12 The operation of EMU

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12.1 Introduction

The EU's European monetary union (EMU) has four broad ingredients: the euro and the single European monetary policy (SMP); the coordination of European macroeconomic policies through the Stability and Growth Pact (SGP), the Broad Economic Policy Guidelines (BEPG) and related processes; the completion of the Single European Market (SEM); and the operation of the structural funds and other cohesion measures. This chapter will consider only the first two, as the others are dealt with in Chapters 7, 11, 12 and 19.

Although the euro did not come into existence until 1 January 1999, and then only in financial markets, most of the characteristics of stage 3 of EMU (Chapter 11) were operating once the European Central Bank (ECB) opened in June 1998. The ECB, in the form of the European Monetary Institute (EMI), had been preparing for the day with all EU national central banks (NCBs) since 1994. The form of the coming SMP was already known by 1998, in both framework and instruments. In the same way, much of the framework for the operation of the economic coordination among the member states (MSs) had been developed with the SGP of July 1997 and BEPG commencement in 1998. The generalized framework was incorporated in the Treaty of Amsterdam (October 1997). There was thus no great break in behaviour at the beginning of 1999, especially since the main qualification period under the Treaty on European Union (TEU) convergence criteria had related to 1997. However, the SGP effectively broke down in 2003 and had to be revised in 2005 after a period of debate.

In what follows we begin by looking at the provisions for the SMP, then consider those for policy coordination, before we explore how they have worked. EMU weathered the global financial crisis quite well until 2010, when problems for the most exposed states, particularly Greece, followed by Ireland and then Portugal, imposed strains on the whole system and prompted extraordinary measures.

12.2 The Eurosystem and the euro

The institutional system behind the SMP is quite complex because it has to deal with the fact that some EU MSs are not (yet) participants in stage 3 of EMU. The TEU sets up the European System of Central Banks (ESCB), which is composed of all the national central banks and the ECB, which is sited in Frankfurt. The ECB and the participating NCBs form the Eurosystem, which is what is running the monetary side of the Eurozone. The term 'Eurosystem' has, however, only been coined by its members in order to make the set-up clearer; it is not in the TEU. The body responsible for the ECB and its decisions is the Governing Council, which is composed of the governors of the NCBs and the six members of the Executive Board, who provide the executive management of the ECB. The Executive Board is composed of the president and vice-president and four other members, responsible for the various parts of the ECB, which are labelled Directorates General in the same manner as the Commission. If that were not enough, the ECB also has a General Council, which is composed of the president, vice-president and the governors of *all* EU NCBs, whether participating in the Eurozone or not. Thus the General Council has twenty-nine members, including Bulgaria and Romania (twenty-seven governors + two), but the Governing Council has twenty-three members (seventeen governors + six) since Slovenia joined at the beginning of 2007, Cyprus and Malta in 2008, Slovakia in 2009 and Estonia in 2011, and it will increase in size as more MSs join the Eurozone.[1] A representative from the Commission and the presidency may also attend, but may not vote. Figure 12.1 may help to clarify the structure.

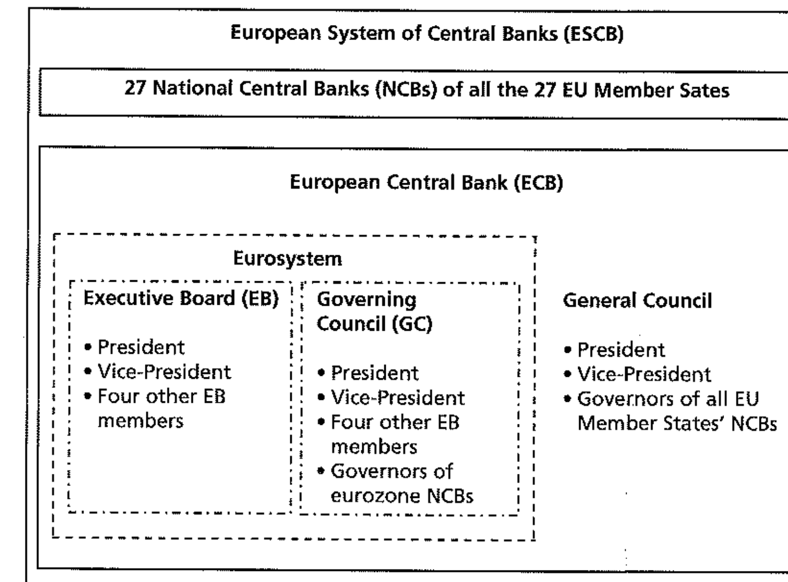

Figure 12.1 Structure of the European System of Central Banks *Source*: adapted from the ECB's website

The Eurosystem is relatively decentralized compared to the USA's Federal Reserve System, although the names for the various institutions imply the opposite relative structures. The central institution in the USA, the Board of Governors of the Federal Reserve System, which is the controlling body, having powers over the budgets of the twelve Federal Reserve Banks, does not have another label for its staff and administrative operations. The seven governors of the Federal Reserve Board hold a voting majority on the monetary policy-making body, the Federal Open Market Committee (FOMC), where only the president of the New York Fed and four of the presidents of the other Fed Banks, by rotation, are voting members (although all are present at each meeting and can speak).[2]

The Eurosystem, on the other hand, operates through a network of committees, where each NCB and the ECB has a member.[3] The ECB normally provides the chairman and the secretariat. It is the Governing Council that takes the decisions, but the Executive Board coordinates the work of the committees and prepares the agenda for the Governing Council. Many of these committees meet in two compositions, one for the Eurosystem and one for the whole ESCB, depending on the subject.

