Working Paper No. 296

An Alternative Stability Pact for the European Union

by
Philip Arestis, Kevin McCauley and Malcolm Sawyer

October 1999

The authors are at the University of East London (Philip Arestis and Kevin McCauley) and the University of Leeds (Malcolm Sawyer). Philip Arestis and Malcolm Sawyer are Senior Visiting Fellows at the Jerome Levy Institute. We are grateful to an anonymous referee for constructive comments.

INTRODUCTION

The main purpose of this paper is to propose an alternative stability and growth pact amongst European Union (EU) governments to underpin the introduction of a single currency and a "single market" within the EU. The alternative pact proposed in this paper embraces a number of new aspects of integration within the EU which entails a number of insights. These include a different analysis from that of "new monetarism" (see Arestis and Sawyer, 1998b), new objectives for economic policy to include employment and growth, and new institutions to reduce various kinds of disparities across the EU.

The paper begins by critically examining the Stability and Growth Pact, which accompanied the introduction of euro in January 1999, but which has not received as much attention in the policy debates on the euro as some other aspects of it. We follow this with a discussion of the institutional underpinnings of the euro, and we argue that the institutional arrangements have a number of weaknesses. We then propose an alternative pact governing monetary and fiscal policy with the promotion of the objective of full employment and which requires the creation of new institutions. A final section summarises and concludes.

THE STABILITY AND GROWTH PACT

The Stability and Growth Pact accompanied the introduction of a single currency in the European Union as part of the third stage of economic and monetary union. It will govern the economic policies of the member countries which have joined the single currency and strongly constrain the policies of those who do not join.

In its earliest form the Stability Pact was advanced by Theo Waigel, the former German finance minister, in November 1995. Agreement on the main components of the now renamed Stability and Growth Pact was reached at the European Council Summit in Dublin in December 1996, and it was formally adopted at the Amsterdam Summit in July 1997. Before the final settlement on the Pact was reached, there had been several rounds of negotiations. It was suggested by the French government that a better balance would have to be struck between budgetary discipline and employment policy. Two suggestions were made: the first called for greater emphasis to be placed on Articles 102a and 103 of the Maastricht Treaty and was aimed at reforming economic co-ordination; and the second called for greater political control over economic policy which would have to include monetary policy. The second proposal was a non-starter for the German and the Dutch governments. The aim of the first proposal was reflected in the Resolution on Growth and Employment, which was adopted by the European Council along with the Stability and Growth Pact. However, unlike the Stability Pact, this resolution was not accompanied by any secondary legislation nor it would seem the political will from member states to implement it. The Resolution simply states an aspiration, that employment policy should be co-ordinated at the EU level, however, employment policy implementation still remains firmly in the hands of national authorities. It appears unlikely that there will exist a sufficient legal framework for EU level employment policy (Snyder, 1998, p. 64).

The Stability and Growth Pact alongside the Maastricht Treaty creates four rules for economic policy. Bovenberg and de Jong (1997) suggest that these four rules were created in the belief that they would facilitate the ECB's primary task of price stability. The four rules are that the ECB was granted independence from political influence; the rule of no-bail out of national government deficits was introduced; the monetary financing of government deficits was prohibited; and member states must avoid "excessive" deficits (which were defined as more than 3 per cent of GDP).

The Stability and Growth Pact consists of three components: a single European Council Resolution and two Council

Regulations. The Resolution commits all parties, member states, the Commission and the Council "to implement the Treaty and the Stability and Growth Pact in a strict and timely manner". The Council Regulations themselves, unlike the Resolution, have legal force and can be seen as composed of two complementary elements. First, the "preventative" element: this resolution refers to the strengthening of budgetary positions and the surveillance and co-ordination of economic policies. It commits those member states which join the single currency to submit to the Commission a stability programme. These stability programmes will have to be updated annually and must detail the member states medium term budget objective, the main assumptions about economic developments, and the projected paths for both the deficit ratio and the debt ratio. Non-euro members should submit a "convergence plan" which should be similar in outline to the stability programme. These programmes are intended to act as an early warning system and will signal when a member state is close to breaching the reference values detailed in Protocol 5 of the Treaty. The second Council regulation is the "deterrent" element. This is aimed at speeding up and clarifying the implementation of the excessive deficit procedure and it seeks to reduce the scope for discretion, which is allowed under the Maastricht Treaty.

THE THEORY OF THE STABILITY AND GROWTH PACT

The Stability and Growth Pact appears to be based on what we have elsewhere termed new monetarism (Arestis and Sawyer, 1998b). The essential features of new monetarism are:

(i) politicians in particular, and the democratic process in general, cannot be trusted with economic policy formulation with a tendency to make decisions which have stimulating short-term effects (reducing unemployment) but which are detrimental in the longer term (notably a rise in inflation). In contrast, experts in the form of central bankers are not subject to political pressures to court short-term popularity, and can take a longer term perspective where it is assumed that there is a conflict between the short-term and the long-term. The logic underpinning this reasoning mirrors that found in the rules versus discretion debate. Policy makers" scope for using discretion should be curtailed and the possibility of negative spillovers from irresponsible fiscal policy must be reduced within the eurozone, hence, fiscal policy will be permanently constrained by the Stability Pact and monetary policy has been removed from national authorities and from political authorities and placed with the ECB.

(ii) inflation is a monetary phenomenon and can be controlled through the monetary policy. The money supply is difficult (or impossible) to control directly, but the central bank can set the key interest rate (the "repo" rate) to influence the monetary conditions, which in turn influence the future rate of inflation.

(iii) the level of unemployment fluctuates around a supply-side determined equilibrium rate of unemployment, generally labelled the NAIRU (non-accelerating inflation rate of unemployment). The level of the NAIRU may be favourably affected by a "flexible" labour market, but is unaffected by the level of aggregate demand or by productive capacity.

(iv) fiscal policy is impotent in terms of its impact on real variables and as such it should be subordinate to monetary policy in controlling inflation. It is recognised, though, that the government budget position will fluctuate during the course of the business cycle but in the context of an essentially passive fiscal policy.

