Should economic policies be co-ordinated for EMU?

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The countries participating in Economic and Monetary Union (EMU) must continue to concentrate their action on two essential fronts: the consolidation of public finances and, above all, the reduction of the high rate of unemployment. There may be a case for some co-ordination of policies on these matters, provided price stability is maintained.

In the years ahead, macro-economic policy in the euro area will be subject to several constraints. For a start, any exchange rate flexibility within the area is obviously ruled out and countries will no longer be able to conduct an independent monetary policy. Furthermore, even though all the participating countries have made substantial progress in cutting their public deficits, they cannot afford to let up on their efforts if they are to meet the requirements of the Stability and Growth Pact as defined in the Maastricht Treaty (see box, p. 5). To judge by previous recessions, it is estimated that in order to be sure of keeping the budget deficit below 3% of GDP, an average deficit of the order of 0.5-1% of GDP will have to be aimed for over the cycle. Such a low level would also make it possible to achieve a substantial reduction in GDP/debt ratios.

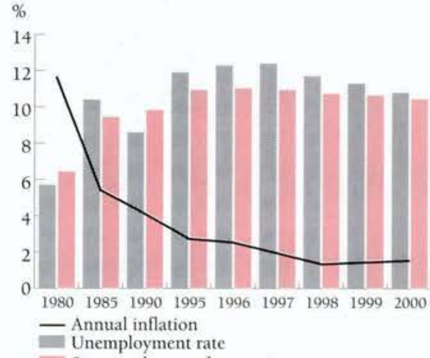
Quite apart from these considerations, it will be important to maintain, and even strengthen, fiscal discipline in the euro area, since fairly soon – probably towards 2005 – demographic pressures will begin to weigh very heavily on the budgets of member states, particularly on funding for pensions, health care and long-term assistance.

But the biggest challenge facing policy-makers in the EMU area in the coming years will be unemployment: about 12% of the area's labour force is currently jobless. Most of this unemployment is structural; according to OECD estimates, the structural component of unemployment in EMU's three main countries – Germany, France and Italy – is on average about 10%. The average actual unemployment rate for the three is also close to 12%, which makes the cyclical component of unemployment very small. In other words, even with a recovery, getting the unemployment rate below 10% by deliberately expanding aggregate demand would, at present output potential, lead to higher inflation.

Structural reforms first

Attacking structural unemployment *via* supply-side reforms is probably the best way forward if inflation is to be avoided. A significant reduction in the structural unemployment rate would substantially improve general government financial balances. And the resulting improvement in fiscal positions as well as in supply conditions would in turn allow more leeway in fiscal policy without the risk of inflation. The upshot would be large gains in employment.

Unemployment and prices
1980–2000



Source: OECD

While there is scope on the supply side for improving the employment situation, room on the demand side is still fairly limited. One reason is that product markets have to be improved anyway to raise the level of potential output and labour market rigidities have to be reduced, otherwise demand-side policies might not succeed. Moreover, euro area countries do not at present have the choice of simply adopting active counter-cyclical measures.

Given the scale of the unemployment problem, it may be legitimate to ask whether governments could not envisage a fiscal expansion, even at the price of a rise in inflation. But such a course of action would be problematic, for two reasons. First, it would run counter to the core aim of EMU which is to achieve price stability; second, without price stability, it is highly unlikely that any job gains could be sustained in the medium term. The widespread stagflation (high inflation coupled with low growth) that followed the two oil shocks bears this out.

Market expectations will undoubtedly be influenced by the policies of the new European Central Bank (ECB), the European System of Central Banks in general and the signals the monetary authorities send out. These expectations will have a positive effect on economic developments if monetary policy is seen to be credible. It would thus be very ill-advised on the part of the new central bank to set leading interest rates at a level so low as to be incompatible with price stability.

This does not rule out the possibility of a reduction in interest rates if demand conditions worsen at current low inflation levels. However, even assuming that an expansionary macroeconomic policy resulted in only a limited rise in inflation – thanks to tight wage agreements, for example – a sharp reduction in unemployment below its structural level would be possible only if the three main economies in the euro zone grew at a rate well above their current potential rate over several years. And even this somewhat inflationary approach would not cut unemployment to below 8% in the medium term. Furthermore, it would result in a sharp deterioration in government finances and external balances.

In short, to embark upon expansionary policies without first having carried out the structural reforms needed to improve supply conditions, would be to risk re-igniting inflation and increasing public deficits before there were any positive effects on the level of unemployment. Of course, it may be asked whether European economies would not benefit from increased investment in infrastructure, since that would encourage growth in ailing regions in which high, long-term unemployment is concentrated. But it would still be important to ensure that such investment triggered a genuinely endogenous development process, and unfortunately past experience contains few successful examples of this.

The case for co-ordination

The question of whether policy co-ordination between EMU participants should be increased to achieve fiscal targets and reduce unemployment is an interesting one. The theory of fiscal federalism clearly shows that decisions regarding expenditure and regulation should preferably be taken by each country, except for secondary effects of economies of scale and where there are shared policy priorities and responsibilities. It is only when tax bases are very mobile that decisions need to be taken at a higher level. However, when, as in the case of EMU, transitional, regional and asymmetrical shocks have to be dealt with, there are a number of arguments in favour of co-ordinating fiscal policies. For example, the mechanism for transmitting monetary policy may vary from country to country, leading to short-term divergences; a co-ordinated fiscal policy may then be the only economic policy instrument available for ensuring that growth remains close to its potential rate throughout the euro area. In line with the basic principle of insurance, a large number of countries can better absorb asymmetrical risks together than individually.