To complete the confusion over labels, the Eurosystem has a Monetary Policy Committee, but, unlike the UK and many other central banks around the world, this is not the decision-making body on monetary policy. It organizes and discusses the main evidence and discussion papers to be put before the Governing Council on monetary matters.

There are, however, some key characteristics of this structure and other elements of the institutional set-up of the Eurosystem that have important implications for policy. As the Delors Committee (see Chapter 11), which designed the set-up for the Eurosystem, was composed almost entirely of central bank governors, it is not surprising that it is very well adjusted to the current views about the needs of monetary policy. First of all, although the TEU sets down the objective of monetary policy (maintaining price stability) – in general terms – the Eurosystem has a high degree of independence from political influence in exercising responsibility. Not only is the taking or seeking of advice explicitly prohibited, but Governing Council members are protected in a number of ways in order to shield them from interest group pressures. First, they have long terms of office – eight years in the case of the Executive Board – but these are not renewable, so they are less likely to have any regard for the prospects for their next job while setting monetary policy.

Second, the proceedings are secret, so that people cannot find out how they voted. Each member is supposed to act purely in a personal capacity and solely with the aims of price stability at the Eurozone level in mind, without regard to national interests. No system can ensure this, but a well-designed one substantially increases the chance of this happening. More importantly, it can reduce any belief that the members will act with national or other interests in mind. Third, the Eurosystem is explicitly prohibited from 'monetizing' government deficits.[4]

The point of trying to achieve this independence is simply credibility – to try to maximize the belief that the Eurosystem will actually do just what it has been asked to do – namely, maintain price stability. The stronger that belief can be, the less costly monetary policy will be. If people do not believe that the ECB will be successful, they will base their behaviour on that belief. Hence price- and wage-setters who believe that there will be increases in inflation substantially beyond what the ECB says it will deliver will set their prices with that higher outcome in mind. That means that the ECB then has to struggle against that belief, thereby entailing high interest rates. Thus, even though the ECB may intend exactly the same outcomes in both cases, it does not have to run such high interest rates to achieve them if it is credible.

This credibility comes from other sources as well as independence. The structure of the Governing Council is strongly reminiscent of that of the Bundesbank. The Bundesbank was highly successful in maintaining low inflation. By having a similar structure (probably assisted by the Frankfurt location just a few kilometres down the road), the Eurosystem has been able to 'borrow' much of the Bundesbank's credibility.

12.2.1 The monetary policy of the Eurosystem

The Eurosystem is further assisted in the inherent credibility of its policy by having a single, simple objective of price stability laid down by the TEU. If a central bank has multiple objectives, it will have difficulty explaining the balance between them, especially when they conflict. There was, for example, a short period of confusion at the outset over exchange rate policy, as the Eurosystem is not responsible for the regime, only the execution. However, it rapidly became clear that since exchange rate policy and the objective of monetary policy are inextricably linked, one of the two must have primacy, and ministers made it clear that it was price stability that was the driving force. The other common objectives for a central bank of maximizing employment and the rate of economic growth – in this case expressed as 'without prejudice to the objective of price stability . . . [the] ESCB shall support the general economic [EU] policies' – are clearly subservient.

However, for monetary policy to be credible it is necessary that the objective should be clear enough for people to act on and that the central bank's behaviour in trying to achieve that objective should be both observable and understandable as a feasible approach to success. Here the ECB had to define the objective, since the TEU's concept of price stability is far too vague to be workable. They opted for inflation over the medium term of less than 2 per cent. They also defined the inflation they were talking about as that in the harmonized index of consumer prices (HICP). After a swift clarification that this meant that zero inflation was the lower bound, the specification was widely criticized for being too inexact (compared with other central banks). Not only is the length of the medium term not spelt out, but it is not clear how much and for how long prices can deviate from the target. Nor is there any indication of how fast inflation should be brought back to the target after a shock hits. In 2003 the target was reappraised and 'clarified' as being 'less than but close to 2 per cent'.

This means that a range of policy settings would be consistent with such a target. Policy is thus inherently not very predictable – something the Governing Council has sought to offset by trying to give clear signals about interest rate changes. Despite the inevitably diffused structure of decision-making with eighteen (now twenty-three) independent decision-makers, the Eurosystem has come to offer a single explanation of how it regards the working of the economy and the appropriate response to it. One facet of Eurosystem strategy that came in for criticism was what is known as the 'two pillars' approach. Rather than adhering to any specific model or suite of models, the Eurosystem announced that it would base its decisions on a wide range of indicators under two pillars. The first of these assigned a prominent role to money and has included a 'reference value' for the growth of broad money (M3).

The second was a broadly based assessment of the outlook for price developments. In the 2003 reappraisal it was made clear that the monetary pillar was assigned a medium-term role and acted as a cross-check on the broad-based assessment that underpins policy decisions. While some controversy remains, this brings Eurosystem policy more into line with thinking in other central banks. If anything, the problems of the global financial crisis have stimulated new interest in the monetary pillar.

