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## Making EMU work: some lessons from the 1990s

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## Working Paper No. 326

### Making EMU Work: Some Lessons from the 1990s <sup>1</sup>

by  
[Jörg Bibow](#)

March 2001

#### INTRODUCTION

The Maastricht route to economic and monetary union (EMU) prescribed that a process of *convergence* must precede the launching of the common currency into a *stable* economic environment. In 1991, Europe thus embarked on policies considered conducive to convergence and stability. In retrospect, economic performance over the convergence period was characterised by two key developments: inflation was brought down successfully and price trends converged, on the one hand, while unemployment soared to unprecedented levels, on the other. In addition, mirroring that drastic deterioration in the employment situation, Europe's debt/GDP-ratio increased by some 15% between 1991 to 1997.

Our objective is to investigate what lessons may be learned from the experience over the convergence period. A sound diagnosis of the deeper causes of this miserable legacy is crucial. For a failure to properly understand our past follies is bound to lead to false prescriptions for the future. And a continuation of the 90s performance might even de-rail the process of European integration.

Among the major players in European economic policy making, and in the shaping of public opinion, are central bankers. The *independence* of the newly established European Central Bank (ECB) has been firmly enshrined in the Maastricht and Amsterdam Treaties. And Europe unashamedly prides itself of its monetary "representatives", independent of any democratic interference, accountability and political control. The diagnosis and policy prescriptions of central bankers are generally perceived not as opinionated judgements, but as independent and especially sound and competent advice.

In his speech at the ceremony on the occasion of the establishment of the European System of Central Banks (ESCB) in Frankfurt, on June 30, 1998, Mr Duisenberg, the ECB's first President, provides us a sample of the conventional wisdom of Europe's independent central bankers:

In the context of what monetary policy can and cannot achieve, I repeat what I have said before on several occasions: monetary policy is neither the cause of nor the solution to the still unacceptably high level of unemployment in Europe. Solving that problem mainly requires structural policies to make markets operate more flexibly (Duisenberg, 1998).

In what follows, I shall challenge the wisdom of all three of Mr Duisenberg's assertions. I shall argue, first, that rather than being an irrelevancy, monetary policy was a, if not the, chief cause of the severe deterioration of the employment situation over the 90s. Second, I shall argue that competently managed monetary policies will be a necessary ingredient to any solution of today's scandalously high level of unemployment. Third, I shall argue that "structural policies" *alone*, and despite the fact that certain supply-side reforms may well be desirable on pure efficiency grounds, would *not* improve the employment situation in any momentous degree.

Our analytical task is thus laid out, broadly following the order of Mr Duisenberg's assertions in the above quotation. Section 2 critically assesses the monetary policies of the 90s as a candidate cause of the rise in unemployment over the convergence period. Our analysis concentrates on Germany, the Bundesbank's *de jure* policy domain, emerging as the "sick man of the Euro" (Economist 1999) by 1998-9. Section 3 then analyses the most significant changes brought about by the new macroeconomic regime, the prospects it offers, and the risks that come with it, concentrating on the ECB's role in solving Europe's unemployment malaise. The key issue here is whether the new regime might encourage learning from the 90s, or leave us prone to see a continuance of that decade's dismal performance. Section 4 addresses the role of structural reform and the appropriate behaviour of social partners in the new environment, drawing some crucial lessons from the "Dutch miracle". Section 5 concludes by briefly reflecting upon developments in 1998-9.

#### THE OLD REGIME AND BUNDESBANK POLICIES IN THE 1990s: THE ART OF MONETARY OVERKILL?

Towards the end of the 1980s, a decade of generally sluggish European investment and growth, the world economy experienced an US-led boom of considerable strength. In West Germany of 1989, rates of investment and employment growth reached levels not seen in a decade, while inflation remained subdued at the 80s level of 2 to 2.5% (temporarily depressed in 1986-7 due to an energy price shock). Inflation accelerated somewhat in the US though. And in 1988-9 the Fed thus adopted a restrictive monetary stance, with the result that the US slipped into recession in the second half of 1990.

The tightening of the Fed's stance was mirrored in Europe, led by the Bundesbank, and so was the marked slowdown in economic activity - except for West Germany itself. For Germany's economy was under peculiar influences at the time. First, the three-stage income-tax reform of 1986/88/90 provided a strong fiscal stimulus. Second, strong exports furnished another expansionary impulse (Germany's capital-goods orientation being accentuated by a real depreciation of the D-Mark within the EMS). As a result, Germany was in a more favourable position than its European partners, even *before* unification. Unification then yielded another powerful stimulant to domestic demand in 1990-1, a rather timely one, moreover, as export demand was by then flagging. Tight money thus took a little longer to work and Germany fell into recession only by mid-1992, giving way to Europe's exceptionally severe slump of 1992-3.

In this context, 1991, the year of the Maastricht negotiations, marked a watershed in European integration. For at Maastricht it was decided, not only to adopt a common currency by the end of the decade, but also that a process of convergence should precede the launching of the new currency into a stable economic environment. In 1991, Europe thus embarked on policies considered conducive to convergence and stability. National finance ministers attuned themselves to fiscal consolidation, while monetary policy was left in the safe hands of Germany's Bundesbankers, acclaimed for their independence, strong inflation aversion, conservativeness, credibility and reputation, etc. The EMS crisis of 1992 and the system's *de facto* breakdown in 1993 temporarily threatened the project, but by springtime 1998 the eleven EU countries willing to embrace the "Euro" were declared fit to do so. The real economic facts to be explained, however, are hardly impressive, being well summarized by Fig. 1.

Clearly, economic performance differed drastically in *western* -Germany<sup>2</sup> and the US over the 90s. Taking the Maastricht year of 1991 as our base, the US steamed ahead over the decade on a "3 per cent plus" growth trend, while Germany managed only half of that. True, the economies were out-of-sync in the early nineties. But this cyclical factor plays only a minor part in the story. More important is the fact that Germany *got stuck* on a low growth trend and *persistently* underperformed over the whole decade, as illustrated in Fig. 1. Behind the different growth trends were a strong investment boom in the US on the one hand, and poor and stagnant investment in Germany on the other. A growth differential of roughly 10 per cent has built up between 1992 and

1997, the year of successful convergence in Euroland.<sup>3</sup>

Much in line with output and capital growth, employment in Germany and the US evolved rather differently too. Starting from around 6 per cent for both actual and structural unemployment in both countries in 1989, a year broadly comparable in cyclical terms, US unemployment since the 1990-1 recession has fallen below levels previously believed to be compatible with non-accelerating inflation. By contrast, roughly 1.5 million jobs (or 5% of the labour force) were wiped out in (West!) Germany after 1991, unemployment reaching the historical record of 10% in 1997. Inflation performance in Germany and the US was similar though. Peaking in the early 90s, inflation fell to about 2 per cent until 1997 in both countries. In Germany inflation even encroached the neighbourhood of zero in 1998-9.<sup>4</sup>

It is of some interest to consider also the economic performance of Italy and the UK over the same period. For Italy and the UK both shared the same destiny in the September 1992 EMS crisis. But another stark difference in economic performance emerges here: while Italy's performance was even poorer than Germany's, the UK's was much closer to that of the US.

One explanation for these stark differences in performance concentrates on labour markets. As has been repeated *ad nauseam*, labour markets in both the US and the UK are very "flexible", whereas Germany and Italy are stuck with hopelessly "inflexible" labour markets, "structural rigidities", and so on. An extreme version of this view, epitomizing the convenient conventional wisdom of Europe's central bankers, puts all the blame on this factor alone. Yet, in economics mono-causal explanations invite scepticism. In section 4, we will therefore scrutinize closely the Netherlands' impressive performance over the 90s (see Fig. 1), widely seen as the paragon of sound economic policies. But here we pursue another explanation.

The alternative hypothesis concentrates on demand-side factors, mainly the role of macroeconomic policies and their effects on aggregate demand over the 90s. In this regard too, bringing Italy and the UK into the picture is of particular interest. For, following the devaluations of the Lira and the pound in 1992, Italy and the UK pursued very different strategies. Embarking on the Maastricht consolidation crusade led by Germany, Italy also stuck with the ERM, i.e. the monetary stance as dictated in Frankfurt (initially at an undervalued exchange rate, followed by an untimely Lira appreciation in 1995-6, and plagued with a time-varying risk premium). By contrast, the UK left the ERM for good, pursuing its own monetary policies of quick and drastic interest rate cuts from (not quite so) Black Wednesday onwards. These were accompanied by fiscal expansion until 1994, when the UK switched to growth-based fiscal consolidation by a timely tightening of fiscal stance. Perhaps, then, demand management policies make some difference after all.

Demand management involves both fiscal and monetary (and exchange rate) policies. In what follows, we concentrate mainly on monetary policy and exchange rate developments, as the role of monetary policy in relation to Europe's unemployment malaise is our key concern here. In Germany, Bundesbank proclamations concerning the employment neutrality of "stability-oriented" monetary policies are widely believed.<sup>5</sup> Elsewhere, observers tend to be more closely in touch with economic theory with respect to the "short run" real effects of monetary restriction. But the possibility that tight money may also have more lasting real consequences is not taken seriously either. For instance, Nickell (1997), after carefully analysing (and debunking!) the received wisdom about Europe's rigid and inflexible labour markets, largely brushes aside demand side factors as a potential explanation of any protracted rise in unemployment, it seems, if a long enough period were taken.<sup>6</sup> Concentrating on the 1990-97 period, Artis (1998) finds that monetary policy was considerably tighter in the EU15 than in the US in the first half of the 90s and concedes that deflationary policies may have made some difference. He even refers to probable hysteresis effects. Yet his overall verdict reads: "while the timing might have been different, both fiscal consolidation and cautious counter-inflationary monetary policy were inevitable" (Artis 1998, p. 104).

