S. Smith, Stabilization

A. Majocchi and M. Rey, A special financial support scheme in economic and monetary union: Need and nature

T. Papaspyrou, Stabilization policy in economic and monetary union in the light of the Maastricht Treaty provisions concerning financial assistance

A. Italianer and M. Vanheukelen, Proposals for Community stabilization and mechanisms: Some historical applications

J. Pisani-Ferry, A. Italianer and R. Lescure, Stabilization properties of budgetary systems: A simulation analysis

This Report preceded the Waigel initiative to establish a permanent constraint on EU country deficit and debt projections, later metamorphosing into the Stability and Growth Pact agreed at the Amsterdam Treaty. Had this latter been in place in 1993, the argument that the major Euro Area countries could use their individual fiscal policies to stabilize adverse asymmetric shocks (Masson and Melitz (1991) and Melitz and Vori (1993)), would have been somewhat weakened.

In any case the regional stabilization mechanism was not the main element in the proposed increase in EC fiscal expenditures from 1.2 per cent of EC GDP (1992) to about 1.9 per cent in the early years of a single currency. As shown in Table 7.1, p. 2, of the Report, external aid was projected as a larger share, and structural expenditures about as much.

Moreover the tax basis to finance the expansion of the federal community budget was spelt out. In my view the most obvious candidate not only was, but remains, the seignorage profits of the ECB. Given that the money supply, the euro, was to be, and now is, a unified, single Euro Area competence, it surely follows that the seignorage resulting should also be a federal receipt. The artificial formula, based on relative population and GDP, for dividing this up amongst the constituent nation states has no good justification except that of making life easier for national Ministers of Finance. Other possible taxes were on CO₂ emissions, and, though this was more debatable, cash flow corporate taxes (see Report, pp. 86–92, and the associated papers by Spahn (1988, 1993a and b).

While my own paper, joint with Stephen Smith, was strongly supportive, the key papers were by EC economists, the first by Italianer and Vanheukelen, and the second by Pisani-Ferry, Italianer and Lescure. The conclusions of the first of these papers read as follows (p. 505):

The first conclusion is that, based on an estimated annual cost equal to some 0.2 per cent of Community GDP, a full stabilization mechanism could be set up which would, on average, provide approximately the same degree of stabilization as in the United States. The main reason why such a high degree of stabilization can be achieved at relatively little cost is that, other than in existing federations where stabilization properties are usually a by-product of the tax and transfer system, the mechanism proposed here is explicitly designed for stabilization purposes. Consequently, its efficiency in terms of the degree of stabilization obtained in relation to the costs of the system is much higher than that in existing federations.

A second conclusion, however, is that the full stabilization scheme, although being simple and operational, could not be devoid of the standard problems involved in stabilization: identification of the shock, an

implementation lag and possibly a procyclical bias. Nevertheless, it was demonstrated on the basis of two different cross-section/time-series estimations for all Community Member States that there is a clear link between the evolution of the unemployment indicator used for the system and shocks to GDP growth in the same year. When the latter variable was replaced by its lagged value, this did not change the estimation result. Moreover, due to the fact that the scheme is based on changes in unemployment rates but consists of intergovernmental transfers, the problem of moral hazard with respect to individuals, which is usually associated with Community unemployment benefit schemes, is avoided.

The third conclusion is that if, for any reason, the full stabilization mechanism is not deemed to be desirable, a limited stabilization scheme can be devised at equal or lower cost which, as a form of insurance, can nevertheless provide a reasonable degree of stabilization in the case of an individual shock above a certain threshold. The overall degree of stabilization of both the full and the limited stabilization mechanism depends mainly on three parameters which ultimately would need to be determined politically: the minimum threshold for the relative unemployment change which qualifies for payment, the size of the payment and the maximum annual payment per Member State.

Despite being offered a purpose-built stabilization scheme, giving as much stabilization to adversely affected nation states (or regions depending on the structure of the system) as in the United States, but at a tiny fraction of the cost, the Report was badly received at the time by the representatives of the nation states, roundly rejected and thrown on one side. Indeed, it entered the oubliette of rejected Reports, to become almost entirely forgotten.

There were no doubt many reasons for this rejection. At least six can be identified:

- (a) An inbuilt disinclination amongst national Ministers of Finance for *any* transfer of competences, on either the expenditure or the revenue side, from themselves to the Community federal budget.
- (b) A concern about the moral hazard implication of *any* insurance (stabilization) scheme. Thus the ultimate resolution to asymmetric shocks is usually held to be greater labour market (wage) flexibility. Would intra-Euro Area transfer payments reduce the pressure to introduce structural changes to enhance such flexibility?
- (c) A belief that a Euro Area stabilization scheme was not necessary, since member countries could do just as well on this front on their own (Mélitz and Vori, 1993).
- (d) Mélitz and Vori (1993) also argued that a stabilization scheme based on relative movements in unemployment or income, or even on first

differences of these variables, could easily cross the borderline into redistribution, because such variables tend to be auto-correlated.

- (e) A lack of appreciation that there was any necessary connection, or interaction, between having a federal monetary system and a complementary fiscal system.
- (f) The fact that the minimal stabilization proposal was part of a larger package that would have raised the EU budget to over 2 per cent of GDP.

Some of these arguments have, in my view, become weaker over time. The idea (item (b) above) that labour market reform is more likely to be successful when unemployment is high, or product market reform when profits are squeezed, is not self-evident. In an article in the *Financial Times*, 31 August 2005, on 'Only teamwork can put the euro area on a steady course' (p. 15), Pisani-Ferry wrote that:

This interdependence matters especially for measures that are costly in the short run, because a lower interest rate can help to offset their adverse effects and improve their overall balance. This is the case for many reforms. Labour market reforms may increase unemployment before they lower it if they create anxiety and lead firms to shed labour faster than they create new jobs. Product market reforms may also depress growth because incumbents react immediately to the loss of rents while entry only develops over time. This is why reform is easier when accompanied by monetary expansion (to offset the negative effects of reform on aggregate demand) and fiscal stimulus (which also helps to compensate the losers). This kind of strategy can be followed outside the eurozone, not within it – unless reforms are co-ordinated.

So a stabilizing fiscal transfer, when a Euro Area country is suffering an asymmetric adverse shock, is, it can be argued, just as likely to promote, as to deter, structural reform.

As regards (c), self-stabilization implies the assumption of greater debt within the country, whereas a fiscal transfer from the Euro Area spreads the debt burden more widely. Insofar as there is *any* validity in neo-Ricardian analysis about the dampening effect on present expenditures of future expected taxes, the fiscal transfer would, euro for euro, be more stimulating than the self-stabilization. Furthermore, the operation of the Stability and Growth Pact has meant that there have been quite strict limits to the extent that Euro Area countries can self-stabilize by fiscal means, at least without breaking, or bending, the terms of the SGP.

As regards (d), it is certainly the case that one could not base a stabilization scheme (without redistributive content) on differentials between *levels* of income or unemployment. But it is implausible that countries would suffer greater declines in income, or increases in unemployment, than other Euro

Area countries on a *persistent* basis. Moreover, if they did, pressures on them to exit the Euro Area would grow. Take the example of Italy. It is hypothetically possible that continuing lack of competitiveness could lead incomes (unemployment) to grow slower (faster) than in the other Euro Area countries for several years in a row. It is also arguable that in such circumstances fiscal support from other members of the Euro Area would not help to resolve the basic problem, of lack of competitiveness. But if the basic alternatives would then seem to be to bite the bullet in the labour market, or to leave the euro, might a modicum of fiscal help from the other countries of the Euro Area make the first choice more palatable? Also such fiscal assistance could be made repayable in the event of a net debtor country exiting the euro, (but not otherwise?), and if it is assumed that asymmetric shocks are temporary and cancel out over time, members should not be net-debtors in the long run.

Finally, as regards (e) above, realization that the success of a currency depends crucially on its relationship with the fiscal, and other, policies of the central sovereign body is beginning to become more widely understood. The failure to make that mental link, largely due to errors in mainstream monetary theory, on which I have written elsewhere, for example Goodhart (1998), and the consequent weakness of the monetary/fiscal relationships in the Euro Area, was always the single currency's fundamental weakness. If the constituent nation states are going to abide by fiscal rules, and thereby limit their ability to adjust their own economies to a shock, they need to expect to gain something in return. Imposing non-credible, and politically unacceptable, penalties for transgression of the SGP was never going to be successful, certainly not on its own.

The (implicit) bargain in most federal countries is that the constituent states abide by fiscal rules, while the central federal government provides the main redistribution and stabilization functions. For reasons outlined in the Report, pure redistributive transfers were not advocated. Thus the Report noted (p. 6) that:

The explicit instruments for interregional redistribution should attempt to minimize the inherent dangers of interregional redistribution: distributional inertia preventing funds from being allocated according to changing needs; aid dependency leading to higher factor prices, hindering rather than fostering productivity gains and innovation; 'grantsmanship', profiting often richer and better organized recipients; moral hazard, i.e. creating eligibility artificially; and simple economic inefficiency, i.e. 'cathedrals in the desert'.

Also see the papers in Sections II and IV of 'The Economics of Community Public Finance'.

In truth, the targeted stabilization mechanism outlined in the Report was purposefully thinned down to be as small as possible, and yet make a

significant difference. It was never expected, or intended, to offset asymmetric shocks completely. Yet it would have a political economy function as well. It would represent a benefit, in facilitating adjustment, from membership in the euro, that would help to counter the costs in not being able to adjust to the asymmetric shocks that Euro Area membership brings with it. Otherwise a country, facing rising unemployment with no macro-economic means to respond, may be all the more tempted to exit the euro and go it alone.

Even, however, with the addition of some centralized stabilization mechanism, the larger Euro Area nation states will still be tempted to run large deficits during periods of slow, or negative, growth. We discuss how to counter such temptation, and in the process to get rid of the SGP, in Section 7.3.

That leaves the remaining two objections to the proposal to introduce a centralized Euro Area stabilization scheme, which is (item (a) above) that national Ministers of Finance (and their officials) are generally opposed to losing any competences to the federal community budget, and (item (f) above) that it would raise the proportionate size of the EU budget. Note that such a stabilization scheme would only be applicable, for obvious reasons, to Euro Area countries. Those EU countries, such as the United Kingdom and Sweden which are not members of the Euro Area would not benefit, since the scheme would hardly be applicable to them. This suggests that such fiscal decisions should be the province of the Euro Area heads of state. Again Pisani-Ferry (2005) has put the point well, he wrote:

First, the institutional framework needs to be adapted. The eurozone finance ministers who meet in the eurogroup do not set the reform agenda. The heads of government who are in charge of that agenda never meet in eurozone format. Neither do the labour or economy ministers. A eurozone meeting of the heads of government would remind them of their responsibility for the sustainability of the currency area that they have created, and would allow them to discuss their reform agendas and confront the effects of their interdependence.

There would, however, be constitutional and institutional problems in shifting the balance of government from the European Union more widely to the narrower Euro Area. All the main institutions, Commission, Parliament, Court, are established at the wider EU level. It was never envisaged that the EU would be split on a quasi-permanent basis, with a long-standing division between a central Euro Area group and a penumbra of member states with independent monetary policies. Can the Euro Area continue successfully without supporting fiscal, and related, governance mechanisms? But if such governance mechanisms were established at the Euro Area level, what would happen to the established wider EU institutions? These are deep questions, which go beyond the scope of this chapter.

Of course, it remains quite probable that the Euro Area politicians on their own would still reject a mutual self-help federal stabilization scheme. That would just underline the key point that it is inherently extremely difficult to combine a single federal monetary system with a decentralized system in which fiscal and most other sovereignty is retained at the nation state level. The euro regime is not only unique; it is also uniquely unbalanced, as between the federal monetary system and the national fiscal systems.

It is also unbalanced in another, but quite similar, dimension. This is that macro-monetary policy resides, at the federal level, with the Governing Council of the ESCB, but responsibility for systemic financial stability and crisis management resides with the nation states. As Padoa-Schioppa has written, in his Chapter on 'Supervision in Euroland', in *Regulating Finance* (2004):

This essay will focus on another, less fundamental but still important novelty of the euro-area's monetary constitution. It will discuss the novelty of abandoning the coincidence between the jurisdiction of monetary policy and the jurisdiction of banking supervision. Monetary policy embraces the twelve countries that have adopted the euro, whereas banking supervision remains national. Just as there is no precedent of any comparable size of money disconnected from states, there is no precedent for a lack of coincidence between the two public functions of managing the currency and controlling the banks. In the run-up to the euro this feature of the system was explored, and some expressed doubts about its effectiveness.

This latter divorce, in my view, arises largely from another facet of the monetary/fiscal imbalance in the Euro Area. This is that the resolution of a financial crisis can prove very expensive. The only present source of funds to meet such crisis calls is to be found in taxpayers' money in each individual nation state. If the individual Euro Area Treasuries are to bear the costs of financial rescues, they are going to want to be able, if not to run the show, at least to have a veto, a control, over any use of their own funds. He who pays the piper calls the tune.

Whereas it is generally believed that the initial decision to give no clear-cut prudential role to the ECB was due to the ideological position at the time of the Bundesbank and the German representatives at Maastricht, the deeper and longer-lasting barrier is the absence of any Euro Area fiscal competence in support of ECB crisis management. Indeed, absent of any such fiscal back-up, the ECB may even be reluctant to participate in Lender of Last Resort operations, because such LOLR actions may leave a central bank open to the risk of loss, depending on collateral and margin requirements. Without fiscal support, the ECB may prefer the member NCBs, with their access to national Treasuries, to take full responsibility for any necessary LOLR action.

So the argument here is that, should there be a desire to centralize the financial stability function in the Euro Area, alongside the single macro

monetary policy function, then the very first priority is to identify how the associated necessary fiscal support may also be centralized. There are various possible ways of doing so, and I intend to do further research on this, in conjunction with Dr D. Schoenmaker of the Netherlands Ministry of Finance. Perhaps the simplest alternative would be to allow the EC to borrow, in order to raise funds to resolve and settle a cross-border financial crisis. As in the case of the Tripartite Standing Committee on Financial Stability in the United Kingdom, restriction on undue resort to such usage of funds could be achieved by giving each party to the exercise, that would be the EC, the ECB, any separate Euro supervisory body, and perhaps also the main national bodies involved, a veto to prevent the use of such rescue funding.

7.3 How to replace the stability and growth pact

Walter Wriston of Citibank is notorious for having claimed that 'Sovereigns never go bankrupt.' This is not necessarily so, even when the sovereign offers debt denominated in its own currency. When, however, a sovereign, or a subsidiary layer of government, issues debt in the currency of another party, then the debtor can no longer meet its obligations by printing money to do so, thereby reducing its real cost by inflation. In this case, of foreign currency debt, the choice on the debtor reverts to two, that is, raise the requisite funds or default. That raises the potentiality for default considerably.

Most emerging market economies (EMEs) find it hard to borrow much in their own domestic currencies. Lenders fear the temptation for such government borrowers of subsequently inflating away the real value ('original sin'), and the markets for such debt are thin, with large bid-ask spreads and sizeable other transaction costs. The roll-call of EMEs who have defaulted on their foreign currency debts is long, and needs no repeating.

But just as EMEs cannot issue debt denominated in their own currency, nor can subsidiary governments, at regional, provincial, state, local, municipal levels. When federal control of subsidiary-level deficit financing is weak, as has been the case in Argentina and Brazil, for example, then this tends to work back to weaken fiscal control at the federal centre. There are several reasons for this:

1. *Financial.* Many local banks and other financial intermediaries hold so much local government debt that they would also be driven into default by the failure of their local government. So the initial public sector default could/would generate a wider financial sector debt/default spiral. So the subsidiary government cannot be allowed to default and must be bailed out.
2. *Political.* The collapse of a major subsidiary government with large outstanding debts would adversely affect so many other stakeholders (beyond the banks and OFIs) that it would adversely impinge on the standing of the political party in office at the federal centre.

3. *Reputational.* The default of a major local governmental body would cause an immediate review, and re-rating of all other possibly similar-based bodies, and indeed very possibly of the federal government itself.

For all these reasons there has usually been an (implicit) contract between the federal and the provincial (subsidiary) layers of government. On its side the subsidiary (state) government agrees to some fairly stringent (often federally imposed) constraints on its ability to run deficits. On the other hand the federal government implicitly (or even explicitly) guarantees the debt of the lower level governments, *and*, partly through automatic stabilizers and partly directly, offsets adverse asymmetric shocks affecting differing regions by a system of inter-regional fiscal transfers.

There is no basis for such a bargain amongst the major countries and the federal institutions in the Euro Area. The federal institutions in the EU have neither the ability, nor the wish, to guarantee the deficits of the subsidiary state governments. The ECB is admonished *not* to support failing state governments, and there is no fiscal competence at the federal level either to make inter-regional transfers in response to asymmetric shocks or to support the ECB in meeting the burden of bailing out a failing state government. So the federal government in the EU neither can, nor wants to, carry out its part in the kind of implicit bargain observed in other federal systems.

Since there is no *quid pro quo* from the federal side, it is not surprising that the (large) nation state governments in the Euro Area chafe at the constraints imposed on their freedom of fiscal action by the Stability and Growth Pact, despite the fact that the SGP gives them more fiscal flexibility than available to subsidiary state governments in many other federal countries, for example in the United States. Absent observance of the SGP, excessive deficits in the EU could be a major potential source of financial fragility.

An additional problem is that the financial regulators, being mostly public sector bureaucrats themselves, are prone to be 'captured' by, be unduly concerned with, their masters and their masters' concerns in Ministries of Finance. Thus regulators are inclined to give low risk-weightings to nation state debt irrespective of whether such debt is in foreign currency or domestic currency form. The independent ratings agencies are better in this respect, but may still be somewhat swayed by political pressure. In particular, there is no appropriate risk weighting for concentrations of (bank) holdings of the debt of a single obligor. Thus Belgian banks hold vast quantities of Belgian government debt; Italian financial intermediaries massive holdings of Italian government debt, and so on. In the absence of a strict, and strictly observed, SGP, this is a source of danger.

If the SGP is found to be unenforceable, or so relaxed as to be ineffective, this danger would need to be recognized. What should be done is, then, to relate the risk-weighting to the proportion of the portfolio represented by any single obligor's debt, where that debt was denominated in foreign

currency form (remembering that the euro is effectively a foreign currency for the member nation states, in the sense that no member nation state has any control over the printing press). Thus, under an appropriate risk weighting, a bank might hold up to, say, 2.5 per cent of its assets in the debt of any one such obligor, at the risk weighting applied to that obligor. Beyond that, and on an increasing scale, the risk-weighting applied to concentrations of such risk would rise. The idea would be effectively to limit the holdings of, say, Greek government debt in Greek banks and other Greek financial intermediaries.

The purpose would be to try to ensure that, if a euro nation state defaulted, it would not drag down its own financial system into a messy collapse with it. By the same token a euro nation state government which was increasing its debt would have to persuade the wider market beyond its own domain to buy that debt. There would no doubt be transitional problems. Nevertheless, imagining the counterfactual of thinking through what would happen if the financial intermediaries in the highly indebted Euro Area countries were induced to lighten their holdings of such debt significantly indicates what a powerful mechanism of market control this could be.

Ignoring the real transitional problems, could one impose appropriate prudential requirements on concentrations of foreign currency government debt, and then leave the control of Euro Area fiscal deficits to market mechanisms alone, junking the SGP entirely into the dustbin, alongside other failed institutional devices? One of the main advantages, however, of joining the Euro Area for those countries with relatively high debt ratios was that it brought down the interest rates that they had to pay on their own debt below the levels that they could have obtained acting on their own. If this benefit, of Euro Area membership, was to be (progressively) removed, the case for them remaining in (or joining) the Euro Area would be significantly weakened. Some of the other Euro Area members states might, however, view that with equanimity.

Another major problem is that the market's penalty for 'excessive' deficit/debt is to push up required yields, and this leads to a knife-edge (saddle-point) condition. If fiscal conditions appear good, default risk is perceived as low, which helps to keep interest rates low, which in turn helps to keep down the deficit, which keeps fiscal conditions looking good. Then assume some adverse event occurs which raises perceived default risks. Then required yields rise, which raises the deficit further, which makes fiscal conditions look worse. In one of the key supporting papers of the Delors Committee, Lamfalussy (1989) argued the need for an accompanying fiscal constraint to the single currency on the grounds that markets do not move continuously. They appear to move late (in response to a worsening fiscal position), but when they do, to do so abruptly and, perhaps, excessively.

Moreover, even if the Financial reason, (1) above for bailing out a financially failed nation state was removed, or at least much mitigated by this

proposal, that would still leave reasons (2) Political and (3) Reputational and Contagion. Nevertheless, the apparent problem is not one of deficits, or debt levels, *per se*, but rather one of fiscal (un)sustainability and potential default. What is fiscally sustainable, or not, is a hideously difficult question; it depends on future configurations of growth, real interest rates, demography, the balance of state/private commitment to pensions, education, health, and so on, which are inherently unknowable. One potential institutional suggestion, which might be valuable (whatever the balance between market mechanisms of control over Euro Area nation state government deficits and SGP-type mechanisms), would be to establish at the central EU level an independent, academic body of economists, to assess the long-term sustainability of each nation state's fiscal sustainability, and to report. To ensure such independence, and academic standing, appointment would be made by the leading economic society in each country, *not* by Ministers. An exactly similar proposal has been put forward by Frankel (in Posen 2005).

7.4 Conclusions

One of the main hypotheses, or themes, of this chapter has been that the basic problems of the euro arise from a common error in monetary theory. This (mainstream) error is to assert that the functions and development of money involve primarily the minimization of transactions costs, in a context which can be quite separate from government and the various functions of the state. Consequently relatively little attention was paid to the crucial issue of what accompanying fiscal reforms needed to be made to support the euro. The main exception, the Stability and Growth Pact, initiated by Theo Waigel of Germany, was badly designed. There were few, arguably no, offsetting benefits (carrots) for countries committing themselves to give up their own abilities to use fiscal policy to mitigate asymmetric shocks, and the disciplinary mechanism (stick) was badly designed. The earlier attempt by the EC in its Report 'Stable Money – Sound Finances' (1993) to do this exercise had been rubbished, and forgotten.

It is an opportune time to resurrect this Report. A well-designed, and specifically engineered, stabilization function could be transferred to a central Euro Area budget, largely, perhaps entirely, financed by shifting the seignorage receipts from the euro to that same budget. The prohibition of borrowing against future revenues could be lifted, allowing the Euro Area to provide fiscal support to help handle cross-border financial crises. All this would involve Euro Area fiscal institutions, since the issues of stabilization and crisis handling are germane to the Euro Area countries, but not to the EU non-members that are not part of the Euro Area.

Even despite the carrot of intra-area fiscal transfers to help countries respond to asymmetric shocks, there would still be incentives, pressures, and temptations for politicians in constituent nation states to indulge in unwise

and unsustainable deficit finance. It is not sensible to try to deal with this by self-imposed fines. The Stability and Growth Pact should be junked. The way forward is to recognize that sizeable accumulations of the debt of such constituent nation states are truly risky, especially when piling up in the banks and financial intermediaries of that same country. There needs to be a rising marginal capital requirement applied to the holding of the debt of any one obligor, especially if that obligor does not have command over the printing press, as in the case of Euro Area member states, and perhaps even more generally too, although at a more gradual gradient. The aim is to prevent Euro Area nation states parking their excessive debt in partly captive domestic financial intermediaries.

Making the financial system of a constituent nation state safe in the event of the default of its own government would make the no-bail-out provision much more, but far from fully credible. A further reform would be to establish a European-wide fiscal institute, whose members should be appointed by the countries' leading economic associations, not by politicians, to provide independent assessments of the sustainability, or otherwise, of each country's fiscal policies. One would expect ratings agencies and markets to take note.

I believe that this package of reforms would work. But I doubt very much whether any of it will be put into practice.

Notes

1. Other contributors in this volume question the proposition that market mechanisms have worked in an equilibrating fashion and 'restored' competitiveness in Germany's case (see Chapters 3 and 11).
2. Also see Feldstein (2005).

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8

Fiscal Policy and Macroeconomic Performance in the Euro Area: Lessons for the Future[#]

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8.1 Introduction

Since the start of the Economic and Monetary Union (EMU) fiscal policy in the Euro Area has been dominated by the Stability and Growth Pact (SGP). However, the SGP has been unsuccessful in fulfilling both its goals, fiscal sustainability and supporting economic growth: In recent years, more and more countries have exceeded the 3 per cent of GDP limit for the budget deficit. At the same time, macroeconomic performance has been unsatisfactory, with the Euro Area economy only slowly recovering from the post-2000 stagnation. The prolonged stagnation as well as the ongoing fiscal problems have revived the macroeconomic debate on a reform of the SGP. A reform was finally introduced after a legal conflict between the European Commission and the European Council about the Council's right to simply ignore the Commission's recommendation to further pursue the 'excessive deficit procedure' (EDP) against France and Germany. However, the reform did not fundamentally change the SGP. Therefore, the economic and political debates on SGP reforms continue. In this chapter we would like to contribute to this debate. After a rather detailed account of fiscal policy developments and their impact on the Euro Area economy, we present a modified expenditure path concept as an alternative to the current SGP.

The chapter is an extension of our earlier work, in which we tried to explain the long-run growth and employment differentials between the Euro Area and the United States with the more restrictive stance of monetary, fiscal and wage policies under the 'Maastricht Regime'.¹ We proceed as follows: Section 8.2 compares the macroeconomic performance in the Euro Area and its individual member countries with the performance of the US economy. Section 8.3 provides a more detailed description of fiscal policies and consolidation efforts in the Euro Area since 1991. In Section 8.4 we analyse the macroeconomic impact of fiscal policy and in Section 8.5 we will put this in

a broader perspective, discussing also monetary and wage policies. In Section 8.6 we comment on the recent modifications of the SGP and present our reform proposal based on expenditure paths. Section 8.7 points to a potential drawback by asking whether fiscal policy reform alone can really improve growth and employment under the current regime of monetary and wage policies in Europe. Section 8.8 concludes.

8.2 Unsatisfactory macroeconomic performance in the Euro Area

Since the growth slowdown in 2000/1 the Euro Area has had a difficult recovery and macroeconomic performance has been worse than in the United States. There the economy returned rather quickly to its impressive growth path of the late 1990s. On average over the period 2001–05, annual real GDP-growth in the Euro Area has remained more than one percentage point below US-growth (Table 8.1). The growth differential, already to be found since the start of the convergence process towards the EMU in the mid-1990s (Hein/Niechoj 2006), seems to have become persistent. The unemployment rate in the Euro Area is still considerably above the US level. Between 2001 and 2005 inflation in the Euro Area has on average slightly exceeded the European Central Bank's (ECB) inflation target of 'below, but close to, 2 per cent in the medium term' (ECB 2003, p. 79). But the deviation from the US inflation rate is rather small. Taken together, in recent years the US-economy has once more managed to combine reasonable growth, low unemployment, and low inflation in a far better manner than the Euro Area.

Slow growth and high unemployment are by no means equally distributed across the Euro Area (Table 8.1). Whereas during the period 2001–05 in particular the large economies of Germany and Italy, together with the Netherlands and Portugal, have been suffering from real GDP growth rates well below the Euro Area average, Spain, Finland, Greece and Ireland have experienced growth considerably above this average. The unemployment rates display a wide dispersion across Euro Area countries, too. Finally, inflation rates also show major differences between Euro Area countries, with rates well below the ECB's target in Germany and Finland, and well above the target in Spain, Greece, Ireland, the Netherlands, and Portugal.

8.3 Maastricht, the SGP, and fiscal consolidation in the Euro Area-countries since 1991

Since the early 1990s fiscal policy in the Euro Area has been dominated by the Treaty of Maastricht and since the start of the euro in 1999 by the Amsterdam SGP (European Commission 2002). As conditions of entry to EMU, the Maastricht Treaty set a maximum deficit ratio (proportion of current budget deficit in relation to GDP) of 3 per cent and a maximum debt

Table 8.1 Real GDP growth, growth contributions of demand aggregates, unemployment rate and inflation rate in the Euro Area countries and the United States, average values for 2001–2005

	USA	Euro Area												
		Germany	France	Italy	Spain	Austria	Belgium	Finland	Greece	Ireland	Netherlands	Portugal		
Real GDP, annual growth rate, per cent	2.6	1.4	0.7	1.6	0.6	3.1	1.5	2.3	4.4	4.6	0.9	0.6		
Growth contribution of domestic demand including stocks, percentage points	3.1	1.3	-0.2	2.0	1.0	4.2	0.7	1.4	2.3	4.5	3.0	0.5	0.5	
Growth contribution of private consumption, percentage points	2.2	0.8	0.2	1.1	0.3	2.0	0.6	0.6	1.6	2.7	1.9	0.2	0.9	
Growth contribution of public consumption, percentage points	0.4	0.4	0.0	0.5	0.4	0.8	0.1	0.5	0.4	0.3	0.5	0.5	0.4	
Growth contribution of gross fixed capital formation, percentage points	0.5	0.2	-0.4	0.3	0.3	1.4	0.0	0.4	0.4	1.4	1.4	-0.1	-0.7	
Growth contribution of balance of goods and services, percentage points	-0.5	0.1	0.9	-0.4	-0.4	-1.1	0.8	0.1	0.0	-0.1	1.6	0.4	0.1	
Employment, annual growth, Per cent	0.7	0.9	-0.2	0.5	1.2	2.9	0.2	0.5	0.9	1.3	2.9	0.0	0.4	
Unemployment rate, per cent	5.4	8.5	8.7	9.2	8.4	10.5	4.4	7.8	8.9	10.2	4.4	3.6	5.9	
Inflation rate (HICP), ¹ per cent	2.6	2.2	1.6	2.0	2.4	3.2	1.9	2.0	1.4	3.5	3.4	2.8	3.2	

¹ USA: national CPI

Source: Eurostat; authors' calculations; US inflation rate: Reuters Ecowin.

ratio (proportion of public debt in relation to GDP) of 60 per cent. In 1997, the SGP made this regulation even tougher by prescribing for the medium term, that is, a time span which stretches across economic cycles, balanced budgets or budget surpluses in order to reduce the level of debt.² Achieving these conditions was intended, on the one hand, to enable the automatic stabilizers to work during economic downturns without violating the 3 per cent deficit criterion. On the other hand, it should ensure the long-run sustainability of public finances. In particular, it was intended to create leeway for possible future funding objectives which may arise from demographic developments such as social security provision for the elderly.

The SGP requires member states to present annual stability programmes to the European Commission, which describe how they intend to achieve balanced budgets, and which can be employed as an advance notice when a country is approaching the 3 per cent limit for its current budget deficit. If this mark is exceeded, the EDP is applied (EC Treaty, Art. 104). If the country is not in a deep recession, defined as an annual real GDP shrinkage of more than 2 per cent, and if the country in question refuses to introduce consolidation measures, penalties of up to 0.5 per cent of GDP per year may ultimately be incurred. In spring 2005 the SGP has been modified so as to mitigate the strictness of the EDP somewhat. In Section 8.6 we turn to a more detailed description and evaluation of these modifications which have not questioned the substance of the original SGP.

With respect to deficit reduction, fiscal policy has been rather successful (Figure 8.1, Table 8.2). For the Euro Area as a whole the budget balance was reduced from an average -5.1 per cent of GDP in the first half of the 1990s to -2.3 per cent in the second half. After the economic slowdown in 2000/1 the budget balance has decreased again, but on average for the period 2001 to 2005 to only -2.6 per cent of GDP. There seems to have been a permanent improvement in the budget balance of about 2.5 percentage points. The cost of this deficit reduction in terms of a reduced provision of public goods or higher taxes is considerably smaller. The primary budget balance, that is, net lending excluding net government interest payments, only improved by 2 percentage points during the second half of the 1990s and by 0.5 percentage points during the period from 2001-05. The substantially lower average interest burden of public debt is largely due to the remarkable reduction in the average long-term nominal interest rates which was caused by the rapid interest rate convergence towards the lower German level. In that respect fiscal policy obviously gained from the common currency. Similar tendencies with respect to public deficit reduction can be found for most individual member countries, albeit to quite different extents (Table 8.2). Belgium, Finland, Greece, Italy and Spain stand out with particularly large deficit reductions above 5 percentage points. Together with Portugal – and with the exception of Finland – these are also the countries that gained the most from falling interest rates.

Table 8.2 Average government budget balance and primary budget balance for the Euro Area countries and the United States from 1991–05 in per cent of GDP

	Deficit/GDP ratio			Primary deficit/GDP ratio		
	1991-1995	1996-2000	2001-2005	1991-1995	1996-2000	2001-2005
Austria	-4.0	-2.5	-1.0	-1.0	0.5	1.4
Belgium	-6.3	-1.3	0.1	3.5	5.9	5.3
Finland	-4.6	1.3	3.2	-5.2	2.8	3.4
France	-4.6	-2.6	-3.2	-1.9	0.2	-0.7
Germany	-2.8	-2.2	-3.6	-0.1	0.8	-1.0
Greece	-11.2	-5.2	-5.7	0.5	3.6	0.0
Ireland	-2.5	2.1	0.2	2.3	4.2	0.4
Italy	-9.9	-3.3	-3.4	1.7	4.6	1.6
Netherlands	-3.3	-0.3	-1.8	1.0	3.6	0.3
Portugal	-6.5	-3.4	-3.8	0.8	0.3	-0.9
Spain	-5.6	-2.5	-0.1	-1.4	1.3	2.0
Euro Area	-5.1	-2.3	-2.6	-0.2	1.9	0.4
USA	-4.5	0.0	-3.5	-1.0	3.0	-1.5

Note: Balances 2000–02 are corrected for proceeds from UMTS auctions.

Source: OECD (2005); authors' calculations.

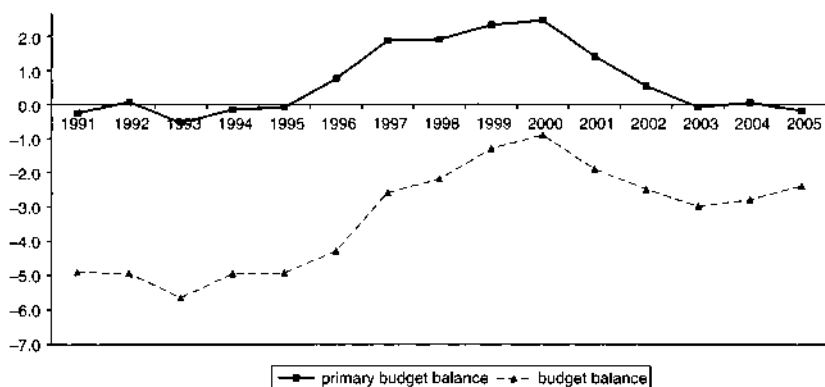


Figure 8.1 Government budget balance and primary budget balance: Euro Area 1991–2005 in per cent of GDP.

Source: Eurostat; primary lending: OECD (2005). Budget balances 2000–2002 corrected for proceeds from UMTS auctions.

Fiscal policy has been rather unsuccessful in stabilizing the gross debt–GDP ratio (Table 8.3). Starting from roughly 60 per cent in 1991 for the Euro Area as a whole, this ratio went up from an average 65.5 per cent of GDP in the first half of the 1990s to 73.5 per cent in the second half. From 2001 to 2005 the average level was somewhat lower (69.5 per cent), but still above the 60 per cent upper limit of the Maastricht Treaty and the SGP. The most important reason for this development is certainly that France and Germany, as the two largest Euro Area economies, both increased their gross public debt–GDP ratio by almost 15 percentage points. After all, six countries managed to reduce their gross indebtedness noticeably.

Many countries did not succeed in complying with the deficit rules of the SGP (see Table 8.4). Over the last four years, for the Euro Area as a whole the deficit ratio has been close to the 3 per cent limit within a narrow band between 2.4 and 3.0 per cent of GDP. Since the start of the EMU, six out of 12 member countries have exceeded the 3 per cent limit of the SGP and, with the exception of the Netherlands, for at least three times.

8.4 The macroeconomic impact of fiscal policy

In order to take account of the macroeconomic impact of fiscal policy it is not sufficient to look at the development of actual deficits, as in the previous section. Actual deficits may simply reflect the underlying economic situation and not active fiscal policy. Therefore, we assess the extent to which fiscal policy exerts a stabilizing or destabilizing influence on the business cycle by comparing changes in the output gap and the cyclically adjusted

Table 8.3 Gross government debt for the Euro Area countries and the United States from 1991–2005 in per cent of GDP

	1991–1995	1996–2000	2001–2005
Austria	60.7	65.8	64.8
Belgium	134.1	119.7	99.5
Finland	46.8	50.3	42.9
France	44.7	58.2	61.7
Germany	47.3	60.6	63.4
Greece	99.3	108.9	109.8
Ireland	90.9	55.7	31.2
Italy	115.3	117.4	106.2
Netherlands	77.5	66.2	51.9
Portugal	60.1	56.9	57.7
Spain	54.9	64.7	49.5
Euro Area	65.5	73.5	69.5
USA	74.5	67.3	62.5

Source: Eurostat; values for USA: European Commission (2005); authors' calculations.

Table 8.4 Excessive deficits in Euro Area countries from 2000–2005 in per cent of GDP

	2000	2001	2002	2003	2004	2005
France			3.2	4.2	3.7	
Germany			3.7	4.0	3.7	3.3
Greece	4.1	6.0	4.9	5.8	6.9	4.5
Italy		3.2		3.4	3.4	4.1
Netherlands				3.1		
Portugal		4.2			3.2	6.0

Source: Eurostat.

budget–balance ratio to potential GDP (CBR), using the relevant values from the OECD Economic Outlook.³ The output gap serves as an indicator of the current state of economic activity. If it is positive, capacity is outstripped, if it is negative, capacity is not fully utilized. Consequently, a positive change in the output gap indicates a cyclical upturn, whereas a negative change points to a cyclical downturn. If there is a positive (negative) change in the CBR, then structural deficits fall (rise) or structural surpluses rise (fall), and fiscal policy provides a restrictive (expansive) stimulus to demand. If the CBR remains constant in the face of a changing output gap, fiscal policy is neither expansive nor restrictive and the automatic stabilizers are simply left to take effect.

Such cyclically adjusted measures can be criticized for a number of theoretical and empirical reasons and should therefore be interpreted with great

care. Theoretically, they are very close to the idea embedded in the standard NAIRU models: There is a long-run equilibrium, determined by structural characteristics of the labour market, which is independent of the short-run fluctuations generated by demand shocks or macroeconomic policy. We do not share this view (Hein 2004, 2006a, 2006b). Empirically, these measures are very sensitive to the exact method used and to the choice of observation period. The separation of a cyclical from a potential or trend component can be biased because the potential component may be endogenous. After some years of high (low) growth caused by 'short-term' demand-side measures or shocks, the potential or trend growth will go up (down) thereby underestimating the cyclical component compared to a situation without such demand-side measures or shocks. Therefore, the cyclically adjusted budget deficits (surpluses) for low (high) growth countries may be considerably overestimated. Despite these serious problems we consider the measures as useful. First, the OECD numbers we have used have proven to be less susceptible to the endogeneity bias than, for example, the values published by the European Commission (2005). Second, if certain empirical findings about the stabilizing or destabilizing effects of fiscal policy can be derived within such a mainstream framework, then this rather strengthens the point from a heterodox perspective.⁴

Measured in the way described, fiscal policy in the Euro Area as a whole from 1991 to 2005 developed as follows (Figure 8.2): In a first rather long phase from 1991–99, fiscal policy was strongly restrictive with average

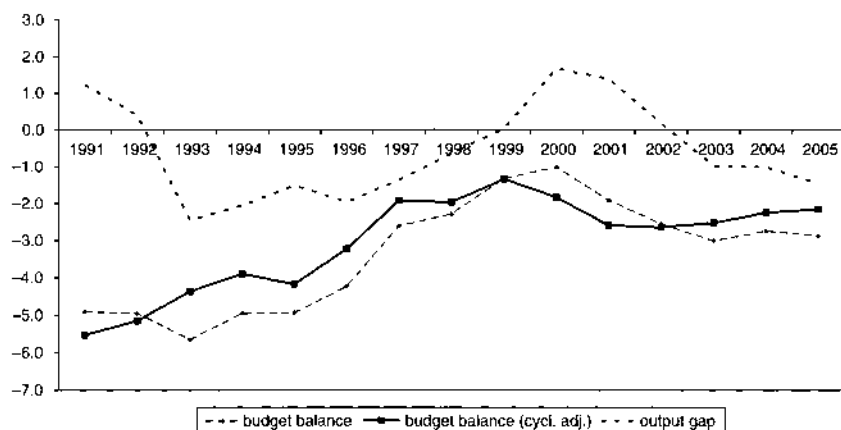


Figure 8.2 Government budget balance, cyclically adjusted budget balance (CBR) and output gap: Euro Area 1991–2005

Source: OECD (2005) Budget balance 2000–02 corrected for proceeds from UMTS auctions.

annual improvements in the CBR of more than 0.5 percentage points. Especially at the beginning of the 1990s, fiscal policy went through a seriously pro-cyclical episode because it decreased structural deficits despite a sharp fall in the output gap reflecting the severe slump at the time. From 1999–2000 fiscal policy switched to pro-cyclical expansion in the peak of the 2000 boom. From 2000–02 it counter-cyclically stabilized the Euro Area economy after the slowdown in 2000/1. Finally, from 2002 until today, fiscal policy has had a destabilizing effect because the CBR has been slightly increased despite the continuing slowdown. This general picture – strong restriction over the 1990s, loosening at the end of the 1990s, a brief counter-cyclical reaction after the 2000/1 slowdown, and a pro-cyclical stance during the phase of protracted stagnation – applies to almost all of the individual Euro Area countries. With respect to the extent and the exact timing, there are some substantial differences across the countries, though.