Assigning money such an important role by at least some of the members of the Governing Council was inevitable, given that this was the Bundesbank's policy, as well as that of some other successful predecessor NCBs. The particular reference value of 4.5 per cent growth (based on the sum of the expected medium-term inflation of around 1.5 per cent, the expected rate of growth of around 2 per cent and the drift in the velocity of circulation of around 1 per cent) has proved a problem, as it has been exceeded almost all of the time and a lot of effort has had to be spent explaining the discrepancies. Similarly, the price assessment began as a narrative rather than a firmly based discussion of options and their possible outcomes. However, the process has developed steadily. The Eurosystem publishes its forecasts (broad macroeconomic projections) twice a year, with updating by ECB staff in the intervening quarters. Although these are 'staff' forecasts and do not necessarily represent the views of the Governing Council, they are increasingly being used as a basis for explaining policy. The decentralized structure of the Eurosystem would make any closer 'ownership' of the forecasts by decision-makers impossible.

The Eurosystem is, of course, in good company. The USA's Federal Reserve has multiple objectives and offers no quantification at all for its target for the price level/inflation. It only publishes the staff forecasts by the Board of Governors with a lag.

Thus far policy has been generally successful, but between mid-2000 and 2011 inflation was stubbornly above 2 per cent. It is possible to blame the rapid rise in oil prices and some other shocks, but the deviation reached the stage where it had an effect on expectations (as calculated from French index-linked bonds). At that point, the Governing Council reacted by raising interest rates ahead of a clearly revealed recovery in the economy. This helped to enhance the Eurosystem's reputation as an inflation fighter, but has been controversial in some political circles.

One concern, which does not seem to have proved relevant, was the fear that NCB governors and Executive Board members would, either explicitly or unconsciously, as a result of their backgrounds, tend to promote monetary policy decisions that supported the particular economic conditions in their country of origin rather than in the Eurozone as a whole. As a result, complex models of coalitions have been developed and there have been worries about whether those voting in favour are sufficiently representative of the Eurozone as a whole. The first reason why this is not relevant is that the Governing Council has not been voting on these issues. It has operated by consensus, in the sense that decisions are taken when the majority in favour is such that the minority withdraws its objection and does not feel the need to register dissent in some public manner.

The possible objection to that form of behaviour is not some form of country bias, but that it might engender conservatism in policy-making. Since the records of the debates are not published, there is no way of finding out whether the particular structure has inhibited or delayed action. The simplest way of judging the issue is to look at the voting records in the FOMC, where the results are published with a lag. Here it is immediately clear that deep divisions over what to do are relatively unusual. Most of the time there is not only no division at all, but also no proposal to change policy. When there are divisions, the number of dissenters, even before the vote in the debate, tends to be quite small. The problem is thus predicated on a much more random and indeed contentious approach to policy-making than is actually the case.

There has been strong pressure on the Governing Council to be more open and to publish minutes of its discussions, as this would inhibit the members from following obviously national interests. However, it is not at all clear what the impact would be. Publishing minutes or resolutions leads to more formal proceedings or taking positions for the sake of having them recorded if US and Japanese experiences are anything to go by (Pollard 2003). If the real discussion is pushed outside the meeting into informal sub-groups and consultations, the result may be counterproductive and it will be even more difficult to sort out which opinions were responsible for which decisions.

12.3 The coordination of fiscal and other macroeconomic policies

Operating an SMP for a diverse area has proved quite tricky. Policy that is well suited to some economies has been ill suited to others. It is important to be clear about the extent of the differences. Mayes and Virén (2000, 2002c) have shown that in some MSs the exchange rate is at least twice as important as a determinant of inflation (as compared with interest rates). Similarly, the length of time it takes for the impact of policy on inflation to take its full effect also varies by a factor of two. Thus if the main problem lies in a region where policy has both a relatively small and a relatively slow effect, a policy based on the average experience of the Eurozone would not be very efficient.

The problem is further complicated because the main economic relationships involved, such as the Phillips curve (see Chapter 10), are non-linear and asymmetric. To spell this out a little: whereas a low unemployment/positive output gap has quite a strong upward pressure on inflation, high unemployment and a negative output gap have a considerably smaller downward impact for the same-sized difference. This means that simply adding up inflation rates and growth across the Eurozone and exploring aggregate relationships will be misleading. The analysis needs to be at the disaggregated level and then summed using the appropriate estimates of the effect in each region/MS.

However, once we look at fiscal and structural policy these differences become even more important, because they have to offset the differential impact of monetary policy. The coordination of fiscal and other policies therefore needs not merely to permit different policy settings by each MS, subject to the constraints of prudence, but to expect them.

12.3.1 The coordination processes for macroeconomic policies

The structure of the 'economic' side of macroeconomic policy-making thus involves constraints from following policies that could harm the system as a whole - the excessive deficit procedure (EDP) with the SGP, and the system of enhanced policy learning or soft coordination under the BEPG. The annual BEPG forms the framework that brings together three main elements:

- the orientation of general fiscal policy (EDP, SGP and multilateral surveillance);
- the European Employment Strategy (the Luxembourg process; see Chapter 23); and
- the actions on structural reforms (the Cardiff process).