In what follows, we shall identify some key aspects of the Bundesbank's (not so cautious) policies of the 90s that should better not be overlooked if erroneous assessments are to be avoided. This is especially true when the cyclical timing of Maastricht-style consolidation is taken into account as well. Taking US performance as our standard of comparison, we concentrate on Germany, representing the Bundesbank's *de jure* policy domain, and only briefly comment on some wider European ramifications.

Given the similarity of their respective operating procedures, overnight interest rates provide a good indicator for a comparison of monetary stance in Germany and the US. Figure 2 shows the development of the Fed Funds rate and of DM overnight rates (targeted by the Bundesbank's Repo rate), both CPI deflated. More precisely, Fig. 2 illustrates the *synchronised* policy responses to the early 1990s recession by the US Fed and the Bundesbank respectively, the *Q0 base* representing the onset of recession in the third quarter of 1990 in the case of the US and the third quarter of 1992 in Germany's. In addition, we include a spread term as a measure of the slope of the term structure of interest rates, yielding another indicator of the tightness of monetary stance over the relevant period.<sup>7</sup>

A clear picture emerges here: on both counts the Bundesbank's stance was *relatively* tighter than the Fed's, and quite significantly so. I do not just mean that the level of (real) short-term rates was considerably higher in Germany than in the US for 16 quarters subsequent to the onset of recession. Rather, notice that the Fed had loosened its stance preemptively, reducing rates rather quickly and to low levels, then keeping the real Fed Funds rate between zero and one percent for quite some time; namely, until the US economy was growing strongly and stance thus needed to be shifted to neutral. By contrast, the Bundesbank's stance peaked when the economy cracked, while subsequent cuts came late and slowly.

It may be argued that the Fed's relatively easier stance, reflected by the steep positive slope of the US's yield curve in the early 1990s while Germany's remained inverse for the (historically-record!) period of three years, was partly motivated by the need to re-capitalise US banks. This issue is certainly of much interest in its own right. In the context of demand management, however, far from contradicting the argument, this consideration actually proves the case, namely, that the Fed carefully takes into account the factors relevant for stimulating domestic demand and getting the economy moving again.<sup>8</sup>

Other relevant factors include fiscal policies and exchange rate developments. As regards fiscal stance, a U-turn occurred in Germany in 1992, while much of the rest of Europe too embarked on the concerted Maastricht fiscal consolidation crusade - at the time of recession! Given the weakness of exports since 1990, this shift in fiscal stance would have required a significant (and pre-emptive!) easing of monetary stance to avoid a falling off in aggregate demand. The US picture was very different on this count: automatic stabilisers were allowed to do their natural work in the early 90s, a tightening of fiscal stance took effect only when the economy was growing strongly. Table 1 shows the cyclical timing of US vs German-style consolidation strategies and their respective results.<sup>9</sup>

Exchange rate developments are more directly related to monetary policy, whether they are pegged or not. It is thus worthwhile to note that the Fed's easy money policies of the early 90s were accompanied by prolonged dollar weakness, a factor which brought additional and timely relief to US manufacturing. By contrast, there was a drastic DM appreciation in the first half of the 90s, with the German economy, moreover, being far more sensitive to exchange-rate movements.

A "Monetary Conditions Index" (MCI; cf. Freedman 1995, Corker 1995) captures exchange rate developments and their effects on monetary stance. Effectively, a MCI *combines* two indicators of monetary stance, a short-term interest rate and the effective (i.e. trade-weighted) exchange rate, the two factors being *weighted* according to their relative role in the transmission mechanism in their effects on aggregate demand and activity.<sup>10</sup> Note that the *absolute* value of the MCI does not represent a measure of monetary stance. The MCI merely indicates whether stance has become more or less restrictive *relative* to some base.

Our MCI yields some interesting new information. Both the term spread and short-term interest rates indicate that the Bundesbank's stance was *relatively* more restrictive than the Fed's in response to the recession of the early 90s, with the *relative* positions of their stances being further accentuated by the fact that both exchange rate movements and changes in fiscal stance worked in the same direction. The additional point about the MCI (see Fig. 3a) is this: the MCI indicates that the Bundesbank's stance remained *basically unchanged* between 1990 and 1995, that is, for six years! In other words, although interest rates were cut gradually from their peak level of 10 per cent (6 per cent in real terms; along with historical records for the official discount and Lombard rates) after September 1992, reaching the historical record low of 3 per cent in mid 1996, exchange appreciation fully compensated any monetary easing during this drawn out period of very sluggish interest rate reductions. Note, then, that *if* the Bundesbank's stance was restrictive at any time in the early 1990s, its stance hardly became any less restrictive until early 1996.<sup>11</sup>

This inference needs to be further qualified in the light of monetary theory. For the degree of monetary tightness prevalent at any time, whether policy stance restricts or stimulates demand, may not be simply read off from the *absolute* level of interest. According to Wicksell (1898), the relevant measure is whether the level of interest is high or low *relative* to some equilibrium interest rate, that rate of interest which keeps the system at its current equilibrium level (of activity and prices). Thus, when we infer from the MCI that the monetary stance of 1990 remained basically unchanged until early 1996, we implicitly assumed that other demand determinants did not become significantly stronger in the meantime.

The rate of capacity utilisation captures the essence of Wicksell's insight well, summarizing the degree of demand pressures on given capacities prevalent at any time. For, presumably, a level of interest which is neutral when capacity utilisation is in balance, would be felt the more restrictive the more capacities become underutilised. Fig. 3b shows not only that capacity utilisation fell sharply in 1992-3, but that it remained at a persistently depressed level.<sup>12</sup> From the Wicksellian perspective, then, we would have to conclude that, if anything, monetary stance became even *more* restrictive after 1992 due to the fact that the authorities allowed the recession to drag on and persist - for the rest of the decade.

After six years of ultra-tight money, a significant easing of monetary conditions finally occurred from spring 1996 onwards. This easing was not due to any drastic interest rate reductions though, as there was only one minor 30 basis points cut in mid 1996 (which hardly compensated for falling inflation). The easing arose through the exchange rate channel alone. Hence the improvement in the situation in Germany since 1996 was solely due to stronger exports, with accelerating US growth and dollar strength pulling in the same direction. Domestic demand, by contrast, remained stagnant: *persistently* depressed levels of capacity utilisation reflecting the *deflationary* policy mix. As theory would predict, investment in capacity expansion was notable for its absence in Germany after 1991.

In conclusion, to deny that monetary policy has been a cause of unemployment over the 90s, as Mr Duisenberg does in his monotone Bundesbank refrain, is to disregard both theory and facts. No serious economist ever claimed that money would be neutral in the short run, and, obviously, the "short run" of comparative-static thought experiments may become fairly long run in the real world when monetary restriction is exercised for long enough. In Germany, monetary conditions were persistently ultra-tight from 1990 to 1995. During this six-year period, niggardly interest rate cuts were fully compensated by exchange appreciation, while persistently underutilised capacities provided a strong extra drag on investment. In addition, this long (rather than short) run of severe (rather than cautious) monetary restriction was accompanied by pro-cyclical fiscal consolidation: a thoroughly unsound and counterproductive policy mix. These facts cannot be denied - contrasting starkly with demand management in the US (and UK) - whatever importance one may attach to supply-side factors. In fact, compared to faster growing economies, stagnant *domestic demand* represents *the* distinctive feature of Germany's economic performance over the 90s.<sup>13</sup>

We do not deny that certain structural reforms may well improve economic efficiency in Germany. But we deny that supply-side factors represented a key constraint over the 90s. Unless it is argued that "structural problems" *caused* deficient demand while it was impossible to address the protracted demand deficiency by more appropriate monetary policies. If interdependencies between demand and structural factors are seen as important, the opposite direction of causality seems far more compelling though.

For instance, the marked rise in non-wage labour costs of the 90s is widely seen as a key negative *supply-side* factor behind the German unemployment malaise. This supply-side *effect* arises quite automatically though when the costs of unemployment are not only dramatically rising in absolute terms, but also distributed over a dwindling number of jobs. It is the inevitable result when the public authorities attempt to avoid debt finance, responding to the shrinking contribution base by raising tax and contribution rates instead. To the extent that rising "Lohnnebenkosten" (and the increasing tax and contribution wedge) then lead to further job losses, a *deflationary spiral* emerges quite naturally from such behaviour (similar to benefit cuts in this respect). Thus monetary restriction is *non-neutral* with respect to the *supply-side* too and these effects may even be cumulative and persistent - until the vicious employment trend is being reversed.

A number of lessons may be drawn from the great German disinflation, with headline inflation being successfully reduced from 4% to 0% between 1992 and 1998, while - coincidentally? - unemployment soared to unprecedented levels and, hence, public finances deteriorated markedly. For one thing, the exercise has proved that a long run of ultra-tight money may give rise to a protracted period of deficient demand and long-term unemployment. Other lasting effects arise on the supply side, when the budgetary squeeze leads to cuts in public investment on one hand, and a widening of the tax and contribution wedge on the other. Most importantly, the unsound German policy mix of the 90s saw a constrained fiscal authority paired with an independent monetary authority free to impose its will on the overall outcome.

Apparently, it is widely hoped that Europe's new independent monetary policymaker will behave very much like the old one, the Bundesbank. In the light of our analysis of this section we would content that European citizens deserve better from the ECB. The question is whether the new regime allows any justified hopes that more appropriate monetary policies may actually be forthcoming.

