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## **Alternative economic policies for the Economic and Monetary Union**

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### **Abstract**

The problems of the euroarea stem from design faults of the EMU with current account imbalances, differential inflation, and a poor macroeconomic framework, and failures to accommodate differences in institutions between the member countries. The design of the 'independent' European Central Bank has largely precluded the necessary co-ordination of fiscal and monetary policy, and has also disabled the central banking system from providing sufficient support to national governments and their budget deficits. Little regard was paid to issues such as convergence of business cycles and economic conditions between potential member countries (with its implications for the operation of a 'one size fits all' monetary policy). No attention appears to have been paid to the institutional differences between member countries with respect to how labour markets, housing markets, banking system etc functioned and operated. The paper outlines a set of alternative policy proposals for the Economic and Monetary Union. These proposals are very far removed from the present policy positions, and remote from what could be viewed as politically feasible. The proposals would require significant income transfers between countries through the development of a Federal tax system and social security system. The policy framework seeks to specifically address the malfunctioning of the Economic and Monetary Union, and as such do not address the relationship between EMU member countries and the other member countries of the EU. The proposals are put forward to illustrate a different direction of travel.

**Journal of Economic Literature classification codes:** E60, E61

**Key words:** Economic and Monetary Union, euro, single currency, macro-economic policies, optimal currency area

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## **Alternative economic policies for the Economic and Monetary Union**

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### **Introduction**

The problems of the euroarea stem from design faults of the EMU with current account imbalances, differential inflation, and a poor macroeconomic framework, and failures to accommodate differences in institutions between the member countries. These design faults were already present in the nature of the 'convergence criteria' (under the Maastricht Treaty) for membership of the Economic and Monetary Union (EMU), which focus on nominal rather than real variables<sup>2</sup>, paying no attention to the validity of the exchange rates at which countries enter the EMU, or to the prevailing current account deficits and surpluses; or to the differences in inflation mechanisms between countries. They continue with the inadequacy of a fiscal policy based on numerical targets (upper limit of 3 per cent of GDP on budget deficit, for example) operating at the national level. The design of the 'independent' European Central Bank has largely precluded the necessary co-ordination of fiscal and monetary policy, and has also disabled the central banking system from providing sufficient support to national governments and their budget deficits (Arestis and Sawyer, 2011). Little regard was paid to issues such as convergence of business cycles and economic conditions between potential member countries (with its implications for the operation of a 'one size fits all' monetary policy). No attention appears to have been paid to the institutional differences between member countries with respect to how labour markets, housing markets, banking system etc

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<sup>1</sup> An earlier version of this paper was presented at 18<sup>th</sup> Euromemorandum conference 'The deepening crisis in the EU: The need for a fundamental change in policy', Pozan, Poland 28<sup>th</sup>/30<sup>th</sup> September 2012 and I am grateful to participants at the session for discussion and comments; and also to Philip Arestis for comments on earlier draft.

<sup>2</sup> The convergence criteria to be applied to a country for membership of the EMU under the Maastricht Treaty are:

1. Average exchange rate not to deviate by more than 2.25 per cent from its central rate for the two years prior to membership;
2. Inflation rate not to exceed the average rate of inflation of the three community nations with the lowest inflation rate by 1.5 per cent;
3. Long-term interest rates not to exceed the average interest rate of the three countries with the lowest inflation rate by 2 per cent;
4. Government budget deficit not to exceed 3 per cent of its GDP;
5. Overall government debt not to exceed 60 per cent of its GDP.

It is also required that a country has adopted an 'independent Central Bank', that is a central bank with operational independence from the national government under which the central bank would adhere to the ECB's decisions on interest rates in pursuit of mainly the price stability objective; each national central bank adopts the interest rate as set by the ECB.

functioned and operated. Yet institutional differences in labour markets, for example, are highly relevant for the evolution of wage inflation, productivity and employment<sup>3</sup>.

There have been on-going policy responses to the crises within the euroarea (under which heading we would include the unemployment crisis, sovereign debt and banking crisis and an existential crisis with the future of the euro itself placed in doubt). Various policy initiatives have been pursued including the European Financial Stability Facility (EFSF), the European Stability Mechanism (ESM) and proposals for a form of banking union (for our discussion on these see Arestis and Sawyer, 2013). Other major policy initiatives came under the heading of the 'six pack', 'fiscal compact' culminating in the *Treaty on Stability, Coordination and Governance in the Economic and Monetary Union* (European Union, 2012). The *Treaty* is argued below to involve imposition of further austerity (with the proposed budget limits being unachievable) and attempts at a neo-liberal agenda with the emphasis on 'structural reforms'.