The course of fiscal policy in the Euro Area is in remarkable contrast to that in the United States (Figure 8.3). There, after a strong counter-cyclical stabilization effort in the recession 1990/1, fiscal policy changed to a clearly counter-cyclical path of strong restriction during the upswing until the peak of the boom in 2000. After the sharp downturn in 2000/1, fiscal policy once again reacted in a strongly counter-cyclical way, decreasing the CBR by more than 5 percentage points between 2000 and 2004. From the empirical evidence over the whole period, therefore, it must be concluded that fiscal policy in the United States has played its macroeconomic stabilization role properly, whereas in the Euro Area fiscal policy has acted in an often pro-cyclical and therefore destabilizing way.

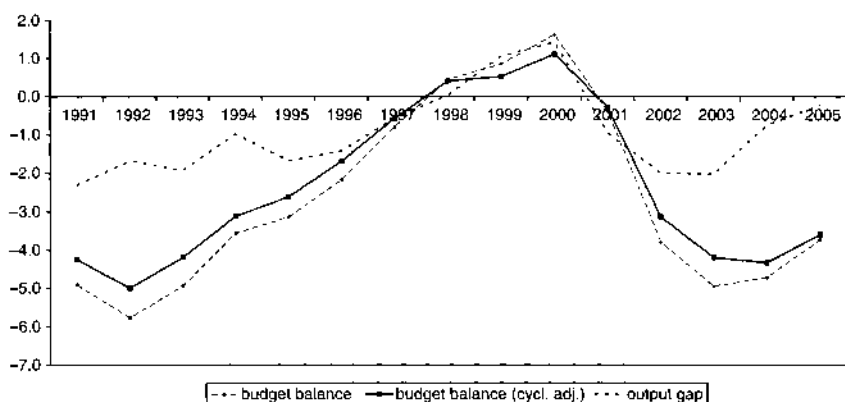


Figure 8.3 Government budget balance, cyclically adjusted budget balance (CBR) and output gap: United States 1991–2005 in per cent of (pot.) GDP

Source: OECD (2005).

This result is reinforced by the developments in the recent economic slowdown from 2001–05 (Table 8.5). In the face of an average annual fall in the output gap of 0.6 per cent of GDP, Euro Area fiscal policy was only slightly expansive with an average annual decrease in the CBR of 0.1 percentage points. However, nearly the entire expansive, counter-cyclical reaction occurred in 2001, when the fall in the output gap was small (Figure 8.2). In 2002 fiscal expansion was hardly measurable and since 2003, fiscal policy has even been slightly pro-cyclically restrictive. The cumulated negative fiscal stimulus over the last three years has amounted to 0.5 per cent of GDP.

For the individual Euro Area countries the picture is rather diverse (Table 8.5). However, there has not been a single country that did not see a pro-cyclically restrictive fiscal policy in at least one year during the recent slowdown. Over the whole period from 2001–05, fiscal policy was strongly expansive in only two countries: The high growth countries Finland and Ireland both decreased their average annual CBRs by 0.8 percentage points. Four countries, namely Italy, Greece, France, and Germany saw a mildly expansive fiscal policy over the whole period with their CBRs decreasing by 0.3, 0.2, 0.1 and 0.1 percentage points, respectively. In Greece the fiscal expansion turned out to be pro-cyclical, as the output gap improved at the same time. The precise pattern in that country, however, was of a stop-and-go nature. In France fiscal policy at first reacted in a properly counter-cyclical way against the fall in the output gap from 2000–03. After 2004 it switched to restriction and became noticeably pro-cyclical in 2005. In Italy, almost all of the expansion occurred from 2000–01, when the output gap was still slightly improving. From 2002–04, however, when the output gap worsened considerably, fiscal policy was pro-cyclical, before once more turning to expansion in 2005. In Germany, virtually all of the expansion occurred in 2001 with only a minor worsening of the output gap. In 2002 German fiscal policy was neutral in the face of a strong fall in the output gap. Since 2003 it has pro-cyclically tightened despite further substantial drops in the output gap. In the five remaining countries, Spain, Austria, Belgium, the Netherlands, and Portugal, fiscal policy was pro-cyclically restrictive over the whole period from 2001 to 2005. Whereas in Spain both the drop in the output gap as well as the pro-cyclical fiscal drag have been comparatively small, both values have been substantial in the other countries. In Portugal and Austria the cumulative negative pro-cyclical fiscal stimulus between 2001 and 2005 amounted to 3.8 and 3.0 per cent of GDP, respectively.

In striking contrast to the European experience, US fiscal policy from 2001–05 was very expansive with an average annual decrease in the CBR of 0.9 per cent (Table 8.5). There has not been a single year with pro-cyclical fiscal restriction during the economic downturn. Since 2005, the second year with an improving output gap, US fiscal policy has returned smoothly to careful restriction, again.

Table 8.5 Indicators for fiscal policy in the Euro Area countries and the United States, average values, 2001–2005*

	USA	Euro Area											
		Germany	France	Italy	Spain	Austria	Belgium	Finland	Greece	Ireland	Netherland	Portugal	
Budget balance (per cent of GDP)	-3.5	-2.6	-3.6	-3.2	-3.4	-0.1	-1.0	0.1	3.2	-5.7	0.2	-1.8	-3.8
Budget balance (per cent of GDP), annual change, percentage points	-1.1	-0.4	-0.5	-0.3	-0.5	0.3	0.0	0.0	-1.0	-0.1	-1.1	-0.6	-0.5
Cyclically adjusted budget balance (per cent of cyclically adjusted GDP), annual change, percentage points	-0.9	-0.1	-0.1	-0.3	0.3	0.4	0.3	0.3	-0.8	-0.2	-0.8	0.1	0.1
Output gap, (per cent of cyclically adjusted GDP), annual change, percentage points	-0.3	-0.6	-0.8	-0.5	-0.5	-0.1	-1.0	-0.5	-0.5	0.4	-0.8	-1.4	-1.4
Number of years with pro-cyclical fiscal policy during an economic slowdown	0	3 (2003–2005)	3 (2003–2005)	1 (2005)	3 (2002–2004)	3 (2001–2002; 2004)	4 (2001–2003; 2005)	1 (2005)	1 (2005)	2 (2003–2004)	2 (2003–2005)	3 (2002–2004)	3
Negative fiscal stimulus in economic slowdown, cumulated (per cent of potential GDP)	-	0.5	1.1	0.5	0.8	0.9	3.0	1.9	0.5	2.2	2.8	1.2	3.8

Notes: *Forecast values for 2005.

Source: OECD (2005); authors' calculations.

Therefore, it is hard to escape the conclusion that the SGP did lead to destabilizing, pro-cyclical fiscal policy reactions to the post-2000 crisis in several countries. Far from being ineffective, the Pact inspired unsound fiscal policies. With the exception of Greece and to some extent also France, all the countries with excessive deficit problems stopped their initially expansive fiscal policy and were driven into pro-cyclical, restrictive measures as soon as their deficit had reached the 3 per cent of GDP limit. Without doubt, the resulting negative fiscal stance has contributed to the ongoing stagnation tendencies after 2000 within these countries and in the Euro Area as a whole. Of course, fiscal policy is only one factor in the explanation of macroeconomic performance. However, with respect to GDP growth it is striking that all of the four countries with below Euro Area average growth rates (Germany, Italy, the Netherlands, and Portugal) suffered from untimely restrictive fiscal policies. And from the four countries with above average growth rates, after all three countries (Ireland, Finland, and Greece) had expansive fiscal policies.

It is sometimes argued that the countries with excessive deficits might have avoided their problems and the ensuing pro-cyclical fiscal policy if they had pursued a tighter fiscal policy during 'good times'. At first sight this argument has some appeal, as most of the countries in question had at least one short episode of pro-cyclical expansion at the end of the 1990s or in 2000. However, stronger fiscal restriction could have meant some damage. As a rough estimate suggests, in order to avoid excessive deficits and pro-cyclically restrictive policies in the period from 2001–05, the countries concerned would have had to decrease their budget deficits by an additional 2 to 4 per cent of GDP within only two or three years. Moreover, the restriction would have hit the economies in a situation in which they were just recovering from the early and mid-1990s stagnation with a prolonged period of tight and often pro-cyclical fiscal policies. Without doubt, the 'good times' would have been turned into 'bad times' by such a policy. Proponents of tighter fiscal policy might turn to question that restrictive fiscal policy causes any demand-side problems, due to 'non-Keynesian effects' of fiscal consolidation (see, for example, Alesina and Perotti 1996). However, it has convincingly been argued that such a position cannot be defended in any sensible way (see, for example, Arestis and Sawyer 2003).

8.5 The macroeconomic impact of monetary policy and wage developments

Macroeconomic performance cannot be explained solely by fiscal policy but has also to take into account monetary and wage policies. Monetary policy can be assessed by the development of the short-term real interest rate. It is now widely accepted that modern central banks use the short-term nominal interest rate as an economic policy instrument. If central banks target inflation,

they have to set nominal interest rates with an eye to the ensuing real rate, as proposed in the famous Taylor-rule, for example (Taylor 1993). In order to take into account the underlying economic situation, we consider the differences between both the short- and the long-term real interest rate and real GDP growth. We expect a negative influence of real interest rates on economic growth working through different transmission channels (money, credit, asset prices, exchange rates) (Bernanke and Gertler 1995, Cecchetti 1995).

Whereas the Euro Area short-term real interest rate was positive on average over the period after the 2000/1 growth slowdown, the Federal Reserve (Fed) managed to establish a negative short-term real interest rate of -0.2 per cent in the United States (Table 8.6). These expansionary monetary policies contributed to the quick recovery of the US economy. The United States returned to a negative short-term real interest rate-real GDP growth rate-difference already in 2002, whereas in the Euro Area this difference became negative only in 2003 (Figure 8.4). On average over recent years, the Fed has succeeded in establishing a favourable short-term real interest rate-real GDP growth-difference (-2.7 percentage points), as well as a growth-friendly long-term real interest rate-real GDP growth difference (-0.7 percentage points). By contrast, in the Euro Area the short-term real interest rate-real GDP growth-difference has been only slightly negative (-0.8 percentage point) on average over the period 2001-05. The long-term real interest rate-real GDP growth-difference has even been positive (0.7 percentage points). The ECB has been reluctant to stimulate the economy by cutting interest rates in the face of the slowdown.

ECB policy has been particularly harmful for the largest Euro Area member country, Germany (Table 8.6). As the German inflation rate has been lower than the EMU average and the nominal interest rates have almost completely converged since 1999, Germany's real interest rates have been even higher than the Euro Area average since then. This has contributed to an unfavourable short-term real interest rate-real GDP growth-difference. Germany was the only member country in which that difference was positive on average over the period 2001-05. On the other hand, higher inflation countries (Spain, Greece, and Ireland) have had negative short-term real interest rates and negative differentials between both the short- and long-term real interest rate and real GDP growth.

Therefore, the ECB's 'anti-growth-bias', that is, a too restrictive definition of price stability for the heterogeneous currency area – and an asymmetric response to the expected deviation of actual from target inflation,⁵ has contributed to the weak growth and employment performance of the Euro Area as a whole and to the economic problems of the largest Euro Area member, Germany, in particular. However, it has to be conceded that the ECB cannot react directly to the inflation differences between Euro Area member countries. This is where wage policies become relevant.

Table 8.6 Indicators for monetary and wage policies in the Euro Area countries and in the United States, average values, 2001–2005*

	USA	Euro Area										Portugal
		Germany	France	Italy	Spain	Austria	Belgium	Finland	Greece	Ireland	Netherlands	
Monetary Policy												
Short-term real interest rate, (per cent)	-0.2	1.2	0.8	0.4	-0.4	0.9	0.8	1.4	-0.7	-0.6	0.0	-0.4
Long-term real interest rate, (per cent)	1.9	2.6	2.3	2.0	1.1	2.5	2.3	2.9	1.0	0.9	1.4	1.2
Short-term real interest rate minus real GDP growth, (percentage points)	-2.7	0.5	-0.8	-0.4	-3.5	-0.5	-0.7	-0.8	-4.9	-5.7	-0.8	-1.0
Long-term real interest rate minus real GDP growth, (percentage points)	-0.7	1.9	0.7	1.3	-2.0	1.0	0.8	0.7	-3.3	-4.3	0.7	0.6
Wage Policy												
Nominal compensation per employee, annual growth, (per cent)	4.0	2.5	1.7	2.7	3.1	3.3	2.0	3.2	6.5	5.7	3.9	2.3
Nominal unit labour costs, annual growth, (per cent)	1.7	1.7	0.3	1.7	3.2	2.9	0.8	1.8	3.3	3.3	2.7	2.1
Labour income share*, (per cent)	62.6	58.0	58.1	57.4	55.6	57.1	62.5	55.6	58.0	47.8	59.2	63.0
Change in labour income share, (percentage points)	0.4	-0.2	-0.5	0.0	0.2	-0.5	-0.6	-0.2	-0.2	-0.2	0.0	-0.6

Notes: * Forecast values for 2005; † compensation per employee divided by GDP at current market prices per person employed.

Source: European Commission (2005a, OHCD (2005); authors' calculations.

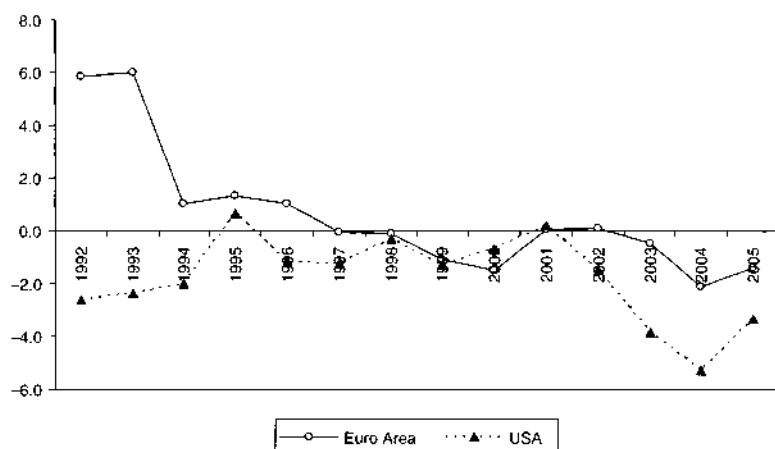


Figure 8.4 Short-term real interest rate minus real GDP growth rate in the Euro Area and in the United States, 1992–2005, percentage points

Source: European Commission (2005); OECD (2005); authors' calculations.

Wage policies can be assessed by nominal wage growth (compensation per employee), unit labour cost growth, and the labour income share. Nominal wage setting affects unit labour cost growth and inflation. If nominal wages increase at a faster pace than labour productivity plus inflation, unit labour cost growth and inflation will speed up.⁶ This will cause real interest rates to fall. If nominal wages increase at a rate below the sum of productivity growth and inflation, unit labour cost growth will slow down and cause disinflation. Finally, deflation may be the consequence. Disinflation and deflation cause increasing real interest rates. Deflation causes rising real debts with potentially negative effects on investment and growth.⁷ Once deflationary processes have started, monetary policies lowering nominal interest rates will be ineffective.

Wage policies, however, may not only affect prices, but may also change distribution if firms do not completely pass unit labour cost variations to prices or if prices of other inputs do not change in step with unit labour costs. Under these conditions nominal wage moderation causes the labour income share to fall (Hein, Schulten and Truger 2006). Theoretically, the effects of income shares on GDP growth are ambiguous (Bhaduri and Marglin 1990). With the propensity to save out of wages falling short of the savings propensity out of profits, a falling labour income share means a cut-back in consumption demand and capacity utilization with directly contractionary effects on investment and GDP growth. A fall in labour income shares that is associated with nominal wage restraint would, on the other

hand, improve international competitiveness and, therefore, stimulate export demand, investment and growth. With a slowdown in inflation, the central bank may also cut interest rates and stimulate investment and growth. Finally, a falling labour income share is associated with rising unit profits which may also improve investment and growth.

Since the stimulating effects of wage moderation and declining labour income shares for investment and growth are rather indirect and uncertain, in particular in large and rather closed economies as the Euro Area and the United States, the direct and contractionary effects will presumably dominate here. And since nominal wage increases, which will shift distribution in favour of labour income, will also trigger inflation and concomitant restrictive central bank interventions, nominal wage growth equal to the sum of long-run productivity growth and the central bank's inflation target (and hence a roughly stable labour income share) should be generally favourable for growth and employment in large and rather closed currency areas.

On average over the period 2001–05, nominal wage growth in the Euro Area has been lagging behind the United States (Table 8.6), but taking into account productivity growth, nominal wage increases in both currency areas have been stability oriented: nominal unit labour costs have grown by 1.7 per cent each and have hence not caused any inflationary pressures. Moderate wage increases were accompanied by a decline in the labour income share, both in the Euro Area and in the United States. Whereas in the United States this decline compensated for the increase in the previous years generating a stationary trend since the early 1990s, in the Euro Area the recent decline has continued the decreasing trend since the early 1990s. Although labour income shares in the two economies had similar levels in the early 1990s, the Euro Area value is by now 4 percentage points below the US-value, contributing to domestic demand problems in Europe.

Below the surface of Euro Area aggregate values there is a wide dispersion of wages and nominal unit labour cost growth rates (Table 8.6). In Italy, Spain, Greece, Ireland, and the Netherlands, nominal unit labour costs have grown at rates around 3 per cent on average between 2001 and 2005 which interfered with the ECB's overly ambitious inflation target. Nominal unit labour costs in Germany, however, and to a lesser extent in Austria, have grown at especially low rates, causing deflationary risks which have been accompanied by a rapid decline in labour income shares, contributing to domestic demand problems. In Germany wage developments especially have been completely inappropriate for the largest economy in a currency union:⁸ Overly moderate wage policies have improved price competitiveness and profitability of German firms and have made German export surpluses almost quadruple between 2001 and 2005. Since around 44 per cent of German exports go to the Euro Area, increasing German export surpluses cause major problems for the other Euro Area countries. Whereas Germany has continuously increased its current account surplus, amounting to 4.1 per cent of GDP in 2005, the

other larger Euro Area countries (France, Italy, Spain) are increasingly driven into current account deficits (Table 8.7). Some of the smaller countries either see their surpluses decline (Belgium, Finland) or cannot decrease their huge deficits (Greece, Portugal). If this constellation persists it will inevitably induce the other Euro Area countries to use deflationary wage policies as well. The risk of deflation will then spread across the Euro Area.

It would be highly desirable to have a closer look at the interaction between monetary and wage policies, on the one hand, and fiscal policy, on the other. However, such an analysis would be beyond the scope of this chapter. Only a few, qualitative and preliminary remarks can be made at this stage. From the empirical indicators presented in Sections 8.4 and 8.5 it seems that fiscal policy played an important and in some cases even decisive role in the explanation of individual countries' macro-performance relative to the Euro Area. Wage and monetary policies in the fast growing countries (Ireland and Greece) generated macroeconomic conditions that were quite favourable for above average growth rates. Likewise, in the slowly growing countries (Germany, and to a lesser extent also Italy) the conditions generated by monetary and wage policies seem to have been adverse to growth. In the four countries just mentioned, fiscal policy seems to have played the role of an additional factor amplifying the tendencies generated by other policies. In Spain, the slightly restrictive effect of fiscal policy was too weak to

Table 8.7 Current account balances as a percentage of GDP in Euro Area countries, Sweden, Japan, the United Kingdom, and the United States, 2001–2005

	2001	2002	2003	2004	2005
Germany	0.2	2.3	2.2	3.8	4.1
France	1.6	0.9	0.4	-0.4	-1.6
Italy	-0.1	-0.8	-1.3	-0.9	-1.5
Spain	-3.9	-3.3	-3.6	-5.3	-7.7
Austria	-1.9	0.3	-0.5	0.3	-0.4
Belgium	3.4	4.6	4.1	3.3	1.4
Finland	7.2	7.6	3.8	5.3	3.5
Greece	-8.1	-7.5	-7.2	-6.3	-7.0
Ireland	-0.6	-1.0	0.0	-0.8	-1.5
Netherlands	2.4	2.9	2.8	3.3	5.8
Portugal	-8.4	-8.0	-0.9	-3.6	-6.7
Euro Area	0.1	0.7	0.3	0.5	-0.2
UK	-2.2	-1.6	-1.5	-2.0	-1.8
Sweden	4.4	5.3	7.5	8.2	7.1
Japan	2.1	2.8	3.2	3.7	3.4
USA	-3.8	-4.5	-4.7	-5.7	-6.5

Source: OECD (2005).

compensate for the favourable growth conditions generated by monetary and wage policies. However, it seems that in the Netherlands and Portugal, where monetary and wage policy reactions were rather close to the Euro Area average, fiscal policy turned the balance towards the below-average growth performance. The same seems to hold for Finland's above average growth.

8.6 Improving fiscal policy within the EMU: towards an expenditure path concept

8.6.1 The 2005 reform

In the light of these results, a reform of the SGP was inevitable. The recent reform in spring 2005 means some important changes (European Council 2005). Alongside substantial modifications with respect to the medium-term objectives, which permit some deviation from the 'close to balance or in surplus rule' depending on national circumstances, the application of the EDP has been reformed and softened to some extent: The Council has specified the 'relevant factors' to determine whether a country exceeding the 3 per cent limit 'really' has an excessive deficit. The previous exception of a severe economic downturn has been softened and now includes an accumulated loss of output due to protracted very slow growth. The following types of spending may justify a temporary and small violation of the deficit limit: spending on the Lisbon agenda (especially R&D and innovation policies), public investment, financial contributions to international solidarity, and European unification as well as pension reforms. Debt sustainability is to be given greater relevance, too. In addition, the deadlines for identifying an excessive deficit, taking action following a policy recommendation, and correcting the deficit have all been extended.

The reform has addressed one of the most obvious failings of the original SGP: countries with difficulties in meeting the 3 per cent ceiling or the close to balance medium-term target now have a range of possible factors that they can call upon to justify their inability to meet the targets. Some of the factors – debt sustainability or spending on the Lisbon agenda certainly make more sense from a macroeconomic point of view than others (pension reform). Nevertheless, the reform has increased fiscal leeway for some countries to a certain extent. For example, Germany and France can avoid the immediate threat of penalties. However, the practical usefulness of the reform is limited. This has been demonstrated by the recent recommendations by the Commission and the decisions by the Council concerning the EDPs against Germany, Italy, and Portugal.⁹ In these cases both the Commission and the Council have taken a rather narrow view and do not even seem to concede the full leeway given by the reformed SGP. Despite the fact that the economic recovery is only weak and uncertain, a rather ambitious and risky consolidation path has been called for.

Therefore, a more fundamental reform of the SGP is required. In what follows, we present an alternative coordination and consolidation concept based on expenditure paths that allows for coordinated fiscal policies across the Euro Area in a counter-cyclical way, while at the same time ensuring fiscal sustainability. We first present the original concept and then some modifications.¹⁰

8.6.2 Expenditure paths for non-cyclical government spending

We take as given that fiscal policy remains essentially a matter of national responsibility. The goal for national fiscal policy is having automatic stabilizers work – always under the constraint that for the individual countries a given medium-term debt to GDP ratio is not exceeded. Without such a limit, there may arise the ultimate danger of an ever-accelerating government debt limiting the room of manoeuvre for public investment and other desirable government expenditure. Increasing public interest payments may also have serious regressive distributional effects with a negative impact on aggregate demand.

To this end, the individual countries should establish expenditure paths for non-cyclical spending, which would be financed in the long term by tax revenue.¹¹ Cyclical spending should then be allowed to float freely around this target without being constrained by budget deficit limits. In this concept, governments can and should refrain from discretionary tax cuts/increases other than for purposes of changing the level of government spending. In a downturn, increases in expenditure and falls in revenue cause budget deficits and increasing debt. In an upturn, budget surpluses arise, which are used for consolidation purposes. If non-cyclical spending grows at a higher rate than long-term nominal GDP, the result is rising structural budget deficits. If it grows at a slower rate, structural deficits are reduced. Alignment of the expenditure path with a growth rate below the long-term nominal GDP path can therefore contribute to a revenue-side budget consolidation, if a structural deficit requiring consolidation existed at the outset. Therefore, countries exceeding their public debt target value should choose an expenditure growth rate slightly below nominal GDP trend growth, whereas others could let expenditure grow at the same rate as nominal trend GDP.¹² Of course, such values for the expenditure paths should be a matter for coordination between member countries. In addition, with a modified stability pact there should be checks to ensure that individual countries comply with the prescribed expenditure paths for non-cyclical public spending. Moreover, the appropriateness of these expenditure paths themselves should also be subject to regular review, since the reference variable, that is, the nominal potential GDP path, is liable to change as a result of public and private investment activity.

In our view, the expenditure path concept has several advantages.¹³ First, with respect to consolidation, the ultimate target value is the debt to GDP ratio, which is much more directly relevant for fiscal sustainability than budget deficits. Second, the chosen variable, non-cyclical government spending,

is in fact under the government's control, whereas the budget deficit is an endogenous variable of the whole macroeconomic process. Third, the expenditure path allows for automatic stabilizers to take effect. The adoption of pro-cyclical fiscal policies is prevented. Fourth, there is real coordination of fiscal policies within the Euro Area, preventing free-rider behaviour. Pressure from the European level might also help to enforce counter-cyclical fiscal policy on the level of the individual countries. Fifth, under the current macroeconomic regime dominated by monetary policy, macro-economically sensible and hence 'credible' rules for fiscal policy might also induce the ECB to cooperate.

8.6.3 An adjusted expenditure path concept with a bit more discretion

How would the Euro Area and its member countries have fared in the period 2001 to 2005 under the described expenditure path regime? As the concept relies completely on automatic stabilizers, one can use the results of the analysis of cyclical deficits from Table 8.5 as well as Figure 8.2 as a first approximation. If fiscal policy had been completely neutral, that would have meant a zero percentage point change in the cyclically adjusted budget deficits. Obviously, fiscal policy in Belgium, Spain, Austria, the Netherlands, and Portugal could have been more expansive and hence less destabilizing. As seen before, the latter three countries have been hurt particularly by the restrictive stance of their fiscal policies, and the latter two are also among the countries that were, or still are, subject to the EDP. On average, in all the other countries fiscal policies would have been more restrictive under the expenditure path. For Greece this would have been desirable, because its fiscal policy was pro-cyclically expansive. For Italy, the same may be true, as the fiscal expansion occurred in 2001 when the output gap was still improving, so that fiscal policy would have been slightly less restrictive during the slowdown from 2002 to 2005. Ireland and Finland would have been forced to refrain from their more or less successful discretionary counter-cyclical fiscal policies, which would certainly have reduced their above-average growth substantially. From these countries' point of view, this would have been regrettable, but from the point of view of decreasing economic divergence within the Euro Area, it would have been welcomed – under the condition, of course, that the average level of growth attained by the macroeconomic policy mix in the Euro Area is appropriate. The more problematic cases seem to be France and Germany. In both countries the substantial discretionary counter-cyclical fiscal expansions in the first years after the slowdown, would not have been possible under the conditions of an expenditure path. On the other hand, these countries would not have been forced into restriction in later years. At first sight the expenditure path would have been an improvement for many countries, but not for all, particularly not for France and Germany, two of the countries most in trouble with their excessive deficits.

However, this rather mixed evaluation changes considerably, if one takes a look not only at the development of structural deficits but also at the average growth rates of public expenditures and revenues (Table 8.8). If we take final government consumption, public investment and subsidies as a proxy for non-cyclical expenditure, according to the expenditure path, these fiscal aggregates should grow in line with the nominal GDP trend (moving average of the growth rates of the past six years). Government social benefits and interest payments may vary with cyclical fluctuations; the former can be expected to grow at a higher rate than nominal GDP trend during economic slowdowns and rising unemployment. In the absence of discretionary tax increases/tax cuts, public revenue should grow in line with actual nominal GDP.

For the Euro Area as a whole and for most of the countries, especially for Germany, public revenue grew at a rate significantly lower than actual nominal GDP. This is a strong indication that there have been substantial discretionary tax cuts in many countries (for Germany: Truger 2004; Truger and Jacoby 2004). At the same time, for some of these countries, again especially for Germany, non-cyclical government expenditure, and indeed also total expenditure, grew at a significantly lower rate than nominal trend GDP. Quite strikingly, for some countries the growth rate of social benefits has been lower than could be expected from the extent of the economic slump. This suggests that in some countries a more expansive fiscal policy could have been achieved through a shift in the expenditure/revenue mix. Most importantly, less tax cuts in favour of higher expenditure growth would have been more in accordance with the expenditure path concept and could have had a positive macroeconomic effect, because expenditure multipliers are substantially higher than tax multipliers. In addition, a shift between different revenue categories might also have been conducive to growth.

Under the conditions of an expenditure path, however, the gain in terms of fiscal expansion relative to the *status quo* would certainly not have been very strong and it is doubtful that fiscal expansion alone would have been strong enough for a sustained economic recovery in those countries that were hit the hardest by the post-2000 slowdown. Even in the absence of reliable quantitative econometric results, qualitative considerations provide reasons to doubt this. Taking the US economy as a benchmark, letting automatic stabilizers work would hardly have been sufficient for the Euro Area to recover in a comparable way. As already demonstrated (Figure 8.3), US fiscal policy reacted in an aggressively discretionary counter-cyclical way against the slowdown, decreasing the CBR by more than 5 percentage points from 2000–04.

Two objections against the comparison with the United States may be raised. First, automatic stabilizers in the United States are usually estimated to be considerably smaller than in most European welfare states, so that relying on automatic stabilizers might nevertheless be sufficient in Europe. Second, it is well known that the US government reacted to the post-2000

Table 8.8 Nominal growth rates of GDP, trend GDP, selected categories of government expenditures and total revenue for the Euro Area countries and the United States, average 2001–2005 in per cent

	Euro												
	USA	Area	Germany	France	Italy	Spain	Austria	Belgium	Finland	Greece	Ireland	Netherlands	Portugal
Gross domestic product, value, market prices	4.9	3.5	1.7	3.3	3.5	7.4	3.1	3.6	3.2	8.1	9.0	3.4	3.6
GDP trend*	5.2	4.0	2.2	3.8	4.5	7.4	3.5	3.8	5.6	8.5	13.3	5.6	6.4
real GDP trend* plus target inflation rate	5.3	4.4	3.7	4.6	3.7	5.9	4.4	4.3	4.7	5.8	10.4	4.8	5.0
Government final consumption expenditure	7.0	4.2	1.2	4.3	4.9	8.4	2.5	5.0	5.6	6.6	12.1	5.6	5.4
Government fixed capital formation	5.0	3.5	-4.2	4.3	8.2	9.5	-2.9	2.5	6.1	3.1	11.2	4.0	-1.6
Subsidies	6.1	1.7	-4.0	7.9	1.9	5.1	3.5	2.6	-0.1	1.4	4.7	1.8	10.4
Gross government interest payments	-1.2	-1.4	-0.3	0.6	-1.7	-3.5	-1.0	-4.2	-6.7	-1.2	-2.1	-4.3	2.0
Social security benefits paid by government	7.3	4.0	2.5	3.8	4.4	7.0	4.0	4.7	4.2	9.4	14.8	3.7	8.7
Government total disbursements	6.3	3.7	1.4	4.1	4.0	7.1	2.2	3.6	4.4	6.1	11.5	5.3	5.4
Total receipts	2.9	2.9	0.2	3.4	2.9	7.9	2.2	3.5	2.3	6.2	8.3	3.8	4.3
Government investment (per cent of GDP)	2.7	2.5	1.5	3.2	2.5	3.5	1.1	1.7	2.9	3.7	3.9	3.3	3.3

Notes: *GDP trend: 6-year moving average of annual growth rates.

Source: European Commission (2005).

slowdown to a large part with aggressive tax cuts, which may be rather ineffective due to low multipliers. Both objections, however, cannot change the basic conclusion. With respect to the question of the size of automatic stabilizers, the overall fiscal policy reaction in the United States was much more aggressive than anything that could have been achieved by automatic stabilizers in any Euro Area country: The actual deficit in the United States was increased by 6.6 per cent of GDP from 2000 to 2003 in the face of a worsening of the output gap of 3.4 per cent of GDP, that is, an increase of almost two percentage points per percentage point of decrease in the output gap. Usual estimates for automatic stabilizers in many European countries are somewhat higher than 0.5 per cent (see, for example, van den Noord 2000). One must also take into account that many of the labour market reform strategies advocated by the European commission would actually lead to a considerable weakening of automatic stabilizers in Europe (Mabbett and Schelkle 2005). With respect to the question of the size of the tax cuts, although the Bush tax cuts played a very substantial role in the fiscal expansion in the United States, the expenditure side was much more expansive than its Euro Area counterpart, with a growth rate of government final consumption substantially above nominal GDP trend growth (Table 8.8). Moreover, a much more expansive fiscal policy in the United States was accompanied by much more aggressive Fed monetary policy than the ECB's reluctant and restrictive action (Section 8.5). Moreover, the ECB's interest rate policy can only be oriented towards the economic situation in the Euro Area as a whole. It cannot take into account the specific national economic circumstances of those countries that were hit especially by the post-2000 slowdown. Therefore, in the context of asymmetric shocks in a monetary union the case for discretionary national fiscal policy is on the agenda.

This leads us to discuss how the expenditure path concept can be modified in order to allow for stronger fiscal expansion during economic slowdowns and recessions. One way is to allow public investment to grow above the expenditure path level. Another is to allow discretionary increases in social benefits and other expenditure categories or permit certain tax cuts. All such violations of the path should, of course, be coordinated on a European level. In order to reconcile such periods of more aggressively expansionary discretionary fiscal policies with the goal of fiscal sustainability, the expenditure path for non-cyclical spending would have to be slightly below nominal trend GDP growth during 'good times' in order to allow for sufficient consolidation.

Actually, this seems to have been exactly the strategy US fiscal policy has chosen (Figure 8.5). In the United States, non-cyclical government expenditure grew at a rate of about 3 per cent from 1992 until 1998, whereas the nominal GDP trend grew between 5 and 6 per cent. During the persistent upswing with decreasing unemployment, the growth rate of social benefits declined, and tax revenue grew more than proportionately, as is to be expected in the absence of major tax cuts. The result was fiscal

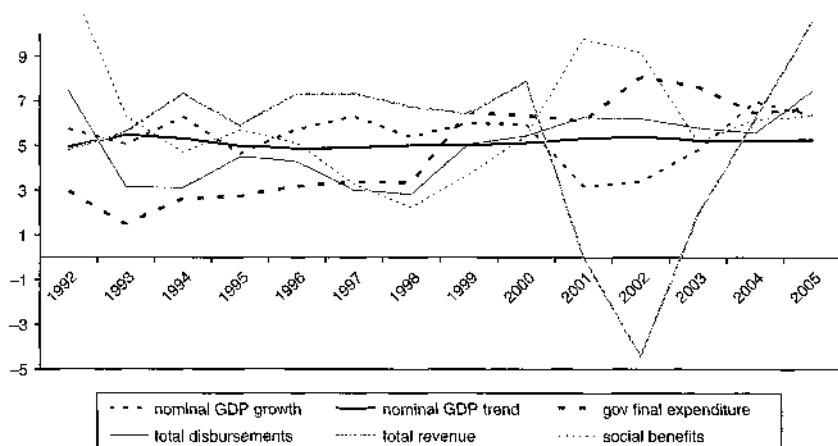


Figure 8.5 Nominal GDP, nominal trend GDP, government expenditure and revenue: United States, 1992–2005, growth rates in per cent

Source: European Commission (2005); authors' calculations.

consolidation: By 1998 the government budget was in balance. After consolidation had been achieved, non-cyclical expenditure grew in line with nominal GDP trend until the slowdown in 2000/1. Since then, non-cyclical expenditure growth has significantly accelerated, social benefits have been raised in a discretionary way, and huge tax cuts have been implemented, thus exerting an enormous fiscal stimulus to the economy. Since 2004, well after the recovery had been achieved, tax revenues have been accelerating strongly again. At the same time the expansion of government expenditure has been decreased to a certain amount. It remains to be seen, whether fiscal policy in the United States will repeat its successful consolidation strategy of the 1990s.

In striking contrast to the US experience, fiscal policy in the Euro Area was much less systematic. (Figure 8.6) There is no systematic pattern in the development of government final consumption. Years with strong counter-cyclical restriction (1997) are followed by pro-cyclical expansion (1999 and 2000), which in turn is followed by pro-cyclical restriction since 2004. Revenue growth rates are subject to substantial variation which hints at intermittent hectic attempts of consolidation and stimulation. Therefore, Euro Area fiscal policy could learn a lot from its US counterpart.

8.7 Can fiscal policy do the job under the current regime of monetary and wage policy?

Switching from the current SGP to a suitable concept based on expenditure paths would substantially improve fiscal policy's macroeconomic stabilization

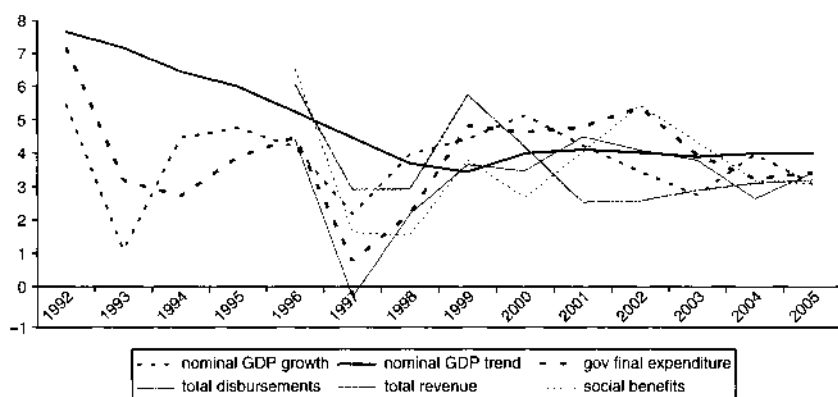


Figure 8.6 Nominal GDP, trend GDP, government expenditure and revenue: Euro Area, 1992–2005, growth rates in per cent

Source: European Commission (2005); authors' calculations. Missing data from 1992–95 for total disbursements, total revenue and social benefits. Total disbursements 2000–02 corrected for proceeds from UMTS auctions.

role while at the same time not endangering the medium-term objective of fiscal sustainability. This result has been implicitly derived under the *ceteris paribus* assumption with respect to the other policy areas, monetary and wage policies. Unfortunately, however, it is highly probable that the advocated change in the fiscal policy regime would lead to reactions in the other areas. Under the current 'Maastricht regime' dominating the Euro Area, these reactions might worsen macroeconomic performance. In the end, isolated changes in fiscal policy institutions might not be sufficient.

The switch to an adjusted expenditure path concept during the period from 2001–05 would have meant a more expansive fiscal policy both for the Euro Area as a whole and for most of the individual countries. It is questionable, whether the ECB would have tolerated such a policy. As it is a strong defender of the SGP in the strictest possible form, it might even be that fiscal policy has already entered the ECB's reaction function, so that it would have directly compensated a more expansive fiscal policy with an even more restrictive monetary policy. Even in the absence of fiscal policy as an explicit argument in the ECB's reaction function under the current un-coordinated state of wage policy within the Euro Area countries, a stronger fiscal expansion would have certainly led to an increase in wage growth. Given the ECB's too ambitiously low inflation target, the ensuing inflationary tendencies or just the improvement in the output gap, would certainly have induced the ECB to raise interest rates, thereby worsening macroeconomic conditions all over the Euro Area.¹⁴ As a side effect, government debt and interest payments would have further risen, limiting fiscal leeway in the future. Therefore, a thorough change in the framework of fiscal policies in the Euro Area might

require a similarly thorough change in the framework of monetary and wage policies to be effective in enhancing economic performance.

8.8 Conclusion

Since the start of the EMU, fiscal policy in the Euro Area has been dominated by the SGP. Quite obviously the SGP has been unsuccessful in fulfilling its goals, fiscal sustainability and supporting economic growth. More and more countries have exceeded the 3 per cent of GDP limit for the budget deficit and the public debt–GDP ratios have been growing, while at the same time macroeconomic performance has been unsatisfactory. It has been shown that, whereas US fiscal policy has acted in a strongly counter-cyclical way, stabilizing the economy, in the Euro Area fiscal policy has been much more restrictive and has had pro-cyclical and therefore destabilizing effects for many countries. It has also been shown that one cannot put all the blame on fiscal policy: The ECB's restrictive monetary policy and divergent wage developments across the Euro Area are at least as important as fiscal policy in the explanation of the Euro Area's weak economic performance.

As a possible solution for the future we have suggested replacing the SGP by expenditure paths for non-cyclical spending as the coordination tool, and we have discussed an important modification of the concept. Expenditure paths could coordinate fiscal policies within the Euro Area in a counter-cyclical way and at the same time ensure fiscal sustainability. As the comparison with US fiscal policy suggested, the expenditure path should be set at a rate below nominal trend GDP with variations above trend allowed during economic downturns. Replacing the SGP with such an expenditure path concept would substantially contribute to a better macroeconomic performance within the Euro Area. Unfortunately, as long as monetary and wage policies remain uncoordinated and destabilizing any isolated improvements in fiscal policy might not be very effective in enhancing economic performance. Therefore, the key to improving the Euro Area economy is to establish a regime of coordinated macroeconomic policy including fiscal as well as monetary and wage policies.

