# Is Europe Doomed to Stagnation?
## An Analysis of the Current Crisis and Recommendations for Reforming Macroeconomic Policymaking in Euroland

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"It is not too farfetched to say that Europe chose never really to recover from the two worldwide oil-shock, anti-inflation recessions of the decade 1973 to 1982. Europe seems content to return to sustainable growth rates at lower and lower rates of utilization, without ever recapturing the ground lost in those recessions. With chronic double-digit unemployment rates in several members of the EU, the policy might be described as cutting out of the economy large fractions of the population, buying their acquiescence by welfare-state transfers, and then blaming the "structural" unemployment on the transfers. ... I am not enthralled by the recommendations I heard ... that the U.S. follow the European example and gear monetary policy exclusively to price stability. This orientation of monetary policy has been very costly in Europe, and it is likely to be even more costly if it is enshrined as dogma by the Maastricht Treaty." (James Tobin 1994).

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**ABSTRACT**

This paper challenges the view that external shocks caused Euroland's 2001 slowdown and subsequent stagnation. Instead, the design of Euroland's macro policymaking arrangements is found lacking in looking after sufficient domestic demand growth. In the event the ECB has failed on its stabilization role—a rather vital role given that fiscal policy is severely constrained by the Stability and Growth Pact. As a result, Europe is in a precarious situation of stagnation today, and under the current regime there is even a risk of self-reinforcing destabilization. Hence, reforming the regime is urgent. A nominal GDP target to be pursued by fiscal and monetary policies in cooperation would provide Europe with the growth anchor that is currently missing.

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## 1. INTRODUCTION

After a brief span of relatively strong GDP growth between 1998 and 2000, the eurozone experienced a pronounced slowdown in 2001. With hopes for a quick recovery in 2002 having turned out unfounded, in early 2003, Euroland appears set for yet another year of stagnation, at rising unemployment and a relentlessly growing negative output gap. What went wrong? And how can Euroland pull itself out of the current mess?

This paper attempts to give answers to these questions, questions that seem all the more urgent in view of the prospective enlargement of the European Union in 2004. There is a risk of serious crisis by that time unless Euroland's economic engine starts up again soon.

The analysis proceeds as follows. Section 2 investigates—and rejects—the view that the 2001 slowdown in Euroland may have been due to external shocks. Three findings are striking. First, domestic demand growth began to decline in mid 2000 whereas exports grew strongly through 2000. Second, both domestic and external demand growth plunged in 2001, but Euroland's "recovery" in 2002 was largely export-driven, with domestic demand merely stabilizing at a depressed level. Third, throughout the ECB thoroughly misjudged developments.

These findings squarely direct our attention to domestic factors. Critically discussing macro policymaking arrangements under the Maastricht regime, section 3 argues that, if that regime is to be made to work at all, the ECB has to play a vital role in stimulating domestic demand and stabilizing the economy. The subsequent section 4 reviews the actual behavior of the key players. It is found that both social partners and finance ministers essentially played after the rules. By contrast, the ECB completely failed on its stabilization role: its all too aggressive interest rate hikes in 2000 where followed by all too "cautious" rate cuts in 2001–02. As a consequence, the prospects for Europe under the current regime are grim, as discussed in section 5. Reforming the regime is thus a matter of urgency and section 6 recommends that a

nominal GDP target should be pursued by fiscal and monetary policies in cooperation—providing Europe the growth anchor that is currently missing. Section 7 concludes.

## 2. THE 2001 SLOWDOWN: CAUSED BY EXTERNAL SHOCKS?

Raising this question might come as a surprise. After all, a key idea behind EMU was that this would create an economic area under common policymaking nearly resembling a closed economy; a large economic zone sheltered from those recurrent bouts of instability in the rest of the world where economic policies might still be guided by principles other than the "stability-oriented" ones inspiring policymaking in Euroland.

In line with this thinking, the U.S. economy's severe nosedive in 2000–01 (according to official NBER dating recession began in March 2001) represented no serious concern to the ECB for quite some time. Eurosystem staff economic projections for the euro area of December 2000, based on an unchanged monetary policy stance, showed strong growth for 2001 (2.6 – 3.6%) and 2002 (2.5 – 3.5%). In its Monthly Bulletins of December 2000 and January 2001, the ECB held that medium-term risks to price stability were on the upside. The January Bulletin discussed the U.S. Fed's first 50 basis points cut of 3 January 2001 with reference to increasing uncertainty surrounding the economic growth performance in the U.S., but in February the ECB declared:

> While this deceleration will have some dampening effects on euro area net exports, the euro area is a large economy in which economic developments are determined mainly by domestic factors. Overall, the fundamentals in the euro area remain broadly favourable (ECB 2001, February Bulletin: 5).

This assessment of the situation was confirmed in March with the ECB stating that:

> The general outlook for this year and next remains positive. Economic activity in the

> euro area is mainly determined by domestic factors. The conditions on the domestic side, as shown in long-term financing costs and real disposable income developments, for example, have remained favourable. ... This notwithstanding, an element of uncertainty with regard to the outlook for euro area growth continues to be the world economy and its potential impact on euro area developments. However, at this juncture, there are no signs that the slowdown in the U.S. economy is having significant and lasting spillover effects on the euro area (ECB 2001, March Bulletin: 5).

No doubt U.S. growth was not held to be all that important to economic performance in the eurozone, with the ECB declaring in May 2001 that "economic growth, supported by domestic demand, will be broadly in line with estimates of potential growth in 2001" (ECB 2001, May Bulletin: 5). Yet, on May 10, the ECB cut its key policy rates by 25 basis points; once again, stirring widespread confusion in financial markets (Bibow 2002b).

The ECB soon came to appreciate the role of external developments. In fact, before long it explicitly stated that the deceleration of growth was *caused by* external factors, but would be supported by both fiscal and monetary policy in the eurozone:

> Real GDP growth in the euro area in 2001 is expected to come down from the high level reached in 2000 to levels more in line with trend potential growth, primarily as a result of the less favourable external environment. ... At this juncture, however, the contribution to real GDP growth from domestic demand is expected to remain robust. This is consistent with the favourable economic fundamentals of the euro area, the impact of current and planned tax reforms and favourable financing conditions (ECB 2001, June Bulletin: 5)

In July, the ECB for the first time related the slowdown to dwindling domestic demand, albeit with declining investment seen as linked to adverse influences from the world economy and weakening consumption partly due to adverse income effects relating to energy and food price increases. At any rate, the ECB predicted that "in the course of [2001], domestic demand should gradually recover, in view of the sound economic fundamentals of the euro area, previous and ongoing tax reforms and favourable financing conditions" (ECB 2001, July Bulletin: 5).

Given this assessment any further rate cut had to wait until August 30. In fact, only after the September 11 attacks interest rates were cut more decisively, by 50 basis points each on September 17 and November 8. Weakening demand was seen as

**reducing price pressures. With falling inflation and high uncertainty, these cuts were retrospectively described as "forward-looking" (ECB 2001, December Bulletin: 5). Growth was forecasted to resume its potential rate in the course of 2002, particularly as Euroland was not suffering from any serious imbalances:**

> The conditions exist for a recovery to take place in the course of 2002 and economic growth to return to a more satisfactory path. The economic fundamentals of the euro area are sound and there are no major imbalances which would require a prolonged adjustment. The uncertainty currently overshadowing the world economic should diminish over time. Further positive effects on economic growth should stem from the increase in real disposable income caused by the substantial decline in inflation and the impact of tax reductions in several euro area countries. In addition, interest rates across the entire yield curve are now *low, meaning that current financing conditions are clearly supportive to economic growth* (ECB 2001, November Bulletin: 6).[1]

**On the degree of synchronicity of the 2001 global slowdown a consensus view has emerged among international authorities emphasizing increased international linkages on the one hand, and commonness of shocks on the other. For instance, the BIS's Annual Report (2002, p. 16) states: "On balance, it seems that the synchronized downturn in 2001 mainly represented the effects of common shocks, reinforced by the high trade intensity of the demand components most severely affected."**

1. Emphasis added as this quotation nicely illustrates that the ECB has fallen victim of the "Wicksellian fallacy," that is, the illusion that the degree of monetary ease or restraint might be read off the *absolute* level of interest rates (Wicksell 1898). On this reasoning, of course, the Bank of Japan could fancy even more that its policies might have been supportive to growth throughout the 1990s.

No doubt international linkages exist and a reawakening to the fact that Euroland remains part of an ever more tightly integrated global economy is to be welcomed. Particularly, as Euroland itself is big enough to pose risks to the rest of the world too. As it happened Euroland's brief span of prosperity during 1997–2000 owed much to the U.S.'s "new era" growth spur (Bibow 2001a,b).[2] A U.S. slump was bound to have a significant impact on the eurozone—and policymakers should have been especially alert to this prospect.

Nor can the commonness factor of certain "shocks" be denied. The oil price surge since 1999, the IT bubble bursting and general stock market decline after March 2000, and monetary tightening feature as common shocks in the BIS's and IMF's account of causes of the global slowdown. As to the latter "common" shock, the IMF also identifies some differences though:

> As in previous business cycles, monetary policy in G-7 countries was tightened prior to the recent downturn. Given that inflation was relatively low toward the end of the previous expansion, central banks had to raise interest rates by less than usual, which is one factor behind the relatively mild recessions. Relatively low inflation going into the recessions also allowed central banks—especially in the United States, the United Kingdom, and Canada—to cut interest rates aggressively over the past year, helping to set the stage for recovery (IMF 2002, April WEO: 71).