The final sections of this paper outline a set of alternative policy proposals for the Economic and Monetary Union. These proposals are very far removed from the present policy positions, and remote from what could be viewed as politically feasible. The proposals would require significant income transfers between countries through the development of a Federal tax system and social security system. The type of policy framework which is sketched below sharply conflicts with the ideological policy framework which currently dominates notably within the European Commission (and the Directorate of Economics and Finance) and the European Central Bank<sup>4,5</sup>. The policy framework seeks to specifically address the malfunctioning of the Economic and Monetary Union, and as such do not address the relationship between EMU member countries and the other member countries of the EU. The proposals are put forward to illustrate a different direction of travel.

Before coming to the alternative policy proposals we reflect on the lessons which can be drawn from the first years of the euro.

### **Lessons from the decade plus of the euro**

At the end of the first decade of the euro (in 2008) the Commissioner for Economic and Monetary Affairs was able to write 'A full decade after Europe's leaders took the decision to launch the euro, we have good reason to be proud of our single currency. The Economic and Monetary Union and the euro are a major success. For its member countries, EMU has anchored macroeconomic stability, and increased cross border trade, financial integration and investment. For the EU as a whole, the

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<sup>3</sup> No implication should be drawn that some institutional arrangements are necessarily superior to others but rather we point to differences which have impact on dimensions of economic performance.

<sup>4</sup> This argument has been elaborated in Arestis and Sawyer (2006), and the nature of the dominant economic paradigm within which policy makers appear to think exposed (we focus particularly on the roles of the new consensus macroeconomics and the associated dynamic stochastic general equilibrium).

<sup>5</sup> The dominance is of course not monolithic: for a recent different policy perspective see, for example, European Commission (2012a).

euro is a keystone of further economic integration and a potent symbol of our growing political unity. And for the world, the euro is a major new pillar in the international monetary system and a pole of stability for the global economy. As the euro area enlarges in the coming years, its benefits will increasingly spread to the new EU members that joined in 2004 and 2007.’ (Joaquín Almunia, Introduction to European Commission, 2008, p.3). The report though did argue that ‘While the euro is a clear success, so far it has **fallen short of some initial expectations**. Output and particularly productivity growth have been below those of other developed economies and concerns about the fairness of income and wealth distribution have grown.’ (emphasis in original, p.3)

It could lay claims to have experienced falling unemployment in the first decade of the euro, which could be ascribed to ‘labour market reforms’: for example ‘All these positive developments have culminated in the creation of **a record 16 million jobs during the first decade of EMU** in the euro area. Employment has risen by almost 15% since the launch of the single currency while unemployment has fallen to about 7% of the labour force, the lowest rate in more than fifteen years. Importantly, job growth outpaced that of other mature economies, including the United States. The bulk of these improvements reflect reforms of both labour markets and social security systems carried out under the Lisbon Strategy for Growth and Jobs and the coordination and surveillance framework of EMU, as well as the wage moderation that has characterised most euroarea countries.’ (p.6). Such claims were rather blown out of the water by the experiences of rising unemployment since the financial crisis to reach a level of 11.8 per cent at the end of 2012, the highest recorded during the time of the euro

The picture for the euro at the beginning of 2013 does not look as rosy!. We have elsewhere (for example, Arestis and Sawyer, 2012) argued that the economic performance of the Eurozone in general was somewhat lack lustre during the 2000s (prior to the financial crisis) with growth (particularly in the larger countries) low relative to historic experience and other countries, though unemployment was tending to decline until the financial crisis. Inflation tended to be above the target of 2 per cent (albeit by a small margin), but with continuing differences between countries which had consequences for competitiveness of those with relatively high inflation and for real interest rates. Current account imbalances tended to widen with Germany moving from a small deficit to a substantial surplus. There were corresponding capital outflows from surplus countries and capital inflows into deficit countries which had strong elements of being unsustainable insofar as inflows were used for consumption purposes rather than investment, and were dependent on continuing willingness of banks and other financial institutions in current account surplus countries to lend to the deficit countries.

From an economic perspective (and hence ignoring here the political thrust towards further integration which the euro represented, the steps towards a two-speed euro and the setting in motion forces towards political union which would follow from a single currency), the benefits of a single currency related to lower transactions costs and removal of exchange rate volatility between member states), the prospects of lower (nominal and real) interest rates for a range of countries and lower inflation. These benefits were to a larger extent realised though the interaction of a common nominal interest rate set by the ECB and differential inflation may well have fed into the credit booms in a number of countries. And although inflation was much lower in Southern European countries than had been their previous experience, differences in inflation rates remained with consequent effects on relative prices and competitiveness. The estimates of the effects of the euro on trade have varied enormously (from zero to 70 per cent), but a recent paper concludes 'For countries in the EZ [eurozone'], the effect [of single currency on trade] appears more elusive: In particular, we could not find statistically significant effects on trade among EZ members following the introduction of the euro, though previous work has found positive, yet generally small, effects'. (Santos Silva, J. M. C. and Tenreyro, Silvana , 2010a): or more succinctly in the title of Santos Silva, J. M. C. and Tenreyro, Silvana , 2010b 'Has the euro increased trade? Short answer: no'.

