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ECONOMIC GOVERNANCE

European Monetary and Fiscal Policy Revisited

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The European Economic and Monetary Union (EMU) constitutes a case of monetary union with a single currency and a common monetary authority, but without a political union. The EMU had run ahead of fiscal and financial integration and happened at a time of diverse economic records in Europe. However, multiple benefits have accrued to its Member States over time. The EMU has forged the necessary nominal policy anchor for macroeconomic stability, increased transparency, enhanced competition and integrated capital markets. It also induced structural change and productivity growth. Nevertheless, in times of crises or asymmetric shocks, the EMU may not be able to reduce potential costs. As the eurozone and the European Union (EU) face a sustained debt crisis, the question of whether a monetary union can be viable without a fiscal union is resurfacing. This paper addresses this question and other relevant issues in the context of efforts to manage the debt crisis in Europe.

The Euro in perspective and the case for a fiscal union

During the short period of its existence, the euro contributed to growth for all eurozone members. The EMU led to integrated capital markets, has supported a more stable economic environment by anchoring inflationary expectations, lowered borrowing costs across the board, and thus underpinned considerable economic growth. This ultimately helped to advance real convergence (although more remains to be done), thus reducing marked disparities in per capita income levels. The elimination of transactions costs and increased price transparency further enhanced trade and benefited consumers.

However, the international financial crisis of 2008 and the European debt crisis that ensued ushered in a new period of introspection and intra-European rivalry. The first period of the euro was also marked by widening imbalances amongst Member States and rising debt burdens. This was the result of weak fiscal structures and tax enforcement mechanisms that failed to maintain the necessary fiscal discipline across Member States. It was also the result of a bubble mentality that prevailed in the 1990s as an outcome of several factors, including an inadequate regulatory financial framework. Subsequently, the financial and economic crisis in the United States (US) also critically affected developments in the EU.

Problems in European banking originated with the general global credit expansion that began in the early 2000s. The adoption of the euro in 1999 effectively allowed traditionally higher inflation countries – like Spain, Portugal and, after 2002, Greece – access to credit at much lower rates. Corresponding spreads with German bonds narrowed sharply and dropped almost to zero in some instances. This situation led to unprecedented credit expansion, creating a number of housing bubbles across Europe.

The EU is a relatively diverse region in terms of geography, political systems, national endowments and economic fundamentals. Northern European countries are capital rich, and technologically and administratively advanced in comparison with peripheral countries in the south. Countries in the north would favour a strong currency, while countries in the south would favour a weaker currency in order to be more competitive abroad. This diversity of the EU renders efforts for a political and fiscal union highly complicated.

With the creation of the eurozone, interest rates in the countries of southern Europe dropped to near German levels and spreads almost dropped to nil in the period prior to the eruption of the global financial crisis. An environment of significantly lower interest rates in these countries led to an unprecedented credit expansion by corporations, consumers and governments alike. Growth in the peripheral countries was debt financed and was accompanied by growing fiscal and payment imbalances. A decade of remarkable growth came to a sudden end on a pile of private and public debt.

For the export oriented, highly productive and technologically advanced German economy, the single currency has been especially advantageous. About 40% of Germany's exports go to less productive and less capital-intensive eurozone partners. With the exchange rate locked in the currency union, these eurozone countries cannot devalue in order to gain a competitive advantage and to correct their payments imbalances. The result is amassing trade and current account imbalances, which are also reflected in fiscal imbalances and rising debt burdens.

Highly competitive economies like Germany are able to amass huge trade and current account surpluses against eurozone trading partners. In the context of the current crisis, Germany acquires considerable leverage to force upon eurozone member countries its economic and fiscal reforms.

Obviously the pre-crisis fiscal framework in the eurozone requires major overhaul. If weak fiscal structures sit at the centre of the eurozone's current problems, then what is needed to safeguard the stability of the eurozone is a form of a fiscal union. The real issue is what combination of power sharing between the eurozone and the nation-states would make the EMU

stable and viable. The challenge is to arrive at a fiscal union that would allow nation-states to have a high degree of flexibility with their economic policy.

Managing Europe's debt problems

Europeans expect to manage their debt problems by a series of measures and reforms that strengthen European integration. These measures include:

- Expanding the size and powers of the European Financial Stabilisation Facility (EFSF) that was created in the wake of the Greek debt crisis in May 2010;
- Establishing a permanent stabilisation fund to replace the EFSF when it expires in 2013;
- Including the private sector in funding the bailouts;
- Strengthening economic governance in the eurozone.

