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## **"Third Way" and the Challenges to Economic and Monetary Union Macropolicies**

by  
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### **INTRODUCTION**

This paper is concerned with three issues. The first is to seek to decipher the type of economic analysis that underpins the ideas of the "third way." The second is to suggest that the ideas surrounding the economic analysis of the Economic and Monetary Union (EMU) theoretical and policy framework are firmly embedded in that of "third way." The third is to argue that the challenge to the EMU macropolicies lies in their potential to achieve full employment and low inflation in the eurosystem. On this score, we conclude that these policies as they operate at the moment, are not very promising. Alternatives are suggested.

In the UK, the emergence of "new Labour" has been closely associated with the development of the notion of the "third way." Tony Blair, for example, stated that "New Labour is neither old left nor new right. Instead we offer a new way ahead, that leads from the centre but is profoundly radical in the change it promises" (Blair, 1997, p.1). In a similar vein, Giddens (1998) locates the "third way" by reference to two other ways of "classical social democracy" and neoliberalism. Although there has been some notable contributions on the "third way" (e.g. Giddens, 1998, 2000), there has been rather little specifically on the economic analysis underpinning it, though speeches and other pieces by Blair (1996, 1997, for example) and Brown (1997a, 1997b, 1999, 2000, for example) provide some material. In this paper we work back from the policies and policy pronouncements of governments (particularly in our case of the new Labour government) to seek to infer an economic analysis behind the "third way."

We begin in the section entitled "Theoretical Foundations of The "Third Way,"" by sketching out what we see as the analysis of a market economy which underpins the ideas of the "third way," by reference to the policy statements of the new Labour government in the UK. It is our view that the economics of new Labour and of the "third way" is embedded in New Keynesianism and this is highlighted. The section that follows, entitled "EMU Macropolicies," deals with the nature of the economic model surrounding the EMU and suggests that it is essentially of the New Keynesian variety. The key challenge is whether in the EMU these policies are adequate to deal with the problems of unemployment and inflation, and thus help to achieve and maintain a framework of full employment. In the section entitled "Policies For Full Employment And Low Inflation," the paper argues that the institutional and policy arrangements surrounding the EMU and the euro are quite inadequate to deal with problems of unemployment and inflation. We propose alternative policies and institutional arrangements. A final section summarises the argument and concludes.

### **THEORETICAL FOUNDATIONS OF THE "THIRD WAY"**

It is unlikely that economic policy pursued by any government is fully consistent either internally or with some theoretical paradigm. However, in view of the approach adopted by those governments that purport to follow the "third way," it can be thought of as embedded in the New Keynesian economics paradigm. We argue that the approach can be viewed as new Keynesian through its emphasis on the supply-side determined equilibrium level of unemployment (the "natural rate" or the non-accelerating inflation rate of unemployment, the NAIRU), its neglect of aggregate or effective demand, and of fiscal policy, the elevation of monetary policy, the concern over the "credibility" of economic policies (Brown, 2000, for example), and its adoption of the assumption of rational expectations. Also, that the microeconomic notion of "market failure" can be interpreted to support significant government intervention when "market failures" are viewed as widespread. "Market failure" is viewed as arising from the existence of externalities, the "public good" nature of some goods and monopoly, and the emphasis on training and education by the new Labour government (and others) can be seen in this light of the government provision or encouragement of activities which would be under-provided by the market.

We postulate that the economics of the "third way" can be understood as based on the eight elements listed below which we would argue justify the description of a new Keynesian variety (see, also, Giddens, 2000; Hutton, 1998). The eight elements which we see as underlying the economics of the "third way" are as follows:

(i) The market economy is viewed as essentially stable, and that macroeconomic policy (particularly discretionary fiscal policy) may well destabilise the market economy. Markets, and particularly the financial markets, make well informed judgements on the sustainability of economic policies, especially so in the current environment of open, globalised, capital and financial markets.

(ii) Monetary policy can be used to meet the objective of low rates of inflation (which are always desirable in this view, since low, and stable, rates of inflation are conducive to healthy growth rates). However, monetary policy should not be operated by politicians but by experts (whether banks, economists or others) in the form of an "independent" Central Bank.<sup>1</sup> Politicians would be tempted to use monetary policy for short-term gain (lower unemployment) at the expense of long term loss (higher inflation). An "independent" Central Bank would also have greater credibility in the financial markets and be seen to have a stronger commitment to low inflation than politicians do.<sup>2</sup> It is argued that a policy which lacks credibility because of time inconsistency is neither optimal nor feasible (Kydland and Prescott, 1977). The only credible policy is the one that leaves the authority no freedom to react to developments in the future, and that even if aggregate demand policies matter in the short run in this model, a policy of non-intervention is preferable. It is precisely because of the time-inconsistency and credibility problems that monetary policy should be assigned to a "credible" and independent Central Bank which should be given as its sole objective that of price stability.