#### *Optimal Currency Area considerations*

The Optimal Currency Area (OCA) literature had much influence in academic debates but appears to have little impact on the design of the Economic and Monetary Union (EMU). Many authors who were attached to the OCA approach tended to conclude that the euroarea was not an optimal currency area – or at least by comparison with the USA, the euroarea had lower factor (notably labour) mobility, and lacked fiscal transfers authors (see, for example, Eichengreen, 1997) . Insofar as regard was paid to the OCA criteria, the argument was put that there would be endogeneity in the fulfilment of the criteria, that is whilst at the time of formation of the euro the criteria would not be satisfied, the experience of the single currency and the enhancing trading between countries would lead in the direction of their fulfilment (see, for example, Baldwin and Wyplosz, 2009). This is reflected in the question 'Is EMU more justifiable *ex post* than *ex ante*?' (Frankel and Rose, 1997, 1998). The answer given by Frankel and Rose (1997) was positive in their *ex ante* analysis; they argued that the EMU would be more justifiable in the *ex post* sense. However, more recently, Vieira and Vieira (2012) in an *ex post* analysis of the EMU's first decade in existence (including the initial group of eleven countries as members of the EMU plus Greece) conclude that the hypothesis does not hold for some countries.

The OCA approach suffers from being developed within an essentially competitive demand/supply framework: that is a 'shock' in one country could potentially be addressed through a combination of

price and quantity adjustments: if demand in one country fell, then prices of goods and services produced in that country could fall, and resources shift from that country. The exchange rate was similarly viewed as a price adjustment mechanism to shocks, with, of course, that adjustment mechanism being removed in the single currency case. The OCA approach then overstated the benefits of an adjustable exchange rate. It overlooked the forces of cumulative causation and the degree to which imbalances between countries (or regions) can be re-inforcing rather than self-correcting. It pays little attention to situations of initial imbalance when the single currency is formed, and then how those imbalances could be resolved in the context of a fixed exchange rate system. This was in effect the position with the formation of the euro, with large differences in unemployment rates and current account positions. There were also substantial differences in income per capita and trend growth rates.

The differences between the member countries of EMU in terms of institutions, laws, history, policy outlooks raised questions of the compatibility of those differences with a single currency. Whilst there are regional differences within a country, there are broad similarities in institutions, going alongside the currency union. One of the shortcomings of the OCA approach is that there is an assumed similarity across countries in terms of competitive markets in which price and quantities adjust to 'shocks'. Considerations of institutional differences arose over questions of the transmission mechanism of monetary policy—the ways in which interest rate changes impacted on economic activity, how demand influenced price and wage inflation could be seen as dependent on institutional arrangements. The general inflationary climate depends on historical experience and expectations, the structure of the labour market, relationships between employers, employees and the State etc., and differences in inflation, unit labour costs and competitiveness are relevant for the evolution of a currency union.

There is indeed something of a paradox involved here. In the formation of a free trade area or customs union, the trade benefits, which are thereby generated, could be seen to depend on the differences between countries in that trade exploits differences in comparative advantage. Countries which were rather similar in the composition of production and in the relative costs of production between sectors/product would gain rather little from removal of trade barriers. In some contrast differences between countries, particularly with regard to institutional and political structures, the manner in ways in which markets operate, the levels of development and phases of the business cycle would detract from the operations of a single currency.

*European Central Bank and its policies*

The key player in a currency union is the Central Bank, and in the EMU the ECB was the only supra-national institution. The issues arising from the role of the ECB can be conveniently divided into three:

(i) The 'one size fits all' problem: the key policy instrument to be applied by the ECB is the policy interest rate, which has to apply across the whole of the currency union. This issue was exacerbated by the key role given to monetary policy (following the 'new consensus macroeconomics', Arestis and Sawyer, 2006). It was generally realised that this would mean that the interest rate would not be set at rates suitable for all, and that the impact of interest rate changes would differ across countries. This could be downplayed as a problem since it arises in all currency unions and there was the hope that there would be convergence between countries thereby reducing the degree to which the common interest rate did not suit each country and the degree to which interest rate had differential effects.

(ii) The ECB was constructed as an 'independent' central bank and 'price stability' (interpreted as inflation below 2 per cent per annum as the central and only objective of macroeconomic management. There was in effect no mention of other macroeconomic objectives such as high levels of employment, or of concern over financial stability. We have argued elsewhere (Arestis and Sawyer, 2006) that the 'independence' of central banks in general and the ECB in particular relates to their relationships with political institutions, and does not mean that it is ideologically independent. Indeed the ECB has persistently advocated policies of fiscal consolidation and labour market 'reforms' and generally promoted a neo-liberal agenda. We have also argued there that 'inflation targeting' has not been an effective way of controlling inflation, and indeed the ECB has generally missed its inflation target, albeit by relatively small margins. It is not surprising that the ECB could not address the differential inflation rates experienced by countries within EMU. In the context of monetary policy, this had the outcome that countries experiencing relatively high rates of inflation had low (and often negative) real rates of interest, whilst those with relatively low rates of inflation had high real rates of interest, which is perverse in the context of 'inflation targeting' approach whereby high real interest rates are intended to be used in the context of high inflation.