#### PROSPECTS AND RISKS OF THE NEW REGIME: THE PROMISED (EURO-) LAND OF ECONOMIC STABILITY?

In the light of the previous section we must reject the validity of the first of Mr Duisenbergs assertions. The Bundesbank's overkill policies of the 90s have burdened Europe with economic legacies which are hardly the envy of the world. With regard to the EMU regime change, a key issue is that the Bundesbank conducted *European* monetary policy with a view to the *German* situation only. Correspondingly, solving this "policy-domain problem" (Kenen 1995) is a, or even the, key benefit of EMU. For the ECB's task is to conduct monetary policy not for any particular country, but for the Euro zone as a whole.

To get an idea of this issue, imagine for a moment German unification would have taken place under the new regime. Clearly, European affairs would have developed very differently over the 90s. For the monetary stance would have been considerably easier at the start of the decade, as was appropriate for *Europe* as a whole (Gros and Thygesen 1998, p. 321). Not only would the policy stance have been generally easier, EMS satellite currencies would have enjoyed the extra benefit of not having to shoulder risk premia and financial instability, accentuating the degree of monetary restriction quite severely at times.<sup>14</sup> Without the Bundesbank's foot being glued to the monetary brake, unemployment and public debt would be substantially lower today - while the capital stock would be higher. In short, we would all be richer now and would have enjoyed higher consumption in the meantime too. And it is not even clear whether, under hypothetical EMU conditions, Germany's price level would be any higher today. As US experience shows, higher investment and growth may be *disinflationary*, by keeping unit-labour costs in check. Moreover, with more favourable public finances, *inflationary* indirect tax increases would have been avoidable.<sup>15</sup>

Beware not to confuse two separate issues though. One concerns the key benefits of a common currency, namely that of solving the "policy-domain problem" and preventing exchange crises and financial instability, which are bound to arise with free capital mobility and bound to disturb the common

market. In fact, by taking away the threat of competitive devaluations and untimely exchange appreciations, this benefit may even compensate the loss of the anchor currency's former privilege. At any rate, these benefits by far exceed any additional gains from transaction cost savings, a factor much emphasized in "One market, one money", a study sponsored by the EC Commission (1990) in promotion of the common currency.

Another, separate issue is whether the new regime will yield those *dynamic* benefits identified by the EC study, believed there to arise from establishing "a policy framework conducive to stability-oriented macroeconomic policies". Clearly, German unification presented a very specific type of *asymmetric* shock, a shock hitting the system's anchor. But, in principle, nothing would have prevented monetary policies more conducive to economic performance in Germany. We must not confuse the potential benefits from solving the policy-domain problem on the one hand, with the chances of being spared poor monetary policies on the other. For it remains to be seen whether *the* EMU regime *à la Maastricht* will bring forth future macro policies less inappropriate than the ones inflicted upon Europe in the 90s. What are the chances?

Achieving enhanced economic stability in general, and monetary stability in particular, depends on a variety of factors. Essentially "the long-run stability or instability of prices will depend on the strength of the upward trend of the wage-unit (or, more precisely, of the cost-unit) compared with the rate of increase in the efficiency of the productive system" (Keynes 1936, p. 309). The real issue therefore is whether the Maastricht regime in general, and the ECB's conduct of monetary policies in particular, are conducive to productivity growth and overall social consensus in Euroland. Specifically, the issue is whether the Maastricht regime struck a sound balance between flexibility, coordination, and discipline.

### The Flexibility Issue

When I said above that a main benefit of EMU is that the ECB will not be able to focus too much on the peculiar situation in any specific country, but will have to look at general developments in Euroland instead, I did not mean to imply that a monetary stance which is appropriate for Euroland as a whole will be equally appropriate for each individual country (or region). Quite the contrary: a "one-size-fits-all" monetary stance is quite unlikely to furnish a tailor-made fit for any one country (representing a *new* downside only for Germany). What I meant, then, is that the new monetary arrangements are, in principle, more likely to lead to a stance that is appropriate for Euroland as a whole than the previous ones. In addition, to the extent that policies appropriate for Euroland as a whole will actually be forthcoming, this may tend to lead to more convergence with respect to monetary policy requirements in individual countries (Frankel and Rose 1998).

Nevertheless, in light of the theory of optimum currency areas (OCA), a *common* (rather than *single*) monetary policy implies an increased need for national (and regional) flexibility through alternative channels, both market or policy adjustments. In essence, fiscal policy is the only tool left to take care of the flexibility issue at the national level, coping with desynchronized developments due to those asymmetric shocks featuring in the OCA literature. By contrast, the labour mobility issue may be highly over-rated.

Large-scale migration is clearly out of the question in the case of countries (or regions) just being temporarily out-of-sync, that is, the domain of traditional (short-run) stabilisation policies. But even in the case of longer-term structural developments, large-scale intra-union migration does not appear to be an aspired EU goal. Rather, it seems to me, that general labour mobility, apart from certain professions and regions, is out of the question even in the long run, and whatever the situation in the US may be.

For longer run developments this conclusion has clear implications regarding the role of capital mobility, both private and public. One issue concerns provisions for a level playing-field for competing regional fiscal authorities, performing a vital, complementary role by providing an infrastructure conducive to attracting private capital.<sup>16</sup> Another concerns the scale of redistribution required at the national and union levels to make large-scale migration a non-issue (cf. Begg 1995). Adjustments in relative wages between countries and regions do not represent a long-term alternative if "cohesion" is to be taken seriously.

In the case of cyclical developments, adjustments in relative wages between countries and regions may bring *some*, albeit limited, relief. But the brunt of the flexibility issue will have to be borne by *stabilising* (i.e. counter-cyclical) fiscal policies. Now it may be the case that at any time there is only a limited scope for truly discretionary public spending with a chance of timely effectiveness. And it may also be the case that long-term planning of public spending, public investment spending in particular, would have much to say for it. The point is, however, that the gloomy 90s were characterised by largely de-activated automatic stabilisers and *pro*- cyclical discretionary cuts in public investment spending. It is clearly counterproductive to apply the only instrument available to look after the flexibility issue in such a *destabilising* way, doubly destabilising, indeed, if all countries pursue the same (coordinated?) deflationary policies at the same time.<sup>17</sup>

Thus, the question is whether the "Stability and Growth Pact" (SGP), installed as the basis for a *rule-based* fiscal policy, will prevent such *irrational discretionary* policies in the future. Any individual country's scope for fiscal flexibility in response to a shock depends on three factors: first, the severeness of the shock, second, the sensitivity of the budget to that shock and, third, its initial budgetary position. Unfortunately, the SGP features the following paradox (apart from many other arbitrary and unsound elements). On the one hand, it is argued that the SGP would allow sufficiently flexible responses of national policies to asymmetric shocks, *if* countries succumb to the rule of a balanced budget (or even surplus) over the cycle. But the need for such flexibility during the transition towards the required "equilibrium position" is completely ignored, on the other hand. Essentially, the requirement for fiscal flexibility has fallen victim to fiscal "discipline" at just the time when it may be most needed. It is not just the individual members' lack of flexibility in response to asymmetric developments which seems worrying.<sup>18</sup> The prospects for the union's aggregate fiscal stance are hardly any less dire, which leads us on to the coordination issue.

### The Coordination Issue

The coordination issue breaks down into three key parts: first, the coordination of national fiscal policies with the aim of attaining an appropriate *overall fiscal stance* (permitting, at the same time, sufficient flexibility to individual members); second, the coordination of macro policies with the aim of attaining an appropriate *policy mix*; and third, the coordination of macro policies and the behaviour of social partners. It is a remarkable feature of EMU *à la Maastricht* that the coordination issue is treated very much like a non-issue.

### Euroland's Fiscal Policy Stance

One may of course argue that the "aggregation" of national fiscal policies amounts to a coordinated overall fiscal stance for Euroland. It seems more difficult to argue though that such *random-style* "coordination" necessarily brings about an *appropriate* overall fiscal stance. Currently, no *genuine* coordination of national fiscal policies is taking place at all. The body most nearly involved in coordinating national fiscal policies is Ecofin (or, more informally, the "Euro-11"). And Article 99 of the Treaty on European Union (TEU) requires members to treat their economic policies as a matter of common concern, laying down the procedures for preparing and adopting the "Broad economic policy guidelines", and including provisions for a process of multilateral surveillance. It remains to be seen whether Ecofin, on the basis of Article 99, may in the future evolve into a body of genuine coordination of national economic policies. Currently, however, Article 99 is hardly anything else but a deputy to the "excessive deficit" provisions of Article 104 TEU. The principle of "budgetary discipline", enshrined in Article 104 and enforced in the SGP, defines the overriding fiscal targets--and, in important cases, binding constraints--if the "Stability (and Convergence) Programmes"; to be submitted by members for "coordination" along the lines of Article 99. It is one thing that discipline is enforced *asymmetrically*, which may give rise to a free-riding issue. More importantly, under adverse conditions, the SGP may quite easily turn out to be an "Instability and Stagnation Pact" (cf. Allsopp 1998, Eichengreen 1996, Eichengreen and Wyplosz 1998, Arestis, McCauley



and Sawyer 1999). In fact, with the traditions of sound finance as witnessed over the 90s, are we not bound to see a continuation of gloom? It all depends on whether timely and sufficiently expansionary stimuli are forthcoming from elsewhere to counterbalance any continuing fiscal contraction.