There is actually a fourth process - the Cologne process - which involves an informal exchange of views twice a year between, inter alios, the current, past and future presidents of ECOFIN, the Employment and Social Affairs Councils, the ECB, the Commission and the social partners. These processes are named after the location of the meeting places at which they were agreed.[5] The coordination is somewhat broader than this, as the annual SEM reviews are also taken into account by the Economic Policy Committee (EPC): the committee of officials responsible for overseeing the Cardiff process. This is not to be confused with the Economic and Financial Committee (EFC), also composed of officials, which undertakes the preparation and offers advice for the decision-making Council of Economics and Finance Ministers (ECOFIN).

The general approach, spelt out in some detail in the Conclusions of the Lisbon Council in 2000 (see European Council 2000c and Chapters 7 and 14), was to set 'a *new strategic goal* for the next decade: to become the most competitive and dynamic knowledge-based economy in the world, capable of sustainable economic growth with more and better jobs and greater social cohesion'. This involves aiming to change the structure of EU development so that it could achieve a rate of growth of 3 per cent a year (without inflationary pressure), which should have been enough to bring down unemployment/increase employment to acceptable levels over the course of a decade. The key ingredients in this were continuing structural reform (overseen by the Cardiff process), a labour market strategy (Luxembourg) and the development of the appropriate fiscal incentives through a sound budgetary system within MSs. (It was amended at the end of 2002, at the Laeken Council, by the addition of a social policy strategy, which follows the same form of process as for the labour market.) Despite a thorough appraisal and rethink at the halfway stage (Sapir *et al.* 2003a, b, c), the strategy showed only limited success and was finally swept aside by the global financial crisis that rendered its targets irrelevant. However, a new strategy with similar structure and ambitions, labeled Europe 2020, has been implemented to replace it.

These processes do not compel, but by agreeing objectives, setting out how each MS intends to achieve the objectives, and evaluating progress, particularly through annual reports by the Commission, they act as considerable moral suasion. The meetings and the annual round of plans and evaluations enable MSs to learn from each other and encourage a search for best practice. These plans can be quite detailed. The annual National Action Plans under the Employment Strategy (see Chapter 22), for example, have covered over twenty guidelines grouped under four pillars: employability, entrepreneurship, adaptability and equal opportunities. Although the Commission produces assessments, much of the point of the arrangement is that it involves multilateral surveillance, so that each country is looking at the successes and failures of the others.

While there are obvious opportunities for window-dressing, this process, labelled the Open Method of Coordination, appears to have worked remarkably well. The key feature of the method is that it does not compel specific actions, but allows each MS, and indeed the regions within them, to respond to the challenges in the manner that best meets their local conditions, institutions and structures. Given that the whole structure of social welfare varies across the EU (Mayes *et al.* (2001) distinguish four different sorts of regime, for example), any given measure will have different outcomes in different MSs. In a sense, this is an example of the operation of the subsidiarity principle (see Section 2.3.4, page 30).

12.3.2 The Stability and Growth Pact and the excessive deficit procedure

As was argued above, the SGP and EDP have two features: a general orientation to ensure a policy that is sustainable over the longer term, and a constraint on short-term actions - the excessive deficits - to ensure that the process is not derailed on the way. This general orientation is to achieve budgets that are 'in surplus or near balance'. This orientation will actually result in a continuing reduction in debt ratios. While this is necessary anyway for MSs exceeding the 60 per cent limit, it has been thought generally more desirable because of the expected strains on the system that are likely to occur with the ageing of the population. In any case, it makes sense to have sufficient headroom to meet shocks, as vividly illustrated by the global financial crisis. This headroom is required in two respects. First, given the structure of automatic stabilizers, each MS needs to be far enough away from the 3 per cent deficit ratio limit for the normal sorts of adverse economic shock not to drive them over that limit. If that threatens to happen, the MS would need to take contractionary fiscal action when the economy is performing weakly.

This was precisely the problem that faced German authorities in 2003. The combination of being too close to the limit and lower than expected growth forced them a little over the limit. Needing to raise taxes and restrain expenditure proved politically difficult. At the same time, French authorities also breached SGP terms, although it is more arguable that this was deliberate rather than a result of incorrect forecasting. As a result, ECOFIN agreed to suspend the SGP rather than declare the two countries in breach of it, as recommended by the Commission. The Commission appealed this decision to the European Court of Justice (ECJ), which ruled that ECOFIN could decide to take no action but that it could not suspend the process. This provoked an intensive debate on how to improve the SGP in the light of the difficulties, and a new agreement was reached in March 2005.

The extent to which an MS needs to be inside the 3 per cent boundary to avoid an undue risk of a breach and to maintain a stance that is sustainable in the long run depends on the extent of the automatic stabilizers and the distribution of expected shocks. Thus a country like Finland, which has fairly large stabilizers and seems prone to above-average shocks, would need to run a small surplus if it is to avoid hitting the 3 per cent boundary.

There is a danger (von Hagen and Mundschenk 2002) that having the 3 per cent deficit boundary will have a deflationary longer-term bias on the EU if MSs compete too strongly to have very strong stabilizers. Sweden might be regarded as a case in point, as its reaction to the pressures from membership has been to advocate the establishment of a substantial buffer fund (Johansson *et al.* 2002). These funds, if implemented, would be far larger than Finnish buffer funds, which were put in place when Finland joined the Eurozone. However, Ricardian equivalence would suggest that simply repaying debt should have no influence on longer-term growth; it is only having a higher tax burden today at the benefit of a lower burden in the future.

