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1

Introduction

Economic and monetary union (EMU) in Europe is a bold and unprecedented development. Although it has long been seen as an obvious extension of the market integration that began in the 1950s, EMU goes significantly further than regional economic arrangements elsewhere in the world by changing the topography of macroeconomic policy-making. Clearly, too, it is more than just the integration of national currencies, encompassing other policy areas that it is not customary to analyse in looking at monetary integration from the perspective purely of creating a common currency. This has profound implications for the processes of economic adjustment. It also raises the question of what the eventual character of economic governance in the European Union (EU) will be, with options ranging from minor tinkering with the present set up to a fully federal system.

Since the pioneering work of Mundell (1961) on optimal currency areas (OCAs), monetary union has had to rise to a relatively simple challenge: Will welfare be enhanced by merging the currencies of the participating nations? So long as the balance of the various criteria – degree of factor mobility, openness, flexibility and so on – is adjudged to be positive, the union is deemed to be worthwhile. Implicit in this way of assessing a proposal for monetary union is the expectation that the mechanisms that allow a national economy to adjust to problems will be replicated in the unified currency area. Critics of EMU such as Feldstein (1997) have stressed that, in practice, EMU lacks most of the adjustment mechanisms on which countries rely and is consequently misconceived. Others (for a good introduction, see De Grauwe, 2003) are more sanguine, believing that once account is taken of the full range of effects, the balance of costs and benefits is positive.

In this volume, we aim to move beyond the cost-benefit calculus and the well-worn question of whether or not countries should join. Instead we ask whether EMU as currently constituted is suitably equipped to allow economic adjustment to shocks – symmetric as well as asymmetric – to take place in a timely and effective manner, and how the policy framework needs to evolve to ensure that it does. Adjusting to EMU and adjusting an
economy within EMU involves a dynamic process where prior circumstances and actions in the preceding period have major effects. Since adjustment involves the interaction of people and institutions within a framework of rules that are themselves being developed, its path is only partially predictable from previous experience.

We therefore try to disentangle these different aspects, which can be placed in four groups:

1. How countries' adjustment is influenced by their structures, institutions and conditions.
2. How the rules of EMU have influenced the adjustment process and how institutions and other actors have responded to those rules.
3. How the short-run policy choices over the few years before and since EMU started have affected adjustment in the face of world economic developments over the period.
4. How the rules themselves have adjusted, in the light of experience and as EMU has proceeded.

While monetary union had a fixed starting date and rules of implementation that had been largely developed beforehand, the 'economic' side of EMU has been very much a work in progress, where the plans are much less clearly written. It is not clear when EMU might be ‘completed’, nor indeed what the concept of completion means in this context. The Lisbon Strategy aimed at revitalising the supply-side of the EU economy set an arbitrary target of 2010 for many of its key variables, but given issues over debt, pensions and structural unemployment, to say nothing of the continuing quest to 'complete the internal market', a longer and somewhat indeterminate process seems a suitable framework for the discussion.

That EMU changes the economic environment is generally accepted and there is broad agreement on several of its expected effects. Equally, there are possible outcomes where neither theory nor evidence provides a solid basis for judgement and no easy way of reconciling the conflicting views. Indeed, despite the large body of research in the OCA tradition and extensive analysis of fiscal and monetary rules as applied to EMU as a macroeconomic framework, the early years of the euro have exhibited a consistent capacity to surprise.

Economic and monetary union not only changes the assignment of competence for monetary policy, but also radically alters the overall system of economic governance in the EU. This may appear to be a statement of the obvious, yet its ramifications are rarely well understood. First, it means that it is a fundamentally flawed conception to view the advent of EMU as little more than a largely technocratic replication of the mechanisms of economic policy employed by Member States at the supranational level, with the latter acting as a quasi-state. Second, it means that when economic
adjustment is required, different policy levers have to be pulled and their effects may differ from those that applied for Member States. Certain levers of policy that governments have relied on will lose their effectiveness, while others will need to evolve to play a more extensive role in economic management. Third, economic actors have to adapt to new signals and reaction functions, and may have to go through an extended period of learning and assimilation.

The game, in short, is a different one, played under rules that differ from those to which all sides are accustomed. For countries that participate fully in EMU, the changes may be quite pronounced, especially if the new policy context encompasses features that are far removed from what they are used to. For instance, permanently low inflation is virtually guaranteed by the mandate given to the European Central Bank (ECB) and for many countries this will be a novel experience.

1.1 Outline of the policy framework

The new policy framework in the euro area is complex and, arguably, can be properly appreciated only by viewing it as a very profound regime change (Allsopp, 2002), thereby undermining much of the analysis of its prospects rooted overly narrowly in OCA approaches. It follows that the mechanisms for managing the economy and responding to shocks also have to evolve.

The architecture of demand-side policies under EMU is clear. Monetary policy is assigned the primary task of assuring price stability, leaving fiscal policy and supply-side policies – which remain under the jurisdiction of national governments – to deal with country-specific macroeconomic problems. The approach to policy combines some rule-based procedures with much ‘softer’ modes of decision-making. For monetary policy, the over-arching rule is the target of price stability which has – so far – been defined operationally by the ECB as a medium-term value for the annual increases in the harmonised index of consumer prices (HICP) of less than but ‘close to’ 2%. The ECB has adopted a two-pillar strategy (see Issing et al., 2001; ECB, 2004) in which one pillar is a reference value for growth of the money supply (M3), so far of 4.5% a year. But the apparent clarity of the rules is complicated by the other pillar which involves the ECB looking at a range of other economic indicators such as the interplay of supply and demand in the goods, services and factors markets to gauge the trajectory of the economy over the short to medium term. The monetary analysis relates more to the longer-term prospects for inflation and the ‘economic’ analysis more to the shorter (ECB, 2004: 65–6).