Notes

[#] We are grateful to the editors for helpful comments.

^{*} The authors would like to thank Katja Rietzler for updating some of the data used in Sections 8.2 and 8.3.

1. See Hein and Truger (2005a, 2005b) and Hein and Niechoj (2006) on the Maastricht regime, Hein and Truger (2005c, 2005d) on the special situation of the German economy and Hein and Truger (2006a), Hein, Schulten and Truger (2006) on the risks of deflation in Germany and Europe associated with this constellation. Also Fritzsche et al. (2005), Palley (1998) and Solow (2000) have argued that a favourable coordination between monetary and fiscal policies rather than deregulated labour markets can be held responsible for the superior development of the US-economy during the 1990s compared to Germany or the EU.

2. See Allsopp and Vines (1998); Arestis et al. (2001); Eichengreen (1998); and Semmler (2000) for a more detailed analysis of the original SGP.
3. OECD (2005). For a detailed exposition of the methods used by the OECD, see Giorno et al. (1995).
4. Of course, the results for a given set of countries and a given time period should be more or less robust to the method used and to additional observations due to new data over time. At least with regard to the latter and for Germany, the Euro Area, and the United States, most of the qualitative results we obtain have proven to be rather robust to new data, as we conducted this kind of analysis with almost every new edition of the OECD Economic Outlook data since 2001 (see Hein, Muelhaupt and Truger 2001; Hein and Truger 2005a, 2005b, 2005c, 2005d; Truger and Hein 2002).
5. The ECB has tended to tighten whenever inflation increased above the target without relaxing when inflation expectations came down. For a general critique of the ECB's 'anti-growth bias' see Bibow (2002, 2005a, 2005b); Hein (2002); and Hein and Truger (2006b).
6. See Arestis and Sawyer (2005) and Hein (2006a) for recent post-Keynesian models of distribution conflict and inflation.
7. See Hein (2006a, 2006b) for the integration of real debt effects into Kaleckian models of distribution and growth with conflict inflation.
8. See Hein and Truger (2006a) for a more extensive discussion.
9. For an up to date overview of the EDPs see the relevant internet pages of the European Commission under: http://ec.europa.eu/economy_finance/about/activities/sgp/procedures_en.htm.
10. Buti et al. (2003a) give an overview of a series of reform approaches which for reasons of space cannot be discussed here. For an overview of the more recent debate on the SGP, see Coeuré and Pisani-Ferry (2005); and Calmfors (2005).
11. For the original proposal for the Euro Area see Hein and Truger (2005d). On similar proposals for Germany see Bartsch et al. (2002); Eicker-Wolf and Truger (2003); and Horn and Truger (2005). These proposals are based on the work of Horn and Scheremet (1999) who refer to the successful process of budget consolidation in the United States during the 1990s.
12. Taking nominal GDP trend growth as a reference for non-cyclical spending may be problematic if there are large variations in the inflation rate. The trend may then be subject to frequent changes that do not reflect changes in the underlying real growth trend. Additionally, there might be an incentive for governments to inflate, in order to get more fiscal leeway. We are grateful to Joerg Bibow and Andrea Terzi for pointing out this latter possibility to us. Therefore, one might also use the real GDP trend plus the ECB's target rate as a reference for the expenditure path. In order to simplify the exposition we refrain from doing so in the text. Nevertheless, we have included the real GDP trend plus the inflation target in Table 8.8.
13. It has been argued that expenditure paths imply a very specific concept of the desirable public spending ratio and that they therefore restrict national governments' room for manoeuvre (Buti et al. 2003b, pp. 104). However, it should be pointed out that in the context of the concept presented here, the paths established are country-specific. In addition, the path approach allows for changes in the public spending-GDP ratio. In this case, however, an increase in this ratio would have to be financed by additional taxation. A reduction in the public spending-GDP ratio would be possible by lowering the expenditure path and taxation. Although this

could have the effect of increasing the average restrictiveness of fiscal policy, the adjustment would nevertheless be smoothed out and the automatic stabilizers would be able to continue operating in a somewhat weakened fashion around the lower path.

14. For a recent empirical estimation of the ECB's reaction function see Hein and Truger (2006b). Empirically there is no indication that the budget deficit has entered the ECB's reaction function. Unit labour cost growth, however, has turned out to be highly significant.

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9

Germany's Choice and Lessons from Japan: Supply vs. Demand Policy, Fiscal vs. Monetary Policy¹

Richard Werner

9.1 Introduction

The goal of this chapter is to apply the lessons from the Japanese macroeconomic experience of the 1990s to the European context. Specifically, it is suggested that an analysis of the choices faced by Germany will benefit from a deeper understanding of the relationship between structural and cyclical policy on the one hand, and fiscal and monetary policy on the other. The Japanese experience has offered important lessons on these issues that should not be neglected in the European context.

There are many parallels between Germany and Japan: both countries experienced economic under-performance and a lack of utilization of their factors of production. These economic recessions were accompanied by fiscal deterioration – which is not surprising, since recessions imply fewer tax revenues and larger expenses in the form of unemployment benefits and fiscal stimulation programmes. In both countries, the central banks have been recommending fiscal tightening and fundamental reform of the economic structures, while they have kept monetary conditions tight. In both cases, it will be argued, fiscal policy has been hampered by tight monetary policy and lack of coordination of monetary policy with government policy goals. There are other parallels, as will be seen.

9.1.1 Views on German economic performance

The Stability and Growth Pact (SGP) was adopted by the EU members as a tool to enforce fiscal policy discipline. One of the corner-stones of the SGP is the rule that countries need to keep budget deficits below 3 per cent and debt below 60 per cent of gross domestic product. Since then, Germany has violated the SGP for several years in a row. How did the fiscal deficits and rising outstanding debt of Germany come about? Basic economic statistics for

Germany suggest the German experience to be in line with the standard pattern of deficits occurring during times of recession (Table 9.1).

Real GDP growth decelerated significantly, from almost 3 per cent in 2000, to less than one per cent in 2001. In 2002 and 2003, no positive growth rates were recorded. Unemployment rose beyond 10 per cent in 2003, reaching 12.6 per cent in early 2005, the highest since 1932. Meanwhile, government consumption increased. As a result, the government budget moved from a surplus of 1.1 per cent of GDP in 2000 to a 3.6 per cent deficit in 2002, and a 4 per cent deficit in 2003. Outstanding national debt rose from 60.5 per cent of GDP in 2000 to 63.9 per cent in 2003. In addition, German industrial production was depressed in 2001, 2002 and 2003: having grown on average by 5.1 per cent year-on-year in 2000, industrial production recorded an average contraction of 0.4 per cent in 2001, followed by -1.3 per cent on average in 2002. Average production growth remained unusually modest at only 0.2 per cent in 2003 (Statistisches Bundesamt).

It is thus reasonable to observe that the deterioration of the fiscal situation in Germany has been due to the recession. What, however, has been the cause of this recession? This question is important – not only because a correct answer will allow the right policies to end the recession, but also because it affects our view of the SGP itself.

One view is that the recession has been due to Germany's economic structure. Many neoclassical economists have supported this view. Among policy-makers, it has been most strongly advocated by the European Central Bank. The ECB has argued consistently that its monetary policy has been supportive of the German economy, but structural problems have held growth back. Thus, it has argued that the onus was on the German government to implement structural reforms (deregulation, liberalization, and privatization) and

Table 9.1 Data on German economic performance

	2000	2001	2002	2003
GDP per head (\$ at PPP)	26,114	26,311	26,690	27,060
GDP (per cent real change pa.)	2.86	0.85	0.18	-0.10
Government consumption (per cent of GDP)	18.99	19.01	19.16	19.70
Budget balance (per cent of GDP)	1.10	-2.80	-3.60	-4.00
Consumer prices (per cent change pa. ave.)	1.34	1.98	1.36	1.07
Public debt (per cent of GDP)	60.50	60.21	62.40	63.90
Recorded unemployment (per cent)	9.61	9.37	9.81	10.50

Source: Country Data, as compiled by the Economist Intelligence Unit, 25 May 2004; accessed on 2 January 2005 at: www.economist.com/countries/Germany/profile.cfm?folder=Profile-Economic per cent20Data

to reduce fiscal expenditure so as to meet the Maastricht deficit and debt criteria. The ECB has also argued that responsibility for fiscal deficits and debt lies with the German government, while monetary policy was not implicated or at fault (see Issing 2001, for instance).

If the ECB's structural argument is correct, demand-side policies would indeed not be helpful. Meanwhile, there is another explanation of the German recession, which until recently has been the majority view of economists: weak demand, triggered by tight monetary policy, has held back economic growth below its potential. In this situation, structural reform will not help. Indeed, the Japanese example has shown that a recession that is due to misguided monetary policy cannot be overcome by structural reforms.

Should the latter argument be correct, we would be left with the conclusion that the very SGP, and indeed monetary union, are flawed, because they have neglected the possibility that the ECB could create recessions, while governments would be forced to implement misguided structural reforms. All the while, there would be no mechanism to address the problem and induce the ECB to change monetary policy: according to the Maastricht Treaty, the central bank cannot be forced, or even 'persuaded' to change its policies. Meanwhile, under this scenario there are serious doubts about the viability of fiscal policy. The issue of fiscal and monetary policy interaction and coordination thus assumes a larger role, though neglected even by critics of the ECB.

Before focusing on the latter issue, namely the link between the two main demand management policies, it is therefore necessary to briefly evaluate the merits of the ECB's structural supply-side argument.²

9.2 Testing the supply-side reform argument

The case for structural reform that is made by the ECB and neoclassical commentators is the same as that made by the Bank of Japan since the mid-1990s concerning the Japanese economy.

In general, there are two theoretical foundations of the structural reform argument. The first is neoclassical growth theory, and the second is neoclassical welfare economics. Both are briefly discussed below, in order to give the structural reform argument the full benefit of the doubt.

9.2.1 Neoclassical growth theory

The weak performance of the German economy has been expressed in low GDP growth. Next it is necessary to distinguish between potential and actual growth. By definition, actual growth is due to the quantity of factor inputs (QFI) employed, such as land, labour, capital and technology, and the total productivity of those factors (TFP). This can be written as follows:

$$\text{Actual growth} = f(\text{QFI}; \text{TFP}). \quad (1)$$

Neoclassical growth theory is built on a number of assumptions. These vary depending on the precise type of model employed, but they usually include perfect information, complete markets, no transaction costs and perfectly flexible prices. Based on such assumptions, neoclassical growth theory assumes that markets are in equilibrium. Hence factor inputs are fully utilized and actual growth is identical with potential growth.

The following is therefore assumed to hold:

$$\text{Actual growth} = \text{potential growth.} \quad (2)$$

Since actual growth is simply assumed to always be at potential, any observed weak economic performance must be due to a weak or declining potential output or potential growth.

Whether or not the above assumption holds can be tested empirically. To do this, one needs to evaluate whether:

- (i) the productivity of the employed factors of production have declined significantly (or their productivity growth has slowed sufficiently);
- (ii) the supply of available factor inputs has fallen significantly (or their growth slowed);
- (iii) and/or the combination of the above factors is sufficient to explain the decline in observed actual growth.

Alternatively, one can directly test the fundamental assumption of this approach, namely whether:

- (iv) all available factors of production are actually employed (and thus whether equation (2) holds).

9.2.1.1 Productivity

It has almost become commonplace to argue that productivity in Germany is low. But is this true? Since productivity refers to the factor inputs actually employed, it is invalid to include unemployed resources in a measurement of productivity. German labour productivity can only be measured for those working hours of those members of the workforce actually working. However, often productivity is measured incorrectly, so that unemployment is allowed to reduce productivity estimates (or increased employment boosts them). Statistics that measure German productivity by, for instance, dividing output by the workforce, would give erroneous results. Meanwhile, US productivity, often measured similarly, appears high, simply because US employees work longer hours than their European counterparts.³ However, when measured correctly (such as by dividing output by working hours of those actually employed), many studies found that German productivity was

among the highest in the world and exceeded British productivity in the late 1990s and early 2000s.⁴ *The Economist* (2003) concluded its survey on the topic by arguing that:

The figures certainly show that when they are actually at their desks (or lathes) the Germans, French and Dutch (though not the British) are more productive than Americans.

In 2003, the OECD (2005) found, the United States ranked seventh in terms of labour productivity per hour worked among OECD members, while Germany was a close eighth. Meanwhile, the United Kingdom, Spain, Switzerland, and in total 22 countries were ranked below Germany. Thus it seems unlikely that productivity is the reason why German economic growth was weak between 2001 and 2004.

Nevertheless, much depends on the precise productivity estimates employed, and international comparisons remain fraught with difficulties. Thus it may be useful to employ an alternative and readily available, as well as internationally comparable measure of productivity. According to neo-classical theory, German overall productivity is reflected by the German trade performance, as represented by its trade or current account balance.⁵ What does this measure tell us about German productivity, especially during the 1990s and early 2000s?

Traditionally among the world's largest net exporting nations, during the observation period (2001–04) Germany is found to have recorded a trade surplus that was heading towards new record highs (see Figure 9.1). In 2005

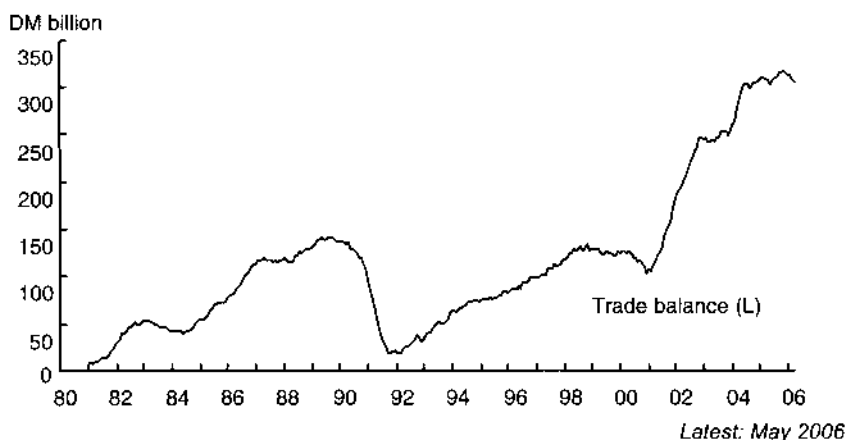


Figure 9.1 German trade balance (annual moving sum)

Source: Statistisches Bundesamt; Profit Research Center Ltd., Tokyo.

it reached a level that was more than twice as large as the previous record of 1990. The surplus in 2004 was approximately twice as large as the trade surplus of Japan, then the second largest exporter (approximately USD 180 billion vs. USD 83 billion in 2004).⁶ Clearly, using this measure we find that there is no evidence that weak German economic performance of the recent years has been due to a decline in productivity (or productivity growth).⁷

Meanwhile some readers may remember that Germany is often given low rankings in so-called international 'competitiveness' or 'productivity' surveys. One example is that produced by the World Economic Forum on an annual basis. However, these measures and rankings are usually based on subjective assessments or polls of businesses that may reflect other issues – such as costs – rather than productivity. They cannot be considered objective measures of productivity.

9.2.1.2 Factor inputs

There is little evidence that the available factor inputs have declined (or their growth rate has declined) sufficiently to explain the weaker economic performance 2001–04.⁸ Meanwhile, a detailed discussion of this possible explanation is left for future research.

9.2.1.3 Full employment

The most straight-forward test of the structural reform argument, as based on neoclassical growth theory, is to examine whether all factors of production were fully employed during the observation period. If unemployed resources are found, then the neoclassical growth theory, and thus the recommendation to reform the economic structure based on it, would have to be dismissed, because Equation (2) would not hold. Put simply, if actual growth is falling short of potential, increasing the potential growth rate will not help in raising actual growth.⁹

The evidence on this count is clear-cut. Not all factors of production were fully employed, as can be seen from the unemployment figures cited above. The capacity utilization of the manufacturing sector had declined between 2001 and 2002. According to the DIW, it fell from a peak of 87.1 in 2000, to 86.1 in 2001 and 83.9 in 2002.¹⁰

We conclude that the structural reform thesis, as based on neoclassical growth theory, is not supported by empirical evidence. The argument that the German recession has been due to an under-utilization of available factor inputs is more compelling. In this case it is not supply-side reforms that will be helpful, but old-fashioned demand management policy. What demand management policy mix is recommended is subject of discussion in Section 9.3.

9.2.2 Neoclassical welfare economics

There is another possible argument in support of the structural reform thesis. This is based on neoclassical welfare economics. The fundamental

theorem of welfare economics lists the particular set of assumptions under which the competitive economy is Pareto-efficient. These include perfect information, complete markets, perfect competition, zero transaction costs, and so on. They define an economy where interventions, such as by the government in the form of regulations, must by definition reduce allocative efficiency. This theory is often interpreted as follows: the more an economy resembles the conditions for Pareto efficiency, the better it will perform. The less it resembles these conditions, the worse it will perform. Consequently, it is often argued that structural reform should be implemented to deregulate, liberalize, and privatize an economy, so as to increase its market-orientation and help it to move closer to the Pareto-efficient ideal.

The argument in the case of Germany is as follows: because the German economy is characterized by regulations, government intervention, and non-market mechanisms, it cannot be expected to operate in a Pareto-efficient way. Thus its economic structure should be reformed, by deregulation, liberalization, privatization, and generally moves towards a greater role for market mechanisms. Such structural reforms will increase the degree of efficiency and hence enhance economic performance.

This argument can be empirically tested. A testable hypothesis concerning the link between the economic structure and economic growth can be derived. Second, a link between structural reform (i.e., changes in the economic structure) and economic growth can be derived and tested. The two testable hypotheses are:

- (a) Countries that are more market-oriented and shareholder-focused are more efficient and thus deliver higher growth than countries that are less market-oriented.
- (b) Implementing structural reform towards greater market and shareholder orientation will increase economic growth.

It is interesting to note that probably a majority of 'trained' economists would consider both hypotheses to be good descriptions of reality, and would expect there to be significant empirical evidence in their favour. However, as is often the case with much-recited views, there is little hard-core empirical evidence published in support of these hypotheses.

To test the first of these hypotheses, we must classify a number of relevant countries by their degree of market orientation. Here it is commonly argued that the United States and United Kingdom are more market-oriented and focused on shareholder value, while Germany, Japan, and Korea are examples of less market-oriented economies (characterized by government regulation, cross-shareholdings, less reliance on equity markets for corporate finance, less influence of shareholders, lower dividends, even cartels, etc.).

To test this hypothesis, a longer time period of observation is necessary than just a few years, since we need to abstract from business cycles. Thus if the neoclassical welfare theory was empirically relevant in the way proclaimed, we would expect over longer time periods that the more market- and shareholder-oriented economies would deliver higher economic growth. Below we show the empirical evidence from the United States, United Kingdom, Germany, Japan, and Korea, for the half-century from 1950 to 2000 – a time period sufficiently long to be able to give an indication of the role of structural differences.

As can be seen in Figure 9.2, the empirical evidence is stacked against the first hypothesis. Considering average real GDP of the United States, the United Kingdom, Germany, Japan, and Korea in the half-century from 1950 to 2000 as a generally accepted and widely used proxy for economic performance, we observe that during this long time period Germany has had higher real GDP growth than the United Kingdom or the United States. Meanwhile, the even less market-oriented economies of Japan and Korea recorded still higher long-term economic growth. This, despite the fact that Japan had been mired in a decade-long slump in the 1990s and Korea suffered the negative effects of the Asian crisis in the late 1990s. It would appear that the first hypothesis of neoclassical welfare economics is rejected by the data.

The second testable hypothesis derived from neoclassical welfare economics is that structural reforms that increase the role of markets and shareholders will, *ceteris paribus*, improve economic performance. Conversely, structural reforms away from markets (namely increasing the number of cartels) are expected to reduce economic performance.

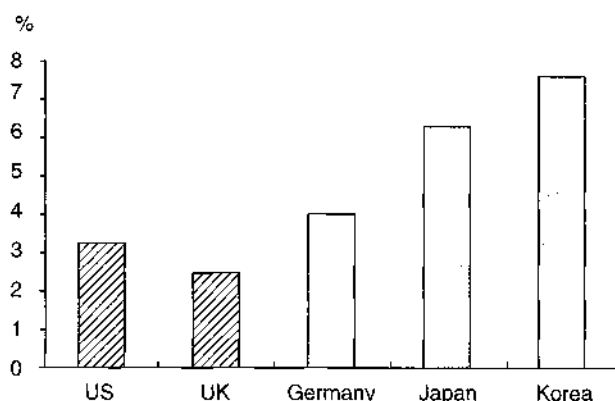


Figure 9.2 Average real annual GDP growth, 1950–2000

Source: Financial and Economic Statistics Monthly, Bank of Japan.

Here, for space reasons our empirical analysis is restricted to the case of Japan, which after the Second World War showed an extreme case of non-market economy, and which experienced significant structural reform over the past half-century to increase its market orientation: Begun in the early 1970s, a range of structural reform programmes, including deregulation, liberalization, and privatization, sharply increased the role of markets and shareholders. This structural reform programme accelerated in the 1980s and peaked under the Koizumi administration in 2001. Werner (2004) argues that a ready proxy for the degree of market orientation and hence structural reform is the number of official cartels: They represent direct non-market mechanisms to settle economic transactions that were pervasive in the early post-war era. Initially, the number of cartels was increased as a matter of policy, and it reached over 1000 at their peak in the 1960s. Since the 1970s, under political pressure from the United States, the number of cartels has been drastically reduced. As a result of decades of structural reform today there are none left.

The testable hypothesis is that an increase in the number of cartels should be associated with lower economic growth and a decrease in the number of cartels with higher economic growth. Thus the two variables should be negatively correlated. Figure 9.3 shows the correlation between the number of cartels and economic growth over 42 years.

The Japanese case study provides no compelling empirical evidence in support of the asserted relationship between economic growth and structural reform. To the contrary, it would appear that the empirical record suggests a

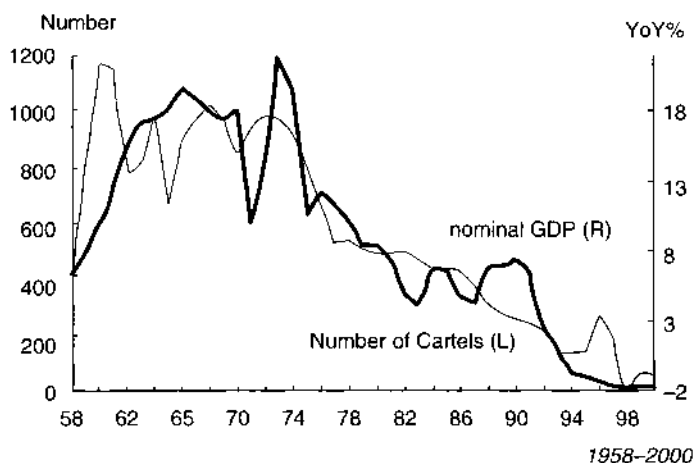


Figure 9.3 The number of cartels and economic growth in Japan

Source: Werner (2004).

positive link between the number of cartels and growth: when more cartels were introduced in the 1950s and 1960s, growth was explosive. When the number of cartels was curbed, growth decelerated. As the number of cartels hit zero in the late 1990s, growth had ground to a halt.

In the case of Germany there is also no known published empirical evidence in support of the argument that structural reform towards markets has improved economic performance: just like Japan, Germany recorded its highest growth rates during the post-war era in the early decades, when the economic system was least market-oriented.

Should this finding surprise us? It must be remembered that neoclassical welfare economics is based on a highly restrictive set of assumptions that apply nowhere in the world we live in. Neoclassical welfare economics has demonstrated that the conditions for market efficiency are so stringent that we cannot expect them to apply to us, and hence we cannot expect markets to be efficient. That, in turn, provides a rationale for government intervention and non-market solutions. Cartels may, after all, be less inefficient in the 'real world' we live in, where markets are rationed due to imperfect information.

9.2.3 Conclusion concerning the supply-side reform argument

The ECB's argument that supply-side structural reforms are most needed in order to stimulate the German economy remains without merit. A more plausible explanation of the economic performance of Germany (as well as Japan) is the simpler argument of weak demand. Thus we now need to consider the role and connection of the two main demand management policies, namely monetary and fiscal policy.

9.3 Fiscal and monetary policy

Among economists critical of central bank policy in general and of the ECB's policies in particular, it has become commonplace to argue that fiscal policy is more useful than the ECB claims. Further, many proponents of Keynesian, Post-Keynesian, and fiscalist schools of thought often argue in general that fiscal policy is more effective than monetary policy. Meanwhile, this view is diametrically opposed to the monetarist and neoclassical camp, which argues that fiscal policy is not likely to be effective. So far, the empirical record has been mixed. As the topic is large, while the aim is to highlight the link between fiscal and monetary policy, the subsequent discussion will focus on the government expenditure and investment policy aspect of fiscal policy.

A significant number of empirical studies have aimed at estimating the contribution of public expenditures to economic growth, using time-series or cross-country data.¹¹ One study found that public expenditures had no impact on growth in developed countries, while it had a positive impact in developing countries (Sattar 1993). The IMF (1995) concluded that the relationship between aggregate public expenditure and economic growth is not

well established empirically. This also applies to public investment as a component of public expenditure.¹² Barro (1991) found only a statistically insignificant relationship. Crowding out is found, among others, by Aschauer (1989), Munnell (1990) and Holtz-Eakin (1994). Cross-country studies have also not produced robust statistical support for a link between public investment and growth (Levine and Renelt, 1992).

9.3.1 Japanese government expenditure policy

We begin with an empirical examination of the issue of the efficacy of fiscal expenditure policy, with reference to a major economy that has experienced fiscal stimulation of fairly extreme proportions. We thus focus attention again on the Japanese case and the lessons that can be learnt from it for countries such as Germany.

First, consider the data that establish the expansive fiscal expenditure stance in Japan. We use the national income accounts data, aggregating government consumption, investment, and inventories, which provide a consistent measure of the expenditure dimension of the fiscal stance. According to these figures, Japanese government expenditure (G) rose from an aggregate of ¥705 trillion in the 1980s to ¥1136 trillion in the 1990s (¥113.6 trillion every year on average during the decade of the 1990s, up from ¥70.5 trillion on average per year during the 1980s). This was an increase from 20.9 per cent of GDP on average in the 1980s to 22.7 per cent on average in the 1990s. During the 1990s, the share of government expenditure rose from a low of 19.8 per cent in 1991 to a high of 23.9 per cent in 1999.

Considering changes, the expansionary fiscal expenditure stance during the 1990s becomes even more obvious: G increased by ¥32 trillion in the 1980s, and ¥33 trillion in the 1990s. This may appear as a fairly stable fiscal policy. However, growth was far lower in the 1990s and thus the role of G was far more prominent than in the 1980s: Table 9.2 shows the breakdown by contribution to growth of each GDP component. On average, government spending contributed almost half of growth in the 1990s, while it only contributed about a sixth of growth in the 1980s.

As nominal GDP grew by ¥199 trillion in the 1980s, while growing only ¥72 trillion in the 1990s, the ratio of government expenditure growth to nominal GDP growth ($\Delta G/\Delta \text{GDP}$) rose sharply from 16.3 per cent in the 1980s to 46.5 per cent in the 1990s. In the second half of the 1990s there were years when this ratio was negative (in 1997 and 2000, government expenditure declined, but nominal GDP rose). In 1998 and 1999, government expenditure rose, but nominal GDP declined (with the 1999 increase in government expenditure being three quarters the size of the fall in nominal GDP). The simple period 'multiplier' ($\Delta \text{GDP}/\Delta G$) fell from an aggregate of 6.1 in the 1980s to only 2.2 in the 1990s. However, for half of the 1990s, it was below one, and for the last four years of the decade it was significantly negative.

Table 9.2 Contribution to nominal GDP growth in the 1980s and 1990s

	(a)	(b)	(c)	(d) = (a) + (b) + (c)	(e)	(f)	(g) = (e) + (f)	
	Consumption + Housing	Capital expenditure (+ Inventories)	Net Exports	Private Demand:	Government Consumption	Government Investment (+ Inventories)	Total Government	TOTAL
1980s ave.	3.4	1.5	0.3	5.2	0.8	0.2	1.0	6.2
1990s ave.	1.0	-0.1	0.4	0.8	0.6	0.2	0.7	1.5

Source: Cabinet Office, Government of Japan.

Here it is noteworthy that the apparently diminishing positive 'effect' of government expenditure was not predicted by contemporary observers, including the official government forecasts at the time. This is important, because any *ex post* rationalization of why fiscal policy failed to have a large effect must also be able to explain why fiscal expenditure policy clearly disappointed observers and forecasters at the time. Tanaka and Kitano are representative of many observers when they conclude that 'aggressive fiscal policy was implemented in Japan. [...] However, despite the aggressive fiscal mobilization, the economy remained in recession' (2002, p. 1). Interestingly, when they compare this experience to other countries, they find that the Japanese experience – even though numerically more obvious – was not an outlier, because fiscal expenditure policy had virtually no impact in all the countries they examined. Why is it that fiscal stimulation might not be as effective as traditional Keynesian textbooks would have us believe?

9.3.2 The effect of funding the public sector borrowing requirement

When fiscal expenditure rises, but total GDP fails to rise as much, we know that by definition other components of GDP must have acted to dampen growth. This may on occasion be coincidence. But there may be reasons why a rise in fiscal expenditure may actually trigger a fall in private sector consumption, capital expenditure, housing investment or net exports in a more systematic fashion.

Already in the 1970s, a growing literature pointed out that initial 'first round' positive effects of fiscal stimulation may be 'crowded out' by the negative effects of funding the government's expenditure. Christ (1968), Blinder and Solow (1973), Hansen (1973) and others showed that in the case of bond-financed deficit spending, the positive effect of fiscal policy is smaller than that derived in traditional Keynesian models that do not take funding into consideration.¹³ This crowding out was seen to work through higher interest rates. Its argument was essentially absorbed in the Keynesian IS-LM synthesis, and also mainstream monetarist models (see Brunner and Meltzer 1976; and Friedman 1956).

In the Japanese case, the government has funded the revenue shortfall mainly from the private sector via bond and bill issuance. New government borrowing increased by ¥300.4 trillion during the 1990s (58.6 per cent of 2000 nominal GDP). This raised total outstanding debt to ¥522.1 trillion by the end of 2000, amounting to 101.8 per cent of GDP. At the end of 2003 the government estimated that the outstanding balance of government debt would reach over ¥700 trillion by the end of March 2005. These facts would appear to deliver a *prima facie* case for the standard crowding out argument: with such vast deficit-funding and build-up of debt, propelling Japan to the forefront of fiscally challenged industrialized countries, a rise in interest rates should be expected to crowd out private demand, and hence at least

partially negate the positive effects of fiscal spending. Is this why the large fiscal stimulation failed to stimulate a recovery in Japan in the 1990s? Alas, this initially seemingly plausible interest-rate crowding out argument faces a major obstacle in many countries, most obviously in Japan of the 1990s: interest rates did not rise enough to account for any crowding out. In the Japanese case, short-term and long-term interest rates actually fell during the 1990s, despite the significant fund-raising and debt build-up by the government.

This has placed the argument of an alternative form of 'crowding out' at the forefront of recent analysis, especially concerning Japan: Krugman (1998) used a model of inter-temporally optimizing rational representative agents to argue that Ricardian equivalence of the type Barro (1974) proposed is relevant in Japan: According to Krugman, Japanese consumers believe that any fiscal spending funded by the issuance of government debt will require the debt to be fully paid off in the future through higher taxes on individuals. Therefore, rational consumers increase their savings – and reduce their consumption – by the same amount that the government increases its expenditure, so that they are ready to pay for it through higher taxes in the future. However, there are also many problems with this argument. The model does not allow for the possibility that the debt will be paid off by other means, and for rational consumers to consider this (e.g., money creation, higher corporate taxes, economic growth that boosts tax revenues without raising individual taxes, or asset sales to foreign investors). Further, the assumption of full employment renders the model unsuitable to gauge the potential impact of increased fiscal expenditure to boost otherwise weak demand. Finally, there is as yet no empirical evidence to support this theory.

This leaves us with a third explanation, as proposed by Werner (1997b), which is based on an explicit link between fiscal and monetary policy. This explanation does not require a rise in interest rates, or the economy to operate at full employment. Instead, it refers back to the basic budget constraints imposed on the economy by the monetary system. It also offers a policy avenue by which fiscal policy may again be rendered highly effective.

The most basic link between money and the economy is expressed by the 'quantity equation':

$$MV = PY \quad (1)$$

In terms of changes, this is rewritten as follows:

$$\Delta(PY) = V\Delta M \quad (2)$$

From this we see that, assuming constant velocity, any exogenous increase in a component of nominal GDP (such as in G) cannot affect total nominal GDP, if the money supply remains unaltered: with $\Delta M = 0$, and breaking down nominal GDP (PY) into nominal consumption c , nominal government

expenditure g , nominal investment i and nominal net exports nx (using lower cases to emphasize the use of nominal variables, rather than the more common disaggregation of national income accounts data in real terms), we obtain:

$$\Delta M = 0 \quad (3)$$

$$\Delta(PY) = \Delta c + \Delta i + \Delta g + \Delta nx \quad (4)$$

Thus:

$$(\Delta c + \Delta i + \Delta nx) = - \Delta g \quad (5)$$

Under the condition expressed in Equation (3) that the money supply is unaltered, each dollar of additional government spending must crowd out exactly one dollar of private spending, as shown in Equation (5). Thus the level of aggregate income will be unchanged and the multiplier for bond-financed government spending (i.e., government spending that does not affect the money supply) zero.

This result is not dependent on the assumption of full employment. Instead of the employment constraint, the economy can be held back by a lack of money, at any level of employment. Further, interest rates do not enter the equation. Instead, there is a direct quantity crowding out effect, as the money used by the government for its fiscal expenditure cannot at the same time be available for spending by the private sector and hence this quantity-based crowding out could happen with rising, falling or unchanged interest rates. Fiscal policy not backed by monetary policy will crowd out private demand even with significant unemployment. Therefore Equation (5) shows that without an increase in the money supply, nominal GDP will remain unaltered and fiscal policy is completely ineffective.¹⁴

Before this theoretical argument can be applied to the Japanese or German cases, a major empirical hurdle must be cleared. Since the mid-1980s, macro-economic models based on the quantity equation and predicated on the assumption of constant velocity have virtually all broken down (Goldfeld and Sichel 1990): the quantity equation approach requires a stable velocity, but in fact substantial declines in velocity (and hence a 'breakdown' in the money demand function) have been observed in many countries since the 1980s. In the words of Charles Goodhart, the previously stable relationship between M and PY 'increasingly came apart at the seams during the course of the 1980s' (Goodhart 1989). Therefore, in practice the quantity equation has not been used to link money and nominal GDP (growth) for the past two decades or so.

However, Werner (1992, 1997a) suggested several improvements to the original quantity equation, which could account for the empirical breakdown

in the relationship between M and nominal GDP. Firstly, Equation (1) neglects financial transactions.¹⁵ A disaggregated quantity equation, which relates changes in nominal GDP to the change in money used for transactions that enter GDP (i.e., excluding real estate and financial transactions), was shown to be consistent over long time periods and reliable for forecasting (Werner 1992, 1994, 1997a, 2003, 2005). This disaggregated quantity equation is shown below:

$$\Delta(P_R Y) = V \Delta M_R \quad (6)$$

where P_R stands for the GDP deflator and M_R for money used for GDP transactions.

Second, concerning the empirical data to express the 'money supply' M in the above equations, Werner (1992, 1997a) pointed out that the Fisher equation originally referred to money used for all transactions. However, the commonly used deposit aggregates measure money out of circulation (essentially savings), not money in circulation. Thus Werner suggested to replace deposit aggregates with credit counterparts, based on a number of theoretical and empirical reasons.¹⁶ Therefore Equation (6) is rewritten as follows:

$$\Delta(P_R Y) = V \Delta C_R \quad (6')$$

This model is simpler than other explanations, as no restrictive assumptions such as perfect information, market clearing, etc. are required. Further, it is also compatible with recent advances in the 'credit view' approach in macroeconomics.

Equation (6') suggests that interest rate policy may not be sufficient, and possibly also not necessary, to stimulate economic growth: there are many scenarios where lower interest rates will not trigger a necessary expansion in credit creation. Equation (6') also suggests that 'pure' fiscal expansion cannot stimulate nominal GDP growth: As seen from the above quantity formulations, if there is no increase in credit used for GDP transactions C_R , there cannot be an increase in nominal GDP. In this case, greater fiscal expenditure must crowd out private demand:

If:

$$\Delta C_R = 0 \quad (3')$$

Then:

$$\Delta(P_R Y) = \Delta c + \Delta i + \Delta g + \Delta nx \quad (4')$$

$$(\Delta c + \Delta i + \Delta nx) = -\Delta g \quad (5)$$

Fiscal policy can only affect nominal GDP growth, if it is backed by the monetary side of the economy, via an expansion in credit. This proposition suggests that fiscal and monetary policy should not be analysed or operated independently – as Lerner (1943) argued long ago.¹⁷ In general, with non-zero credit growth we obtain through substitution of (4') and (5) in (6'):

$$\Delta(c + i + nx) = V\Delta C_R - \Delta g \quad (7)$$

whereby in a regression of private demand $\Delta(c + i + nx)$ on credit and government expenditure, the coefficient Δg is expected to be approximately -1 . Equation (7) shows that, given the amount of credit creation produced by the banking system, an autonomous increase in government expenditure must result in an equal reduction in private demand due to monetary quantity crowding out. An example is the following: if the government funds increased fiscal stimulation by issuing bonds, private sector investors such as life insurance companies, which purchase the bonds, must withdraw their purchasing power from other parts of the economy.¹⁸

The quantity crowding out postulated by this model is different from either the standard Keynesian interest or neoclassical Ricardian quantity crowding out: it is quantity-based and does not require any particular movement in interest rates; it does not depend on restrictive assumptions about unobservable expectations and their formation; it does not operate via a change in household savings or is dependent on individuals' expectations or conscious behaviour. The crowding out occurs due to increased claims by the government on limited credit. A precondition is that the financial system fails to increase purchasing power (credit) creation to support the increased fiscal expenditure. This latter point also indicates when fiscal policy can be expected to be effective: when it is backed by monetary policy through an equal expansion in credit creation.

The policy advice following from this analysis cannot be considered controversial. According to Blinder and Solow, there 'is no controversy over government spending financed by printing money. Both sides agree that it will be expansionary' (Blinder and Solow 1973, p. 323). Needless to mention, 'printing money' is merely a metaphor for creating credit in a modern financial system. In concrete terms, the Japanese or German authorities would need to increase credit creation in order to stimulate growth. They can achieve this by expansionary fiscal policy that is funded by credit creation. More about this after the empirical test of this model.

9.3.3 Empirical evaluation

Werner (2005) put this empirical framework to rigorous tests, using Japanese data. First, a general model of nominal GDP growth which includes a number of competing potential explanatory variables (including short-term and long-term interest rates, M1, M2 and other variables, but also credit creation

for GDP transactions C_R) is reduced downward to the parsimonious model (in application of the general-to-specific modelling methodology proposed by Hendry and others):

$$\Delta \text{GDP}_t = \alpha + \beta_1 \Delta \text{GDP}_{t-1} + \gamma_0 \Delta C_{Rt} + \gamma_3 \Delta C_{Rt-3} + \varepsilon_t \quad (8)$$

This can be broken down and solved for private demand as the dependent variable by substituting Equation (8) into Equation (7):

$$\Delta(c_t + i_t + nx_t) = \alpha + \beta_0 \Delta g_t + \beta_1 \Delta \text{GDP}_{t-1} + \gamma_0 \Delta C_{Rt} + \gamma_3 \Delta C_{Rt-3} + \varepsilon_t \quad (9)$$

Equation 9 can now be put to the empirical test, thereby testing the proposition of complete fiscal policy ineffectiveness. Since credit is one of the explanatory variables, any actual rise or fall in credit would be controlled for. If fiscal policy that is not backed by credit creation is perfectly ineffective, as our theory proposes, we would in the extreme case expect to find that the coefficient for government expenditure (β_0) is minus one:

$$\beta_0 = -1 \quad (10)$$

The actual data used must employ seasonally differenced absolute changes. Figure 9.4 shows the original data – that is, not fitted – during the 1990s,

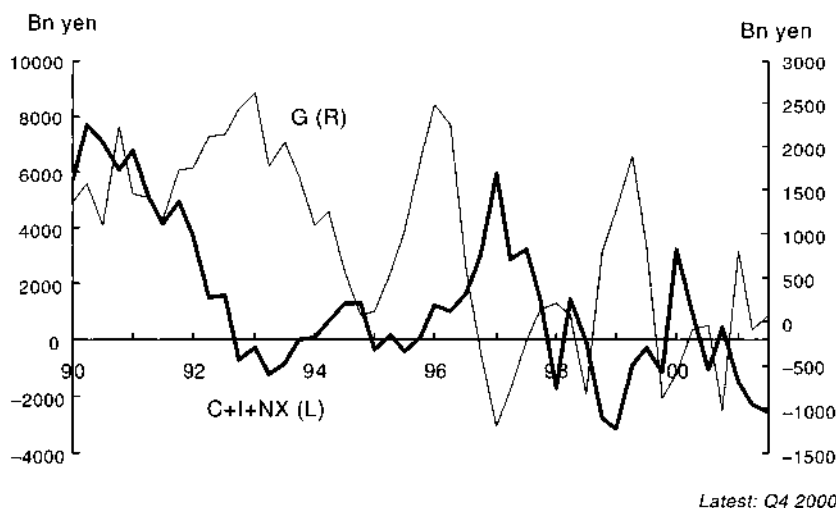


Figure 9.4 Nominal private demand and government expenditure, absolute growth rates

Source: Cabinet Office, Government of Japan.

namely changes in government spending and private demand. Eye inspection of this raw data indicates that a negative correlation is likely, although there are periods when both variables fell or rose together. Such episodes should be explained by the presence of the credit variable.