### Euroland's Policy Mix

In principle, the ECB appears to be in an ideal position to respond *flexibly* to union-wide (i.e. symmetric) developments. Article 105 TEU lays down the E(S)CB's "primary" goal as that of securing "price stability". The Treaty neither defines what price stability is supposed to mean, nor does it specify the conditions under which the ECB could *not* refuse to pursue her "secondary" goals, that is, the Union's *real* objectives as laid down in Article 2 TEU. Effectively, the ECB was granted *discretion* to fall back on grounds of envisioned risks concerning its "primary" objective, as interpreted by itself, under almost any conditions. If such a degree of *goal* independence looks conspicuously risky, do not overlook that the ECB's degree of *instrument* independence is truly exceptional: there is no override clause, no check in place at all.

This is not the occasion to discuss the related and crucial issues of the ECB's strategy, transparency, and accountability (cf. Begg and Green 1998, Bibow 1999, Buiters 1999, OECD 2000). Rather, the point we wish to emphasise is that the *form and degree* of independence of the ECB, as enshrined in Article 107 TEU, rules out the possibility of genuine coordination *on an equal footing*. The Maastricht rules of the game are such that the independent monetary policymaker is automatically in the position of calling the final shot.

The ECB's *unbounded discretion* has vast consequences. In effect, Euroland democracies have granted their *monetary* "representatives" control over the monetary and economic policy mix (without holding them to account on their performance.) If conflicts in views arise, these may *not* at all concern preferences and objectives (cf. Boltho 1998), but theory. For central bankers prevail not just with regard to the former, they also dominate the choice of model on which policies will be based (cf. Allsopp and Vines 1998). This may be of little concern as long as their choice of model approximates realities reasonably well. But the experiences of the 90s, when the Bundesbank's choice of model prevailed (cf. n 3), should alert us to the risks involved.

### Coordination Between Policymakers and Social Partners

It is one thing to ask *how* social partners may best coordinate their behaviour among themselves at the EU level, an issue which was not decided in the Treaty but on which we shall offer some thoughts in section 4 below. It is quite another that it is actually difficult to see how policymakers might possibly decide on appropriate policies (and a sound policy mix) without any reliable *two-way* coordination (cf. Soskice and Iversen 1998).

### Coordination as Envisioned in the "Broad Economic Policy Guidelines"

Reflecting the Maastricht dogma, the broad economic policy guidelines foresee a clear division of labour, with a particular assignment of objectives and responsibilities for each party. Put briefly, these are:

- (1) the ECB shall conduct "stability-oriented" monetary policies;
- (2) finance ministers shall pursue policies conducive to fiscal consolidation;
- (3) social partners shall agree (a) money wage rises compatible with price stability and (b) real wage rises below productivity growth (believed to raise the profitability of labour-intensive investment).

Guidelines (1), (2) and (3a) are broad enough to be fairly uncontroversial. Certainly this author neither recommends that the ECB should pursue instability-oriented policies nor that finance ministers should aim at debt explosion. Given the dismal legacies of "stability-oriented" policies, finance ministers have few options left, while a stable wage-unit is key to price stability anyway. The broad guidelines shun the crucial issue though: the independent monetary policymaker plays the "wildcard" in the European policy game. <sup>19</sup>

### The Actual European Policy Game

Let us identify then the *actual* European policy game, the outcome of which will determine whether future performance will be equally dismal as over the recent past. First, finance ministers are the lame ducks in this game. Fiscal policies were restrictive over the 90s. Whether fiscal stance will be more neutral in the future depends on whether or not sustained growth will be achieved, which, in turn, hinges on whether the other players play their parts. The "instability-and-stagnation" scenario already referred to represents one possibility. With more benign developments, finance ministers may be presented with some leeway to reverse the 90s dismal trend of depriving Europe of a first-class infrastructure as well as for tax reductions. Second, the role of the social partners is to credibly commit to a *stable* wage-unit, that is, price stability at rising levels of employment. Third, monetary policy has to deliver growth and employment, if it can.

### Discipline: Too Much, and Too Little, or Can Two Wrongs Make a Right?

Obviously, then, the ECB plays no mean role. Yet, the belief that price stability was costlessly achieved in the past is one thing. To believe that price stability will - by itself - *cause* higher growth and employment in the future is quite another. The facts give a clear message: huge and persistent negative output gaps, spare capacities and mass unemployment, show that Europe has been out of equilibrium and far away from natural rates and NAIRUs over the 90s. In theory, there is no excuse for independent central bankers to renege on their real responsibility to stimulate domestic demand-led growth. In practice, they may still continue to do so. Genuinely stability-oriented policies feature a *symmetric* conduct of monetary policy. There is no alternative solution to get out of the current malaise other than to engineer *a prolonged period of very easy monetary conditions*, that is, the opposite of the tight money policies seen in the 80s and 90s that have left Europe stranded with today's scandal of mass unemployment and disorderly public finances. <sup>20</sup>

In conclusion, EMU *à la* Maastricht is flawed by its failure to strike a sound balance between flexibility, coordination, and discipline. On the one hand, fiscal flexibility has been subordinated to the (asymmetric) discipline of the SGP. Being utterly misnamed, that Pact may easily turn out to be quite the opposite, and exactly for this very imbalance. On the other hand, the coordination issue has been subordinated to the ECB. Paradoxically, given all this emphasis on discipline, no device is in place to discipline central bankers, enjoying *unbounded discretion* (Bibow 1999). The lesson we draw from our assessment of the new regime takes the form of a warning: Mr Duisenberg's denial of the ECB's crucial role in solving Europe's unacceptably high level of unemployment is hardly reassuring. For monetary policy, *and monetary policy only*, is in a position to brace *domestic* demand-led growth.

### STRUCTURAL REFORM AND BEHAVIOUR OF SOCIAL PARTNERS: LESSONS FROM THE "DUTCH MIRACLE"

So far our analysis has concentrated on macroeconomic management alone. This is not inappropriate, given the unsound macro policies of the 90s. It is time now to scrutinize Mr Duisenberg's third assertion, concerning structural policies. Allegedly, a lack of labour market "flexibility" and wide-spread "structural rigidities" represent the root cause of European unemployment, at least if Europe's central bankers were to be believed. Apparently, then, reducing unemployment requires "mainly" structural reform. In this regard, the "Dutch miracle" is usually seen as proving, what is in effect, a supply-side-only doctrine.

And indeed, the Netherlands represent a particularly interesting exception to today's generally scandalously poor employment situation in Euroland. For the

Netherlands (together with Austria) had been *de facto* "on the D-mark" ever since 1983. Presumably, then, as the Netherlands shared a single monetary policy with Germany, this also proves that Bundesbank policies did no harm at all. Or so it may seem.

To begin with, it is well known that *broad unemployment* in the Netherlands is still significantly above the level of the early 80s, while the rate of employment in *full-time equivalents* has risen only moderately since then. The Dutch miracle mainly consists of a remarkable surge in part-time work (OECD 1998, Schmidt and Helmer 1998). Yet, these observations are not meant to deny that the Netherlands' employment performance over the 90s was significantly better than Germany's. Rather, the real issue is whether the Netherlands, a small and very open economy, represent the paragon of sound economic policies, worthy of emulation by Germany and the rest of Europe.

The crucial point overlooked by most commentators is that the Dutch miracle was *not* built on structural reform alone. What may be dubbed the "Dutch myth" features the popular "supply-creates-its-own-demand fallacy". For instance, the OECD's evaluation of the respective roles of, and the important interplay between, wage moderation and the external sector is peculiarly ambiguous:

While the Dutch model undoubtedly rests on domestic factors, the external sector has played a major supporting role. Net exports have contributed, on average, nearly 0.5 per cent a year to GDP growth and the current-account surplus has averaged 4 per cent of GDP over the past 15 years (OECD, 1998, p. 38).

The OECD also correctly observes that "the positive impact of wage moderation on competitiveness has been accentuated by the ERM regime", but fails to unearth the essence of the Dutch "virtuous circle"<sup>21</sup>

Let us try then to scrutinize the role of wage moderation in the Dutch miracle. The point is that in the case of a small and very open economy wage moderation, i.e. incomes policies, represents both a strategic *external* factor and a force of more general *demand-side* ramifications as well. Concerning the external dimension, wage moderation - in conjunction with the guilder's tight DM-link - has led to a depreciation of the guilder's real effective exchange rate of at least 10 per cent over the period of 1983 to 1997. This marked improvement in international competitiveness (particularly *vis-à-vis* Germany) can hardly have failed to stimulate export *demand* -led growth, playing that "major supporting role".

But that is far from all, as more general demand-side ramifications arose through another channel: while Germany's wage trend was systematically underbid by the practice of *relative* wage moderation in the Netherlands after 1982, price trends in both countries were closely allied (see Fig. 4). That is, relative wage moderation did *not* lead to *relative* disinflation. Dutch enterprises partly used their competitive edge for raising margins. Thus, with prices being anchored by the big neighbour, wage moderation fostered both competitiveness and profitability. Export and investment *demand* -led growth stimulated in this way spurred the *demand* for labour. Attributing the resulting rapid job creation to wage moderation as such, that is, wage moderation as a purely domestic supply-side factor, completely misses the point.