It is also probable that fiscal co-ordination or transfers will need to be envisaged to deal with asymmetrical shocks affecting only certain regions of the sovereign nations participating in EMU. That said, in practice EMU will not alter the nature of the problem. More specifically, it is quite improbable that a shock affecting one country would not affect the others; conversely, if the shock is really asymmetrical, it will only affect certain industries or regions, though across several countries. In the latter case, exchange rate policy being ruled out as a remedy, the best response would be, as always, to make labour, capital and product markets more flexible. The second option would be to use fiscal policy either to pool risks or for redistribution. If there were any secondary effects or externalities, there might then be a case for co-ordinating intervention.

However, even in existing federations like Canada or the United States, the empirical evidence of the stabilising effects at regional level is hardly conclusive, and it has to be borne in mind that the national budgets in the euro area are often much larger than those of sub-national levels of government in these federations. Furthermore, automatic stabilisers have large effects, even in small countries, and the power to tax remains considerable. Moreover, Austria and the Netherlands have been pegging their currencies to the Deutschmark for several years without any formal policy co-ordination or fiscal transfers, and these countries have even performed better than many other countries. In fact, it could be argued that these currency pegs had a disciplining effect on economic behaviour, thereby reducing the need for co-ordination. The euro countries were subject to similar discipline in the run-up to EMU and we may yet see new important changes being encouraged through the existence of the euro, particularly in labour and product market flexibility.

Two important remarks are called for regarding the possibility of macroeconomic co-ordination in the euro

Early confidence justified?

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area. First, the euro area will be the only region in the world combining a common monetary policy with fiscal policies operated by individual countries. The policy mix in EMU will therefore have a crucial impact on exchange rate fluctuations between the euro and the other main currencies. These fluctuations will act as a stabiliser when the policy mix is unbalanced, but large swings in currency values can lead to unhelpful financial turbulence in currency markets, as well as having adverse cyclical effects and perhaps giving rise to renewed protectionist pressures. To avoid these risks, co-ordination may be needed not only within the euro area, but also between it and the other major economies.

The second remark is that a co-ordinating body would be useful to ensure that the ECB is not subjected to unwarranted and dangerous pressures. Given the independence of this institution and the absence of political union, it is liable to become a scapegoat for most of the economic problems that arise in the EMU countries. If the bank was ever seen to give into such pressure, its credibility would be damaged. Moreover, policy reforms that were costly in the short term or just politically difficult, but which addressed the true causes of the problem, could be put off. A rapid and transparent discussion between the monetary authorities and the euro area's governments on policy mix, while preserving the independence of the ECB, would be a very valuable step in the co-ordination process.

The most important task, however, remains that of removing the structural obstacles to employment growth and the reduction of joblessness in the euro area. It is above all with this in mind that economic policy should be co-ordinated. Closer integration of product markets and more labour mobility will enable wage and price formation to adjust more quickly to changing circumstances in the euro area. Participating countries should therefore assure an open policy towards employing workers coming from other EMU countries. To achieve a lasting reduction in unemployment, real wages should be allowed to adjust to the productivity level in each region. Wage agreements and overall industrial relations will thus play a crucial role. And as part of the job of cutting structural (and in particular long-term) unemployment, lay-offs in declining sectors should be accompanied by measures to facilitate re-employment in expanding sectors and enterprises.

Policies to reduce structural unemployment should be set within an overall strategy, as proposed by the OECD in its Employment Strategy, which comprised a detailed set of recommendations for each country. It is worth pointing out that changes in structural policy can themselves lead to asymmetrical shocks, which some countries may have difficulty coping with. If a country embarks on reforms to reduce its structural unemployment, it is essential that the resources made available thanks to those reforms be mobilised quickly to raise potential output. In other words, structural reforms should be given every chance of working. That too is a good argument for co-ordinating structural policy in the euro area. Only then would there be a strong case for co-ordinating fiscal policy, on condition that price stability is maintained. ■

The Stability and Growth Pact

The European Union's Stability and Growth Pact, finalised at the Amsterdam Summit in June 1997, clarifies the Maastricht Treaty's provision for dealing with 'excessive deficits' and provides an institutional framework for its enforcement with, in particular, strengthened surveillance and co-ordination of economic policies via the annual review of national programmes.

For countries participating in EMU, the Pact considers a general government deficit of more than 3% as excessive unless the European Community judges it to be temporary or there are exceptional circumstances. If the deficit is considered to be temporary and corrective measures have not been implemented within ten months, sanctions will be imposed.

When a country is deemed to be in recession, which is defined as an annual fall in real output (GDP) of at least 0.75%, the Pact will be enforced in a differentiated manner. If a member country's GDP declines by 2% or more – and provided that the deficit is temporary – an exemption from the procedure is granted automatically. If the decline in GDP is between 0.75% and 2%, exemption can be granted in exceptional circumstances by the Council of Ministers if the economic slowdown is judged to be 'exceptional' in its abruptness or in relation to past experience.

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