(iii) The level of economic activity fluctuates around the NAIRU, and unemployment below (above) the NAIRU would lead to higher (lower) rates of inflation. The NAIRU is a supply-side phenomenon closely related to the workings of the labour market. The source of domestic inflation (relative to the expected rate of inflation) is seen to arise from unemployment falling below the NAIRU, and inflation is postulated to accelerate if unemployment is held below the NAIRU. However, in the long-run there is no trade-off between inflation and unemployment, and the economy has to operate (on average) at the NAIRU if accelerating inflation is to be avoided. In this long-run, inflation is viewed as a monetary phenomenon in that the pace of inflation is aligned with the rate of interest. Monetary policy is, thus, in the hands of central bankers. Control of the money supply is not an issue, essentially because of the instability of the demand for money that makes the impact of changes in the money supply a highly uncertain channel of influence.

(iv) The essence of Say's Law holds, namely that the level of effective demand does not play an independent role in the (long run) determination of the level of economic activity, and adjusts to underpin the supply-side determined level of economic activity (which itself corresponds to the NAIRU). Shocks to the level of demand can be met by variations in the rate of interest to ensure that inflation does not develop (if unemployment falls below the NAIRU). Fiscal policy has a passive role to play in that the budget deficit position varies over the business cycle in the well-known manner. The budget (at least on current account) can and should be balanced over the course of the business cycle.

(v) The market system involves "market failure" in the neo-classical sense of the term. Markets do not reach an optimum outcome because of the presence of externalities, public and quasi-public goods (that is goods which are non-rivalrous in use and non-excludable), and monopoly situations. The policy conclusion is straightforward, namely that government seeks to correct externalities through appropriate taxation, subsidy and regulation, makes provision for "public goods" either itself or through paying the private sector to provide the goods, and competition policy can be used to reduce or restrain monopoly positions. This idea is, of course, not unique to the "third way," and has been a central element in conventional welfare economics.

(vi) Long-run growth in income per head depends on investment decisions rather than, as in traditional growth theory, on exogenous improvements in technology. Human capital is also seen as particularly important, and since the public sector is a heavy provider of education, and education adds to human capital, the public sector is again seen to play a significant role in growth. Endogenous growth theory also postulates that there are overall increasing returns to scale, but that includes some factors of production which are not privately owned. Knowledge and information, for example, add to productive potential but are not generally privately owned. These "public goods" (in the technical sense of being non-excludable and non-rivalrous) will generally be under-provided by the private sector, and the public sector has a role to play in providing them or encouraging their provision. In effect, endogenous growth theory again points to the role of the State in terms of the correction of market failure, and specifically in this context the provision or subsidy of "public goods," with research and development, education and training being the major examples.

(vii) Inequality is a further element of some significance. In the economics of "third way" there is concern over inequality of outcome rather than inequality of possibilities (see, also, Giddens, 1998). Inequality of outcome could be seen to be addressed through a progressive tax system and a redistributive social security system. Inequality of outcome can be addressed through education and training (initial endowments), through "employability" policies (for inclusion in the labour market and employment), and through seeking to change the rewards offered by the market. With the exception of the national minimum wage, it could be said that there has been little attempt to modify the rewards thrown up by the market. As Giddens (1998, p. 101) notes, a "winner takes all" element in parts of the labour market means large inequalities. But also Giddens (2000) perceives that "incentives are necessary to encourage those of talent to progress and that equality of opportunity typically creates higher rather than lower inequalities of outcome" (p. 86). It could be argued, though, that inequality of opportunity acts as a barrier for many to fulfil their potential. Those disadvantaged do not forego education because of a lack of incentives

in terms of higher pay for the more educated but because of a range of barriers to their doing so. Greater opportunity would be expected to increase the supply of the well trained etc., and reduce the pay of the well trained relative to the pay of the untrained.

(viii) The final aspect refers to globalisation. The rising ratio of international trade relative to GDP (at least again by way of comparison with the ratios of the "golden age" of capitalism in the 1950s and 1960s) and the increased role of foreign direct investment by transnational corporations is an accepted (and indeed welcomed) "fact of life" (see, also, Giddens). "third way" perceives globalisation as having virtually eliminated the possibilities of industrial policy (other than competition policy) and of macroeconomic policy. The mobility of industrial and financial capital is seen to preclude independent national economic policies in these regards. However, the nation state still has a role to play, though there are trends for moving government away from the nation state, sometimes in a downward decentralised direction (e.g. to regions within a country) and sometimes in an upward direction (e.g. to European Union). But the role of government is seen to shift towards creating a favourable environment for transnational investment whether in the form of low taxation on profits, subsidies to inward investment or to creating a highly skilled work force. The effects of globalisation on policy perspectives is orchestrated in terms of a shift from industrial policy and Keynesian demand measures favoured by "old" social democracy, but also from regulation to deregulation and market liberalization emphasised by neo-liberals. "The aim of macroeconomic policy is to keep inflation low, limit government borrowing, and use active supply-side measures to foster growth and high levels of employment" (Giddens, 2000, p. 73). Blair and Schroder (1999) argue in a similar fashion, "In a world of ever more rapid globalization and scientific changes we need to create the conditions in which existing businesses can prosper and adapt, and new businesses can be set up and grow" (p. 163). Hombach (2000) reinforces the point when he suggests that "It is not only the forces of globalization that demand the modernization of our institutions and political programmes, but, to no less an extent, changes in patterns of employment, in values and in demographic and social structures" (p. 31).