(iii) The ECB could, but is not required to, act as 'lender of last resort' to the banking system. A more problematic issue arose from the relations between a national government and the national central bank, and then by extension with the ECB and the European System of Central Banks (ESCB), and the absence of any Federal fiscal authority. The relationship between a government and its central bank is generally one whereby the central bank is the issuer of the currency, and the central bank can and will, whether directly or indirectly, be a purchaser of government debt. The



government debt is thereby monetised. Provided the central bank lends to a national government if required, then the government is always able to finance its deficit.

#### *Current account imbalances*

The Economic and Monetary Union came into being with countries experiencing different current account positions, and the differences in the current account positions have tended to increase (at least up to the financial crisis of 2008). Figure One provides a summary. Current account deficits have, of course, to be funded by borrowing on the capital account, and in the other direction current account surpluses involve capital account outflows. It is well-known that the EMU as a whole has been close to balance with regard to current account position, which implies that directly or indirectly the surplus countries within EMU are lending to the deficit countries within EMU. The single currency with its removal of exchange rate risk between member countries aided such flows, and many of the deficit countries were able to borrow at much lower rates of interest than they had previously experienced.

Figure One near here

The current account position is composed of the trade position and the net income flows, and amongst the latter interest (and similar) payments on borrowing is a particularly significant element. A current account deficit relative to GDP of  $a$ , would eventually lead to a debt (to GDP) ratio of  $a/g$ , where  $g$  is the nominal growth rate, and in that sense a current account deficit could be sustainable (provided there continues to be a willingness for foreigners to lend). But a trade deficit relative to GDP of  $b$  would lead to mounting borrowing from overseas and rising current account deficit (assuming that rate of interest on borrowing greater than the rate of growth). It would be the trade deficit which would feed into the 'balance of payments' constrained growth rate.

Whilst the efficacy of exchange rate adjustments in the correction of trade account deficits may be in question (through, for example, internal price responses offsetting the extent of devaluation leaving real exchange rate little changed, the low price elasticities of demand for imports and/or exports, the inability of supply to respond), the nominal exchange rate route is blocked out under a single currency.

#### *Stability and Growth Pact and fiscal policy*

The Stability and Growth Pact sought to impose a 3 per cent of GDP maximum budget deficit, a balanced or small surplus budget position over the cycle, and 60 per cent of GDP debt limit. The debt limit was widely breached; the balance over the cycle rarely achieved (or even calculated) and significant number of cases where 3 per cent limit was breached. The budget deficits of course, soared in the aftermath of the financial crisis, and after an initial acceptance of rising deficits as the workings of the automatic stabilisers, the policy thrust (under the Six Pack and the 'fiscal compact')

has been to re-assert the need for balanced budgets (now written as balanced structural budget) and to tough up on legal requirements and sanctions. We have argued that the structural budget is ill-defined, and that the achievement of a balanced budget at a high level of economic activity may well not be possible. We have pointed to the deflationary nature of a balanced budget proposal, and to the 'one size fits all' problem which comes from the imposition of a common fiscal policy aimed at a balanced budget (Sawyer, 2013). The main point is that the financial crisis and the associated recession were not in any sense caused by or exacerbated by the scale of budget deficits and the non-fulfilment of the SGP requirements. It is rather that budget deficits were the accounting counter-part of net private savings minus investment and the current account position. The national income accounting identity provides the relationship:

$$(1) \quad G - T = S - I + M - X = S - I + FA$$

(G government expenditure, T tax revenues, S private savings, I private investment, M imports and X exports and net income flow, and FA capital account surplus = current account deficit).

The imposition of a common budget position would require that the right hand side of equation (1) is similar across countries. The large differences in the current account position across countries poses difficulties for the achievement of similar budget positions.

The EMU itself has not adopted policies which may be described as supply-side policies on labour markets, industrial policy etc., but supply-side policies are a combination of national policies and EU policies. However, there are frequent calls from the ECB and others for the adoptions of 'structural reforms' and this becomes embedded in the 'fiscal compact'. The general thrust of EU policies on labour and product market could well be described as in the neo-liberal direction in terms of privatisation, liberalisation and de-regulation, but a single slogan cannot be used to summarise the complexities and diversities of the policies. The EU policies are also implemented (or not) through a range of modes of co-ordination from central imposition of policies through to the open method of co-ordination.