A further feature of the institutional arrangements within the European Union is a complete separation between the monetary authorities (that is the ECB), and the fiscal authorities (in the shape of the national government). Article 107 of the amended Treaty of Rome states that "When exercising the powers and carrying out the tasks and duties conferred upon them by this Treaty and the Statute of the ESCB, neither the ECB, nor a national central bank, nor any member of their decision making bodies shall seek or take instructions from Community institutions or bodies, from any government of a Member State or from any other body. The Community institutions and bodies and the governments of the Member States undertake to respect this principle and not to seek to influence the members of the decision making bodies of the ECB or of the national central banks in the performance of their tasks". This would appear to preclude the co-ordination of fiscal and monetary policies for it would require the ECB to be influenced by national governments and others and to pursue objectives other than price stability.

The elevation of monetary policy as the only policy instrument which can be exercised at the European level, combined with the emphasis of that policy on the control of inflation will tend to generate a deflationary economic environment as any signs of inflation or "overheating" of some part of the European economy is likely to be met by increase in the interest rate. This will be exacerbated by the lack of active fiscal policy and the absence of other mechanisms (such as the promotion of investment) to stimulate aggregate demand. This perspective serves to illustrate that the existing institutional framework is not adequate. There is no EMU framework to provide for a sufficiently strong fiscal policy at the European level, and the very limited economic policy co-ordination provided for under Article 103 of the Treaty is not adequate to afford a EU level fiscal policy.

There are two well-known features of the structure of economic policy making in the European Union which are particularly relevant for our discussion below. First, monetary policy will be operated by the independent European

Central Bank (ECB) through a system, which involves national central banks in addition to the ECB. The ECB has been given the objective of securing price stability, without explicit concern over other objectives. The Protocol on the ESCB (article 105) states that "The primary objective of the ESCB shall be to maintain price stability. Without prejudice to the objective of price stability, the ESCB shall support the general economic policies in the Community" (EU, 1998). The key decision makers on the ECB will be governors of the national central banks and monetary experts.

Second, there will not be any fiscal policy operated at the European level. The size of the European budget is relatively small at less than 1.2 per cent of combined EU members"

GDP in 1997, and is still dominated by the needs of the Common Agricultural Policy (about 50 per cent). Yet, the MacDougall Report (1997) suggested that monetary union would not be viable without a sufficiently large community budget for fiscal policy (7.5 per cent of members" GDP). It is also the case that the EU budget must be balanced. The interaction of those two elements means that there is no scope for active fiscal policy (or indeed for any fiscal policy), and that the European Union budget is too small to operate as an effective stabiliser or to re-distribute funds from richer regions to poorer ones in any significant manner. The EU already provides both stabilisation and redistribution functions in the form of structural and cohesion funds and the common agricultural policy. This redistribution effect in the EU is estimated at between 0.5 per cent (Sal-I-Martin and Sachs, 1992) and 3 per cent (Bayoumi and Masson, 1995) of the difference between national GDP per capita and the EU average.

MECHANICS OF THE STABILITY AND GROWTH PACT

The main feature of the Stability and Growth Pact is a requirement that the national budget deficit does not exceed 3 per cent of GDP, and failure to meet that requirement could lead to a series of fines depending on the degree to which the deficit exceeds 3 per cent (as further discussed below). Non Euro members are also required to exercise similar fiscal control through convergence programmes, though they are not subject to excessive deficit penalties.

A government which aims to avoid an "excessive" budget deficit of more than 3 per cent of GDP would have to ensure that the 3 per cent limit is not breached during economic slowdown; and hence that the average deficit during the course of the business cycle would have to be much lower than 3 per cent. A country"s budgetary data become available for the Commission to scrutinise on 1 March each year when the stability programmes are submitted. Each programme will contain information about the paths of the ratios of budget deficit to GDP and national debt to GDP. The Council (ECOFIN) will examine the stability reports and shall deliver an opinion on a recommendation by the Commission (within two months of the reports submission). If the stability programme reveals that a country is significantly diverging from its medium-term budgetary objective, then the council will recommend that the stability programme is strengthened. If the situation persists then the member state will have been judged to have breached the reference values. The Pact details "escape" clauses which allows a member state that has an excessive deficit to avoid sanction. If there is an economic downturn and output has fallen by more than 2 per cent, then the member state will escape sanction automatically but the deficit should be corrected once the recession has finished. If output falls between 0.75 and 2 per cent then the Council can use discretion when making a decision on an "excessive" deficit, other factors will be taken into account such as the abruptness of the downturn, the accumulated loss of output relative to past trends and whether the government deficit exceeds government investment expenditure.

When the Council has sifted through all relevant information pertaining to the country whose financial position is under review, it must decide as to whether an excessive deficit exists or not. In making the decision, the Council operates with a qualified majority, and under the Maastricht Treaty, all EU member states have a vote, including those countries that are not in the euro area and even the country, which is under consideration. If a country is found to have breached the reference values, then it has four months to introduce the corrective measures suggested by the Council. If the country follows the Council"s recommendations, then the "excessive" deficit can continue, but the budget deficit must be corrected within a year following its identification. A country which chooses not to introduce corrective measures will be subject to a range of sanctions (Article 104c(11)), at least one or more must be imposed, of which one must be in the form of a non-interest bearing deposit lodged by the national government. In this instance, it will fall upon EMU members, exluding the member country under consideration, to reach a decision on sanctions. The non-interest bearing deposit consists of a fixed component (0.2 per cent of GDP), and a variable component, (one tenth of the difference between the deficit ratio and the 3 per cent reference value). If the budget deficit is not corrected within two years, the deposit is forfeited and becomes a fine, whereas if the deficit is corrected within two years the deposit is returned and the penalty becomes the foregone interest.