Agreement had been reached in "principle" at the European Council meeting of 24-25 March, 2011, to increase the lending capacity of the EFSF from €250 billion to €440 billion. However, a decision about how to raise the fund's lending capacity was delayed until the next European Council meeting in June.

This delay in the decision is apparently linked to growing reaction amongst populations in some countries and pending elections. Far-right movements in some cases, which stand against bail-outs and eurozone reforms, are gaining support. As the electoral successes of such non-traditional and nationalistic parties increase, resistance to eurozone reforms, bail-out mechanisms and austerity measures will be increasing. This stresses the need for a better understanding and better communication of the significance and benefits of the eurozone for the future of Europe at large and its position in the global system.

Increasing the lending capacity of the EFSF is absolutely necessary to allay market fears regarding the stability of the eurozone. It is certain that a solution will be found in June to accommodate reactions and thus increase the fund's lending capacity. But going forward, the anti-reform sentiment is an area that European elites should watch very carefully.

The European Council also agreed to establish a permanent stability mechanism: The European Stability Mechanism (ESM). The ESM, which will be a supranational institution, will assume the role of the EFSF in providing financial assistance to eurozone Member States after June 2013. The ESM will have a total subscribed capital of €700 billion, of which €80 billion will be in the form of paid-in capital and the remaining €620 billion will be in the form of callable capital and of guarantees from eurozone Member States.

Access to ESM financial assistance will be on the basis of strict conditionality. There is also an implicit agreement on sovereign debt restructuring. Part of the conditionality for ESM financial assistance is that "[...] the beneficiary Member State will be required to put in place an appropriate form of private-sector involvement, according to the specific circumstances, and in a manner fully consistent with IMF practices”.[1]

Against this possibility, private investors will be requiring higher yields to compensate for the higher likelihood of default, which will be pushing nations’ debt financing costs higher. In case of budget distress, financial assistance is made available only on the basis of well-structured adjustment programmes in the form of strict austerity measures, which are very unpopular. Whilst interest rate spreads in the eurozone remained very narrow for most of the euro’s life, they have started to diverge with the appearance of debt problems. With a formal default policy in place, those spreads are going to diverge further. There is a tendency therefore to return to interest rates that prevailed before the introduction of the euro. Knowing that partial defaults will be part of the solution to the eurozone’s debt problems, there will be upward pressure on corresponding yields on all new debt issues and on old issues that come up for refinance. This will make it more difficult for states to fund their deficits, particularly if they depend more heavily on foreign investors. Higher financing costs, in turn, make a default or the need of a bailout more likely.

The new mechanism has this inherent problem whereby the private sector will be less willing to hold sovereign debt; this may ultimately jeopardise the effectiveness of any permanent bailout mechanism. The financial crisis therefore might just get worse before it can get better. If the new permanent bailout mechanism comes into existence in 2013, when the temporary mechanism expires, many countries will be facing bigger debt burdens and higher financing costs. Germany might be in control of the bailout mechanism, but the mechanism as such does not constitute a political union.

The European Council also agreed on the Euro-Plus Pact, which commits eurozone Member States and six (Bulgaria, Denmark, Latvia, Lithuania, Poland and Romania) non-eurozone Member States – that opted in – to reforms aiming at long-term fiscal consolidation and competitiveness. The Euro-Plus Pact replaces the Competitiveness Pact agreed upon earlier by France and Germany.

Germany at present has considerable leverage inside the eurozone because it provides the bulk of the support needed for the bailouts. Opposition to Berlin’s designs therefore is expected to come mostly from non-eurozone Member States. The United Kingdom (UK) has already expressed disagreement to further eurozone reforms that strengthen coordination between eurozone members at the expense of the entire EU.[2] Countries such as Poland and Sweden, which are not members of the eurozone, but contribute to the EFSF, will object

1. European Council, Conclusions, “Conclusions of the European Council”, EUCO 10/11, 25 March 2011, p.21, available at: http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/120296.pdf
2. Furthermore, it is expected that some countries, including Ireland and Cyprus, will object to the (possible) provision for a common assessment basis for the corporate income tax

to a system dominated by Germany and France. These reforms give Germany considerable leverage in the eurozone, whilst at the same time underpinning a two-tiered EU.

Lessons from the economic crisis and the future of the Euro

When the EMU was created, there was criticism in relation to its economic rationale. One of the issues raised was that countries could face asymmetric recessions and shocks, and as members of a monetary union, they would not be able to exercise discretionary monetary policy. Furthermore, as currency depreciation is not an option under such conditions, participation in a monetary union may be procyclical. On the other hand, it had been supported that the creation of the monetary union and the euro were inevitable. In an economic area of free capital mobility, the alterative would have been regular monetary and currency crises, including speculative attacks. Consequently, although the shortcomings of a monetary union are recognized, the alternative would have entailed higher costs.