Furthermore, rapid job creation achieved through this peculiar demand-side strategy did not fail to buoy household confidence and consumption, thereby setting in motion a *virtuous* circle of rising rates of capacity utilisation, in turn motivating investment to expand capacities and, hence, the creation of even more jobs. This benign cumulative process also proved conducive to both fiscal consolidation and structural reforms. Note how starkly this contrasts with the *vicious* circle in which Germany found itself trapped over the 90s, where deficient aggregate demand was deliberately provoked and allowed to persist. Not surprisingly, Germany's finance minister had to put up with an ever-shrinking tax and contribution base and felt obliged to embark on a quixotic consolidation crusade by cutting public investment and raising the overall tax and contribution wedge. By contrast, his Dutch counterpart further reinforced the Dutch virtuous circle by *reducing* taxes and non-wage labour costs. It is in the very nature of cumulative processes that, once set in motion, the process feeds on itself, either inflationary or deflationary, virtuous or vicious. (Of course, production and export structures helped to prevent the Dutch from joining in the 1992-3 slump.)

Having thus clarified the truly pivotal and multi-faceted role of *relative* wage moderation in the Dutch model of export and investment *demand* -led growth, we do not hesitate to acknowledge that structural reform played a supporting role. In fact, there are good reasons for even admiring the Dutch approach to structural reform, accomplished in an exemplary efficient and consensual way, no doubt fostered by the favourable demand conditions just discussed.<sup>22</sup> No question, structural reform contributed to raising the *supply* of labour. Particularly after 1994, the removal of obstacles to part-time work is likely to have contributed to preventing labour market tightness, thereby allowing unemployment to be reduced to today's low levels. Structural reform though (or an alleged lack thereof) is inappropriate to explain the fact that Germany persistently suffered from deficient demand over the 90s, while aggregate demand (and hence the *demand* for labour) in the Netherlands was sufficient for attaining impressive employment growth.

Whatever lessons one wishes to draw from the Dutch model with regard to structural reform, one needs to be careful in drawing lessons from the Dutch experience with regard to sound macro policies for Euroland. To begin with, note that since 1983 Germany and the Netherlands shared not a *single*, but a *common* monetary policy. Sharing a common monetary policy, importantly, does not imply that policy has identical or even similar effects throughout the common policy area. What distinguished the Netherlands from other ERM members in terms of monetary policy, was the lack of a risk premium on the guilder. What distinguished the Netherlands from Germany were marked differences in monetary policy requirements. The Netherlands could stand the same level of interest much better than Germany itself since - due to the Dutch demand strategy!--ther determinants of aggregate demand were sufficiently stronger.

The episode under discussion thus exemplifies well a familiar problem: a "one-size-fits-all" policy stance is unlikely to suit all members equally well at any one time. We showed above that Bundesbank policies over the 90s represented anything but a tailor-made fit for its *de jure* policy domain. Here we saw how *relative* wage moderation made the common monetary policy far more bearable for the Netherlands. Expressed in Wicksellian terms: the market rate of interest being common to both countries, the Dutch demand strategy raised the Netherlands' neutral rate significantly above Germany's (apart from 1990-1).

We may thus draw a first important lesson from the German-Dutch experience over the 90s which is of continuing relevance for Euroland. Above we emphasized the premium on flexibility when countries share a common monetary policy, as asymmetric shocks may give rise to divergent policy requirements, to be counterbalanced through alternative channels. The first lesson is that there is a case for coordinating economic policies in general, including incomes policies and structural reform, namely to prevent economic divergence and, hence, divergent monetary policy requirements caused along these lines.<sup>23</sup>

A second important lesson from the Dutch experience concerns the issue of *real* -wage restraint, which features in the Commission's "Broad Guidelines" as a means of raising the profitability of labour-intensive investment. A fallacy of composition is involved in simply transferring the Dutch case to the Euro zone. In the former case apparent real-wage restraint was a *consequence* of relative (nominal) wage restraint without relative disinflation, given that price trends were anchored by Germany. For Euroland as a whole, however, no such external anchor exists. And (*ex ante*) real-wage restraint by itself is unlikely to have any positive effects on the volume of investment and employment. This strategy merely tends to twist income distribution in favour of capitalists, with uncertain ramifications (Keynes 1936).

Essentially, the argument for (*ex ante*) real-wage restraint is based on the *belief* in a well-defined relation (long ago proved *non-existent*; see Pasinetti 1997) and strong link between factor substitution and relative factor costs, ignoring, as usual, the demand side. In reality, this foremost neoclassical investment determinant is of little relevance when firms are presiding over underutilised capacities on the one hand, while profitability has been restored

by shedding labour in line with deficient demand on the other (with obvious effects on public finances). Instead, under such conditions, it is far more compelling to tackle *directly* the key deterrent to investment, namely, deficient demand. Only when the rationale for investment in capacity expansion is being restored, is there any chance for a sufficiently greater volume of investment to be forthcoming. And a sufficiently greater volume will have to come forth if Europe's underutilised labour potential is ever to be employed fully (Rowthorn 1999a, b; IMF 1999, p. 114). Profits would grow in line with capacity utilisation and investment. And (*ex post*) real-wage restraint might still result from wages lagging behind rising growth and productivity trends spurred by stronger investment.

While the stimulus to *investment demand-led* growth accomplished in the Netherlands by moderation of wages relative to (externally-anchored) prices thus does not represent an option for the Euro zone, a third lesson is that the part played by *export demand-led* growth in the Dutch model does not qualify for emulation either. In the Dutch case, relative wage moderation stimulated export demand, but led neither to relative disinflation nor provoked retaliation from its neighbours. Wage moderation may also work, of course, for the Euro zone relative to the rest of the world (similar to a Euro depreciation). At some point though, deliberate recourse to beggar-thy-neighbour strategies is bound to provoke retaliation from international partners; with protectionism being hardly in Europe's long-term interest.<sup>24</sup>

Clearly, the relative-wage-moderation strategy would fail altogether in stimulating export demand *within* Europe if all partners were to embark on it at one and the same time. It would be equally futile for them to attempt to devalue *vis-à-vis* one another all at once. This futility indicates, however, that there are not only external risks to wage moderation in the Euro zone. There are also internal ones. In fact, a fourth lesson from the Dutch model refers to the risk of deflation. For Europe has reached the point where further competitive *disinflation* involves *falling* unit labour costs. An attempt to strategically underbid current European wage trends, a beggar-thy-neighbour strategy that worked so well for a small and very open economy like the Netherlands (Delsen and de Jong 1998b, p. 170), represents a recipe for disaster if adopted by the Union's wage-trend setter, Germany (Soskice *et al* 1998 and Spahn 1997). *General and excessive* wage moderation is not unlikely to push Euroland beyond the threshold of outright deflation, and if just by accident. This risk is magnified by the fact that the ECB defined its price stability goal in an ambiguous and asymmetric way ("below 2%") and desires to be held to account (and, hence, stakes its prestige on) nothing else but its "medium-term" inflation performance (Duisenberg 1999, Issing 1998).

We therefore stress that our above reference to a stable wage-unit as the anchor of the price system was meant to imply stability *in both directions*. Again, *symmetry* in behaviour is key. On the one hand, a credible commitment of social partners to a non-rising wage unit leaves no excuse for central bankers to fail focussing on the other, the *y* variable on the right-hand side of the quantity equation. On the other hand, a counterpart commitment to a non-falling wage unit is called for to prevent monetary policy from becoming ineffective. There may be a case for increased flexibility in *relative* wages, i.e. between sectors, regions, and qualifications. But there is no case at all for increased flexibility in the *absolute* level of wages. In fact, an unstable wage-unit makes monetary policy not less, but more intricate (if not impossible).

Thus, *some form of coordination among social partners at the Euroland level* is required, allowing for regional divergence in growth and cyclical positions, but preventing competitive devaluation. The Dutch model gets high praise for its mix of centralised and decentralised wage negotiations, with broad guidelines being decided at the national level and actual negotiations taking place at the sectoral level (OECD 1998). An equivalent broad guideline is required for the Euro zone: to provide a secure basis for a *stable* wage unit. Thirty years of monetary integration directed at controlling the threat of competitive exchange devaluation should not be jeopardized by beggar-thy-neighbour policies through competitive wage depreciation.

In conclusion, the Dutch miracle shows not only that improved microeconomic efficiency cannot substitute for macroeconomic policies directed at the level of effective demand, as the two approaches are not substitutes, but complements. It also shows that it was not left to sheer luck whether an appropriate constellation among the constituent parts of a sound policy mix would come about or not. The Dutch model also features successful coordination between policymakers and social partners at the central level.

#### SOME CONCLUDING OBSERVATIONS ON A LOST DECADE OF FRAGILITY AND UNDERPERFORMANCE

The above analysis shows that all three of Mr. Duisenberg's notorious assertions are to be strongly rejected. As to the past, there can be no doubt that a long run of poor, i.e. *counterproductively* tight, monetary policies goes a long way in explaining the severe and persistent deterioration in the employment situation witnessed in large parts of the Bundesbank's *de facto* policy domain over the 90s. As to the future, the Dutch exception proves the rule, highlighting that structural reform represents not a panacea to Europe's unemployment scandal, but a complement: assisting macro policies directed at attaining a sufficient level of aggregate demand. The Dutch strategy to *demand*-led growth is not an option for the Euro zone though. Instead, the policy game outlined above describes the route to full employment and non-inflationary growth.

In this game of policy coordination, the only player eligible for attaining *domestic* demand-led growth is the one in charge of money, the ECB. Given the straitjacket which the SGP has squeezed fiscal policy into, risking that automatic stabilisers may fail to fulfil their natural stabilising role, as over the 90s, it is upon independent central bankers' shoulders, and upon theirs alone, that duty for attaining a sufficient level of aggregate demand has come to rest. And with social partners in charge of the stability of the wage unit, and, effectively, the *P* variable on the right-hand side of the quantity equation, central bankers set themselves too easy, too useless a task if in tempestuous seasons of protracted output gaps and mass unemployment they can only tell us that the other, the *y* variable, will look after itself as a general attitude of worshipping the glorious *P* variable makes "supply create its own demand" - at least *in the long run*.