The penalty clause would add to the deficit it is meant to cure, and as such it could generate national opposition. Von Hagen and Eichengreen (1996) and Eichengreen and Wyplosz (1998) argue that the Stability and Growth Pact tends to suppress the symptoms without treating the source of the problem. The constraints imposed by the Pact will severely reduce national fiscal independence and effectively preclude the use of national fiscal policy for demand management purposes. This is especially the case at present where countries have entered EMU at the upper limit of the Stability and Growth Pact; OECD (1998) estimates suggest that eight of the eleven countries have budget deficit targets in the range of 1-2 per cent of GDP over the next few years, which is not sufficient to allow automatic stabilisers to work under the Stability Pact. Bayoumi and Eichengreen (1995) suggest that this restriction on the workings of automatic stabilisers could lead to weaker fiscal stabilisation and greater output volatility. Further, von Hagen and Eichengreen (1996) argue that if automatic stabilisers cannot function fully, then pressures will build for fiscal federalism to provide them.

This system of financial penalties for breaches of the budget deficit criterion, implies that deflationary fiscal policies will continue, and indeed intensify as those countries which just met the 3 per cent requirement in conditions of cyclical upswing will have to tighten the fiscal stance to meet the 3 per cent requirement in times of cyclical downswing especially. The European Commission has estimated that the sensitivity of the budget balance to output is around 0.5 per cent for the EU, that is a 1 per cent fall in GDP will increase the budget deficit by 0.5 per cent (Buti et al., 1997, p. 7). It was indicated above that a clause was inserted into the Stability Pact, which allows a country to have a larger deficit in the face of recession. However, even this formal recognition that automatic stabilisers and active fiscal policy could be hampered may not be sufficient to prevent the Stability and Growth Pact operating to exacerbate recessions.

Table 1: Retrospective Application of the Excessive Deficit Procedure: Number of cases where the 3 per cent reference value would have been exceeded.

1961-1996	Severe Recession+	Mild Recession++	Economic Slowdown+++
Total number of recessionary episodes	24	9	17
D = 0 per cent			
Number of recessionary episodes exceeding the D =3 per cent	11	1	0
Number of recessionary episodes exceeding the D =3 per cent in the year following the recession	5	1	0
D = 2 per cent			
Number of recessionary episodes exceeding the D =3 per cent	18	5	6
Number of recessionary episodes exceeding the D =3 per cent in the year following the recession	16	1	5

Source: Tables 8, 9, 10, 11, 11, 12 and 13 of Buti et alia (1997)

+ at least 0.75 per cent fall in GDP

++ 0-0.75 per cent fall in GDP

+++ GDP growth positive but at least a 2.5 per cent worsening in the output gap

D is an arbitrary pre-recession position upon which actual deficit changes are simulated. The balanced budget position (i.e. D = 0 per cent deficit) was selected because it is consistent with the "close to balance" requirement and the D = 2 per cent position was chosen because it is the likely budgetary position of several member states of the eurozone.

Buti et al. (1997) applied the Stability Pact requirement to previous recession episodes in the EU between 1961-96. Table 1 summarises some of their findings, column 2 shows that governments which entered a severe recession (a fall in GDP of greater than 0.75 per cent) with a balanced budget were more likely to avoid breaching the excessive deficit procedure in the year following the recession than those countries with a pre-recession position deficit of 2 per cent of GDP. This evidence would suggest that the early stages of EMU are likely to be fraught with difficulty for member states who have entered Stage Three with deficits ranging from 2-3 per cent of GDP, especially in light of the OECD"s estimates to which we referred above. Column 4 also offers evidence that countries with a pre-recession position deficit of 2 per cent will breech the excessive deficit procedure following an economic downturn. Unlike the case of a severe recession, this situation does not provide exemption from the excessive deficit procedures and sanctions will be invoked automatically. More worrying is the finding that even countries with low pre-recession budget deficits (or even surpluses) are at risk of breaching the reference level in the event of a long recession (Buti et al., 1997, p. 29). In addition, the Pact imposes a heavy burden on those countries with high elasticity of deficit to GDP as the budget deficits rise sharply in the face of declining GDP.

AN ALTERNATIVE FULL EMPLOYMENT, GROWTH AND STABILITY PACT

Background

In this section we propose an alternative pact which we label a *full employment, growth and stability pact* to emphasise the change of policy objectives involved. The development of a full employment, growth and stability pact draws on three elements : namely a Keynesian analysis of the workings of the economy, the articulation of a specific set of policy objectives which include full employment and growth, and third a consideration of appropriate institutional arrangements.

We begin with the recognition that such a pact would be based on an essentially Keynesian analysis of the economy (see also Arestis and Sawyer, 1998a). This analysis would view fiscal policy as an ingredient in the achievement of high levels of aggregate demand required to sustain high levels of economic activity. In addition to the broad stance of fiscal policy, governments can influence the level of aggregate demand through their choice of the composition of taxes and of public expenditure and through influence over investment expenditure.

Monetary policy is viewed as operating through interest rates and our analysis points to the extreme difficulties of controlling monetary aggregates in an endogenous money system. Further, inflation is seen as arising from pressures on the real side of the economy, whether emanating from conflicts over the distribution of income and/or from a lack of adequate productive capacity, and where inflation can proceed through the creation of money by the banking system (see, for example, Arestis, 1997). This brings some important perspectives, namely that creation of adequate productive capacity through investment, and the building of an equitable income distribution should be seen as important ingredients of anti-inflationary policy. It is argued here that the use of interest rates to control inflation can have detrimental effects on the future course of inflation. Unnecessarily tight monetary policy, which may be required to establish credibility of the ECB in the eyes of the financial markets, will have detrimental effects on future capacity and thereby on the ability of the economy to reach high levels of employment without inflationary pressures.

Our analysis would suggest that regional and other disparities in economic performance are a general feature of market economies. These disparities are exacerbated by the forces of cumulative causation with little, if any, tendency for "market forces" to reduce these disparities (cf. Myrdal, 1957). The euro is certainly launched in the face of substantial disparities (in terms of unemployment experience and per capita income levels), and the view here is that there will be little tendency for those initial disparities to decline unless appropriate policy action is taken.