The SGP can be viewed as having two parts: a preventative part that tries to discourage MSs from running imprudent and unsustainable fiscal policies, and a corrective part that requires them to return to prudence as soon as possible if a mistake has been made. The 2005 agreement eased both sides of this, allowing more latitude for problems before declaring a breach (an excessive deficit) and hence permitting a less onerous return to compliance. This was not the full extent of the changes, as MSs also took the opportunity to improve the governance process of surveillance, tightening up the quality of statistics and accounting practices.

The general principles of the SGP remain unchanged. Attempts to correct underlying problems with the SGP, such as the failure to take proper account of the economic cycle and to focus on the underlying problem of sustainable debt, were discussed extensively in the debate on revision, but ultimately not adopted, despite pressure from the Commission. While the changes did not address the fundamental economic problems, they do represent a set of arrangements that are more likely to be adhered to. In practice, the idea that a country could ever be harshly penalized was ambitious. The penalties were intended as a deterrent. If naming and shaming did not work, the SGP was always likely to change if a significant number of countries were affected. With the global financial crisis, the SGP is effectively suspended, as economic performance is generally too weak to generate the EDP. This is proving a major headache, as in just three years a decade or so of fiscal consolidation has been unwound in many MSs, and the financial position of the most exposed – Greece, Ireland, Italy, Portugal and Spain – has become a cause for concern.

Various proposals were put forward for reforming the SGP, and indeed the Commission itself advanced proposals (Buti *et al.* 2002; CEU 2002a), which were then taken into account in considering SGP reform. These can be classified under three main headings, but they all relate to means of easing the constraints somewhat without altering the overall principles. The first set of proposals relates to *symmetry*. MS behaviour is constrained when deficits are in danger of becoming too large. There is no such restraint on surpluses, but a switch from a 2 per cent surplus to balance can have just as much impact on aggregate demand as a switch from balance to a 2 per cent deficit. Hence countries which notch up major surpluses could destabilize the system somewhat, simply by switching rapidly to a modest deficit well within the permissible limit. The Commission in particular suggested enhancing the ability to affect fiscal policy in 'good times' and this is reflected, albeit weakly, in the revised provisions shown in Box 12.1.

The second set of proposals sought to differentiate between MSs according to whether they are well inside, near or above the 60 per cent limit for the debt ratio. Here the argument was simply that countries with no sustainability problem should be allowed more licence in the short run over deficits. This line of argument, of course, runs against that in the first group, as such licence could easily result in much bigger swings in fiscal policy that will affect the overall level of inflationary pressure in the Eurozone if we are talking about larger countries.

The third group of suggestions related to measurement issues. In the traditional literature the concern is with cyclically adjusted deficits. While measurement has indeed been improved, the idea of cyclical adjustment has not been followed. In the main, this is because what is trend and what is cycle can only be established after the event, which is incompatible with the pre-emptive rather than corrective SGP orientation.

There was a fourth set of suggestions that looked for more of a market solution to the question of fiscal discipline. One of the big advantages of EMU has been that interest rates on sovereign debt in the previously more inflation-prone and more indebted parts of the Eurozone converged on the lowest. Credit ratings similarly increased. Although there was explicitly no agreement to bail out MSs across the Eurozone, the market is behaving as if there were. Or at least behaving as if the EDP would restrain MSs from running policies that will ever get them near default. This means that there is not so much pressure on marginal borrowing by those states that have debt or deficit ratio problems.

This has all been completely changed by the financial crisis. Interest rate spreads widened extensively and reflected lenders' concerns that some MSs might default. The extent of the market pressure was such that the EU and the IMF drew up a joint fund, with strong conditionality, that Greece could draw on if it proved impossible for it to raise new debt or roll over existing debt satisfactorily in the market. This fund, the European Financial Stability Facility, had to be enlarged and extended to the Eurozone as a whole

Box 12.1 Revisions to the Stability and Growth Pact agreed in March 2005

The revisions agreed by the Council on the recommendation of ECOFIN are quite detailed, but can be summarized as follows:

(i) The basic precepts are unchanged both in terms of the 60 per cent debt ratio and the 3 per cent deficit ratio, and in terms of the sanctions to be applied if an MS is determined to have an excessive deficit and has undertaken insufficient measures to end it.
(ii) The adjustment processes required have been eased slightly, extending the time allowed by four months (to sixteen).
(iii) The criteria under which there can be exceptions to the 3 per cent rule for an excessive deficit have been softened. A decline in GDP or an extended period of low growth below potential are now admissible, and 'all relevant factors' can be taken into account – although these are not specified in any detail.
(iv) The medium-term adjustment to a sustainable fiscal position has been eased slightly, and MSs' structural balance should be 'close to balance or in surplus' (CTBOIS) and now allows a lower limit of a 1 per cent deficit.
(v) While MSs are still required to reduce their structural deficits to reach CTBOIS by 0.5 per cent of GDP per year, it is now admitted that they should do so faster in 'good times' and may do so more slowly in 'bad times' in the economic cycle.
(vi) Temporary divergences can be allowed for the costs of structural reforms aimed at improving the longer-term position.
(vii) If there are unforeseen events, ECOFIN can issue changed deadlines and requirements.
(viii) Implicit liabilities, such as those for the pension system from the ageing of the population, should be taken into account.

In addition, there is a set of requirements that should improve the governance and operation of the generalized system of preferences, which includes: stronger peer pressure, better national fiscal rules and institutions – such as greater scrutiny by parliaments – improved forecasting, and better statistics and standards.