The regression is not only run for the unusual 1990s, but for a longer time period – any explanation that works both in the 1980s, when fiscal policy was relatively tight, as well as in the 1990s, when fiscal policy was stimulatory, would be superior to one that only works for the 1990s. The results are shown in Table 9.3, with D480CINX denoting private demand, D480G denoting government expenditure and D4CR denoting credit in the ‘real circulation’ (see Werner 1997a, 2005). This is followed by Figure 9.5, which presents the graph of the dependent variable and the fitted model.

The model of private demand has a good fit. There are no obvious misspecification problems. Most of all, the coefficient for government expenditure was found to be -0.974 . Rounding to one digit, this is exactly as the theory suggests:

$$\beta_0 = -1.$$

In addition, linear restriction tests are conducted, in order to check whether the null hypothesis that $\beta_0 = -1.0$ can be rejected (Table 9.4).

The linear restriction F-test fails to reject the null hypothesis that $\beta_0 = -1.0$ (probability: 85.5 per cent).

We have found that for every yen in government spending that is not monetized (i.e., not supported by credit creation), private demand had to shrink by one yen. An economic recovery requires an expansion in credit creation, and fiscal policy will only be effective to the extent that it is backed by credit expansion. Un-monetized fiscal policy will be entirely ineffective.

Testing separately only for the 1990s, the same result was found: the coefficient for government expenditure was -1.0 , and fiscal expenditure policy was completely ineffective when not backed by credit creation.

9.3.4 Policy implications for Japan and Germany

Fiscal policy will only stimulate the economy, if it is supported by monetary policy through credit expansion. Our credit-based model revived the findings of the early Keynesian and proto-monetarist quantity equation proponents. The policy implication is that it is crucial to coordinate fiscal and monetary policy. This conclusion is not controversial, as economists as diverse as Lerner (1943), Schabert (2004) or Wray (2001) are calling for such coordination.¹⁹ However, as the importance of such coordination has been understated because of a lack of understanding of the complete quantity crowding out of fiscal policy when not supported by monetary policy (Lerner 1943, being an exception), there has been too little debate concerning the political implications for the independence of central banks.

Table 9.3 Estimation results of private demand model

	Coeff	Std.Err	t-val	t-prob	Part.R^2
Constant	440.286	244.6	1.80	0.076	0.046
D480nGDP_1	0.476	0.098	4.85	0.000	0.257
D4CR	0.085	0.031	2.75	0.008	0.100
D4CR_3	0.059	0.036	1.64	0.105	0.038
D480G	-0.974	0.140	-6.94	0.000	0.415
Sigma	1231.87		RSS		103190221
R^2	0.832		F(4,68)	=	83.97 [0.000]**
log-likelihood	-620.482		DW		2.03
no. of obs.	73		no. of param.		5
mean (D480CINX)	2441.51		var(D480CINX)		8.39605e+006
AR 1-5 test:	F(5,63)	=	1.214	[0.313]	
ARCH 1-4 test:	F(4,60)	=	0.605	[0.661]	
Normality test:	Chi^2(2)	=	5.672	[0.059]	
hetero test:	F(8,59)	=	1.990	[0.064]	
hetero-X test:	F(14,53)	=	1.772	[0.068]	
RESET test:	F(1,67)	=	0.199	[0.657]	

Solved static long run equation for D480CINX

	Coeff	Std.Err	t-val	t-prob
Constant	440.286	244.6	1.80	0.076
D480nGDP	0.476	0.098	4.85	0.000
D4CR	0.144	0.029	4.93	0.000
D480G	-0.974	0.140	-6.94	0.000

Long-run sigma = 1231.87

ECM = D480CINX - 440.286 - 0.476*D480nGDP - 0.144*D4CR + 0.974*D480G;

WALD test: Chi^2(3) = 334.98 [0.000] **

Tests on the significance of each variable

Variable	F-test		Value	[Prob]
Constant	F(1,68)	=	3.239	[0.076]
D480nGDP	F(1,68)	=	23.512	[0.000]**
D4CR	F(2,68)	=	13.189	[0.000]**
D480G	F(1,68)	=	48.223	[0.000]**

Notes: Modelling D480CINX by OLS; sample 1983 (1) to 2001 (1).

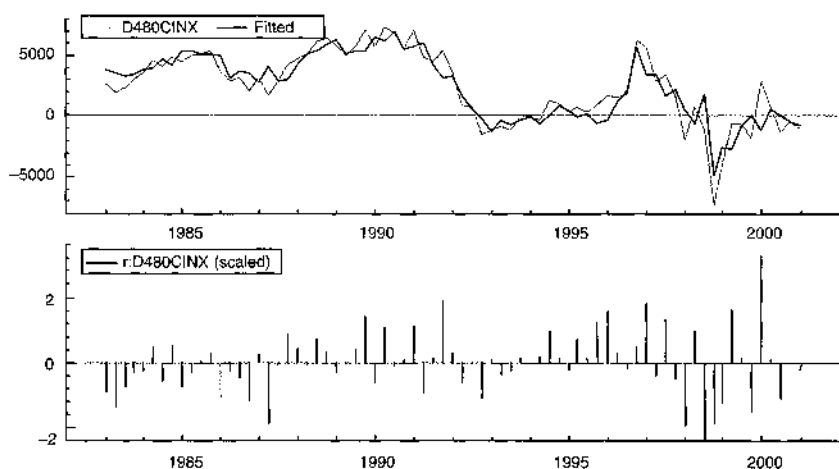


Figure 9.5 Private demand and fitted model. Evaluation of empirical tests

Table 9.4 Linear restriction test of ineffectiveness hypothesis

Test for linear restrictions ($Rb = r$): R matrix

Const	D480nGDP_1	D4CR	D4CR_3	D480G	r vector
0.000	0.000	0.000	0.000	1.000	-1.000

LinRes $F(1,68) = 0.0335743$ [0.8552]

Japan

The Japanese central bank could have rendered the government's fiscal expenditure efforts effective by engaging in equally sized credit expansion policies, such as via open market purchases of government bonds. The credit expansion implemented by the Bank of Japan was woefully inadequate during much of the 1990s. Further, the central bank could have engaged in active policies to increase bank credit creation. For instance, it could have employed its unique status of central bank to solve the bad debt problem, which had paralysed the banks for much of the 1990s. The latter policy was adopted by the Bank of Japan shortly after 1945, when the bad debt problem was even larger than during the 1990s. It simply moved the banks' bad debts onto its own balance sheet, replacing them with credits at the central bank at nominal value. In other words, by buying the bad debts from the banks at face value, banks' balance sheets would be restored and banks would be able and willing to lend again. Meanwhile, the central bank – contrary to public perception – would not make any losses on this transaction. Its actual purchase cost would be zero, as it creates the money to purchase the bad debts

at zero cost. However, it would obtain assets that are worth more than zero. Thus, a profitable proposition. Of course it is possible to book the transaction such that the central bank makes nominal losses in accounting terms. However, there is no rational reason why such artificial book losses should be created. Unfortunately, none of these policies were implemented. Thus it has to be said that the Japanese central bank failed to support fiscal policy specifically and economic recovery policies in general during the 1990s. From this analysis it would seem that the central bank lacked incentives to coordinate its policies with the declared government policy (including fiscal policy). This would appear to be a major disadvantage of central bank independence.²⁰

Germany

From the above analysis it would appear that the ECB should not blame the German government for failing to meet the Maastricht criteria. According to Equation (6'), growth is a function of credit creation. A decline in credit creation results in a recession, which in turn produces fiscal deficits and debt. There is no reason to believe that this chain of causation did not also hold in Germany. Indeed, bank lending declined in Germany from 2000 onwards (Figure 9.6).

In 2002 and 2003 bank lending even contracted. If we recognize imperfect information and hence rationed markets (which are determined by the 'short side' principle, which states that whichever of demand or supply is smaller will determine the outcome of the transaction), we can deduce that a credit crunch occurred in Germany. This was observed at the time (Werner 2002b). The credit-induced recession resulted in greater fiscal expenditure, higher



Figure 9.6 Bank lending in Germany

deficits and aggregate debt. As Equation (6') shows, the recession could have been ended through suitable policies that expand credit creation, such as monetization of the fiscal stance. Consequently it can be said that the rise in the German fiscal deficit and national debt have been largely the responsibility of policies undertaken by the ECB.

Since institutionally – due to virtually global central bank independence – the coordination of fiscal and monetary policy is nowadays extremely difficult – if not impossible – it is necessary to discuss: (a) the need to change institutional arrangements and render the quantity of credit policy of central banks accountable to elected governments; and (b) discuss policies that would enable governments to influence and stimulate credit creation even without the cooperation of the central bank.

On the latter count, there are a number of possibilities. The more radical would be for the government to issue money directly, and use it to fund fiscal expenditure. This has been proposed by Stiglitz in newspaper interviews. Much earlier, it has actually been implemented by US President John F. Kennedy, who in 1963 dared to challenge the monopoly of the privately owned Federal Reserve Banks to create money, and issued so-called 'United States Notes' (which looked identical to the more common 'Federal Reserve Notes').

Yet there is a less radical and readily available method for governments to monetize fiscal policy, even without cooperation from the central bank. Werner (1998, 2000a, 2000b, 2002a, 2003, 2005) pointed out that credit-financed fiscal policy can be implemented by the government, if it chooses to cover the public sector borrowing requirement by borrowing from commercial banks. This would increase bank credit creation, thus provide the necessary credit backing, and hence stimulate the economy.

This policy was adopted in Germany in the early 1930s. From 1933 to 1937, the Reichsbank under its President Hjalmar Schacht, stepped up its own credit creation (by purchasing assets, such as government bonds and bills of other government institutions). Schacht also oversaw the establishment of semi-public institutions that implemented fiscal spending and were funded by the issuance of bills of exchange (*Wechsel*) that banks and central bank purchased. Either way, credit creation expanded. Clearly, at the time this happened with the active cooperation of the central bank. However, in the post-war era it was shown that the same can be done without central bank participation: During the 1950s and 1960s, when Germany enjoyed its high-growth 'economic miracle', fiscal policy was highly effective, with little crowding out. The reason was its high degree of monetization: in 1968, under finance minister Karl Schiller, long-term bank credit accounted for about 70 per cent of the public sector borrowing requirement (PSBR) in Germany (amounting to DM13 billion). Today this proportion has dropped to zero: in 1999, Germany funded its PSBR (amounting to E35 billion, approx. DM70 billion) entirely through the issuance of government bonds,

and reduced its borrowing from financial institutions (by a net E10 billion, approx. DM20 billion).²¹ The differing impact is apparent: fiscal policy cannot be said to have been very effective in the recent past, at least as visible from the reported GDP figures.

There are other commentators who discussed the proposal to fund the PSBR via bank credit: Hawtrey discussed it at the Macmillan Committee in 1930, though in the context of arguing against such an idea.²² Hawtrey's objections can be easily countered: He assumed that (a) the market for credit is in equilibrium, so that interest rates respond proportionately to an increase in the demand for credit and interest-rate based crowding out would occur; and (b) that banks are merely financial intermediaries that cannot create new credit, so that any extension of bank loans to the government must be at the expense of bank lending to alternative uses. We now have a large body of theoretical literature that makes the case for a rationed credit market, where interest rates do not respond proportionately to changes in the demand for money. Further, it is an established fact that the institutional reality of banking systems allows banks to create new purchasing power without withdrawing existing purchasing power from other parts of the economy (Werner 2005, 2006).

It therefore stands that fiscal expenditure can stimulate the economy when funded by borrowing from banks. This would increase credit creation and hence the total amount of purchasing power in the economy. C_R in Equation (6') would rise. This would boost nominal GDP. By suspending bond auctions and instead borrowing the entire PSBR directly from banks – for instance by a transparent quota system – credit creation would rise. Unlike bond markets, banks create new purchasing power when they extend loans. As a result, overall economic activity will expand (via fiscal policy), without the type of quantity crowding out that rendered fiscal policy ineffective during the 1990s.²³

Figures 9.7 and 9.8 illustrate the difference between stimulatory fiscal policy funded via bond issuance and stimulatory fiscal policy that is backed by credit creation. The example of a fiscal spending package amounting to E20 billion illustrates that this can have, in the extreme case, zero effect (when not backed by credit creation) or boost demand by E20 billion (when fully backed by credit creation). Since most governments, including Japan and Germany, today mainly cover their PSBR through the issuance of bonds, there may be substantial, if not complete crowding out of private activity due to fiscal policy.

9.4 Conclusion and further research

The proposed alternative model has provided an answer to the question why fiscal expenditure policy has appeared ineffective during the 1990s in major economies, including Japan and Germany. Empirical tests on the extreme

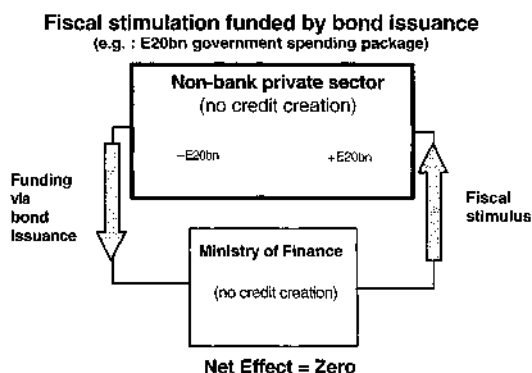


Figure 9.7 Bond-funded fiscal expenditure with credit rationing

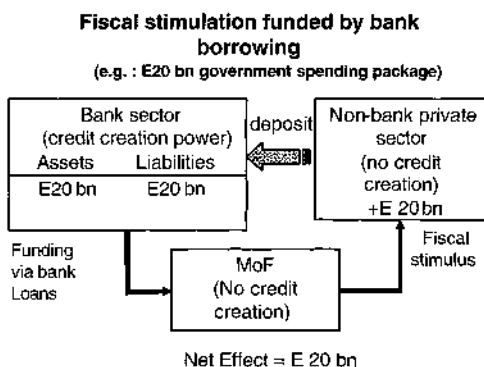


Figure 9.8 Net effect of credit-funded fiscal expenditure

case of Japan, which otherwise had not been explained by the literature, were cited. They were strongly supportive of the proposed explanation, namely that the lack of coordination of fiscal and monetary policy in general, and specifically the lack of backing fiscal policy through expanded credit creation, were responsible for the disappointing outcome of fiscal policy.

It is found that the cause of the German recession of 2000 to 2003 was a lack of credit creation. This problem could have been addressed through policies to stimulate bank credit, including coordination of fiscal and monetary policy. Even without bank lending, the central bank could have increased its own credit creation, and hence stimulated the economy. The government could also have increased the effectiveness of fiscal policy, and hence stimulated the economy, by funding fiscal expenditure through borrowing from banks.

There is much Europe can learn from the Japanese experience in general and these findings in particular. The findings also highlight the need for future research concerning the question whether the ECB may have political reasons why it may be downplaying its role and influence over the economy, and instead advancing a predetermined political agenda (structural reform) through misguided monetary policy. Japan may again hold lessons for us, because there has been some evidence for such a link between the central bank's structural reform agenda and its restrictive credit policies (see Werner 2003). Further implications are discussed in Werner (2005, 2006).

Notes

1. This chapter draws heavily on earlier work by the author. Selected figures, tables and passages reproduced from Werner (2003, 2005) with permission from M. E. Sharpe and Palgrave Macmillan, respectively.
2. Unfortunately, media coverage of central banks has become reduced to an unquestioning and uncritical regurgitation of assertions made by central bank spokesmen without empirical backing.
3. Hayashi and Prescott (2002) confidently proclaimed that Japan's weak economic performance was due to an exogenous productivity shock and not demand-side factors. However, Fukao et al. (2003) and Jorgenson and Motohashi (2003) have shown that Hayashi and Prescott had assumed all factors are fully employed and thus erroneously counted unemployed factors as not being productive. Jorgenson and Motohashi (2003) in their more careful study found that Japanese productivity actually increased in the second half of the 1990s.
4. Gordon (1999) found that in the case of the United States 'after adjusting for the effects of the economic cycle, all of the increase in labour productivity was concentrated in the manufacturing of computers, with no net gain in the rest of the economy'. Other issues are whether to count IT spending as investment or expenditure, or whether higher prices in the IT sector are productivity rises (due to better quality) or inflation.
5. In the 1980s, the US Congress held sessions about 'Japanese productivity – Lessons for America', as it was widely argued that superior Japanese productivity explained the Japanese trade surplus. When China overtook Japan in 2004 as the world's third largest gross exporter (behind Germany and the United States), the WTO explained this surge in China's exports with its 'surplus productivity'.
6. In 2005, China overtook Japan as the world's third largest gross and net exporter, with its trade surplus (annual moving sum) reaching USD94 billion in November 2005.
7. Other measures of productivity or efficiency also did not appear to deteriorate noticeably. Germany did not appear to record a decline in the efficiency of its energy use, for instance. Final energy consumption in Germany only rose by 2.6 per cent between 1993 and 2003, while that in the United Kingdom and United States rose by 5.8 per cent and 17.4 per cent over the same time period, respectively. As for environmental efficiency, German sulphur oxide emissions stood at 7 kg per capita in 2003, while they were as high as 17 and 48 in the United Kingdom and United States, respectively (OECD 2005).

8. A few readily available statistics concerning land and labour can be cited here: Land has remained unchanged in Germany over the observation period. According to the OECD (2005), the German fertility rate rose from 1.28 in 1993 to 1.34 in 2003, while that of the United Kingdom and United States fell (from 1.75 and 2.05 in 1993 to 1.71 and 2.04, respectively). The female participation rate rose from 61.4 in 1994 to 66.6 in 2004 in Germany, while remaining unchanged in the United States during the same time period at 69.8.
9. Instead, it may merely increase deflationary pressures, if inflation and deflation are thought of as functions of the output gap or the gap between actual and potential growth.
10. Accessed on 2 January 2006 at: <http://www.diw.de/english/produkte/datensammlungen/kapazitauslastung/kapatab.html>
11. The IMF summarizes the findings as follows: 'Empirical studies have yielded conflicting results: some support the hypothesis that a rise in the share of public spending is associated with a decline in economic growth (Landau 1986; and Scully 1989); others have found that public spending is associated positively with economic growth (Ram 1986); and still other studies have found no significant relationship (Kormendi and Meguire 1985, and Diamond 1989)' (IMF 1995).
12. Here, the IMF (1995) summarizes: 'While the contribution of public investment to economic growth has been invariably assumed theoretically, empirical studies based on aggregate public expenditure data have found only weak links between public investment and economic growth.'
13. Their work was preceded by Lerner (1943) who rejected debt-financed deficits entirely.
14. As Milton Friedman put it in his entry under 'Money: Quantity Theory' in the Encyclopaedia Britannica: 'The quantity theory implies that the effect of government deficits or surpluses depends critically on how they are financed. If a deficit is financed by borrowing from the public without an increase in the quantity of money, the direct expansionary effect of the excess of government spending over receipts will be offset to some extent, and possibly to a very great extent, by the indirect contractionary effect of the transfer of funds to the government through borrowing' (p. 476).
15. Such a disaggregation into 'real' and 'financial' transactions was also suggested, among others, by Allen (1989, 1994); Howells and Biefang-Fisancho Mariscal (1992); and Spindt (1985). Keynes (1930) made a similar suggestion.
16. See Werner (2005, 2006). The original equation of exchange, as cited by Fisher (1911) and others, attempted to express what could in words be formulated as follows: 'The amount of money changing hands to pay for transactions during a given time period must be equal to the nominal value of these transactions.' Only then is Handa (2000) right in calling it true by definition. Deposit aggregates (such as M0, M1, M2, M3, etc.) are inadmissible as a measure of money that is changing hands to pay for transactions. Credit aggregates do that and, unlike deposit measures, can also be disaggregated by the use money is put to.
17. This means that the theory also has sound Post-Keynesian credentials. See Bell (1999).
18. Velocity is, as always, assumed to be constant. Indeed, in a credit economy velocity is one, when the equation of exchange employs credit creation, a flow concept.
19. Wray (2001) frames his argument in terms of high-powered money, which, however, does not necessarily translate to greater effective spending.
20. The Bank of Japan became formally independent only in 1998. However, *de facto* it has been independent for much longer, as Werner (2003) shows. Meanwhile,

independence is not necessarily an obstacle, since a central bank can voluntarily cooperate to support the government's policy. As Bernanke pointed out, 'Cooperation with the fiscal authorities in pursuit of a common goal is not the same as subservience' (2000, p. 163). Unfortunately, there are few examples of such cooperation.

21. I am grateful to Mr Wolfgang Eichmann, Head of Section III of the German Federal Statistical Office, for kindly writing to me, upon reading some of my work, and pointing out these supportive facts from Germany to me. See also Eichmann's (2002) relevant article on the velocity of money, which, among others, cites Werner (1997).
22. Klein (1968), as quoted by Spencer and Yohe (1970, p. 15). It is not made explicit who had launched this 'radical idea' in the United Kingdom. However, there is some evidence that it emerged from the German credit school of economists, who had been advancing it at least since the early 1920s.
23. This proposal has recently been endorsed by Congdon (2001), Smithers (2001) and the Financial Times' Martin Wolf (2002).

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10

You Can't Always Get What You Want: Why Europe is Not Keynesian-able While the US New Economy is Driven by Financial Keynesianism

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10.1 Introduction

The argument put forward in this chapter makes two rather unconventional points.¹ Our first point is that the European Union (EU) of today is not a 'Keynesian-able' entity, and that for much of its post-Second World War history economic policies in the EU have not been properly Keynesian either. Our second point is that the US 'new economy' of today, paradoxically as it may seem at first, is thoroughly 'Keynesian', namely through a peculiar financial mechanism nurtured by active economic policies. We will support our argument in what follows by a historical, political, and economic narrative, which will also take into account the new role of Asia, especially of China.

In particular, we will argue that the most Keynesian phase in Europe's post-war history occurred during the decade of the European Payments Union, an institution set up by the United States in 1949 to receive the counterpart funds of the Marshall Plan. This phase ended with the introduction of currency convertibility in 1959, after which the European Economic Community (EEC) moved into a stop-go mode, which we call 'reverse Keynesianism', and which was brought to its end by Germany's export counteroffensive. These occurrences would have ended Europe's Keynesian phase were it not for the big wage increases that swept through the continent from 1966 to 1972.

The analysis then moves on to consider developments on the world stage since the 1980s, with a more detailed focus on some crucial novelties in the macroeconomic regime set-up and actual economic policies during the last

decade. Whereas neither the EEC nor later the EU contained any structural elements furthering effective demand, demand growth was indeed generated in a rather novel way under US capitalism, namely through a combination of military expenditure programmes and household debt in a context of industrial delocalization. As regards Europe, we clarify what was special about the European situation in this new global environment that began to emerge in the 1980s and then gathered momentum in the 1990s with the 'new economy' bubble.

We conclude that standard Keynesian fiscal and monetary policies would not work for Europe today if merely tagged on to the existing system of capitalist relations, but would require adapting those very relations by means of appropriate structural policies.

10.2 The Keynesian phase of Europe: the 1950s and the European Payments Union

The United States' main aim after 1946 was to reconstitute the legitimacy of European, and especially German, capitalism. This was actually the main drive behind the creation of a common market for steel and coal known as the European Coal and Steel Community (ECSC) in 1952. The novelty of the ECSC was that its objective was not just to coordinate protection of monopolistic interests. It was a strategy of dynamic oligopolistic growth. The formation of ECSC, with its corollary of ECSC-based support systems, happened in the context of the Marshall Plan and Nato funded expenditure programmes. This meant that the steel companies of every single country of the ECSC, which happened to be exactly the same six countries giving rise in 1957 to the Common Market, could freely buy and sell coal and steel in any of the ECSC countries. This arrangement eliminated one of the main sources of economic conflicts that had marked the history of industrial Europe.

At the time, the Bretton Woods system of fixed exchanged rates prevailed. ECSC programmes of public subsidies were available for the restructuring, and Marshall and Nato plans were in place.² Moreover, steel has always been one of the most concentrated and, hence, oligopolistic sectors in the world. As a consequence of these factors, the ECSC programme implied the creation of a regular and non-conflicting oligopolistic structure in the main industrial sector, fostering both reconstruction and expansion for the six European countries participating in it. Prices were set by mark-ups, and these were not subject to exchange rate risk since parities were fixed. Restructuring towards a market formed by the six countries belonging the ECSC was aided by subsidies, and the growth of the Common Market was guaranteed by the expansion engendered by the 'Marshall plus Nato' plans as well as national policies.

The ECSC case provided the blueprint for the understanding of the dynamics of the Common Market till 1971. Essentially, the dynamics can be characterized as the formation of a European wide system of oligopolistic

capitalism in which firms upgraded their productive capacities to service the expanding level of demand stemming from the six European countries forming the Common Market. Interestingly, US multinationals played a pivotal role in this too, since in their expansion and location decisions they tended to treat the European market as a single whole. US multinationals, especially in the automobile sector, set up intra-firm networks that stretched across national borders, and also across the boundaries of the EEC itself. By contrast, European companies tended to remain relatively more nationally focused, even in the case of major exporters such as the German ones.

The regime of fixed exchange rates was crucial in allowing for the smooth unfolding of the oligopolistic dynamics since, with fluctuating exchange rates, neither mark-ups nor oligopolistic market shares can be stabilized due to the risk of competitive devaluations. Something of the like, as we shall see, happened in fact during the 1970s and, unwittingly, again in the 1990s. At this early stage, however, the fixed exchange rates regime was not a product of European policy-making. Rather, it arose within the context of the international monetary regime established at Bretton Woods in 1944. Indeed, when President Nixon ditched the Bretton Woods system in 1971, intra-EEC economic and monetary relations came under severe pressure. Hence, the question arises here whether the oligopolistic dynamics of the early EEC were, at least until 1971, really the product of the EEC itself or mostly due to external circumstances.

During the 1950s, even before the formation of the Common Market, European integration went on at a high pace, at first stimulated by reconstruction programmes which then turned into a long boom (Milward 1992). Germany acted as the major exporter and key factor behind the revamping of the whole inter-industry matrix of the continent (Halevi 1999). In that decade, there was an institution in operation that was as close as one could imagine to Keynes's idea of an international clearing union, which the US Government had rejected at Bretton Woods. That institution was the European Payments Union (EPU), established in 1949 under US initiative for the purpose of receiving the counterpart funds of the Marshall Plan. This process involved the whole of Europe, and it took place before the creation of the Common Market.

The EPU allowed the smoothing out of trade imbalances among European countries, thereby relieving the balance of payments constraint. Just imagine what would have happened without EPU in the light of the mounting German surpluses *vis-à-vis* the rest of Europe. Other countries, such as Italy, would have had to forgo part of the expansion programmes. Yet even the mechanics of EPU would not have been sustainable without crucial support from the US Congress. In particular, when the outbreak of the Korean War caused a steep rise in raw materials prices that threatened Germany's balance of payments, the US Government quickly injected half a billion dollars into EPU. The Korean War expenditure then became an important factor in the

revitalization of Germany's capital goods industry which, in turn, sustained the process of Europe's industrial renewal. Without the United States injecting money into the EPU, Germany would not have been able to surmount the balance of payments difficulties due to the rise in raw materials prices, and the Korean War would not have presented such a strong stimulus for German capital goods production.

10.3 After EPU: reverse Keynesianism

In 1957 the Common Market came into being and on 1 January 1959 EPU ceased operation as currencies became convertible again. From that year onward there was no cushioning mechanism against balance of payments shortfalls. Surely and systematically the balance of payments constraint began to re-manifest itself in deficit countries. Under fixed exchange rates the way to deal with a balance of payments deficit is to reduce domestic demand, inducing a fall in employment and imports. As the resulting lower rate of job creation restrains wage increases relative to productivity growth, firms can both strengthen their profit margins and cut export prices. This was Keynesian economics in reverse based on the deliberate periodic creation of unemployment. British economists named it 'stop-go policy'. Invariably, countries adopting stop-go policies would be pulled out of a recession by an export expansion, which became increasingly directed towards Europe itself. However, if all countries were to simultaneously adopt this policy, the risk of convergence towards the common 'wait and see' position would be very high.

In 1965-66, West Germany, in view of its dwindling external surplus, decided to prevent a feared balance of payments crisis by creating a domestic recession and generating a new export drive. Quite independently of the 1971 global events, Germany's move ended the era of mutually compatible full-employment growth for Europe and the Common Market countries. While there were certain conditions in place that sustained the European-wide process of accumulation and growth in the 1950s, that is, prior to the formation of the Common Market, these ceased to exist in the 1960s. By the second half of the 1960s the major European economies were willing to ditch full employment objectives in favour of stop-go policies. Four main factors prevented this stance from turning into a systemic pro-recessionary orientation. First, the existence of built-in counter-cyclical programmes that owed to the Common Market countries' determination to expand their infrastructure. Second, the role of development and income support policies for lagging regions and rural areas. Third, the global impact of US military spending, mostly related to the Vietnam War and Nato programmes. Fourth, and most importantly, the general wage rise that swept throughout Europe in the second half of the 1960s until the early 1970s.

Contrary to more popular profit squeeze theories (Glyn and Sutcliffe 1972), the general wage rise propelled the growth of the whole EEC economy.³ The

big burst in demand stimulated investment which, as we learned from Kalecki, boosted profits. The general wage rise was the single most significant factor that prevented the EEC economies from jointly moving into a deflationary pro-balance of payment surplus stance. This is not meant to imply that workers' struggle was irrelevant as a factor generating the crisis marking the end of 'Fordism'. Rather, the crisis was not caused by distributional struggles *per se*, but owed to firms' (partial and temporary) loss of control over valorization in the immediate production process (as anticipated by Kalecki in 1943; see Bellofiore 2001).

From the 1960s onward, with the elimination of the protective, yet financially constraining EPU cushion, European economies shifted onto a path from which they have not strayed ever since, namely that of neomercantilism. And while, as explained by Keynes in the last chapter of the *General Theory*, neomercantilism can be a good thing for profits and employment for any individual country, it cannot work for all countries as a group. This is increasingly the case as their international transactions, both in trade and in finance, gravitate within the same area, this being, in succession, the Common Market, the EEC, the EC, and the EU. The general wage increases from the second half of the 1960s to the mid 1970s, while lifting the level of effective demand, could not possibly eliminate this aspect of Europe's political economy since it is inherent in the very existence of multiple and diverse oligopolistic systems, each aiming at the European market, but each remaining anchored to its national, social, class, and political structure.

When looked at from this perspective, the economic history of the EEC-EC-EU appears as one that is based on a dichotomy between formal institutional integration – through the creation of common EC-EU bodies – and declining economic coordination. In the 1960s, the conflict was mostly between domestic policies and export-oriented dynamics, with the oligopolistic groups giving priority to the latter in the Bretton Woods setting of fixed exchange rates. But in the 1970s, when the United States caused the fixed exchange rate system to collapse, the issue of 'coordination' was in fact a struggle between different components of European capitalism for the establishment of new hierarchies within Europe in relation to their domestic class priorities.

10.4 The neomercantilism at work: Germany and Italy

Following Parboni's (1981) celebrated analysis of the clash between the US dollar and the D-mark, the analysis here starts with Germany. For Germany, the end of the fixed exchange rates regime and the US dollar devaluation meant that a threat could also come from within Europe because of possible devaluations relatively to the D-mark in the main area of German exports. It was in the German interest for Europe to become a rock-solid area of effective demand through which German companies could accumulate

financial surpluses for their international direct investments and to undertake acquisitions. Germany's aim was to stabilize the D-mark with respect to other major EEC currencies while stabilizing its domestic price level, which, through reliance on price stability and productivity growth in excess of wage growth, would generate a tendency of real D-mark devaluation (Parboni 1981; Valli 1981). These objectives of German capitalism were articulated more lucidly by the SPD-led government of the day. By contrast, the Bundesbank, with its price stability focus, was rather sceptical about the merits of the EMS in 1979. Essentially, the same views prevailed in Germany throughout the 1980s and continued even after Germany itself ditched the EMS in 1992-93 in the wake of absorbing the former German Democratic Republic (Ciocca 1997).

To understand the complete lack of any room for Keynesian options, inherent in the accumulation strategy of German capitalism before it was burdened by former East Germany, we may look at an excellent essay by Romano Prodi from the time when he was still an economics professor at the Università di Bologna. In that essay, Prodi effectively resurrected the old Triffin theme of the German surpluses in Europe, applying it to the 1980s. In the 1980s, West Germany had one of the lowest growth rates in Europe. From 1980 to 1987 included, Germany grew at less than 1.3 per cent on a yearly average as opposed to a total growth rate of OECD Europe (which includes also the German low growth) of 1.9 per cent (OECD 1992). German growth rates picked up from 1988 to 1990 to be squashed immediately afterwards. By 1982 Germany got over the second oil price increase and began, yet again, accumulating external surpluses at an increasing rate reaching 4.3 per cent of GDP in 1986 and 4.9 per cent in 1989 (OECD 1992). Most of the surplus was due to intra-European transactions, as West Germany was in deficit with Japan and saw its surplus with the United States dwindling as a consequence of the impact of the Plaza accord. In this context, Prodi pointed out the German surpluses were a drag on the European economy: not just due to their negative macroeconomic impact, but also because they strengthened, through their financial utilization by German corporations, the entry barriers into the respective sectors (Prodi 1990).

These issues have not gone away with the formation of the single currency. Rather, they have been further reinforced. If anything, the central (Kaleckian!) belief in export surpluses as the mainstay of capital accumulation held by German corporations and government agencies has become stronger since Germany has lost its positive investment income inflows generated by the activities of German entities abroad. Hence, unlike the 1980s, when West Germany still experienced a positive and growing net inflow of investment income, export surpluses have acquired an even greater importance.

If Germany has represented the most significant case of neomercantilism, at first under quasi-fixed intra-European exchange rates (1979-92) and later with the single currency, Italy has embodied the opposite example within the

same neomercantilistic model. Historically, Italian exports and overall GDP growth thrived under conditions of a depreciating lira. And to a great extent the deterioration of Italy's public finances in the 1980s was due to the necessity of financing the external deficits resulting from real lira revaluation, as implied under the quasi fixed exchange rate regime of the EMS. After the collapse of the EMS in 1992–93, the renewed devaluation of the lira immediately enhanced Italian exports, which were further aided after 1995 by the US dollar appreciation and the boom in the US economy. Myths about the effectiveness of the network of small companies had another heyday.

Within Europe, however, Italy's net export position started to deteriorate again when Germany, bowing to strong French pressures, began to reduce interest rates, thereby weakening the D-mark. By the time the euro's launching locked in intra-European exchange rates, it was too late for Italy. Its net export dynamics ended up depending upon the performance of the dollar areas, namely the United States, Latin America, and Russia. By 2001 these three areas ceased to act as export engines for Italy. Renewed US military Keynesianism together with an increasing shift by the United States towards competitive imports from China no longer sufficed to sustain the growth dynamics of Italy's small firms. Having abandoned its advanced technology sectors in the 1970s and 1980s, precisely during the years of expanding public expenditure, Italy had entered an unambiguous phase of steep industrial decline not mitigated by a service and a financial sector of the kind Britain has.

We will return to these themes in Section 10.6. At this stage, however, and in view of the two polar cases of Germany and Italy, we can briefly turn to the key question whether some form of Keynesianism might provide a possible solution to Europe's problem. The preliminary answer seems to be negative. In order to open up room for Keynesian policies, Germany and its corporations would have to forgo the acquisition of surpluses as the defining element of their strategy of accumulation. This is tantamount to saying that German capitalism would have to renounce its hierarchical position within Europe. Italian capitalism would have to accept some kind of industrial planning in agreement with the other countries, since Keynesianism as such does not solve the structural issues. Neither do economic interests exist in Italy to initiate such measures, nor do there seem to be economic interests in Germany to address the issue of systemic accumulation of surpluses, which we consider a far more serious deflationary factor than the Stability and Growth Pact (SGP).

10.5 The world stage after the 1980s and the new paradoxical 'financial' Keynesianism in the United States

Before coming back again to Europe, this section surveys the capitalist changes in the world arena. Indeed, there is something 'new' to be appreciated here,

though again in an unconventional fashion. The neo-liberal turn of the early 1980s established a powerful stagnationist tendency. Yet, from the mid-1990s onwards, political counter-tendencies were activated that solved, at least temporarily, the problem of insufficient effective demand despite the weakening and fragmentation of labour which occurred at the same time.⁴

The stagnationist tendency took hold in the 1980s and in the early 1990s. The deregulation of capital movements, restrictive monetary policies, the attack on welfare provisions, aggressive competition of global players in manufacturing and service sectors, have been among the factors at the root of low and unstable levels of investment and pronounced compression of the wage share, and in many cases of real wages too. Depressed workers' consumption was the consequence. The novelty of the last decade manifested itself in two phases. The first phase belongs to the golden years of the new economy, especially after June 1995 when the long-term decline of the US dollar was halted and reversed by the deliberate policy of the Federal Reserve – sustained by the Bundesbank – to stave off the collapse of Japan. The renewed strength of the US dollar and the Fed's monetary policy fostered the stock market bubble that led to an expansion of both consumption and investment, particularly in the technology sectors tightly linked to financial services. The whole process depended in a crucial way upon the private sector's going into financial deficit, with expenditure growth exceeding disposable income growth. As a result, during the second term of the Clinton administration, when the public budget deficit was turned into a surplus, private debt replaced a shrinking public debt. Household rising indebtedness was, in turn, guaranteed *vis-à-vis* financial institutions by that very rapid expansion of financial wealth.⁵

The collapse of the 'irrational exuberance' bubble determined the end of the most naive delusions about the new economy. But it did not produce a steep collapse of the US economy and – by implication – of the world economy too. The crisis in the US economy was cut short by a quick and massive injection of liquidity and lowering of interest rates to practically zero together with the resumption of a deficit-oriented fiscal policy leading – contrary to the Clinton years – to a renewed rise in the public debt. In short, the crisis was avoided by the creation of endogenous money and by relying once again on military Keynesianism.

Yet, it would be rash to conclude here that this approach represents the sole form of Keynesianism compatible with, and acceptable to, contemporary capitalism. We cannot draw this conclusion for two reasons. First, as already hinted above, despite its internal contradictions, the new economy relied on an effective form of Keynesianism through the financial lever, featuring command over money as exercised by the Federal Reserve. Second, low interest rates and military spending were not sufficient to kick-start the US economy and the world economy.

And this leads us on to the second phase of our narrative about the novelty and changes of the last decade. Large injections of liquidity and military spending guaranteed a floor to the fall of economic activity. Yet, the factors that enabled the upswing in the cycle of the world economy were related to two other circumstances which were far from being purely contingent: the US's relations with Asia, first and foremost with China and India,⁶ and the banks' willingness to finance consumption entailing rising household indebtedness – with its key element, that is, the financing of the 'real estate' bubble, now being on the verge of a sharp deflation. This issue is much *en vogue* by now, and it heralds an important message for Europe as well.

Asia has been financing the US's twin deficits for years now. Schematically, we may capture the essence of the contemporary situation as follows. Net world demand is predominantly generated by Anglo-Saxon capitalism and it is supplied through a productive cycle largely based on delocalized production processes. The key variable behind the positive demand dynamics is private indebtedness, which in the United States has grown exponentially. On the whole, net saving by the private sector and even by the household sector alone too, is now negative. Banks and credit institutions, in their constant effort to sustain consumption, provide firms indirectly – but no less efficiently – with both liquidity and market outlets for their production. To finance households' consumption is in fact to finance firms' production, and at the same time it also guarantees an adequate effective demand. Asia is the new world manufacturing engine, exploiting its huge 'industrial reserve army' which has almost doubled world labour supply. By contrast, in the mature economies, deindustrialization and the new service economy inescapably give rise to generalized precariousness of jobs and working conditions.

If there is any kind of Keynesianism present today, it is Keynesianism of a 'financial' kind, which was initially centred mainly on the stock exchange bubble, and later on consumer credit and a real estate bubble. All of this is quite consistent with the growing 'casualization' of employment, that has made 'full employment' intrinsically precarious and unstable.

Workers are sucked into the vortex of this infernal whirlpool activated by financial Keynesianism not only as workers (squeezed by restructuring at home and competitive pressure from the outside), but also as savers and as consumers. They are involved in financial markets, in different degrees depending upon the institutional setup of the countries concerned, either as investors of their own financial savings (which are now mobilizable with no impediment and national controls following the dismantling of the national pension systems and the concomitant emerging of institutional investors), and/or as debtors of the banking system (because of consumption and mortgage loans to households). From the point of view of labour, the essence of contemporary capitalism can be summarized as follows. The unstable equilibrium of today's capitalistic growth rests on 'scared workers' (because of the transformations in the labour process and in the 'labour market'), on 'terrorized savers'

(because of the modifications in retirement systems and the uncertainties related to financial investments), and on 'indebted consumers' (because of the increased dependency of consumption expenditure on banks' credit). This is nothing but the dialectical aspect – from the angle of wage labour – of the process centred on the formation and expansion of an industrial reserve army on the world scale, on global migration flows, and on the global delocalization of manufacturing industries.