The OECD too refers to "lagged effects of earlier monetary tightening" in its euro area survey of 2002, suggesting an interesting link between this factor and inflation and exchange rate developments that will be taken up again further below:

> The sharp hike in oil prices in 1999/2000 reduced purchasing power and squeezed profit margins, while the rise in underlying inflationary pressures led to a tightening of monetary policy by central banks, including the ECB. The continued weakness of the

2. In an article on the "characteristics of the euro area business cycle in the late 1990s," the ECB appears to confirm this: "When foreign demand picked up again in early 1999, extra-euro area exports improved and real GDP growth increased. The exceptionally strong cyclical upturn in extra-euro area exports in 1999 and 2000 benefited from an unusually sharp expansion in the world economy and from the rise in price competitiveness associated with a protracted depreciation of the effective euro exchange rate" (ECB 2002, July Bulletin: 48).

> euro and strong monetary growth also added to concerns about the risk to price stability (OECD 2002a: 19).

**For some reason interest rates do not feature in the ECB's assessment of the slowdown. Ex ante interest rate policies never seem to conflict with economic growth in ECB policy communications and assessments. And ex post economic developments do not appear to have been related to interest rate developments either. For instance, throughout the ECB's brisk tightening phase between November 1999 and October 2000, the ECB proclaimed that monetary tightening would not pose any risk to economic growth. Rather, by keeping inflation expectations in check, confidence in price stability would be sustained which, in turn, would stimulate growth, in the ECB's view (Bibow 2002b). And in comparing the 1998 and 2001 slowdowns in the euro area (ECB 2002, June Bulletin: 41–3), the ECB is conspicuously silent on two key facts. First, the interest rate conversion process and associated asset price surges since the mid 1990s, a one-off adjustment that significantly boosted domestic demand in the late 1990s in some eurozone countries, but had largely run its course by 2001–02. Second, the near doubling of ECB policy rates (225 basis points) in less than a year after October 1999.**

**Given that the ECB's published research on the transmission mechanism in the eurozone shows strong[3] (although allegedly "temporary") real effects of monetary policy, particularly "that investment is a main driving force, with a contribution of more than 80 percent to the total response of GDP after three years" (ECB 2002, 47), it would be surprising if these factors made no difference at all in recent years. It is thus noteworthy that the ECB's comparison does not fail to observe that in the context of the external demand shocks of 1997/98 domestic demand in the eurozone held up quite well, whereas domestic demand plunged in the 2001 slowdown.**

3. A two-year increase of 100 basis points in policy-controlled interest rates is estimated to contract GDP by 0.2 to 0.4% in the first year and by up to 07% in years two and three (effects in later years are not reported). See ECB 2002 (October Bulletin: 45) as well as ECB 2000, Arestis and Sawyer 2002, and Kuttner and Mosser 2002.

With this puzzle at hand getting the empirical record straight seems crucial. Figure 1 captures the broad situation during the last five years, showing (year-on-year) quarterly growth of real GDP, domestic demand, and exports at annual rates. In the late 1990s, domestic demand grew at 3% per year, slowing only mildly and temporarily in the course of 1999. A marked and protracted deceleration of both private consumption and investment then started in mid 2000, pulling down imports along with them. By contrast, after recovering from the 1997–98 crises, exports grew briskly in 1999 and through 2000. Export growth then plunged in 2001, long after the domestic situation had turned for the worse. While government consumption increased slightly over 2001–02, after being broadly stable over 1999–2000, overall domestic demand growth turned negative in late 2001.

A comparison with the U.S. is illuminating. In the U.S. too (Kregel 2002), the situation turned for the worse in mid 2000, as figure 2 shows. However, U.S. exports plunged earlier and far more severely than in the eurozone. A look at the contributions to GDP growth shown in figure 3 is most revealing. Clearly, the U.S. experienced a severe contraction in 2001. But if the slowdown was mainly driven by domestic demand, so was the recovery in 2002. The drag on U.S. GDP growth due to net exports briefly paused in 2001, but quickly reemerged with the recovery. By contrast, as figure 4 shows, while net exports kept Euroland afloat and GDP from shrinking during the slowdown, no recovery occurred in 2002—as domestic demand continued to stagnate at a depressed level.

In conclusion, blaming the current stagnation in the eurozone on external developments has no basis. In so far as "common shocks" were at work in the 2001 global slowdown, Euroland's downturn after mid 2000, and failure to recover ever since, have helped to drag the world economy down; representing a cause and propagation mechanism of global fragility rather than the opposite. Clearly, then, explanations for the economic situation in the eurozone have to focus on domestic factors, macroeconomic policymaking in the eurozone in particular.

Before analyzing actual macroeconomic policymaking in the eurozone before and

since the 2001 slump, it is useful to briefly revisit the design of Euroland's macroeconomic policymaking regime, or "Maastricht regime," and its underlying rationale.

## 3. MACROECONOMIC POLICYMAKING AND THE RULES OF THE MAASTRICHT REGIME

A fundamental imbalance in economic policymaking represents the outstanding characteristic of the Maastricht regime. The EU has created a common market and a majority of members have adopted a common currency, both controlled by supranational EU institutions. But economic and fiscal policies remains under national control—there is no supranational European Treasury.

As laid down in Articles 98 and 99 of the EU Treaty, member states have to "regard their economic policies as a matter of common concern and coordinate them within the Council." Geared at common objectives defined in Article 2, featuring a high level of employment and of social protection and sustainable and non-inflationary growth, policies have to be conducted in compliance with the principles for close policy coordination set out in Article 4, namely, stable prices, sound public finances and monetary conditions, and a sustainable balance of payments. Annual "broad economic policy guidelines" [BEPGs] form the basis for policy coordination and multilateral surveillance of policies within the EU. In addition, the Luxembourg and Cardiff processes were devised to raise the eurozone's growth potential and reduce its high level of unemployment, the former through improving the functioning of labor markets and coordinate employment policies of member countries, the latter through improving the functioning of product and capital markets. Finally, the "Cologne Process" initiated a dialogue between the main macroeconomic players, including social partners as well as the ECB—macroeconomic policy *coordination by dialogue*.[4]

In the field of budgetary policies, principles of "sound finance" were firmly

4. See OECD 2002a for an overview.

**engraved right from the start in the Treaty's "excessive deficit procedure" of Art. 104, prescribing limits for public debt and deficits. For fiscal discipline is held to be vital for safeguarding macroeconomic stability and dealing with the risk of spillovers. The original rationale was that individual member states might otherwise face incentives to spend and borrow too much, putting upward pressure on the union-wide level of interest rates and downward pressure on the external value of the common currency. Apparently, market discipline was considered insufficient in this respect.**

**To further strengthen fiscal discipline the "Stability and Growth Pact" [SGP] procedure was introduced in 1997. The SGP defines the exceptional conditions under which deficits above the 3 percent of GDP (Maastricht) limit would not be considered excessive. And it commits member states to respect the new medium-term objective of budgetary positions of "close to balance or in surplus." Towards this end, since 1999, member states draw up (and regularly update) national "stability programmes" [NSPs], laying out a stability-oriented route to a balanced budget by (originally) 2004 (see Artis and Buti 2000).**

**The SGP's official rationale is twofold. First, a medium-term balanced budget rule is held to secure automatic stabilizers's scope for action, providing flexibility for dealing with short-run instabilities without breaching the 3 percent limit, and preferably in non-discretionary ways. Second, as a balanced budget sets the debt ratio on a declining trend, this would trim the interest burden and make room for dealing with long-run demographic pressures on public finances.**

**Another rationale for fiscal discipline are memories of historical "printing press" experiences. If money matters, so does history. The Maastricht regime is essentially a product "made in Germany." In order to reassure Germany to surrender its beloved deutschmark, and lure the Bundesbank to hand over its monetary reign over Germany (and Europe) to the ECB, the regime simply had to be drawn up along German lines.[5] Without delving into German economic history here in any depth, in German public**

5. Dyson and Featherstone 1999 provide the most comprehensive account. See also: Kenen 1995, Padoa-Schioppa 1994, and Tietmeyer 1991, 1994.

opinion Bundesbank independence became associated with price stability and a "hard" currency, and these in turn with prosperity. However, the miracle phase and prosperity of the 1950s and 60s occurred under the Bretton Woods regime. After its breakdown, attempts at stabilizing the economy in response to OPEC I were judged a failure in Germany—an experience not to be repeated. By contrast, fiscal consolidation in the 1980s, now as ERM anchor, was held a success—a strategy to be continued (despite unification).

Meanwhile much of this peculiar national wisdom has become conventional wisdom at the EU's key policymaking institutions, the ECB and the European Commission. On the role of sound public finances and the SGP the latter body declares:

> Achieving and sustaining sound positions in public finances is essential to raise output and employment in Europe. Low public debt and deficits help maintain low interest rates, facilitate the task of monetary authorities in keeping inflation under control and create a stable environment which fosters investment and growth. ... The Maastricht Treaty clearly recognizes the need for enhanced fiscal discipline in EMU to avoid overburdening the single monetary authority and prevent fiscal crises which would have negative consequences for other countries. Moreover, the loss of the exchange rate instrument implies the need to create room for fiscal policy to tackle adverse economic shocks and smooth the business cycle. The stability and growth pact is the concrete manifestation of the shared need for fiscal discipline (European Commission 2000, p. 1).

As there were lessons to be learned from past mistakes and mal-developments:

> Strong emphasis on fiscal prudence and stability in the Maastricht Treaty derived from the belief that the deterioration of public finances was an important cause behind the poor economic performance of many EU countries since the early 1970s. The subsequent decades taught Europe a salutary lesson of how economic prosperity cannot be sustained in an unstable economic policy environment. Inappropriate fiscal policies frequently overburdened monetary policy leading to high interest rates. On the supply-side, generous welfare systems contributed to structural rigidities in EU economies and fuelled inappropriate wage behaviour. The net effect was a negative impact on business expectations and on investment, thus contributing to a slower rise in actual and potential output. As a result, employment stagnated (ibid, p. 9).