The second element of the development of an alternative pact is the articulation of a set of objectives for economic policy, the pursuit of which should influence the design of the institutional arrangements and the instruments of economic policy. These objectives would be quite different from those which lie behind the Stability and Growth Pact. But they are perhaps largely self-evident, namely those of full employment and sustained economic growth in an environmentally friendly manner. The achievement of full employment necessarily includes the substantial reduction in the disparities of unemployment experienced, and the creation of sufficient productive capacity (Sawyer, 1999). In the development of a different agenda, a symbolic change would be to call the pact between member countries over economic policy a full employment, growth and stability pact, that is bringing full employment as a key element in the pact, and placing growth before stability in order of importance.

The third element is the creation and support of appropriate institutional arrangements at the EU and national levels, and the reformulation of the objectives of economic policy. The only new institution so far created in connection with the single currency has been, of course, the ECB. We have argued elsewhere that the current ECB arrangements are problematic and may very well lead to severe economic difficulties within the eurozone. The view expressed here is that a range of other institutions should be established by the European Union or encouraged by the EU and the member governments.

One of the weaknesses of the present institutional arrangements is the separation between monetary policy conducted by the ECB and the constrained fiscal policy operated by national governments. There is clearly a requirement for the co-ordination of economic policy across the member countries of the European Union and for the emergence of appropriate institutional arrangements and policies at the European level. Economic policy at the EU level faces the additional issue of the disparities of economic performance in terms of employment and unemployment rates and of the level of GDP per capita across the regions and countries of the EU. It is difficult to think of comparable examples of a single currency zone in which the disparities of economic performance were on anything like the scale of those within the EU : for example unemployment in April 1998 varied from 2.1 per cent in the central region of Portugal, 2.6 per cent in Aaland region of Finland, 27.0 per cent in Calabria, Italy and 29.9 per cent in Andalucia in Southern Spain.

There are major differences of banking systems and financial institutional arrangements within the eurozone. This reinforces the difficulties of the one instrument approach to economic policy, which is embodied in the use of interest rates for macroeconomic management. The differences in the financial arrangements will mean that the impact of an interest rate change will vary considerably from country to country. There are many other differences over, for example, wage bargaining and price determination such that national economies behave in different ways, leading to different policies being appropriate (for a comprehensive analysis of these, and other relevant issues, see Arestis and Sawyer, 1999).

Inflation

Much of the Stability and Growth Pact focuses on the achievement of low inflation through the use of monetary policy, and interest rate in particular. There are a range of views as to how monetary policy, change in interest rates more specifically, influences the pace of inflation, and it is worthwhile to distinguish two particular views. The first, which is essentially a monetarist view, is that there is a causal mechanism running from changes in the stock of money to the rate of inflation. This view rests on either the stock of money being exogeneous for the private sector but subject to change by the authorities or the supply of money being manipulated by interest rates. In the latter case there is the question of how to manipulate interest rates to affect the money supply since the liquidity preference of banks may lead to a different stock of money than what is intended. For example, it may very well be that the authorities raise interest rates to try to achieve a lower (than otherwise) stock of money, but commercial banks increase the supply of credit and thus the stock of money since it is now more profitable to do so. It is also the case that money has to enter the system in some way, and the most obvious route is that it is created by the banking system in response to a demand for loans (credit) by the private sector. However, the view that inflation is a monetary phenomenon and that expansion of the money supply can be used as a control mechanism over the rate of inflation appears to lie behind the operations of the ECB.

The second, which runs along the lines suggested by the Bank of England (1999) in their discussion of the transmission mechanism of monetary policy, focuses on the impact which interest rates have on aggregate demand, and then the impact which demand has on the pace of inflation. The Bank of England (1999) view the official interest rate as influencing market interest rates, asset prices, expectations and confidence, and the exchange rate. These factors then influence domestic and net external demand, which in turn influence domestic inflationary pressures, and import prices. The growth of the stock of money adjusts to the pace of inflation as the stock of money is willingly held by the public, and the demand for money depends on the level of nominal income.

The first view suggests that inflation can be controlled by monetary policy without any harm to the real side of the economy. The second view would suggest that the stock of money adjusts to inflation, generated on the real side of the economy, and that monetary policy in the form of interest rates can have effects on the real side of the economy. Further, it should also be recognised that monetary policy through the manipulation of interest rates may *not* an effective way of guiding the economy, and the effects of interest rate changes on economic performance are highly indirect and uncertain, and as such difficult to predict. We, thus, cast some doubt on the effectiveness of interest rate policy in the relatively closed EU economy, specifically in terms of the inflation objective. In so far as interest rate policy can influence the pace of inflation, it does so through suppressing aggregate demand, which in turn may well have detrimental effects on investment and the creation of productive capacity and have hysteresis effects on labour force participation.

The perspective on inflation underlying our proposals is rather different. Inflation is generated by factors on the real side of the economy, and then in effect validated by a growth of the stock of money. The achievement of high levels of economic activity without inflationary pressures then requires two elements. First, institutional arrangements for collective wage determination and price setting which are conducive to low inflation. Wage determination within the EU is currently undertaken on a decentralised and fragmented basis, even where it is (or has been) centralised within a particular national economy. The institutional arrangements for collective wage determination at the EU level do not currently exist, and this effectively rules out any possibilities for the operation of incomes policy or similar for the next few years. There are a number of examples in Europe (within and without the EU) of centralised institutional arrangements, which have been conducive to relatively low inflation : for example Austria, Germany and perhaps the most successful Norway.

Second, in addition to the construction of relevant institutional arrangements, it is necessary to construct a well functioning real economy which is also conducive to combining low inflation with high levels of economic activity. We take the view that a major element of that would be the construction of a level and location of productive capacity which is capable of providing work to all that seek paid employment. This would require that not only is the general level of productive capacity is raised but also that much of that increase is directed towards the less prosperous regions of the EU. This would require the enhancement of the functions of the EIB (or a similar institution) to ensure high rates of capital formation, appropriately located across the European Union : and we return to discuss an investment bank below.

Inflation has generally recently reached low levels, not just in European economies but almost world-wide. The present danger is more one of deflation, both in terms of low levels of demand and of falling prices, rather than of inflation. The construction of European wide institutional arrangements would be a long-term project, and is not something, which the European Union or its member countries can readily bring into being. It may though be able to act as a facilitator through appropriate legislation on the role of trade unions and employers" organisation, and the encouragement of the operation and growth of such organisations at the European level.

