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Working Paper No. 385

Macroeconomic Policies of the Economic Monetary Union: Theoretical Underpinnings and Challenges

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INTRODUCTION

This paper is focused on the macroeconomic policies of the European Monetary Union. It seeks to decipher the type of economic analysis and macroeconomic policies of the Economic and Monetary Union (EMU) theoretical and policy framework. It argues that the challenges to the EMU macroeconomic policies lie in their potential to achieve full employment and low inflation in the euro area. It is concluded that these policies as they currently operate have not performed satisfactorily since the inception of the EMU and are unlikely to operate any better in the future. The paper presents some alternatives, which are based on a different theoretical framework and which propose different institutional arrangements and policies.

The first main section is entitled Theoretical Underpinnings of the EMU Model, and deals with the nature of the economic model surrounding the EMU which is seen as essentially what has been termed the "new consensus" in macroeconomics. The macroeconomic policies that emanate from this model are then deciphered in the section entitled EMU Macroeconomic Policies. 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. The two sections that follow examine Monetary Policy and Fiscal Policy respectively, within the EMU context. They are both found as unable to steer the euro area to a non-inflationary full-employment environment. 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 desperately need to be changed in that they are quite inadequate to deal with problems of unemployment and inflation. We propose alternative policies and institutional arrangements. A final section summarizes the argument and concludes.

THEORETICAL UNDERPINNINGS OF THE EMU MODEL

It is unlikely that economic policy pursued by any government or institution is fully consistent either internally or with some theoretical paradigm. However, in view of the approach adopted by the EMU, and the theoretical positions put forward by its officials (see, for example, Issing, 2003, and European Commission, 2000, for recent expositions), it can be thought of as embedded in the "new consensus" macroeconomics paradigm. We argue that the approach can be viewed as "new consensus" 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 (particularly in the long run), and of fiscal policy, and the elevation of monetary policy at the expense of fiscal policy.

We postulate that the economics of the EMU can be understood as based on the following elements listed below, which we would argue justify the description of a "new consensus" variety. These elements are as follows:¹

(i) The market economy is viewed as essentially stable, and that macroeconomic policy (particularly discretionary fiscal policy) may well destabilize 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, globalized, capital and financial markets.

(ii) Monetary policy is taken as the main instrument of macroeconomic policy, with the view that it is a flexible instrument for achieving medium-term stabilization objectives: it can be adjusted quickly in response to macroeconomic developments. Indeed, monetary policy is the most direct determinant of inflation, so much so that in the long run the inflation rate is the only macroeconomic variable that monetary policy can affect (see, for example, ECB, 2003c). Fiscal policy is no longer viewed as a powerful macroeconomic instrument (in any case it is subject to the slow and uncertain legislative process). It is recognized that the budget position will vary over the course of the business cycle in a counter cyclical manner (that is deficit rising in downturn, surplus rising in upturn), which helps to dampen the scale of economic fluctuations (i.e. act as an "automatic" stabilizer). But these fluctuations in the budget position take place around a balanced budget on average over the cycle. The budget (at least on current account) can and should be balanced over the course of the business cycle. Fiscal policies "based on clear mandates and rules reflect a macroeconomic policy design that is generally preferable to the ad-hoc discretionary co-ordination of day-to-day policy action in the face of shocks" (ECB, 2003c, p. 37). Monetary policy has, thus, been upgraded and fiscal policy has been downgraded.

(iii) Monetary policy can be used to meet the objective of low rates of inflation (which are desirable in this view, since low, and stable, rates of inflation are conducive to healthy growth rates).² 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 (ECB, 2003c, pp. 40-41). Indeed, 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). 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.³

(iv) Credibility is recognized as paramount in the conduct of monetary policy to avoid problems

associated with time-inconsistency. This is an argument that reinforces the requirement of central bank independence. It is argued that a policy which lacks credibility because of time inconsistency is neither optimal nor feasible (Kydlund and Prescott, 1977). The only credible policy is the one that leaves the authority no freedom as to how 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. Such Central Bank should be given as its sole objective that of price stability.

(v) Inflation targeting is preferred to money supply targeting. Inflation targeting is neither a rule nor discretion (in practice only degrees of discretion prevail): it is rather a framework for monetary policy whereby public announcement of official inflation targets, or target ranges, is undertaken along with explicit acknowledgement that low and stable inflation is monetary policy's primary long-term objective. This improves communication between the public and policy-makers and provides discipline, accountability, transparency and flexibility in monetary policy. Inflation targeting has been described as "constrained" or "enlightened" discretion, in that inflation targets serve as a nominal anchor for monetary policy. As such, monetary policy imposes discipline on the central bank and the government within a flexible policy framework. For example, even if monetary policy is used to address short-run stabilization objectives, the long-run inflation objective must not be compromised, thereby imposing consistency and rationality in policy choices (in doing so, monetary policy focuses public's expectations and provides a reference point to judge short-run policies). Although the ECB allegedly does not pursue an inflation targeting policy (Duisenberg, 2003a; Issing, 2003; see, also, our discussion below), it does, nonetheless, pursue a monetary policy strategy with "the clear commitment to the maintenance of price stability over the medium term" which "implies a stable nominal anchor to the economy in all circumstances" (ECB, 2001b, p. 49).

(vi) 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 labor market.⁴ 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 the 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.

(vii) 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).

Most of these general ideas can be seen as formalized (explicitly or implicitly) in what has become known as the "new consensus" of macroeconomics (see, for example, Arestis and Sawyer, 2002b). This "new consensus" can be summarized in the following three equations:

$$(1) \quad Y_t^g = a_0 + a_1 Y_{t-1}^g + a_2 E(Y_{t+1}^g) - a_3 [R_t - E_t(p_{t+1})] + s_1$$

$$(2) \quad p_t = b_1 Y_t^g + b_2 p_{t-1} + b_3 E_t(p_{t+1}) + s_2 \quad (\text{with } b_2 + b_3 = 1)$$

$$(3) \quad R_t = RR^* + E_t(p_{t+1}) + c_1 Y_{t-1}^g + c_2 (p_{t-1} - p^T)$$

where Y^g is the output gap, R is nominal rate of interest, p is inflation, and p^T is inflation target, RR^* is the "equilibrium" real rate of interest (that is the rate of interest consistent with zero output gap which implies from equation (2) a constant rate of inflation), and s_i (with $i = 1, 2$) represents stochastic shocks.

Equation (1) is the aggregate demand equation; equation (2) is a Phillips curve; and (3) is a monetary policy operating rule which replaces the old LM-curve. There are three equations and three unknowns: output, interest rate and inflation. This model has a number of additional, and relevant, characteristics. Equation (1) resembles the traditional IS, but expenditure decisions are seen to be based on intertemporal optimization of a utility function. There are both lagged adjustment and forward-looking elements; the model allows for sticky prices (the lagged price level in the Phillips-curve relationship) and full price flexibility in the long run. The term $E_t(p_{t+1})$ in equation (2) reflects central bank credibility. A central bank that credibly signals its intention to achieve and maintain low inflation will be "rewarded" by lower expectations on the rate of inflation. The inclusion of term $E_t(p_{t+1})$ in equation (2) indicates that it may be possible to reduce current inflation at a significantly lower cost in terms of output than otherwise. This is an important element in ECB monetary policy (see, for example, Duisenberg, 1999, Issing, 2003). The operating rule implies that "policy" becomes a systematic adjustment to economic developments rather than an exogenous process. Also, it contains no stochastic shock implying that monetary policy operates without random shocks. It contains the neutrality of money property, with inflation determined by monetary policy (that is the rate of interest), and equilibrium values of real variables are independent of the money supply. The final characteristic we wish to highlight is that money has no role in the model; it is merely a "residual," and this is more extensively discussed in Arestis and Sawyer (2003a, 2003b).