* Structural balance is defined as the cyclically adjusted deficit after removing the effect of temporary and one-off measures (as determined by the Commission).

when the problem threatened to spread to Ireland, Italy, Portugal and Spain. By 2011, Greece, Ireland and Portugal were all subject to fund arrangements, with associated strong conditionality requiring determined efforts to bring the rising government debt under control. This facility, in conjunction with the IMF, only lasts for three years, and its extension into a more permanent arrangement has been subject to considerable debate in the fiscally prudent countries that will be the lenders.

The Eurozone has thus got itself to a position that it previously resisted. MSs did not want to bail each other out, and SGP and TEU criteria were designed to make such a threat implausible. By admitting states with debt problems, albeit assisted in the Greek case by incorrect national accounts statistics, and by not having a stronger SGP, it has reached the point where the weaker states can threaten the system. Much of the reason for the compromise, however, was that financial institutions in the other MSs had bought Greek government debt and hence stood to make major losses in the event of a default.

12.3.3 Policy coordination

The type of policy coordination described thus far differs from that normally discussed in the literature, where much of the point is the coordination of monetary and fiscal policy. The argument is that there are some choices that can be made over how much to use fiscal policy rather than monetary policy to smooth fluctuations in the real economy or to maintain price stability. The set-up within EMU rests on a fairly simple

economic model. The first side of it is that monetary policy cannot be used effectively to achieve longer-term real objectives, except in two senses:

- first, that having higher rates of inflation beyond levels near zero will tend to result in reductions in the overall rate of economic growth, and indeed having falls in the price level may also be damaging; and
- second, that inept policy that does not generate credibility will also impose a cost on society.

In general, taking these together, the argument is, in effect, that the long-run Phillips curve is vertical and monetary policy per se will not have adverse effects on the longer-term level of unemployment (see Chapter 10). Monetary policy can therefore be targeted appropriately at the stabilization of the price level rather than on objectives for the real economy. The scope for using monetary policy for smoothing real behaviour beyond that point is limited. As Thornton (2002) puts it, in general, the impact of monetary policy on inflation variation and output gap variation should be regarded as one of complements rather than trade-offs. A credible monetary policy aimed at restricting inflation to a fairly narrow range in a smooth manner should, *ipso facto*, also restrain the fluctuations in output round the sustainable path.

Similarly, in this simple paradigm, fiscal policy can affect the rate of growth in terms of how funds are raised and spent - for example, one can view this in terms of incentives. Moreover, as discussed above, for fiscal policy to be consistent with price stability over the medium term it has to be sustainable (and believed to be so by markets). But discretionary fiscal policy, beyond the automatic stabilizers, is unlikely to be of much value, except to help exit the deflationary spiral, as Keynes identified in the 1930s; Feldstein (2002) offers a clear exposition of this view. One of the main reasons for avoiding discretionary fiscal policy to address fluctuations in the economy is that policy operates with a lag, and there is a danger that by the time the problem is identified, the necessary measures are agreed by the legislature and implemented, and the impact occurs, it may destabilize what is then going on.

In the event of a major adverse shock, such as the global financial crisis, the model is still not disturbed. The shock is so great that emergency action is warranted. Each country acting in its own interests nevertheless acts to stimulate joint demand and reduce the short-run impact (albeit at the expense of higher taxation in the future to pay for the surge in debt).

Under these circumstances there is no need for much policy coordination between the monetary and fiscal authorities beyond transparency. The monetary authorities need to be able to make a reasonable assessment of the inflationary pressure likely to stem from fiscal policy, and the fiscal authorities need to know what to expect from monetary policy when setting their fiscal objectives. The potential conflict comes from the fact that, unlike fiscal policy, monetary policy can be changed quickly and substantially, and indeed with fairly limited transaction costs. In the EU's framework the coordination works because the monetary authorities are predictable. If they do react quickly it is to specific crisis signals, like the shock of 11 September 2001. Given the time lag for fiscal changes, the fiscal authorities need to be confident that their monetary counterparts will not do anything in the intervening period that will render their policy stance inappropriate.

Pinning the ECB down to a single objective helps to achieve this predictability, in the same way that SGP rules and macroeconomic coordination ensure that the ECB has plenty of warning about the way in which fiscal policy is likely to develop and hence is less likely to set inappropriate levels for interest rates. EMU coordination will not work if the Eurosystem believes that the fiscal authorities will always be too inflationary and/or if ECOFIN always believes that the Eurosystem will set interest rates that are too high. In these circumstances the problem will be self-fulfilling, and monetary policy and fiscal policy will tend to push against each other. The resulting bias will be a cost. Fiscal policy needs to be credible to the monetary authority and vice versa. There is a danger of paying too much attention to the rhetoric in this regard.

The final part of the simple model which underlies the coordination mechanism is the belief that it is structural policies that will change the underlying rate of economic growth. Hence these form a key part of the continuing annual policy discussion. Once fiscal policy is largely automatic with respect to shocks, the surveillance mechanisms can focus on sustainability and on whether the size of budgetary swings that the automatic processes deliver are appropriate. If there were little concern for fine-tuning, then having more than the current six-monthly informal dialogue laid down by the Cologne process would seem unnecessary.