Fiscal Policy

Two specific considerations inform our approach to fiscal policy. The first is the idea that there is no strong reason to believe that the private sector will generate sufficient demand to underpin full employment, and consequently full employment may well require a budget deficit which in effect mops up excess private savings. This is not to say that budget deficits are inevitable or in some way desirable in themselves, but rather may be a necessary element in the achievement of full employment. The second is the potency or otherwise of fiscal policy in stimulating aggregate demand. Here it is argued that within the European Union, fiscal policy would be expected to be a more, rather than a less, effective policy as compared with fiscal policy at the national level. The European Union will constitute a relatively closed economy, and as such there would only be small leakages of any demand stimulus. It is ironic to note that fiscal policy is being downgraded at time when it may become more potent. In our discussion of fiscal policy, it should be clearly understood that we are not advocating any form of "fine tuning" involving frequent (more than annual) changes in tax and expenditure policies. Instead we would be advocating "coarse tuning" under which budget deficits are used to support aggregate demand as necessary, given the levels of private demand.

At both national and European Union level, the use of fiscal policy is heavily constrained by the Stability and Growth Pact. It has been indicated above that the limit in the Stability and Growth Pact on budget deficits of no more the 3 per cent of GDP translates into a requirement for a budget, which is in surplus or very small deficit averaged over the business cycle. A balanced budget implies (as a matter of an accounting identity) that the net sum of private savings minus investment plus trade deficit (borrowing overseas) is zero. There is little evidence that high levels of employment would necessarily generate an equality between savings and investment, and specifically it is expected that there would be an excess of savings over investment which needs to be mopped up by foreign lending or budget deficit. The limits on budget deficits would prevent this occurring, and hence full employment would require a balance of trade surplus and the consequent foreign lending. At present, the European Union runs a significant trade surplus with the rest of the world, but the counterpart is, of course, that other countries run a trade deficit and are borrowing from the European Union. It is doubtful whether such a pattern of surpluses and deficits is sustainable in the long term with the consequent build up of interest flows to service the borrowing.

It is generally recognised that the 3 per cent of GDP limit on budget deficits in the Stability and Growth Pact is arbitrary, and that this figure appears to have been plucked out of the air (some suggest a combination of the average German experience and a figure which corresponded to capital expenditure by many governments). In view of this argument and also of the ability to absorb shocks as well as to underpin high levels of aggregate demand, would suggest that the figure of 3 per cent is highly inappropriate. In the absence of an EU level fiscal policy, national governments should be allowed to pursue budget deficits as they think appropriate. Ideally, this should be seen as a temporary arrangement during a period in which a proper EU fiscal policy is generated. In the interim, national governments may well be constrained by the financial markets on how far they can borrow, and different governments may face different credit ratings in the financial markets (as different States within the United States of America do at present). There are no doubt "externalities" of one country's fiscal policy on another in the context of the European Union, which can operate through the spill-over effects of demand from fiscal policy and perhaps through the effects on interest rates. There is a paradox here in that interest rate is used as an instrument of monetary policy with the "repo" rate set by the ECB, and concern over the size of budget deficits through their impact on interest rates. There is then much to be said for co-ordinated fiscal policies, but in the context where that co-ordination is over the stances of active fiscal policies and where the policies themselves are aimed towards the achievement of high levels of economic activity. In view of the arguments of the European Commission (1977, what is known as McDougall Report (1997) , such co-ordination of fiscal and monetary policies become paramount. The euro will be greatly enabled to work under such circumstances.

Rules which specify a fixed limit on government borrowing fail to recognise that it serves as a mechanism for distributing over time the cost of adjustment to shocks and for smoothing the tax burden associated with public investment. We would argue that constraints on government borrowing reduce the flexibility of national governments" fiscal policy and make fiscal co-ordination extremely difficult. Moreover, we would suggest that the motivation behind the adoption of fiscal constraints by the Maastricht Treaty and their strengthening through the Stability and Growth Pact are questionable. Borrowing restrictions are not present in existing monetary unions (Eichengreen, 1997). In fact, it could be reasoned that borrowing constraints would be justified only if the sub-central government had little or no tax raising powers and was dependent on central government for most of its income because this increases the risk of a bailout. In instances where a significant proportion of sub-central government expenditure was generated from its own tax base, then the central government could force the sub-central government to take remedial action by either a decrease in expenditure or an increase in taxation, or indeed both, and government borrowing restraints should not be employed. The latter case applies to European monetary union, national governments still retain tax powers with a large tax base and as such it can use this as a means to finance borrowing.

The separation of the monetary authorities from the fiscal authorities and the decentralisation of the fiscal authorities will inevitably make any co-ordination of fiscal and monetary policy difficult. Since the ECB is instructed to focus on inflation while the fiscal authorities will have a broader range of concerns, there will be considerable grounds for conflict. This suggests a need for the evolution of a body, which is charged with the co-ordination of these monetary and fiscal policies. In the absence of such a body, tensions will emerge in the real sector when monetary policy and fiscal policy pull in different directions (Begg and Green, 1998, p. 131). The Stability and Growth Pact in effect resolves these issues by establishing the dominance of the monetary authorities (ECB) over the fiscal authorities (national governments). From this discussion, our proposals concerning fiscal policy would include three elements. First, the present constraints on national budget positions should be removed, and national governments should be allowed to set fiscal policy as they deem appropriate in the light of economic circumstances, and their perceptions of the costs and benefits involved. Second, institutional arrangements for the coordination of national fiscal policies be strengthened. Third, European Union institutional arrangements are required for the operation of an EU fiscal and to ensure that monetary authorities do not dominant economic policy making.