The core of this new model – which rests, it must be stressed, on the US's use of expansive monetary and fiscal policies, exactly the opposite of the European combination of 'stability oriented' monetary policy and the SGP – can then be portrayed as follows: low wages, precarious jobs, budget deficits, high indebtedness, plus absorption of wage earners in the financial circuits *qua* investors and debtors. Such is the general economic tendency everywhere, supported and driven by the active 'new' economic policies. It would be difficult to predict how long this sort of solution might last since it contains unstable and, in the long run, unsustainable elements and forces. These are to be seen both within the dominant economies, in geopolitical factors, and, perhaps increasingly, also within the global industrial reserve army economies of China and India.⁷

10.6 Europe behind the Stability and Growth Pact: the neomercantilist trap once again

As indicated above, Europe is part of the newly emerging global arrangements.⁸ The new American-Asian model is such that Europe plays the role of a residual actor – and appears as a loser. The US-Asian axis requires that the US dollar remain the pivot of the world financial system, even under conditions of systemic but controlled devaluation. This factor, together with the rise of the Asian manufacturing sector, hurts the Old Continent, notably its weakest areas such as Italy, whose decline has become a free fall. Yet, were the new model – as described above in general terms – to implode, this would bring to a halt the only global economic locomotive that is still active; notwithstanding its limitations. Europe would simply not be in a position to replace it even if it wanted to. Europe's impotence ensures that the United States will always hold a significant blackmailing power. Furthermore, Europe is increasingly taking the social and financial reality of the United States as its model, albeit in contradictory and, sometimes, reluctant terms. At last, even Italy – in a more dogged manner compared to other European countries precisely because of the country's relative backward conditions which prompts policy-makers to catch up with the mores of 'advanced capitalism' – is recklessly implementing the reorganization of its financial institutions, the labour market, production processes, and of the governance of firms, along criteria imported from Anglo-Saxon capitalism. Indeed, Italy is the last carriage of one and the same train!

It is an urgent necessity to avoid a serious misunderstanding. We should not believe that the Maastricht Treaty and the SGP of Dublin and Amsterdam were just mindless or 'stupid', to quote the former head of the European Commission and Italian Prime Minister of today, Romano Prodi. Instead, the Maastricht Treaty and the SGP represent the alibi in the name of which Europe's industrial restructuring has occurred, together with the creation of a financial space and the formation of new regional articulations and the dismantling of the welfare state based on acquired rights. These processes, however, stem from substantial factors that are bound to, and will, persist, even in a scenario of lessening the Treaties' constraints on public finances. These processes not only allow for, but even require divergent dynamics for the different areas of the EU. The new entrants from Eastern Europe – with their disguised high unemployment and low wages, including of skilled labour – make these divergent dynamics even more pronounced.

Our analysis identifies four different and divergent areas within the EU and among the countries gravitating towards it. First, a quality-based manufacturing pole centred on the traditional Franco-German heart of Europe, including Belgium, Austria, and Switzerland's heavy industry regions. Through Germany's restructuring activity, this pole now controls an industrialized periphery in Eastern Europe, mostly in the Czech Republic and to some extent in Slovakia. The Western European side of this pole retains a substantial system of welfare provisions that is being gradually thinned out. A second pole is based on niche productions of advanced technologies located in the Scandinavian countries, including Finland, where the essential features of the social democratic model seem to be still holding up pretty well (although a generalization of this model to the rest of Europe appears to be out of the question). Next, we have the United Kingdom, essentially a pole unto itself, but with strong ties to the Netherlands and Luxembourg *qua* financial and service centres, mostly tied to Anglo-Saxon capitalism. The final pole is centred on Italy and is characterized by being an area of relocation of low-level industries, as evidenced by the outsourcing of the small Italian firms in the traditional sectors to countries like Romania and Albania. The new economic geography of Europe both updates and confirms the old one. Some countries, such as Italy, slide down the ladder and abandon their previous positions and roles, while at the same time there are tendencies to establish an imperialist pole centred on *Mitteleuropa*.

In this context, one cannot simply bury one's head in the sand and refuse to see that in the first few years of the new century a redefining of the SGP, not just on paper but in practice, has become the lever by which power relations are exercised and altered. The ways in which countries pretend to apply it or decide to bypass it, highlight in full the predominantly national dimension of European policy-making. The European nation states (countries) constitute the pivot of the political and institutional dimensions of the Continent's and of the EU's class articulations. The small countries support

the SGP precisely because they went through heavy sacrifices to comply with it. In the Dutch case, this meant redefining both the relations between the government and the trade unions and social relations within the society more generally. In the Netherlands, for instance, the path to compliance has entailed the transformation of around 40 per cent of the total employment into part-time jobs. Neither capitalists nor any government could, in all good faith, call this outcome into questions and say 'sorry we were wrong, let us pay no attention to the SGP for which we put 40 per cent of you into precarious occupations'. Thus, the Netherlands is fending off the possible repercussions coming from the (large) countries that are not abiding by the criteria, in order to preserve the new class articulation achieved through the imposition of those sacrifices. The situation in France and Germany appears altogether different. With the launching of the new single currency, these two countries were (fudging of data considered) already outside the fiscal parameters. And the situation has certainly not been corrected since then. These were also the two countries that most adamantly opposed, using all their influence, the creation of a truly European budget.⁹ They were exercising their pressures while they were successfully demanding to be excused from respecting the very rules that they imposed upon the smaller members of the EU as well as to Italy. It is equally significant that France and Germany are crucial contributors, at the EU level, to the reformulation of the discretionary rules in a way which would favour a greater severity regarding the criteria of public debt. The new discretionary rules that France and Germany are supporting, are constructed on the basis of an ideal culprit, Italy, so that Paris and Berlin can continue to ignore the SGP, while Italy will have to converge towards its parameters.

It follows that it is impossible to see any kind of common interest as the basis for the emergence of a European form of Keynesianism, which would lead to a coherent reform of the SGP. There is simply no scope for this kind of action. Effectively, Europe has been a unified territory for quite a long time. This did not owe to the impact of the overarching process of globalization. Rather, what unified the European territory was, and remains, political intervention. It is a unified space in terms of markets which on a regular basis form the target of neomercantilist incursions by the very same national capitalisms forming that space.

A brief look at Germany's current account *surplus* of 110 billion dollars in 2005 must suffice. If the Swedish, Dutch, Belgian, and the Swiss surpluses are added together, they form a joint surplus position equal in size to Germany's. The bulk of these surpluses are realized through intra-European transactions. This fact points to a problem that, for the Continent as a whole, has by far deeper, more structural and serious consequences than the ones stemming from the Maastricht parameters. Indeed, in Europe there is absolutely no mechanism to recycle the current account surpluses in a Keynesian fashion. The recycling used to occur quite swiftly in the 1950s

before the creation of the European Community, thanks to the EPU that was set up to receive the counterpart funds of the American Marshall Plan. While the balance of payments issue must be faced in one way or another, the Maastricht parameters can in practice be ignored, just as France and Germany (and Britain) are doing right now.

We can rest assured that despite the size of its soaring external surplus, Germany will never accept the formation of a European-wide clearing union along the lines suggested by Keynes during the negotiations at Bretton Woods. This reason is rather basic. For Germany, these surpluses are the profits obtained on external transactions by German companies or by the German affiliates of foreign multinationals. And profits must remain profits: it is not acceptable to 'socialize' them. If one follows a 'non-idealistic' reading of Keynes' (and Kalecki's!) analytical apparatus, like we do here, the anti-Keynesian implications of the current account surpluses are as easy to grasp as the present-day impossibility of a European wide Keynesianism.

10.7 The Italian case

A few more observations on Italy – the 'true sick man of Europe' for many – are in order here. A regular obsession in commentaries about this country refers to the state of public debt, the cost of labour, and the alleged inflexibility of the labour market. But the reality behind Italy's economic weaknesses is quite different. Just to take one example, the responsibilities of the Bank of Italy, from the time of Governor Ciampi onward, cannot be omitted from the picture. In the 1980s, the Bank of Italy kept interest rates higher than would have been warranted by the international situation and by the borrowing needs of the public administration. The Bank of Italy's policy of dear money imposed upon firms an adaptive strategy of industrial restructuring, which tamed labour conflicts in the workplace. As a result, unions entered a phase of systemic long-run weakness, thus clearing the ground for mutual agreements (rather than compromises arrived at by means of struggles) in matters of labour relations and industrial policies in general. Moreover, after more than 20 years of the same old story, the alleged lack of flexibility and mobility of the Italian labour force remains no more than a myth. The real problem is the decline in productivity. This, however, is just the other side of the coin of a reckless policy of de-structuring labour and of the collapse of Italian manufacturing.

In fact, Italian 'industrial decline' has its origin almost 40 years ago, when Italian capitalism responded in a regressive way to the conflict in the valorization process revealing the inner limits of the 'dualistic', unbalanced 'economic miracle'. No serious attempt at some form of planning to help in upgrading the position of Italy in the international arena was promoted. The strategic choices made – or rather missed – by Italian capitalists in the 1960s led to the disappearance of entire sectors in the 1970s, such as nuclear engineering,

electronics, pharmaceutical industry, chemical industry, civilian aeronautical industry, automotive, steel industry, telephony (Gallino 2003). There has been no industrial or banking policy imposing a positive change in the international specialization of the Italian economy, nor one favouring the emergence of new sectors and the formation of a new set of large firms. No active policy was ever put in place, just a 'passive' adaptation to foreign competition.

It should not come as a surprise that in this relatively backward context, the policy pursued to join the EMS, and later the single currency, could find its 'room to move' only in the downward compression of the exchange value of labour-power (the wage) and in higher exploitation of its use value (mainly through the higher intensity of work). Alas, entering the EMS (1979) and later the Euro Area (1999) deprived the economy of the safety valve of competitive devaluation. The adoption of the euro has led to the abandonment of any independent monetary and fiscal policy. The crisis of the old industrial sectors and the absence of new ones left the country bereft of a solid structural basis. No surprise, then that labour has become the only adjustment variable. Indeed, the attack on labour has been the hallmark of all the governments of the past legislatures since 1994, and by the entire entrepreneurial class regardless of its internal divisions. Unfortunately, the 'casualization' of labour caused the degradation of labour productivity, further aggravating Italy's economic difficulties. The development of Italy, to the extent it exists at all, is nowadays towed by outside forces only. This is not to deny the existence of small high-quality niche sectors or firms that due to their limited range, however, fail to generate any self-propelling impulse for the country as a whole.

The decline of Italy went in parallel with the European stagnation of the first years of the new century, but with worsening features. Indeed, the US-Asia axis marginalizes Europe but, within it, Italy is particularly affected because this country does not possess a world-class financial system like the United Kingdom, or world-class industrial sectors like Germany. It is clear that Italy's decline did not begin with Berlusconi, nor was it the consequence of the pricking of the Wall Street speculative bubble (though it is true that the end of this latter has impacted negatively on fashionable Italian exports). Similarly, the difficulties linked to the strong revaluation of the euro merely highlight the nature of the decline rather than accounting for it.

The 'sound finance' policies enforced by the centre-left governments in the 1990s have a much greater responsibility in furthering the decline. Especially since they were in line with the strategy of disengagement from the leading industrial sectors followed – as a matter of choice – by Italian capitalism. The massive privatizations implemented by the centre-left meant the abandonment of public strongholds in industry and the banking system, which would have been of crucial importance in any truly alternative economic policy. Instead, these widespread privatizations have launched and sustained a *rentier* capitalism. This aspect is made evident by the fact that,

these days, the only large private firms with a positive balance sheet are nothing but the former state monopolies.

10.8 Concluding remarks

Implicit in our analysis is a criticism of much of present day post-Keynesianism. Post-Keynesian economists – the many writings of Philip Arestis and Malcolm Sawyer (1998, 2003, 2004) can be taken as a paradigmatic example – tend to argue that if a rational economic theory were adopted at the EU level, then rational full employment policies would naturally follow. The proposed policies are Keynesian in nature. They are based on getting rid of the Maastricht parameters and the SGP and the related dogma of central bank independence. These authors argue that it is necessary to ensure a more equitable distribution of income, as this would work in favour of Keynesian dynamics, namely through raising the spending power of lower income recipients with their generally higher propensity to consume. It is also necessary to keep an eye on cost-induced inflation, although, unintentionally, this negates the emphasis on a more equitable distribution of income that should be obtained via wage increases. Real wage increases beyond productivity growth are always the safest way to effect changes towards a more equitable distribution of income, because upper income strata pay little taxes. Finally, these authors stress, quite rightly, that it is necessary to be aware that demand enhancing policies cannot be of a one-size-fits-all nature, since economic conditions differ from country to country.

This may look promising at first. Moreover, it is a farsighted approach since it tells the capitalists that with full employment they will obtain a larger volume of profits. We call this sort of approach Hegelo-Keynesian. From this perspective, the problem lies not with the 'material' evolution of the capitalist economy, but with the particular 'ideas' which inform and dominate policy-making. Change the predominant set of theories and you change reality! Keynes himself eventually came to doubt the power of ideas in policy-making when he considered it as politically impossible for a capitalist democracy to organize expenditures on the scale sufficient to prove his case, except under war conditions. In the *General Theory* Keynes argued that his theory had to be completed with an appropriate political philosophy, which would then give rise to the formulation of the institutions required to implement his policies. No Keynesian or post-Keynesian has ever ventured into such an enterprise, so that Keynesians end up being great idealistic believers in the capacity of institutional reforms, regardless of the economic and political relations in which these institutions themselves are embedded.

In our view, the Keynesian approach is not sufficiently 'structural' in orientation. It is true that 'structural reforms' are indeed needed, although reforms of a kind very different from what is nowadays meant with these words. In order to provide for better provision of social needs, what is

needed is: (i) expansionary macroeconomic policies fuelling internal demand; (ii) supported by financial market regulation and taxation; (iii) with a strong structural determination of the content of effective demand; (iv) and supply-side orientation of industrial and banking sectors of the economy; (v) so that the objectives of full employment and of a stable and guaranteed labour force with regular, permanent and better jobs, go hand in hand with; (vi) higher social welfare and public services; and (vii) a defence of the public nature (pay-as-you-go) of the social security system. Of course, this may appear as mere utopia. Not moving in this direction, however, has not only social costs, but increasingly also economic costs. Current policies increase instability and inequality, and at the same time slow down productivity growth: both because they limit the output that can be sold and because they undermine human capital formation.

The economic and political limits of Keynesianism are well known. Just before the beginning of the so-called Golden Age, Michael Kalecki (1943) affirmed that the maintenance of full employment would undermine 'discipline in the factories'. Almost at the end of the Golden Age, Joan Robinson (1972) pointed out that the second crisis in economic theory had its origin in an 'omission' in Keynesianism of having sidestepped the issue about what employment should be for. The conservative counter-revolution was, and remains, also an attack on labour because the social crisis of the 1970s put in question exactly these two issues: work conditions and the composition of output. An alternative economic policy, in Europe as elsewhere, not only needs a strong structural determination of demand and supply. It also has to focus on policies against the fragmentation of labour and the globalization of finance. Otherwise, the supposed alternative will be just another technocratic dream.

Notes

1. The argument developed in this chapter draws upon the authors' collaborative research as presented at the following three conferences. The first was presented at a conference held in Rome on 30 September 2005 and published as "Tendenze del capitalismo contemporaneo, destrutturazione del lavoro e limiti del "keynesismo" ('Trends in contemporary capitalism: The destructuring of labour and the limits of "Keynesianism"') in the conference proceedings edited by Sergio Cesaratto and Riccardo Realforzo, titled *Rive Gauche. Critica della politica economica* (Rome: manifestolibri, 2006). The second paper titled 'Is the European Union Keynesian-able? A sceptical view' was presented at a conference held in Berlin on 28–29 October 2005 organized by the Research Network for Alternative Macroeconomic Policies in cooperation with the Post-Keynesian Economic Study Group and the Association pour le Développement des Études Keynésienne. It was published in: *Macroeconomics and Macroeconomic Policies: Alternative Approaches to European Policies*, ed. E. Hein, A. Heise and A. Truger (Marburg: Metropolis, 2006). The third paper titled 'Deconstructing labor: What is "new" in contemporary capitalism and economic policies: a Marxian-Kaleckian perspective' was presented at the conference 'Keynesianische Ökonomie

als alternative Ökonomie? Potentiale, Ambivalenzen und Perspektiven', held in Berlin on 24–26 February 2006 (organized by the Rosa Luxemburg Stiftung) and is forthcoming in the conference proceedings, ed. Günter Krause, titled *Keynes als Alternative?* (Berlin: Karl Dietz Verlag, 2007).

2. It was to the merit of Charles Kindleberger to have pointed out that the Marshall Plan never ended as it became the Nato plan (Kindleberger 1970).
3. From 1960 to 1968 the average annual GDP growth rate of the EEC was 4.5 per cent while in the 1968–73 period it was 4.9 per cent. France's strong post-1967 GDP growth, which was the highest among the big economies of Europe, created a minor deficit in the balance of payments – but only in the years 1968 and 1969. Afterwards, and till the oil crisis of 1973–74, the current account returned to a surplus. In Italy, which experienced a larger wage rise, the current account remained in a hefty surplus till 1972 while GDP growth stayed high too, although with cyclical fluctuations due both to the end of Bretton Woods and the social struggles without which fast wage increases would not have been obtained. West Germany showed the most significant increase in GDP growth as well as a sustained surplus. If the EEC had been a single country the outcome of the wage rise would have been unambiguously even more positive as the balance of payments constraint would have been less significant. See OECD (1982).
4. For a more detailed analysis, cf. the last sections of Bellofiore and Vertova (2006).
5. Very good work has been done on this topic by economists related to the Levy Economics Institute, such as Wynne Godley and Randy Wray. A representative and timely paper that appeared before the collapse of the stock market bubble is Godley (1999). Cf. also Bellofiore (2000).
6. On East Asia, Japan, and China, see Halevi (1999); Halevi and Kriesler (2006); Halevi and Lucarelli (2002).
7. A recent study by the Asian Development Bank (2006) has highlighted that the persistence of low wages and an expanding job-wise unstable informal sector may actually bring down the growth rates of both China and India to the relatively low level of 3 per cent per annum, which in per capita terms would be less than 2 per cent.
8. On these issues please see Halevi and Kriesler (2004) and, with greater consideration of the consequences of these processes for labour, Bellofiore (2004).
9. France did suggest the formation of a European Treasury, but not the creation of a common fiscal pool to generate European-wide fiscal transfers. It was, rather, politically conceived as an instrument to enhance France own weight over European finances and was not intended to serve as a truly European budget.

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Part IV

Prospects and Limits of the Euro as a Global Currency

11

'Not my fault' or Would Spreading the Maastricht Wisdom beyond Europe Really Do Much Good at All?*

Fabrice Capoen and Jérôme Creel

11.1 Introduction

EMU in Europe involved the launching of an unprecedented economic policy architecture. Contrary to US-style monetary union, Europeans decided they did not need the federal financial clout that would allow them to carry out an effective redistribution policy between member states on a grand 'European' scale. With an upward limit of about one per cent of European GDP and torn as it is between the common agricultural policy and structural funds, the Community's budget can neither boost an agricultural revival nor assure the realignment of poorer regions. Euroland seems to be better characterized by its shadowing of US theoretical models than by its shadowing of US institutions. In particular, following the seminal contributions by Kydland and Prescott (1977), Barro and Gordon (1983), and Rogoff (1985), the European Central Bank (ECB) was granted independence without political accountability, while national fiscal policies were capped so as to prevent their alleged inflationary tendencies from jeopardizing the ECB's objective of 'price stability'. Moreover, governmental power was distorted to such an extent that governments may have to turn to the European Commission for recommendations on their national public finances (the Stability and Growth Pact, SGP), or even on structural reform (Broad Guidelines for Economic Policy). The institutional provisions that contribute to the democratic deficit afflicting the European Union (EU) add up to a long list.

Broadly speaking, Euroland's economic performance since 1999 has undergone two phases: in 1999 and 2000, the accommodative monetary policy

implemented by the ECB helped the European economies to dampen the shocks that had occurred in emerging economies. Thanks to relatively high economic growth rates, limitations to public deficits embedded in the SGP did not pose any problem in this period, when Euroland growth rate exceeded potential growth (see Figure 11.1).¹ Since 2001, however, and parallel to the slowdown of the US economy, Euroland has entered a long phase of subdued growth.

The extent to which Euroland's economic policies were responsible for this poor performance will be investigated in the following. Yet, given the advanced state of global integration, one cannot study Euroland without considering the global environment. In this respect, Euroland's choice of exchange rate regime is a key factor. The euro's exchange rate is perfectly flexible *vis-à-vis* other key currencies like the US dollar and the Japanese yen, and almost fully fixed *vis-à-vis* smaller currencies that participate in the redesigned European Exchange Rate Mechanism (ERM II). The euro's flexibility *vis-à-vis* key currencies has long been viewed as a protection shield against external shocks. On the other hand, fixed (but adjustable) pegs within the ERM II, have benefited Euroland in terms of macroeconomic stability at its borders. Moreover, the monetary union itself has permitted transaction cost savings, then lower interest rates for its members.

In this context, the ECB was expected to manage the euro with a primary focus on its domestic goals, especially price stability, and thus not expected

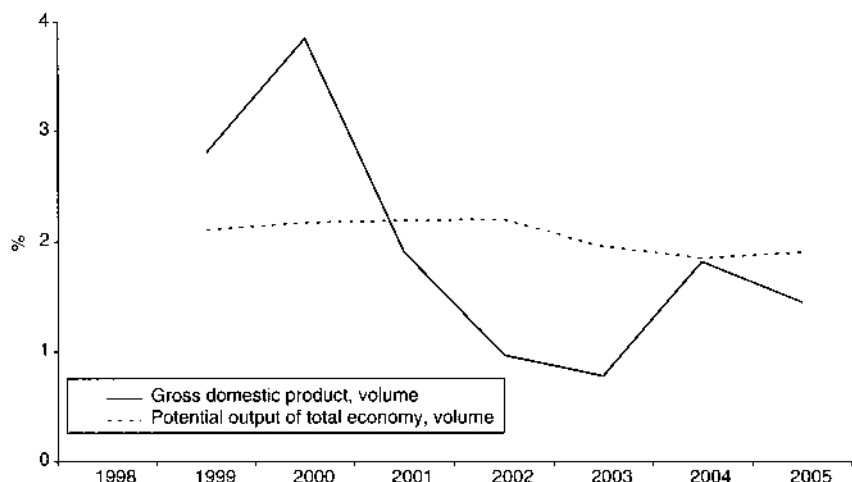


Figure 11.1 Actual and potential growth, Euro Area

Source: OECD.

to pay much attention to the external stability of the currency. Hence, it was feared that the euro might be extremely volatile compared to the post-September 1992 period and that the United States, Euroland, and Japanese economies would be subject to large fluctuations of their exchange rates, increasing global uncertainty with potentially unfavourable effects on growth in international trade.² Also, the euro's volatility provides a third candidate cause behind Euroland's poor growth performance since 2001 – in addition to those related to the monetary and fiscal framework.³

An additional candidate cause behind poor growth in Euroland is the pro-cyclicality of the euro-dollar exchange rate, as documented by Fitoussi (2004), for instance. Since 1990 the euro-dollar exchange rate has contributed to the stabilization of the US economy, but presented rather destabilizing effects on the European economy. As our empirical findings will show further below, the euro has generally appreciated *vis-à-vis* the US dollar when growth in Euroland was low already, so that – following inverse J-curve effects – current account balances deteriorated (turning decisively negative in a number of Euroland member countries, like Belgium, Finland, France, Italy, Ireland, Portugal, and Spain), slowing down growth. As Figure 11.2 shows, Euroland's current account has deteriorated by one per cent of GDP following euro appreciation since 2002, reaching a deficit of close to 0.5 per cent of GDP in 2006.

In our view, these key features characterizing Euroland – slow growth, volatility and pro-cyclicality of the euro exchange rate – that are generally addressed separately need to be investigated in a common framework that

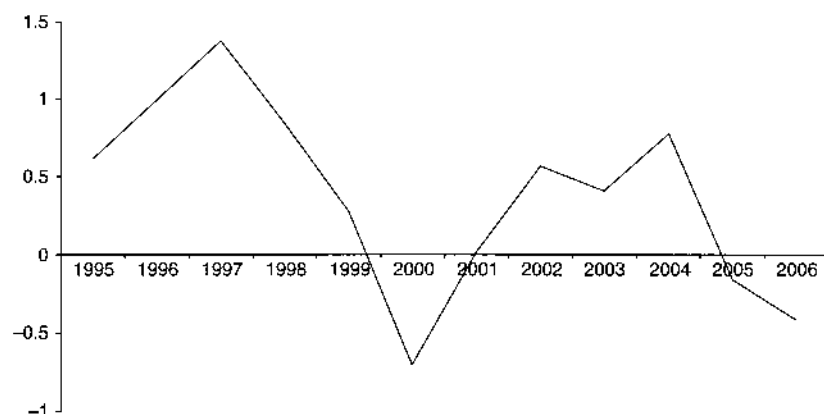


Figure 11.2 Current account, as a percentage of GDP, Euro Area

Source: OECD.

incorporates the main institutional features of both the United States and Euroland economies.⁴ Using a four-country macroeconomic model, the analysis in this chapter explores these three features in conjunction with both shocks and institutions. Euroland's peculiar institutions were already referred to above. The Maastricht architecture of fiscal and monetary policies exemplifies the 'new macroeconomics consensus' (see Arestis and Sawyer 2003; Fitoussi and Padoa-Schioppa 2005). Briefly summarized, the 'consensus' consists of two key parts: first, fiscal policy is largely denied its efficiency, except for in the very short run and as far as automatic stabilizers are concerned. Second, monetary policy must primarily ensure price stability and the central bank is therefore 'conservative' in its approach. Unfortunately, applying the 'new consensus' to Euroland has so far not led to any improvement in economic growth. In terms of GDP per head, European countries are no longer converging towards the United States.

Moreover, the role of shocks hitting Euroland since 1999 should not be underestimated. It is possible that the nature of these shocks has prompted policy reactions that have proved counterproductive, even in view of the 'consensus'. For example, in case of a negative symmetric supply shock, the ECB might be unwilling to sustain economic growth for fear of losing credibility should market participants come to suspect that the ECB fails on its price stability objective.⁵

With these institutions in mind and after documenting the various types of shocks that have hit Euroland since 1999, we will construct a consistent benchmark model that mimics the three above-mentioned features of slow growth, volatility, and pro-cyclicality of the euro-dollar exchange rate. The relationship between these European features and institutions begs the question whose institutions, Euroland's or the United States', are responsible for the situation. So far we have assumed that Euroland's institutions alone are the issue. But it is also possible that the counter-cyclical behaviour of the US dollar primarily owes to US institutions. To investigate this point we perform another simulation exercise that, as a variation on our benchmark macroeconomic model, modifies the objectives of fiscal and monetary authorities. This is designed to answer the following question: In cases of either demand or supply shocks, be they external or internal, asymmetric or symmetric, would Euroland be better off if its institutions were exported to the United States or not? In other words, does Euroland have good institutions while bad ones existing elsewhere impact negatively on Euroland?

The rationale for this approach lies in the standard 'not-my-fault' excuse of Euroland's stability oriented guardians, notoriously blaming occurrences 'elsewhere in the world economy' for Euroland's poor performance. The victim Euroland only seems to suffer and lag behind the rest of the world because others continue to behave irresponsibly – which is to be understood as: not in a stability-oriented manner.

The remainder of this chapter is organized as follows. Section 11.2 summarizes the main theoretical arguments attempting to explain why exchange rate volatility should be either lower or higher in a monetary union in comparison with other exchange rate regimes. Section 11.3 presents some empirical findings on euro volatility and pro-cyclicality and discusses institutional reasons for these phenomena as well as the nature of shocks. Our dynamic four-country benchmark macroeconomic model is presented in Section 11.4. Section 11.5 then pursues the counterfactual: we simulate exporting Euroland's institutions to the United States and compare the results to the actual situation captured by our benchmark. Section 11.6 concludes the analysis.

11.2 More or less volatility in a monetary union?

The theoretical arguments

There have been numerous arguments explaining why the euro might be more or less volatile than the former European currencies like the D-mark, the French franc, the peseta, and so on. They have been discussed and summarized in Creel and Sterdyniak (2000). Three categories of arguments can be distinguished. First, arguments that relate to the creation of the single currency. Second, arguments that relate to Euroland institutions (the ECB and the SGP). Third, arguments that relate to policy reactions to shocks. Although the latter relate to institutions as well, they also involve another dimension: the size of the monetary union, which is important as it may slow down the diffusion of the policy reaction.

In the first category one finds the pure size effect, which is linked to the degree of openness. The creation of Euroland has modified the relative size of the European economies: many small countries, which were heavily dependent on external factors, have entered a big area where dependence on external factors is lower. The Euro Area is obviously much less open to international trade than each of the countries that constitute it.⁶ A large and relatively closed country has sufficient margins for manoeuvre to use its interest rate to stabilize output or inflation because it does not have to worry about the consequences of its choices on the exchange rate: to a certain extent, exchange rate fluctuations are painless and can be disregarded. Such is generally the case of the United States, which is attributed a 'benign neglect attitude' towards the dollar exchange rate that largely stems from the low degree of openness of the United States. On the contrary, a small open economy will be more concerned with the stability of the exchange rate in order to avoid inflationary shocks (in the case of depreciation) or trade shocks (in the case of appreciation).

In this respect, the euro's introduction could be expected to entail large fluctuations between the dollar and the euro because central bankers or governments would have disregarded exchange rate stability from both ends.

Nevertheless, this argument does not take into consideration Euroland's peculiar policy framework.

As a matter of fact, EMU does not have size effects only. It is also characterized by a new type of economic policy organization. As already referred to above, the ECB's independence has introduced risks of conflict between monetary and fiscal policies if these do not share the same objectives. Consider a supply shock where output falls and prices rise. In so far as the ECB is committed to stabilizing prices whereas governments try to dampen the fall in output, the ECB would implement a restrictive monetary policy whereas governments would implement expansionary fiscal policies. The ECB would then drive up the interest rate to curb inflation and to compensate for the expansionary fiscal stance, whereas governments would increase spending (or reduce taxes) to enhance growth and to compensate for the restrictive monetary stance (Capoen, Sterdyniak and Villa 1994). In such a setting, the interest rate, public deficits and the euro's exchange rate would be driven up too much and they would be a source of instability.

In order to circumvent those risks, the SGP has imposed restrictions on fiscal policies, thus leaving the field open to monetary policy. Nevertheless, the sole use of monetary policy would necessitate large swings in euro interest rates following a demand shock if fiscal policies are unable to supplement monetary policy.⁷ This would be another source of instability for the euro. On the contrary, after a supply shock, the SGP would prevent bad strategies, such as a very restrictive monetary policy associated with a lax fiscal policy; the SGP would then reduce volatility.

Another characteristic of a monetary union is that it shares a common nominal short-term interest rate. As a consequence, both in the case of an asymmetric shock, or if member countries have to cope with different economic conditions, the union-wide monetary policy reaction would be limited in comparison with that of a single country: the ECB would be unable to fully stabilize the economy in which the shock occurred; meanwhile its reaction would destabilize the economies in which no shock occurred. The ECB's monetary impotence in terms of shock stabilization would, however, enhance exchange rate stability: the smaller the interest rate variations, the smoother the exchange rate swings,⁸ indicating a trade-off between economic stabilization (related to usual objectives like output and inflation) and exchange rate stability.

The last category of arguments is related to policy reactions in a monetary union, in comparison with other exchange rate regimes. First, an automatic cooperation effect would occur following a symmetric external shock (hitting homogeneously all Euroland countries). In this situation, the ECB would not react as national central banks would do in a flexible exchange rate regime because the ECB internalizes the impact of its action on the whole monetary union, whereas national central banks simultaneously use the flexibility of their exchange rates to dampen the shock. Consequently,

after a common external supply shock, the ECB would increase its policy rate less than a national central bank would in a flexible exchange rate regime: the ECB would consider that an appreciation of the euro has less disinflation effects in Euroland (because the area is not highly open to external international trade, but it is more open to intra-trade over which the appreciation of the euro has no incidence) than an increase of the D-mark had on German inflation. Recognition of this effect would limit the use of monetary policy and would enhance exchange rate stability.

Furthermore, it is noteworthy that Euroland has replaced an asymmetric fixed exchange rate regime, the European Monetary System (EMS).⁹ Following an idiosyncratic shock, the ECB would react according to the average economic situation in Euroland, whereas the Bundesbank's behaviour was mostly taking the German situation into account. Hence, when compared to EMS, the euro would entail lower exchange rate volatility following idiosyncratic shocks hitting primarily Germany, but higher volatility following EU shocks occurring mainly outside of Germany. By contrast, in the case of symmetric shocks, the ECB would have the same behaviour as the Bundesbank's, at least if the latter was conscious that the other European central banks were following its policy to stabilize their exchange rate *vis-à-vis* the D-mark (see Sterdyniak and Villa 1993). In this case, the euro's volatility would be the same as that of hard EMS currencies and any possible volatility increase should have already been observed during the EMS period.

The six above-mentioned arguments, and their incidence on exchange rate volatility, have been summarized in Table 11.1.

With a static Keynesian three-country model, Creel and Sterdyniak (2000) showed how the reaction of a non-European country could possibly modify these determinants and their consequences on exchange rate volatility. They were notably able to link exchange rate volatility ever more closely to shocks, be they domestic or external ones. On the one hand, symmetric demand and external supply shocks would entail exchange rate volatility higher than if European countries shared a flexible exchange rate regime.¹⁰ On the other hand, symmetric internal supply shocks would entail lower

Table 11.1 Euro-dollar exchange rate volatility

Pure size effect	+
ECB's independence	+
Stability and Growth Pact	– (supply shock) + (demand shock)
Unique monetary policy	–
Symmetric shock	–
Post-EMS	– (shock on Germany) + (EU shock outside Germany)

Notes: '+' : higher volatility; '–' : lower volatility.

volatility. If European countries were in a flexible exchange rate regime, national central banks would, as recalled earlier, consider the relative stronger influence of the interest rate on prices and the trade balance: after a demand shock or an external supply shock, interest rates would be higher than in EMU to curb inflation and compensate for the trade surplus: the interest rate would thus be less volatile than in EMU.¹¹

11.3 More or less volatility in a monetary union? Some stylized facts

The concept of volatility can be defined and measured according to different methods.¹² We will limit ourselves here to one indicator: standard deviations for monthly variations in exchange rates against the dollar.¹³

Data reported in Table 11.2 below give a preliminary assessment of the 'size effect'. Before EMU, volatility of the D-mark was certainly high, and quite clearly so shortly before the EMS crises of 1992–93, but the deviations of the D-mark volatility from the yen's have been very low and do not allow clear-cut conclusions on the 'size effect'. The sterling volatility has only been slightly less volatile (out of periods where sterling joined the ERM) than the D-mark.

With EMU, it is clear that the euro volatility has considerably increased in comparison with the D-mark's during the convergence process towards the euro (the so-called post-Maastricht period). The constitution of a vast monetary union has coincided with an increase in exchange rate volatility similar in value to that of the yen-US dollar exchange rate. In the meantime, the volatility of sterling has substantially decreased.

The recent rise of exchange rate volatility for Euroland raises at least two questions which in part stem from the above-mentioned theoretical arguments: First, the question of the institutions involved in the policy mix: Have they been responsible for this rise? Should ECB conservativeness and

Table 11.2 Standard deviations of monthly variations in exchange rates expressed in dollars

	Germany	France	Euroland	Japan	UK
1974 :8-79 :2	2.08	1.93	–	2.17	2.11
1979 :3-83 :2	2.84	2.96	–	3.25	2.61
1983 :3-87 :8	2.97	2.92	–	2.82	2.89
1987 :9-92 :8	3.00	2.86	–	2.75	3.02
1992 :9-98 :12	2.38	2.63	–	3.80	2.77
1999 :1-06:01	–	–	2.78	2.75	2.19

Source: Datastream (monthly data), authors' calculations.

Table 11.3 EU shocks and euro-US dollar exchange rate volatility

EU shocks	Volatility
Asian and Russian crises (1998–99)	+
IT revolution (2000–02)	+ / -
Oil shock (2000–02)	+
Geopolitical tensions (2002–03)	+
Oil shock (2004–05)	+

Notes: '+' higher volatility; '-' lower volatility.

fiscal policies restrictiveness be blamed? Second, do the shocks that have occurred in Euroland since 1999 explain the rise in volatility?

Starting with the second question, the various shocks that have occurred in Europe since 1999 are reported in Table 11.3. Their (theoretical) relationships with the euro's volatility are also presented. Most of the shocks can reasonably be considered as supply shocks, although their determinants have been diverse: political shock in Russia, external financing shock in Asia, geopolitical shocks related to the Middle East, and so on. Their influence on Euroland has been mostly driven towards the supply-side of the economy.

As explained by Creel and Sterdyniak (2000), a positive external supply shock, like the IT shock, can be supposed to have increased euro's volatility; meanwhile, IT diffusion in the EU countries should have decreased volatility, with the originally external shock becoming an internal one. The other negative shocks on the EU (Asian and Russian crises, oil shocks, geopolitical tensions) were all supposed to have increased euro's volatility.

As regards the question on institutions, one may begin to observe Figures 11.1 and 11.3 showing the amazing pattern of the euro-dollar exchange rate, falling until the end of 2000, whereas European economic growth was high, and appreciating for a relatively long period until the middle of 2005, when economic growth in Euroland was about to resume: the euro evolved pro-cyclically.

The above-mentioned literature and statistics indicate a trade-off between exchange rate stability and economic stabilization; hence, (a) exchange rate volatility may favour economic stabilization; however, (b) exchange rate volatility may increase uncertainty and may be detrimental to economic growth; (c) exchange rate volatility may increase with some types of shocks; and (d) the euro evolved pro-cyclically.

Combining conservative institutions with the occurrence of supply shocks in a macroeconomic model will be shown, in Section 11.4, to foster exchange rate volatility and a pro-cyclical behaviour of the euro. Indeed, it

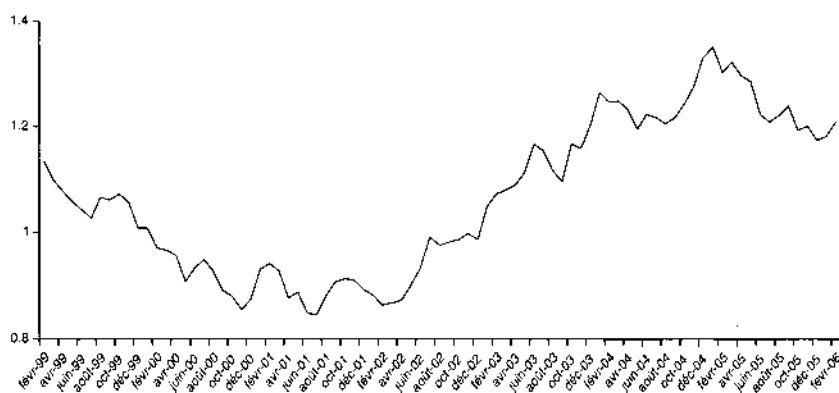


Figure 11.3 US dollar vs. euro exchange rate

Source: Datastream.

is likely that both factors – volatility and pro-cyclicality – have hindered the economic performance of Euroland. The benchmark macroeconomic model featuring four countries will mimic the European context and present an extensive and consistent view on the various interactions between economic policies and the public.

The model will also help to assess alternative hypotheses. It has been common to blame European institutions for the bad Euroland's economic record (see, for instance, de Grauwe 2006); and the previous sections have shown that these institutions were partly responsible for exchange rate volatility and pro-cyclicality. But rather than blaming Europe for its 'bad' institutions, we will pursue the hypothesis that they are 'good' institutions. Coherently with the new macroeconomic consensus, member countries of Euroland follow fiscal rules that depend on the output gap (in the medium-run, member countries should balance their cyclically adjusted deficit) and on public debt (since the SGP's reform of March 2005, member countries with higher debt levels have to improve their public finances more than low-debt countries; before the reform, high-debt countries were under close scrutiny by the European Commission). As for the ECB, although it denies following an inflation targeting strategy, its policy is aimed at price stability, consistently with the New Classical Economics' prescriptions. Since European institutions are clearly in accordance with mainstream economics it would seem ironic if they could be labelled 'bad institutions'.

So, in assuming that they are indeed 'good institutions', it may be that their efficiency depends on whether other countries adopt the same type of

institutions: for instance, after a worldwide negative supply shock, different types of institutions on both sides of the Atlantic – conservative in the Euroland, pragmatic in the United States – leave a heavy burden on the ECB which has to curb inflation. Now if institutions are the same across the Atlantic, the burden would be better shared, worldwide economic stabilization would improve, as also would the economic record of European institutions.

Before jumping to such a conclusion, we need to check that a better coordination on the chosen institutions would be beneficial to Euroland and that such a choice would also be beneficial to non-European countries. If this were the case, our conclusion would be simple: Europeans should promote their institutions abroad rather than blame them.

Nevertheless, as our model will show, and although we have done our best to save European institutions, there is no way to make them acceptable abroad. Worse: the fact that they have been adopted only in Euroland is beneficial to non-European countries but not to European countries! There will be two important conclusions: first, institutional change is needed in Euroland; second, the new consensus has not produced blueprints for efficient institutions.