Fiscal policy is constrained by the Stability and Growth Pact (SGP), which aims to set a limit of 3% of GDP for the public deficit and initially had a medium-term target of ‘close to balance or in surplus’ and escalating sanctions to assure compliance. Despite the disarray in the SGP after 2002, leading up to its de facto suspension in November 2003, the reforms agreed in March 2005 broadly retain the 3% limit, though in future the terms on which
countries can breach it will be interpreted more flexibly. The rationale for fiscal policy rules is that there are spillover effects amongst decentralised governments in an economically and financially integrated area. Indeed, the spillover arguments appear to have inspired the rules in the Maastricht Treaty and been carried forward into the SGP. The logic is that due to market integration, ‘excessive’ public deficits in one country will have adverse effects on others through higher interest rates, threats of higher future inflation and so on in a way similar to pollution or any other external effect. Examples are common trends in long-term interest on public debts in federations and, since the inception of monetary union in Europe, the observed trends in, and the narrow band of risk premia on, European governments’ debts.

These rules mean that if a country has to deal with more severe economic shocks, it may be unable to do so through demand management while abiding by the terms of the SGP. The Pact has an in-built asymmetry in that it sets limits to national deficits, but imposes no rules on public surpluses. There is, therefore, a co-ordination issue to resolve if the aggregate fiscal policy of the euro area is to be consistent with monetary policy. Moreover, policy co-ordination cannot be seen purely in terms of optimising the conventional policy mix between fiscal and monetary policy, but must also embrace supply-side policies, especially those that bear on the labour market given the political compromise between national and European Council competence.

Agreeing on the virtues of rules to constrain national policies in a multilevel government setting leaves open the question of the nature and content of the rules, and it is by no means obvious that the current institutional mix is optimal (Holzmann, 1996; Creel et al., 2002). Nevertheless, although rules may not fully resolve fiscal policy co-ordination problems in the euro area, there is little doubt that rules are needed to prevent governments from engaging in policies that would be detrimental for the union as a whole.

1.2 Adjustment challenges

As the UK Treasury has shown in its ‘5 tests’ report (HM Treasury, 2003i), there are diverse obstacles to the elaboration of adjustment policies and very disparate strategies can be envisaged. Problems to be confronted not only vary between economies, but are also dependent on the institutional framework and conventions in the Member State, for example in housing finance. As a result, susceptibility to shocks are different, as are the respective roles of the various tiers of government in dealing with the consequences of integration. There are both economic and constitutional dimensions to these issues and it is clear that policy choices have to take account of legal frameworks.

The degree of flexibility any economy exhibits, and thus its capacity to adjust under EMU, will depend, first, on the structure of the labour market and its institutions. This includes not just the bargaining systems in place in the labour market, but also the responsiveness of product markets and the relationship between labour market outcomes and budgetary decisions.
There is very considerable variety across the EU in this regard, and it is for this reason that the present volume assesses a range of national circumstances. Thus, the Nordic ‘model’ of consensus building and centralised bargaining provides a clear contrast to the more flexible and decentralised system of the UK, and to the more regulated systems of, for instance, France and Germany.

In thinking about the impact of EMU and how it bears on economic adjustment, three general questions arise. First, are stabilisation and growth likely to be at odds with each other for any country that participates fully in EMU? In the right circumstances no such conflict should arise, but it may be a matter of timing: the medium- to longer-term benefits of stabilisation may be uncontested, but if rapid transition is very costly, it is conceivable that the short-term costs may be so great as to make the long-term benefits politically unattainable. Second, if EMU delivers its promise of higher growth in the medium to long term, will it benefit the richer parts of the Union at the expense of the poorer? In similar vein, will the advantages within countries be evenly spread or unbalanced? Third is the particular institutional form of EMU suitably configured to facilitate Member States in adjusting their economies, bearing in mind the diversity in their national institutional structures and policy traditions? In this volume, we explore all three dimensions, drawing on the experience and singularities of different Member States.

1.2.1 Stabilisation effects

There is little dissent from the view that there are long-run benefits to be realised from the enhanced stability that EMU is expected to deliver. Instead, the issues surrounding stabilisation are more about the short- to medium-term effects. The expected gains in stabilisation come about because full participation in EMU immediately confers on the country that joins commitment and credibility benefits that it would otherwise find it very difficult to achieve. It is generally accepted that these gains will have to be paid for in the transition to EMU and possibly beyond. The argument about transition costs is straightforward, if empirically contentious. Countries with inflation rates or fiscal ratios above the Maastricht thresholds have had to rein back the economy to attain the required macroeconomic balance and, in so doing, may have lost output growth. The extent of any output loss will depend on a range of influences, such as the magnitude of the adjustment that had to be made, the sequencing of different stages, and whether the main fiscal retrenchment took place in a generally buoyant or stagnating economic environment (both internally and among key trading partners). The degree of internal conflict associated with fiscal consolidation, such as resistance to public expenditure cuts is also an issue.

Certainly, countries that had to travel a long way to achieve nominal convergence had to forgo more growth to attain a stabilised economy than those which only needed to make minor adjustments. Joining EMU prematurely – an issue that the new members who joined the EU in 2004
will have to confront soon – could necessitate the over-riding of other macroeconomic policies while at the same time slowing structural reforms, with heavy costs in terms of output foregone. However, if the pursuit of EMU constitutes a shift from ‘bad’ to ‘good’ policy, then the process may well be unambiguously beneficial. A question to pose is, therefore, whether the pre-EMU policy regime was one that favoured growth or, instead, had had a debilitating effect. For example, the Greek economy appeared to pick-up from the mid-1990s onwards as the macroeconomic excesses of the previous decade were replaced by more sensible policies. Ireland, too, rapidly saw benefits as the large deficits and high debt of the decade before were brought under control from the late 1980s onwards. Indeed, the transformation of Irish macroeconomic policy in the late 1980s is regarded as one of the foundations of that country’s subsequent spectacular growth (Barry, 1999).

By contrast, both the French and the Italian economies seemed to lose dynamism during the 1980s and 1990s, first through targeting the exchange rate in order to stay in the exchange rate mechanism (ERM) of the EMS, then in making the further adjustment to EMU. It is, perhaps, salient that the small open economies have, on the whole, found it easier to adjust than their larger peers. EMU can also act as an external benchmark cum incentive for policy improvement and there is evidence that it contributed to the recasting of policy in Greece (with results that can be regarded as positive for growth) and Italy (though with, thus far, less encouraging outcomes).