Given historical experiences with financial and currency crises, fiscal strains and low economic growth constitute major risk-considerations for the single currency and the EMU. On the other hand, such circumstances tend to enhance the need for solidarity and coordination. Whilst the welfare state can be the basis of much social stability and economic resilience in Europe, the classic trade-off between social welfare and economic efficiency sets limits on the reach of the welfare state.

Government finances are coming under severe strain as a result of two interconnected developments. On the revenue side, there is increasing pressure in a globalised world to reduce corporate tax rates. On the spending side, a number of interrelated factors – the ageing of the population, rising medical costs and rising demand for public services in general – are straining public finances. Lack of coordination of national fiscal policies may create a serious threat to the single currency.

The long run success of the euro also critically depends on a sustained rate of real growth. Low growth or markedly variable growth rates across different regions and countries would generate political strains against the euro. That means that in addition to fiscal discipline, there must also be provisions for flexibility encouraging growth. For example, the rules of the Stability and Growth Pact in relation to the fiscal deficit should be revisited. It may be wiser to expect the 3% fiscal deficit to be an average over time instead of an annual target.

The recent international economic crisis was the most serious since the Great Depression. One of the lessons is that international coordination and cooperation on various issues, including regulation of financial institutions, is of utmost importance. For the eurozone, the crisis also had additional dimensions. Countries with serious structural fiscal problems found themselves in an extremely difficult situation and had to cope without having the option of currency depreciation. The EU was successful to offer a particular level of solidarity to countries requiring support. Nevertheless, it is questionable whether this, on its own, will be enough to effectively address similar crises in the future.

The greatest challenge for the EU and the eurozone is to further encourage structural reform for real economic convergence. At the same time, the EU should seriously consider the adoption of a form of fiscal union. This may imply that the budget of the EU should be higher than what it is today. After all, a major characteristic of any fiscal union is the capacity to spend and subsequently influence economic outcomes. Given that, in the case of the eurozone, the business cycles are not uniform, such a move will be a major step in the right direction. It is essential to note that the budget of the EU today is about 1% of Gross Domestic Product (GDP) – in the US, the federal budget revolves around 37% of GDP.

Following the marked devaluation of the US dollar, beginning in 2005, the euro has come into focus as an alternative international currency. Consequently, the strength and governance of the new currency constitute areas of increasing interest in global finance. But the single currency in the framework of divided and / or shared sovereignty raises a number of issues and potential threats.

The fundamental question and challenge is whether, in the long run, the euro can be successfully sustained without further political integration. A key problem is conflict among national agendas for growth and full employment. This is related to the incidence and severity of potential asymmetric shocks. Further integration and the creation of cooperative fiscal arrangements will be vital for the durability of the EMU.

It may also be interesting to assess the impact of the common currency on the identity of eurozone members. Future generations that will not have gone through the experience of national currencies, but will be using and sharing the euro, may have a higher propensity to put more emphasis on European identity.

The euro has *de facto* evolved as the second reserve currency of the world. However, the euro stands in contrast to the dollar in a number of respects. Unlike the dollar, the euro is not the currency of a superpower. The euro is held for political reasons and for diversification purposes. More importantly, it is not dependent on continued capital inflows like the dollar.

During the deep international financial and economic crisis of 2008-2010, the euro proved to have reduced negative impact in eurozone countries. The multidimensional utility of the euro is well understood and complaints about loss of national monetary and economic independence are gradually fading. The sustainability of the euro as well as the achievement of other economic objectives are core issues. These dynamics raise de facto the issue of further economic deepening and political integration. Even if not all Member States of the EU and of the eurozone may be interested in discussing further economic and political integration,

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this will be undertaken by some countries. This may lead to a multi-speed EU, with the core moving toward a form of federation.

Recommendations

Besides any suggestions for fiscal discipline and harmonisation, the EU must also revisit its philosophy in relation to spending. First, while the rule of the Stability and Growth Pact for an annual fiscal deficit no higher than 3% is essential, given the reality of business cycles, it may be wiser to expect the 3% deficit to be an average over time, instead of an annual target. Second, the EU must gradually increase its own budget. Currently, it only represents 1% of EU GDP; this is very low for an economic and monetary union. Such an approach would certainly encourage further integration as well as economic stability.