11.4 The benchmark model

The benchmark model used here originates from earlier work by Creel et al. (2003) studying the dynamic consequences of a financial shock in Asia on different regions of the world. It is a dynamic Mundell-Fleming model extended to four theoretical countries¹⁴: the 'United States', 'Japan', 'Germany', and 'France', where the former two are double the size of the latter two, and where the latter two form a monetary union, called 'Europe', of the same size as the former two.

11.4.1 The model¹⁵

The model includes a *real* and a *financial* bloc. The *real bloc* consists of an aggregate demand bloc and an aggregate supply bloc. Aggregate demand (Equation 1) depends positively on households' income net of taxes ($y-T$), public spending (g), the trade balance (b), and negatively on the real interest rate (r). It also depends on a wealth effect.¹⁶ Households' income excludes interest earned on assets (i.e., public debt (d) and net foreign assets (ϕ)), which is assumed to contribute to wealth accumulation and to indirectly affect aggregate demand through the wealth effect. Households are assumed to have a planned level of wealth, W_0 , while their consumption-saving trade-off assures that their effective wealth (the sum of public debt and net foreign assets) tends toward the planned level. Equation 1 shows that consumption and portfolio decisions are closely linked, which is in accordance with Purvis (1978):¹⁷

$$y_t^i = c(y_t^i - T_t^i) - \sigma r_t^i + g_t^i + b_t^i + \mu(\phi_{t-1}^i + d_{t-1}^i - W_0) \quad (1)$$

The trade balance of country i (Equation 2) depends on the cyclical gap relative to other countries j (with $j \neq i$) and on the respective real exchange rate between country i and countries j :

$$b_t^i = \sum_{j \neq i} [n^{ij}(y_t^j - y_t^i) + n^{ij}\delta_x x_t^{ij}] \quad (2)$$

where n^{ij} is the degree of openness between country i and country j , x_t^{ij} the real exchange rate between country i and country j , and δ a positive parameter which satisfies the Marshall-Lerner-Robinson condition.

The supply bloc consists of a wage-price loop: prices follow an expectations-augmented Phillips curve. Desired production prices (p_t^d) depend on wages, on the output, and on financing costs, approximated by the real interest rate (Equation 3). *Ceteris paribus*, a rising interest rate will increase prices because firms pass the financing costs on to prices and substitute labour for capital, which puts wages under pressure. Production prices (p) depend on past prices and current desired prices (Equation 4). The desired wage (w_t^d) depends on consumer prices (q) and on output (Equation 5). Wages (w) depend on past wages and on current desired wages (Equation 6). Consumer prices depend on current production prices and foreign prices (Equation 7):

$$p_t^d = w_t^i + v_1 y_t^i + \theta r_t^i \quad (3)$$

$$p_t^i = l_1 p_{t-1}^i + (1 - l_1) p_t^d \quad (4)$$

$$w_t^d = \lambda q_t^i + v_2 y_t^i + w_{0t}^i \quad (5)$$

$$w_t^i = l_2 w_{t-1}^i + (1 - l_2) w_t^d \quad (6)$$

$$q_t^i = p_t^i + \sum_{j \neq i} n^{ij} x_t^{ij} \quad (7)$$

Inflation expectations are assumed to be backward-looking, consistent with Fuhrer (1997) and Mankiw (2001). This assumption is not as strong as it may appear since the outcomes of the model are the same when price expectations are assumed to be forward-looking. This is partly due to the fact that wages are only partially responsive to prices in the short and medium term, and because prices and wages adjust only slowly (see Capoen and Villa 1997, pp. 19–20).

The *financial bloc* includes the real interest rate, equal to the nominal interest rate minus expected inflation; an equation of public debt accumulation, which depends on the interest burden and the public primary deficit (Equation 8); and equations for the gross demands of net foreign assets by private agents in country i (with $i = F, G, J$ or U , see Equations 9 and 10).

These demands depend on the expected variation in the nominal exchange rate and on the interest rate gap between country i and countries j (with $j \neq i$) (see Equations A1a to A1d in the appendix). Expectations regarding the future nominal exchange rates are forward-looking.¹⁸ The net asset position of country i is the sum of net external assets of households in country i and households in country j (with $j \neq i$). The net asset position depends on the domestic valuation of foreign-currency denominated foreign assets (the terms in x in Equation 9):¹⁹

$$d_t^i = d_{t-1}^i + r_{t-1}^i(\bar{d}/100) + r_0(d_{t-1}^i - \bar{d}) + g_t^i - T_t^i \quad (8)$$

$$\begin{aligned} \phi_t^{ij} = F_t^{ij} - F_t^j = & \phi_{t-1}^{ij} + 2(x_t^{ij} - x_{t-1}^{ij})F_0 + (r_{t-1}^i - r_{t-1}^j + \\ & y_t^i - y_{t-1}^i - y_t^j + y_{t-1}^j)F_0 + r_0\phi_{t-1}^{ij} + b_t^{ij} \end{aligned} \quad (9)$$

$$\phi_t^i = \sum_{j \neq i} \phi_t^{ij} \quad (10)$$

where \bar{d} stands for the government public debt target, F^{ij} for assets of country j owned by agents of country i denominated in that country's currency, in real terms, and ϕ^i for net external assets of country i towards country j .

In accordance with Branson (1979), it is assumed in Equations (9) and (10) that assets denominated in domestic or foreign currencies are not perfect substitutes: because of an exchange rate risk, households only want to hold a limited share of their wealth in foreign currency; this share depends on the expected forward-looking return differential. The latter includes the expected variation in the nominal exchange rate. The same specification was used recently by Blanchard, Giavazzi and Sa (2005) and applied to the US current account deficit and its sustainability. According to them, the mechanisms at work are the following: first, under imperfect substitutability, the initial depreciation in response to a trade deficit is more limited than with perfect substitutability, and by implication, the deficit is larger and longer lasting. Second, an increase in the foreign demand for, say, Euroland assets leads to an initial appreciation of the euro and a trade (or current account) deficit.

The exchange rate regimes are chosen as follows. France and Germany form a monetary union ('Euroland') and thus share the same central bank and the same nominal interest rate. The three central banks are independent from the governments and do not abide by the rules of a fixed exchange rate regime: the dollar, yen, and euro therefore fluctuate freely against one another.

11.4.2 Policy functions

Economic policy decisions are taken in a dynamic inter-temporal framework within a forward-looking expectations framework. Economic policies pursued here are time-consistent, as advocated by the new consensus since the seminal paper of Kydland and Prescott (1977).

Economic policies are conducted with the aim of minimizing loss functions that include the policy-makers' targets and instruments.²⁰ Each policy-maker has basically four main targets: stabilizing output at its potential level, stabilizing the price level, meeting the external constraint so that fluctuations in the exchange rate are stabilized,²¹ and satisfying the inter-temporal budget constraint of the government because public debt accumulation reduces the economic policies future rooms for manoeuvre.

In addition, policy-makers, in controlling their instrument, try to minimize the negative impact of its use. On the one hand, fiscal policy can be costly because of implementation delay, and because it may be irreversible; on the other hand, monetary policy affects future growth through its impact on investment so that using the interest rate can be costly.

Hence, governments use public spending in order to minimize the following intertemporal loss function:

$$L_g(0) = \frac{1}{2} \sum_{t=0}^{\infty} \rho^t \left\{ \alpha_g y_t^2 + \beta_g q_t^2 + \gamma_g \phi_t^2 + \delta_g (d_t - \bar{d})^2 + \epsilon_g g_t^2 + \eta_g i_t^2 \right\} \quad (11)$$

while central banks choose the interest rate so as to minimize their intertemporal loss function:²²

$$L_b(0) = \frac{1}{2} \sum_{t=0}^{\infty} \rho^t \left\{ \alpha_b y_t^2 + \beta_b q_t^2 + \gamma_b \phi_t^2 + \delta_b (d_t - \bar{d})^2 + \epsilon_b g_t^2 + \eta_b i_t^2 \right\} \quad (12)$$

where y and q are in log, ϕ , d , and g are in percentage of GDP, and i (the nominal interest rate) is in percentage, ρ is the discount factor, assumed to be constant, and \bar{d} is the government *ex ante* planned public debt target. The discount factor ρ is set equal to 0.95.

With quadratic loss functions and the model set linearly in deviation from the baseline, Nash equilibria have the property that policy instruments are linear functions of the states of the model. Economic policies are computed as in Oudiz and Sachs (1985): policy-makers follow time-consistent economic policy rules in a rational expectations framework ('closed loops'). We only deal with non-cooperative equilibria set as Nash equilibria.

The weights for the different targets in the loss functions differ both between the monetary and fiscal policymakers as well as between countries. This assumption will be partly relaxed in Section 11.5.

In the benchmark model, the following, typical preferences have been assumed. In the United States, the Fed is supposed to balance production and inflation targets so that the nominal interest rate responds with equal weight to production and inflation deviations from their respective targets; the *real* interest rate increases with inflation deviations. The US government places

Table 11.4 Benchmark case: loss function parameters

		α	β	γ	δ	ϵ	η
USA	Gov.	0.5	0.25	0.0	0.5	0.5	0.5
	CB	0.5	1.5	0.0	0.25	0.25	0.5
Europe	Gov.	0.5	0.5	4.0	1.0	1.0	0.5
	CB	0.5	2.25	1.0	0.5	0.5	0.5
Japan	Gov.	0.5	0.25	4.0	0.5	0.5	0.5
	CB	0.5	1.5	1.0	0.25	0.25	0.5

more weight on production target than on inflation target. Both authorities share a benign-neglect view as regards the stability of the US dollar exchange rate *vis-à-vis* the euro and the yen (γ are set equal to zero). Last, weights attributed to the public finance targets (public spending and debt) are relatively low.

In the case of Euroland, governments and the ECB are more 'conservative' than US authorities. By conservative, we mean that Euroland's authorities are more averse to inflation, relative to the output growth target, than in the United States. Globally, the European weight on inflation target has been increased by 50 per cent in comparison with the US case. Moreover, European authorities are assumed not to share the 'benign-neglect' attitude of the US authorities. Last, weights attributed to public spending and debt targets are higher than in the United States, testifying for the existence of the SGP. It is well-known that the SGP limits deviations of public deficits (hence public spending – since in our model lump-sum taxes are supposed to be fixed) and public debts from their respective targets.

The preferences of the Japanese authorities (or Asian economies) are assumed to be the same as those of the United States, except regarding the exchange rate target for which Europe's preferences have been adopted. Table 11.4 summarizes our assumptions.

11.4.3 Methodology

The analysis will draw on different scenarios that analyse the advantages and drawbacks of European institutions both in terms of stabilization and in terms of exchange rate swings and counter- versus pro-cyclicality. Although the adoption of the euro was meant to help member countries to dampen external and internal shocks, institutions that have been associated with the euro – a conservative central bank and fiscal targets – may have jeopardized the efficiency of this new exchange rate regime.

Changing the institutions is thus an option. But comparability is also at stake. Even without reference to the 'Lucas-critique' (Lucas 1976), one can only compare similarly structured loss functions. In this respect, we must in our model keep the same loss functions for the European authorities, meaning that we cannot change European institutions (they are described by the loss functions).

After having computed, in the benchmark case, the loss functions of European authorities after symmetric and asymmetric shocks have hit European countries or their partners, the next step of our computations will be to change the US institutions and ask: would Europe be better off if the United States adopted the same institutions as Europe?

In order to mimic the Euroland situation, we have checked for the types of shocks that either produce large swings in the euro-dollar exchange rate or hamper the stabilization capacities in the Euroland. This preliminary step has therefore identified the shocks that were more detrimental to EU loss functions (the issue of stability/optimality of economic policies) or to exchange rate variations (the issue of volatility). Consistently with the European experience (see Table 11.3 and comments), an external supply shock (a supply shock on the United States) has the largest consequences on the variations of the euro-dollar exchange rate. As for loss functions, they are highest following a demand shock on EU countries (see France in Table 11.5). In the following, we will hence concentrate on a supply shock in the United States and on a demand shock in France. In the following we will distinguish responses to shocks between the short, medium, and long run; hence we will

Table 11.5 Benchmark case: effects of different shocks⁽¹⁾

		Mid-run (5 years)	Long-run (40 years)
Demand shock in France	$L_{gov}^{(2)}$	6.26	0.00
	L_{BCE}	1.51	0.00
	$1\$ = \dots \text{€}$	-0.14	-0.35
Supply shock in France	L_{gov}	1.23	0.00
	L_{BCE}	0.60	0.00
	$1\$ = \dots \text{€}$	0.05	0.18
Demand shock in the USA	L_{gov}	0.14	0.00
	L_{BCE}	0.05	0.00
	$1\$ = \dots \text{€}$	0.28	0.54
Supply shock in the USA	L_{gov}	0.11	0.00
	L_{BCE}	0.06	0.00
	$1\$ = \dots \text{€}$	-0.55	0.90
Demand shock in Japan	L_{gov}	0.08	0.00
	L_{BCE}	0.03	0.00
	$1\$ = \dots \text{€}$	-0.11	-0.16
Supply shock in Japan	L_{gov}	0.06	0.00
	L_{BCE}	0.04	0.00
	$1\$ = \dots \text{€}$	0.07	0.10

Notes: ⁽¹⁾: All shocks are negative ones. The absolute value of the size of the shocks in the USA and Japan is half that occurring in France; ⁽²⁾: only the loss value of the French government is reported in this table.

take into account the impacts of wage indexation and of the progressive adjustment of prices and wages to their desired 'steady state' values on the outcomes.

11.5 Do institutions matter?

11.5.1 Responses to the shocks in the benchmark case

Responses to a *negative demand shock* (on consumption or investment) in France are reported in Figure 11.4. This type of shock occurred after the weekly working time reduction in 1997 (the 35-hour week legislation). Originally a supply shock, it has rapidly translated into higher uncertainty, which induced slower aggregate demand.²³

With our model, the shock in France immediately induces a sharp reduction of output up to almost 0.5 per cent one year after the shock. Consumer prices are almost immediately below their initial steady-state level. Expansionary

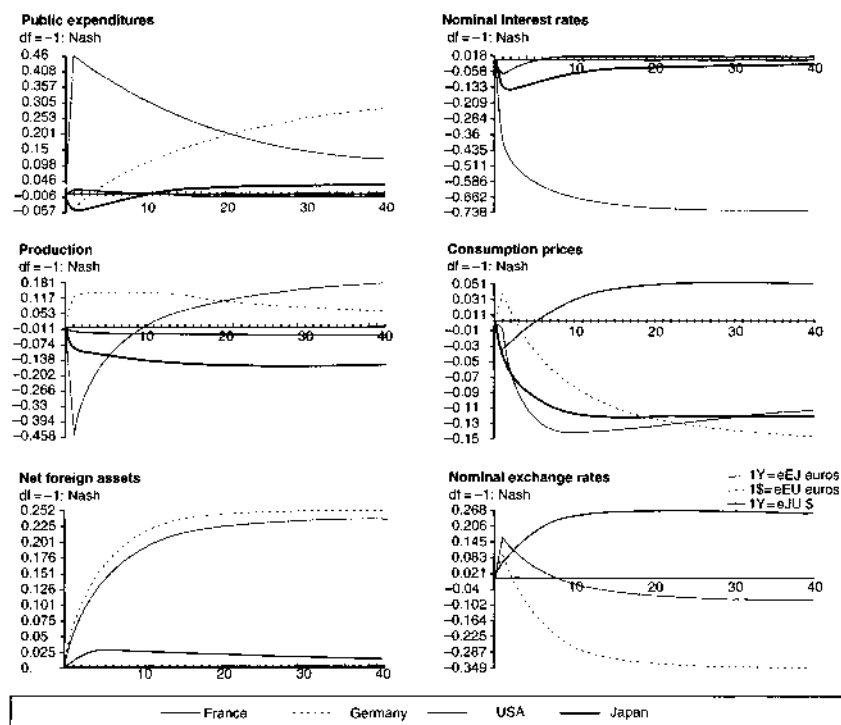


Figure 11.4 Benchmark case: demand shock in France

policies follow: public expenditures are increased²⁴ and the nominal interest rate is reduced. These policies provoke a depreciation of the euro (*vis-à-vis* both the dollar and the yen) in the short run. In the medium and long run, the initial improvement in European countries' trade balances, interest rate differentials (nominal interest rates decrease less in the United States and Japan than in Euroland), and differentials in growth performance lead to a sharp increase in European net foreign assets. The euro is thus expected to appreciate in the long run. Within a forward-looking framework like our model, the euro appreciates in the medium run. Noteworthy, the euro's appreciation is preceding growth resumption: in the medium run, the euro is pro-cyclical.

Thanks to the reduction in the European interest rate, German output increases. This output boost is long-lasting despite the appreciation of the euro because German public expenditures are also increased: the lower interest burden provides greater fiscal leeway. Owing to the appreciation of the euro, German prices are permanently below their initial steady-state value. The pro-cyclicity of the euro exchange rate is thus favourable to price stability; in a globalized world, a lower price level enhances market shares. Partly for this reason Germany has greatly improved its trade balance since 2002.²⁵

In its reactions to this internal demand shock, the model quite consistently mimics the recent history of Euroland: slow growth in some countries has contributed to increasing public deficits (some of them above the 3 per cent of GDP limit of the SGP), and to reducing nominal interest rates (mid-2001 and the beginning of 2003); in the meantime, the euro started appreciating in the mid-2002 and has shown a pro-cyclical behaviour. Still meanwhile, deflation trends have been evoked in the case of Germany.

Let us now turn to the situation in the United States after the shock in France. The US trade balance deteriorates immediately after the shock, as French and Japanese outputs are below their steady-state and the US dollar has been appreciating: US output therefore decreases slightly below its initial steady state in the short run. The reaction of US authorities is immediate: the nominal interest rate is decreased and public spending increased. Both policies coupled with the depreciation of the US dollar then fuel inflation and policy stances are reversed. Here again, the benchmark model seems consistent with the highly reactive actions of the Fed and the US government.

As regards the reversal in the policy stances, it has actually happened at the end of the Greenspan era as far as monetary policy is concerned; the reversal in the fiscal stance has been postponed, at least partly for electoral reasons and also because of the financial costs of the 'war on terrorism'.

As reported in Table 11.3, there have been mostly negative external supply shocks hitting Euroland. We therefore focus on these kind of shocks. Responses to a *negative supply shock* in the United States are reported in Figure 11.5. This shock illustrates the oil shocks that have hurt the European economies, more than the (positive) IT shock that has diffused over European countries.

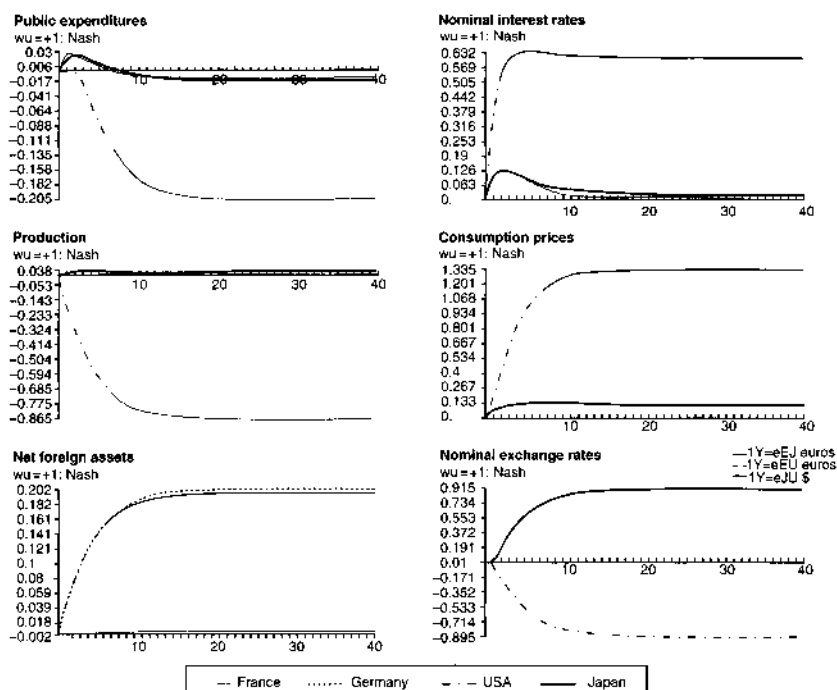


Figure 11.5 Benchmark case: supply shock in the United States

The shock induces a sharp rise in US prices and a sharp decline in US output. Slower growth and higher prices in the United States lead to a deteriorating US trade balance, meaning that price effects have been stronger than volume effects; conversely, Japan and Euroland benefit from an output increase due to an improvement in their competitiveness *vis-à-vis* the United States, and they thus increase their net foreign assets positions *vis-à-vis* that country.

The US authorities then face a trade-off: should they use their policy instruments to foster growth or to curb inflation? In fact, in the presence of imperfect substitutability between domestic and foreign assets and the corresponding presence of a home bias, the rise in US net foreign indebtedness is associated with a lower exchange rate. The US authorities can therefore take advantage of the expected depreciation of the dollar that will stabilize output in the long-run to dampen economic fluctuations in the short run with a restrictive monetary policy. They thus follow both restrictive policies: interest rates are increased and public spending decreased. Note that the reaction of the US monetary authority *vis-à-vis* inflation has to be tough

enough to ensure price stability: in so far as it is not the case, the nominal interest rate would need to be raised and net foreign indebtedness would still increase; stabilization of net foreign assets and indebtedness therefore requires interest rate stability and the latter, in turn, requires price stability.

The swings of the euro-dollar exchange rate are substantial: a half percentage point increase in US labour costs would provoke almost a one percentage point depreciation of the dollar. This is quite strong and is consistent with the euro-dollar exchange rate volatility, which was briefly documented in Section 11.3.

Reliance on the exchange rate to dampen economic fluctuations is also fundamental when one compares the outcomes of a symmetric supply shock in Euroland and a supply shock in the United States of the same size.²⁶ After these two shocks, it appears that fiscal stances are similar for the countries hit by the shock, but monetary policy in the United States is more restrictive than what that of the ECB would be. However, prices increase by more and output declines by less in the United States than in France and Germany. The only possible reason for these different outcomes on the monetary stance, prices, and output can be found in the variations of the dollar exchange rate: whereas the dollar depreciates by 2 per cent in the long run after a shock in the United States, the euro depreciates by a mere 0.4 per cent after a symmetric shock in Euroland. The less active behaviour by the European monetary authority in comparison with its US counterpart seems to jeopardize the ability of the euro to dampen economic fluctuations. As such, one institution seems to matter greatly: exchange rate (non) policy.

11.5.2 Changing institutions: the variant case

Before studying the outcomes of the shocks when United States and European authorities share the same preferences, one must recall that fiscal and monetary policies in this model stem from time-consistent computations on an infinite horizon. Modifying only slightly the parameters in the loss functions is thus not expected to substantially change the reactions of the different authorities as well as their outcomes on output, prices, and so on. The model is meant to be illustrative and it is also highly normative. Normative models help to gain consistency in the analysis of the numerous macroeconomic mechanisms at work, so that the directions of change one will find between the benchmark and variant cases are economically consistent, although their size may be different in the 'real world'.

In the variant case, the United States is supposed to adopt European institutions: parameters in the US authorities' loss functions are thus the same as European authorities'. Some of the results are reported in Table 11.6 below. Related figures are Figures 11.6 and 11.7.

After a *negative demand shock* in France, in this setting we observe two important results. First, the loss values of the French government and the ECB are reduced, meaning that they are better off than in the previous situation in which only Euroland countries had relatively conservative institutions.

Table 11.6 Benchmark and variant cases compared: values expressed as deviations from steady-state

	Demand shock in France				Supply shock in the USA			
	Benchmark		Variant		Benchmark		Variant	
	1 yr.	5 yrs.	1 yr.	5 yrs.	1 yr.	5 yrs.	1 yr.	5 yrs.
French gvt. loss value	9.00	6.25	8.85	6.16	0.16	0.11	0.16	0.11
German gvt. loss value	1.75	1.39	1.79	1.42	0.16	0.11	0.16	0.11
ECB loss value	2.19	1.51	2.17	1.50	0.09	0.06	0.11	0.07
Prices in France	-0.01	-0.13	-0.01	-0.13	0.05	0.12	0.05	0.15
Output in France	-0.46	-0.14	-0.47	-0.15	0.02	0.03	0.01	0.00
Public debt in France	0.60	1.79	0.60	1.77	0.02	0.24	0.03	0.24
Public spending in France	0.46	0.39	0.46	0.39	0.03	0.01	0.03	0.00
ECB interest rate	-0.42	-0.59	-0.43	-0.58	0.11	0.08	0.12	0.10
Value of dollar in euros	0.10	-0.14	0.15	0.01	-0.03	-0.55	0.17	-0.10

The main reason for this result is linked to the euro-dollar exchange rate: first, the euro depreciates more in the short run than in the benchmark case; second, depreciation is a lasting (medium-run) phenomenon; third, the absolute value of the euro appreciation in the long run is lower than in the benchmark case (compare Figures 11.4 and 11.6 for the nominal exchange rate). The conclusion is straightforward: If the US authorities cared more about the dollar exchange rate stability, the pro-cyclicality of the euro would be substantially erased. At least one reason for the euro's pro-cyclicality can be attributed to US preference not caring much about the stability of the US dollar.

With more conservative preferences than in the benchmark case, the US government and the Fed implement, respectively, more restrictive policies in the short run (public spending is decreased) and the long run (the interest rate is raised). Consequently, output, prices, and public debt in the United States are decreasing more than in the benchmark case. Slower growth in the United States reduces the growth of European net external assets *vis-à-vis* the United States; the latter reduction thus explains the lower appreciation of the euro in the long run.

The second important result is that, with the change of institutions in the United States, the situation of the second European country, Germany, deteriorates: the loss value of the German government is higher. With the substantial depreciation of the euro (compared with the benchmark case) that boosts German output, German public spending is set at a lower level; hence, public debt is lower than in the benchmark case. Why it is detrimental to the

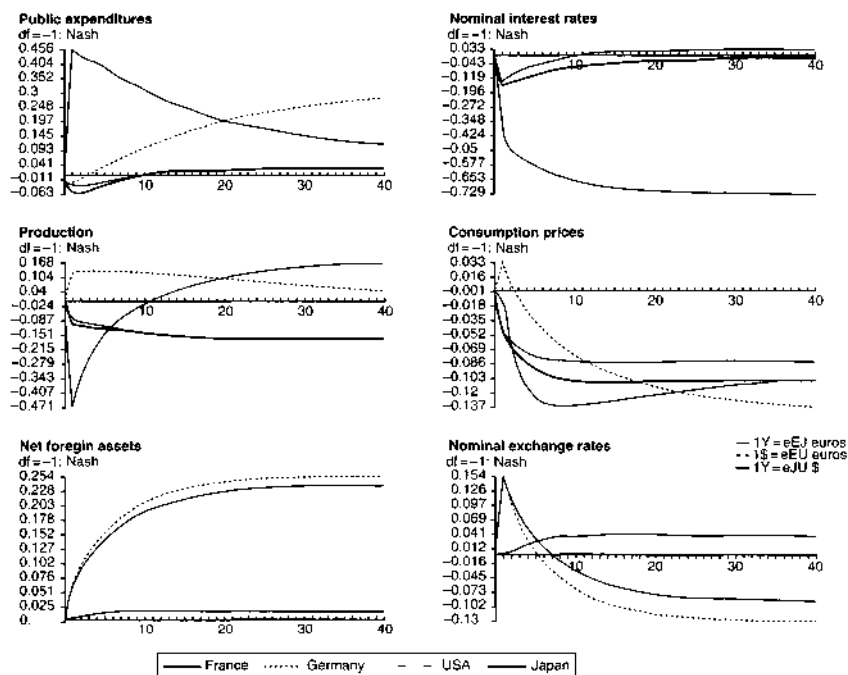


Figure 11.6 Variant case: demand shock in France

German government in our model has to be made clear. Arithmetically, the important weights, stemming from the SGP, allocated to (positive or negative) deviations of public finance variables from their initial steady state are detrimental to the German loss function.

With quadratic loss functions like those used in this chapter, it is in fact difficult to depict the SGP's asymmetry. This asymmetry is such that in case of favourable budgetary position, discipline does not necessarily exist and the budget may have to be adjusted later on in a pro-cyclical fashion, whereas the disciplining force of SGP only bites in case of an excessive deficit, with fiscal policy ending up being pro-cyclical in this case too. In both cases of favourable and unfavourable budgetary position, then, disciplining force will bite sooner or later. Within our dynamic time-consistent macroeconomic framework with quadratic preferences, even lower debt (than in the benchmark case) is immediately costly because it increases future fiscal leeway. Given a lower public debt, fiscal policy may then be more expansionary in the future, raising the risk of exceeding the SGP limit.

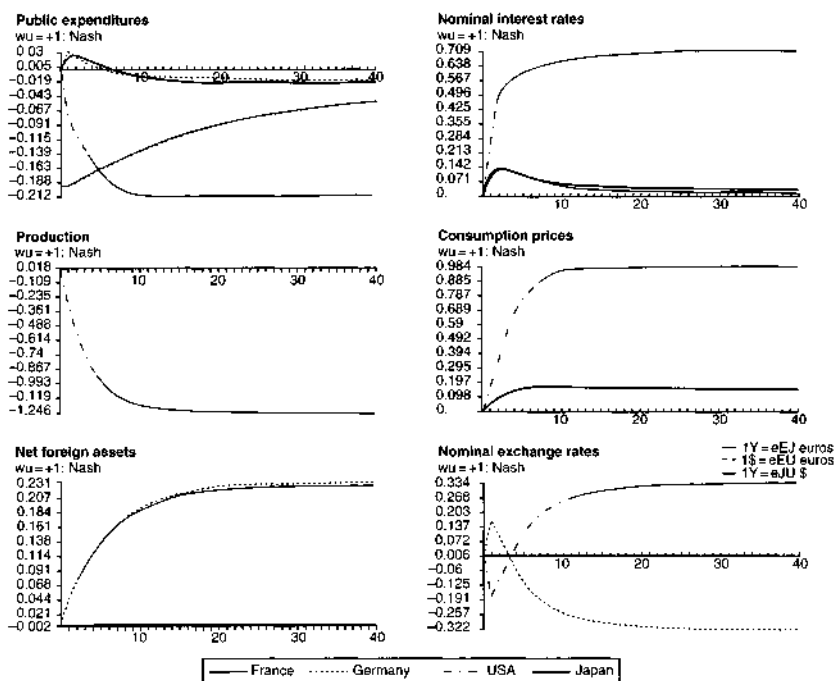


Figure 11.7 Variant case: supply shock in the United States

After a *negative symmetric demand shock* in Euroland²⁷ however, both European countries would be better off if US authorities adopted European preferences. In the case of Germany, the shock-induced immediate reduction in output is better handled if the euro behaves counter-cyclically; the depreciation of the euro, more substantial in the variant case, enables the German authorities to increase public spending to a lower extent than in the benchmark case.

The case of Germany here is revealing of the strong relationships between exchange rate policy and fiscal policy. With the latter fettered by the dispositions of the SGP, exchange rate variations may appear either detrimental or favourable to a domestic economic performance, depending on the nature of extra-European institutions. Interactions between these policies must be carefully designed and institutions should be consistent with one another: limiting the fiscal stance may be inconsistent with a worldwide-shared 'benign neglect' attitude towards exchange rates. In this respect, the fact that the United States and Euroland do not share the same preference in the 'real' world may legitimize European fiscal rules. But this statement holds for

asymmetric shocks, not symmetric ones. One has then to carefully document and analyse the nature of shocks hitting Euroland²⁸ before concluding that fiscal rules are necessary in a heterogeneous world.

The adoption of European-style institutions in the United States sharply reduces exchange rate swings in the medium and long run after a *negative supply shock* in the United States. Notably, changing institutions is detrimental to the ECB, as the euro's depreciation that occurs in the variant case quite rapidly increases European prices. As for the United States, adopting conservative preferences reduces the ability of the government and the central bank to curb inflation and dampen economic fluctuations: after a more restrictive fiscal policy than in the benchmark case (public debt was permanently increased, whereas in the variant case, it is decreasing in the long run), US output declines substantially. After this type of shock, which always creates a trade-off between the output and inflation objectives, it appears that the trade-off turns in favour of inflation, consistently with the assumption that US authorities are more conservative than they were in the benchmark case. The reduction in exchange rate swings here is thus contradictory with economic stabilization in the United States.

More generally, the dollar-euro exchange rate can well help to stabilize both the United States and Euroland in cases of opposite economic requirements (or, asymmetric shocks). It is only in cases of common requirements (or, symmetric shocks) that benefits from exchange rate movements to the United States mean these movements are at the same time detrimental to Euroland.

11.6 Conclusion

In this chapter, we have argued that shocks and institutions are responsible for Euroland's poor economic performance, as well as for two related aspects: pro-cyclicality and relatively high volatility of the euro-dollar exchange rate. We have strengthened our argument using a normative and simulated macroeconomic model that mimics Euroland's situation since the beginning of the new century. We have, finally, modified the benchmark model in the following respect: to investigate the responsibility of Euroland institutions, which we labelled 'conservative', as they are mainly focused on price stability rather than on better economic performance, we have studied the consequences of exporting them to the United States. Results are manifold.

First, the less active behaviour of the European monetary authority in comparison with its US counterpart jeopardizes the ability of the euro exchange rate to dampen economic fluctuations. By contrast, a flexible exchange rate and a 'benign neglect' attitude towards it may help to dampen shocks. Second, had the United States more conservative institutions and not a 'benign neglect' attitude towards the exchange rate of their currency, euro's pro-cyclicality would be substantially reduced. One recent feature of

Euroland would certainly disappear and Euroland member countries would not undergo the unfavourable trends of the euro exchange rate. Third, in the case of a European asymmetric demand shock, the adoption of conservative institutions by the United States would be detrimental to the Euroland member countries that were not hit by the shock. This results from the eagerness to limit public finances variations: the logic underlying a symmetric functioning of the SGP may thus impede the reaction capacities of member states. Fourth, if the demand shock hitting Euroland were symmetric, the adoption of conservative institutions by the United States would be beneficial to all Euroland member countries. This outcome would not be dependent on the specific features of the European fiscal rules. Fifth, after an external supply shock, the adoption of conservative institutions by the United States is detrimental to the ECB: the euro's depreciation is harmful to the price stability objective. Two conservative central banks that do not cooperate closely may produce negative outcomes for one of them. Last, US authorities, for which the trade off between price stability and output has a lower slope than in Euroland, are generally better off if European institutions are conservative: economic stabilization in the United States is improved with lower variations in economic policy's instruments. Clearly, the United States benefits from Euroland member countries having relatively more conservative institutions.

The last conclusion has strong implications in terms of the type of institutions that should be advocated. Whereas the new macroeconomics consensus emphasizes the efficiency of central banks' independence coupled with a conservative central banker and fiscal rules that limit the power of nuisance *vis-à-vis* the central bank's prevailing objective – price stability – we have shown that this policy framework has more favourable effects on countries which do not adopt this framework than on countries that do.

Notes

* We are grateful to conference participants and, especially, to Jörg Bibow and Andrea Terzi for their stimulating comments and remarks. We also thank Etienne Farvaque for his remarks. The usual disclaimer applies.

1. Data for potential output come from the OECD database and therefore stem from the OECD's methodology. Assessing potential output is still a disputable issue which remains beyond the scope of the present contribution.
2. How exchange rate volatility impinges on international trade was originally discussed in IMF (1984) and Krugman (1989).
3. It should be noted, though, that other observers (Bénassy, Mojon and Pisani-Ferry (1997), Cohen (1997), and Martin (1997)) had reached mixed conclusions regarding a possible decline in exchange rate volatility following the creation of the euro.
4. Some contributions, like the Sapir report (Sapir et al. 2004) that investigate the poor economic performance of Euroland, discuss institutions' efficiency at length but do not say much on the exchange rate of the euro; whereas some contributions, like Altavilla and de Grauwe (2005), that investigate the euro-dollar

exchange rate, relate its volatility partly to GDP differentials but without discussing the role of institutions.

5. Referring to the same type of shock, Bernanke et al. (1999) argue that official 'inflation targeting', through adopting a transparent strategy, reduces the fear of losing credibility: transparency produces credibility. Measures to temporarily stimulate economic growth following a negative shock would then not be interpreted as bad policy. It is worth mentioning here that the ECB does not officially follow an 'inflation targeting' strategy and is generally criticized for its low transparency (see, for example, Buiters 1999).
6. With the adoption of the euro, openness that relates to financial flows did not change as dramatically as that related to trade because all member countries had fully liberalized financial flows by 1990 at the latest.
7. This would be the case if member countries had been unable or unwilling to reduce substantially their public deficits prior to the shock. The European experience has shown that few countries have effectively consolidated.
8. Here we assume that exchange rate variations depend (at least partly) on short-run interest rates.
9. The EMS still exists for European countries which have not adopted the euro and are willing to participate. The 'new' name is ERM II (Exchange Rate Mechanism II).
10. Shocks hit the European countries symmetrically, but not the non-European ones.
11. Creel and Sterdyniak (2000) explain why the conclusions would be the opposite if the sensitivity of intra-European trade to relative prices were particularly strong.
12. See IMF (1984), Artis and Taylor (1988), Bartolini and Bodnar (1996), or Tse (1998).
13. We will not deal with 'leptokurtic' exchange rate distributions (see Artis and Taylor 1988, or Pesaran and Robinson 1993). In general, this specificity disappears when monthly or quarterly exchange rates are studied.
14. The model hinges extensively on Capoen and Villa (1997). Long-term and stability conditions can therefore be found in their paper. Three substantial modifications to their model are worth mentioning. First, two countries with heterogeneous sizes are added. Second, the consumption function is simplified by the assumptions that households neither consume the returns on their financial assets, nor the capital gains on foreign assets net of exchange rate variations. These assumptions have no influence on the results. Last, balanced budget rules are ruled out.
15. All the equations and definitions are given in the appendix. Variables have a subscript for time, a superscript for the country, with $i = F, G, J$ or U representing respectively France, Germany, Japan, and the United States. Except for net external assets, all variables are expressed as deviations from the baseline.
16. Barrell and Sefton (1997) also introduce a wealth effect, but with a weak form of Ricardian equivalence, since public debt has a negative effect on aggregate demand. We disregard this 'equivalence' here.
17. The model, as will be shown below, contains portfolio and wealth effects. Portfolio effects are due to the existence of risk aversion on foreign currency denominated assets (see Branson 1979). Wealth effects in consumption functions are introduced as a consequence of these portfolio effects, in order to be consistent with Purvis's (1978) extension of the Brainard and Tobin (1968) model: 'The existence of adjustment costs (*here, due to risk aversion*) means that there is no portfolio balance problem *per se* (in the sense of allocation of a given level of wealth), but rather a (longer run) problem of determining an optimal path for each asset and for the level of consumption. Thus a natural extension of the Brainard-Tobin model is to treat saving and portfolio decisions in an integrated fashion' (Purvis, p. 403; our emphasis).

18. In fact, with backward-looking price expectations and forward-looking exchange rate expectations, an asymmetry of information exists between households (workers) and financial markets: the first are less informed than the latter. Another explanation for introducing this gap could be that workers are linked by staggered and protracted contracts (at time t , there are always workers with 'old' contracts still running, so that expectations of workers at the aggregate level are a mix of backward and forward behaviours, the now so-called 'hybrid Phillips curve'), whereas agents on financial markets can protect themselves against news and noises and, therefore, have forward-looking behaviours.
19. For a theoretical justification, see Bénassy and Sterdyniak (1992).
20. The structures of these loss functions are quite standard (see, for instance, Beetsma and Bovenberg 1998, 2005; Hughes Hallett 1998; Hughes Hallett and Ma 1996).
21. One might also consider this target as reflecting an indicator of national savings (Masson and Melitz 1991).
22. The ECB's loss function includes average targets for France and Germany.
23. Launched in 1998 and 2000, the working week reduction reform was meant to increase employment and productivity. Firms negotiated more flexibility in the working time (it has been calculated on a yearly rather than a weekly basis ever since) and a wage freeze. Finally, employment has not increased as much as expected and the associated wage freeze, together with a still high unemployment rate, has largely hindered consumption growth; investment growth has also decreased afterwards.
24. The working week reduction reform in France included an expansionary fiscal policy through lower social contributions.
25. Germany also benefits from high-quality competitiveness, from a strong specialization in chemical, mechanical, and car industries for which demand is high in emerging economies, and from world demand. Gaulier, Lahreche-Revil and Mejean (2005) have shown that the last determinant was clearly more intense for Germany than for France.
26. Figures and tables are available upon request.
27. Figures and tables are available upon request.
28. The literature on this topic originates in Bayoumi and Eichengreen's (1993) seminal article.

Appendix

The model

F stands for France, G for Germany, J for Japan, U for the United States and E for Euroland; $i, j = F, G, J, U$.