It follows from this analysis that to the extent the "third way" represents the "new" social democracy, it begs the question of how it may differ in its policy approach from the "old" social democracy. An answer may be attempted once it is recognised that like the "new" social democrat economic policies (see, for example, Arestis and Sawyer, 2001), the "old" social democrat economic policies did not fit into a single mould, and of course varied over time and across countries. At the cost of gross over-simplification (and no doubt other costs as well), we would suggest that the following played significant roles (at least so far as the UK is concerned). There was an acceptance of some key aspects of Keynesianism, particularly that budget deficits can be used to support aggregate demand - fiscal policy was given an active role. Each post-war Labour government, and other "old" social democratic governments made some extension of public ownership. The perceptions of the "failures" of the economy were broader than "market failure." These failures have ranged over lack of exploitation of economies of scale, poor management, under investment etc.. Unemployment was addressed through regional and industrial policies rather than labour market policies. There was generally a use and development of some form of corporatism, for example, through a tripartite approach to industrial policy, the operation of incomes policy etc..

It is clear that the "third way" and the new Labour government, operate along quite different lines from old social democracy. Macroeconomic policy is of the new Keynesian type, with an emphasis on control of inflation rather than the reduction of unemployment and a perceived need to acquire credibility in the financial markets. We have described microeconomic policy as concerned with the correction of "market failures": this can also be seen as a policy that accepts the beneficial operation of markets, albeit one that can be improved by appropriate government action. The "third way" does appear to seek to equip individuals to compete in the market, e.g. through training and education<sup>3</sup>. Ultimately, we agree with Tsakalotos (2001) that these features suggest "an explicit rejection of many of the economic, political and philosophical ideas of social democracy, let alone democratic socialist ideas" (p. 43).

## EMU MACROPOLICIES

The launch of the euro as a "real" currency, rather than as a "virtual" currency (since January 1999), takes place against an economic environment where there is the prospect of slowing growth and rising unemployment across the world and the eurozone, adding to the already high levels of unemployment. Table 1 makes the point very well. Since the second quarter of 2000, there has been a continuous slow down in real GDP growth rate in the euro area. The forecasts for the years 2002 and 2003 and the European Central Bank (ECB) projections for the same years is that this slow down will continue in 2002, with some recovery expected in 2003. These projections are based on the assumption that world real GDP growth outside the euro area will be 1.5 per cent in 2002 and 4.0 per cent in 2003. Reflecting these assumptions, the euro area's export markets are expected to be weak in 2002, growing at only 0.5 per cent, and then recovering to 6.5 per cent in 2003. A similar pattern is evident in the cases of the US economy and Britain (where the situation does not appear to be as bad). However, it is the US growth rate expected at 1.7 per cent in 2002, against the euro area's 1.2 per cent, which appears to lead the world economy out of the present slowdown. In terms of unemployment and inflation the situation is no better. The euro area unemployment is very high at 8.5 per cent, and though the rate is much lower in the US and Britain, it is now increasing in all three countries (and quite rapidly in the US case) - note the expected increase in unemployment to 8.6 per cent in 2002 in the euro area. Inflation may not be a problem in the US and Britain but in the euro area it is above the 2 per cent target set by the ECB. The forecasts for inflation and the ECB projections relating to inflation tell a rather similar story; the situation may improve by the year 2003, although it may still be above the 2 per cent ECB inflation target.

We see the challenges to the EMU macropolicies surrounding the euro, the extent to which they can tackle the problems just summarised. These are embedded in the monetary policy operated by the ECB, and in the Stability and Growth Pact (SGP). We begin by briefly locating the key theoretical features and policy implications of the EMU system. They are actually firmly rooted in the theoretical foundations of the "third way" discussed earlier. They are as follows (see, Duisenberg, 1999; also, Arestis, Brown and Sawyer, 2001; and Tsakalotos, 2001):