Monetary Policy and the ECB

Monetary policy typically operates through the setting of a key interest rate (such as the "repo" rate), rather than through controls over the stock of money. This means that there is a single instrument which is taken to influence the future rate of inflation. But the rate of interest (or more accurately the spectrum of interest rates which rests upon this key rate) has a wide range of influences, and of particular importance is that over the exchange rate and possibly the rate of investment. A recent review of the properties of the major macroeconometric models of the UK indicates that "the chief mechanism by which the models achieve change in the inflation rate is through the exchange rate" (Church *et alia* , 1997, p. 92). The effects of an exchange rate change will be much smaller on the European Union economy which trades relatively little with non-European Union economies than on say the Dutch economy where imports and exports amount to over 50 per cent of its GDP. The relatively closed nature of the European Union in terms of international trade (with imports and exports amounting to less than 10 per cent of GDP) means that variations in the exchange rate of the euro will have much less impact on prices than in more open economies.

It should be noted that monetary policy through the use of interest rates becomes more problematic at the European level as compared with the national level for four rather different reasons. First, the differences in financial structures, and in particular differences in the extent of variable rate and fixed rate borrowing and in the effect of interest rate changes on economic activity, mean that the effects of interest rate changes will be far from uniform across the EMU member countries. An interest rate rise may succeed in slowing down economic activity in some countries but not in others. As noted by Begg (1997), there is a large divergence in the nature and use of financial products across countries. For example, the use of longer-term financial contracts that insulate the borrower from the fluctuations in the short-term interest rates is more common in some countries in comparison with others, and this will retard the impact of monetary policy on aggregate demand.

Second, monetary policy has differential effects on different regions and countries. As the Bank of England (1999) recognises, monetary policy "sets one interest rate for the economy as a whole, and can only take account of the impact of official rate changes on the aggregate of individuals in the economy" (p. 7). Monetary policy is undifferentiated in that a single official rate will apply (though it may lead to a range of interest rates depending on the mark-ups applied by individual banks). The rules governing the allocation of credit may differ according to the decisions of the national central banks (though, of course, there are constraints on the variation of the rules in a single market), but the variation of rules is not undertaken centrally in pursuit of regional development.

Third, the emergence of the euro will lead to a rather novel situation in which there are two or three dominant currencies at the global level: the dollar, the euro (especially if UK joins the EMU) and possibly the yen (depending on resolution of the present difficulties in the Japanese economy). Each of these major currencies will have a basket of currencies whose value is virtually fixed relative to it. The setting of the euro interest rate will be heavily conditioned by the dollar and the yen interest rates and, in particular; there is the threat of instability as one set of interest rates responds to the setting of the others. For example, the pursuit of inconsistent exchange rate targets through interest rates would lead to a form of interest rate war.

Fourth, under present arrangements the European Union cannot run a budget deficit and national governments cannot monetise their deficits. A growing economy requires a gradual increase in the stock of money as well as a banking system, which can provide loans to finance investment, in the course of which money is created. The first statement implies that there is no direct mechanism by which the monetary base can expand as the EU and national governments are not allowed to "print money". The second statement implies that broad money (say M2 or M3) has to expand in line with national income (though not necessarily at the same rate), and hence that the ratio of M2 or M3 to M0 grows over time. There would seem to be three possibilities. The first is that in effect the ECB does monetise national government debt through open market operations, even though that would run counter to the general ideas on the non-monetisation of government deficits. The second is that as the ratio grows, the banking system becomes less liquid and more prone to instability. The third is that the ECB imposes a reserve ratio requirement that prevents the ratio from rising, but equally prevents the necessary monetary expansion to underpin economic growth.

Central banks usually have a range of roles linked with regulation and stability of the financial system, but these appear to be lacking in the case of the ECB. In particular, there is no specific requirement for the ECB to act as lender of last resort, though the ECB can decide to do so (see, for example, Articles 17 and 18 of the *Stature of the European System of Central Banks and of the European Central Bank*). Under a single currency there is no proper framework for crisis management. The traditional role of a central bank has been completely decoupled, with the ECB assuming monetary control and the national central banks retaining the supervisory role. It is argued that in the event of a banking crisis these two roles over-lap, the national bank, acting as lender of last resort, would wish to inject liquidity into the financial system; however, it would be constrained given that money supply control falls under the remit of the ECB (*Financial Times* , 23rd September, 1998). This argument should be qualified in an important way. The ECB"s main objective is the pursuit of price stability, but it is also responsible, along with national central banks, for banking surveillance (Hahn, 1991; Article 105(5) of the *Stature of the European System of Central Banks and of the European Central Bank*), though in this respect it can only offer a non-binding opinion. Yet in this area, the ECB"s potential role could be enhanced considerably, there remains scope for an expansion of its current supervisory role subject to ECOFIN approval (Article 105(6), op.cit). Furthermore, prevention can play an important role in limiting the possibility of financial crisis: higher capital and liquidity reserve requirements than those currently in operation can in principle reduce the severity of crises and strengthen banking supervision which would lessen the risk of bank bankruptcies.

The ECB at present stands as the only body which can implement economic policy at a European Union level. The ways in which the ECB operates is crucial for the economic health of the European Union, although we argue below that economic policy making at the EU level should be also substantially extended. The ECB suffers from two major shortcomings, namely its undemocratic and unrepresentative nature, and the objective which it has been set. Hence, we argue that the ECB should be changed in two significant ways : the membership of the board of directors should be broadened and the directors made directly answerable to the European Parliament, and the objectives set for it reformulated. A further change would be an increase in the transparency of the operations of the ECB.

The setting of interest rates seems to be regarded by some as a technical matter : indeed part of the rationale for an independent central bank is that decisions on interest rates are depoliticised by being taken out of the hands of politicians. When, in contrast, interest rates have distributional consequences and have differential impacts on regions and industries (whether directly or indirectly through, for example, the exchange rate), then the setting of interest rates should be influenced by those possible consequences. The board of directors of the ECB should be broadened through the explicit representation of different industrial sectors and of workers and consumers. An alternative would be for the board of directors to be appointed by the European Parliament in a way which, at least informally, leads to a wide representation of interests.

An alternative full employment, growth and stability pact would, thus, involve major changes to the operations of the ECB. We have argued for a change in the objectives set for the ECB, and a recognition of the channels of monetary influence with due regard being paid to the distributional effects of interest rate changes. Further, there is a need for the reformulation of the regulatory role of the ECB. In this respect, the ECB"s most important function is that of ensuring orderly conditions prevail in the money market. In order to achieve this, the reformulated ECB should be required to act as lender of last resort and not merely possess the potential to act as such. Moreover, the ECB should adopt a more pro-active stance regarding bank surveillance and supervision. The proposal for the reformulation of objectives readily follows from what has been previously said: that is the ECB should be charged with setting interest rates in a manner, which encourages growth and full employment, rather than merely inflation.