Box 1 summarizes the Maastricht regime's design and underlying rationale. Fiscal discipline is believed to improve economic performance through mainly two channels. First, fiscal discipline is supposed to lead to lower interest rates, both

**because the public sector withdraws fewer loanable funds from the available pool as well as through securing the success of stability-oriented monetary policies, i.e. price stability. Lower interest rates, in turn, as seen as stimulating investment and growth, and hence employment as well. Second, fiscal consolidation would also lead to a smaller, i.e. better, state, which stimulates investment, growth and employment also through reducing the tax burden and improving the supply side.**

**This clarifies the fiscal policy part in the game: Europe's finance ministers need to focus on the overriding objective of fiscal consolidation. Member states with a balanced-budget position may allow automatic stabilizers to work freely under adverse conditions; a rule-based regime. By contrast, any "pre-sound" ones still laboring en route to a balanced budget may be severely constrained in coping with the "short-run" effects of fiscal retrenchment; conducting discretionary policies, albeit procyclical ones. There is no coordination of national fiscal policies other than through the imposed discipline to cut deficits and balance the budget at any price. And there is no discipline in place to prevent countries from attempting to be too thrifty.**

**Social partners' role is also indicated in the above: appropriate wage behavior. In the BEPGs this is further specified as real wage increases conducive to employment growth and nominal wage increases that do not conflict with the ECB's understanding of price stability. As to the ECB's part in the game, the BEPGs remain quiet and the Treaty in Art. 105 merely says that its primary objective is that of maintaining price stability and, without prejudice to price stability, to support the community's other objectives laid down in Article 2.**

**It has thus been left to the ECB itself to decide on the role it wishes to play. As I argued elsewhere (Bibow 2001a; see also Allsopp and Vines 1998, Kregel 1999, Arestis and Sawyer 2001, and Hein 2002), the Maastricht game, if it might work at all, *requires* the ECB to play quite a vital role. With uncoordinated national fiscal policies, and especially when these are constrained by not-as-yet attained balanced-budget targets, monetary policy is the only instrument available for managing domestic demand growth. And certainly as long as wage inflation remains calm, monetary policy**

**is also perfectly free to fulfil this crucial stabilization role. In fact, with price stability secured by social partners, focussing monetary policy on price stability too, amounts to wasting the only policy instrument available for demand management in Euroland.**

**The crucial point is that fiscal consolidation *itself* will not—magically—steer interest rates towards levels conducive to potential growth at full employment in the first place. For one thing, interest rate determination is not left to market forces anyway, since in Euroland the process is manipulated by the ECB. For another, the idea that an attempt to save more might lead to more investment is a truly dubious one, at least outside corn economies (Bibow 2001e); while the same can be said for the idea that a fall in nominal interest rates along Fisher-theorem lines might cause an investment boom. Instead, if the Maastricht regime is to be made to work at all, it is the ECB that would have to stimulate and manage aggregate demand so as to produce growth and employment, and *thereby* to allow the aspired fiscal consolidation in the first place. Growth-oriented monetary policies are thus a necessary precondition. Only by sufficiently stimulating private spending and employment growth would consolidation be made possible at all. What is needed, then, is "easy money" in the Wicksellian-Keynesian, that is, monetary policies that deliberately push interest rates below their neutral levels at which the economy would merely remain in its current equilibrium (which may be one characterized by stagnation and high unemployment).**

**Essentially, this involves the policy-mix pursued in the U.S. during the 1990s (Blinder and Yellen 2001). By gearing monetary policy at GDP growth rising employment together with a shrinking interest burden deliver fiscal consolidation, which in turn allows the release of rewards for social partners' disciplined wage policies—the virtuous circle shown in Box 2. By contrast, if the ECB fails to play its proper role, attempts at consolidation are doomed to fail. Worse, they might even backfire, and public deficits and debts rise still further in a stagnating economy—a vicious circle (that differs from previous decades only in so far as fiscal policy is no longer allowed to (partly) compensate monetary policy excesses). As the Japanese experience has clearly shown, even with a looming fiscal crisis due to protracted**

stagnation interest rates might eventually fall to very low levels. Alas, it is of little help if the "market rate" is merely trailing, though never even catching up with a dwindling "natural rate." Should we trust central bankers to steering us safely within the realm of virtuous circles?

In *The General Theory*, Keynes (1936) compared two policy regimes. In his preferred Keynesian regime, monetary policy is applied flexibly towards managing aggregate demand, while prices are anchored by a stable wage unit. The opposite regime features aggregate money wage flexibility together with stabilized or "neutralized" monetary policy. Milton Friedman's (1960, 1968) famous "*k*-percent rule" may be understood as representing the latter-type regime.

In Keynes's analysis, at least as a tendency, an automatic monetary stabilizer is at play, namely, through the working of labor market forces and their effects on the liquidity situation and interest rates. For instance, in a downturn, falling wage inflation pushes for market-driven monetary easing. If it were trusted that Friedman's rule anchors prices and inflation expectations, aggregate money wage flexibility would seem to pose no risk either. Whether sufficient so as to counterbalance the falling off in demand in a downturn and stabilize the system or not, the crucial point is this: in Friedman's *k*-percent regime the central bank has no hand in manipulating interest rates. That is, faith in the efficient working of flexible labor markets is paired with faith in the efficient working of financial markets, unguided by some central bank leader (Bibow 2002d).

Clearly, then, the Maastricht regime is *not* designed along monetarist lines. Not because of Euroland's legendary inflexible labor markets, but for the plain fact that the ECB sets interest rates. Once central bankers set interest rates, any idea (or pretense) that they do not thereby engage in fine-tuning aggregate demand is an illusion—as Friedman made clear. The idea that central bankers' manipulations of interest rates might somehow control inflation, while aggregate demand—magically—manages itself, is pure fantasy and lacking any basis in economic

theory.[6]

Of course, this is not to suggest that any such monetary fine-tuning attempts will necessarily be successful. Far from it. Both Keynes and Friedman, to name only two serious economists, have warned us of the intricacies of controlling the economy by monetary policy. While Keynes thought there was no way around this problem, Friedman designed a regime in which the monetary villains' (i.e. central bankers') hands would be tied in chains.

The Maastricht regime is not only peculiar for the fact that the task of demand management—an *inevitable* task, in Keynes's view—is not explicitly looked after at all. It is also quite grotesque for featuring the world's most independent central bank at its core—the exact opposite to Friedman's prescriptions.[7] I have dubbed the firmly institutionalized *unbounded discretion* in the conduct of the eurozone's common monetary policy the *Maastricht paradox*: "Starting from an overriding principle of disciplining policymakers as the foundation of stability, the ECB ended up as the 'benevolent dictator' in the scheme" (Bibow 2002b, 33).

The next section will scrutinize how things have played out in practice. Of particular interest is whether either social partners or fiscal policymakers have failed on their respective roles, thereby jeopardizing the goal of price stability and, hence, curbing Euroland's monetary policymaker's required role as key stabilization instrument.

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6. There is no denial of the fact that the current practice of monetary policy all over the world follows the Keynesian reaction function approach and the theory of monetary policy has clearly gone this way too. See Blinder 1998, Allsopp and Vines 2000, for instance. Of course the popular time-inconsistency literature has sparked a lot of confusion in this regard (see Bibow 2001d, and Forder 1998, 2002). For early skeptical views on the ECB see Begg and Green 1998 and Buiter 1999, for instance.

7. Unsurprisingly, Friedman has recently also recommended scrapping the SGP (see DMEuro 2002).

## 4. THE MAASTRICHT REGIME AT WORK: WHAT HAS GONE WRONG?

Figure 5 shows annual percentage changes in compensation per employee in the business sector, illustrating the degree of wage disinflation that occurred over the 1990s. Since 1995 a 2 percent trend has emerged—way below the implicit Maastricht parameter of a 5 percent nominal GDP trend and also well below the 4 percent nominal GDP trend rate implicit in the ECB's monetary reference value. Such an extraordinarily low rate of wage inflation might perhaps help to enhance Europe's external cost competitiveness. Note the cumulative gap in compensation growth that has opened up vis-à-vis the U.S. since the mid 1990s (far exceeding any labor productivity gap). But the corresponding redistributive changes hardly bode well for domestic demand growth in Euroland.

At any rate, the rise in compensation growth in Euroland since 2000 was conspicuously small, particularly when compared to the quadrupling of headline inflation between January 1999 and mid 2001. In fact, between 1999 and 2002 the growth rate of "negotiated wages," a measure that reflects the direct outcome of the bargaining between social partners and is unaffected by changes in social security contributions or working hours, accelerated by roughly half a percentage point *only* (ECB 2003, March Bulletin: 41; see also ECB 2002, September Bulletin, 38).