- (i) politicians cannot be trusted with economic policy formulation with a tendency to make decisions which have stimulating short-term effects (reducing unemployment) but which are detrimental in the longer term (notably a rise in inflation). In contrast, experts in the form of central bankers are not subject to political pressures. Consequently, monetary policy has been removed from national authorities and from political authorities and placed with the ECB, and fiscal policy will be permanently constrained by the SGP.
- (ii) inflation is a monetary phenomenon and can only be controlled through monetary policy. The ECB can set the key interest rate (the "repo" rate) to influence monetary conditions, which in turn influence the future rate of inflation. Central banks have no discernible effects on the level or growth rate of output in the long run, but do determine the rate of inflation in the long run. Thus, inflation is still a monetary phenomenon and ultimately it is central banks that determine the inflation rate.
- (iii) the level of unemployment fluctuates around NAIRU, the supply-side determined equilibrium rate of unemployment. The level of NAIRU may be favourably affected by a "flexible" labour market, but is unaffected by the level of aggregate demand or by productive capacity. The thrust of the European Employment Pact agreed in Cologne by the European Council in June 1999 is very much based on this theoretical construct; there are notions of more flexible labour markets, but there is no industrial policy (Tsakalotos, 2001).
- (iv) fiscal policy is impotent in terms of its impact on real variables (essentially because of beliefs in crowding out and that fiscal policy is inflationary). As such it should be subordinate to monetary policy in controlling inflation. It is recognised, though, that the government budget position will fluctuate during the course of the business cycle but in the context of an essentially passive fiscal policy.

In terms of the institutional framework, it is worth noting the following three key elements. First, the ECB is intended to be independent of the European Union (EU) Council and Parliament and of its member governments. Thus, there is a complete separation between the monetary authorities, in the form of the ECB, and the fiscal authorities, in the shape of the national governments comprising the EMU. It follows that there can be little co-ordination of monetary and fiscal policy. Indeed, any attempt at co-ordination would be extremely difficult to implement. For apart from the separation of the monetary and fiscal authorities, there is also the requirement that national governments (and hence the fiscal authorities) should not exert any influence on the ECB (and hence the monetary authorities). Any strict interpretation of that edict would rule out any attempt at co-ordination of monetary and fiscal policies.

Second, the ECB is the only effective federal economic institution. The ECB has the one policy instrument of the rate of interest (the "repo" rate) to pursue the main objective of low inflation. Fiscal policy is subject to the requirements of the SGP as noted above.

Third, the ECB and the national central banks are linked into the European System of Central Banks (ESCB) with a division of responsibility between them. The ECB has the responsibility for setting interest rates in pursuit of the inflation objective and the national central banks responsibility for regulatory matters.

We may turn our attention next to the EMU policy framework, and discuss first monetary policy as implemented by the ECB, followed by the fiscal policy aspects.

## **Monetary Policy**

ECB monetary policy has been assigned a quantitative definition of price stability in the form of a 0-2 per cent target for the annual increase in the Harmonised Index of Consumer Prices (HICP) for the euro area. A "two-pillar" monetary strategy has been adopted. The "first pillar" is a commitment to analyse monetary developments for the information they contain about future price developments. This is the quantitative reference value for monetary growth, where a target of 4.5 per cent of M3 has been imposed. Being a reference level, there is no mechanistic commitment to correct deviations in the short term, although it is stated that deviations from the reference value would, under normal circumstances, "signal risks to price stability." The "second pillar" is a broadly based assessment of the outlook of price developments and the risks to price stability. This broad range of indicators includes: the euro exchange rate; labour market indicators, such as wages and unit labour costs; fiscal policy indicators; and financial market indicators, such as asset prices.

The management, operation and potential efficacy of monetary policy within these institutional arrangements by the ECB entails five sets of problems. The first is that the timing of policy decisions has been very slow. It is of some interest to note in



this context the reluctance of the ECB to reduce the rate of interest when a downturn in economic activity in 2001, not just in the eurozone, became rather obvious. In particular, the ECB is faulted for underestimating the impact of the US recession on the eurozone, and for not reacting on time in terms of reducing interest rates; and when it did, there was unusual confusion between the markets and the ECB. After signalling in April 2001 an imminent cut in interest rates, it never implemented it; however, when in May signalled no change, the ECB subsequently cut interest rates!

This leads us to the related second problem, the ECB's methods of operation. They are confusing to the markets as the example just cited reveals. The problem with the ECB's methods of operation is partly the bank's secretiveness, for it does not publish minutes of its meetings. This is compensated to some extent by the ECB president's news conference once a month after the monetary policy meetings, by the president's testimony to the European parliament on a regular basis, by the monthly publication of the ECB Bulletin, and by the ECB's GDP growth and inflation projections twice a year. The trouble is that the ECB has not learned to communicate its methods of operation. In addition to not publishing minutes of the monetary policy meetings, important ECB policy decisions have been leaked prior to official pronouncements and the speeches of different ECB officials have given different signals regarding ECB policy.