12.3.4 Asymmetry

Traditionally, the focus on the suitability and sustainability of EMU has been on asymmetry in the sense of the differences between MSs, as discussed at the beginning of Section 12.2 (page 182). However, a different asymmetry is also present in MSs' behaviour, namely asymmetry over the cycle (Mayes and Virén 2002a).[5]

The total deficit is much more responsive in the downward than the upward phase. While responsiveness over the cycle as a whole is of the order of 0.2–0.3 (a 1 per cent increase in real GDP lowers the deficit ratio by 0.2–0.3 per cent) in the first year, it is five times as large in the downturn as the upturn. This bundles together all the influences - automatic stabilizers, discretionary policy changes, interest rate changes and any special factors. On unbundling, we can see that the automatic or cyclical part of the deficit behaves in a fairly symmetric manner. It is what governments choose to do with the structural part of the deficit that causes the asymmetry. What has happened is that governments increased the structural deficit in both downturns and upturns. Thus in good times governments tend to allow the system to ratchet up. The effect is split between revenues and expenditures, but the asymmetry is more prominent on the revenue side. Tax rates are cut in upturns so that revenue to GDP ratios do not rise.

The SGP, EDP and other components of macroeconomic coordination in EMU would have to lean against this tendency for asymmetric behaviour to reduce the pressures it generates. In practice, the pressure is placed somewhat more on the downside: the area where governments have themselves responded more effectively in the past. Tackling this asymmetry and 'procyclicality in good times' was incorporated in general terms in the revised SGP (see Box 12.1). Whether this will have much effect is debatable, especially after the experience of the financial crisis.

12.4 Completing EMU

It has to be said that the earlier discussion of coordination leaves a lot to the credibility of the process. Institutional credibility would be much greater if the degree of control over fiscal actions at EU level were larger and there were some parallel institution to the ECB on the fiscal side. While this is not on the political agenda, its relevance would be much greater if one further plank, which characterizes most economic and monetary unions, were in place, namely a significant revenue-raising and spending capability at EU level. This does not have to take the form of a larger budget per se (see Chapters 10 and 19), as transfers from one region or MS to another in a form of fiscal federalism would also suffice (see Chapter 10). Currently stabilization takes place automatically within MSs. It only takes place between them to the extent that their agreed and automatic actions spill over from one to another because of their economic interdependence. The actual size of such a budget - around 2.5 to 7 per cent of EU GDP - would be highly effective (MacDougall Report/CEU 1977a; Mayes *et al.* 1992; Chapter 19), but is quite small compared to many existing federal states. It is, however, large compared to the structural funds and the current budgetary limit.

EU enlargement has increased the need for fiscal federalism, although the current small economic size of new member states (NMSs) keeps down the scale of any transfers needed in the short term. We are concerned here with cross-border fiscal flows to help balance out the effect of asymmetric shocks; dealing with income inequality is a problem of a very different order. Nevertheless, given the persistence of shocks, particularly with respect to their impact on the labour market, if fiscal flows do not ease the pressure then other changes will result to compensate. The most obvious would be an increase in migration. That is also not politically attractive at present (see Chapter 8). It remains to be seen whether some greater integration on the macroeconomic side of EMU may not be preferred to increasing flexibility through cross-border migration. The relative attraction of stabilizing flows is that, according to their definition, they should be temporary. However, the shape of economic cycles does vary across the EU. Nevertheless, as economic and financial integration increases across the EU, so self-insurance increases with diversification of income and wealth generation across the EU as a whole, helping to smooth the asymmetric shocks hitting any particular region without recourse to fiscal transfers (Mundell 1973b; Chapter 10).

12.5 Conclusion: enlargement

Before EMU moves further towards 'completion', it is likely to continue to expand through the inclusion of new members. Thus far the five NMSs that have joined – Cyprus, Estonia, Malta, Slovakia and Slovenia – are all small. Even if many of the NMSs were to join, the economic effect would be limited. Only Poland and, to a lesser extent, Romania are of any size. Their effect on the dynamics of decision-making would be much more dramatic, and indeed the Eurosystem may well invoke its ability to alter the voting arrangements on monetary policy to move the balance back in favour of the large, original members. Adding Denmark and Sweden would make little difference to the structure of the Eurozone or the issues that have been raised in this chapter. If the UK were to join, the position would be different, as the country is large enough to alter the balance of the SMP. Also, since the UK is somewhat different, both in its flexibility of response and its symmetry with the other MSs, the consequences could be measurable. Adding more NMSs is likely to take place with a level of income per head well below the average of the existing members, as convergence in these real terms is not one of the criteria. This could alter the character of the Eurozone.

We have already noted that in the run-up to membership there was greater convergence of MSs than there has been in the period since. This was because they had to run their monetary and fiscal policies individually to converge to quite a narrow band. Once inside, the SGP, EDP and the rest of the coordination under the BEPG apply, but the SMP is no longer related to the inflation concerns of each country, just the total, so more inflation, and indeed growth variation, is possible and feasible. This experience is likely to be reflected even more strongly by the new members, as they are generally expected to 'catch up' quite rapidly with the existing members in real terms. This means that they will have faster rates of growth than the existing members, driven primarily by productivity. It has also been pointed out that this may have implications for inflation and monetary policy. While the price of tradable goods and services may be reasonably similar across the EU, the same is not the case for non-tradables. Large portions of non-tradables are public and private services, where their principal input is labour. As productivity grows in the tradable industries, so wages are likely to rise with it. In turn, in a competitive economy, this is likely to result in wage increases in the non-tradable sector. There it will not be so easy to find productivity growth to offset it and prices will tend to rise. In so far as there are no offsets elsewhere, this will result in a rise in the general price level that is faster than in the rest of the euro area (see Chapter 11).