If the quick drop in U.S. compensation growth in 2001 reflects the U.S.'s legendary labor market "flexibility," do not overlook that a corresponding drop would have pushed Euroland into deflationary territory straight away. In a monetarist regime central bank politicians would not be in a position to interfere in the envisioned market-driven interest rate easing as labor market slack unfolds. From a Keynesian perspective a stable wage anchor paves the way for flexible monetary policy to actively steer the interest rate adjustment process; a sharp drop in wage inflation as faced by the U.S. Fed would be considered precarious, particularly if starting from a low level. Certainly Euroland's wage anchor has been remarkably stable since the mid

**1990s—and at such a low level that any prospect of aggregate downward flexibility poses a serious risk.**

**Turning to public finances, figure 6 shows the evolution of debt ratios during the 1990s. Starting from 66 and 60 percent in the early 1990s, respectively, the U.S.'s debt ratio peaked at 76 percent in 1993–4, and then declined to 60 percent by 2000. By contrast, Euroland's debt ratio peaked at 80 percent in 1996–7, reaching 72 percent by 2000. That is, over the decade the U.S.'s debt ratio declined by six percentage points, whereas Euroland's rose by double that.**[8]

**While the truly massive budgetary swing that has happened in the U.S. since 2000 dwarfs occurrences in the early 1990s, qualitatively the contrasting approaches to fiscal policy in Euroland and the U.S. were quite the same then and now. At issue here are automatic stabilizers and the timing of fiscal consolidation, issues that help to explain different outcomes of attempted fiscal consolidation in Euroland and the U.S. during the 1990s. As figure 7 shows, starting from deficit ratios of around 5 to 6 percent in the early 1990s, the U.S.'s structural primary deficit increased further during the 1990–91 recession, and consolidation then started in 1993–94 —after the recovery (and start of the long prosperity of the 1990s) had asserted itself. By contrast, Euroland embarked on consolidation in the fateful year of Maastricht—as countries were either in or heading for recession. Nonetheless, similar to the U.S., structural primary surpluses of around 3 percent were attained in Euroland between 1997 and 2000. Alas, in Euroland, this achievement came at a high price in terms of growth. GDP growth, however, is rather vital for both employment growth and debt sustainability.**

8. It is wrong to blame the rise in Euroland's debt ratio on German unification. Only about a third of the 20 percentage points rise in Germany's debt ratio is directly attributable to unification (Bibow 2001c)—roughly equivalent to the excess of the rise in Germany's debt ratio over the Euroland average. For instance, France's debt ratio increased by 30 percentage points between 1990 and 1998.

**It is therefore wrong to suggest that finance ministers might have failed to take advantage of the upswing in the late 1990s in pushing their objective further, that their ambitions lost momentum after taking the Maastricht hurdle of 3 percent in 1997–98. For one thing, growth recovered in Euroland between 1998–2000 partly because fiscal stance was switched to neutral after long years of fiscal tightening and subdued growth. It is simply unsafe to assume that GDP growth would have been the same and more ambitious attempts at consolidation since 1998 improved the budgetary position, if Euroland had continued consolidation attempts after 1997 at the same pace as in previous years. After all, the upswing was brief and not especially strong. For instance, in Germany's case, strong (2.9%) GDP growth lasted for one year only. Moreover, the budgetary position attained by 1997–98, equivalent to the U.S.'s in terms of structural primary balances, was sufficient to set debt ratios on a decline anyway. The point is that Euroland's lack of success in getting the debt ratio under control during the 1990s was not due to less ambition compared to the U.S., but resulted from a pro-cyclical consolidation strategy and non-accommodating monetary policies. Today, Euroland's debt ratio is on the rise again not due to fiscal profligacy, but protracted stagnation.**

**At any rate, there was no case of irresponsibly loose fiscal policies that risked an overheating of the Euroland economy and might have required a "stabilization crisis" to be deliberately engineered by the ECB in order to prevent run-away inflation. The economic situation in 2000 was tame both at the wage and fiscal fronts. Neither excessive wage pressures emerged from labor markets, nor excess demand in good markets. Finance ministers played according to the script. Holding out for them the overriding objective of fiscal consolidation, they inflicted a severe fiscal tightening on their economies over the 1990s. Social partners also complied. Despite a marked rise in headline inflation Euroland's wage inflation remained extremely low and remarkably stable. In 2000, Euroland was on its way to close protracted negative output gaps of the 1990s. So why, then, did the ECB hike interest rates so aggressively—a near doubling (and total rise of 225 basis points) in less than a year?**

**Inflation obsession and a remarkable disrespect for economic growth is the short answer. The longer answer will elucidate how very counterproductive the ECB's policies really were. Starting from the extremely low level of 0.8% in early 1999, headline inflation subsequently increased and peaked at 3.4% in May 2001, staying above the ECB's price stability definition of "below 2 percent" most of the time during the last three years. Some commentators (see CEPR 2001, 2002, for instance) see this as a sound justification for the ECB's aggressive rate hikes, given its primary and sole objective of maintaining price stability. Euroland may be in a mess, but at least inflation has not exceeded 2 percent by much. The ECB is demanding praise for its inflation performance, the rest, it proclaims, was none of its business. Should we all agree and applaud then?**

**In the light of economic theory, no, is the answer. The rise in headline inflation since 1999 owed to a number of factors, neither excess demand nor excessive wage inflation though. Rising oil prices, seasonal food prices, and animal diseases represented one-off price level shocks. Temporary shocks, moreover, except for the possibly more lasting rise in oil prices. The theory of monetary policy[9] prescribes ignoring such price level shocks, at least as long as they do not provoke excessive wage inflation. The ECB was rather too keenly focussed on its sole goal, ignoring what the textbooks say—but punishing finance ministers and social partners no less so. Using monetary policy to depress aggregate (domestic) demand represented a clear case of mis-medication.**

**It is important not to overlook the central role of the euro's plunge in this context: until October 2000 the euro lost a third of its initial value against the U.S. dollar, a 20 percent drop in effective terms. Given that protracted euro weakness—lasting until the spring of 2002—was key in pushing up first headline inflation and then core inflation too, this factor was also key behind the ECB's aggressive interest rate policies (OECD 2002a). After all, hiking rates represents**

9. See Cecchetti 2000, Clarida et al. 1999, and Taylor 1998, for instance.

central bankers' traditional weapon to defend the currency.

The trouble was: market climate in the late 1990s was one of growth enthusiasm (Corsetti and Pesenti 1999, De Grauwe 2000). And with inflation calm all round, monetary policy actions and communications were assessed in this light. This had peculiar consequences for exchange rate developments. As the BIS's 2002 Annual Report (see also the previous year's report) states:

> "Repeating a pattern observed in 1999 and 2000, but in stark contrast to the 1980s and most of the 1990s, monetary policy decisions and interest rate differentials appeared to influence exchange rates mostly through their effect on growth expectations" (BIS 2002: 86).

The ECB's aggressive rate hikes were perceived by the markets as representing growth risks, which led to a general downgrading of euro-denominated assets and a faltering outlook for the euro's future external value. This backfired on the euro spot rate: the euro did not strengthen, but weakened. No doubt the ECB's idiosyncratic "price stability above all else" anthem proved rather conducive to the markets' thumbs-down for inflation obsession (Bibow 2001b, 2002a,b,c).

In the short run, the euro's plunge extended the span of easy money through interest rate convergence and the DM's plunge after 1995. Alas, aggregate demand was further skewed towards exports, while rate hikes took their toll on domestic demand. Despite indications of an imminent slowdown emerging since early 2000, the ECB continued tightening until October 2000. Perversely, in view of its intentions, by pushing the euro down, the ECB thereby pushed import prices and inflation up—above 2 percent. Given its disrespect for growth and rear-mirror approach to inflation, the ECB subsequently proved extraordinarily "cautious" in cutting rates in the context of deteriorating economic conditions (see box 3 below). Its misjudgements of developments in 2001, and policies based thereupon, were appraised in section 2 above. A review of developments in 2002 will prepare us for assessing the prospects for Europe in the next section.

Despite negative domestic demand growth, at the start of 2002, the year of the euro cash changeover, the ECB saw the prospect of a gradual recovery in the course of

2002: as "no fundamental economic imbalances have built up in recent years in the euro area which would require a long correction process" (ECB 2002, January Bulletin, 5). The ECB thus quickly dissipated any hopes in financial markets for further interest rate cuts. Already in late January, Otmar Issing, the ECB's chief economist, was keen to give indications that the next move would rather be in the upward direction, and perhaps not that far off (Financial Times Deutschland 30 January 2002).

The ECB's mood became increasingly more bullish in subsequent months. In April it was noted that the "persistence of excess liquidity in the economy could become a concern once the economic recovery in the euro area gathers pace" (ECB 2002, April Bulletin, p. 5). And in May another indication for preparing a hike came when the ECB observed that "the prospects for price stability appear to be somewhat less favorable than they were towards the end of last year [when rates had been cut preemptively]" (ECB 2002, May Bulletin, p. 5). The reasoning behind the ECB's optimism is revealed in its repeated insistence that

> the conditions for a sustained upswing in domestic demand, including favourable financing conditions, continue to be in place. The more positive international environment should stimulate euro area exports, thereby fuelling aggregate demand in the euro area. Finally, sound fundamentals and the absence of major imbalances support the positive outlook for the euro area economy (ECB 2002, May Bulletin, 5).

One cannot deny that the ECB was taking a forward-looking approach to real economy developments, at this juncture. It was due to a positive net trade contribution, compensating the negative domestic demand one, that GDP growth stabilized just above the zero line. Moreover, in April the euro had started to appreciate strongly against the U.S. dollar. The Swiss National Bank cut interest rates. Alan Greenspan emphasized the risk of continued economic weakness. Yet, mysteriously, the ECB seemed to seriously contemplate hiking rates soon.

Perceptions then changed in the summer. Accounting scandals and plunging stock markets were part of it. The U.S. Fed signalled further cuts. Recovery hopes dwindled. In September the ECB declared that the acceleration in economic activity towards potential growth was postponed until next year rather than the end of 2002.

But it took until December for the ECB to shave another 50 basis points off its policy rates last changed in November 2001:

> The decision reflected the Governing Council's assessment that the evidence has increased that inflationary pressures are easing, owing in particular to the sluggish economic expansion. Furthermore, the downside risks to economic growth have not vanished (ECB 2002, December Bulletin, 5).