The three relationships that summarize the "new consensus" contain all the essential elements of the theoretical framework of the EMU (see, also, ECB, 2003a). There are, however, two important differences worth highlighting here though pursued further in the section on Monetary Policy. The first is that arguably the ECB does not pursue inflation targeting. Duisenberg (2003a) is adamant that the ECB approach does not entail an inflation target: "I protest against the word 'target.' We do not have a target...we won't have a target." The second is that in the ECB view the demand for money in the euro area is a stable relationship in the long run--most central banks would suggest the opposite in the case of their economies.⁵

EMU MACROPOLICIES

The launch of the euro as a "real" currency (since January, 2002), rather than as a "virtual" currency (since January, 1999), took place against an economic environment of slowing growth and rising unemployment across the world and the euro area, adding to the already high levels of unemployment. Table 1 illustrates this point. 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 2003 and 2004 and the European

Central Bank (ECB) projections for the same years is that this slow down will continue in 2003, with some recovery expected in 2004. A similar pattern is evident in the cases of the U.S. economy and Britain (where the situation does not appear to be as bad). However, it is the U.S. growth rate expected at 3.4 and 3.6 percent in 2003 and 2004 respectively, against the euro area's 1.0 and 2.3 percent respectively, which might lead the world economy out of the present slowdown, though the recent rise in the value of the euro may knock the rate of growth down further. In terms of unemployment and inflation the situation is no better. The euro area unemployment is already high at 8.8 percent (April, 2003) and is forecasted to remain at 8.8 percent for 2003 and for 2004, and though the rate is much lower in the U.S. and Britain, it is now increasing in all three countries (and quite rapidly in the U.S. case).⁶ Inflation may not be a problem in the U.S. and Britain (though some forecasts indicate that inflation may hit against the upper limit of the inflation target range of 1.5 percent to 3.5 percent) but in the euro area it has been above the 2 percent limit set by the ECB though dipping below 2 percent in May, 2003. The forecasts for inflation and the ECB projections relating to inflation tell a similar story: the situation may improve by the year 2004, although it may still be above the 2 percent ECB inflation target.

The challenges to the EMU macropolicies surrounding the euro arise from the extent to which they can tackle the problems just summarized. These are embedded in the monetary policy operated by the ECB, and in the Stability and Growth Pact (SGP).⁷ Can they deliver full employment without inflationary pressures? We now attempt to answer this question and begin by briefly locating the key economic policy ingredients of the EMU system.

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. 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. Central banks are viewed as having 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 seen as a monetary phenomenon and ultimately it is central banks that determine the inflation rate.

The ECB is set up to be independent of the European Union (EU) Council and Parliament and of its member governments. There is, thus, 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 constitutional 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.

The ECB is the only effective federal economic institution, and it has the one policy instrument of the "repo" rate to pursue the main objective of low inflation. The ECB is clear on this issue. In, for example, ECB (2003a) it is stated that "In the field of monetary-fiscal policy co-ordination, the emphasis has shifted away from the joint design of short-term policy responses to shocks towards the establishment of a non-discretionary, rule-based regime capable of providing monetary and fiscal policy-makers with a time-consistent guide for action and thus a reliable anchor for private expectations Therefore there will generally be no need for further co-ordination of day-to-day policy moves" (p.

38).

National fiscal policy is subject to the requirements of the SGP (with no fiscal policy at the level of the EU with a balanced budget requirement and EU expenditure set at 1.24 percent of EU GDP). The official rationale for the SGP is twofold. The first is that a medium-term balanced budget rule secures the scope for automatic stabilizers without breaching the limits set by the SGP (see below for more details). Second, since a balanced budget explicitly sets the debt ratio on a declining trend, it reduces the interest burden and improves the overall position of the government budget. Underlying the approach to SGP, though, is the notion of sound public finances. The European Commission (2000) is emphatic on this issue: "Achieving and sustaining sound positions in public finances is essential to raise output and employment in Europe. Low public debt and deficits help maintain low interest rates, facilitate the task of monetary authorities in keeping inflation under control and create a stable environment which fosters investment and growth ... The Maastricht Treaty clearly recognizes the need for enhanced fiscal discipline in EMU to avoid overburdening the single monetary authority and prevent fiscal crises, which would have negative consequences for other countries. Moreover, the loss of exchange rate instrument implies the need to create room for fiscal policy to tackle adverse economic shocks and smooth the business cycle. The stability and growth pact is the concrete manifestation of the shared need for fiscal discipline" (p. 1).

It is further argued that these views spring from experience in that both emphases on fiscal prudence and stability in the founding Treaty of the EMU spring from the firm conviction that "the deterioration of public finances was an important cause behind the poor economic performance of many EU countries since the early 1970s. The subsequent decades taught Europe a salutary lesson of how economic prosperity cannot be sustained in an unstable economic policy environment. Inappropriate fiscal policies frequently overburdened monetary policy leading to high interest rates. On the supply-side, generous welfare systems contributed to structural rigidities in EU economies and fuelled inappropriate wage behavior. The net effect was a negative impact on business expectations and on investment, thus contributing to a slower rise in actual and potential output. As a result, employment stagnated" (European Commission, 2000, p. 9). The level of NAIRU is viewed as being favorably affected by a "flexible" labor 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 the theoretical construct we expounded in the first section of this paper. Interestingly enough, recent theoretical and empirical contributions suggest that capital stock is an important determinant of NAIRU (see, for example, Arestis and Biefang-Frisancho Mariscal, 2000), thereby establishing the importance of aggregate demand in curing unemployment. Baker et al (2002) provide evidence that supports the view that those "inflexible" euro area labor markets cannot be held responsible for the high unemployment rates there (see Table 1 above). Union strength, the severity of employment protection legislation, unemployment benefits replacement ratios and labor market deregulations of the 1990s, cannot be held responsible for the euro area unemployment rates. They conclude that "the empirical case has not been made that could justify the sweeping and unconditional prescriptions for labor market deregulation which pervade much of the policy discussion" (p. 56).

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

Institutional and Policy Arrangements

ECB monetary policy has been assigned a quantitative definition of price stability in the form of a 0-2 percent target for the annual increase in the Harmonized Index of Consumer Prices (HICP) for the euro area (preferably hovering in the lower range of 0-2 percent). The ECB, however, announced at a press conference on May 8, 2003, its intention to maintain inflation "close to but below 2 percent" over the medium term. Issing (2003) insists on the "clarification" aspect as being "totally different from what is normally seen as inflation targeting." Furthermore, the "close to but below 2 percent" inflation "is not a change, it is a clarification of what we have done so far, what we have achieved--namely inflation expectations remaining in a narrow range of between roughly 1.7 percent and 1.9 percent--and what we intend to do in our forward-looking monetary policy."⁸ This "clarification" may have become necessary in view of "deflation" fears in the euro area, in that the ECB would worry about deflation if it were to arise. The President of the ECB at the press conference on May 8, 2003, expressed "the ECB's commitment to provide a sufficient safety margin to guard against the risks of deflation," although he insisted that "We do not share this fear for the euro area as a whole" (Duisenberg, 2003a). Issing (2003) concurs when he suggests that "it is clear enough that we are not blind in the eye which identifies deflationary problems. We have both eyes watching deflationary as well as inflationary developments." And yet Duisenberg in a subsequent press conference, June 5, 2003, argued strongly that "We are convinced that we don't have to prepare ourselves for deflation because we don't see deflation coming. And that's what I have said, I think, loud and clear" (Duisenberg, 2003b).⁹

The official doctrine of the ECB based on a "two-pillar" monetary strategy has been adopted. The "first pillar" is a commitment to analyze 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 percent 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; labor market indicators, such as wages and unit labor costs; fiscal policy indicators; and financial market indicators, such as asset prices.