To be sure, the ECB is not to be blamed for the Bundesbank's blunders. But the ECB cannot escape facing the legacies of Bundesbank policy disasters inherited at the turn of 1998-9. The 50 basis points surprise cut of April 1999 may thus appear as an encouraging sign of a more symmetric approach to monetary policy (OECD 2000). Ironically, though, when the much belated cut finally occurred, reflecting just how very scary the deflationary abyss's ugly yawning was in the winter of 1998-9, the worst had already past - thanks to the US Fed's vigilance in venting off a melt-down in international markets.<sup>25</sup>

Clearly, without the US as borrower and spender of last resort and massive measures to prop up the deflationary contagion in crisis regions, Europe's current recovery would nowhere to be seen. In essence, Europe, once again, preferred to free-ride on external factors to counterbalance the *deflationary bias* in its own macro policy mix. Almost by accident, certainly against the ECB's declared intentions, the benign scenario of easy monetary conditions slipped in through the back door. In Germany's case, the Euro's plunge, that blessing in disguise orchestrated by the markets, but towards which ECBankers unwillingly contributed by destructive ambiguity amounted to an easing of monetary conditions equivalent to a cut in real interest rates of some 3-4 per cent! Europe's structural paralytic thus rose from its sick-bed as soon as export *demand* spurred growth and employment - when nothing but inflation would have had to be expected if the structural shibboleth were to be believed. Unsurprisingly, Germany's Phoenix-like rise from the ashes remains severely unbalanced, vulnerably plagued by the legacies of the 90s: depressed domestic demand.

Another lesson emerges here in comparison with the US: easy money, through stimulating investment, growth and employment, may yield a strong currency; while ultra-tight money, through chocking off the economy, bestows a weak currency, at least in the longer run. As one rather embarrassing side-effect, Europe's current price "pressures" are not arising from economic strength, but weakness. The rise in headline inflation above the ECB's ceiling of "below 2%" is to a significant extent due to Euro weakness, accentuating the oil price surge. The inherited growth differential thus posed an immediate credibility problem to the ECB. Given its ambiguous (and overly ambitious?) definition of price stability the ECB coped badly by sending confusing signals as to the role of the exchange rate in its opaque strategy.

Have Europe's independent central bankers learned their lessons from the 90s? The fact that the ECB, while presiding over large and protracted negative output gaps, that root cause of Europe's *fragility*, started talk about rate hikes when the first signs of recovery were barely in sight is particularly



discouraging. Up to a point rate hikes *per se* may only do limited harm, at least as long as the export boom continues. But grave international (and US-internal) imbalances have been built up (see Godley and Wray 1999) due to Europe's free-riding behaviour, paired to the US's benign neglect. Once US growth slows and central bankers' strong Euro dream becomes true, easy monetary conditions would soon be a moment of the past. Yet stabilising activity at levels of deficient demand is bound to inflict further structural problems on the system - in continuance of our past follies. Current wage trends and disinflation from deregulation and competition, combined with falling oil prices and a rising Euro, would tend to drive inflation back towards zero - satisfying that fetish. But in order to generate genuine *domestic demand* -led growth Europe will have to mount that formidable barrier posed by the deflationary bias of the Maastricht regime.

And yet, the 90s deflationary crusade has proved beyond any doubt that ignoring the D-blade of the Marshallian/Keynesian pair of scissors is a vain affair.<sup>26</sup> Fortunate external developments unfolding over the course of 1999 should not lead one to overlook Euroland's key structural problem: asymmetric monetary policy. Among Euroland's infamously plentiful structural problems her peculiar creed of central bankers may well represent the single-most costly one.

Table 1: Stability-oriented vs Maastricht-style Consolidation Strategies												
	US						Germany					
	A <sup>1</sup>	B <sup>1</sup>	C <sup>1</sup>	D <sup>2</sup>	E	F <sup>1</sup>	A <sup>3</sup>	B <sup>4</sup>	C <sup>4</sup>	D <sup>3,5</sup>	E <sup>6</sup>	F <sup>1</sup>
1990	1.8	-1.0	0.9	2.7	-1.7	-4.3	5.7	2.0	3.2	5.3	2.9	-2.0
1991	-0.5	-3.0	0.4	1.4	-1.3	-5.0	5.0	1.1	0.2	5.3	-0.4	-2.9
1992	3.1	0.4	0.4	0.5	-0.9	-5.9	2.2	-1.9	-1.1	5.5	1.4	-2.5
1993	2.7	0.0	-1.0	0.1	-0.4	-5.0	-1.2	-4.0	-0.4	3.8	-1.1	-3.2
1994	4.0	1.1	-1.0	1.6	1.5	-3.6	2.7	-0.1	-0.7	2.7	-1.2	-2.5
1995	2.7	-0.3	-0.6	3.0	1.4	-3.1	0.9	-0.7	-0.3	2.8	1.8	-3.2
1996	3.6	0.4	-0.8	2.2	-0.8	-2.2	1.1	-0.6	0.2	1.9	-1.8	-3.4
1997	4.2	0.9	-1.0	3.6	1.4	-0.9	2.3	0.5	-0.4	1.5	-2.3	-2.6
1998	4.3	0.5	-1.2	3.2	-0.4	0.4	2.9	1.1	-0.4	2.5	1.1	-1.7
1999	4.2	0.6	-0.4	3.0	-0.2	1.0	1.4	n.a.	n.a.	2.1	-1.5	-1.1

Sources : OECD<sup>1</sup>, IMF<sup>2</sup>, Statistisches Bundesamt<sup>3</sup>, German Council of Economic Experts<sup>4</sup> (Annual Report 1998/99: tables A1 and D2), Deutsche Bundesbank<sup>5</sup>, own calculations<sup>6</sup> (see n. 7).

*Indicators of policy stance and cyclical timing of consolidation strategy*

A: Growth rate of real GDP

B: Change of output gap on previous years (+/- = higher/lower rate of capacity utilisation)

C: Change of structural balance on previous year (+/- = expansionary/restrictive stimulus)

D: Level of real short-term rate of interest (Fed Funds rate and Frankfurt overnight rate; CPI deflated)

E: Change of monetary conditions (US: real Fed Funds rate; Germany: real MCI) on previous year

(+/- = restrictive/expansionary stimulus)

*Broad indicator of success of consolidation strategy*

F: General government financial balances (+/- = surplus/deficit)

Figure 1. An International Comparison:  
The Real Consequences of "Stability-Oriented" Policies à la Maastricht

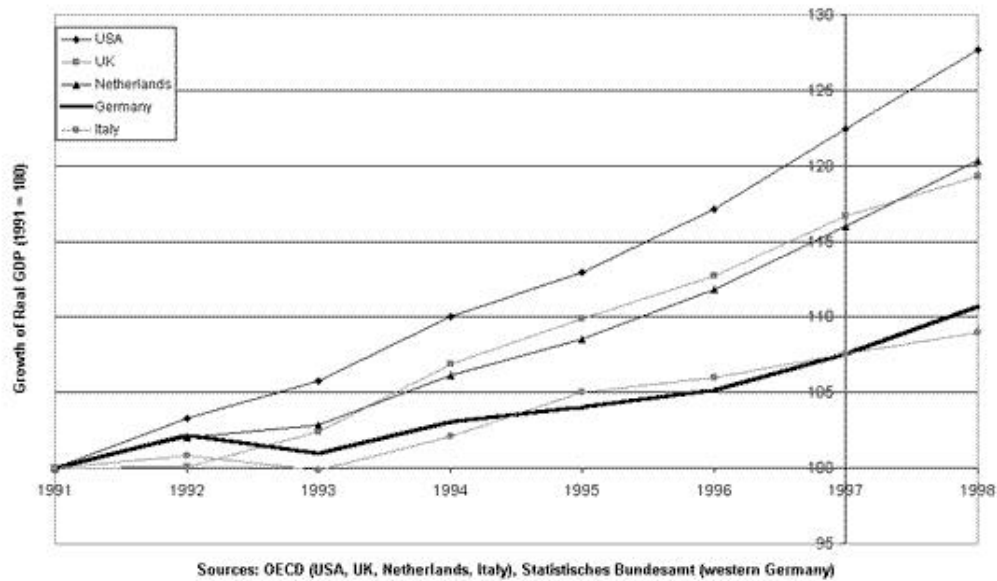


Figure 2. The Art of Monetary Overkill

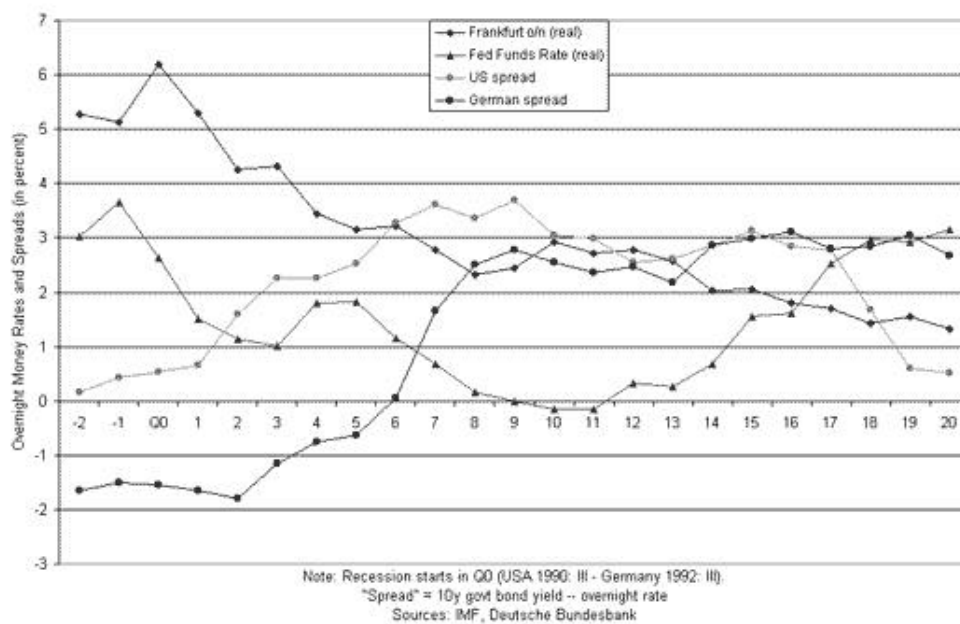


Figure 3a. 1990-1995: Six Years of Ultra-Tight Money ...