In conclusion, it seems the ECB might be wholly unaware of the vital stabilization role it is required to play under the Maastricht regime. With fiscal policy constrained, the stabilization burden rests squarely on the central bank's shoulders—say the textbooks. Horst Köhler, the IMF's head and one of the chief architects of the Maastricht regime, even reminded the ECB of this role when he explained that monetary policy was "the first line of defense." Mr. Duisenberg's response was that he had never heard of that. It also seems fair to say that the ECB might have been at a certain loss in grasping developments in the economy under its monetary reign. Not only did it take some convincing that Euroland was not a closed economy. Rather fatefully, the ECB fully misjudged the impact of its aggressive interest rate hikes on both domestic demand as well as the euro's exchange rate (and hence inflation); while choking off Euroland's brief upswing through careless monetary tightening lacked any sound rationale in the first place. As the economy took a dive, the ECB was outstandingly "cautious" in easing policy stance. Having failed to cut rates aggressively in time, in the spring of 2002, the ECB nevertheless contemplated hiking them—the slump progressed and Euroland's promised recovery never materialized. Largely due to the ECB's impressive record of policy blunders, Euroland is today in a rather inconvenient situation.

## 5. THE CURRENT SITUATION AND PROSPECTS FOR EUROPE UNDER ITS CURRENT REGIME

To see just how very precarious the situation really is, it is useful to start with Germany. In the aftermath of its unification and in the spirit of the Maastricht Treaty, Germany engineered a severe fiscal tightening in 1992 and subsequent

**years—despite protracted domestic demand weakness. As noted previously, growth is key to the debt sustainability issue. For the higher the rate of GDP growth, the higher the maximum tolerable deficit ratio compatible with a non-rising debt ratio. "Maximum stability balances" [MSB], so defined, provide a straightforward definition of public debt sustainability. If consolidation is the aim, then crunching growth is not the way to go.**

**Figure 8 illustrates the point, showing that stability-oriented macroeconomic policies have squeezed Germany's nominal GDP growth to 2 percent in the course of the 1990s. For illustrative purposes a *hypothetical* growth rate of zero was assumed for 2003. Zero growth requires zero net debt issuance (i.e. a balanced budget) to prevent any given debt ratio from rising. The trouble is: while MSB shrink in line with GDP growth, actual deficits might not. Despite—or because of?—more than a decade of attempts at consolidation, Germany is today in a far worse budgetary position than at any time since unification. Crunching growth is not conducive to "sound public finances."**

**Being Europe's largest economy, Germany's performance is bound to have a significant impact on Europe as a whole. Admittedly, Germany was disadvantaged during the run-up to EMU compared to other EU countries. It neither got any relief from interest rate convergence, a factor that stimulated domestic demand and reduced the interest burden on the public debt in various EU countries since the mid 1990s. Nor should it be overlooked that the ERM crises of 1992–3 came at Germany's expense in terms of competitiveness. With these factors having largely run their course, today, the rest of EU may be in a situation more similar to Germany's in the recent past. Alas, still leading the pack, Germany is getting sicker rather than better, having meanwhile slipped into a deflationary spiral.**

**As in the previous year, in 2003 Germany is once again enforcing the wisdom of the SGP by raising taxes and social security contributions in response to the ongoing recession and a soaring budget deficit. Real disposable incomes declined in Germany last year, and so did real consumption expenditures. In fact, GDP growth was slightly**

above zero only for the fact that a positive net exports contribution compensated a negative domestic demand one. Bankruptcy rates have entered unchartered territory. Employment is falling and unemployment back to were it was five years ago. Yet, in the name of "stability and growth," Germany is implementing another fiscal tightening of some 0.5% to 1% of GDP.

Apart from further crunching disposable incomes and business revenues, falling public investment and rising social security contributions create "structural problems" too. Most perversely of all, perhaps, ever new rounds of indirect tax hikes keep inflation up which, in turn, helps to forestall monetary easing. Box 3 summarizes the vicious circle that the Maastricht regime has pushed Euroland into. Largely due to the ECB's deflationary policy bias, a needlessly self-inflicted recession provoked a fiscal squeeze that is eliciting the policy responses just described as the "Instability and Stagnation Pact" is playing out its harmful medicine. These phenomena are not new though. They could be witnessed in Germany over the 1990s (Bibow 1998). But Europe's supposed economic powerhouse is now being sent off the cliff edge, it seems. Even if nominal wages and prices are not falling yet, Germany clearly is in a contractionary spiral and heading for "it." Might European partners not send out a lifeboat?

Apparently, the situation in Euroland as a whole is not quite as dramatic yet. According to the OECD's December 2002 forecast shown in figure 9, Euroland's deficit ratio is projected to shrink and its debt ratio supposed to decline again this year—*if GDP growth resumes* as forecasted. Alas, Germany is not the only EU country operating in a fiscal straitjacket that calls for perverse responses to recession. Today, France and Italy (and Portugal) are in budgetary positions not all that different from Germany's about a year ago or so. According to Mr. Duisenberg the few laggards just need to hurry up a bit and quickly make up what the majority of member states has long accomplished. What he fails to mention, though, "the big three" make up some 70% of the eurozone.

As the big three currently miss the SGP target by a large margin, the balanced

budget deadline by 2006 implies that another round of severe fiscal tightening will be inflicted upon Europe in coming years. If the smaller members are today vigorously pressing the big three for more fiscal retrenchment, they might soon come to regret it. Consolidation attempts by the big three will have spillovers in good and labor markets across the EU—and beyond.

There may be other "headwinds" too, and only some weak relief factors. For instance, budgetary savings due to falling interest rates, quite important during the brief phase of apparently successful consolidation between 1997 and 2001, will be limited in the future. Next, as the ECB has refused to stimulate domestic demand for long enough employment growth went into reverse in 2002. Rising unemployment is spelling extra trouble for budgetary positions and disposable incomes. Finally, the ECB's unwillingness to play its proper part may no longer be the key obstacle blocking fiscal consolidation. Today, another question is whether the ECB could still do it, even if it wanted to.

The monetary conditions index in Figure 10 pinpoints the problem, showing the development of monetary conditions since 2001. Clearly the ECB was in no hurry to foster recovery since the business cycle turning point in mid 2000. Real interest rates came down by some 150 basis points from their early 2001 peak until 2002, but the 50 basis points cut in December 2002 just about compensated for the fall in inflation over the course of that year. Most strikingly, however, monetary conditions have tightened significantly since early 2002. If the ECB in late 2001 believed that it had responded appropriately to the 2001 slowdown, a truly remarkable complacency followed in 2002: Europe's independent central bank chose "to keep its power dry" so that monetary conditions tightened in an environment of a deteriorating state of the economy and despite an ever gloomier outlook. A half-hearted 25 basis point cut then followed in March 2003, which did no more than belatedly reverse some of the unwarranted tightening in monetary conditions that has built up meanwhile. This is once again demonstrating a conspicuous asymmetry in its policy approach. No such "caution" could be detected back in 2000 when the ECB was in hiking mood.

**While domestic demand shows ever less liveliness, the euro's sharp appreciation since April 2002 further increases the risk that Euroland's last lifeline might be cut off: exports. Of course, dollar depreciation is the right medicine from a U.S. perspective, trimming the U.S.'s current account deficit and reversing the negative contribution of net exports to U.S. GDP growth into a positive one. By contrast, a drying up or even reversal of external growth stimuli makes the OECD's forecasted resumption of growth in Euroland look all the more improbable. In an uphill struggle for growth, a mix of fiscal tightening, currency appreciation, and "cautious" and backward-looking monetary policy orientation is unlikely to render a healthy macroeconomic policy cocktail.**

**Particularly, as the ECB's assessments continue to be marred with manifold confusions that stand in the way of sound policymaking. One major confusion may be seen in the ECB's notorious assertion that no major imbalances have accumulated within the eurozone; a situation it likes to contrast with "existing imbalances elsewhere in the world economy" (ECB 2002, August Bulletin: 5). The point is that those imbalances, apparently originating "elsewhere," are merely a reflection of conflicting approaches to macroeconomic policymaking, with U.S. policies geared at growth and Euroland free-riding on U.S. growth while persistently depressing domestic demand. This is a policy imbalance that quite inevitably results in current account imbalances. In fact, after the "new era" boom of the late 1990s ended in 2000, U.S. growth undershot Euroland's for one year only, namely, 2001. This constellation was quickly reversed again in 2002, as domestic demand grew at a 3 percent pace in the U.S., whereas no recovery took hold in Euroland—with imbalances piling up further.**

**Whether flexible labor markets contributed anything to the U.S.'s quick turnaround (other than through sparking deflationary fears as the unemployment rate quickly jumped from 4 to 6 percent) seems more than doubtful. Instead, mainly two factors explain the superior U.S. performance. First, since early 2001 the U.S. Fed has led a monetary easing process that was quick even by its own historical record. Second, between 2000 and today the Bush administration, without much ado, has engineered a dramatic fiscal easing: a budgetary swing of about 5 percent of GDP (see**

fig. 11).[10]

If the situation in the U.S. remains fragile even despite these massive efforts to spur growth, this is not least due to the fact that the world economy's weakness continues to act like a drag on U.S. growth.[11] If U.S. fragility is posing a risk to Euroland, this is first of all an implicit acknowledgment of the fact that Euroland's parasitical strategy of free-riding on U.S. growth has finally reached its close. Clearly the root of the problem is not that the external growth anchor Euroland relied upon for much too long is no longer holding up as well as it used to. The heart of the matter is that Euroland's macroeconomic policies remain firmly geared at stagnation at a time when Euroland's lack of an internal growth anchor is becoming ever more of a threat, both to Europe and the world economy.

The ECB's peculiar obsession with structural reform is another case in point. That Euroland requires structural reforms to raise its growth potential is of course conventional wisdom. But it is strange for a monetary policymaker to focus all policy communications on potential growth, given that monetary policy affects aggregate demand and actual growth (according to a conventional neutrality postulate; see Mankiw 2001), and Euroland's *actual* growth notoriously undershoots its *potential*

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10. Just to get an idea of the magnitudes involved, between 1989 and 1991 and in the context of its unification, Germany had a budgetary swing of 3 percent of GDP. Regarding the relevance to the world economy, one also has to bear in mind that the U.S. economy is five times bigger than Germany's.