Once in EMU, a country has to adapt to a policy regime that is radically different. In particular, it has to recognise that the ECB will deliver price stability and that resort to inflation as an adjustment mechanism, or to calling on the central bank to print money to finance expenditure are no longer options. Adjustment to shocks, symmetric or asymmetric, will require the creation of room for manoeuvre in fiscal policy, as well as obliging the supply-side to assume a greater share of any burden. Consequently, the fiscal authorities will have to adapt and labour market actors have to recognise that monetary policy can no longer accommodate inflationary pay deals.

1.2.2 Inter-territorial disparities

Even if EMU does fulfil the expectation of its supporters that it will facilitate stable growth in the EU as a whole, there is no guarantee that the resulting growth will be balanced, whether among Member States or regions. Yet there is by no means a consensus in the literature on how the furthering of economic integration by monetary union will affect disparities. In the Delors report (Commission, 1989: paragraph 29) that paved the way for the euro, the fear was expressed that ‘historical experience suggests, however, that in the absence of countervailing policies, the overall impact on peripheral regions could be negative’. This statement echoed concerns expressed in the Padoa-Schioppa report (1987) and led directly to the acceptance that there should be some sort of compensatory policy to assure cohesion. The thrust
of much of the new economic geography analysis as applied to EMU is that integration will favour core areas at the expense of the periphery through the mechanism of increased trade flows. The evidence on trade creation is indeed that monetary union does give it a sizeable fillip (Rose, 2001, 2004; see also HM Treasury, 2003i), so that the location of activity is affected. But whether it is necessarily to the benefit of core areas will be the result of a balancing of different effects (succinctly summarised in Krugman, 1998) which can only sensibly be assessed empirically.

An alternative view is that EMU will provide a stimulus to the less competitive countries and regions that will enable them to make a leap forward (Barry, 2003), the implication being that separate currencies have acted as a barrier to economic development. Possible explanations for such advances include the overcoming of inhibitions on factor movements that have prevented the optimal allocation of resources, especially investment flows, and the negative effects of markets fragmented in a way that has slowed innovation and the exploitation of economies of scale. The ‘Sapir’ report notes that ‘growth may have a negative effect on cohesion if market forces lead to a widening of the income gaps between regions or between individuals. In the case of economic convergence between regions, there is little evidence of such effects and, on the contrary, lagging regions have provided a boost to overall EU growth’ (Sapir et al., 2004: 88). The same report also states that although redistributive policies have helped to assure social cohesion, they may have done so ‘at the expense of lower incentives for growth’ (Sapir et al., 2004: 89). The inference to draw is, perhaps, that EMU provides a new setting, but that its impact on convergence will depend on the detailed choices made on institutional matters and on supporting policies, rather than there being an unambiguous overall impact of monetary union.

1.2.3 Institutional factors

In contrast to the proposals in the Werner report (1970) for a common fiscal policy as a complement to European monetary integration, the path chosen for EMU leaves economic (as opposed to monetary) policy under the control of Member States. However, if policy anarchy is to be avoided, some form of concertation of these national policies is required. The Delors report (Commission, 1989) that constituted the blueprint for EMU stressed that co-ordination is an essential part of the policy framework, precisely because the choice taken was not to introduce a common policy.

The EMU policy regime combines a specific philosophy of economic policy, a novel distribution of responsibility between the national and the supranational levels of economic governance and a reconfiguration of policy instruments and targets. It is easy to forget just how profound the change is. In addition, because of political imperatives that have resulted in a delicate balance of power between Member States and the supranational level, EMU has also had to establish means of co-ordinating a range of national policies. Although co-ordination is explicitly called for in the Treaty (notably in Article
98 EC, given force in Article 99), it comprises a mix of different approaches. Even for fiscal policy, there is a combination of hard law aimed at curbing excessive deficits (adopted for the Stability and Growth Pact) and the much softer provisions for multilateral surveillance and the Broad Economic Policy Guidelines (BEPGs). Amtenbrink and de Haan (2003) suggest the former is a ‘closed’ method of co-ordination in contrast to the ‘open’ method employed for the latter. However, the politicised nature of the sanctioning process in the excessive deficit procedure – a key element of the SGP – and the uncertainty which exists over measuring compliance with the SGP give considerable discretion to Member States over the application of EMU’s fiscal rules, thus rendering economic policy co-ordination in the euro area primarily soft in character.

A key question is whether what might be called the Artis-Buti policy framework goes far enough in assigning policy roles. In this conceptualisation – to simplify greatly – the role of monetary policy (and thus the ECB) is to deal with system-wide economic effects – including symmetric shocks – while national autonomy (fiscal and supply-side policies) is retained to deal with effects specific to the Member State – notably asymmetric shocks. At the same time, fiscal and supply-side policies have to be aggregated in a manner that is consistent with supranationally set monetary policy. The challenge for economic policy is to combine these three sets of policies (central monetary, national fiscal, and national and EU-level supply side) into a coherent policy mix.

The difficulty with this framework is that it departs significantly from what is customary within nation-states as currency areas, where there is, typically, also fiscal union. In a fiscal and monetary union, an asymmetric shock hitting a region of the union will be substantially attenuated by net fiscal flows from the centre, predominantly through the operation of automatic stabilisers (see Bayoumi and Masson, 1995; Obstfeld and Peri, 1998; Melitz and Zumer, 2002). The EU budget simply cannot fulfil this function and, although national budgets do provide a substantial degree of stabilisation that diminishes the problem when it manifests itself at the regional level, there remains a gap in the policy framework when it is a whole country that is affected asymmetrically. Finland, for example, suffered a sharp recession in the early 1990s that was largely unrelated to trends elsewhere in the EU.

1.2.4 The constitutional dimension

Economic policy-making is, however, also hemmed-in by legal constraints. The policy/law dynamic is complex in the Community, because policy implementation occurs through a system of multi-level governance where Community rules are generated at the supranational level, yet are mediated through national and sub-national levels of governance. As EMU is consolidated, this interplay of tiers of government and governance raises a number of issues at the EC and national levels.
First, does the Community have the legal competence to develop general economic policies in addition to its powers over monetary policy? While Article 99 TEC clearly signals the ‘common interest’ in economic policies more generally and requires the Commission and the Council to develop broad guidelines on economic policy, it does not specify how policy is to be pursued. Since the Treaty also stresses the principle of subsidiarity, this leaves open the question of where the boundaries between Community and national policy should lie.