The third is the problem of voting behaviour of the ECB Governing Council,<sup>4</sup> and the real possibility of the ECB policy decisions being affected by national loyalties. Meade and Sheets (2001) argue that they are affected. They formulate a hypothesis that each council member would vote on the basis of the differential between national and euro-area inflation rates in the month prior to the monetary policy meeting. They also hypothesise that if the national inflation rate of a country is higher than the euro-area average in the given month by more than a threshold value, then the council member from that country will vote for monetary tightening or against monetary easing; and conversely if national inflation is below the euro-area average. They investigated all the ECB policy changes since January 1999, and calculated the aggregate number of Governing Council members who would have dissented from the actual policy change, given the authors' voting rule and different threshold values. They concluded that voting behaviour reflects their hypothesis. There is, thus, national bias in the ECB policy-making, and reform of the ECB's structure appears inevitable.<sup>5</sup> The fourth problem is with the official "two-pillar" strategy. It is uncertain as to the value attached to the M3 reference value. The target has never been met, and yet this does not seem to worry official strategy. There is also the question of whether the 2 per cent inflation target is not too restrictive. It is by any standards so low that it can easily be overshoot, requiring continuously high interest rates. A recent example is the ECB president's testimony to the European Parliament's economic and monetary affairs committee on the 8<sup>th</sup> of December, 2001. He declared that the key "repo" rate decided on the 8<sup>th</sup> of November, 2001, "continued to be appropriate for the maintenance of price stability over the medium term." But as noted above, the indications for the "real" economy in the euro area and elsewhere suggest that lower interest rates may be more appropriate.

The fifth problem relates to the extent that changes in the rate of interest (the only monetary instrument available to the ECB) can actually control inflation. Interest rates are likely to influence investment expenditure, consumer expenditure, market interest rates and asset prices, expectations and the exchange rate. These changes in turn influence domestic and external demand, and then inflationary pressures. In addition interest rate changes can also have distributional effects, whether between individuals or between economic regions.

A number of reservations may be raised in terms of the efficacy of this monetary policy. First, there is the problem of the "one-size-fits-all" monetary policy, a point raised recently by the Governor of the Bank of England. He argued, in an interview on the German television on the 20<sup>th</sup> of December, 2001, that such policy is risky and that "The same monetary policy is not necessarily the best for every country at the same time" in such a diverse economic area. The Governor also suggested in an interview on BBC radio on the 21<sup>st</sup> of December, 2001, that unlike monetary policy in a single country where "mitigating factors" exist, such as labour migration and fiscal redistribution, these factors "are not present to any significant degree at the eurozone level." There is, thus, no way a country can offset undesirable effects of a too high or a too low rate of interest imposed by the ECB. The second impinges crucially on the problem of the transmission mechanism of monetary policy in the euro area since, as Duisenberg (1999) concedes, "Relatively little is known as yet" about it. Consequently, "One important challenge for the Eurosystem is to obtain better knowledge of the structure and functioning of the euro area economy and the transmission mechanism of monetary policy within it, so that policy actions can be implemented accordingly" (p. 189). Third, there is considerable doubt that may be cast on the effectiveness of monetary policy in terms of responding to recession and as a means of controlling inflation (witness how slow the world-wide reductions in interest rates have been, and also the unsuccessful counter-inflation monetary policy of the ECB). Fourth, in terms of the impact of interest rates on expenditure, there are questions relating to the magnitude of the impact, timing and variability of the time lags involved. Fifth, since interest rate policy has a range of effects, such as on aggregate demand, on the exchange rate and also has distributional effects, the objectives of monetary policy should reflect that, and should, thus, be recast to include growth and high levels of employment alongside inflation. Sixth, exchange rate changes are expected to have small effects on the EMU economy. Its relatively closed nature in terms of international trade (with imports and exports amounting to less than 10 per cent of GDP) means that variations in the exchange rate of the euro will have much less impact on prices than in more open economies.

## **Fiscal Policy**

The core elements of SGP are three: (a) to pursue the medium-term objectives of budgetary positions close to balance or in

surplus; (b) the submission of annual stability and convergence programmes by the member states; and (c) the monitoring of the implementation of the stability and convergence programmes. The main feature of the core elements is the requirement that the national budget deficit does not exceed 3 per cent of GDP, and failure to meet that requirement could lead to a series of fines depending on the degree to which the deficit exceeds 3 per cent. It is also necessary for national budgetary policies to "support stability oriented monetary policies. Adherence to the objective of sound budgetary positions close to balance or in surplus will allow all Member States to deal with normal cyclical fluctuations while keeping the government deficit within the reference value of 3% of GDP." Furthermore, "Member States commit themselves to respect the medium-term budgetary objective of positions close to balance or in surplus set out in their stability or convergence programmes and to take the corrective budgetary action they deem necessary to meet the objectives of their stability or convergence programmes, whenever they have information indicating actual or expected significant divergence from those objectives" (Resolution of the European Council on the Stability and Growth Pact, Amsterdam 17 June 1997).