11. See Godley and Izurieta 2002a,b and Godley 2003 on the current dilemma. Falling on deaf ears in the "new era," Wynne Godley had pointed out early on that developments in the U.S. and world economies were unsustainable. (See Godley 1999, Godley and Wray 1999, Godley and Izurieta 2001.) Internally, the successful U.S. consolidation had its necessary counterpart in private spending outpacing disposable incomes, with private debts piling up accordingly. Externally, a rising U.S. current account deficit reflected the fact that the U.S. was pulling a deflationary outside world along with it, further magnified by dollar strength.

anyway. Distracting attention from what conventional wisdom views as the proper role of monetary policy, the ECB has exhibited both creativity and courage in boosting the notion of structural problems to super-status in the ongoing stagnation. For instance, as the promised 2002 upswing failed to materialize, the ECB was ready to declare in September 2002 that structural reforms

> would help to foster consumer and investor confidence in the long-term growth and employment opportunities in the euro area, thereby having a *positive effect on consumption and investment decisions in the short and medium term* (ECB 2002, September Bulletin, 7; italics added).

And a month later the ECB went even further and declared that

> further delays in tackling, with greater determination, the underlying reasons for limited growth in potential output over the medium term, *and for only partially exploiting the current potential*, are costly (ECB 2002, October Bulletin: 7; italics added).

Puzzlingly, the ECB never seems to be worried at all that "further delays in cutting interest rates" might be related to Euroland's only partial exploitation of its current potential. The structural shibboleth offers a convenient excuse for all sorts of matters, it seems. So do not overlook that structural reforms might involve some important risks too, particularly in the current environment.

For if structural reforms, especially liberalizing Euroland's legendary rigid labor markets, raised growth potential, this would further increase Euroland's negative output gap, huge and rising anyway. In other words, more deflationary pressures would be unleashed by getting rid of labor market rigidities. That structural reforms might do the "confidence trick" and stimulate aggregate demand is wishful thinking along "supply-creates-its-own-demand" lines. A hard fact is that, if Otmar Issing, the ECB's chief economist, denies the existence of deflationary risks on grounds of Euroland's all-pervasive labor market rigidities, this makes it all too clear that, effectively, the ECB is free-riding on these very rigidities to foster its own prestige. But does the ECB have enough dry powder in store in case structural reforms were carried out under current conditions?

Others might fear the world economy's fragility. Mr. Issing is worried about

**something else: a return of the 1970s phenomenon of stagflation (Financial Times Deutschland, 3 December 2002). Stagnation accompanied by ongoing inflationary pressures poses a dilemma to monetary policy, and the OECD (2002b) too found Euroland's inflation persistence in the 2001 slowdown puzzling. A number of factors might help to explain the apparent lack of responsiveness of inflation to weak economic activity in the Eurozone.**

**First, inflation persistence might be related to the ECB's uniquely stringent definition of price stability itself. As the U.S. Fed, for instance, is content with somewhat higher inflation on average, U.S. inflation is bound to come down quicker when the economy weakens as too low inflation causes the very rigidities that give rise to inflation persistence. This is just the other side of the coin called inflation obsession. A second factor directly related to monetary policy itself (and already discussed further above) is the "euro puzzle," as the inflationary pressures that stemmed from protracted euro weakness fed through to core inflation with some lag.**

**But a third factor represents a peculiarity inherent and probably unique to the Maastricht regime. The point is that, by causing a budgetary squeeze, an economic downturn is prone to provoke inflationary pressures—given that the rules of the SGP might force finance ministers to raise indirect taxes and social security contributions and cut public investment (see box 3 above). The first measure pushes up headline inflation directly.[12] The second—similar to direct tax hikes—not only causes structural problems, but might enkindle wage inflation too (especially if social partners reckon that wage restraint is not being rewarded by other players). Finally, cutting public investment jeopardizes productivity growth. If Mr. Issing is worried about stagflation,**

12. As previously noted, this factor was highly relevant in Germany during the 1990s, both in pushing headline prices up in 1991–92, and in keeping it from coming down faster in subsequent years (and hence preventing the Bundesbank from a more timely easing). Recent estimates by the ECB (see March 2003 Bulletin) show that increases in indirect taxes and administered prices may have upwardly distorted headline inflation in Euroland between 1999 and 2002 by almost half a percentage point. Given the ECB's tight "below 2 percent" price stability definition and rear-mirror policy approach when headline inflation was only a few decimal points above its holy grail, the policy relevance of this issue can hardly be over-emphasized.

he might wish to bear in mind that, at least in Euroland, too tight money is prone to provoke inflationary risks too.

Inflation obsession came at a high price for the eurozone. The actual working of the Maastricht regime in recent years has exemplified this rather well. But damages reach far beyond the eurozone. Economic prospects for the wider Europe are just as bleak.

Of the three pre-ins, the UK's experience is of great interest. Since sterling's ERM departure in September 1992, the UK has run its own monetary policy regime. Moreover, the UK did not join in the Maastricht-inspired consolidation crusade. Instead, a huge (ten percent of GDP) budgetary swing in the early 1990s recession was followed by growth-based consolidation as the economy recovered. By 2000, the UK achieved a budget surplus—the only large EU country to do so.

No doubt the UK's rather impressive performance since 1992 owes much to its sound macroeconomic demand management, contrasting with the eurozone. Alas, as a reward for its superior macro policy regime, sterling became severely overvalued after 1996, increasingly unbalancing the economy in the late 1990s. Even so the UK coped with the 2001 slowdown much better than its continental peers. Due to the Bank of England's flexible and symmetric policy approach and discretionary public spending increases, consumption spending remained strong—as property prices and household indebtedness soared. Similar to the U.S., another downside to sustaining domestic demand growth within a deflation-prone world was a growing current account deficit (see fig. 11). It would be rash to conclude that euro adoption could have avoided this. The UK's superior macro performance that provided the basis for the overvalued pound would have been impossible within the Maastricht regime in the first place. Today, the UK is vulnerable, both due to its own success and the fact that it is too close to a big deflationary neighbor.

As to the EU accession countries, so far most of them have survived the 2001 slowdown remarkably well too. Of course, their exports were severely hit by the slowdown in the EU, destination of some 70 percent of their exports. But at the same

time interest rate convergence has stimulated domestic demand in prospective new member states, similar to the situation in some current members in the 1990s. So far huge current account deficits have found their counterpart largely in foreign direct investment inflows. In a benign endgame scenario a continuation of this state would allow further employment growth and ongoing budgetary consolidation together with an appreciating currency that reduces inflation. In a vicious scenario, though, the "twin deficits" might quickly unravel, with monetary and fiscal policies—geared at reducing inflation and budget deficits in compliance with the Maastricht convergence rules—magnifying macroeconomic instability. Clearly, accession countries are vulnerably exposed to stagnation in the EU.

Much is at stake. Continued stagnation is a threat to the whole process of European integration. The strategy of free-riding on external growth has reached its close. Instability brought upon Europe by the ECB is now being further reinforced by the SGP. Miracles apart, under the current regime, ongoing stagnation or worse lies ahead. Perhaps Ecofin might prove creative enough in finding ways around the "Instability and Stagnation Pact" in the short run. Defiant France is pushing the case.[13] Iraq might provide an excuse.[14] Perhaps even the ECB—enjoying all the discretion it takes to improve its conduct—might eventually learn about the age-old Wicksellian fallacy of mistaking "low" rates of interest as an indicator of monetary ease.[15] But there is the risk that the Iraq war might provide yet another distraction

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13. Currently France is on collision course with the Commission by ruling out an austerity package to get its deficit back below 3 percent of GDP (Financial Times, 25 February 2003), while the UK's spending plans have led to a clash within Ecofin too (Financial Times, 14 and 20 February 2003). Contrasting fiscal philosophies came to the surface at the recent G-7 economic summit. Rather than showing their gratitude for providing the 2002 stimulus package that just about kept Euroland afloat, absurdly, Euroland's finance ministers and central bankers criticized U.S. fiscal policies as a risk to the world economy (Financial Times, 23 February 2003).

14. While the Commission has given some signals in this direction, Euroland's central bankers outright reject any such idea—alleging damage to the credibility of the pact and confidence in the euro (Financial Times, 17 and 19 February 2003).

15. It is somewhat amusing that Knut Wicksell's fundamental insight, first published in German in 1898, has become part of U.S. conventional wisdom on sound monetary policy (see Fed Governor Bernanke's (2002)

from Euroland's true underlying problem: the lack of an internal growth anchor. A thorough reform of the Maastricht regime is urgent.

## 6. SUGGESTIONS FOR REFORMING THE MAASTRICHT REGIME: THEORY AND BEST PRACTICE

As to the role of social partners, despite the fact that there are currently no coordination procedures in place at the central level, it cannot be denied that wage inflation was both very (some would say too) tame and stable since the mid 1990s. Certainly social partners complied with the BEPGs. The rise in wage inflation in 2001–02 was minor and did not warrant the punishment that was actually enacted. If anything, the slowdown itself has played a causative role in pushing labor costs up—partly due to common feature that unit labor costs tend to rise initially as the economy tanks, partly due to the peculiar working of the Maastricht regime as the fiscal squeeze due to stagnation then reinforced these cost-push effects.

If divergence is an issue, Germany is the conspicuous outlier. German wage inflation is on a 1 to 2 percent trend, unit labor costs are falling—a recipe for deflation. Germany runs a huge trade surplus, also vis-à-vis its EU partners, while domestic demand has been stagnant for a decade and is now shrinking. Some view German-style wage restraint as appropriate for adjusting relative prices and leading back towards equilibrium. Others see it as risky beggar-thy-neighbor and deflation export par excellence, creating fundamental imbalances within the EU on the way.