The rationale of the "two-pillar" approach is based on the theoretical premise that there are different time perspectives in the conduct of monetary policy that require a different focus in each case. There is the short- to medium-term focus on price movements that requires economic analysis. In this analysis, "Broad range of economic/financial developments are analyzed, to assess economic shocks, dynamics and perspectives and the resulting risks to price stability over the short to medium term" (Issing, 2003). There is also the focus on long-term price trends that requires monetary analysis.¹⁰ There is, thus, a strong belief in the long-term link between money (M3 in this case) and inflation. Issing (2003) leaves no ambiguity of the ECB belief in this relationship, when he argues that there is "No evidence that long-run link between money and prices has broken down in euro area; many studies show good leading indicator properties"; and that "Excess money/credit may provide additional information for identifying financial imbalances and/or asset price bubbles, which ultimately may impact on price developments." The ECB also conducts "cross checking" between the two analyses so that consistency is ensured (Issing, 2003).¹¹

Policy Defects with the ECB Monetary Policy Arrangements

These policy arrangements we have just discussed suffer from a number of defects. First, if inflation is induced by a demand shock (i.e. a higher level of demand pushes up inflation), then a policy to influence aggregate demand--and thereby, it is hoped--inflation, may have some validity. But such a policy is

powerless to deal with cost inflation or supply shock inflation. A supply shock would lower (raise) output whilst raising (lowering) inflation. Further, the extent to which the domestic interest rate can be changed is circumscribed by exchange rate considerations and are likely to take some time to have any impact on aggregate demand (and then the impact may be rather small). Indeed the British monetary authorities (and others) talk in terms of a two-year lag between the change in interest rates and resulting impact of changes in aggregate demand on the rate of 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 (see, for example, Arestis and Sawyer, 2002a).

Second, changes in interest rates have only a limited impact on aggregate demand. But further in so far as interest rates do have an impact it comes through effects on investment and on the exchange rate. High interest rates have long-term detrimental effects through reducing future productive capacity and through the impact of foreign trade. We have surveyed elsewhere (Arestis and Sawyer, 2002b) the results of simulations of the effects of monetary policy using macroeconomic models. The survey is based on work undertaken for the ECB, the U.S. Federal Reserve System, and for the Bank of England. The conclusion of that survey is that the effects of interest rate changes on inflation tend to be rather small--typically a 1 percentage point change in interest rates may dampen inflation by 0.2 to 0.3 percent after two years.

Third, monetary policy is a "one policy fits all" approach. Within the euro area there has to be a single Central Bank discount rate. It is well-known that the setting of that single interest rate poses difficulties--the rate which is appropriate for a country experiencing high demand and perhaps inflationary pressures is not the same as that appropriate for one facing low demand. Indeed, monetary policy may address the average inflation picture but cannot address differences in inflationary experience across the euro area countries. At the time of writing, there is evidence of significant disparities in inflationary experience despite the convergence of inflation that was required by the Maastricht criteria (and indeed a number of countries would not now satisfy the inflation convergence conditions of the Maastricht Treaty).¹² Further, the impact of interest rate changes is likely to differ markedly across countries.

Fourth, the ECB assessment of the level of economic activity is completely impervious to the behavior of interest rates. Bibow (2003) puts it aptly: "Ex ante interest rate policies never seem to conflict with economic growth in ECB policy communications and assessments. Ex post economic developments do not appear to have been related to interest rate developments either" (p. 5). The ECB rationale is that monetary tightening would not pose any risk to economic activity. Such policy keeps inflationary expectations under control, thereby sustaining confidence in price stability, which stimulates economic activity. This is rather surprising in view of the work undertaken on the transmission mechanism in the euro area (ECB 2002, October) shows that monetary policy has strong real effects, especially so in "that investment is a main driving force, with a contribution of more than 80 percent to the total response of GDP after three years" (p. 47).¹³

Problems with the ECB Monetary Policy

The management, operation, communication and potential efficacy of monetary policy within these institutional arrangements by the ECB have entailed many problems. In terms of the management aspect, the response of monetary policy decisions to evolving events has been slow. It is of some interest to note in this context the reluctance of the ECB to reduce the "repo" rate of interest when a downturn in

economic activity in 2001, not just in the euro area, became rather obvious. In particular, the ECB can be faulted for underestimating the impact of the U.S. recession on the euro area, and for not reacting on time in terms of reducing interest rates. After signalling in April, 2001 an imminent cut in interest rates, it never implemented it; however, when in May it signalled no change, the ECB subsequently cut interest rates! It is of considerable importance to note that the ECB (2001b) in March, 2001 was claiming that "The general outlook for this year and next remains positive. Economic activity in the euro area is mainly determined by domestic factors. The conditions on the domestic side ... have remained favorable This notwithstanding, an element of uncertainty with regard to the outlook for euro area continues to be the world economy and its potential impact on euro area developments. However, at this juncture there are no signs that the slowdown in the U.S. economy is having significant and lasting spillover effects on the euro area" (p. 5). In the May issue of the Monthly Bulletin, the ECB (2001d) was declaring that "economic growth supported by domestic demand, will be broadly in line with estimates of potential growth in 2001" (p. 5). As mentioned above, the ECB cut its key interest rate on May 10, 2001, thereby throwing the financial markets into widespread confusion (see, also, Bibow, 2002).¹⁴

ECB monetary policy since then has been no less confusing. In the January issue of the Monthly Bulletin, the ECB (2002a) was stating that "no fundamental economic imbalances have built up in recent years in the euro area which would require a long correction process" (p. 5), thereby attempting to let the financial markets believe that there was no intention for further interest rate cuts. If anything, increases in interest rates were implied. In April 2002 the "thread" of interest rate increase was evident enough: "the persistence of excess liquidity in the economy could become a concern once the economic recovery in the euro area gathers pace" (ECB, 2002b, p. 5). Similarly, in May, 2002 the ECB (2002c) was more explicit about "the prospects for price stability," which "appear to be somewhat less favorable than they were towards the end of last year" (p. 5). In the meantime, on the other side of the Atlantic the Federal Reserve (Reserve) Open Market Committee (FOMC) kept lowering interest rates aggressively. It took the ECB until December 2002 to lower interest rates on the premise that "the evidence has increased that inflationary pressures are easing, owing in particular to the sluggish economic expansion. Furthermore, the downside risks to economic expansion have not vanished" (ECB, 2002d, p. 5).

The Federal Reserve System already reduced interest rates on a number of occasions (no less than thirteen times between January 3, 2001 and June 25, 2003). Still in March 2003 a 25 basis point reduction in the "repo" rate prompted ECB to argue that "Overall, ECB interest rates have reached very low levels. On the basis of currently available information, this policy stance, while contributing to the preservation of price stability over the medium term, provides some counterbalance to the factors which are currently having an adverse effect on economic activity" (ECB, 2003b, p. 6). However, the sharp euro appreciation since April 2002 would suggest the opposite: relative interest rates have not reached very low levels; so much so that "The euro area's immediate problem is overly tight monetary and fiscal policy" (*The Economist*, May 3, 2003, p. 71). And yet, the ECB President at a press conference, May 8, 2003, declared that "the euro at the moment--is about at the level which, better reflects the fundamentals and it is roughly at average historical levels. So, there is not yet anything excessive about the level" (Duisenberg, 2003a). As a result, the euro jumped to its highest level against the dollar and the pound sterling for four years.¹⁵

The ECB's methods of operation and communication have been confusing to the financial markets. In the "two-pillar" strategy, there is uncertainty as to the value attached to the M3 reference value. The target has rarely been met, and yet this does not seem to impact on official strategy. As Fitousi and Creel (2002) have put it, "In its communication with the public, the ECB consistently highlights its 'reference

value' for inflation and--often in a confusing way--its monetary policy target. This may well have undermined the ECB's credibility, rather than added to it" (p. 67). The "clarification" offered on May 8, 2003, appears to downplay the importance of the money stock, and yet it reaffirmed its long-run importance.

There is, indeed, the further question of whether the aim of inflation being "close to 2 percent" is not too restrictive, and it suffers from not being symmetrical. Let alone the confusion it has created by the statement "close to but below 2 percent"; is there no change as the ECB suggested, or is it a move to a 2 percent mid-point target (flatly denied by the ECB as noted above)? The ECB has been reluctant to manipulate the rate of interest sufficiently and for other purposes, when it is abundantly clear that such a move is paramount. In practice most central banks do not concentrate on inflation to the exclusion of any other policy objective (they usually take unemployment into account). In any case, it actually becomes more and more obvious that the "close to 2 percent" formulation is by far too low. Especially so currently when it is apparent that this policy stance "provides an inadequate cushion against the risk of deflation in the event of a serious slump in demand" (*The Economist*, September 28, 2002, p. 11). Clearly, the ECB believes that it is an adequate cushion as evidenced by the May 8, 2003, "clarification" of monetary policy by its officers (Duisenberg, 2003a; Issing, 2003; see, also, above for relevant discussion).