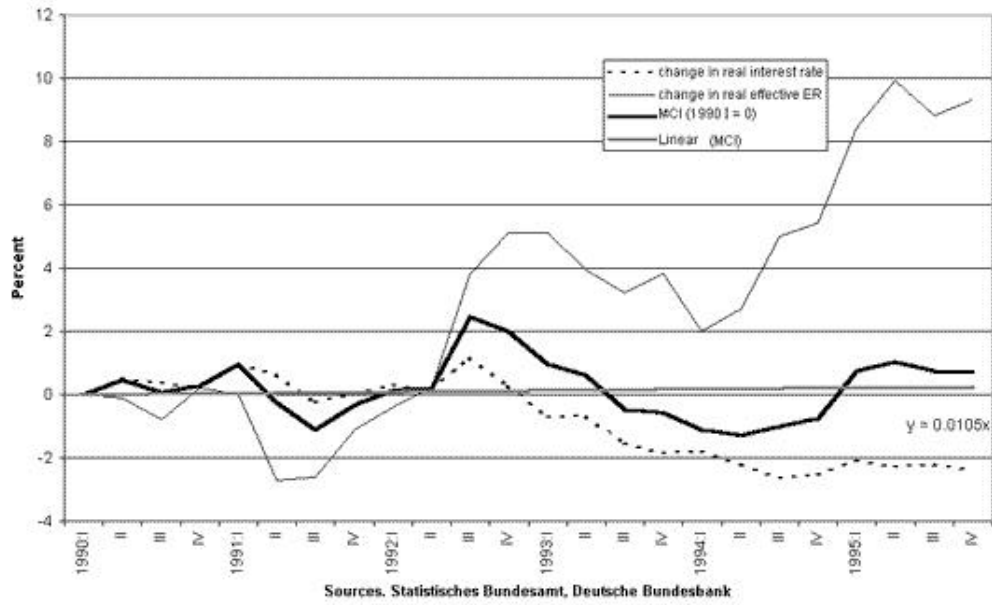
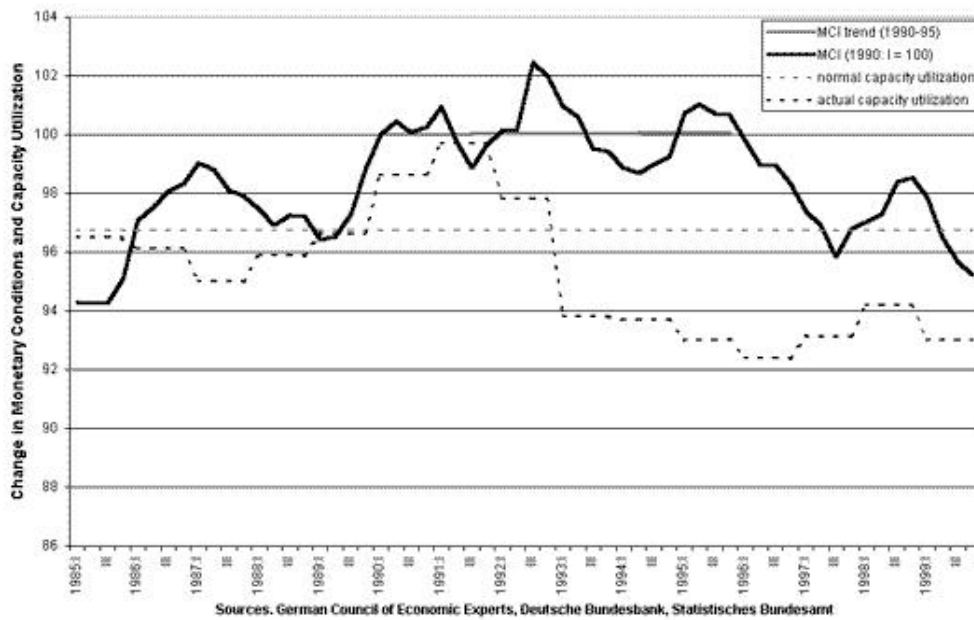
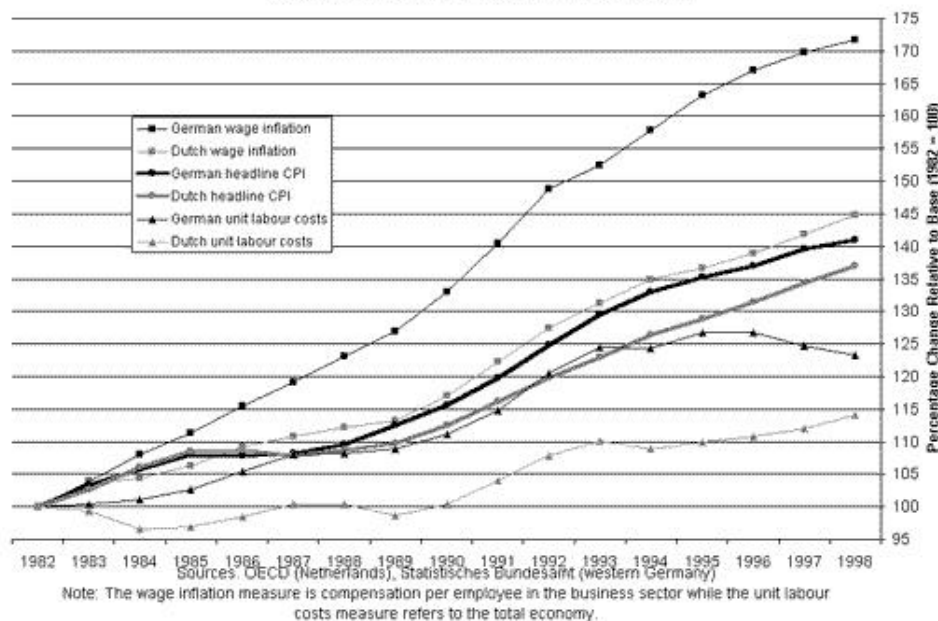


Figure 3b. ... and the Real Consequences of Monetary Overkill



**Figure 4. Germany and the Netherlands: Wages, Prices, and Unit Labour Costs**  
Competitive Wage Disinflation When Prices Are Anchored



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## NOTES

1. Forthcoming in *International Review of Applied Economics* . The author gratefully acknowledges comments from Christopher Allsopp; Sheila Dow; James Forder; Bob Rowthorn; Jochen Runde; the participants of the 2000 Annual Conference of the Money, Macro & Finance Research Group, held at South Bank University, London, UK; and anonymous referees.
2. Given the rather special situation in former East Germany, our analysis concentrates on western Germany's economy. The GDP (as well as price and wage) data used refers to western Germany only, based on the old German (ESA 79) National Accounting conventions. The broad picture is not affected when using the new harmonized (ESA 95) conventions instead. Based on the new conventions, an even flatter growth trend emerges for *all* -Germany over the 90s. (Revised data for western Germany is still unavailable). Particularly with regard to price and wage trends, today's common focus on All-Germany gives a distorted picture of the true situation in the early 90s. Cf. Sinn and Sinn (1992).
3. This growth differential amounts to a cumulative and *permanent* output loss which would seem to dwarf estimates used in proving the case for going from low inflation to price stability, popularised by Feldstein (1997).
4. Despite the strong expansion since 1988, and also despite the oil price hike in the wake of the Iraqi crisis, inflation remained dormant in Germany until 1990, when CPI inflation fell to 2.7% from the previous year's 2.8%. western Germany's headline CPI inflation rose only slightly thereafter, peaking at 4.0% [sic!] in 1992, with this rise being largely due to strong increases in housing costs and indirect taxes. Wage inflation too accelerated somewhat in western Germany, peaking at just below 6% in 1991-2 (comparable to the US!), then dropping sharply in the recession of 1993, and remaining significantly *below* [sic!] US wage inflation for the rest of the decade.

5. In 1996, Bundesbank President Tietmeyer (1996) outright rejected James Tobin's (see FAZ 1996) accusation that the Bundesbank's one-sided preoccupation with inflation caused sluggish growth and employment. In an interview in 1999, Professor Tietmeyer went even further and asserted that the Bundesbank's "stability-oriented" policies were conducive to growth and employment in Germany (see Herz 1999). This would seem to imply that with less deflationary policies Germany's unemployment scandal over the 90s would have been even more serious.

6. To be fair, Nickell's (1997) period of analysis reaches from 1983 to 1996, and his sub-periods for comparing OECD standardized unemployment rates are 1983-88 (US 7.1% vs West-Germany 6.8%) and 1989-94 (US 6.2% vs western Germany 5.4%). A stark and lasting divergence has emerged after 1991, which is our main concern here.