It might be best to establish a wage norm at the union level focussed on productivity growth plus some desired inflation trend, replacing the *asymmetric* BEPG's. Wage inflation would thereby be tied to nominal GDP growth or, rather, prices be anchored by wages—and thus monetary policy be free to focus on things that

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observations on this point), while Euroland's central bankers got stuck with the simple Fisher theorem, due to the American economist Irving Fisher (1896).

really matter. De facto this opportunity has prevailed since the mid 1990s, except that the monetary policymaker has refused to play its part in the deal. At any rate, it would be safer to institutionalize the arrangement; including sufficient scope for flexibility in relative wages at the national, regional, industry and firm levels, as the situation might require. It is key to stabilize aggregate wages and prevent beggar-thy-neighbor behavior. This requires symmetric coordination and mechanisms to enforce symmetric discipline.

A fundamental overhaul of Euroland's macroeconomic policymaking arrangements is urgently required. Experience has clearly shown a malfunctioning of current arrangements. They are not at all conducive to growth, but prone to give rise to stagnation and crisis. It is key that both arms of the macro policy-mix act as partners rather than opponents, as is currently the case, in achieving common objectives. A nominal GDP target should be laid down as the common starting point of macro policymaking—*providing the internal growth anchor that is currently missing*.[16] Thus it is vital that the ECB's hegemonic position and unbounded discretion in monetary policy must end. The ECB's position must be clearly defined as instrument independence only: the practising of constrained discretion at targets laid down for it. Since the role of monetary policy in this mixed double depends on the part to be played by fiscal policy, if the latter's contribution to the shared stabilization burden is constrained, the lead role of monetary policy in this respect has to be made clear to everyone (including the ECB).

Looking at the SGP's flaws offers a good starting point as to the vital issues in fiscal policy reform. Most fundamentally, focussing fiscal policy on an endogenous variable governments cannot control—the budget deficit (ratio)—lacks any economic sense. Targeting some arbitrary values for deficit and debt ratios *at any price* is both senseless as well as hopeless, particularly when the strategy pursued completely ignores the key variable in the play: growth. A balanced budget rule implies a debt

16. Quite unusually, nominal GDP targeting finds support right across the main macroeconomic schools. Proponents include: Meade 1978, Tobin 1980, Hall 1984, and McCallum 1987, for instance.

**ratio that is converging to zero in the long run, a goal which is lacking any basis in economic theory. But a balanced budget rule also spells trouble while we are still alive—by causing instability and stagnation. Propagating the SGP as a means to safeguard sustainability of public finances in view of prospective demographic developments is misleading when its actual effect is to crunch the very variable that really matters to the prosperity of future generations: capital accumulation (including infrastructure investment).**

**To be sure, so-called sound finance has inflicted truly gigantic real damage upon Euroland in the first half of the 1990s. Only briefly interrupted, mainly due to the U.S.'s "new era boom" and one-off factors, we are now back on track for more of that. Continued cuts in public investment and a contractionary fiscal stance regardless of the economic situation will lead to neither stability nor growth, but further impoverish Europe and foster its demise. Paradoxically, as it may seem, by trying to save too much, we end up saving (rather, investing) too little. By depressing the economy and allowing the infrastructure to rot, a larger unemployment bill has to be picked up in the end. It is vital to prevent a continuation of these developments.**

**At the very least public investment has to be excluded from any balanced budget guidelines and due consideration be given to cyclical positions and debt (ratio) levels. Proposals along these lines imply a move towards the UK's fiscal regime—a move which would no doubt significantly improve on the current state. An alternative involves a more fundamental shift away from today's deficit ideology and towards variables directly controlled by governments: tax rates, the rules underlying entitlement spending, and the volume of discretionary spending. U.S. experience after the Budget Enforcement Act of 1990 provides an example along these lines (see Blinder and Yellen 2001). Essentially taxes and entitlements were grouped together in a separate pay-as-you-go pool. The rule applied that the budget must balance *at the margin*, that is, policy-induced changes have to be compensatory, while endogenous changes in the budget owing to the state of the economy did not require any fiscal policy response. Budgetary discipline also applied to discretionary spending—through**

annual "caps" on permissible increases.

In the Euroland context, a more symmetric rule for discretionary spending may be warranted. The dogma underlying the SGP is preoccupied with one risk only: excessive public spending and borrowing, and the spillovers in financial markets this might have. The opposite risk of excessive thriftiness with its associated spillovers in good and labor markets is ignored. Yet, a thrift campaign in Germany, for instance, is bound to depress activity in Europe. Similarly, a spending boost in France, for instance, will benefit its neighbors too; while French taxpayers alone will have to pick up the bill. In view of this free-riding problem fiscal discipline needs to be imposed symmetrically. Linking discretionary spending to the nominal GDP target might solve the problem. Particularly public investment should be based on long-term planning and be spared the kind of vagaries that characterize the current imprudent regime.

As to the pay-as-you-go part of the budget, the important point to bear in mind is that currently high tax rates and social security contributions are largely a reflection of prevailing levels of unemployment broadly defined. Moreover, two decades of disinflation and tight money was the senior partner in pushing up debt ratios and the interest burden. Bringing down unemployment and abstaining from the tight money excesses would do wonders to European public finances—and solve many a "structural problem" on the way too.

The proposed fiscal regime outlined here would offer rule-based flexibility and conform with economic theory: endogenous budget deficits would no longer be at the forefront of all planning, but quietly take a backseat.[17] Of course in the medium to longer run deficit and debt levels must follow along reasonable and sustainable paths, and as such be part of the nominal GDP strategy. The crucial point is that without growth, sustainability will never be achieved.

As to the ECB, renewed tight money excesses must be prevented in future, as they would ruin any idea of keeping public finances under control. But more than that

17. See also the proposals by Arestis et al 2001 and Kregel 1999.

would be required if fiscal policy remained passive (while at least no longer counterproductively retarding growth). The ECB would have to take on the lead role in stimulating domestic demand sufficiently—at last. Linking wage inflation to nominal GDP growth is designed to look after the standard tight money excuse for crunching the economy. Monetary policy has to be an integral positive part of any nominal GDP strategy that can succeed. Germany's experience during the 1990s—that is*, when it could no longer rely on its European partners behaving differently from itself*—depicted the risks of asymmetric monetary policy well. Squeezing inflation down from four percent to zero between 1992 and 1999, the Bundesbank gained public prestige—despite crunching nominal GDP growth to 2 percent on the way. Maintaining price stability by preventing growth is too simple a scheme to command any admiration. The ECB is trying hard to emulate the Buba success story. It must be stopped.

The most obvious course of action is to lay down a nominal GDP target for the ECB and require it to pursue a transparent nominal GDP targeting strategy. In practice, the U.S. Fed with its high employment and price stability goals on an equal footing comes close to this regime (and criticisms of the fact that U.S. monetary policy in the 1990s became overburdened with both pay-down-the-public-debt hysteria as well as external free-riding should not be laid at the Fed's door). A key issue is that a "let bygones be bygones" attitude with respect to negative output gaps condemns unemployment to become "structural" (Ball 1997, 1999), while growth—both actual as well as potential—get permanently depressed. Like the Bundesbank, the ECB seems always content with formulating optimistic views of actual growth returning to growth potential, at least in the long run;[18] as optimism of this kind might seem "cautious"

18. It is rather illuminating that no other than Milton Friedman (2002) found himself "baffled" on reading one of Otmar Issing's habitual statements to the effect that prudent central bankers might get comfort from monetary neutrality propositions. Explaining that neutrality propositions give little if any guide to effective central bank behavior on this planet, Friedman suggested that "perhaps they offer comfort to central bankers by implying that all mistakes will average out in that mythical long run in which Keynes assured us "we are all dead." " Keynes went on, "Economists [central bankers] set themselves too easy, too useless a task if in tempestuous seasons they can only tell us that when the storm is long past the ocean is flat again"

from the viewpoint of an inflation-obsessed central bank. Yet, regarding Euroland's so-called growth potential as measured by some average of actual growth in recent years as a binding supply-side constraint is a clear case of "fool's logic."[19]

In practice, as the example of the Bank of England shows, an inflation-targeting regime might even approximate the proposed regime, at least under two key conditions. First, policy conduct must be truly forward-looking and ignore temporary price shocks. Second, the inflation target must not be too low. The first condition is required to make sure that any slowdown in demand growth or any wage restraint will elicit the appropriate *pre-emptive* monetary easing response, the second to make sure that inflation does actually have some room to fall without immediately hitting the danger zone.[20] The trouble is that the ECB's conduct has starkly conflicted with both conditions, and continues to do so.

There has been widespread criticism of the ECB's peculiar definition of price stability, being both too ambitious and asymmetric (Fitoussi and Creel 2002, Svensson 2000, 2002a,b). A symmetric inflation target of, say, 2.5 (Bank of England) or 3% (U.S. Fed) would probably be right for Euroland and an enlarged EU too. Beware, though, while changing the ECB's definition of price stability in the upward direction would make Europe a safer place, this measure alone would not have prevented the monetary policy blunders seen in recent years. For instance, if we had started out from 1.8% rather than 0.8% inflation in 1999 and if the ECB had adopted a "below 3 percent" price stability definition, arguably, things would have played out not much differently. More is required to end stagnation-oriented monetary policies. The Maastricht

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(Friedman 2002).

19. Tobin (1994) puts it all in a nutshell in the quotation at the start of the text. At a forum in November 2002 an interesting challenge to the infallibility myth has occurred. Former Bundesbank President Karl Otto Pöhl, one of the architects of the Maastricht regime, called on the ECB to pay more attention to economic growth, as: "In the present situation, price stability or inflation are not the main problems. The problems are stagnation or even a recession." Current Bundesbank President Ernst Welteke dismissed such criticism, saying that repeated calls for monetary and fiscal policy to be more growth-oriented were "based on fool's logic" (Financial Times 18 November 2002).