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, essentially because it does not publish minutes of the monetary policy meetings.

A further problem is that of voting behavior of the ECB Governing Council, and the real possibility of the ECB policy decisions being affected by national loyalties.¹⁶ Meade and Sheets (2001) argue that they are so 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 hypothesize 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 behavior reflects their hypothesis. There is, thus, national bias in the ECB policymaking, and reform of the ECB's structure appears inevitable.¹⁷

Reservations Regarding the Efficacy of ECB Monetary Policy

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. For example, the Governor of the Bank of England argued, in an interview on the German television on the December 20, 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 December 21, 2001, that unlike monetary policy in a single country where "mitigating factors" exist, such as labor

migration and fiscal redistribution, these factors "are not present to any significant degree at the euro area 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, considerable doubt may be cast on the effectiveness of monetary policy in terms of responding to recession and as a means of controlling inflation (for an extensive discussion on this general point see Arestis and Sawyer, 2002b). There has been a reluctance to cut interest rates in the face of recession (with the U.S. a notable exception in this regard). The ECB has failed to meet its inflation target of below 2 percent for three years (and has presided over widely differing inflation rates within the euro area).

Fourth, the inflation target of below 2 percent can be argued to be too low. The consequence is that deflationary policy is continuously pursued. This has a number of implications, of which two stand out here. The first is that it is very difficult to see how full employment with no inflation can be achieved. The deflationary thrust to the policies ensure not only that unemployment rises in the present but they also serve to depress investment and capital formation, thereby harming future prospects for employment. The second is a serious concern about the distributional effects of contractionary policies. Moderate rates of inflation improve the relative position of low-income groups, and deflationary policies deteriorate it (Nordhaus, 1973). Blinder (1987) concurs with the contention that contractionary monetary policies distort income distribution against low-income groups (see, also, Forder, 2003).

Fifth, 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.

Sixth, 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.

Seventh, 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 percent of GDP) means that variations in the exchange rate of the euro will have much less impact on prices than in more open economies.

Further Critique

Despite all these problems and criticisms, the ECB president went to new lengths in early October, 2002, when testifying before the European Parliament, to defend the prevailing high level of interest rates in the euro area despite its economic problems (see Table 1 above). He defended his decision arguing that "I, perhaps unkindly, compare the euro area economy with the other major economies in the world, which have followed, what I would call a more-aggressive interest rate policies. If one looks at the results of these policies, then I am positively convinced that our policy stance, which implies historically low real interest rates and nominal interest rates, but also presents an image of stability, forward-looking and creating no hindrance whatsoever to the resumption of growth in both investment and consumption; with a liquidity situation which can be described as ample and a monetary policy

stance which can be characterized as accommodative, is one which deserves to be greatly valued" (Duisenberg, 2002). The ECB president was referring to the reduction of the key euro-area interest rate by 1.5 percentage points, to 3.25 percent in November 2002 from the height of 4.75 percent in October 2001 (though the interest rate had been raised from 3.50 percent in March 2001). By contrast, the U.S. Federal Reserve System cut its equivalent rate by 4.75 percentage points, to 1.75 percent, between January 2001 and October 2001, and then by a further 1.25 percent in the period to November 2002. The results of the ECB policy as compared to the Federal Reserve System's are not complimentary to the president's argument, to say the least--compare the GDP annualized growth rates in the first three quarters of 2002, 0.3 percent, 0.7 percent and 0.8 percent in the case of the euro area respectively, and 1.4 percent, 2.2 percent and 3.3 percent in the U.S.; also the annualized unemployment rate of 8.1, 8.2 and 8.3 percent, respectively in the euro area, as compared to 4.0, 4.0 and 5.8 percent, respectively in the U.S.¹⁸ Furthermore, the dollar did not suffer over the period the kind of decline suggested by the ECB president's comparisons. On the contrary, following the statement of the ECB president referred to above, the dollar moved higher than the euro at that time.¹⁹ Clearly the claims of the ECB president could not be sustained.

But the ECB continues to insist that the current level of interest rate in the euro area is the "right" one. The euro has appreciated substantially since October 2002 and three of its major countries, Germany, Italy and the Netherlands appear to be on the brink of recession (and Portugal has already experienced two quarters of negative growth). Recent data, European Commission (2003), reveal that Germany contracted by 0.03 percent in the last quarter of 2002 (at an annualized rate), and by 0.2 percent in the first quarter of 2003, thus experiencing two consecutive quarters of negative growth. Italy reported 0.1 percent contraction in 2003 quarter 1 (although it had expanded by 0.4 percent in 2002 quarter 4), the Netherlands shrunk by 0.3 percent in the same quarter having contracted by 0.2 percent in the fourth quarter of 2002. France experienced a 0.1 percent contraction in the fourth quarter of 2002, but a 0.3 expansion in the first quarter of 2003, while the whole euro area growth was zero in the first quarter of 2003, following growth of 0.1 percent in the fourth quarter of 2002. The dangers of "deflation" in the euro area are very clear indeed, and yet the ECB (2003d) argues that "the monetary policy stance remains consistent with the preservation of price stability in the medium term" (p. 5). Duisenberg (2003b) goes even further when responding to a press conference question relating to the 50 basis points interest rate reduction on June 5, 2003, "There is nothing linked to deflation. It is only linked to, what in itself is, a very favorable outlook for price developments. It's so favorable that we can afford to lower interest rates without endangering our projection and goal of price stability, which is close to but below 2 percent."

FISCAL POLICY

Institutional and Policy Arrangements

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 percent 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 percent. 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 percent 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 of 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 June 17, 1997).

A country's budgetary data become available for the Commission to scrutinize on March 1 each year when the stability programmes are submitted. Each programme contains information about the paths of the ratios of budget deficit to GDP and national debt to GDP. The Council (ECOFIN) examines the stability reports and delivers 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 is 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 percent, 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 percent 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. The scale of the downturn, which would be involved if the "escape clauses" were to be invoked, occurs rarely and would involve a very severe economic downturn. 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 percent of GDP), and a variable component, (one tenth of the difference between the deficit ratio and the 3 percent 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.

Flaws of the SGP

These SGP institutional arrangements point to a general deflationary bias in the operation of the SGP. It is illustrated by the response of the ECB president at a press conference on December 6, 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" (Duisenberg, 2001). The ECB President was more forthcoming at a similar press conference on May 8, 2003, when he argued that "Looking ahead, it is crucial to underpin the fiscal policy framework with decisive action, strong peer pressure and consistent implementation of the rules of the Treaty and of the Stability and Growth Pact. Countries should maintain budgetary positions close to balance or in surplus over the cycle, and, where this is not the case, take the required structural consolidation measures" (Duisenberg, 2003a).

There are serious flaws in the management of the SGP. One illustration of this is the predictions made in January, 2002 by the European Commission for the year 2002 relating to budget deficits under the terms

of the SGP. Those predictions 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 percent ceiling (it stood at 2.7 percent of GDP in the case of Germany and 2.2 percent in the case of Portugal, though it later transpired that the figure for 2001 was 4.2 percent). 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.²⁰ 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 constraints that are imposed on the perspective new EU entrants in the period leading to their accession. It also supports the charge that the EMU does not keep to its own rules and pledges. The comparison with the episode of the application of the Maastricht criteria in the period leading to the introduction of the virtual euro, when the criteria were fudged to ensure that a large number of countries could join the euro, is telling (Arestis et al., 2001).

More Flexible SGP Fiscal Rules?

In September, 2002, the European Commission admitted for the first time that the SGP fiscal rules relating to the single currency need to be changed. They would be more flexible in the future in view of the euro area economic weaknesses. The European Commission actually relaxed the deadline of 2004 by which Germany, Portugal and France should balance their budgets. These countries were given until 2006 to balance their budgets. In return the Commission demanded that the members reduce their deficit by 0.5 percent a year starting in 2003. It was at the 2002 summer summit in Seville of the 15 European Union members when they all signed a commitment "to achieve budgetary positions close to balance or in surplus as soon as possible in all Member States and at the latest by 2004" (Council of the European Union, 2002, p. 8). The European Commissioner for Economic and Monetary Affairs admitted at the time that it was of great concern to them that the original political commitment of national governments to uphold the SGP was substantially weakening.