#### *The fiscal compact*

The remedy to the Eurozone crisis which is currently being brought into force is embodied in the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (European Union, 2012) (hereafter referred to as the Treaty) of which the 'fiscal compact' is the central part, and the associated so-called 'six pack' of policy measures. The essential features of the 'fiscal compact' are:

(i) The imposition of a 'structural budget deficit' rule such that that notion of budget deficit does not exceed 0.5 per cent of GDP.

(ii) A stricter policy imposed on countries with debt ratio exceeding 60 per cent of GDP. The Treaty (following the Six Pack) makes it 'possible to open an EDP [excessive deficit procedure] on the basis of the debt criterion. Member States with government debt ratios in excess of 60% of GDP should reduce this ratio in line with a numerical benchmark, which implies a decline of the amount by which their debt exceeds the threshold at a rate in the order of 1/20th per year over three years. If they do not, they could be placed in EDP depending on the assessment of all relevant factors and taking in particular into account the influence of the cycle on the pace of debt reduction.' (Article 4).

(iii) The deficit requirement is to be written into a country's national constitution or equivalent. The 'fiscal compact' could be viewed as a development of the Stability and Growth Pact in which the intention to balance the budget deficit over the cycle is superseded with a balanced structural deficit rule, with the addition of the stricter policy rule as under (ii).

The writing of requirements on the achievement of a structural balanced budget into the national constitution or equivalent has two points of significance. First, it embeds economic policy into the constitution whereas ideas on appropriate economic policy are not unchanging over time. It seems a folly to incorporate ideas what some, but no means all, think are appropriate policies into a document which is difficult to change, especially when those ideas are mistaken. It can also be seen as an attempt to tie the hands of the electorate and future governments on economic policies – what is the point of a party presenting a manifesto committed to raising public expenditure when the constitutional court would rule the implementation of such a commitment illegal.

Second, the implementation of a balanced structural budget requirement will be made difficult by disputes over the measurement of the structural budget position. The implementation of a requirement that there be a balanced annual budget (as is the case with the European Union itself) does not face such difficulty as the annual budget outcome can be readily measured, though it is the *ex post* annual budget, which can be measured but not the *ex ante* budget. The structural budget is 'structural' public expenditure (that is some 'normal' level of expenditure excluding any one-off forms of expenditure) less the tax revenues, which would be generated from the 'normal' set of tax rates when the economy operates at some 'average' level (which will be described as 'potential output' in line with the literature). Each of the elements of the structural budget is a matter of estimates and dispute, and notably what constitutes 'potential output'.

We have pointed elsewhere (Sawyer, 2013) to the ambiguities of the notion of structural budget deficit, and the degree to which interpretation of whether a country meets its structural deficit requirements is in effect left in the hands of economic forecasters. We have also argued that a structural balanced budget may be impossible to achieve, as it not only requires that the budget would be balanced at a high level of employment but also that there would be equality between

investment and savings (including foreign savings) which can be seen from equation (1) – if the right hand side equals zero for a high level of economic activity (e.g. when the output gap is zero) then the left hand side would also have to equal zero at the same level of economic activity.

### **An alternative set of policy frameworks for EMU**

In the rest of the paper the main question addressed relates to the nature of economic policies, institutional arrangements etc. could underpin a successful and prosperous Eurozone<sup>6</sup>. It will be self-evident that the proposals sketched below are far from being politically feasible. The Treaty of Lisbon and requirements for changes being agreed on a unanimous basis forms one major obstacle. The economic philosophy which lies behind these proposals (broadly post Keynesian if a name is needed) clashes with the neo-liberal agenda (with regard to both micro-economic and macro-economic policies) which is embedded into the European institutions and the thinking of the major (and minor) players. It would also involve considerable fiscal transfers between regions and countries. It is though our general belief that the present EMU structures will fail – in the sense that the ‘fiscal compact’ will turn out to be unworkable (Sawyer, 2013) and that those countries suffering current account deficits will not be able to restore anything like prosperity.

### **Budgets and fiscal policies**

We have argued that fiscal policy can play a major role in the stabilisation and achievement of high levels of economic activity. Two major issues here. First, what should the nature of fiscal policy be? And second what should the role of a EMU-level Federal budgetary and fiscal policy be?

There should be two basic principles underlying the approach to fiscal policy within EMU. First, the fiscal stance should be set to enhance the levels of output and employment, and not set in order to achieve some arbitrary balanced budget target (which anyway is likely to be unachievable). This applies to national and supra national fiscal policies though it is only the former which in operation at present. This will likely imply that not only should fiscal policy through augmented automatic stabilisers seek to dampen down economic fluctuations, but also that budget deficits will often be required on a long-term basis. For those countries where there is a tendency for savings to exceed investment, there will be a need for budget deficits to secure high levels of employment.