A country's budgetary data become available for the Commission to scrutinise on 1 March each year when the stability programmes are submitted. Each programme will contain information about the paths of the ratios of budget deficit to GDP and national debt to GDP. The Council (ECOFIN) examine the stability reports and deliver an opinion within two months of the reports submission. If the stability programme reveals that a country is significantly diverging from its medium-term budgetary objective, then the council will make relevant recommendations to strengthen the stability programme. If the situation persists then the member state will have been judged to have breached the reference values. The Pact details "escape" clauses which allows a member state that has an excessive deficit to avoid sanction. If there is an economic downturn and output has fallen by more than 2 per cent, then the member state will escape sanction automatically but the deficit should be corrected once the recession has finished. If output falls between 0.75 and 2 per cent then the Council can use discretion when making a decision on an "excessive" deficit, other factors will be taken into account such as the abruptness of the downturn, the accumulated loss of output relative to past trends and whether the government deficit exceeds government investment expenditure. If a country is found to have breached the reference values, then it has four months to introduce the corrective measures suggested by the Council. If the country follows the Council's recommendations, then the "excessive" deficit can continue, but the budget deficit must be corrected within a year following its identification. A country which chooses not to introduce corrective measures will be subject to a range of sanctions, at least one or more must be imposed, of which one must be in the form of a non-interest bearing deposit lodged by the national government. In this instance, it will fall upon EMU members, excluding the member country under consideration, to reach a decision on sanctions. The non-interest bearing deposit consists of a fixed component (0.2 per cent of GDP), and a variable component, (one tenth of the difference between the deficit ratio and the 3 per cent reference value). If the budget deficit is not corrected within two years, the deposit is forfeited and becomes a fine, whereas if the deficit is corrected within two years the deposit is returned and the penalty becomes the foregone interest.

These institutional arrangements, along with relevant experiences (e.g. the condemnation of Ireland for cutting taxes and raising public expenditure when output was above trend; criticisms of Britain, even though outside of the eurozone, for proposing public expenditure increases above the trend rate of growth of output), point to a general deflationary bias in the operation of the SGP. This is illustrated by the April 2001 recommendation to the British government (not formally governed by the SGP) that in the event of a downturn in 2002, public expenditure should be reduced (below planned levels) to maintain the then public expenditure to GDP ratio. It is also illustrated by the response of the ECB president at a press conference on 6 December, 2001, after the ECB's policy-making council, to an Italian request to delay target dates for budget balance in view of the projected downturn in economic activity. He argued that "it is of the greatest importance to enhance confidence with both consumers and investors if governments stick to their medium-term strategy, whatever happens."

Just as in the case of monetary policy, similarly in the management of the SGP there are serious flaws. The point can be made vividly by referring to the recent European Commission predictions for the year 2002 relating to budget deficits under the terms of the SGP, which prompted the possibility of the "early warning" mechanism in the case of Germany and Portugal in particular. ECOFIN ignored the European Commission's recommendation for Germany and Portugal to be censured in view of the size of their deficits, which were creeping close to the SGP 3 per cent ceiling (it stood at 2.7 per cent of GDP in the case of Germany and 2.2 per cent in the case of Portugal). ECOFIN chose, instead, to strike a deal whereby no formal warning was issued, but the two countries made pledges to keep within the rules of the SGP. This accord raises questions about the governance of the euro area, and provides fertile ground for financial markets to question the credibility of the EMU institutions. Furthermore, it could substantially weaken the credibility of the fiscal discipline to which the perspective new EU entrants are being asked to adhere in the period leading to their accession. Most importantly, though, it perpetuates the charge that EMU always prefers to fudge rather than to adhere to its principles. The comparison with the episode of the application of the Maastricht criteria in the period leading to the introduction of the virtual euro is very telling indeed (Arestis et al., 2001).

The separation of the monetary authorities from the fiscal authorities and the decentralisation of the fiscal authorities will inevitably make any co-ordination of fiscal and monetary policy difficult. Since the ECB is instructed to focus on inflation while the fiscal authorities will have a broader range of concerns, there will be considerable grounds for conflict.<sup>6</sup> This suggests a need for the evolution of a body, which would be charged with the co-ordination of EMU monetary and fiscal policies. In the absence of such a body, tensions will emerge in the real sector when monetary policy and fiscal policy pull in different directions. The SGP in effect resolves these issues by establishing the dominance of the monetary authorities (ECB)

over the fiscal authorities (national governments).

## **POLICIES FOR FULL EMPLOYMENT AND LOW INFLATION**

If current EMU policy arrangements cannot produce full employment and low inflation within the euro area, then the obvious question is the extent to which necessary changes to the existing framework are required to achieve this objective. This section attempts to answer this question.

The achievement of full employment does require an appropriate high level of aggregate demand. This translates into some combination of increased demand for consumption, for investment, for public expenditure, and for exports. Whether such a level of aggregate demand would require a substantial budget deficit inevitably depends on what happens to the other sources of demand in the equation. But a high level of aggregate demand is only one condition for the achievement of full employment. In the context of the eurozone, there are further significant obstacles to the achievement of full employment. The first is the lack of productive capacity in many regions to provide high levels of employment. Estimates by the OECD of the "output gap" are currently around zero, that is actual output is about equal to potential output; yet this is combined with over 8 per cent unemployment. In a similar vein, the OECD's estimates of the Non Accelerating Inflation Rate of Unemployment (NAIRU) average of 8.8 per cent for the eurozone (in 1999), is again close to the current experience. Interpreting the NAIRU as an indicator of a capacity constraint, suggests capacity problems.<sup>7</sup> In this context, higher levels of aggregate demand would place pressure on capacity and could well have some inflationary consequences. The second obstacle is the disparity of unemployment, in that a general increase in demand would push some regions to or even above full employment. The third problem is that there has been incomplete convergence of business cycles across eurozone countries, suggesting the need for differentiated policies across countries (and specifically differentiated fiscal policies). But even if there were convergence of business cycles, the cyclical movements would be around with quite different levels of unemployment.