The Commission also said that they would pay more attention to structural deficits so that a country's fiscal deficit would be judged in relation to cyclical conditions. These changes have taken place alongside Germany, Portugal and France, showing evidence of having breached the conditions of the SGP. Portugal became the first country to breach the 3 percent rule, and admitted to a budget deficit in excess of the 3 percent of GDP upper limit in 2002. Italy's 2002 budget deficit was also criticized by the European Commission for reaching "dangerous proportions," and the charge was made that the Italian government were massaging the figures. France, too, was criticized by the European Commissioner for Economic and Monetary Affairs, for the 2003 tax and spending plans of this country; and expressed concern that France may not be able to meet the new deadline of 2006. In fact France initially refused to adhere even to the 2006 deadline, arguing that its expenditure plans were affordable.

These incidents have raised the validity of the use of a "one-size-fits-all" approach to fiscal policy, without accounting for the different circumstances of the countries involved and the differential impact which recession can have. They further illustrate that the SGP serves to operate in a deflationary manner.

The ECB president in his early October, 2002, testimony to the European Parliament actually blamed France, Germany and Italy for being responsible over the uncertainty surrounding the economic recovery in the euro area; he argued that "Three of the larger countries have not used the time when there were good economic conditions..... to consolidate their budgets. Now they bear the burden of it" (Duisenberg, 2002). In fact, the SGP has been the focus of growing controversy within the euro area member countries. There is still the argument, mainly from the ECB, that reforming the SGP, especially relaxing

its rules, would damage euro's credibility. It can be argued, though, that the opposite may be nearer to reality. In any case, the relaxation that has been implemented is too small by far to create any serious problems of credibility. It is our view that a great deal more is needed if fiscal policy is to help the euro area to speedily lead towards a real recovery. Under these circumstances, credibility might be enhanced rather than reduced.

More recently (April, 2003), when it became apparent that France had a public deficit of 3.1 percent in 2002, with European Commission provisional forecasts putting it to 3.7 percent for 2003 and 3.6 percent for 2004, and Germany (where the budget deficit is thought to rise to 3.6 percent in 2003) and Portugal (with an expected 3.2 percent deficit in 2003), all three could very well be fined. In fact the Commission is of the opinion that "an excessive government deficit" already exists in France. It has recommended that France should eliminate the deficit by the end of 2004, with the necessary measures being in place by October, 2003. In 2004, France should also bring back to a declining path its government to GDP ratio.

It has become apparent that the slow down in economic growth has brought about-- largely through the operation of the "automatic stabilizers" rather than discretionary fiscal policy--the scale of budget deficits, which could readily be predicted from the size of the slow down. Buti et al (1997) had found that a 1 percent change in GDP produced on average a 0.5 percent change in the average budget deficit in the EU countries.

The economic slowdown in the eurozone has clearly shown that the fiscal rules of the SGP are counterproductive during a slowdown and the budget rules cannot cope with the effects of recession. Moves to enforce the fiscal rules will inevitably add further deflationary pressures.

Flaws Relating to the Balanced-Budget Requirement

Further reservations relate to the requirement of a balanced budget over the cycle. Even if it is accepted that the budget should be balanced over the cycle, there is little reason to think that the extent of the swings in the budget position will be similar across countries. What reason is there to think that a swing in the deficit to a maximum of 3 percent of GDP is relevant for all countries? Countries will differ in the extent to which their GDP varies in the course of a business cycle and in the extent to which the budget position is sensitive to the business cycle. Buti et al. (1997) found that the budget balance is negatively linked to GDP growth, but in a way which varies between countries with estimates of changes in the deficit to GDP ratio of up to 0.8 percent and 0.9 percent for the Netherlands and Spain respectively for a 1 percent slowdown in growth. The notable feature is the differences among countries.

The next question is whether there is any reason to think that a (on average) balanced budget is compatible with high levels of employment--indeed whether it is compatible with any level of employment (including the NAIRU). A well-known identity (though generally forgotten by advocates of the SGP) drawn from the national income accounts tells us that: (Private Savings minus Investment) plus (Imports minus Exports) plus (Tax Revenue minus Government Expenditure) equals zero, which is in symbols:

$$(4) \quad (S - I) + (Q - X) + (T - G) = 0$$

Individuals and firms make decisions on savings, investment, imports and exports. For any particular level of employment (and income), there is no reason to think that those decisions will lead to

$$(5) \quad (S - I) + (Q - X) = 0$$

But if they are not equal to zero, then $(G - T)$, the budget deficit, will not be equal to zero, since

$$(6) \quad (G - T) = (S - I) + (Q - X)$$

The SGP in effect assumes that any level of output and employment is consistent with a balanced budget ($G - T = 0$), and hence compatible with a combination of net private savings and the trade position summing to zero. But no satisfactory justification has been given for this view. Two possible arguments could be advanced. First, it could be argued that budget deficits cannot be run forever as the government debt to income ratio would continuously rise and that would be unsustainable. Hence governments eventually have to run balanced (on average) budgets. However, that depends on whether post tax rate of interest (on government bonds) is greater or less than the growth rate, the debt to income ratio being unsustainable in the former case but not in the latter case. Further, it relates to the size of the primary deficit, which is the deficit that excludes interest payments. It is the overall budget deficit which is targeted by the SGP, and it can be readily shown that an *average* 3 percent budget deficit and a 60 percent debt ratio are compatible and sustainable, if the rate of growth of money GDP is 5 percent (which is not an unreasonable assumption and could arise from, for example, 2½ percent inflation and 2½ percent real growth).²¹ In general a 3 percent budget deficit would be compatible with a sustainable debt ratio of $3/g$ where g is nominal growth rate.

Second, some form of Say's Law could be invoked to the effect that intended savings and investment are equal at full employment (or modified for foreign trade, domestic savings plus trade deficit equals investment). Even if Say's Law held (which we would dispute), what is required here would be that the level of private demand could sustain the supply-side equilibrium—that is the non-accelerating inflation rate of unemployment, and the NAIRU does not correspond to full employment. In particular, there is no reason to think that a balanced budget position is compatible with employment at the level given by the NAIRU.

This equality can be viewed in another way. Suppose that the condition of balanced budget is imposed; it, then, follows that:

$$(7) \quad (S - I) + (Q - X) = 0$$

If (as is likely) $S > I$, then $Q < X$. Hence a country would be required to run a trade surplus (and hence run a capital account deficit with the export of capital to other countries). A budget in balance would imply that net private savings ($S - I$) is equal to the trade surplus ($X - Q$), which in turn is equal to the capital account deficit. It can first be noted only some countries can run a trade surplus, and that must be balanced by others which run a deficit. This would then imply that some countries would have positive net private savings and others negative private savings. Countries that are able to run a trade surplus (at high levels of employment) can, in effect, export their "excess" savings, but that cannot be the case for all countries.

The imposition of an upper limit of 3 percent of GDP on the size of the budget deficit and the declaration of the aim of a balanced budget over the cycle represented a significant tightening of the fiscal position as compared with the 3 percent of GDP target for the budget deficit in the Maastricht Treaty convergence conditions. In those conditions, the 3 percent was to be achieved at a particular point in time: under the SGP the 3 percent limit is to be exceeded only under extreme conditions. Although no justification was

ever given by the European Union for the choice of 3 percent in the convergence conditions, two were advanced by others. Buiter et al (1993), for example, suggested that the choice of the 3 percent figure for the deficit to GDP ratio arose from a combination of advocacy of the so-called "golden rule" (that current expenditure should be covered by current revenue) and that "EC public investment averaged almost exactly 3 percent of EC GDP during 1974-91" (p. 63). Others have suggested that the 3 percent figure corresponded to the range of deficits run by a number of countries, notably Germany and was achievable.²² These possible justifications remind us of two points. The first is that typically governments have run budget deficits. The imposition of a balanced budget requirement represents a major departure from what governments have done in the past. The second is that governments invest, and it is generally accepted that governments can and should borrow to fund their investment programmes. The SGP imposes the requirement that governments generally fund their investment programmes from current tax revenue.