Second, once competence at the Community level is established, how can policy be implemented at the national level? Although legal systems form part of a single social system of law, the jurisdictional differences that exist between the national and EC orders mean that EC law is both internal and external to each national legal order (Maher, 1998). As such, successful integration into the domestic legal order turns in part on the ‘fit’ between the new Community rule and the existing legal order (Teubner, 1998). If legislation emanating from the Community is confluent with the Member State preferences, it will tend to be assimilated fairly easily, whereas if it requires significant changes in procedures or practices, implementation tends to be much more problematic. Some of the disputes over the Lisbon agenda illustrate the difficulties, with, for example, certain Member States happy to press ahead with liberalisation of network industries and financial services, while others drag their heels.

Third, can a system in which hard law and soft law are inter-mingled be simultaneously robust, flexible and effective? Abbott and Snidal (2000) explain some of the strengths and weaknesses of the hard and soft approaches and many of the points they highlight are exemplified in the EMU setting, not least in the difficulties surrounding the Stability and Growth Pact in 2003. Can formal sanctions be effective, or is it only softer, more political pressures that will induce Member States to change tack?

In short, the relationship between legal rules at the Community and the national level, notably in relation to questions of implementation, is important in establishing the extent to which the policy environment can and will change in the euro area and beyond. It is also essential to distinguish between the formal institutional and regulatory structures and the actual behaviour that occurs: ostensibly harsher regimes may, for example, be characterised by evasion in contrast to apparently softer regimes.

1.2.5 The Stability and Growth Pact

In many ways, the experience of the implementation of the SGP exemplifies the constitutional challenges. The relatively favourable macroeconomic environment of the first two years of the euro and the previous efforts made by many governments to reduce public deficits and debts before entering monetary union, meant that the deficit ceiling in the SGP did not prove excessively binding until 2002. As a result, the fault-lines that subsequently surfaced in the operation of the Pact (Begg and Schelkle, 2004a) remained largely hidden, although it is worth noting that many prominent economists
Adjusting to EMU

had foreseen some of the difficulties. One of the most visible problems is the SGP’s pro-cyclical bias which aggravates business cycle fluctuations and had already become apparent in the decade prior to the launch of monetary union (Fitoussi, 2000). In the good times, several governments (especially the two largest Member States, France and Germany) relaxed their efforts to reduce deficits, preferring to increase expenditures and cut taxes at a time of buoyant economic activity. By 2003, these same governments were under pressure to implement more restrictive fiscal policies at a time of slow growth or even recession.

In November 2003, the SGP was effectively suspended when the Council refused to accept Commission recommendations regarding excessive deficit in France and Germany. The Commission then asked the European Court of Justice to rule on the legality of the Council decision, and the Court provided its answer in July 2004, ruling that the Council was wrong, but also clarifying the procedures (see Chapter 4 for more detail). Implicitly, all parties then accepted that the SGP had to be changed and agreement on a way forward was then reached – not without acrimony – in March 2005.

Amtenbrink and de Haan (2003: 1077) note that calls for reform of the SGP were partly motivated by the quest for a combination of ‘long-run sustainability of fiscal policy with short-run fiscal flexibility as a tool for macroeconomic stabilisation’. Solutions may involve changing the rule and moving to a ceiling in terms of a cyclically adjusted public deficit, that is a structural budget deficit (see, for instance, Creel and Sterdyniak, 1995; Eichengreen and Wyplosz, 1998; Buiter and Grafe, 2003a; Begg et al., 2004).

The successive controversies surrounding the SGP have prompted searching questions about whether the current EMU policy framework is appropriate and, although criticisms centre on the SGP, other dimensions of economic policy-making also come under scrutiny (Pisani-Ferry, 2002). In particular, what has become known as the Lisbon Agenda – shorthand for a range of supply-side (or structural) reforms – has come to be seen as an essential complement to EMU (see, for example, Issing et al., 2001), even if the Kok report (2004) bemoans its lack of achievements. At the same time, the ECB has come under fire for adopting an approach to monetary policy that gives too much weight to a low reference value (2%) for inflation, while paying too little heed to output targets. The ECB is also criticised for technical aspects of policy implementation, such as not following an inflation targeting approach and having too unwieldy a decision-making structure.

1.3 The impact of EMU

In assessing how EMU will alter the performance of an economy and thus place demands on policy to establish adequate adjustment mechanisms, three different categories of effects can be delineated (Table 1.1). These are:
<table>
<thead>
<tr>
<th>Mechanism</th>
<th>Effect</th>
<th>Impact</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Macroeconomic shifts, of which:</strong></td>
<td>Change to the new policy regime recasts established policy signals and rules</td>
<td>Affects all members of EMU, but spatial impact uncertain; depends on willingness and capacity to adapt</td>
</tr>
<tr>
<td>Acclimatisation in the short term to new policy settings</td>
<td>Low nominal interest rate; impact on asset prices; but disparities in real rates</td>
<td>Previously inflation-prone regions face over-heating. Thus far, positive for less prosperous areas, but increases prospect of macroeconomic imbalances</td>
</tr>
<tr>
<td>Adoption of stability-orientated macro policy approach</td>
<td>Alters government and financial market behaviour</td>
<td>Most pronounced for those who have to change most, with need for policy learning; risks from Balassa–Samuelson effect for countries with least developed service sectors</td>
</tr>
<tr>
<td><strong>Labour market and transformations of it, of which:</strong></td>
<td>More of the burden of adjustment falls on labour market</td>
<td>Creates problems for least flexible economies. Could aggravate unemployment</td>
</tr>
<tr>
<td>Systems for wage setting</td>
<td>Influence wage flexibility and scope for short-term adjustment</td>
<td>Potentially damaging for areas with rigid systems and engenders problems of social cohesion (insiders and outsiders)</td>
</tr>
<tr>
<td>Geographical, sectoral and occupational mobility</td>
<td>Affects medium-term scope for labour market adaptability to deal with competitiveness problems</td>
<td>Induced pressures from migration; could lead to brain drain (gain). Possibility of aggravated imbalances within countries</td>
</tr>
<tr>
<td>Regulatory setting and institutions under-pinning labour market</td>
<td>Shapes long-term potential for adjustment through supply-side</td>
<td>Adverse for less developed economies that lack training provision, especially where de facto regulation is pronounced</td>
</tr>
<tr>
<td><strong>Induced effects on economic structure</strong></td>
<td>Market opening accelerates pace of restructuring</td>
<td>Potential threat to least competitive economies; likely to widen disparities</td>
</tr>
<tr>
<td>Regional industrial specialisation</td>
<td>Mix of centripetal and centrifugal ‘NEG’ consequences</td>
<td>Initially favours core regions; but creates opportunities for low cost areas; ambivalent overall</td>
</tr>
<tr>
<td>Concentration of financial services</td>
<td>Lowers intermediation margins; enhances pool of liquidity and supply of risk capital</td>
<td>Economies with weak financial sectors lose activity; ambivalent overall</td>
</tr>
</tbody>
</table>