This process, known as the Balassa-Samuelson effect, will probably not be substantial by the time NMSs join the Eurozone – perhaps of the order of 1 per cent a year (Björksten 1999). Given that NMSs, taken together, will only contribute a fraction of Eurozone GDP, this implies that the total effect on inflation would be of the order of 0.2 per cent a year. That may seem very small, but with a medium-term target of inflation below 2 per cent, it could represent an increase in the rate of interest. The actual impact is speculative and could vary from the disastrous to the trivial. It would be disastrous if some countries cannot cope with the increase in the real exchange rate that this relative inflation might imply. The problems of asymmetry that have worried some of the old EU MSs could be much larger for NMSs, yet the drive for locking in credibility and buying lower interest rates by Eurozone membership may be sufficient to play down the worries about sustainability at the time of joining. Too rapid an expansion of EMU could actually harm the prospects of the enterprise as a whole. It is therefore not surprising that the ECB has already blown relatively cold on some of the ideas implying early membership and has sought to toughen the interpretation of the convergence criteria.

Nevertheless, the harsh experience of the Baltic States in the global financial crisis has shown that, by and large, they can cope with the largest adverse shocks that are likely to hit them and, in the case of Estonia, bounce back sufficiently to meet the convergence criteria for joining the Eurozone. With a currency board, Estonia has effectively been a member of the Eurozone since the outset, but without a vote.

Summary

- The structure of EU monetary institutions set up in 1998 for euro introduction on 1 January 1999 have a lot in common with the USA's, but the nomenclature is confusingly different and the arrangements complex. The Governing Council, chaired by the ECB president, composed of the six members of the Executive Board and governors of the participating central banks, currently seventeen, decides on monetary policy (MP).
- Eurozone MP is focused on price stability, defined as inflation below but close to 2 per cent over the medium term. The system's structure emphasizes the Eurosystem's independence.
- Although there is no single fiscal policy (FP) to match the single MP, EU MSs have an elaborate annual cycle of policy coordination under Broad Economic Policy Guidelines (BEPG).
- The most important element in FP management is the Stability and Growth Pact (SGP), which on the one hand tries to keep MSs' fiscal position on a path of consolidation towards a low and sustainable public debt, and, on the other, has an excessive deficit procedure (EDP) to try to prevent fiscal deficits in excess of 3 per cent of GDP in any year. The system was revised in 2005 and the EDP is not operating in the financial crisis because of the severity of the downward pressure on GDP.
- Coordination between MP and FP occurs through open discussion and having a rule-based system for MP that makes it predictable for FP-making.
- The SGP is inherently asymmetric and does not have matching rules for surpluses; nevertheless, the focus on deficits counters the previous asymmetric trend towards a worsening fiscal position in most MSs.
- There is little enthusiasm for a clear, EU-level fiscal capability, but countries remain keen to join the Eurozone, with Cyprus, Estonia, Malta, Slovakia and Slovenia having joined since the notes and coin were introduced in 2002. It is the inflation criterion that makes enlargement so difficult, as a country must be within 1.5 per cent of the inflation rate of the lowest three inflating countries in the entire EU of 27, not just the Eurozone.

Questions and essay topics

1. Compare the structure of the monetary institutions and decision-making in the EU and the USA.
2. What is the objective of MP in the EU? How is it achieved?
3. Is the Eurosystem really independent?
4. How is coordination of FP among MSs achieved in the Eurozone?
5. What is the excessive deficit procedure? Does it work?
6. How does the SGP hope to achieve a prudent FP in the EU?
7. Are MP and FP coordinated in the EU?
8. What is the Balassa-Samuelson effect? Will it inhibit the expansion of the Eurozone?
9. What problems does the lack of an EU-level fiscal capability create for macroeconomic policy in MSs?

FURTHER READING

CEU (2008h) *EMU@10: Successes and Challenges after 10 Years of Economic and Monetary Union*, DG ECOFIN, Brussels.

de Grauwe, P. (2009) *The Economics of Monetary Union*, Oxford University Press.

ECB (2004) *The Monetary Policy of the ECB*, ECB, Frankfurt.

NOTES

1 ECB (2001) is one of the most comprehensive and straightforward of the many available descriptions of the institutional arrangements; see also Chapter 3.

2 The Eurosystem is also planning to move to a system where only some of the governors have a vote (by rotation) when the number of MSs exceeds fifteen. However, it will still be the case that the number of voting governors will substantially exceed the number of Executive Board members. Despite the number being seventeen for the start of 2011, this system is yet to be implemented.

3 Sometimes more than one.

4 The special measures taken during the global financial crisis show that this is not really true in practice, at least in the short run, as the ECB has bought extensive amounts of governmental debt from commercial banks, particularly from the troubled MSs, in order to maintain liquidity and effectively ease monetary policy once interest rates approached zero.

5 See Hodson and Maher (2004) for a clear exposition of the processes and their role in policy-making. These various processes are brought together under the 'Helsinki process'.

6 The study uses annual data for the period 1960–99 for the 2002 EU MSs, excluding Luxembourg, and treats them as a panel. The structural deficits are as defined by the Commission.