Adjustment Mechanisms

The adoption of a single currency by eurozone countries clearly removes the possibility of variation in the value of their domestic currency. Changes in the exchange rate can allow a country to offset differential shocks and differences in economic performance. It may be questioned how far a country can determine its own exchange rate in the globalised financial markets, though since an exchange rate is the relative value of one currency in terms of another it is rarely the case that one country can completely determine the value of its own currency. It is also the case that exchange rates have been highly volatile since the breakdown of the Bretton Woods system, and that exchange rates have diverged significantly from purchasing power parity (see, for example, Krugman, 1989, and Rogoff , 1996). Nevertheless, variation in the exchange rate (whether in the context of a fixed or a flexible exchange rate system) does provide a safety valve to adjustment to differential shocks and economic performance, even though the safety valve may not always work quickly (in the case of fixed exchange rates) or may often be faulty (in the case of flexible exchange rates).

It is clear that there are few, if any, mechanisms with the Stability and Growth Pact and the single currency for a country or region to adjust to differential shocks and economic performance. There is a notable absence of automatic stabilisers at the level with the requirement of a balanced EU budget and the small scale of that budget. The ability of national governments to stabilise their own economies becomes more circumscribed through the requirements of the Stability and Growth Pact and the limits on the size of budget deficits. It is often pointed out that most single currency zones involve a central or federal government tax and public expenditure programme, which is substantial relative to national GDP and a government budget, which can run significant deficits. The tax and public expenditure programme generally involves redistribution from richer regions to poorer ones, whether as an automatic consequence of a progressive tax and social security system or as specific acts of policy. The redistribution acts a stabiliser with negative shocks leading to lower taxation and higher social security payments in the region which is adversely affected. With the removal of exchange rate variations as an adjustment mechanism, it could be expected that economies would adjust to differential shocks and economic performance through a variety of other routes. These would include (in response to a negative shock) declines in economic activity, reductions in living standards and outward migration. There is then a requirement for the development of a larger EU tax base within a progressive tax system and the use of the tax revenue in a redistributive manner.

The problem of unemployment will be particularly serious in those cases where governments have chosen the wrong exchange rate at entry. An overvalued entry exchange rate will mean an extended period of recession to accommodate its effects, which emanate from the absence of the adjustable exchange rate safety valve. This is accentuated by the virtual absence of fiscal transfers, whether automatic or discretionary, from the relatively rich regions to the relatively poor ones. There is clearly not a tax and social security system operating at the European Union level which would make transfers between rich and poor in an automatic manner, and to provide an element of fiscal stabilisation. The expenditures on regional aid (structural and cohesion funds) and to a lesser degree agricultural policies do make some transfers from rich to poor, but on a very limited scale. In short, the European budget is neither on a sufficient scale nor of the right design to provide significant interregional insurance in the EMU (Fatas, 1998).

Investment Bank

The present disparities in regional unemployment levels (and also in labour market participation rates) within the EU would suggest that even if full employment were achieved in some regions, there would still be very substantial levels of unemployment in many others. In the presence of such disparities in unemployment, the achievement of a low level of unemployment overall (not to mention full employment) would be well neigh impossible. Inflationary pressures would build up in the fully employed regions even when the less prosperous regions were still suffering from significant levels of unemployment. Interest rates would then rise to dampen down the inflationary pressures in the prosperous regions without consideration for the continuing unemployment in other regions.

Eichengreen (1997) offered the suggestion that the European Investment Bank (EIB) can borrow off-budget to perform tax-smoothing functions, however, this would exceed the EIB"s present remit. Article 198e of the Maastricht Treaty states that "the task of the EIB shall be to contribute, by having recourse to the capital market and utilising its own resources, to the balanced and steady development of the common market in the interest of the community". Whether the functions of the EIB can be enlarged to include stabilisation policy (distribution over time) is extremely questionable, however, it can entail redistribution across countries, and it is specifically this function which should be expanded and strengthened from its present form where assistance is only in the form of loans and guarantees.

Therefore, a further recommendation would be to have a revamped EIB to supplement the activities of the ECB, with the specific objective of enhancing investment activity in those regions where unemployment is acute. Enhanced investment activity will, thus, aim to reduce the dispersion of unemployment within the framework of reducing unemployment in general. This could be achieved through encouraging long-term investment whenever this is necessary by providing appropriate finance for it.

We suggest an overhaul of the EIB"s remit because of the changing environment in which it operates. As highlighted by Honohan (1995), the EIB was established at a time when national capital markets were less developed than at present. Now, however, many lenders of loanable funds compete with the EIB and in this respect its public policy role is shrinking. Despite this trend, there still remains scope to extend the EIB"s public policy role. In particular one area for possible intervention has been identified. The case for a revamped and extended EIB is based on three considerations. First, there is a need for differentiated policies, which will enable the less prosperous regions to catch up with the more prosperous ones, which will enable higher average levels of employment and economic activity. Second, the forces of cumulative causation in the context of a single currency and market will tend to stimulate investment in the more prosperous regions rather than in the less prosperous ones. Third, the high set-up costs of venture capital projects and the disproportionate number of small firms in the EU peripheral areas (which generally experience higher levels of unemployment) provides scope for the provision of subsidies for venture capital activities because costs are mainly independent of the scale of borrowing (Honohan, 1995).

SUMMARY AND CONCLUSIONS

The current proposals for the EMU are based on the classical dichotomy with a separation between the real and the monetary sides of the economy with the (equilibrium) level of unemployment (effectively the NAIRU) and output determined on the supply-side of the economy and the level of prices (and hence the rate of inflation) set by the rate of expansion of the money supply. These arrangements along with the so-called Stability and Growth Pact we view as highly undesirable in view of the problems that we have identified above. It is for this very reason that we have suggested a new pact, *a full employment, growth and stability pact*, a very different pact from the one currently proposed for the EMU.