These considerations suggest that the restoration of full employment in the eurozone will take much more than a level of aggregate demand. It will require the creation of sufficient capacity to support full employment, and the substantial reduction of regional disparities. But the creation of high levels of aggregate demand remains a necessary, though not sufficient, condition for the creation of full employment. At the present time, the eurozone lacks any significant policies which address the unemployment issue: it lacks the power to create high levels of aggregate demand to promote investment or to reduce regional disparities.

Although inflation has been above the target level, there does not seem to be any perception that there is an inflationary problem currently. Inflation worldwide as well as in Europe appears to be subdued (at least by comparison with the late 1960s and 1970s, though not by comparison with the 1950s). It may then not be a matter of much concern that the euro area has no effective policy for responding to inflationary pressures. We have argued above that interest rate policy is unlikely to be able to cope with major inflationary pressures (and can only do so through deflationary measures).

The achievement of high levels of economic activity without inflationary pressures then requires four elements, in addition to high levels of aggregate demand. First, institutional arrangements for collective wage determination and price setting which are conducive to low inflation. Wage determination within the EU is currently undertaken on a decentralised and fragmented basis, even where it is (or has been) centralised within a particular national economy. The institutional arrangements for collective wage determination at the EU level do not currently exist, and this effectively rules out any possibilities for the operation of incomes policy or similar for the next few years. There are a number of examples in Europe (within and outside the EU) of centralised institutional arrangements, which have been conducive to relatively low inflation: for example Austria, Germany, Norway and Sweden.<sup>8</sup>

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

Third, an alternative full employment, growth and stability pact would involve major changes to the operations of the ECB. The reformulated ECB should be required to act as lender of last resort and not merely possess the potential to act as such. Moreover, the ECB should adopt a more pro-active stance regarding bank surveillance and supervision. The proposal for the reformulation of objectives readily follows from what has been previously said: the ECB should be charged with setting interest rates in a manner that encourages growth and full employment, rather than merely inflation.

Fourth, the present disparities in regional unemployment levels (and also in labour market participation rates) within the EU would suggest that even if full employment were achieved in some regions, there would still be very substantial levels of unemployment in many others. In the presence of such disparities in unemployment, the achievement of a low level of



unemployment overall (not to mention full employment) would be difficult. This problem is compounded by the fact that within the EMU not only is there high unemployment on average, but there is at the same time a severe shortage of highly qualified labour in many member countries. On top of all these problems, there is still very low or even negligible mobility within the EMU (Fertig and Schmidt, 2002). Inflationary pressures would build up in the fully employed regions even when the less prosperous regions were still suffering from significant levels of unemployment. Interest rates would then rise to dampen down the inflationary pressures in the prosperous regions without consideration for the continuing unemployment in other regions. Therefore, a further recommendation would be to have a revamped EIB to supplement the activities of the ECB, with the specific objective of enhancing investment activity in those regions where unemployment is acute. Enhanced investment activity will, thus, aim to reduce the dispersion of unemployment within the framework of reducing unemployment in general. This could be achieved through encouraging long-term investment whenever this is necessary by providing appropriate finance for it.

## SUMMARY AND CONCLUSIONS

We have sketched in this paper the theoretical foundations of the "third way," and suggested that they are rooted in the New Keynesian tradition. Furthermore, we argued that the EMU theoretical foundations are embedded in this theoretical approach. We have examined the policy implications of the EMU, along with its theoretical and institutional dimensions surrounding monetary and fiscal policies. The real challenges to EMU macropolicies lie in their ability to move the euro area to a full-employment situation with low inflation. They are actually unsatisfactory to withstand the challenge. We have proposed a number of changes that would include the following elements. First, a revamped EIB to supplement the ECB is vitally necessary. Second, any political constraints on national budget positions should be removed, and national governments set fiscal policy as they deem appropriate. Third, institutional arrangements for the co-ordination of national fiscal policies be strengthened. Fourth, EU institutional arrangements are required for the operation of an EU fiscal policy, and to ensure that monetary authorities do not dominate economic policy making. Fifth, serious co-ordination of monetary and fiscal policies is paramount.