Second, there should not be any attempt to impose a ‘one size fits all’ fiscal policy on national government in the sense of imposing the same numerical limits on the scale of budget deficits (where a zero limit or any other). The fiscal policy and resulting budget position should be tailored to the requirements of the country concerned: some countries will require budget deficits whereas others may be able to operate successfully with budget surpluses. It is also evident from above that the current account positions vary substantially across countries, and the accounting identity in

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<sup>6</sup> In doing so, we return to a theme, which was set out in Arestis, McCauley and Sawyer (2001), under the heading of An Alternative Stability and Growth Pact for Europe.

equation (1) above indicates the likelihood that differences in current account positions will to some degree be reflected in differences in the budget position.

There has long been the need for the development of an EMU-level fiscal policy with the scale of the EMU budget very much larger than the current EU budget (of just over 1 per cent of EU GDP, and with a requirement to be balanced). A significant question here is whether EMU or the EU itself would operate the larger scale budget. The EMU would be able to run budget deficits (or surpluses) to support the level of economic activity within the EMU. The important features of such a fiscal union would be tax raising powers, undertaking public expenditure and ability to run budget deficits (or surpluses) as required for stabilisation purposes. Further it would require the support of the ECB in the operation of fiscal policy and willingness to buy where the bonds issued by that Federal authority. This form of fiscal union is very different from what is currently being discussed within EMU which would be no more than the attempted imposition of balanced budgets.

An EMU-level fiscal policy should be used for stabilisation purposes for the euroarea as a whole. A progressive tax system applied across the euroarea would serve to operate as an automatic stabiliser. Further, an EMU-level fiscal policy would also cushion a region (or country) against economic shocks which hit the region (or country). An income tax system, which is proportional or progressive, will involve more tax revenue (per capita) being raised in higher income regions than would be raised in lower income regions. The degree to which fiscal transfers between countries are involved would depend on the progressivity of the tax system and the structure of public expenditure undertaken from the EMU-level budget. These fiscal transfers would serve to redistribute spending power, and could go somewhere to easing current account imbalances. An EMU-level fiscal policy must involve the ability of EMU to levy taxes in its own right to help underpin borrowing by EMU. The relationship between EMU as a fiscal authority and the ECB as the central bank would be comparable to that between a national government and its central bank in terms of the support which the central bank can provide to fiscal policy and the ability of government to borrow.

There would remain for the foreseeable future a role for national fiscal policies where there would be a good case for co-ordination of those policies around the objective of securing high levels of employment. There should be requirements that the ECB provides support for national fiscal policies, rather than continual calls for fiscal consolidation, through their operations (e.g. standing ready to always purchase debt of national governments).

### **Monetary and financial policies**

There is the need to recognize that there is in effect a shift from monetary policy to credit and financial policies on the part of central banks. The inflation targeting regime was based on some

general notion that money influenced the pace of price change. Such a regime was not notably successful on its own terms, but more seriously did not address issues of credit booms and financial instability. The objectives of the ECB and its relationship with national and other European institutions in which the arguments developed will be for a non-independent central bank whose policy decisions are co-ordinated with others; and where the focus of the ECB's activities relate to financial stability.

The first is to end the independence of the ECB and to integrate the ECB into a set of democratic policy making procedures. The ECB would retain charge of operational matters such as the implementation of interest rate decisions but would co-ordinate its decisions with other monetary and fiscal authorities. The integration of ECB into the policy-making arrangements would enable policy co-ordination which should lead to more effective policy making. The 'independence' of the ECB would appear to preclude co-operation and co-ordination between the different bodies responsible for aspects of macroeconomic policies. Yet, in a world of multiple objectives (including high levels of economic activity and employment, financial stability, inflation etc.) there is a need for multiple instruments, which are operated by different authorities, and where there should be serious co-ordination.

The second arises from the dominance of inflation targeting as the prime policy objective. The ECB has not generally achieved the price stability target albeit that the inflation rate has tended to be just over 2 per cent. A more significant issue has been the differential inflation rates between countries and the inability of monetary policy to address those differences in inflation rate. Monetary policy has had a perverse effect in that with a single policy nominal interest rate leads to lower real interest rates in higher inflation countries – exactly the reverse of the way in which inflation targeting is intended to work whereby real interest rate is high when inflation is high with the intention of damping down demand.

The pursuit of financial stability should become the prime objective of the ECB (and other central banks). This argument is based, in part, on the relative frequency of financial instability and the significant costs associated with financial crisis, which are several orders of magnitude greater than any costs of inflation. The instruments of policy have to be further developed. The key argument here though is that the pursuit of financial stability should become the prime focus of the ECB.

Third, the relationships between the ECB and national governments (and other fiscal authorities which may be developed) have to become akin to that between national central banks and the central government in most countries. The ECB should on all occasions stand ready to operate as 'lender of last resort'. It should always accept the bonds and bills issued by national governments (within EMU) as part of open market operations in the way in which a national central bank would

always accept the bonds of its government. It should also stand ready to directly lend to national governments (in exchange for bonds in euros of that government) if required. The general proposition is that the ECB should support the fiscal policies determined by EMU national governments, whether or not those policies involve deficits of which the ECB disapproves.