Equations

$$y_t^i = cR_t^i - \sigma r_t^i + g_t^i + b_t^i + \mu(\phi_{t-1}^i + d_{t-1}^i - W_0)$$

$$R_t^i = y_t^i - T_t^i$$

$$T_t^i = T_{t-1}^i$$

$$b_t^i = \sum_{j \neq i} [n^{ij}(y_t^j - y_t^i) + n^{ij}\delta_x x_t^{ij}]$$

$$p_t^{id} = w_t^i + v_i y_t^i + \theta r_t^i$$

$$p_t^i = l_1 p_{t-1}^i + (1 - l_1) p_t^{id}$$

$$w_t^{id} = \lambda q_t^i + v_2 y_t^i + w_{0t}^i$$

$$w_t^i = l_2 w_{t-1}^i + (1 - l_2) w_t^{id}$$

$$q_t^i = p_t^i + \sum_{j \neq i} n^{ij} x_t^{ij}$$

$$d_t^i = d_{t-1}^i + r_{t-1}^i (\tilde{d}/100) + r_0 (d_{t-1}^i - \tilde{d}) + g_t^i - T_t^i$$

$$r_t^i = i_t^E - \pi_{t+1}^{ia} \text{ for } i = F, G$$

$$r_t^i = i_t^j - \pi_{t+1}^{ia} \text{ for } i = J, U$$

$$\pi_{t+1}^{ia} = p_t^i - p_{t-1}^i$$

$$x_t^{FG} = p_t^G - p_t^F$$

$$x_t^{ij} = p_t^j - p_t^i + e_t^{Eia} \text{ for } i = F, G \text{ and } j = J, U$$

$$x_t^{UJ} = p_t^J - p_t^U + e_t^{UJa}$$

$$e_{t+1}^{Eia} = e_t^{Ej} + (i_t^j - i_t^i) + k(\phi_t^{Ej} + \phi_t^{Gi}) \text{ for } j = J, U$$

$$e_{t+1}^{UJa} = e_t^{UJ} + (i_t^U - i_t^J) + k\phi_t^{UJ}$$

$$F_t^{ij} = F_0 + \frac{1}{6k} (e_{t+1}^{ija} - e_t^{ij} + i_t^j - i_t^i) \text{ for } i = F, G \text{ and } j = J, U \quad (A1a)$$

$$F_t^{ji} = F_0 - \frac{1}{6k} (e_{t+1}^{ija} - e_t^{ij} + i_t^j - i_t^i) \text{ for } i = F, G \text{ and } j = J, U \quad (A1b)$$

$$F_t^{UJ} = F_0 + \frac{1}{6k} (e_{t+1}^{UJa} - e_t^{UJ} + i_t^J - i_t^U) \quad (A1c)$$

$$F_t^{JU} = F_0 - \frac{1}{6k} (e_{t+1}^{UJa} - e_t^{UJ} + i_t^J - i_t^U) \quad (A1d)$$

$$\phi_t^{ij} = \phi_{t-1}^{ij} + 2(x_{t-1}^{ij} - x_{t-1}^{ji})F_0 + (r_{t-1}^i - r_{t-1}^j + y_t^i - y_{t-1}^i - y_t^j + y_{t-1}^j)F_0 + r_0 \phi_{t-1}^{ij} + b_t^{ij}$$

$$\phi_t^{ji} = F_t^{ij} - F_t^{ji}$$

$$\phi_t^i = \sum_{j \neq i} \phi_t^{ij}$$

$$W_t^i = d_t^i + \phi_t^i$$

$$\tilde{W}_t^i = W_0 + ar_t^i$$

Parameter values and baseline calibrations for the variables

$c = 0.6$; $\sigma = 0.4$; $\mu = 0.1$; $\lambda = 0.5$; $\theta = 0.1$; $\rho = 0.75$; $k = 1$; $l_1 = 0.5$; $l_2 = 0.5$;
 $v_1 = 0.15$; $v_2 = 0.2$; $\delta_x = 1.2$; $\tilde{d} = 30\%$; $d_0 = 30\%$; $w_0 = 0.03$; $\phi_0 = 0$; $r_0 = 0.025$;
 $F_0 = 0.05$;
 $n^{FG} = n^{GF} = n^{FU} = n^{GU} = n^{FK} = n^{GK} = n^{UK} = n^{KU} = 0.1$; $n^{KF} = n^{KG} = n^{UF} = n^{UG} = 0.05$.

Definitions of the variables

(Note: except for F variables, all the variables are expressed as deviations from the initial steady state level.)

- y, output (Log)
 p^d , desired production price (Log)
 p , current production price (Log)
 w^d , desired wages (Log)
 w , current wages (Log)
 q , consumer price (Log)
 b^{ij} , trade balance of country i towards country j denominated in money i (per cent of GDP)
 e^{ij} , nominal exchange rate (Log, a monetary unit of country j is worth e^{ij} monetary units of country i)
 x , real exchange rate (Log)
 F^{ij} , assets of country j owned by agents of country i denominated in country i currency, in real terms (per cent of GDP)
 ϕ^{ij} , net external assets of country i towards country j (per cent of GDP)
 i , nominal interest rate (per cent)
 r , real interest rate (per cent)
 T , taxes (per cent of GDP)
 d , public debt (per cent of GDP)
 π^a , anticipated inflation rate of production price (Log)
 g , public spending (per cent of GDP)
 R , consumers' revenue (Log)
 \bar{d} , government public debt target (per cent of GDP)
 W , desired consumers' wealth (per cent of GDP).

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12

The Role of the Euro in the International Monetary Arena: Present and Prospects

*Sergio Rossi**

12.1 Introduction

Since the introduction of the euro as a single currency in the countries that participate in the European Economic and Monetary Union (EMU) fully, there has been growing empirical evidence that this currency is becoming the prominent invoicing and settlement currency in trade between the Euro Area countries and the rest of the European Union (EU) – notably with respect to the new member countries of the EU – as well as in trade relations between the latter countries themselves, and between them and non-EU countries (see European Central Bank 2005a, 2005b; Goldberg 2005). The 2005 *Review of the International Role of the Euro* by the European Central Bank (2005b) confirms the strong regional and institutional pattern that continues to characterize the internationalization of the euro. In particular, from mid-2004 to mid-2005, the share of the euro in the stock of international debt securities rose to 31.5 per cent (from a share of 30.7 per cent in the previous twelve-month period),¹ whilst in cross-border loans (6.2 per cent) and deposits (8.4 per cent) as well as in foreign exchange trading (43.0 per cent) the euro's share remained stable. By contrast, the euro has been increasingly featuring as invoicing and settlement currency in international trade concerning regions neighbouring the Euro Area, notably within the so-called 'euro time zone' (Mazzaferro et al. 2002) as well as in the so-called 'euro bloc' (Padoa-Schioppa 2004).² In this regard, the euro has been used as a vehicle currency (defined as the use of the euro between two non-Euro Area trading partners) mainly for countries with institutional links to the EU. This has been related to the issuance of euro-denominated international bonds by non-Euro Area private residents as well as by governments, which are largely bought by Euro Area investors (see Bernanke 2005; European Central Bank 2003; Geis, Mehl and Wredenberg 2004; Hartmann and Issing 2002). At the

end of 2005, 'more than one-half of international euro-denominated securities are held by euro area residents' (European Central Bank 2005b, p. 17).

In light of the euro's role in today's international monetary regime as described above, this chapter proposes letting it become a truly international currency for those countries that wish to keep their national currencies and stabilize their exchange rates. The aim of this proposal is not to make the euro a means of domestic payment within any countries outside the Euro Area. In fact, a truly international currency is a currency used as a means of payment *between, not within, countries*. In explaining the key distinction between the traditional understanding of an 'international' currency (like the US dollar) and the analytical definition of international money, this chapter points out why the euro is now a factor of instability and depression, rather than stability and growth, for all those countries that abandoned their currency and hence an important tool of economic policy like the exchange rate. It thereby elaborates on a proposal to let the euro become a truly international currency. This means that the European Central Bank (ECB) would take on board the role of an international settlement institution. This will allow all those (neighbouring) countries having commercial and/or financial ties with Euroland to adopt the euro as their *common* (yet not *single*) currency, without therefore having to abide by the EMU convergence criteria and Stability and Growth Pact as well as to enter into an exchange rate arrangement (the Exchange Rate Mechanism II) that cannot protect them from both exchange rate instability and currency crises (on these shortcomings, see Rossi 2004b, pp. 451–3). This proposal mainly concerns non-EU countries; but since all EU countries (excepting the so-called opted-out countries) must adopt the euro as their single currency once they respect all convergence criteria for full EMU membership, it could also represent an instrumental, preliminary step towards convergence for newly joining EU members. Indeed, it could help accelerate their convergence process, as it guarantees the room for manoeuvre that domestic macroeconomic policies need to have in order for these countries to converge towards the Euro Area.

The structure of this chapter is as follows. The next section focuses and expands on a conceptual distinction in international monetary economics that has been lost since the Bretton Woods conference back in the 1940s, namely, the distinction between a single (supranational) currency and a common (international) currency for a number of countries. The third section explores some negative consequences of the adoption of a single currency for a number of still economically heterogeneous countries such as the Euro Area's. The fourth section elaborates on the international role that the euro should perform in order for it to become a means of final payment between countries that are neither willing nor able to adopt the euro as a single currency for their residents in the foreseeable future. The last section concludes.

12.2 The distinction between a supranational and an international currency

Views on the international monetary regime have too often been muddled conceptually, in Europe as well as elsewhere. Indeed, since the Bretton Woods agreements setting up the International Monetary Fund and the World Bank in 1944, there has been a rather superficial understanding of the workings of international settlement systems by both academics and economic policy-makers. This can be ascribed to a phenomenological understanding of the specifics of money and banking. The public, but also academics as well as national and international policy makers, merely consider money in the form of a (fully liquid) financial asset, and banking as the industry of financial intermediation. Generally speaking, they do not see beyond surface phenomena, nor are they interested in entering into a difficult and demanding analysis such as investigating the underlying nature of the phenomena they observe. In their view, this analysis pertains to what they regard as a branch of philosophy. As such, they consider it sterile in terms of economic policy advice, which ought to improve the international monetary-financial architecture of the real world, in order to avert, or at least to limit, the occurrence of financial crises (in the form of either currency, banking, foreign-debt, or balance-of-payments crises, as noted in the taxonomy adopted by the International Monetary Fund (1998, pp. 74–5)).

Owing to the complexity of the real world, however, it should be plain that observation of surface phenomena, such as the exchange of a number of money units for a particular good or service, within or across national borders, cannot be enough to fully understand the underlying structure and mechanisms at work. In particular, in monetary economics empirical evidence cannot be derived from factual observation alone: phenomena rarely coincide with their factual appearance. Phenomena must be interpreted and their results evaluated, which can be done only via a conceptual detour. A theoretical framework is therefore always required to understand the empirical givens.

In the case of international monetary regimes, a theory of international money is thus an unavoidable analytical requirement to understand the observed phenomena (positive analysis) as well as to design policy able to solve the problems at their roots (normative analysis). This fundamental requirement was clearly noticed by Keynes in the 1940s, when he elaborated on an international settlement system in the form of his 'Proposals for an International Clearing Union' (Keynes 1942/1980). As he noticed with respect to the essence of international money:

[w]e need an instrument of international currency having general acceptability *between nations* ... ; that is to say, an instrument of currency used by each nation in its transactions with other nations, operating

through whatever national organ, such as a Treasury or a central bank, is most appropriate, private individuals, businesses and banks other than central banks, each continuing to use their own national currency as heretofore.

(Keynes 1942/1980, p. 168, emphasis added)

Indeed, Keynes was aware that every local currency is a valid means of payment within the currency area where it is issued. Hence, reforming the international monetary regime does not require replacing national currencies with a supra-national currency, as has been done within the Euro Area countries in 1999 in order to solve the exchange rate problem as well as to make a step forward to geopolitical union in Europe. Keynes's aim was, in fact, not to integrate any countries in geopolitical terms, but to provide a means of final payment for international transactions that was, and still is, missing in foreign trade both on goods and financial markets.³ To this effect, '[i]nternationally all transactions [have] to be cleared between central banks, operating on their accounts with an International Clearing Bank' (Keynes 1941/1980, p. 34). Note, however, that if international money is not used for the final payment of every single international transaction entering either the current or the capital accounts of any two countries, but only for the settlement of foreign trade imbalances, as in Keynes's netting scheme headed by the International Clearing Bank he proposed, then it remains a unit of account (Schmitt 1985, pp. 204–6). In fact, no current or capital account deficit can be financed with a unit of account: an international means of final payment is needed for that purpose.⁴

In short, a bank should be set up to act as a settlement institution between countries. In other words, this bank must imitate our national central banks in their capacity of finally settling interbank debts daily, and must be an international bank, that is to say, the settlement institution for national central banks themselves, each of them representing its country in the international monetary arena, into which the countries *themselves* are involved as their residents sell and purchase commercial and financial items across borders – whose settlements these countries enter in their current and capital accounts according to the nature of the items exchanged across borders.

Keynes observed that the logic of bank money implied the hierarchical structure of banking systems. Within countries inter-bank settlements are daily proceeded in central bank money Keynes thought that the same logic could be forwarded to international settlements, if a third stage was built in linking national banking systems together.

(Aglietta 2004, p. 52)

This amounts to arguing that, from the two-tiered banking system existing today within every country, Keynes aimed at implementing a three-tiered system, the additional (and, for the time being, still missing) banking tier

concerning the settlement of international transactions exclusively. Figure 12.1 illustrates this point in a stylized form, indicating with dotted lines both the missing tier and the international settlement institution (to be set up yet).

Referring to the notion that money is an acknowledgement of debt of the issuer, and to the principle that no agent can pay by issuing an acknowledgement of debt – which is in fact a promise of payment – it follows that non-bank agents have to use a third party's acknowledgement of debt (bank money) to pay their counterparty finally. For instance, a firm has to use bank money in order for it to pay out wages and for wage earners to be paid finally. Similarly, households have to surrender a third party's debt in order to pay for produced goods or services finally. Needless to say, the same principle applies to the general government sector, which cannot finally pay by issuing its own acknowledgement of debt and has therefore to ask a third party, often the national central bank (but any other bank would do), for the emission of a means of final payment (often in the form of central bank money) – in a similar vein as this occurs to those non-bank agents pertaining to the private sector. Indeed, as Goodhart points out, payment finality

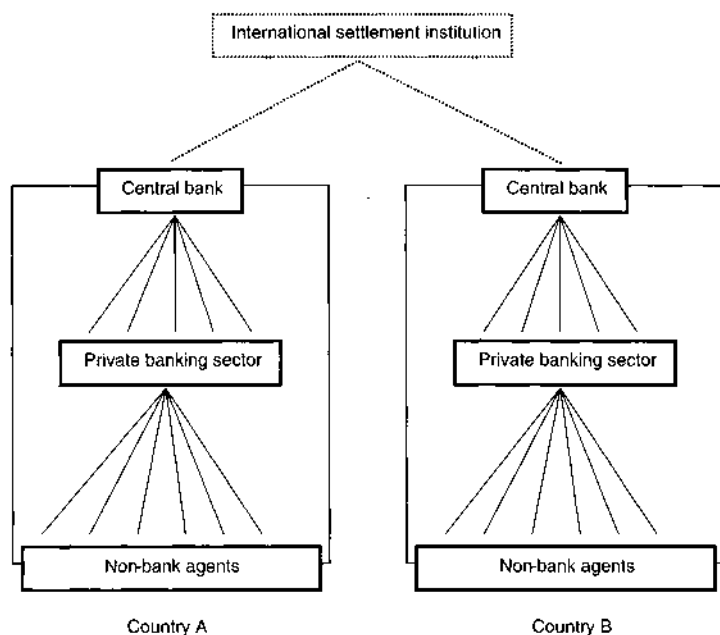


Figure 12.1 The three-tiered banking system

means that 'a seller of a good, or service, or another asset, receives something of equal value from the purchaser, *which leaves the seller with no further claim on the buyer*' (1989, p. 26, emphasis added).

However, the means of payment is not issued in an act of sale, or purchase, by its issuer, as otherwise this would amount to an act of seigniorage, which is not the way money is issued in the real world. Any bank, either central or private, acts as a 'go-between' when it issues money as a means of payment; it is a 'non-agent' between two agents, that is, the buyer (payer) and the seller (payee) of any commercial or financial items. As a matter of fact, the bank is neither a creditor nor a debtor of the economy when it issues money, as it is simultaneously debited and credited with the number of money units that it issues in any payment it carries out on behalf of one of its clients. Money is indeed an 'asset-liability' (Schmitt 1975, p. 13): it appears at one and the same time on both sides of a bank's balance sheet, therefore affecting at one and the same instant the payer's as well as the payee's position in the bank's accounts. In short, money carries out payments, whilst bank deposits finance them (Rossi 2003 provides an analytical distinction between money and bank deposits that elaborates on this point). As money issuer, the bank is a 'non-agent', because it neither sells nor purchases anything; it merely expresses all objects of economic transactions in numerical terms, thus making them homogeneous.

Now, whilst non-bank agents (firms, households, state) may choose between using bank money or central bank money for settling their economic transactions finally – because for them both forms of money are a non-agent's debt – things change for the settlement of interbank transactions, that is to say, payments that banks need to carry out between themselves as a result of those payment orders that non-bank agents send to the banking sector in a multi-bank system (see Rossi 2005 for analytical elaboration). As a matter of fact, bank money is the banks' acknowledgement of debt; as such, it cannot be used as a means of (final) payment for settling those economic transactions that concern a bank's own debt to another bank: nobody (even a bank) can pay by surrendering the promise to pay of an agent, that is to say, a purchaser or a seller of real goods, services, or financial assets. As modern banking practices show indeed, 'banks do not accept bank money in interbank transactions, but ultimately require their claims to be settled in central bank money' (Deutsche Bundesbank 1994, p. 46). The rationale for the daily interventions of the central bank in domestic payment systems is that banks need a settlement institution, that is, a non-agent, whose acknowledgement of debt they can use in order finally to pay any interbank positions that can arise as a result of those payment orders that non-bank agents address to them daily on an ongoing basis⁵ – as in Real-Time Gross Settlement (RTGS) systems, which are today the norm for the settlement of large-value transactions, especially in financial and foreign exchange markets (see Bank for International Settlements 2005).

If so, then it follows straightforwardly that, owing to the increasingly open economies in the modern world, central banks themselves need an international settlement institution in order to guarantee payment finality for all those economic transactions that concern any two agents residing in two different currency areas (usually defined by the political borders of the nation states, apart from the notable case of the multinational area named after the euro). As a matter of fact, the present regime of international payments is a 'non-system', as Williamson (1977, p. 73) put it. To be sure, no national currency (not even the US dollar) can be a means of final payment internationally, that is to say, between countries, since in the international monetary space it represents the acknowledgement of debt of an agent in this space, and as such it is nothing more than a promise to pay for foreign trade. For example, when a key-currency country, say A, pays an amount of money A to the rest of the world, R, for its net imports of commercial or financial items, it merely transfers to R a claim on A's deposits within its banking system. This is enough to show that country A does not really pay for its net imports, as it surrenders a mere promise to pay. Indeed, the bank deposits in money A are the acknowledgement of debt of country A's banking system. They are a promise to pay that country A, considered as a whole, delivers to R in exchange for (net) imported goods, services, and/or financial assets. This promise does not settle the trade imbalance really: no country would indeed accept to be paid with a promise to pay in exchange for produced output (in the form of exported real goods and/or services) or in exchange for a claim to future production (in the form of financial assets), if this 'non-payment' were spelt out and understood clearly.

Indeed, as explained by Rueff (1963, pp. 323–4), any country subjects its bank deposits to a process of duplication in so far as it pays its imports of real goods, services, and/or financial assets from the rest of the world using its local currency. In the current, post-Bretton Woods regime for international payments, country A transfers to the rest of the world merely a claim on A's deposits within its banking system when it pays for its (net) commercial or financial imports from R; the deposits themselves remain recorded within A's banking system. The same bank deposits, however, are recorded, as a duplicate, in the banking system of the rest of the world, which in the above stylized example is a net (commercial or financial) exporter and, as such, is paid with an amount of money A that it enters, as foreign-exchange reserves, on the assets side of its banking system's balance sheet (including the national central bank). These claims may then circulate erratically on foreign exchange markets, subjecting exchange rates to erratic fluctuations that hamper the economic development of our countries, be they advanced, emerging, or in transition.

Now, readers might still argue that in the real world both international trade and foreign exchange transactions are settled using (a few) key currencies, such as the yen, the euro, and the US dollar (in a sort of tripartite

international monetary standard, which has been referred to as $\text{¥} \text{€} \$$). In light of this empirical evidence, so the argument goes, it would be a matter of logic to conclude that, if the real world adopted some national currencies as international monetary standard, there is nothing wrong with their international role as a means of payment. This argument might seem appealing at first sight, but it suffers, in fact, from a superficial (surface phenomena) analysis. Indeed, if one can easily observe, by personal experience or with the help of statistics provided by international financial institutions such as the Bank for International Settlements (notably through its *Triennial Central Bank Survey* of foreign exchange and derivatives market activity, whose latest edition was published in March 2005), that the US dollar is now the leading currency in the international monetary arena, with a share of approximately 52 per cent as invoicing currency in foreign trade (2004), followed by the euro (25 per cent), and the yen (5 per cent), this does not prove that those international transactions featuring the dollar (or the euro) in one side of them are final payments for any of the countries concerned as a whole. In fact, as surprising as this might seem, all these transactions are promises of payment at the international level, that is to say, between countries pertaining to different currency areas, owing to the nature of the bank deposits involved (see above).⁶

To put it clearly, if the international payment of country A's net (commercial or financial) imports is not a final payment because the rest of the world obtains a claim on a deposit that remains in the banking system of the issuing country, then international circulation of this claim (a promise of payment) can certainly not transform it into a means of final payment: it remains an acknowledgement of debt of the country issuing it. To be sure, a sequential chain of provisional payments can only become a chronological series of final payments when the issuer of the acknowledgement of debt (country A in our example) accepts this promise of payment in settlement of its own sales of real goods, services, and financial assets (that is to say, country A's net commercial or financial exports). If the closure of this monetary circuit is postponed indefinitely, however, as has too often been the case with respect to the trade deficit of the United States since the 1970s, then the rest of the world sacrifices a fraction of its output (produced at a positive cost) for a claim (whose cost is zero) on future output that its issuer will never actually provide.

Hence the solution is logically not to make the euro outcompete the US dollar in the international monetary arena, but to replace the current 'non-system' for international payments with a system, that is, an orderly working monetary architecture *between* countries. This requires that a settlement institution be created for the countries themselves, which should be in charge of the daily settlement of international transactions in the spirit of Keynes (see above). If so, then each payment between any two countries or currency areas for the real goods, services, or financial assets sold across borders is final – and

not just a promise to pay as is the case today – for the countries involved as a whole. To be more precise, payment finality applies at the international level as soon as an international settlement institution (to be set up) issues an acknowledgement of debt on demand from the importing country,⁷ which uses it to pay the exporting country in a circular flow via the national central banks involved by the transaction because of the use of local currencies for the payment among the non-bank public (Figure 12.2).

To be sure, non-bank agents will in fact continue to be able to use any national currency (including the euro) they may want and that their national legislation allows them to use in the settlement of their transactions. As a matter of fact, being a non-agent's debt, any national currency (including the euro) is a means of final payment for agents residing in any countries. In the above stylized example, the importer of real goods, services, and/or financial assets in country A will continue to be able to pay for the imported items in any local currency of choice – provided that the counterparty agrees on that choice. For any non-bank agents (households, firms, states), it is therefore

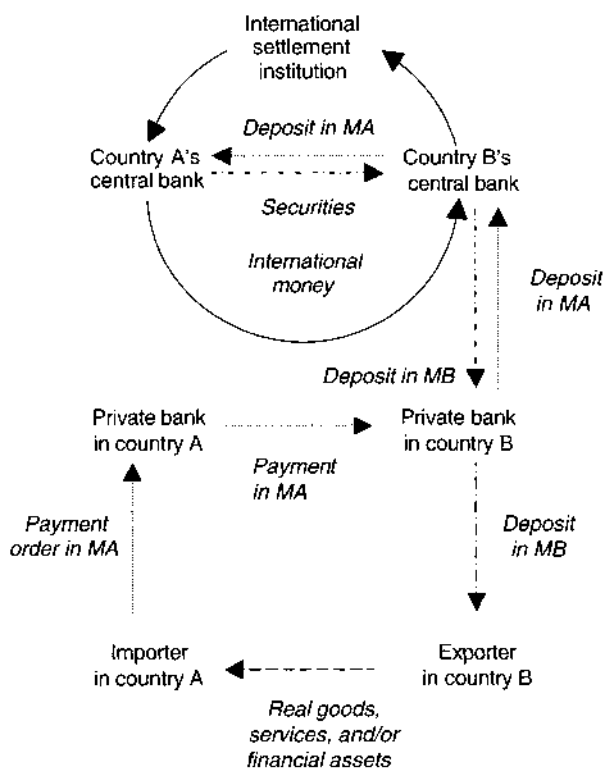


Figure 12.2 The circular flow of international money

'business as usual'. What is new is that cross-border payments at the interbank level (say, between a private bank in country A and a private bank in country B) will take place through their central banks finally. This means that when the bank of the payee (in country B) is informed (from the bank of the payer in country A) that it owns a deposit in the banking system of the (net) importing country, A, then it surrenders this claim to its central bank in exchange for a deposit in the domestic banking system. The central bank of the (net) exporting country, B, transfers the claim on a bank deposit with country A's banking system to the central bank of the issuing country, A, asking for a final payment to take place at the international level. In order for this payment to occur, the central bank of country A has to ask the international settlement institution to issue the means of final payment. If this happens, then country A can finally pay country B, which, as a result, owns a deposit denominated in international money and held at the international settlement institution. At this stage, the payment between countries is final, since the (net) exporting country, B, has no further claim on the (net) importing country, A (Rossi 2007b, elaborates on the settlement machinery at the international level, which in fact implies the transfer of securities from the paying country, A, to the receiving country, B – a transfer to which we will return later).

Things are fundamentally different in the present regime for international payments: no country today is finally paid for the real goods, services, and/or financial assets it exports more than it imports from any other currency area, as there is no international settlement institution providing an international means of final payment. The result of the lack of a truly international money is, among other things, exchange rate instability, which gives rise to foreign exchange speculation and exchange rate erratic fluctuations. As a matter of fact, the present 'non-system' for international payments transforms currencies from means of payment into objects of trade: their exchange rates vary thus according to their daily sales and purchases on foreign exchange markets and in these markets speculation arises with a view to making capital gains from these variations. This speculation is the main cause of exchange rate fluctuations, which become the main incentive to speculate on foreign exchange transactions.

12.3 Some dismal consequences of a supranational currency: the case of the euro

The European solution to exchange rate instability has been monetary union, in the form of a single currency area named after the euro. Hence, in order to avoid exchange rate fluctuations, which are disruptive for both financial stability and economic growth, the EU went so far as to abolishing local currencies, replacing them with a single European currency. The replacement of national currencies with a supranational currency like the euro led to the creation of a new monetary space, the Euro Area, which, from

a monetary point of view, may be considered as a single country, as it is a single currency area and therefore has a unified payment and settlement system. This amounts to saying that all payments within the Euro Area, even if across geopolitical borders, are in fact domestic, not international payments. The euro is indeed a (supra)national and not an international currency, as it is used by residents in any Euro Area countries to pay for their transactions finally. Indeed, both private and public sector agents (firms, households, states) use the euro on factor, product, as well as financial markets within the single currency area, and sometimes even beyond this area, thus competing with the US dollar (see above).

Now, the replacement of national currencies by a supranational currency, like the euro, necessarily implies abandoning monetary sovereignty to a supranational institution, the ECB in the case of Euroland. As a result, monetary policy will henceforth be conducted by this supranational authority, which, in the case of the EU, is also fully independent of European political institutions like the European Parliament or the EcoFin Council. This is not the place to discuss the problems raised by the wide independence of the ECB and its employment-related costs (see Rossi 2004a for an analysis of these problems). Suffice it to say here that the low inflation environment of the Euro Area, associated with its low rate of growth of real GDP, ought to induce the ECB to implement an expansionary monetary policy rather than increasing its policy-controlled interest rates at any fear, warranted or unwarranted, of 'future inflationary risks'.

Adhesion to a single currency area such as the EMU means also that countries adhere to a monetary space within which capital in the form of bank deposits can move freely, as it can indeed within any local monetary system where a local currency exists. To be sure, free capital mobility is a feature that naturally exists within each currency area – owing to the book-entry nature of money – but does not exist between any two such areas: no financial capital can indeed flee from a currency area (usually defined by the geopolitical borders of the nation state, but not in the case of the Euro Area), as financial capital exists in the form of bank deposits. As pointed out in the previous section, bank deposits are by their nature recorded in the banking system of the country (or the currency area) issuing the money unit in which these deposits are denominated. As such, they cannot leave the (banking) system in which they are recorded – although, of course, their owner can and may often be a non-resident (that is, a resident in another currency area). Clearly, even if a resident of country A manages to hide (a part of) his financial capital by transferring his bank deposits to a non-resident bank, say a bank in country B, which does not pertain to the same currency area of country A, this cannot and does not affect the total sum of bank deposits available in the currency area of country A (although it might of course provoke a fiscal loss to the state of country A, which might not be able to tax this capital in the country (A) where it has been formed).

Free capital mobility in the Euro Area means that financial capital can move from those member countries that are less attractive to investors (in terms of return on investment) to the more attractive countries in that same area. Indeed, both short-term (speculative) investment and long-term (foreign direct) investment are directed into those economies where the rate of return is highest among the EMU member countries. If this rate is positively correlated with the rate of growth, then economic divergence may increase among these countries, thus giving rise to a higher rate of unemployment in those member countries, such as the core countries of Euroland today, that offer less attractive rates of return on investment compared to some other countries of the same currency area (like some of the countries at the periphery of Euroland). Now, owing to the fiscal deficit-to-GDP ceiling of 3 per cent enshrined in the Maastricht Treaty as well as in the Stability and Growth Pact, national fiscal policies cannot really address the unemployment problem arising from free capital flows within the Euro Area. At the time of writing, the number of Euroland countries that fail to meet the fiscal requirements set out in Maastricht, and enforced in Amsterdam, is notably a sign that these requirements represent a straightjacket, which constrains the fiscal policy efforts that a country should be allowed to undertake to fight against capital flight towards another Euro Area country. In short, as total demand is deficient, deflationary forces lead firms to cut back on employment in a number of Euro Area countries.

This analysis shows that the deflationary bias elicited by the creation of a multinational currency area in Europe is not exclusively due to the strong anti-inflationary monetary policy stance that the ECB adopted. Nor is European unemployment only due to the wide independence of the ECB, or the related fiscal constraints pointed out in this section. This deflationary bias can also be explained by free capital mobility, which is an unavoidable result of the creation of a single monetary space once all its participating countries abandoned their national currencies to adopt a single currency. If so, then the eradication of this bias would require reintroducing national currencies in the Euro Area countries, with either the abandonment of the euro altogether or its transformation into a truly international currency. Owing to the unrealistic, politically unfeasible, character of the first proposition, let us investigate and expand here on the second proposition, which is akin to the Keynes proposal that we discussed in the previous section.

12.4 Making the euro a truly international currency

Let us be straightforward. We do not consider that those countries participating today to the EMU fully will be willing, or able, to reintroduce their old national currencies and thus to relegate the euro to the rank of international currency for the settlement of inter-Euro Area countries' transactions. Let us therefore focus here on the international role of the euro as pointed out in

the Introduction. In particular, let us consider here the likely possibility that the euro will increase its international role as an invoicing and settlement currency in foreign trade and foreign exchange transactions concerning a non-Euro Area country (in its relations with a Euroland country or with another non-Euro Area country).

The use of the euro as invoicing and settlement currency outside the Euro Area today has a strong geographical and institutional underpinning (European Central Bank 2005b, p. 10). It is therefore with respect to those countries in the ETZ or in the 'euro bloc' that it may be interesting to elaborate and put into practice an international settlement system with the euro at its core as international money. If this system works, it will then be easy to replicate it in other regions of the world, with or without the name of the euro used to label the means of final payment between countries.⁸ For instance, the Gulf Cooperation Council plan to introduce a single currency by 2010 in its six member countries, namely Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates (see Sturm and Siegfried 2005), might benefit from a preliminary stage during which these countries adopt a common international means of payment before proceeding to enter into a single currency area. It is only when the macroeconomic and institutional issues, as well as the key policy choices that are likely to arise in the process of monetary union among these countries are settled, that the decisive step to transforming the international money into a single (supranational) currency could be taken without fearing those deflationary biases that, in fact, are embarrassing the EMU. To be sure, a truly international currency for the settlement of foreign trade and other international transactions helps accelerate the process of monetary union, as it guarantees the room for manoeuvre that domestic economic policies (not least monetary policies) need to have in order for a national economy to converge with the other countries wishing to adopt a single currency. Letting countries steer their monetary policies towards the needs of their own domestic economy might accelerate the convergence process required to participate in a single currency area, like the EMU: it leaves them with the necessary leeway for monetary manoeuvre, without having to care about satisfying the monetary union criteria in the near future – which is a condition that may harm rather than benefit their domestic economies, as the EMU nominal convergence process showed well (see Rossi 2004b). Let us explore this alternative avenue in the remainder of this chapter.

Today, there are nearly 60 countries referring to the euro in their exchange rate policy, and this number may increase in the near future, owing to the increasing role of the euro in the international monetary arena. Table 12.1 lists all the countries whose exchange rate regime is linked to the euro in some way or another.

Except in the case of EU member countries, the decision to adopt the euro as an anchor currency is in fact a unilateral decision of the country taking it, and does not involve any commitment from the ECB (European Central Bank 2005b, p. 49).

Table 12.1 Countries with exchange rate regimes linked to the euro

Region	Exchange rate regime as of 31 December 2005	Countries
European Union (non-Euro-Area countries)	Exchange Rate Mechanism II	Cyprus, Denmark, Estonia ^a , Latvia ^b , Lithuania ^a , Malta ^c , Slovak Republic, Slovenia
	Peg arrangements based on the euro	Hungary
	Managed floating with the euro as reference currency	Czech Republic
Acceding, accession, and potential candidate countries to European Union membership	Unilateral euroisation	Kosovo, Montenegro
	Euro-based currency boards	Bosnia and Herzegovina, Bulgaria
	Peg arrangements or managed floating with the euro as reference currency	Croatia, FYR Macedonia, Romania, Serbia
Other countries	Euroisation	European microstates ^d , French territorial communities and overseas departments ^e
	Peg arrangements based on the euro	CFA franc zone ^f , CFP franc zone ^g , Cape Verde, Comoros
	Peg arrangements and managed floats based on the SDR and other currency baskets involving the euro	Botswana, Jordan, Libya, Morocco, Russian Federation, Seychelles, Tunisia, Vanuatu ^h

Notes

^a Unilateral commitment to a currency board.^b Unilateral commitment to an exchange rate fluctuation band of $\pm 1\%$.^c Unilateral commitment to maintain a fixed exchange rate.^d Andorra, Principality of Monaco, Republic of San Marino, Vatican City. In the case of Andorra: unilateral euroisation. The other countries and jurisdictions are entitled to use the euro as their official currency.^e French Guyana, Guadeloupe, Martinique, Mayotte, Reunion, Saint-Pierre-et-Miquelon.^f Western African Economic and Monetary Union (Benin, Burkina Faso, Côte d'Ivoire, Guinea-Bissau, Mali, Niger, Senegal, Togo) and Central African Economic and Monetary Community (Cameroon, Central African Republic, Chad, Republic of Congo, Equatorial Guinea, Gabon).^g French Polynesia, New Caledonia, Wallis and Futuna.^h Botswana: weighted basket of currencies including the SDR and the South African rand. Morocco: weighted basket in accordance with the distribution of Morocco's foreign trade and the pattern of settlement currencies. Russian Federation: trade-weighted currency basket for monitoring and setting ceilings for real appreciation; since February 2005 dollar-euro basket for daily exchange rate management. Vanuatu: weighted (trade and tourism receipts) basket of currencies of Vanuatu's major trading partners.

Source: European Central Bank; European Commission; and International Monetary Fund.

Let us consider here the case of the countries in the ETZ, to show how the creation of an international settlement institution based on the euro as a truly international currency may lead to a new world monetary order on regional grounds. Most importantly, this would not abolish national currencies and would leave nation states free to determine their own economic dynamics autonomously.

In many respects, ETZ countries are diverse, as they belong to different continents and have reached different levels of economic development. Nevertheless, these countries have some common features, notably that the Euro Area is their largest trading partner as well as the largest source of foreign direct investment and official development aid (see Mazzaferro et al. 2002). Further, all ETZ countries have strong institutional relations with the EU. In particular, the Middle East and Northern Africa (MENA) is the most important of the ETZ regions in economic terms, as its GDP exceeds the total GDP of all the other ETZ regions.⁹ Yet, the MENA is a highly heterogeneous region in terms of both population and income levels: countries such as Iran and Egypt have more than 65 million inhabitants each, whereas countries like Israel and Tunisia have a population of less than ten million. Per capita GDP ranges from 400 US dollars in Yemen to 28,000 US dollars in Qatar. This income gap within MENA creates migration pressures within the region as well as from it to Europe, with which MENA countries have developed a series of institutional relations since the 1970s. Let us therefore consider the case for an international role of the euro in the MENA, focusing on those MENA countries that are part of the Barcelona Process. This international role for the euro can then equally apply to other economic relations between countries within either the ETZ or the 'euro bloc'.

In 1995, the EU and 12 Mediterranean partner countries launched the Barcelona Process to open a new phase of regional cooperation between both shores of the Mediterranean Sea.¹⁰ One of the objectives of the Barcelona Process is to create a Euro-Mediterranean free-trade area by 2010. More recently, the ECB has established bilateral contacts with the central banks of the partner countries of the Barcelona Process, to discuss common economic policy issues arising from geographical proximity and a long historical record of extensive commercial and financial flows between both shores of the Mediterranean Sea. In particular, the financial ties result from Euro Area bank lending to the Barcelona partner countries, foreign direct investment, as well as workers' remittances. For most Barcelona partner countries, commercial ties with the Euro Area are also very important: on average, the Barcelona partner countries' trade with the Euro Area accounts for some 40 per cent of their total trade over recent years. As the European Central Bank (2004, p. 72) notes, 'the euro area has constantly registered a trade surplus with the Barcelona partner countries'. Now, the formation of a free-trade area by 2010 between the EU and these partner countries is likely to

increase the number as well as the amount of both commercial and financial flows across the Mediterranean Sea. These international flows may therefore become a serious threat to financial stability, if the exchange rate regime is not appropriate to control this situation with a view to making the economy of the Barcelona partner countries grow and develop along a stable monetary–financial path.

As a matter of fact, a number of Barcelona partner countries suffer from insufficient economic growth and from many structural difficulties that are particularly worrisome in light of their high rates of unemployment, both overall and for the young. In these countries, monetary policy is oriented towards stabilizing the local currency's exchange rate *vis-à-vis* the euro or the US dollar, or against a basket of currencies (Table 12.2). The corresponding exchange rate regimes are most of the time intermediate arrangements, as only the shekel and the Turkish lira float independently and no country has a hard peg.

Now, for all the Barcelona partner countries a certain degree of exchange rate flexibility will remain necessary in the next future, in order to facilitate the catching-up process in conformity with economic and financial stability. As a matter of fact, flexible exchange rates 'safeguard the requisite monetary room for manoeuvre' (Deutsche Bundesbank 2001, p. 24). To be sure, even a small open economy is able to implement monetary and fiscal policies oriented to its domestic needs, even in the case of an extremely high degree of financial liberalization, as long as this country sticks to its own currency and

Table 12.2 Exchange rate strategies of the Barcelona partner countries

Country	Currency	Exchange rate regime as of 31 December 2005
Algeria	Dinar	Managed float
Egypt	Pound	Managed float
Israel ^a	Shekel	Free float
Jordan	Dinar	Peg to a single currency ^b
Lebanon	Pound	Peg to the US dollar
Morocco	Dirham	Peg to a basket of currencies
Syria	Pound	Peg to the US dollar
Tunisia	Dinar	Managed float
Turkey	Lira	Free float

Notes

^a Although West Bank and Gaza (Palestinian Territories) belong to the so-called Barcelona partner countries of the EU, they are not sovereign countries and thus have no currency of their own, but use the Israeli shekel.

^b The Jordanian dinar is pegged *de jure* to the SDR, but *de facto* to the US dollar.

Source: European Commission and International Monetary Fund.

hence refrains from entering in a single currency area. The Barcelona partner countries indeed need an exchange rate arrangement by which they can prevent the destabilizing effects on their economies elicited by trade integration and financial liberalization. This reform requires an international agreement between the Barcelona partner countries, and preferably also between them and Euroland, in order for them to set up an international settlement structure based on a double-entry bookkeeping institution to record payments between participating nations or currency areas. The connection to the Euro Area will be able to let the euro become the settlement currency for those international transactions carried out by the Barcelona partner countries among themselves as well as between them and the EMU. Note, however, that if the ECB were to refuse to enter into such an agreement, through which it agrees to function as an international settlement institution, this function can be carried out by a financial institution that either exists already (like the Bank for International Settlements) or that is going to be put into place (such as the financial institution to be created for the Gulf Cooperation Council monetary union). In fact, the ECB has really nothing to lose from functioning as an international settlement institution, since in this function it will merely issue the number of international money units that are required to express numerically the settlement position of all participating countries. In other words, the ECB will act as a money provider, and not necessarily as a credit provider, which indeed may entail a risk of financial losses and requires a series of prudential mechanisms.

In this respect, the advances made by domestic settlement systems in the management of settlement risks can provide a crucial element to this goal. In a nutshell, it is possible to link together funds transfers and securities transfers at the international level, to make sure that the delivery of a financial asset occurs if, and only if, the corresponding final payment occurs (this is the delivery-versus-payment mechanism by means of which both actions take place at one and the same time; see Bank for International Settlements 2003, p. 492).