*Source: Adapted from Begg (2003); see also Ardy et al. (2002).*
• **Macroeconomic changes** resulting from the new policy regime that alter the manner in which policy is conducted and require the country, first, to acclimatise then to develop new accommodations between policy actors and objectives. Thus, a general fall in interest rates (which has occurred as a result of the single currency) favours (relatively) indebted countries. Curbs in public expenditure to meet the SGP may result in lower discretionary public spending.

• **Labour market transformations.** An important consideration in this context is the ease with which countries are likely to be able to render their labour markets more flexible (Nickell, 1997). The difficulties Germany has encountered in pushing forward labour market reforms are in the limelight at the moment, but there is also evidence that there is a lack of adaptability on the part of other lagging countries such as Belgium and France (Algoé and Alphametrics, 2002).

• **Induced effects on economic structure** that shape the longer-term competitive position of the economy by altering the competitive position of different areas and shaping supply-side developments such as backward and forward linkages between intermediate and final producers (Krugman and Venables, 1996).

### 1.3.1 The timing of EMU effects

In thinking about monetary union, a number of phases can be envisaged for different effects. The first is nominal convergence which, in the EMU model, had to take place before Member States could join the single currency. Second, there is assimilation to the resulting new regime. Then follow the medium- to longer-term real economy effects described in the second and third segments of Table 1.1.

The nominal convergence phase proved to be a testing one for many countries, because the obligation to ‘consolidate’ public finances tends to mean a combination of tax increases and public spending cuts that dampen demand. In the EU as a whole, public spending fell by some seven percentage points between 1995 and 2002, with most of the change matched by a fall in public deficits (Table 1.2). There are circumstances in which the holy grail of an expansionary fiscal contraction can be achieved, especially if fiscal restraint permits a markedly looser monetary policy, but the consensus is that most Member States lost potential output during the 1990s as they struggled to meet the Maastricht criteria (see Giudice et al., 2003 for an analysis of this debate).

Another major issue is the price level, with marked differences between countries at the start of Stage 3 of EMU. Portugal stands out as having had a much lower price level, but a simple way of calibrating this phenomenon is that countries where GDP measured in terms of purchasing power is higher than GDP measured at current exchange rates have lower price levels and vice versa. Moreover, in all the new Member States, the price level is well
Table 1.2  Public finance trends: Selected euro area Member States (% of GDP)

<table>
<thead>
<tr>
<th></th>
<th>Gross revenue</th>
<th>Gross expenditure</th>
<th>Interest payments</th>
<th>Expenditure less interest</th>
<th>Net lending</th>
<th>Net lending less interest</th>
</tr>
</thead>
<tbody>
<tr>
<td>Belgium</td>
<td>48.5</td>
<td>51.4</td>
<td>52.8</td>
<td>51.1</td>
<td>9.3</td>
<td>5.6</td>
</tr>
<tr>
<td>Germany</td>
<td>46.1</td>
<td>44.9</td>
<td>49.6</td>
<td>49.1</td>
<td>3.7</td>
<td>3.1</td>
</tr>
<tr>
<td>France</td>
<td>49.7</td>
<td>50.5</td>
<td>55.2</td>
<td>54.7</td>
<td>3.8</td>
<td>3.2</td>
</tr>
<tr>
<td>Italy</td>
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below EU-15 levels; according to a recent report by the OECD (2003), in 2001 it stood at an average of just 51% of the EU-15 level. One potentially disruptive factor is the so-called ‘Balassa–Samuelson (BS) effect’ which arises because productivity in the tradable sector of the economy rises more rapidly than in the rest of the economy, but relative wages do not adjust. If the effect is substantial, measured inflation will be higher, but the competitiveness of the tradables sector will be scarcely affected. In causing a real exchange rate appreciation, there may be problems. Alesina et al. (2001) suggest that the effect may have been quite pronounced for Ireland during the late 1990s, with above-average inflation not detracting from its competitiveness, but possibly perverse for Spain, the implication being that inflation in the trade sector was higher than in the non-traded sector. This problem is likely to be much less important in its impact on the existing Member States, as the combined GDP of the new Members is so small by comparison.

1.4 The challenges of policy co-ordination

Economic policy co-ordination in the EU has made great strides in recent years, yet still finds itself facing uncertainties and awkward choices (Begg, 2002b). Nevertheless, co-ordination is central to the proper functioning of EMU and cannot be seen as just a ritual exercise in which Member States produce reports, the Commission makes some trenchant criticisms, then policy proceeds pretty well unchanged. On the one hand, there is a need to consolidate the policy framework sufficiently to make EMU effective and to ensure that the broader economic and social ambitions of the Union are achieved. On the other hand, subsidiarity in economic policy-making has to be respected and there has been dismay about the conduct of some aspects of policy at the EU level, notably the imbroglio surrounding the application of the SGP in 2003.