7. There is ample evidence on the yield curve's qualities as a predictor of activity in both countries. See Bernard and Gerlach (1996), Estrella and Mishkin (1997), Sauer and Scheide (1995), Smets and Tsatsaronis (1997). See Borio 1997, Bernanke and Blinder 1992, Bernanke and Mihov 1998 on operating procedures and indicators of stance.

8. Explaining the Fed's policies, Alan Greenspan states: "During 1993, [monetary] stance was associated with low levels of real short-term interest rates - around zero. We judged that low interest rates would be necessary for a time to overcome the effects of a number of factors that were restraining the economic expansion, including heavy debt burdens of households and businesses and tighter credit policies of many lenders" (Greenspan 1994, p. 793). Recall that the Fed's remit features the objectives of high employment and price stability on an *equal footing*.

9. An obvious response here is to point out that Germany had to shoulder the so-called "burden of unification". Yet, while unification undoubtedly posed a huge fiscal challenge, this response misses the point. Note that Germany started from a balanced budget position that turned into a deficit of around 3 per cent between 1990-92, then staying at that level - despite (or because?) of consolidation efforts that occurred in the middle of, what turned out to be, a major recession - until 1996. The US started from a 3 per cent deficit that was allowed to deteriorate to 6 per cent due to, what turned out to be, the mild recession of 1990-1. Cyclical timing is the issue here! Cf. Horn and Scheremet 1999.

10. Our base is the 1<sup>st</sup> quarter of 1990. Other inputs are, first, the Frankfurt overnight interest rate deflated at the (western) German CPI and, second, the effective exchange rate *vis a vis* 18 industrial countries and based on the deflator for total expenditure; with a 3:1 weighting (equivalent to the Bundesbank's (1999) recently published MCI). Corker (1995) notes that the MCI starkly contradicted the (pseudo) "expansionary" signals of M3 growth.

11. Some commentators argue that monetary stance was not restrictive enough in the early 90s, but nobody seems to deny the facts of tight money. Facing the choice between a soft landing and a crash landing the Bundesbank consciously chose the latter. As von Hagen (1992, p. 215) observes: "The Bundesbank gave a high priority to credibility considerations and chose a tight stance without too much regard to the risk of unnecessarily choking off the economic growth badly needed in the transition phase."

12. The output gap measure used here is due to the German Council of Economic Experts (the "wise men") which has the advantage of concentrating on western Germany's production potential as derived from the rate of utilisation of the economy's capital stock. The data for 1985-98 are from the Annual Report 1998-99 (p. 285, table A1). For 1999 I used an own estimate, as the wise men's measure for western Germany was discontinued in 1999.

13. De Grauwe (1999) assesses US vs EU11 performance between 1990-98. Given that the Bundesbank's *de facto* policy domain ex-Germany was closely allied to the US in cyclical terms in the early 90s, our results clearly reinforce De Grauwe's acute verdict about the inappropriate policy mix imposed on Europe in the 90s. Yet, aggregative comparisons (EU11 in De Grauwe's case and EU15 in Artis's) fail to bring out the peculiar degree and duration of tight monetary conditions imposed upon the Bundesbank's *de jure* policy domain until 1995. After 1995, countries such as Spain, for instance, experienced monetary easing due to interest rate convergence, whilst in Germany's case monetary easing came through exchange depreciation only. We cannot pursue individual countries' experience any further here; except for the Netherlands' case, which will be taken up in section 4 below.

14. Risk premia and financial instability are highly relevant to the (optimum-currency-area) concern about the loss of the exchange rate (stabilisation) instrument. *De facto* EMS countries other than Germany had lost their monetary sovereignty during the 80s, and by the late 80s they had also decided not to make use of the exchange rate instrument anymore. Yet, they had to cope with risk premia whenever the markets cultivated doubts about their resolve. To them the exchange rate instrument represented a curse, and its credible loss a blessing. The UK's experience over the 90s is informative. Being spared "stability-oriented" monetary policies after September 1992 and smartly avoiding the Maastricht consolidation crusade, the UK had to pay for its far more successful macro policies in the late 90s when a starkly over-valued pound (mirroring DM and Euro weakness) unbalanced the UK economy.

15. Bibow (1998a, b, 1999b) argues that the Bundesbank's overkill policies of the 90s proved counterproductive even in respect of her cherished primary goal of price stability. Fitoussi (1998) refers to the rise in the EU's measured inflation in the early 90s as "the European inflation illusion", emphasising that Germany was unique in this regard while taking the temporarily depressed levels of 1986-7 as the base severely distorts the overall picture.

16. *Real* capital formation is the foremost issue here and it remains to be seen whether financial market integration and consolidation in European banking will contribute towards cohesion, or may actually lead to increased regional disparities. There is also the possibility of de-stabilising private financial capital flows and regional financial instabilities (see Chick and Dow 1997).

17. Buiter *et al.* (1993), Dreze (1994), Fitoussi *et al.* (1993), and Ludlow (1993) for instance launched timely warnings on the predictable consequences of the coordinated public thriftiness campaign. Note: I neither claim that fiscal consolidation is impossible nor senseless. Rather, the point is that there is only one sound and sensible consolidation strategy around, the one pursued by the US and UK: growth (Domar 1944).

18. Most commentators view the choice between financing stabilisation policies through EU channels (i.e. centralised means of intra-union redistribution) or national/regional debt policies as being based on political preferences (see e.g. Bayoumi and Masson 1995). Foregoing both alternatives seems clearly nonsensical though.

19. The EC Commission's Recommendations of 13 May 1998 are most illuminating: "In the *macroeconomic* field, governments and social partners should each make all the required efforts for avoiding a conflict with the stability objective of the common monetary policy. Under such conditions, monetary policy has no reason for being restrictive" (EC Commission, 1998, p. 2). But what are the positive implications?

20. Tobin (1984, 1998) identified asymmetric monetary policies as the root cause of Europe's unemployment persistence a long time ago. Ball (1997) shows that deflationary monetary policies raised "structural" unemployment in Europe over the 80s. Clarida and Gertler (1997) find not only that Bundesbank policies were *exceptionally* restrictive over the 90s, but that the Bundesbank responds *asymmetrically* to output gaps. This asymmetry is particularly evident when it comes to exchange rate developments (cf. Spahn 1997).

21. Nickell and Ours (2000) provide another, more recent example along these lines, asserting that the reductions in actual unemployment rates and estimated NAIRUs in both the UK and the Netherlands since the early 80s were caused by combinations of supply-oriented policies. Their analysis not only fails to show, but simply *postulates*, that monetary policy cannot affect the NAIRU, ignoring the mounting evidence on the role of hysteresis in Europe (cf. Ball 1997, in particular). They also completely overlook those stark and persistent differences in demand-oriented policies identified by our analysis, the

role of asymmetric monetary policy in particular.

22. Structural reform in the Netherlands mainly focussed on the removal of obstacles to temporary work. Some overhaul of the social security system occurred, like the privatisation of the sick-leave scheme and measures to reduce the conspicuously high usage of the invalidity scheme. Active labour market policies and tax reform also played a role, including measures to reduce employers' non-wage labour costs and tax credits for low-wage earners (OECD 1997, 1998). It is not only noteworthy that Dutch legislation governing permanent employment has hardly changed and remains equally restrictive as in Germany. In other respects too, there are amazing similarities in the structures of labour markets in Germany and the Netherlands, including strong corporatist and consensual traditions (cf. Delsen and de Jong 1998a, Meerendonk 1998, Schmidt and Helmer 1998). While the Netherlands are anything but a tax heaven either, Dutch social security benefits are among the highest in the world. Unemployment generosity represents no obstacle to employment growth when the *demand* for labour is actually forthcoming.

23. Having brought unemployment down to 3% the Netherlands today has to cope with a monetary stance that is meant to suit its more laggard partners. This divergence might correct itself if Dutch wage inflation were to converge to, or even overshoot, the EU trend and/or labour productivity were to moderate significantly (see Ark and Haan 2000). Alternatively, given that the exchange rate can no longer adjust (in contrast to the UK's case; see n 13), other asset prices might adjust in ways that might finally derail the Dutch miracle more abruptly.

24. The Netherlands copied and refined the historical German model to export demand-led growth (the "German miracle"; cf. Hölcher *et.al.* 2000). Under ERM conditions the strategy worked well for Germany as long as the larger neighbours inflated faster. But with unification and Maastricht wage and price inflation converged to, or even undershot, German levels. Living up to Europe's responsibility in stimulating *domestic* demand-led growth will neither come easy to adherents of the Bundesbank dogma, nor to those misled by the Dutch "supply-side" miracle. Essentially, the Dutch miracle relied on even underbidding the successful underbidding strategy of its big neighbour.

25. Interest rate reductions represent the automatic response to demand shocks under any rule-based regime, including a monetary rule as favoured by the Bundesbank (cf. Krupp 1996). Yet, when financial turmoil attained new climactic dimensions in late summer of 1998, the Bundesbank made the *purely discretionary* decision to keep rates steady. Germany thus faced not only a negative export demand shock, but also a significant tightening of monetary conditions (see Fig. 3b above). Among other things, the unwarranted DM appreciation of autumn 1998 prepared the Euro's subsequent slide ever since its launch in 1999. (Hutter [1998a,b] reports Professor Tietmeyer's views on the stability of Euroland in the autumn of 1998 - thanks to the "serious preparation" undertaken "on German insistence".)

26. It is noteworthy that the IMF (1999: 109) identifies "a significant cyclical component in European unemployment", arguing that "the elimination of cyclical slack will lead to a gradual reduction in the [NAIRU]".