20. See Akerlof et al 1996, Fuhrer and Madigan 1997, and Summers 1991, for instance.

**paradox needs to be tackled head on. To get symmetric and growth-oriented monetary policies in future, it is vital to enforce discipline upon the ECB. Without that, Europe *is* doomed to stagnation—or worse.**

## 7. CONCLUSIONS

**Eurozone authorities are well-advised to look for internal causes of the 2001 slowdown and ongoing stagnation. While it may be true that external demand forces—all too long relied upon—no longer exert their former pull today, the current crisis is essentially a homemade one. The domestic situation in Euroland turned for the worse in mid 2000. Domestic macroeconomic policies, either deliberately or carelessly, have not only caused a recession that was perfectly needless in the first place. Thereafter they have also failed to reignite domestic demand—until today.**

**Neither social partners' nor fiscal authorities' behavior conflicted with what the BEPGs, the Maastricht regime's central coordination mechanism, prescribe for them. Instead, the current crisis is largely due to the ECB's ongoing refusal to play the part it is required to play, if the Maastricht regime is to be made to work at all: namely, to sufficiently stimulate domestic demand. The eurozone is too big a place to free-ride on external growth forever. And with fiscal policy in a straitjacket, according to mainstream theory, the stabilization burden rests squarely on the ECB's shoulders. Clearly, blaming slack domestic demand on "structural problems" is a shallow excuse when even the world's most flexible (U.S.) economy relies foremost on flexible fiscal and monetary policies to reignite domestic demand—and quite successfully too.**

**Ultimately, current troubles stem from the Maastricht regime's lack of an internal growth anchor and failure to explicitly assign responsibilities for stabilization policy; together with the peculiar flaw of granting the ECB unbounded discretion. Prospects for Europe are grim. Not only does the ECB appear ignorant of its vital lead role in the field of stabilization policy. Thanks to its previous policy blunders the ECB is now facing some important "headwinds" too. With falling employment and further rounds of fiscal consolidation in the pipeline, the euro's appreciation since March 2002 raises doubts about whether the ECB's ammunition, the powder it has preferred to keep dry for all too long, may still be explosive enough to lift Euroland out of the doldrums—even if it chose to try, at last.**

**The Maastricht regime needs thorough reform indeed. Our recommendations center on a nominal GDP target to be pursued by fiscal and monetary policies in cooperation—ending the current gridlock between these two players. In the area of fiscal policy, this would involve moving away from the single-minded focus on budget deficits, an endogenous variable not under governments' control, and towards longer-term expenditure and tax planning in line with the set nominal GDP target. Without the ECB's proper share in the play, this strategy would be doomed to failure; just as the current consolidation strategy was doomed right from the start. The ECB's unbounded discretion must end and its lead role in stabilization policy, if fiscal policy is to remain passive, be endorsed. Complemented by a symmetric wage inflation norm, monetary policy has to be symmetric and growth-oriented in future, and discipline be enforced upon the ECB accordingly.**

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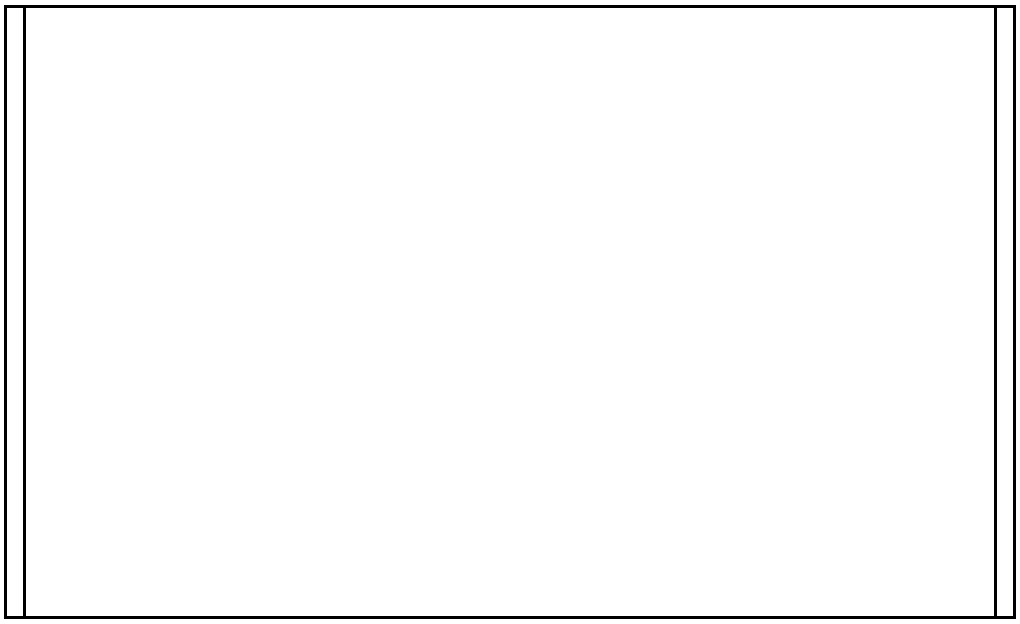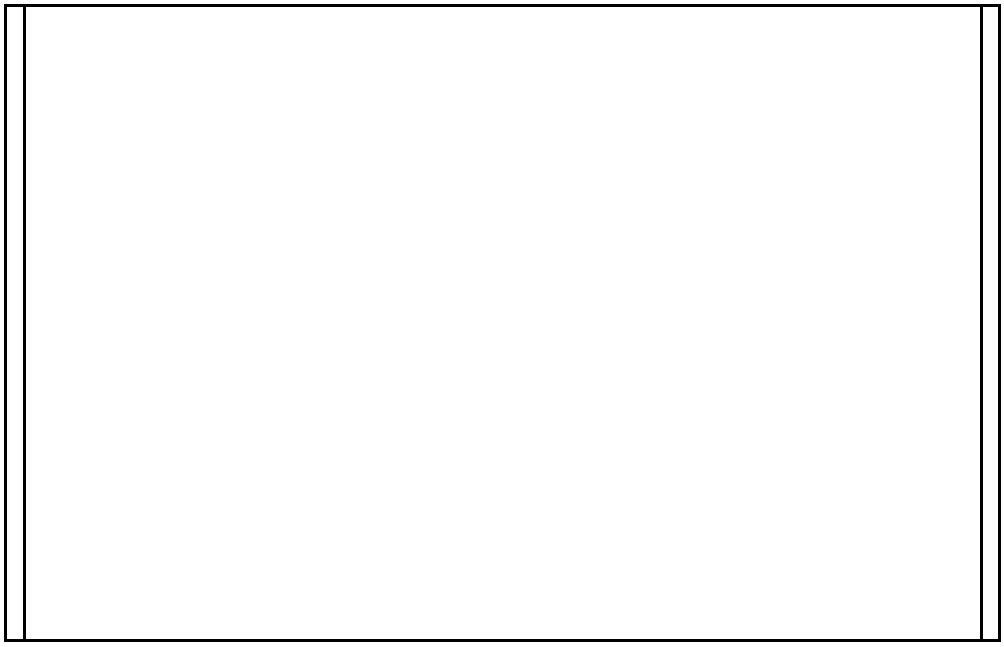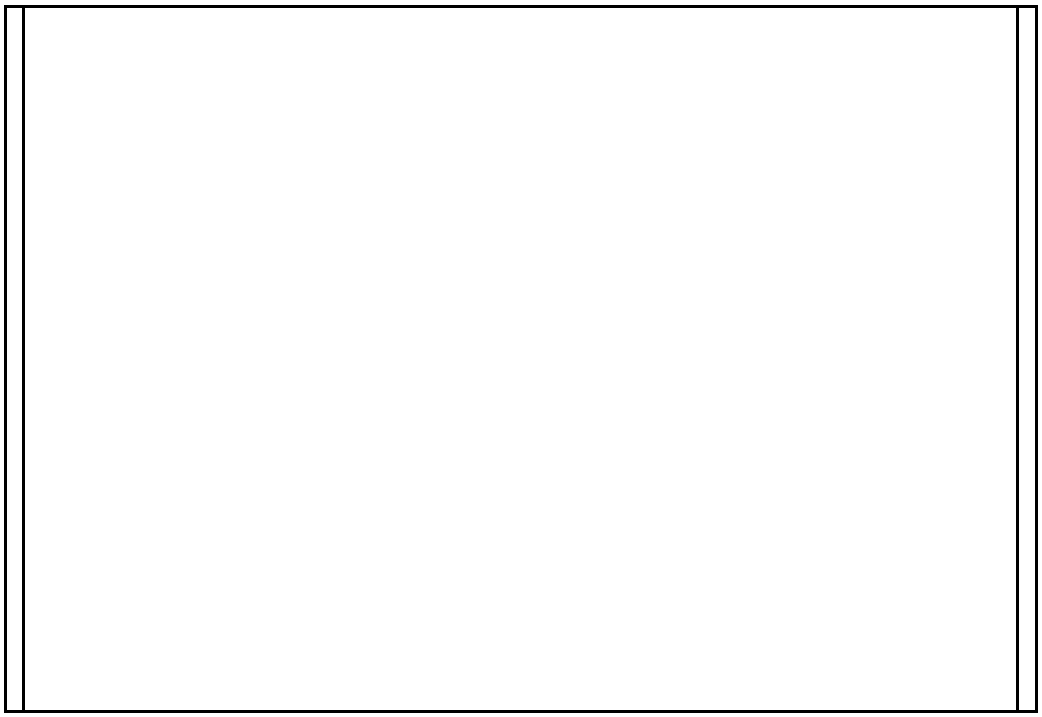
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