Economic policy co-ordination is found in a number of Treaty provisions. These mechanisms have gradually been consolidated since the launch of the euro, yet it has to be stressed that both the EU level and the Member States are in a ‘learning phase’ with regard to economic modes of governance. The BEPGs provide recommendations for the broad thrust of economic policy. These guidelines comprise general policy aims for the EU as a whole (and not just the euro area), together with specific recommendations for individual Member States. They are both broad and comprehensive, covering macroeconomic policy (for which, read ‘fiscal’), a range of labour market and other supply-side policies, and sustainable development. Overlapping with the BEPGs are specific co-ordination ‘processes’ that try to foster common approaches, for example to employment policy (the Luxembourg process), structural policies (the Cardiff process), pension reform and social
Introduction

inclusion policy. These processes are now streamlined with the Commission reporting on the BEPGs, employment guidelines, social inclusion and internal market strategy at the spring European Council and all guidelines now having a three year rather than an annual cycle. The 2005 re-launch of the Lisbon strategy is intended to achieve further streamlining by bringing the Commission’s recommendations on the BEPGs and its proposal on the Employment Guidelines into a single document to be known as the Integrated Guidelines.

However, as noted above, this array of co-ordination machinery does not cover the core of the traditional notion of policy mix, namely how fiscal and monetary policy are combined. Instead, the emphasis is on what might be called horizontal co-ordination across individual policy areas, and the only real links between monetary policy and other economic policy domains are consultative, via fora such as the Eurogroup, the Economic and Financial Committee and the macroeconomic dialogue. That monetary policy is not part of the equation is simply explained. An independent central bank with the primary responsibility to assure price stability cannot plausibly engage in the sort of bargaining with other policy actors that would be implicit in co-ordination. If it did, it would open itself to the possibility that the ensuing bargain might mean trading-off higher inflation for other goals, such as faster growth or lower unemployment. The issue is not whether or not such an outcome is desirable (the contrast with the Fed’s dual mandate is obvious), but whether it is constitutionally allowed, and our interpretation of the legal texts is that the room for manoeuvre is very limited.

The status quo is the ‘horses for courses’ approach that is favoured amongst other by representatives of the ECB (see Issing, 2002). Its essence is that if the authorities or economic agents responsible for a policy area fulfil their obligations, there will be clarity about obligations and no temptation to backslide or compromise. The trouble with this approach, however, is that if the aims of policy are not entirely compatible, the outcomes could be sub-optimal. For Issing, the answer lies in dialogue and careful explanation of policies. Thus, once wage bargainers know and understand that the ECB will be assiduous in assuring price stability, they will take steps to curb inflationary pay settlements. It is, however, less clear how labour market reforms can be informed in this way.

The main alternative is to construct some form of gouvernement économique as espoused, notably, by a number of prominent French economists such as Boyer (1999, 2002) and Pisani-Ferry (2002). The rationale for such a body is to act as a fiscal authority, capable of overcoming the fragmentation of both decision-making and economic policy that results from separate national decisions. But it could be argued that instead of being constituted largely as a fiscal policy counterpart to a powerful and integrated monetary policy, any new body should have a broader remit to orchestrate policy
across a range of supply-side domains. The BEPGs provide a framework within which to develop such an approach – certainly by comparison with the SGP – but have had limited visibility in the policy process, perhaps pointing to shortcomings of ‘soft law’ forms of economic governance.

There are, clearly, problems of compliance and enforcement. It can also be argued that with so many different co-ordination channels, there is a considerable danger of confusion, not to mention diffusion of effort and purpose. We count no fewer than eight distinct economic co-ordination mechanisms: the Council (above all Ecofin) and the Eurogroup at a political level, the SGP and the Cologne process for macroeconomics, the Luxembourg and Cardiff processes, plus Lisbon for microeconomics (overlapping with internal market), and the BEPGs. There have already been high-profile instances of national governments openly disagreeing with, and ignoring, recommendations derived from soft-law processes: the ‘reprimand’ to Ireland for its pro-cyclical fiscal policies in 2001 is a case in point. The lack of coercive enforcement mechanisms for soft co-ordination – which relies on the non-coercive mechanisms of peer review, naming and shaming and so on – is compounded by the perceived blandness of many of the recommendations and the sense that excessive detail and overuse diminish their strategic impact.

Nevertheless, although the bulk of economic policy co-ordination is operated under ‘soft law’ procedures, it does not mean that it cannot be robust, even if it is not immediately obvious how sanctions can be imposed on delinquent Member States. Amtenbrink and de Haan (2003) raise an interesting question, namely whether a Member State that does not conform to the BEPG recommendations or other aspects of surveillance procedures might have formal action taken against it, but conclude that even if there is a theoretical possibility, the issue is politically decided rather than being amenable to a legal decision. Moreover, they note that ‘in any event, if the goal is to avoid the emergence of an excessive deficit, the prospect of the application of a lengthy judicial procedure may not be a very appealing one, as it will almost certainly come too late to be meaningful’ (Amtenbrink and de Haan, 2003: 1083). The inference to draw is that, other than the political costs for a Member State of being named and shamed, surveillance has no teeth when it comes to preventing the emergence of an excessive deficit. Hence it is only when an excessive deficit actually arises that the Member State will face formal disciplinary procedures and even then the first stages are warnings. It could be argued that, especially for a variable as volatile as the fiscal deficit, the timetable for action is too slow to assure fiscal discipline.

1.4.1 Structural reform

There is a broad consensus that structural reforms in the EU not only continue to be desirable, but also hold the key to medium- to long-term improvements in the performance of the EU economy (HM Treasury, 2004). The more extreme proponents of this view would, indeed, argue that structural reform is the only answer to the EU’s current economic problems, but we
hold the view that however strong the case for such reforms, they do not absolve the demand side of the economy from scrutiny. At the same time, it is evident that the pace of structural reforms has been lethargic and there are growing concerns that the ambitious Lisbon agenda is not only overly-optimistic, but also suffers from inappropriate governance (Kok, 2004; see also Begg, 2005). Inertia and political compromises that have weakened the pace of reform have been evident in countries such as Germany, and there can be a tendency at EU level for lowest common denominator solutions to be reached, resulting in only a slow transformation in areas such as network industries (Pelkmans, 2001).

Structural reform is an expression that embraces a wide range of policies, although there is a fair degree of consensus about the directions structural reform need to take, reflected in the Lisbon agenda and in the current priorities for consolidating the single market. At EU level, the opening up of markets, principally through continuing efforts to complete and enforce the single market, is the principal means by which supply-side improvements are advanced. But it also has to be stressed that the removal of obstacles to economic efficiency and the search for productivity gains is very much a concern of national policies. A key point to note about structural reforms is that they can hurt and may, collectively, have adverse short-term effects on output and employment.