Fourth, the regulation of the banking industry and the financial sector should clearly lie with an EMU level body. The present arrangements for regulation may point in the direction of the ECB as that body, but that raises issues of the power of a single body, particularly if that body is 'independent' in a political if not ideological sense.

A single currency seeks to foster full economic integration between member countries, and in the context of the Economic and Monetary Union to build further on the creation of the 'single market'. Integration particularly involves monetary and financial integration. The nature of the relationship between the central authorities (including the central bank) and the banking system inevitably arise even though it was largely ignored at the time of the establishment of the euro. Two sets of issues stand out, which have to some degree been addressed by proposals for 'banking union'<sup>7</sup>. The first relates to the regulation of the financial and banking systems. The second concerns responsibilities for the stability of the banking system, and specifically responsibility for dealing with 'failing banks' including the provision of bail-outs.

### **Inflation**

There is no current policy to address inflation differentials, and the current monetary policy makes it worse (by there being low if not negative (high) real rates of interest in countries with high (low) inflation rate. There is a need for a co-ordinated approach and common inflation target to be addressed by national policies. This would not be 'inflation targeting' if that term is understood to mean an inflation objective pursued by an independent central bank through interest rates, but rather a co-ordinated attempt by the member states of EMU to use their own national policies to achieve a common rate of inflation to avoid the inflation differences. This could take form of using fiscal policy to vary demand – not to be recommended but possible. This could take form of national agreements on incomes etc. What has to be avoided is competitive devaluation of real exchange rate (between EMU member countries) achieved through hyper-low inflation.

### **Current account imbalances**

A currency union effectively is a fixed nominal exchange rate regime which precludes nominal devaluation as a route to resolving current account imbalances. The current account position for any geographical area, even though often not calculated, has to become sustainable, and a trade deficit threatens to lead to an unsustainable current account deficit [put in algebra]. There are many routes

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<sup>7</sup> See, for example, European Commission (2012b)

through which an initial trade deficit can be accommodated – internal deflation, lower price and wage inflation generating a real exchange rate depreciation, migration, the operations of a tax system, regional policies etc (in so far as there is a correlation between trade deficits and income levels). Capital inflows into productive investment which underpins exports can also help.

The return to prosperity within the EMU in a way which includes all countries and regions requires that the current account imbalances be resolved. The move towards a sustainable pattern of current account positions would involve some form of effective devaluation and revaluation within the EMU, even if there is scepticism over the effectiveness of devaluation in addressing a current account deficit, not to mention the costs and difficulties in securing such devaluation through internal deflation. Since in the context of EMU having an overall current account position close to balance one country's surplus is another country's deficit a further requirement would be a degree of agreement on the pattern of current account positions.

The differential trends in prices and competitiveness must raise the question of how those differentials are to be addressed. The previous approach has been that in a single currency, single market there will be competitive and other pressures which would underpin similar trends in prices, and there would be endogenous convergence on a common rate of inflation. The experience of the 2000s suggests that has not yet occurred, and the need for forms of wage and price co-ordination at the EMU level.

### **Supply-side policies**

Most of the issues with regard to supply-side policies (under which heading we would include industrial and competition policies, research, development, technology as well as labour market and employment policies) arise from the European 'single market' rather than the single currency *per se*. Any development of supply-side policies (including the co-ordination of policies across countries as well as those centrally implemented) would inevitably raise deep problematic issues of the relationships between EMU members and the other members of the European Union. What may be termed industrial policies (including competition policy and technology/research and development policies) have been to date conducted at the EU level (as in the case of competition policy), and at the national level within parameters set by the European Commission (as in the case of State Aid). There has been a general thrust in the direction of liberalisation and de-regulation with particular focus on the public utilities. From the perspective of this paper, it is significant that up to the present there have not been EMU level industrial policies. A significant feature of the 'fiscal compact' and *Treaty* is the role given to 'structural reforms' (for which read de-regulation, liberalisation and privatisation) and the associated view that there is 'best practice' and the suitability of a single set of policy measures on labour and product markets. The starting point for an alternative framework



would be dropping the general presumption of the superiority of neo-liberal policies. Whilst in some areas of policies, the nature of a single market strongly points in the direction of a single Federal level policy – competition policy springs to mind, there are others where there are not the same constraints. The argument presented here is that in general there should not be attempts to impose a single framework on all member countries but rather that the industrial and other supply-side policies should be determined by individual countries.