A balanced budget (on average) means, of course, that current government expenditure will be much less than tax revenue since that tax revenue would also need to cover interest payments on debt and to pay for capital expenditure. In the UK, this has been cast in terms of the so-called "golden rule" of public finance, which is taken to be that "over the economic cycle the Government will borrow only to invest and not to fund current expenditure" (Treasury, 1997, p. 1), though capital consumption (depreciation) is regarded as current spending so that it is net capital formation which can be financed by borrowing. The "public debt as a proportion of national income will be held over the economic cycle at a stable and prudent level" (p. 1). Furthermore, "The fiscal rules focus on the whole of the public sector, because the debts of any part of the public sector could ultimately fall on the taxpayer. Looking at the whole public sector also removes incentives to reclassify activities simply to evade prudent constraints on borrowing" (p. 16). Thus, the use of fiscal policy to regulate aggregate demand in the economy is much reduced, if not entirely removed, especially in the direction of stimulating the economy. It is, thus, argued that "Discretionary fiscal changes should only be made if they are demonstrably consistent with achievement of the Government's fiscal rules over the economic cycle" (Treasury, 1997, p. 16).

The general stance of the SGP with its requirement of an overall balanced budget and maximum deficit of 3 percent of GDP is a deeply flawed one. There is no reason to think that a balanced budget position is consistent with high levels of employment (or indeed with any particular level of employment). Further there is little reason to think that the 3 percent limit can permit the automatic stabilizers to work, and striving to reach the 3 percent limit in time of recession is likely to push economies further into recession. The balanced budget requirement does not allow governments to even borrow to fund capital investment projects. Further reservations include the separation of the monetary authorities from the fiscal authorities. The decentralization of the fiscal authorities inevitably makes any effective 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. A serious implication of this is that the SGP is in danger of becoming the "instability" pact. 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).

The SGP seeks to impose a "one size (of straightjacket) fits all" fiscal policy--namely that over the course of the cycle national government budgets should be in balance or slight surplus with a maximum deficit of 3 percent of GDP. It has *never* been shown (or even argued) that fiscal policy should be

uniform across countries. The SGP imposes a fiscal policy, which in the end fits nobody. For in effect there is no reason is there to think that what is in effect a single fiscal policy (balanced budget over the cycle) is appropriate for all. The April 2003 Monthly Bulletin of the ECB is, nonetheless, very explicit. It clearly, and forcibly, suggests that "the Stability and Growth Pact provides a robust and flexible framework within which any strains on public finances can be addressed and budgetary discipline is secured It remains essential that both the commitments made in the stability programmes and the requests to further improve fiscal positions, as subsequently agreed in the ECOFIN Council, be implemented in full. This will help to build confidence in the fiscal framework and anchor expectations about the future macroeconomic environment" (ECB 2003c, p. 6).²³

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.

Institutional Changes

The slowdown in economic activity in the euro area has exposed the serious fault lines in the SGP. The present policy stance would seem to be untenable in the longer term. As detailed above, for fiscal policy, the 3 percent budget deficit limit and on average balanced budget remain in place, but as countries approach the 3 percent limit in practice the limit has been relaxed, though not in all cases. Some countries now have four years to meet the balanced budget requirements with a resulting lack of clarity over the operation of the SGP. One response has been to call for some slackening of the restraints of the SGP; for example, modify the limits to permit borrowing for capital investment. Another response has been to decry the "flexibility" that has been in the interpretation of the SGP, and to seek ways of making the balanced budget requirement really bite. This would simply be a disaster, and would turn the SGP into the Instability and No Growth Pact.

The response of the ECB is worrying when they argue that "It is natural for an economic slowdown to have adverse effects on member countries' budget position. However, for countries with a budget position still not close to balance or in surplus, it is important to adhere to their medium-term consolidation plans. A short-lived slowdown should not significantly change the scope for reaching the targets set in the countries' stability programmes." Further, "as adjustment needs are likely to become more visible in periods of less vigorous economic growth, policy makers must now step up the reforms rather than allowing efforts to abate" (ECB 2001f, p. 6).

The draft of the European Convention (2003a, 2003b) does not indicate any proposals for change in the fiscal and monetary policies of the eurozone. Working Group IV in their preliminary publication begins by suggesting "the Union's economic and social objectives should be included in a new constitutional treaty" (p. 2). Indeed, "Some members of the group have emphasized the importance of including a reference to sustainable growth and productivity. Others attach more importance to highlighting full employment, social and regional cohesion, and a better balance between competition and public services in a social market economy" (p. 2). The final draft proposals stipulate that "The Union shall work for a Europe of sustainable development based on balanced economic growth, with a social market economy aiming at full employment and social progress" (European Convention, 2003a, p. 3). Furthermore, some of the members felt that the objectives of growth and development should be included in the mandate of the ECB, although "A large number of the group considers that the tasks, mandate and statute of the European Central Bank should remain unchanged, and should not be affected by any new treaty

provisions" (p. 3). Transparency and accountability of the ECB, enhancing the reporting of the ECB to the European Parliament and the publication of the ECB minutes are further recommendations. In the event, the proposals in the final EU draft constitution confirms the current objective of the ECB without further recommendations. It merely restates the previous Treaty agreements when it says that "The primary objective of the Bank shall be to maintain price stability. Without prejudice to the objective of price stability, it shall support general economic policies in the Union with a view to contributing to the achievement of the Union's objectives" (European Convention, 2003a, p. 20).

In terms of the SGP, the Working Group IV of the European Convention (2002) did not offer much of a change: "as far as the Treaty provisions on excessive deficit procedures (Article 104) are concerned, a majority of the Group wish to see these amended in order to allow the Commission to issue first warnings of excessive deficits directly to the Member State concerned. In the subsequent phases, the Council should take decisions by QMV (Qualified Majority Voting) on the basis of a Commission proposal, always excluding from voting the Member State concerned" (p. 4). The Working Group went on to suggest that "some propose that the deficit criteria should take into account structural elements, as well as the 'golden rule' on public investments" (p. 4). But in the draft constitution, the European Convention (2003b) simply reiterates existing arrangements without any serious attempt to tackle the thorny and disturbing issue of SGP. Not surprisingly, the President of the European Commission has been quoted in the Financial Times (May 29, 2003) to be unhappy with the whole exercise at a European Constitution: "It is in some respects a step backwards. Despite all the hard work we have put into this, the text that is now before us simply lacks vision and ambition" (p. 9).

Another assessment of the situation, and a set of proposals, comes from the Centre for European Reform. A recent publication (Fitoussi and Creel, 2002) suggests that, "Meanwhile, the Growth and Stability Pact is in crisis. While the European economy is grinding to a halt, euro area governments are less and less willing to comply with the strict fiscal limits of the Pact. Their attempts to evade its rules have undermined the Pact's credibility. There can now be no doubt that a thorough overhaul is necessary For the European policy mix, this "liberation" of fiscal policy would be a breath of fresh air. It would ease the constant pressure on the ECB to adopt a more active style of macro-economic management, and remove many of the constraints that are currently inhibiting economic policy co-ordination in the EU" (p. 68). The UK Treasury has recently published a set of proposals to reform EMU fiscal policy. Treasury (2003) proposes to endow fiscal policy with a stabilization objective along with a trigger point for discretionary action. This would be a rule whereby discretionary fiscal policy is undertaken when the output gap exceeded a certain percentage of GDP, or when expected inflation deviates from the target. Credibility and transparency would be ensured through the publication of a "stabilization report" along the lines of the current "inflation report" of the Bank of England. However pertinent this proposal may be, it does not tackle the serious constraint of the SGP and the 3 percent ceiling on fiscal deficit.