This is even more urgent and pertinent now, in view of the recent pronouncements by ECB officials. Its president stated recently at a press conference (13 October, 1998) that "the structural budgetary positions in several Member States are still far from being close to balance or in surplus as required by the Stability and Growth Pact. Therefore, these Member States are not yet sufficiently prepared to enable automatic stabilisers to function in the event of a slowdown in real GDP growth, while still respecting the 3 per cent reference level set out in the Treaty and ensuring a decline of debt ratios at an appropriate pace. Moreover, in a number of Member States against the background of a still favourable and partly better than expected growth performance, short-term budgetary targets appear not to represent structural improvements". Surely, a healthy future for the EU cannot be in prospect when economic policies are based on these pronouncements.

The *full employment, growth and stability pact*, which we propose in this paper, would have four major elements. First, a reform of the ECB to make it more accountable and to pursue a broader range of objectives. It should be clear that the ECB must act as lender of last resort, and to participate in the co-ordination of monetary and fiscal policies. Second, to extend the EU level budget to become more redistributive (across countries and time) and to provide much more discretion for national governments to pursue expansionary fiscal policy. Third, the expanded role of an investment bank to ensure that the less prosperous regions share in economic growth. Fourth, the encouragement of institutional arrangements which are conducive to low inflation.

REFERENCES

Arestis, P and Sawyer, M. (1998a), "Keynesian policies for the new millennium", *Economic Journal*, vol. 108, pp. 181-195.

Arestis, P and Sawyer, M. (1998b), "New Labour, New Monetarism", *Soundings*, no. 9, pp. 24-42; reprinted in *European Labour Forum*, vol. 20, pp. 5-10 (1998-99).

Arestis, P and Sawyer, M. (1999), "The economic and monetary union: current and future prospects", *mimeo* (University of East London and Leeds University).

Arestis, P (1997), *Money, Pricing, Distribution and Economic Integration*. London: Macmillan.

Artis, M and Winkler, B. (1998), "The Stability Pact: safeguarding the credibility of the European Central Bank", *National Institute Economic Review*, January, 1998, pp. 87-98.

Bank of England (1999), *The Transmission Mechanism of Monetary Policy*, London: Bank of England.

Bayoumi, T and Eichengreen, B. (1995), "Restraining yourself: the implications of fiscal rules for economic stabilisation", *Staff Papers*, International Monetary Fund, vol. 42, no. 1, pp. 32-48.

Begg, D. (1997), *The Design of EMU*. IMF Working Paper WP/97/99.

Begg, I. and Green, D. (1998), "The political economy of the central bank", Ch. 8 in P. Arestis and M.C. Sawyer (eds.), *The Political Economy of Central Banking*, Cheltenham: Edward Elgar Publishers.

Bovenberg, A.L. and de Jong A.H.M. (1998) "The road to economic and monetary union", *Kyklos*, vol. 50, pp. 83-109.

Buti, M., Franco, D. and Ongena, H. (1997), *Budgetary Policies during Recessions: Retrospective Application of the "Stability and Growth Pact" to the Post-War Period*, Brussels: European Commission.

Church, K.B., Mitchel, P.R., Sault, J.E. and Wallis, K.F. (1997), "Comparative performance of models of the UK economy", *National Institute Economic Review*, no. 161, pp. 91-100.

Eichengreen, B. (1997), *European Monetary Unification: Theory, Practice and* Analysis, Cambridge Mass.: MIT Press.

Eichengreen, B. and Wyplosz, C. (1998), "The Stability Pact: more than a minor nuisance?", in D. Begg, J. von Hagen, C. Wyplosz and K.F. Zimmermann (eds.), *EMU: Prospects and Challenges for the Euro*, Oxford: Blackwell Publishers.

European Commission (EC), (1998), *EURO 1999, Convergence Report*, Brussels: The European Commission.

European Commission (MacDougall Report) (1977), *Report of the Study Group on the Role of Public Finance in European Integration*. Brussels: European Commission

Fatas, A. (1998), "Does EMU need a fiscal federation?" *Economic Policy*, no.26, pp.163-203.

Hahn, H. (1991), "The European central bank: key to European monetary union or target?" *Common Market Law Review*, vol. 28, pp. 783-820.

Herdegen, M. (1998), "Price stability and budgetary restraints in the economic and monetary union: the law as guardian of economic wisdom", *Common Market Law Review*, vol. 35, pp. 9-32.

Honohan, P. (1995), "The public policy role of the European Investment Bank within the EU", *Journal of Common Market Studies*, vol. 33, no.3, pp. 315-330.

Krugman, P. (1989), "The case for stabilizing exchange rates", *Oxford Review of Economic Policy*, vol. 5, pp. 61-72.

Lamfalussy, A. (1997), "Securing the benefits of EMU", In Deutsche Bundesbank: Auszuge aud Presseartikeln, no. 14, pp. 4-7.

Myrdal, G. (1957), *Economic Theory and Underdeveloped Regions*. London: Duckworth.

OECD (1998), *Economic Outlook*, December, 1998, Paris: OECD

Rogoff, K. (1996), "The purchasing power parity puzzle", *Journal of Economic Literature*, vol. 34 (2), pp.647-668

Sala-I-Martin, X. and Sachs. J. (1992), "Fiscal Federalism and Optimum Currency Areas: Evidence for Europe from the United States", in M. Canzoneri, V. Grilli and P. Masson (eds.) *Establishing a Central Bank: Issues in Europe and Lessons from the US*, Cambridge: Cambridge University Press.

Sawyer, M. (1999), "Aggregate Demand, Investment and NAIRU", *Discussion Paper*, University of Leeds.

Snyder, F. (1998), *EMU Revisited: Are we Making a Constitution? What Constitution are we Making?* European University Institute Working Paper Law No. 98/6

von Hagen, J. and Eichengreen, B. (1996), "Federalism Fiscal Restraints, and European Monetary Union", *American Economic Review*, AEA Papers and Proceeding, vol. 86, no. 2, pp. 134-38