The single currency obviously imposes the ultimate in a fixed exchange rate regime, and the supply-side policies have to take cognisance of that. In the area of labour market policies, this would suggest (as above) a degree of co-ordination across countries with regard to wage and price increases. The major differences between nations in the institutional arrangements and historical experience suggest that attempts to impose a common set of policies is inappropriate and liable to fail, but that it cannot be left to ‘market forces’ to iron out inflation and competitiveness differentials. The current account imbalances within the EMU have been the major source of economic difficulties, and have to be addressed through co-ordinated approach to supply-side issues. First, there should be a requirement to co-ordinate prices and wages policies between countries to seek to address the differential developments in competitiveness which have been evident. This could also enable the development of more general counter-inflationary policies in light of the relative failures to achieve inflation targets, and (as argued above) the re-assignment of the objectives of the ECB to financial stability rather than inflation. Second, there should also be developed what may be termed regional and industrial policies at the EMU level to address the differences in competitiveness between countries and to enable a resolution of the current account imbalances through capacity construction in deficit countries.

### **Concluding remarks**

The euroarea faces an existential crisis. The present responses to that crisis are a combination of ‘fire fighting’ of sovereign debt and banking crisis and seeking to put in place long-term structures (in the form of the *Treaty on Stability, Coordination and Governance in the Economic and Monetary Union*, European Union, 2012) for the future operation of the EMU. The problem is that the tightened fiscal compact imposes an unachievable balanced budget proposal, seeks to impose a ‘structural reform’ programme and does nothing to resolve the current account imbalances.

The resolution of the euroarea crises, whether along the lines sketched in the previous section or those indicated in European Commission (2012b) under the title of a ‘blueprint for a deep and genuine economic and monetary union’, appears to involve considerable elements of *de facto* political union – the development of fiscal policies, the co-ordination of price and wage policies, the mutual correction of current account imbalances, banking union (see Arestis and Sawyer, 2013 for

further discussion). The emergence of *de facto* political union must also be addressed through the development of democratic structures in parallel.

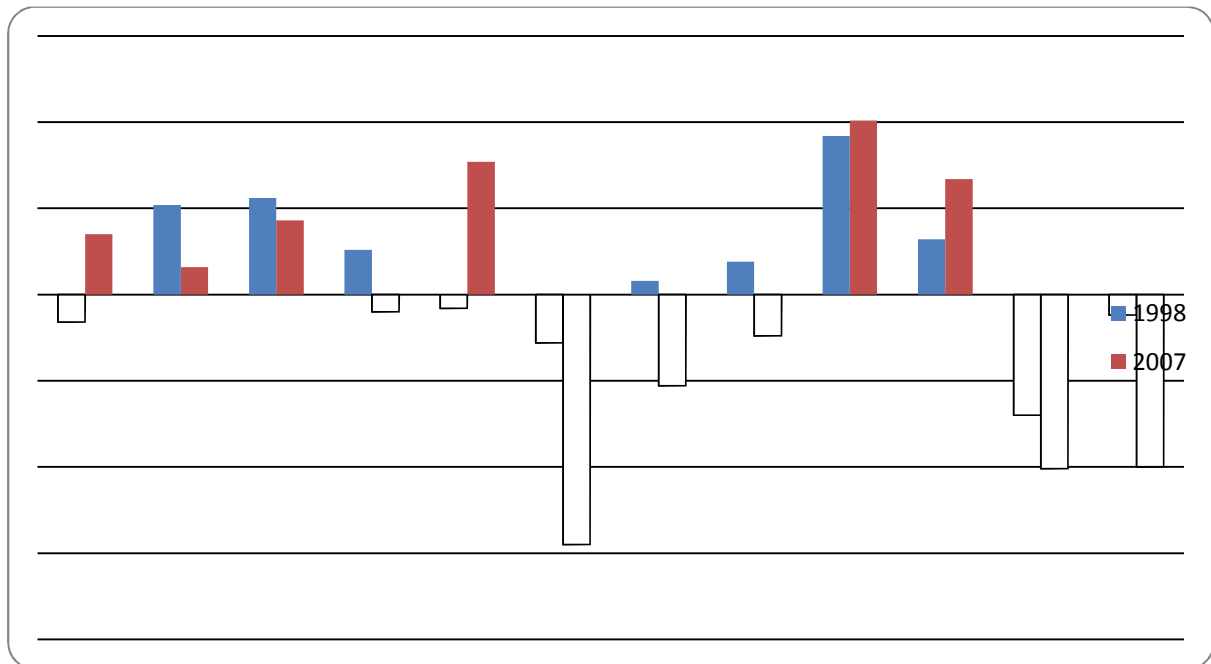
This paper has not attempted to address the immediate problems of the euroarea. Instead we have sought to sketch the elements of an alternative direction of travel, and to think about what would be the policy and institutional arrangements which would be supportive of a single currency area and economic prosperity within that area.

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Figure One **Current account position as per cent of GDP for eurozone countries (original 12 members)**



**Source:** Figures derived from **OECD**, *Economic Outlook*, December 2011