Svensson (2003) calls for the ECB to modify its monetary-policy strategy in the manner of some other central banks. It is, thus, argued that the ECB should abandon completely the two-pillar strategy and "just adopt the much superior international-best-practice strategy of flexible inflation strategy, as it is demonstrated by the Reserve Bank of New Zealand, the Bank of England, the Riksbank and the Bank of Norway" (p. 5). The "clarification" arguments rehearsed above may very well constitute an attempt towards this objective, although by no means does it address entirely the Svensson (2003) recommendation. The problem with this particular proposal is whether the premise of its argument is acceptable. It is rather debatable whether the "international-best-practice strategy" is represented by flexible inflation targeting (European Convention, 2002). Ball and Sheridan (2003) provide evidence that

suggests that this need not be the case. They conclude that there is "no evidence that inflation targeting improves a country's economic performance" (p. 29).

Some of these proposals, especially the one by Fitoussi and Creel (2002), do open the way to improve the institutional set-up of the euro area, but they are incomplete in a serious sense. Although they begin to address the issue of institutional revisions, they do not go far enough to cure the fundamental problem of inherent deflationary bias in the current institutional system. The problems identified above with the operation and management of the ECB remain, save for attempts at accountability and transparency. The objectives of the ECB, and, thus, the deflationary bias in its operation remain intact. Similarly, in the case of the SGP, the stance taken is to essentially accept the current arrangements, other than making the point of "budgetary and financial coordination of the Member States with the objective of monetary stability as a basis for sound economic growth is of utmost common concern" (p. 4). It is essentially the failure of the European Convention to address the issue of the deflationary bias of the euro area institutional arrangements where we find its recommendations incomplete.

Our own response is to call for the abolition of the Stability and Growth Pact in anything like its present form. In other words, we call for the removal of the artificial limits on budget deficits and stop seeking to impose a "one size fits all" policy on all countries. A substantial EU budget (of the order of 5 percent or more of GDP), which could be used to provide fiscal stimulus (as recommended in the MacDougall report, 1977) with co-coordinated national fiscal policies, would be a good way of addressing problems of low demand in the euro area. But in the absence of a significant EU budget capable of providing automatic stabilisers and stimulating the EU economies, active fiscal policy must remain in the hands of national governments.²⁴

It is often argued that the budget position of each country has to be restrained for there are in effect externalities or spillover effects. This sometimes takes the form that a national government's spending puts upward pressure on interest rates (more specifically on bond rates) that is perceived to raise the cost of borrowing for other governments. It can take the form that government expenditure pushes up demand, which pushes up inflation at least in the country concerned. This may then spill over into other countries and/or lead the ECB to raise interest rates to damp down inflation. Without accepting that government expenditure would have these effects, we would observe that the expansion of private sector expenditure could be expected to have similar effects to those of public expenditure. The fluctuations in the overall level of expenditure come in practice predominantly from fluctuations in private expenditure and particularly investment. The logic of imposing limits on public sector expenditure (budget deficit) would also apply to imposing limits on private sector expenditure. Perhaps there should be limits on the size of the private sector deficit or on the trade account!

The objectives and mode of operation of the ECB must also be changed. The objectives of the ECB should conspicuously include growth and employment variables, and not merely inflation. 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. Further, EMU institutional arrangements are required for the operation of an EMU fiscal policy, and to ensure that monetary authorities do not dominate economic policymaking; serious co-ordination of monetary and fiscal policies is paramount, just as the European Convention suggests, but it would have to go hand-in-hand with the other changes to which we have just alluded. These are important institutional changes. In terms of economic policy

further changes are required.

Economic Policy Changes

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 euro area, 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" for 2002 are -0.8 percent, that is actual output is slightly below potential output; yet this is combined with over 8.2 percent unemployment. In a similar vein, the OECD's estimates of the Non Accelerating Wage Rate of Unemployment (NAWRU) average of 8.1 percent for the European Union, is again close to the actual experience of 8.25 percent.²⁵ Interpreting the NAWRU as an indicator of a capacity constraint, suggests capacity problems.²⁶ 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 euro area 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 euro area 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 euro area 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.

The achievement of high levels of economic activity without inflationary pressures then requires three 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 decentralized and fragmented basis, even where it is (or has been) centralized 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 centralized institutional arrangements, which have been conducive to relatively low inflation: for example Austria, Germany, Norway, and Sweden.²⁷

Second, in addition to the construction of the relevant institutional arrangements discussed so far, 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, the present disparities in regional unemployment levels (and also in labor 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 labor 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 EMU model. 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. They are overtly deflationary. We have proposed a number of changes that would include the following elements. First, any political constraints on national budget positions should be removed, and national governments set fiscal policy, as they deem appropriate. Second, institutional arrangements for the co-ordination of national fiscal policies be strengthened. Third, 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. Fourth, serious co-ordination of monetary and fiscal policies is paramount. Above all, though, the current mix of fiscal and monetary tightening along with currency appreciation, cannot deliver a healthy macroeconomic landscape. Especially so, in an environment that is geared to stagnation,²⁸ not to say deflation in some of its major economies (Germany and France).²⁹

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Table 1A: REAL GDP GROWTH RATES																		
Year	1999				2000				2001				2002				GDP FORECASTS	
Quarter	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	2003	2004
EURO AREA	1.7	1.8	2.6	3.3	3.5	3.7	3.2	2.8	2.5	1.6	1.3	0.5	0.3	0.7	0.8	0.7	1.0	2.3
U.S.	4.0	3.9	4.2	4.3	4.2	4.9	3.7	2.3	1.5	-0.1	-0.4	0.1	1.4	2.2	3.3	2.9	3.4	3.6
BRITAIN	2.2	1.9	2.4	3.2	3.4	3.6	3.0	2.3	2.6	2.0	1.9	1.9	1.2	1.6	2.2	2.2	2.2	2.6

NOTES: 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.

SOURCES: EURO AREA - ECB Monthly Bulletin, various issues.
U.S. - Bureau of Labor Statistics (CPI and Unemployment, April 2003)
U.S. - Bureau of Economic Analysis (GDP, March 2003)
UK - National Statistics (March 2003)

FORECASTS - European Commission Spring Forecasts (2003) for the EURO AREA and the UK. The Economic Report of the President for the U.S. (February, 2003) for the U.S. Inflation is defined as the overall Harmonised Index of Consumer Prices (HICP) for the EURO AREA and the UK;
Consumer Price Index (CPI) for the U.S.

Table 1B: INFLATION RATES																		
Year	1999				2000				2001				2002				INFLATION FORECASTS	
Quarter	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	2003	2004
EURO AREA	0.8	1.0	1.1	1.5	2.1	2.1	2.5	2.7	2.6	3.2	2.7	2.2	2.6	2.1	2.0	2.3	2.1	1.7
U.S.	1.7	2.1	2.4	2.6	3.2	3.3	3.5	3.4	3.4	3.4	2.7	1.9	1.3	1.3	1.6	2.2	2.0	2.1
BRITAIN	1.0	1.5	1.3	1.2	0.8	0.6	0.9	1.0	0.9	1.5	1.5	1.0	1.6	1.0	1.0	1.5	1.9	1.8

SOURCES: As in Table 1A.

Table 1C: UNEMPLOYMENT RATES																		
Year	1999				2000				2001				2002				UNEMPLOYMENT FORECASTS	
Quarter	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	2003	2004
EURO AREA	10.3	10.1	10.0	9.7	9.5	9.2	9.0	8.6	8.5	8.4	8.4	8.0	8.1	8.2	8.3	8.5	8.8	8.8
U.S.	4.3	4.3	4.2	4.0	4.0	4.0	4.0	4.0	4.2	4.5	4.8	5.6	5.6	5.8	5.8	5.9	5.7	5.5
BRITAIN	6.3	6.1	6.0	5.9	5.9	5.6	5.5	5.3	5.2	5.1	5.2	5.3	5.2	5.2	5.4	5.2	5.1	5.1
SOURCES: As in Table 1A.																		