In relation to co-ordination, structural reform has to be looked at from two perspectives. First, with increasing economic integration, if some parts of the Union are very divergent in the performance of their ‘real’ economies there will be repercussions for others. Divergence might have knock-on effects for the conduct of macroeconomic policy by increasing the range of conditions with which ‘one-size-fits-all’ policies have to contend. Divergence may also lead to inappropriate responses by vulnerable governments, if they are tempted to reduce well-designed social protection or regulation in a search for competitiveness that leads to a ‘race-to-the-bottom’. In the EU context, a second, much more positive, rationale for co-ordination processes is to stimulate policy learning and enhancement. The latter objective lends itself to the soft ‘open method of co-ordination’ (OMC) approaches that have evolved in recent years. A further question is whether, as the EU itself enlarges, the problems of reaching consensus will be magnified, resulting in a slowing of structural reforms. One way out of this was, as in Sweden, to adjust first then consider joining the single currency, but the signals from many of the new members suggest that they want to be ‘in’ at the earliest opportunity, though there are signs that some, such as Hungary, are having second thoughts.

1.5 Structure of the volume

The remainder of the book is in three parts. The first describes the legal and constitutional framework and examines the conceptual model underpinning
the macroeconomics of EMU. Evidence on key policy areas and how they have evolved in a selection of countries is presented in Part 2. Conclusions are then drawn in Part 3.

Chapter 2 sets the scene for macroeconomic policy in EMU. It identifies the key challenges and how they are being met thus far within the (pervasive) context of the Lisbon Agenda with its call for a quantum leap forward in EU economic performance. The new regime is under pressure with growth slowed and unemployment rising, leading to pressure on the Stability and Growth Pact which so far, correctly, has had minor reforms (see Chapter 4). The macroeconomic policy challenge is explored, noting the diversity as between states necessitating flexibility in the EMU system in general and in policy co-ordination in particular. The degree of difference between states is explored, including whether states are subject to similar shocks and how they respond to them (given states do not have the same social preferences this prompts different responses to the same problems). This phenomenon of asymmetry has been well documented but this chapter contends that asymmetry is not just about inter-country differences but extends to the way the process of growth and economic cycles generate asymmetric problems for macroeconomic policy.

In determining the process of adjustment under EMU, it is clear that monetary policy itself is asymmetric responding to serious threats of inflation more than proportionately and threats of deflation even more strongly. It can counter asymmetry in behaviour and also the asymmetries found in the (decentralised) fiscal policy. The extent to which fiscal policy is asymmetric helps explain the tensions surrounding the SGP. Downturns, such as those currently occurring in the euro zone, worsen employment more than an upturn improves it – a phenomenon compounded by state behaviour in the first years of EMU as states were over-optimistic in the up phase thus creating the controversial deficits seen now. This behaviour has created pressures for the SGP and co-ordination more generally – a theme explored more fully in Chapters 3 and 4. Finally, the extent to which these challenges will exist for the accession states – in particular the risk of higher inflation as a result of catching up – should they look for early entry to EMU are set out.

In Chapter 3 the institutional framework of EMU is examined noting that interdependence is a key characteristic of EMU in relation to both the uniform and highly centralised monetary policy and the de-centralised fiscal policy. This interdependence is manifest even for the ECB with its high levels of independence. The Bank has seen fit to develop higher accountability standards than formally set down in the Treaty, realising the importance of accountability for legitimation of its position and its policies. Interdependence is also important in relation to fiscal policy which is co-ordinated between states through a complex system of Council committees and the Stability and Growth Pact within the context of the Lisbon agenda.
The main compliance mechanism is peer pressure between states based on the shared commitment to the success of EMU. Both fiscal and monetary policies are tightly interrelated – monetary policy cannot be developed in isolation from fiscal policy – a theme developed more fully in Chapter 4. What remains uncertain is what the scope of discretion should be for the states when co-ordinating fiscal policy and in turn, what role the Commission has in that process.

In Chapter 4, the issue of co-ordination of fiscal policy is explored more fully, including an examination of how the issue was addressed in the influential Werner (1970) and Delors (1989) reports. Co-ordination is clearly a defining feature of EMU, a common fiscal policy being seen as unrealistic and even undesirable. As suggested in Chapter 3, the co-ordination system is extensive, complex and opaque. All three of these features are in part due to the nature of the legal norms used to frame it. The balance of soft (non-binding) law and hard law (characterised in the fiscal policy domain by the ultimate sanction of a fine) is central to how the system works and critical to the question of reform. Soft law is presented as having merits in and of itself and not necessarily the ‘poor relation’ of hard law or its precursor. The difficulty is that it is hard to ensure compliance with soft law unless there is a willingness to have regard to the effect of national fiscal policy decisions on the wider euro zone.

Nonetheless, difficulty is not in itself sufficient reason to move to an even less appropriate regime of hard sanctions which are not credible. The Stability and Growth Pact as the centrepiece of fiscal coordination is located within the wider context of the Lisbon Agenda and the parallel coordination of supply-side policies, notably the European Employment Strategy (EES), an issue more fully developed in Chapter 5. The challenges and criticisms of the Pact are addressed as well as the existing piecemeal reforms and proposals for more sweeping reforms including a softer Pact for those states with sustainable debt, providing a much needed carrot to balance the largely symbolic threat of a fine and a suggestion that a form of the ‘golden rule’ be adopted. The paradoxes of the system remain: that naming and shaming (soft law) is more effective than the ‘nuclear option’ of a fine; soft law is rendered ineffective without adequate incentives; some of the most difficult structural problems remain outside the scope of co-ordination because states refuse to address them and finally, how a coherent policy mix is to be achieved has yet to be clearly articulated.

Supply-side policies are important to the adjustment process in EMU because they create the conditions that make demand or supply shocks less likely and they have a vital contribution to make to overall macroeconomic policy co-ordination. Chapter 5 discusses structural policy co-ordination within EMU and as part of the Lisbon Agenda. The reasons for co-ordination of employment and labour market policies are explored with primary reference to the Union of 15 (though Chapter 12 examines the impact of EMU
on the ten accession states). The main challenge is the level of diversity between the states in policy and in approach. Given this diversity, the OMC is an ideal governance mechanism to encourage policy learning within the context of the targets set by Lisbon. Like fiscal policy, soft law predominates but there are no hard sanctions for failure to meet the guidelines. The emphasis is exclusively on peer pressure.