**TABLE 1**  
**REAL GDP GROWTH RATES, INFLATION AND UNEMPLOYMENT**

| YEAR      | 1999 |     |     |     | 2000 |     |     |     | 2001 |     |     |     | FORECASTS |      | ECB PROJECTIONS* |            |           |            |
|-----------|------|-----|-----|-----|------|-----|-----|-----|------|-----|-----|-----|-----------|------|------------------|------------|-----------|------------|
| QUARTER   | 1Q   | 2Q  | 3Q  | 4Q  | 1Q   | 2Q  | 3Q  | 4Q  | 1Q   | 2Q  | 3Q  | 4Q  | 2002      | 2003 | 2002             |            | 2003      |            |
|           |      |     |     |     |      |     |     |     |      |     |     |     |           |      | GDP              | INFLATION+ | GDP       | INFLATION+ |
| EURO AREA | 1.9  | 2.3 | 2.6 | 3.2 | 3.5  | 3.7 | 3.3 | 3.0 | 2.5  | 1.7 | 1.4 | 0.6 | 1.3       | 2.8  | 0.7 - 1.7        | 1.1 - 2.1  | 2.0 - 3.0 | 0.9 - 2.1  |
| US        | 4.0  | 3.9 | 4.0 | 4.4 | 4.2  | 5.2 | 4.4 | 2.8 | 2.5  | 1.2 | 0.6 | 0.5 | 2.5       | 3.5  | -                | -          | -         | -          |
| BRITAIN   | 1.7  | 1.7 | 2.5 | 3.2 | 3.2  | 3.4 | 3.0 | 2.6 | 2.7  | 2.3 | 2.2 | 1.6 | 1.9       | 2.9  | -                | -          | -         | -          |

## UNEMPLOYMENT AND INFLATION

| COUNTRY/AREA | UNEMPLOYMENT<br>(YEAR AGO) | UNEMPLOYMENT<br>ECB PROTECTIONS<br>** |      | ACTUAL<br>INFLATION<br>CONSUMER<br>PRICES (YEAR<br>AGO) | FORECAST<br>INFLATION |      |
|--------------|----------------------------|---------------------------------------|------|---------------------------------------------------------|-----------------------|------|
|              |                            | 2002                                  | 2003 |                                                         | 2002                  | 2003 |
| EURO AREA    | 8.5                        | 8.6                                   | 8.4  | 2.6                                                     | 1.7                   | 1.7  |
| US           | 4.3                        | -                                     | -    | 3.5                                                     | 1.4                   | 2.2  |
| BRITAIN      | 5.2                        | -                                     | -    | 2.7                                                     | 2.1                   | 2.5  |

NOTE: GROWTH RATES =  $100 [X_t / X_{t-1} - 1]$ , where  $X_t$  = is value in quarter t, and  $X_{t-1}$  = is value in quarter of a year ago.

SOURCE: THE ECONOMIST (various issues), except for \* where the source is ECB, *Monthly Bulletin*, December, 2001, and for \*\* where the source is the same but March, 2002 (the projections are the results from the *Survey of Professional Forecasters*, 57 of them all EMU-based). In the case of +, ECB define inflation as the overall *Harmonised Index of Consumer Prices* (HICP).

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## NOTES

1. There is also the idea that those operating monetary policy should be more "conservative" (that is place greater weight on low inflation and less weight on the level of unemployment) than the politicians (Rogoff, 1985).

2. See Forder (2000) for an extensive discussion and critique of the notion of credibility.

3. For example, "in this new economy our task is to ensure that, as individuals and companies and indeed as a country, we are fully equipped to contribute to and compete within this global marketplace" (Brown, 1999). Also, "Foreign investors do want

a flexible labour market, but they are concerned about the poor level of our skills and education. The new Labour approach should be to correct the defects of the latter, without undermining the former" (Labour Party, 1997, p. 15).

4. The Governing Council comprises 18 members as follows: there are six policy-makers based in Frankfurt (they are from Finland, France, Germany, Italy, the Netherlands and Spain); and twelve heads of national central banks (members of the EMU) in the euro area. All 18 members have equal say. There are, thus, six countries with two representatives on the Governing Council.

5. In the same paper, Meade and Sheets (2001) provide evidence that enables them to conclude that in the case of the USA Federal Reserve System, policymakers' regional unemployment plays a significant role in monetary policy decisions. Thus, regional factors play an important role in monetary policy decisions.

6. The SGP, then, would be in danger of becoming the "instability" pact.

7. In this context it is worth quoting Otmar Issing, The ECB Chief Economist, who suggested at a press conference in Berlin on the 16<sup>th</sup> of April, 2002, that the return in 2002 of the euro area to its average growth after the 2001 economic slowdown "is an indication that the euro area and Europe in general still have low potential growth" (reported in the *Financial Times*, 18 April, 2002).

8. The idea of a state-funded "buffer fund" to stabilize employment in cases of difficulties is a relevant suggestion. This has been recently proposed by Sweden's trade union movement. Finland has already in place such a "buffer fund," but it is not state-funded and it is only a tenth of the one suggested in the case of Sweden.