NOTES

1. More details on the euro area theoretical framework may be found in Duisenberg (1999), Issing (2003), Arestis, Brown and Sawyer (2001), Tsakalotos (2001), Bibow (2003), to mention only but a few relevant examples. Our approach extends that in Arestis, Brown and Sawyer (op. cit.).
2. Issing (2003) puts it in the following way: "Widespread consensus: even low inflation entails significant costs." This statement should be judged against evidence provided by Ghosh and Phillips (1998), where a large panel set that covers IMF countries over the period 1960-96 is utilized, to conclude that "there are two important nonlinearities in the inflation-growth relationship. At very low inflation rates (around 2-3 percent a year, or lower), inflation and growth are positively correlated. Otherwise, inflation and growth are negatively correlated, but the relationship is convex, so that the decline in growth associated with an increase from 10 percent to 20 percent inflation is much larger than that associated with moving from 40 percent to 50 percent inflation" (p. 674). However, the point at which the nonlinearity changes from positive to negative is thought to deserve a great deal more research. The statement of Issing (2003) should also be judged in terms of statements like "there is an optimal rate of inflation, greater than zero. So ruthless pursuit of price stability harms economic growth and well-being. Research even questions whether targeting price stability reduces the trade-off between inflation and unemployment" (Stiglitz, 2003).
3. See Forder (2000) for an extensive discussion and critique of the notion of credibility.
4. The March 2003 issue of the ECB's Monthly Bulletin puts it as follows: "the outlook for the euro area economy could be significantly improved if governments strengthen their efforts to implement structural reforms in labour and product markets. Such reforms are important to ultimately raise the euro area's production potential, improve the flexibility of the economy and make the euro area more resilient to external shocks" (ECB 2003b, p. 6). A point repeated in the April 2003 issue of the Monthly Bulletin (ECB, 2003c, p. 6).
5. Our own empirical work (Arestis, Biefang-Frisancho Mariscal, Brown and Sawyer, 2003) suggests that the demand for money differs between the component countries of the EMU and that the demand for money is unstable in a number of those countries.
6. Forecasts from European Commission Spring Forecasts 2003.
7. For more details on the EMU institutional macroeconomic framework, see, for example, ECB (1999, 2001b, 2003a, pp. 37-49).
8. It can, though, be noted that the inflation rate in the eurozone has generally been above the 2 percent level.
9. The ECB Vice President made similar noises at a conference in Vienna on June 13, 2003. He put it this way: "We have repeatedly stressed that there is no risk of deflation in the euro region as a whole--or in other words, if there is risk, it is judged to be weak" (reported in New York Times, June 13, 2003, p. W7).
10. It is for this reason that the ECB "decided to discontinue the practice of conducting the review of the reference value for M3 on an annual basis" (ECB, 2003d, p. 5).
11. The ECB has recently stressed this argument when it states that what the

- cross-checking implies is that its Editorial "will first present the economic analysis, which identifies short to medium-term risks to price stability, and then turns to the monetary analyses, which assess medium to long-term trends in inflation. It will conclude by cross-checking the analyses conducted under these two pillars" (ECB, 2003d, p. 5)
12. In the year to May 2003, the highest annual rates were recorded in Ireland (3.9 percent), Portugal (3.7 percent) and Greece (3.5 percent); the lowest rates were observed in Germany (0.6 percent), Belgium and Austria (both 0.9 percent). Thus there was a near 3 percent differential between the three countries with highest inflation and the three with the lowest inflation.
 13. See, also, Arestis and Sawyer (2002b) and Kuttner and Mosser (2002).
 14. In the June Monthly Bulletin (ECB, 2001e), the picture changed to one that suggested, "Real GDP growth in the euro area in 2001 is expected to come down from the high level reached in 2000 primarily as a result of the less favourable external environment" (p. 5). However, "the contribution to real GDP growth from domestic demand is expected to remain robust. This is consistent with the favourable economic fundamentals of the euro area" (p. 5). The November 2001 Monthly Bulletin (ECB 2001g), reverts to "The conditions exist for a recovery to take place in the course of 2002 and economic growth to return to a more satisfactory path. The economic fundamentals of the euro area are sound and there are no major imbalances which would require prolonged adjustment. The uncertainty currently overshadowing the world economy should diminish over time" (p. 6). This ought to be contrasted to the Bank of International Settlement (BIS) Annual Report (2002) statement that "On balance, it seems that the synchronized downturn in 2001 mainly represented the effects of common shocks, reinforced by the high trade intensity of the demand components most severely affected" (p. 16).
 15. The euro exchange rate jumped to \$1.1506 against the dollar. It had been at \$1.1360 against the dollar ahead of the ECB's decision.
 16. The Governing Council comprises 18 members as follows: there are six policymakers 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.
 17. In the same paper, Meade and Sheets (2001) provide evidence that enables them to conclude that in the case of the U.S. 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.
 18. The U.S. also had fiscal stimulus first from the Bush tax cuts of mid-2001 and then the increased expenditure on security measures in the aftermath of September 11th.
 19. The Financial Times (Wednesday October 9, 2002) explained that dollar rise as "traders expressing disappointment at the outlook for euro area growth"; this was essentially due to "Comments by the president of the European Central Bank" which "dampened tentative hopes that the ECB had been braced to support growth with a cut in interest rates."
 20. On January 30, 2002, the European Commission issued for the first time a recommendation with a view to giving an early warning to Germany and Portugal

- in an attempt to avoid excessive budgetary deficits. On February 12, 2002, ECOFIN decided to abrogate the early warning in view of the commitment by Germany and Portugal to take action to avoid the occurrence of an excessive deficit.
21. The general formulation is $d = b/g$ where b is budget ratio, d debt ratio and g the rate of nominal growth.
 22. In the decade up to 1992 the German general government financial balance averaged 1.8 percent deficit, and the Euro area as a whole averaged 4.45 percent deficit (calculated from OECD *Economic Outlook*, various issues).
 23. A further disturbing, and highly objectionable implication of the monolithic focus on price stability and on the 3 percent SGP rule, is the manner in which it is thought appropriate "to address the fiscal challenges of population age" (ECB, 2003c, p. 46). The ECB (2003c) paper warns actually that free health care, as for example in many euro area countries, will have to be restricted to emergency services only. This is so in view of the high and rising "ratio between the number of pensioners and the number of contributors"; for "otherwise the cost would overwhelm economies and lead to rising inflation" (p. 39). Although the report recognizes that raising the retirement age should produce large gains, funded-pension arrangements are thought to carry potentially larger benefits for economic growth. These relate to the beneficial effects on the labor market (social security contributions would thereby be perceived as savings for retirement rather than as taxes) and capital market (higher capital accumulation of capital). This absurd suggestion is not unrelated, of course, to the SGP ideas, to which we have objected vehemently in this study.
 24. An interesting case was made by Joseph Stiglitz in the Guardian (May 8, 2003) under the title "Don't trust the bankers' homilies: the EU stability pact destabilizes by cutting spending in a downturn," that "The lesson for Europe is clear: the EU should redefine the stability pact in terms of the structural or full employment deficit--what the fiscal deficit would be if the economy were performing at full employment. To do otherwise is irresponsible."
 25. The figures in this and the preceding sentence derived from OECD (2003) databank.
 26. In this context it is worth quoting the ECB Chief Economist, who suggested at a press conference in Berlin on April 16, 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*, April 18, 2002).
 27. The idea of a state-funded "buffer fund" to stabilize employment in cases of difficulties is a relevant suggestion. The trade union movement in Sweden has proposed this idea, recently. Finland has already been operating 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.
 28. Interestingly enough, the OECD (2003) cut sharply its forecasts for the euro area growth for 2003 (from 1.8 percent in its December 2002 forecasts to 1.0 percent in its April 2003 forecasts), and for 2004 (from 2.7 percent in its December 2002 forecasts to 2.4 percent in its April forecasts). This while trimming its forecasts for the U.S. in 2003 only to 2.5 percent in its April 2003 forecasts (from 2.6 percent in its December 2002 forecasts) and raising expected GDP growth for 2004 to 4

- percent in its April 2003 forecasts (from 3.6 percent in its December 2002 forecasts).
29. A relevant table published in *The Economist* (May 3, 2003, p. 70) clearly indicates that forecasts for core inflation (inflation that excludes energy, food and tobacco) for the period March, 2003 to June, 2004, portray Germany moving into deflation with France being on the margin.