Let us illustrate the working of this mechanism by referring to a stylized example. When the central bank of country B is informed that it is entitled to a deposit in international money, say euro, at the international settlement institution, say the ECB, it must decide whether to lend this amount directly to a deficit country (that is to say, a country in the position of country A) or to spend it for purchasing an amount of interest-bearing securities on the international financial market.¹¹ In both these cases, country B spends on the international credit/financial market the deposit in euro it gets as a result of its trade surplus. This international purchasing power can therefore be lent to country A either directly – if country B buys those securities that country A aims to sell in order for the latter country to finance its trade deficit – or indirectly – if the international settlement institution also acts as a financial intermediary, namely lending to deficit countries those amounts

saved by surplus countries. If so, then country A can find on the international financial market the funds it needs to reimburse the international settlement institution, so that, on the whole, international money disappears as the reflux principle indicates (Rossi 2006 provides an analytical example and elaboration with respect to the Barcelona partner countries). The statutes of the international settlement institution need, of course, to indicate some limit, for instance in terms of a percentage of either total foreign trade or real GDP (say, calculated on a five- or ten-year moving average), beyond which no country is allowed to finance its trade deficit by selling financial assets. This should occur when the country's risk and stock of debt are already too high in order for this country to provide sound collateral. In such a case, the country has to cut back on its commercial imports and/or increase its exports of real goods and services (not least to pay for debt service, that is, interest on securities sold to either surplus countries or the international settlement institution, in order for the country to finance its current or capital account deficit).¹²

Be that as it may with regard to the international *financial* position of the countries that participate in the system of international payments headed by an international settlement institution, no country would have a *monetary* imbalance, that is, a *payments* deficit, in respect of either the international settlement institution or another participating country. Indeed, within a payment system with international money, each participating currency is changed into itself – in an absolute exchange – through the purely vehicular emission of the international means of final payment, whose nature is that of a numerical unit that is needed to homogenize all currencies participating to this system.

To show this, let us suppose that country A has to pay country B for those commercial and financial items that its residents imported from B (as in Figure 12.2). If the international payment between A and B has to be finalized, then country A must recover its currency, MA, as soon as it surrenders it in payment of commercial and financial imports from B. This means that country B has to be led to spend the deposit in MA as soon as country A transfers to it the corresponding property right (as noted above, a deposit cannot leave the banking system where it has been formed). This requirement implies that country B has to spend an amount of money B, MB, when it is informed that it is entitled to a deposit in MA in the banking system of country A. But this also implies that country A has to obtain the property of a deposit in MB as soon as it surrenders the ownership of a deposit in MA. Both these operations need a common numerical standard in order for both MA and MB to be made homogeneous: in these operations, international money is the numerical unit of measurement of all national currencies, making them homogeneous as they are taken into absolute exchanges. In this case, international payments guarantee monetary order as well as exchange rate stability: monetary order obtains as any purchase of real goods, services, or financial assets is finally paid through a sale of securities, whilst exchange

rates remain stable as every demand for a given currency is simultaneously a supply for the same currency and for the same amount.

12.5 Conclusion

The international role of the euro as invoicing and settlement currency for cross-border transactions has been increasing since its creation (in 1999/2002). Residents in different currency areas, both in the private and the public sector, are using the euro to settle their (external) purchases of real goods, services, and/or financial assets. This chapter shows that whilst payment finality occurs at the level of any country's residents (that is, firms, households, and states), this is not yet the case at the level of the countries themselves. Borrowing the concept of vehicle currency from the foreign exchange market, on which a third country's currency (say, the US dollar) may be used to pay for a transaction involving two (non-key) currencies as objects of trade, the euro may and should become a truly international money, used as means of final payment to vehiculate goods, services, and financial assets between two different currency areas – such as the Euro Area and the rest of the world – provided that the ECB acts as an international settlement institution in the spirit of Keynes's proposal.

This reform of the international monetary regime does not need a new institution, but only a political will that – for the time being – is missing, but that is not utopian, as it can increase the economic well-being of the population within as well as outside the EMU. Once academics and economic policy-makers understand that bank money is a means of payment and not a financial asset, it will be a matter of logic to notice that monetary integration only requires creation of a common currency for the participating countries, rather than a single currency for their residents. The necessary institutions are already in place, as the ECB can (be required to) perform the role of an international settlement institution, guaranteeing payment finality between all those countries that will use the euro as a means of final payment in the international monetary space. Let us hope that macroeconomic policy advisors and European politicians are willing to accept both novel proposals and the revival of older views previously rejected for adoption in different situations of the world economy, as these proposals can indeed provide important ingredients for a viable solution to the present monetary and financial imbalances, both in Europe and elsewhere.

Notes

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1. The definition of the international issuance of debt securities considered here is the so-called 'narrow' definition, which comprises only issues in a currency other than the currency of the country in which the borrower resides. See Detken and Hartmann (2000) for alternative definitions and analytical discussion.
2. The 'euro time zone' (ETZ) includes the countries located in time zones close to that of the Euro Area (Central European Time $-2/+3$ hours). See Mazzaferro et al. (2002, p. 9) for the list of ETZ countries. The 'euro bloc' is formed by those countries, overseas territories, and microstates whose exchange rate regime refers to the euro as the main or unique key currency, namely, Andorra, Benin, Bosnia and Herzegovina, Burkina Faso, Cameroon, Cape Verde, Central African Republic, Chad, Comoros, Côte d'Ivoire, Equatorial Guinea, French Polynesia, Gabon, Guinea-Bissau, Mali, Mayotte, Principality of Monaco, Montenegro, New Caledonia, Niger, Republic of Congo, Republic of San Marino, Saint-Pierre-et-Miquelon, Senegal, Serbia, Togo, Vatican City, and Wallis and Futuna.
3. As central bank literature indicates, a final payment is 'the discharge of an obligation by a transfer of funds and a transfer of securities that have become irrevocable and unconditional' (Bank for International Settlements 2003, p. 496). More on this later.
4. Certainly, any current or capital account deficit has to be financed, and this can only occur via a sale of securities – provided, of course, that there is a purchaser for them, otherwise the country must cut back on its (net) imports of commercial and/or financial items.
5. Rochon and Rossi (2007) elaborate on these central bank interventions. Note that even if the settlement platform is not operated by the central bank necessarily, the central bank is always and everywhere the settlement institution for any interbank transactions, as it issues the means of final payment in the form of an asset-liability as explained earlier on. See Rossi (2007b, ch. 3) for analytical elaboration.
6. Let us stress, however, that all these transactions are final payments as far as the payer (resident in some country or currency area, A) and the payee (resident in a different currency area) are concerned. Indeed, at their level any local currency is a non-agent's debt. As such, it has settlement power for them – but not for the countries or currency areas involved as a whole, since the countries, and not their residents, are the agents in the international economy (which is the economic space that exists between countries, in which they buy and sell current and/or future productions on international commercial and/or financial markets).
7. Notice the endogenous nature of the supply of international money. See Rossi (2007a) for elaboration on money endogeneity at the international level.
8. Clearly, the same proposal may apply to the US dollar, if there will ever be the political will to issue it as an international means of final payment. This will require, as explained in this chapter, creation of an international settlement institution, so that the US dollar becomes a means of final payment between countries (instead of being an object of trade across a country's borders, as is presently the case). Indeed, there might be a number of international means of final payment (say, one for every continent), the important point being that every economic transaction between any two countries is finally paid for the countries concerned as a whole.
9. The MENA includes 19 countries: Algeria, Bahrain, Egypt, Iran, Iraq, Israel, Jordan, Kuwait, Lebanon, Libya, Morocco, Oman, the Palestinian Territories, Qatar, Saudi Arabia, Syria, Tunisia, the United Arab Emirates, and Yemen. The other ETZ regions that can be identified more or less precisely in geopolitical terms are the Western Balkans, the European part of the Commonwealth of Independent States including the Russian Federation, and Sub-Saharan Africa (see Mazzaferro et al. 2002, p. 9, Box 2.1).

10. The Barcelona partner countries of the EU are Algeria, Egypt, Israel, Jordan, Lebanon, Morocco, Syria, Tunisia, Turkey, and the Palestinian Territories (West Bank and Gaza). Cyprus and Malta were among the Barcelona partner countries before they joined the EU on 1 May 2004.
11. These financial assets may be issued by any sovereign or private institution, and may be denominated in any currency of choice, the important point being that the final payment of these transactions between countries occurs using international money as a vehicle, that is to say, as a means of payment, whose object of trade is given by the securities transferred from the seller to the buyer (see Figure 12.2).
12. The rate of interest paid by deficit countries on their borrowings will depend on the extent of their trade deficit and stock of foreign debt. A country recording a financial deficit, especially one elicited by capital account imbalances, is hardly in a position to issue new debt instruments at favourable terms. If so, then it must accept the onus of either paying higher rates of interest on new debt or slowing down the domestic economy by a hike in interest rates in order to attract foreign investment.

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13

International Payments Imbalances and the Prospective Role of the Euro

Andrea Terzi

13.1 Introduction

The term 'global imbalances' has recently come to describe the latest formation of increasingly large disparities in the balance of the international current accounts of the main world regions, notably the United States and Asia. Considered a warning signal of international financial instability, it is also being seen as a symptom of current world asymmetries in policy regimes and growth rates. Addressing the problem should thus aim at setting world growth on more solid ground, and begin to tackle the true global imbalances of today's world.¹ In this global scenario, the single currency area in Europe (or Euroland) is a new player. How does the euro economy navigate in the midst of international payments imbalances? And what can Euroland do to contribute to correct global payments imbalances in such a way as to play a role within the broader scope to rebalance the course of world economic development?

Judging from the current triad of EU policies (namely federally implemented price stability, federally constrained fiscal balance of national budgets, and a prescription that countries accomplish structural reforms on an individual basis), Euroland's potential contributing role to a benign rebalancing of global imbalances seems hampered by the fact that Euroland has limited means to solve its own internal imbalances. In fact, the effort to shape, in a slow growth environment, a more competitive and dynamic economy through individual countries' initiatives guided by the 'open method of coordination', and not by way of common governance, may keep Euroland busy for a long time, a time during which the external environment may rapidly change and become less favourable. Common governance established by common monetary policy and a common exchange rate is yet insufficient to make significant steps towards reducing traditional divergences in the areas of social and labour policies, dynamics of unit labour

costs, budget and taxation decisions, thus augmenting the strains of euro members rather than multiplying their potential, as documented elsewhere in this volume. This also indicates little alertness on the part of Euroland's architects regarding the distinct possibility that current world developments may turn against Euroland and force it to face considerable challenges. Indeed, as argued in this chapter, virtually all scenarios of international payments 'rebalancing' currently considered entail problematical consequences for Euroland, and a more resolute willingness to actively play a global role seems not only to be wished for, but a condition for the success of the EMU project. Adopting a proper system of macroeconomic governance in a truly integrated single market, as warranted by its new currency, is one of those structural reforms that should be given priority in the interest of Europe.

13.2 The widening of international financial imbalances

The recent wave of concern for 'global imbalances' in international payments dates from the late 1990s when a persistently growing US current account deficit becomes concurrent with a persistently growing negative net international investment position of the United States. Until then, the question of the sustainability of current account deficits and international debt had been studied exclusively with reference to developing and emerging countries. With the escalating excess of foreign-owned assets in the United States over US-owned assets abroad, however, concerns developed that financial flows to the United States could reverse, thus engendering a financial and dollar crisis.²

A full parallel with the financial dependence of developing and emerging countries, however, is unwarranted: the external account deficit on goods, services, and income payments of the country issuing the world key currency is not subject to the same financial constraints as that of any other country. In providing the world with international liquidity, the United States issues dollar-denominated claims that the rest of the world demands as a means of payment for acquiring financial assets in the United States, as well as for trading with third parties (as most of the international invoicing is denominated in dollars). The accounting imbalances thus reflect, in fact, a market equilibrium condition between demand and supply of dollars. As compared to the situation of a developing country where debts are denominated in a currency that the country cannot issue, the fact that virtually all external outstanding liabilities of US economic units are denominated in dollars softens the US borrowing constraint. This gives the United States the privilege of a longer time horizon available before the external financing constraint begins to bite. Indeed, and to many's surprise, the US imbalance position survived with no dramatic repercussions through the burst of the US stock market in 2000 and the ensuing recession: an array of US macroeconomic policies targeted at domestic growth set both the tone of the dollar

in floating currency markets and the tone of policy steering in countries that were willing to follow (i.e., peg) the dollar. The result was that the United States went back on a growth track and its current account continued to enlarge.

With the turn of the century, the US financial imbalance has continued to increase while Latin America, emerging Asia and oil-exporting economies have reversed their external deficit positions into increasing current account surpluses. Figure 13.1 documents the changing set of international financial positions by relating the current account balances of selected world regions to domestic (private and public) financial balances, through the 1995–2005 decade. From national and flow-of-funds accounting we know that the following identity holds for each accounting system:

$$\text{Private sector net borrowing} + \text{Public sector net borrowing} = \text{Current account deficit.}^3$$

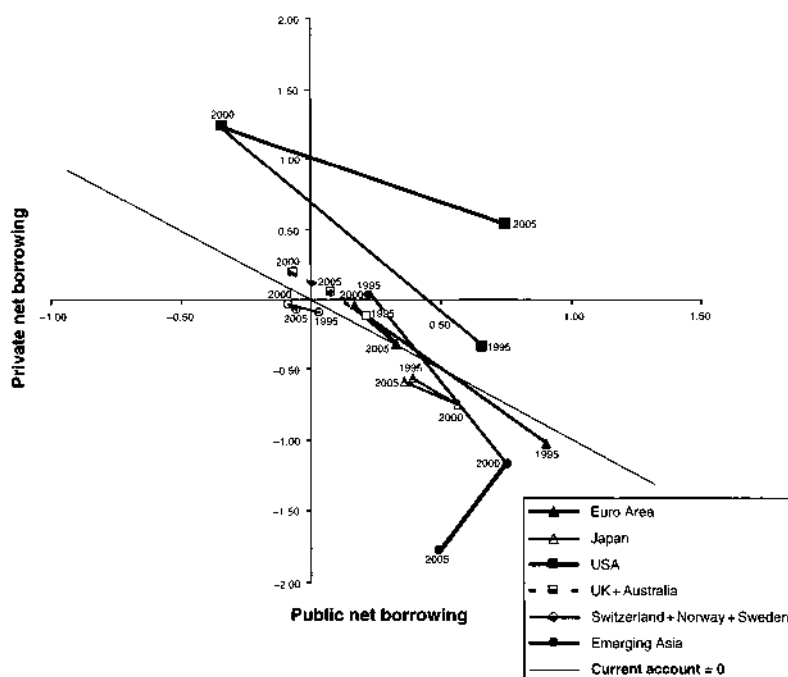


Figure 13.1 Global financial imbalances: 1995–2005 (per cent of world GDP)

Note: Emerging Asia includes People's Republic of China, India, Republic of Korea, Indonesia, Taipei China, Thailand, Philippines, Malaysia, Hong Kong China, and Singapore.

Source: IMF World Economic Outlook; Asian Development Bank Key indicators.

The diagonal line in Figure 13.1 shows combinations of private and public accounts that deliver a balanced current account position. The actual current account balance of each country (or region) is identified—at three dates of observation (1995, 2000, and 2005)—by plotting private net borrowing against public net borrowing: the resulting distance from the ‘Current Account (CA) = 0’ line measures a deficit (if a combination lies to the right of the line) or a surplus (if to the left).

In the decade considered, it is worth noting how the widening of the US external deficit has persisted, irrespective of the changing combinations of private and public borrowing patterns: the external deficit was concurrent, in 1995, with a government deficit; in 2000, with a government surplus that was more than offset by private net borrowing; and in 2005, with both private and public net borrowing. The growing external deficit reflects an ongoing theme of the US economy that has endured irrespective of changing cyclical conditions and policies: an increasing excess of domestic demand over domestic product, with corresponding demand spill-over effects on the rest of the world.

The Asian pattern is quite different, as the current account position of emerging Asian countries reversed in the period considered. In 1995, net public borrowing was concurrent with an external deficit that then turned into a rising external surplus in 2000 and 2005, when rising private savings (and profits) more than offset fiscal deficits. Not only the United States and Asia are now on opposite courts with respect to the ‘CA = 0’ line, but they have now reached antithetical positions. When we consider, in addition, the reversal (from deficit to surplus) of external account positions of Latin America and oil-exporting countries, the deficit court remains near empty, with the notable exceptions of the UK, Australia, emerging Eastern Europe, and only a few countries now incorporated into the euro currency area, while Euroland as a whole has, in its brief history, gravitated near the ‘CA = 0’ line in spite of relatively large swings in fiscal balances, mostly offset by corresponding swings in private sector’s financial balances.

Such polarization between the United States, on the deficit side, and the rest of the world, on the surplus side, is particularly meaningful if one considers that countries that consistently belong to opposite sides of the ‘CA = 0’ line pursue very different growth strategies. A country on the right side of the line is a country that generates net savings (including profits) abroad by means of expanding demand *by domestic units* (and *for both domestic and foreign units*, depending on its marginal propensity to expend and import) financed by private and/or public deficits. By contrast, a country on the left side is a country that absorbs net savings (including profits) from abroad by means of an expanding demand *for domestic units* (and *by foreign and domestic units*, depending on its marginal propensity to expend and import) financed abroad. Considering that any external deficit requires the disposal of a means of payment accepted internationally and that any external surplus entails accumulating such means of payment, then, for the time

a region lays to the right of the 'CA = 0' line, it is a net generator of world demand and a demander of international finance, and for the time it lays to the left of the line, it is a net dragger of world demand and a supplier of international finance.

Asia moved over to the left of the 'CA = 0' line following the 1998 crisis.⁴ This conspicuous reversal of a growing number of developing and emerging countries in Asia, and elsewhere, is likely to reflect an increasing reluctance of being in the risky court of net world demand generators. The 1998 crisis showed that, apart from the privileged position of the key currency country, such condition is tolerated for limited time periods before capital flows reverse. Successful growth-oriented policies in the United States that prevented the world recession many had foreseen in the aftermath of the dot-com bubble corroborated this choice.

While these developments have led to the widening of current account disparities, financial and currency markets continue to play a crucial role in maintaining this 'equilibrium of imbalances'. The dollar provides the key world currency, while other currencies of higher and lower hierarchy have acquired liquidity at various degrees relying on their capital markets. The sizeable widening of the US current account deficit in a context of sustained world growth (and increasing polarization of current account imbalances as described above) has been made possible by the world's appetite for dollar-denominated assets. From a purely accounting view, the recycling of dollar liquidity back to the United States is a precondition to prevent that spending income abroad drains liquidity in the United States. In this sense, foreign investment in US assets has provided a method equivalent to the one Keynes considered essential to any international monetary 'system', as well as an element of his own proposal for reform, that is, 'a method by which the surplus credit balances arising from international trade, which the recipient does not wish to employ for the time being, can be set to work ... without detriment to the liquidity of these balances and to their holder's faculty to employ them himself when he desires to do so' (Keynes 1942/1980, p. 169).

At the same time, the significant widening of imbalances was made possible by the fact that another element Keynes considered essential is missing in today's 'system', that is, 'an internal stabilizing mechanism, by which pressure is exercised on any country whose balance of payments with the rest of the world is departing from equilibrium in either direction, so as to prevent movements which must create for its neighbours an equal but opposite want of balance' (Keynes 1942/1980, p. 169). This was a missing element in the Bretton Woods system as well, and one that contributed to its demise. Indeed, when drawing parallels between historical international payments systems,⁵ one should be reminded that this remains today an element of weakness.

In sum, financial imbalances will continue as long as both surplus nations and the largest deficit nation do not feel the need to adjust, and this is being seen today as leading to either of two scenarios. Under a classical

view, the widening and polarization of imbalances just cannot go on forever as it increases the vulnerability of the international economy: if less-than-efficient market mechanisms have not prevented the build-up of an excessively unbalanced situation, then an abrupt crisis can only be avoided by returning quickly to 'sound policies'.⁶ Under an alternative view, imbalances may continue unchecked as long as they remain coherent with a world system that combines different, complementary strategies: the current system of dollar-dominated international financial markets permits export-led countries to recycle their surpluses back to deficit countries (i.e., the United States) and hence prevents a US slowdown, with the United States and Asia keeping the world in balance by pulling in opposite directions. Even under this less dramatic scenario, however, there remain several elements of concern, including a higher capital mobility (than under the Bretton Woods system) and the dependence of the local stability of this system on mutual interest, including an enduring compatibility with domestic US objectives. A situation where world stability requirements under this latter scenario should conflict with the domestic goals of the key world currency, such as a surge in US inflation, would be a real threat to the dollar-based recycling of financial imbalances, and thus to world growth.

13.3 Risks of a US-Asian adjustment

Most economists agree that current 'global imbalances' pose a real threat to the world economy, but the same diagnosis and therapy are not shared by all. Inevitably, the character of solutions strictly depends on the goals one sets, and in the debate of diverse, alternative, and competing policies one must first clarify the goal they aim at. In this respect, the IMF (2005, 2006) has expressed serious concerns that the widening of financial imbalances may prove to be only temporarily sustainable and that the current pattern will have to be unwounded by dollar depreciation as foreigners will be increasingly reluctant to hold dollar-denominated assets. In the face of an increasing vulnerability, the IMF has warned that financial imbalances require policy correction and, if left unchecked, will correct through an abrupt and risky dollar drop. In describing the aims of a policy coordination effort, the IMF is thus stressing the goal of reducing the danger of a financial meltdown ignited by a dollar collapse.

This may well be a concern for the world economy, and the analysis will return to this issue below. Yet, there exists an equally, if not more important, concern that should guide policy action: US internal economic conditions and policy choices remain crucial to world economic growth as long as the majority of countries are highly dependent on US demand. In fact, the risk is that a weakening of the American economy may ignite a global recession.

This difference in diagnosis and goals matters because while dollar stability may require that adjustment falls predominantly on the United States,

and possibly on Asian pegging policies, a reduction of the world economic dependence on US consumers and business may lead us to consider adjustment on other players, notably, and perhaps somewhat counter-intuitively, Euroland. Indeed, one should not disregard that some of the policies endorsed by the IMF do in fact consider the latter concern, prodding a boosting of growth in Japan and Europe, thus indicating the need to widen the effort to generate demand engines beyond the United States. Yet, the IMF's biggest emphasis remains on the dollar stability concern, aiming at re-equilibrating actions (such as a reduction of US private and public net borrowing) that could easily prove counter-productive to demand and growth, thus further increasing the risk of the world economy running out of steam.

By combining some key contributions on the question of imbalances, the IMF promotes adoption of a coordinated package of policies: fiscal measures in the United States to spur private saving and cut the federal deficit, exchange rate flexibility, and reforms that spur domestic demand in surplus countries. Thus, the IMF prescribes a constellation of policies, in consideration of the fact that imbalances are common to a number of regions and that rebalancing international payments must necessarily entail both a reduction of deficit positions and a reduction of surplus positions. Entrusting both substitution and income effects, policies are expected to foster an orderly market adjustment by providing exchange rate flexibility in Asia and fiscal consolidation in the United States before market movements become disruptive, and spur growth predominantly through policies that enhance productivity in Europe and Japan and lead to increased spending by oil exporters.

When it comes to priorities, however, pundits hold different views. An influential view places an exceptional emphasis upon the US imbalance position and the need that US policy-makers change their course of action and begin to restore 'sound policies'. One can find a number of apparently intuitive and yet questionable reasons why most of the adjustment of existing imbalances should fall on the United States: First, while the surplus side of global imbalances is shared by, and spread among, a number of world regions, the deficit side concentrates on US external accounts: over two-thirds of all external deficits originate from the United States. This has unwarrantedly suggested that because the anomaly sits primarily in one country, adjustment should be made at the US domestic level. The fact that the United States is the world region furthest away from 'equilibrium' does not, however, warrant that it is the region that must adjust first. Should the United States attempt to reduce imbalances by cutting down the flow of savings they generate abroad to increase domestic savings, while others continue to attempt to 'import' savings from abroad, an 'international paradox of thrift' situation would develop: a demand drop that would reduce income and investment and actually result in less, not more world savings. Slowing down the biggest demand engine could only make sense if demand

was first rising elsewhere. The point is that this cannot happen as long as Asian and key European countries remain strongly oriented to use exports as their demand engine.

Another reason for commonly emphasizing the need for US adjustment lays in the conventional argument that a deficit country faces a financing (though in the case of the United States 'soft') constraint, while surplus countries do not: the United States may have more leeway than emerging countries, but ultimately it must adjust. This asymmetry is often described as being one between (borrowing) countries indulging in spending profligacy and (lending) countries practising frugality. Finally, the 2000–03 dramatic reversal of US fiscal accounts has provided an additional source of concern for US fiscal sustainability in the face of an increasing outstanding net foreign holding of Treasury securities. A group of American economists have vigorously blamed both the excessively low personal saving rate and the looming budget deficit in the United States for reducing national saving and creating the needs of a rising borrowing from abroad to 'finance domestic investment'. In their view, rising debt bears on Americans both for the returns that must be paid on debt and for the increased risk that this may entail, eventually driving US interest rates up,⁷ pushing the dollar as well as investor confidence and the stock market down, and thus spreading to the real economy: 'These same forces could lead investors and businesses to scale back use of the dollar as the leading world currency for international transactions. That, in turn, could limit the ability of the United States to finance its current account deficits through dollar-denominated liabilities and thus increase the nation's net exposure to substantial exchange rate changes' (Rubin, Orszag and Sinai 2004, p. 32).

This connection between US fiscal soundness and the global role of the dollar is questionable in at least two respects. Regarding the fears that a dollar drop implies an enduring dollar crisis, due considerations should be given to the following: the dollar has proved it can stand large fluctuations in its international value with no impact on the stability and liquidity of US financial markets. Investors' activity in temporarily reallocating international portfolios does not create conditions whereby the dollar loses its appeal as key world currency. Arguably, should 'unwarranted fears' develop, initiating a dollar crisis, the most powerful central bank in the world would be operative, and other central banks would be highly interested in cooperating to protect their domestic investors and their own portfolios, until an orderly dollar market is restored.

On the other hand, should fiscal retrenchment, or tax hikes, in the United States, unaccompanied by a rising US private net borrowing, move the United States towards current account balance (i.e., towards the 'CA = 0' line in Figure 13.1), this would be concomitant with a reduction of the surplus imbalance elsewhere. Restoring 'sound policies' in the United States would thus prove counter-productive, it would reduce the US net generation of world

demand and be deflationary for the United States and the world. It could well contribute to moving regions in Figure 13.1 towards the 'CA = 0' line, but at the cost of a generalized reduction of United States and world growth. Considering the relative importance of the US economic engine, the effect could be devastating if demand did not increase first elsewhere in the world.⁸

When the deflationary effects of unilateral US adjustment are considered, one should begin looking elsewhere. A conventional alternative recipe is exchange rate adjustment, and this would involve a policy effort by the Asian countries, notably China. Considered as a way to address concerns about the deflationary effects of a unilateral US adjustment, the aim is to simultaneously restore 'sound policies' in the United States (by increasing US savings) and in Asia (by eliminating exchange controls), and ultimately to guide a price adjustment. In this vision, a concerted effort of the United States and Asia to adjust imbalances bilaterally through a reduction of the US fiscal deficit parallel to Asian currencies' appreciation⁹ would lead to an orderly global rebalancing through 'expenditure reduction' and 'expenditure switching' (cf. Setser and Roubini 2005).

It is worthwhile to recall here Keynes's approach on how to stabilize international imbalances, which was based on a concerted effort to keep world aggregate demand high. Keynes did not trust the price mechanism as a means to restore financial balances and full employment: he stressed income and balance-sheet effects of exchange variations on top of uncertain price-elasticity and expenditure switching effects. Today, in a world of international financial flows and international outsourcing, a dollar drop is even less likely to reduce imbalances. For aiming at sufficiently large expenditure switching effects, the dollar drop should be happening against nearly all surplus regions currencies, including the now pegged Asian currencies (and not just the renminbi). This would require an unlikely sweeping and coordinated change in policy in a number of Asian countries with different interests and constraints: with still fresh memories of the 1997–98 crisis, some Asian nations would be reluctant to move into current account deficit and standing speculative financial flows in the appreciation process. Currency appreciation in Asia could result in greater financial instability if a small appreciation encouraged greater speculative capital flows into China and its neighbours, as well as if a large revaluation damaged the Chinese model of economic development (cf. Cooper 2005). The size of the expenditure-switching effect is also questionable: dollar depreciation entails more expensive imports, but with a significant share of US imports contributing towards the formation of US GNP (i.e., income earned by US companies abroad). As Kregel (2006) has stressed, an increasing portion of the US deficit reflects the existence of large foreign direct investment (FDI) by US companies as well as the imports of foreign affiliates selling in the US market: FDIs, outsourcing, and the globalization of international production may significantly reduce the impact of exchange rate adjustment on external accounts. In addition, if

current account imbalances are primarily due to growth rate differentials, and if further dollar depreciation is likely to sustain, not reverse, such differentials, account imbalances are unlikely to disappear.

In conclusion, the effectiveness of correcting imbalances through a slowdown of demand in the United States and currencies' appreciation in Asia is questionable, and the related risks seem considerable for the world economy, as well as for Euroland – as discussed in the next section.

13.4 The perilous navigation of the euro in the midst of global imbalances

Within the policy framework described above, where imbalances should be adjusted through US fiscal correction (on the debtor side) and more flexible exchange rates (on the creditor side), Euroland has hardly any role to play, and it may well remain on the sidelines. Indeed, within a (classical) framework where the recipe for international balance is a combination of balanced budgets, price stability, and flexible exchange rates, then Euroland, with its overall nearly balanced position, should have little to fear from imbalances, and its current policy approach might as well be seen as a template for the rest of the world. Yet, arguably, Euroland cannot rely on its current set of policies for protection from a deflation in the United States. The effects of a US deflation on the Euro Area would be that of creating further strains on economic and political cohesion: without a sustained increase in domestic demand, Euroland countries will continue to struggle over export shares, engage in 'beggar-thy-neighbour' policies, and further sustain deflation. Many European officials in Brussels and Frankfurt, as well as many of their economic advisers, may continue to believe that the answer is to reform welfare systems as well as product and labour markets to reduce rigidities and increase labour force participation, but they cannot dismiss the risk of a dramatic new strain on Euroland if world growth came to an abrupt halt. Euroland has not so far proved to be mature enough to counter serious external challenges.

An equally risky scenario for Euroland, though considered by many as inevitable and even salutary, is the 'shock therapy' of a dollar drop. Euro appreciation reduces Euroland's international competitiveness and creates deflationary pressures, especially in those regions within the euro economy that remain largely based on exports. The outcome for the Euro Area could be particularly severe, given the lack of coordinated policy actions in the face of external shocks.

Would this conclusion modify if the euro could challenge the dollar's world dominance? Should the scenario prospected by Rubin, Orszag and Sinai materialize, and the dollar lose its world leadership, would the euro be capable to replace, or rival the dollar as the world key currency? A shift in currency portfolios would most likely (and problematically) cause euro appreciation. An appreciating currency, however, is not automatically a

candidate to the key currency role in monetary relations, and a euro appreciation does not in any way imply that the euro might soon replace the dollar as the key world currency. In fact, the long dominance as the key world currency has not prevented the dollar from undergoing significant up and down movements, as portfolio allocation changed between US dollars, German marks, Swiss francs, and Japanese yens, and largely in the interest of the US growth objective, as documented elsewhere in this volume. In the same fashion, the euro may well go through steep appreciation without fully or even partially replacing the dollar as the world monetary standard.

Exploring this aspect requires that the question of portfolio allocation be kept separate from the question of rivaling the dollar as the world key currency. In fact, what we know of international currencies does not give much comfort to the possibility that the euro may soon replace the dollar and take world monetary leadership, as some fundamental conditions are missing. One should first distinguish a key currency (KC) from a high-hierarchy currency (HHC). In today's international monetary system, the dollar is the KC and a few other currencies that are heavily traded are HHCs. A HHC is a high-quality substitute in international portfolios that takes a prominent role as a share in private and official portfolios and may be used as a temporary safe-heaven investment in times of uncertainty and of cyclical depreciation of the KC. A HHC's perceived quality depends on the size and liquidity of its underlying money market, as well as by international reserve and/or current account surplus conditions (cf. Terzi 2006). By contrast, a KC is a currency that has international money status, that is, it is used to settle international payments and is largely adopted as unit of account in international contracts. It is the currency with the highest degree of international 'moneyiness'.

Generally, the conditions for a currency to be used internationally include a high exposure to trade and capital flows, a large domestic market, a large financial market, and economic and political stability. The dollar has all these features and also a characteristic that is strongly linked to the role of KC, namely the largest and most liquid capital market. It may thus seem that the euro is close to being a credible challenger of the dollar. Yet, there remain five areas where the euro does not score well. One pertains to a lack of progress in what we described above as a decisive feature of a KC, namely the quality of the capital market: in this regard, the European capital markets remain largely fragmented and are still far from being competitive in breadth, depth, and liquidity with the US market (cf. Kregel 2000). A second area of concern regards inertia, a typical disadvantage of the challenger with respect to the incumbent: this requires that a new contender offer substantial advantages over the incumbent to stimulate switching.

The following three reasons pertain not so much to the list of characteristics that a currency must acquire to be a candidate for a KC role, but rather to the euro's lack of quality related to its 'supranational' character. First, as

powerfully argued by Goodhart in this volume, the separation between political and monetary authority in Euroland implies the absence of provisions as well as of possible funding (by a non-existing euro federal treasury) of bailouts, and thus a risk of default of national debts no longer guaranteed by the national states is significantly higher. If the typically default-risk free investment medium of a currency area (consider the attractiveness of US government securities for private and official investors) is instead potentially risky and subject to investors' apprehension in response to news about government ratings and 'excessive deficit procedures', then the attractiveness of the euro as a KC inevitably suffers.

Second, the lack of a single decision-making body that implements macro-economic governance, and thus aims at Euroland's growth damages the credibility of the euro: on this point, Cohen (2003) noted that in the euro economy 'in place of decisive management, market agents see fragmented decision making and a potential for chronic bickering'. And finally, as also noted by Cohen (2003), an anti-growth bias 'built into the institutional structure of the euro' has a negative effect on prospective rates of return on euro-denominated assets.

From these considerations, it seems that Euroland cannot at this stage escape from its original sin, that of a monetary union functioning with a largely incomplete political union. Euroland has some features that permit a comparison with the United States, such as economic size and price stability. Yet, there are other areas that put the euro at a disadvantage in competing with the dollar as an official reserve asset as well as a denomination of international contracts.

This may have a dismal consequence. Should the dollar really collapse for reasons of a confidence crisis, the euro would be totally unprepared to replace it in its KC role. Not all that different from the old D-mark, all the euro – as a HHC! – could really offer is a safe-haven for international investors, with likely deflationary consequences due to euro appreciation. Vulnerability to external shock, which was presumably eliminated by the creation of the single currency, inevitably re-emerge as a result of the missing federal economic policy. A problem of the euro indeed seems to be that it may continue to look like the D-mark rather than the dollar.¹⁰

Considerations developed in the previous section suggest that a US demand drop or a dollar depreciation would both put Euroland under severe strain: the resulting slowdown in the demand for Euro Area exports would confront the euro economy with a deflation scenario. Likewise, a continuation of current imbalances does not seem favourable to the stability of the euro economy either. Having reached a size comparable to the United States, Euroland still remains the sum of regional (national) economies, where national authorities and national policy actions of key individual members like Germany maintain a small open economy approach to their (now financially irrelevant) balance of payments, and where in case of difficulty they hope that the US market will bail them out. But while the

United States is unlikely to change its policy and Asia is in a good position to defend its current policy, the euro economy may soon find itself in a politically unsustainable situation: euro appreciation will have to be countered by downward adjustment of prices and wages to preserve competitiveness, thus creating further pressure for euro disintegration (cf. Kregel 2006).

In sum, to address global imbalances from the standpoint of Euroland, there seems to be no alternative to a radical change in strategy towards policies that boost demand in slow-growth regions such as Japan, oil-exporting countries, and Euroland itself. With respect to Euroland, this might entail a profound review of current policy-making, well beyond the current emphasis on structural reforms.

13.5 Will the euro build its own identity and rival the dollar?

A critical review of the most prominent policies towards the challenge of 'global imbalances' reveals a vision of economic history whereby economies move on long-run paths and, when they temporarily deviate from long-run fundamentals, they ultimately converge back to trend and restore long-run equilibrium conditions. In this sense, a 'solution' to the question of international payments imbalances should entail a mere 'rebalancing' of payment flows, either through market mechanisms or 'sound policies'. This is in stark contrast to an alternative vision, whereby economic development is intrinsically tied with the emergence of imbalances. Throughout history, differences in growth rates, differences in the degree of openness to trade and financial flows, current account imbalances, and other asymmetries have been the norm rather than the exception. Imbalances may continue unchallenged for long periods as long as they are in the interest of the parties involved. Indeed, 'imbalances' may be reversed not exclusively when they become unsustainable, but when growth patterns and national interests change. The current configuration, shadowing Keynes's mechanism, has allowed the widening of imbalances, at the cost of an increasing dependence on the US domestic market conditions, and while leaving a significant economic region of similar size, namely Euroland, on the sidelines.

If the response to the risks posed by the current configuration of international payments imbalances is to prod adjustment on surplus regions, then, in the absence of an international mechanism managed by a multilateral system, candidates must be found among those who can afford the role of demand generators with no fear of engendering financial instability, and are willing, ultimately in their own best interest, to share with the United States the 'burden' – and enjoy the benefits – of generating world demand.

The way out for the euro and for 'global imbalances' could begin with Euroland exploiting the monetary power it has acquired with respect to the discontinued national currencies¹¹ in order to modify its character into a

growth-generating region, and being open to daring into the right-side court in Figure 13.1. This requires more structural policies than the individual countries' initiatives can accomplish. Euroland's priorities should be those of completing single market integration and of proceeding towards a more centralized coordination of macroeconomic governance that pursue the missing goal of euro policies, namely domestic demand growth. This mission could be accomplished more effectively if the acquired prominent role of the euro were exploited in such a way that the euro economy becomes capable to be another 'world demand generator' in the global economy. This would entail being open to running external deficits as well as to exercise governance on the euro-dollar exchange rate.

If the euro proceeds along its current path, it cannot realistically aspire to playing the role of a KC and will inevitably continue to play, willingly or unwillingly, the role of a temporary safe-haven currency. It will remain more similar to the D-mark than to the dollar. Instead, adopting a system of macroeconomic governance, as warranted by its new currency, is one of those structural reforms that should be given priority in the interest of Europe. It would also provide an additional means to correct global imbalances through a policy of growth rather than deflation.

For Euroland to be part of the next round of trend changes in international financial flows, it should reconsider the role of its currency and reform its macroeconomic policy regime. The international challenge for the euro is to abandon its current role of a HC, inherited from the former D-mark, before it can realistically play the role of a KC. One can envision the euro, injected into the world economy through current account deficits and/or a large-scale plan for development aid, acquiring a prominent role closer to that of the dollar. This could happen within a variety of arrangements including the setting of common growth and employment (and not only price stability) objectives to Euroland member countries, a centralized economic policy, and perhaps some degree of exchange rate coordination with the dollar (which is hard to envision in the present system where Euroland remains on the sidelines of world demand generation). Priority to single market integration and further political union at the level of the Euro Area, and not necessarily at the broad EU level, may be needed too.¹² In any event, a new international identity for the euro requires that Euroland develop improved means of internal macroeconomic governance aimed at securing domestic demand growth and accept responsibility for global growth to be shared with the United States. This is the tough economic and political challenge ahead.

Notes

1. A list of 'true' global economic imbalances should include growing income inequalities, widespread and persistent unemployment, unequal access to financial resources, and considerable disparities in countries' vulnerability to external shocks.

2. While in 1996 Milesi-Ferretti and Razin could still discuss current account sustainability with no reference to the United States, three years later the scenario had changed. Amongst others, Blecker (1999, p. 15) warned that the external position of the United States was going to make the United States dependent on international borrowing and vulnerable to international investors' portfolio decisions.
3. Public sector net borrowing equals the public sector deficit, while private sector net borrowing is the difference between total expenses (including investment) and total receipts of all households and businesses (equal to the difference between investment and saving in the private sector).
4. Incidentally, at the time of the Asian crisis, global accounts and Asian deficits in particular were much less unbalanced than they are today.
5. For Dooley, Folkerts-Landau and Garber (2003) the current system is a 'revived Bretton Woods' system, reflecting a mutually beneficial two-way dependence between the United States and Asia.
6. This variety of the classical view must assume that markets cannot be trusted to lead a timely, orderly adjustment.
7. For a critique of the view that fiscal deficits in the US (or Euroland) cause rising interest rates, see Terzi (2007).
8. On this point, Cooper (2005) has argued that 'any attempt to reduce the United States deficit abruptly, other than through a spontaneous but unlikely surge in domestic investment in many other countries, would undoubtedly produce a world recession.'
9. Paradoxically, critiques of Asian deficits as the supposed culprit of financial crisis in the late 1990s have turned into critiques of today's Asian surpluses.
10. Rotondi and Vaciago (2002) find that private agents regard the euro 'as depending on the same fundamentals as the German mark' and suggest that 'the euro is the D. Mark in disguise.'
11. Except for the D-mark, pre-euro currencies could be seen as low-hierarchy currencies (at par with most Asian currencies today), constraining the viability of external deficits.
12. In its pioneering role for full EMU in Europe, the Euro Area has a reason for paving the way to market integration and macroeconomic governance, even when other, non-euro EU countries may not feel the same urgency.

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