Effectiveness is hindered by the lack of clearly demarcated responsibility – ownership of the goals is collective but collective responsibility for failure to meet them is not an effective sanction and is a very weak form of accountability. It is difficult to ascribe any job creation to the EES itself after seven years but the procedures of the EES have had some impact on policy formation. The operation of the EES has encouraged the adoption of best (or, at least, better) practice, improving the quality of employment policy in particular. But, just as there has been a failure to articulate how a coherent policy-mix is to be achieved as between fiscal and monetary policy, so too it is unclear how the EES fits with overall policy co-ordination. The 2003 streamlining reforms of the BEPGs may help integrate the EES into the wider policy framework and the 2005 re-launch of the Lisbon strategy promises to go further. There remain the problems at the EU and state level of different ministries co-ordinating their activities. Nonetheless, the EES despite the problems identified is important, as it keeps employment firmly on the agenda and offers one route to greater labour market flexibility.

Part II concentrates on empirical analysis of how countries adjusted to EMU, with five of the chapters focusing on single Member States. To give a more general perspective, we first present an overview of empirical developments in Stage 2 and Stage 3 in Chapter 6. In the mid-1990s, a widely held view was that Germany, the Benelux countries, Austria and France, with Ireland probably also a viable contender, were the Member States most likely to be in the first wave to establish the euro area. Evidence from Bayoumi and Eichengreen (1997) that France and Germany were not, in fact, ideally suited to form a currency area using optimum currency area criteria might have given some reason for caution, but the convergence criteria gave little reason for doubt. In the event, the four geographically peripheral countries were also able to adjust (or be deemed to have adjusted) sufficiently for the euro to be launched with eleven Member States, although the chapter shows that a degree of fudging proved to be necessary.

More surprisingly, as the chapter shows, there have been very diverse experiences in Stage 3. Rather than being the engine of the euro area, Germany has struggled, and in the early years of full EMU the Member States that have had the best economic performances are not those that many would have expected. The chapter presents brief assessments of the contrasting fortunes of three of the largest Member States, France, Italy and Spain, concluding that the challenges of Stage 3 adjustment may well have been under-estimated. The outcomes reveal that acclimatisation to the euro has
proved more tricky for some Member States while also offering opportunities to others.

The next two chapters assess the two economies that, so far, appear to have prospered least and most under EMU, Germany and Ireland. That Germany has entered the euro facing a range of economic problems is well known. It has had disappointing growth and has been slow to advance structural reforms. It has also found it difficult to curb its fiscal deficit in line with its commitments under the SGP. Chapter 7 looks in detail at the German economy, especially the problems that have arisen in the labour market. As the largest euro area economy, what happens in Germany clearly has a major impact on other countries in macroeconomic terms.

Chapter 8 presents an analysis of the Irish economy, one which is well accustomed to being part of a monetary union, having been joined to sterling prior to linking to the EMS in 1979. Ireland’s phenomenal economic growth in recent years has, plainly, marked it out as a success story. Although Ireland’s economy remains strongly linked to that of the UK, potentially exposing it to risks of asymmetric shocks relative to its euro area peers, as a small open economy, it already had to develop appropriate adjustment mechanisms.

Chapters 9 and 10 examine Finland and Sweden, neighbouring countries that opted for starkly contrasting approaches to EMU. Both countries experienced severe economic downturns in the early 1990s, but both have also been among the better performers in the EU in recent years. Finland was quick to embrace Stage 3 and serves as an interesting exemplar of how adjustments needed to enter Stage 3 can be made compatible with a successful economy. As one of the more rapidly growing economies during the early years of Stage 3, Finland could have been discomfited by a euro area that was too loose, but it seems to have avoided problems by other forms of adjustment.

Sweden, by contrast has opted for the slow route to EMU. It meets the budgetary and price stability criteria for membership of the euro area and, unlike the UK and Denmark, does not formally have an opt out, although its non-membership of the ERM provides an escape clause. Essentially, Swedish reluctance to enter Stage 3 owes as much to political factors as to any economic assessment, although as with the UK, the fact that Sweden has appeared to prosper outside the euro area has been telling. If or when Sweden does join, it is not expected to face much of an adjustment problem.

The UK, which is analysed in Chapter 11, has long been among the most euro-cautious members of the EU and has made clear its ambivalence about EMU. In contrast to other countries, the UK has elaborated its own criteria – the five economic tests – for whether or not to end its opt-out and has conducted a very extensive assessment of those tests, coming up with a negative conclusion in 2003. In common with Sweden, the UK would meet
the nominal convergence criteria except for exchange rate stability. It has, however, enjoyed a better economic performance than the euro area since the start of Stage 3, and has also developed what many regard as a better macroeconomic policy framework.

For the new members that joined the EU in 2004, how quickly to seek entry to Stage 3 will be a big decision with substantial effects on economic development. A balance has to be struck between preserving flexibility to cope with the challenges of transition and adjustment to the EU internal market, on the one hand, and gaining the macroeconomic stability advantages of full participation in EMU, on the other. The new members are, however, very diverse. Six of them are very small economies that will probably gain from rapid entry and some of them may, indeed, choose to do so at the first opportunity. Reservations have, however, surfaced elsewhere. Chapter 12 discusses the outlook for the new members and focuses on Estonia, which has maintained a currency board since 1992 and has had a stable exchange rate vis-à-vis the euro since day one of Stage 3. The conclusion of the chapter is that Estonia should prosper within Stage 3 and has become sufficiently open to have suitable adjustment mechanisms.

The last part of the book draws together the material in the book and discusses policy issues. It highlights the shortcomings that have become evident in the policy framework, notably with the problems in the SGP, but also in other policy co-ordination processes. A key lesson that emerges from the volume is that not only are there diverse approaches to adjustment under EMU, but also that the experiences of the different Member States show that there is no single best practice. Rather, and this has implication for the new members, it is important to be aware of the choices and how they affect policy strategy.
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