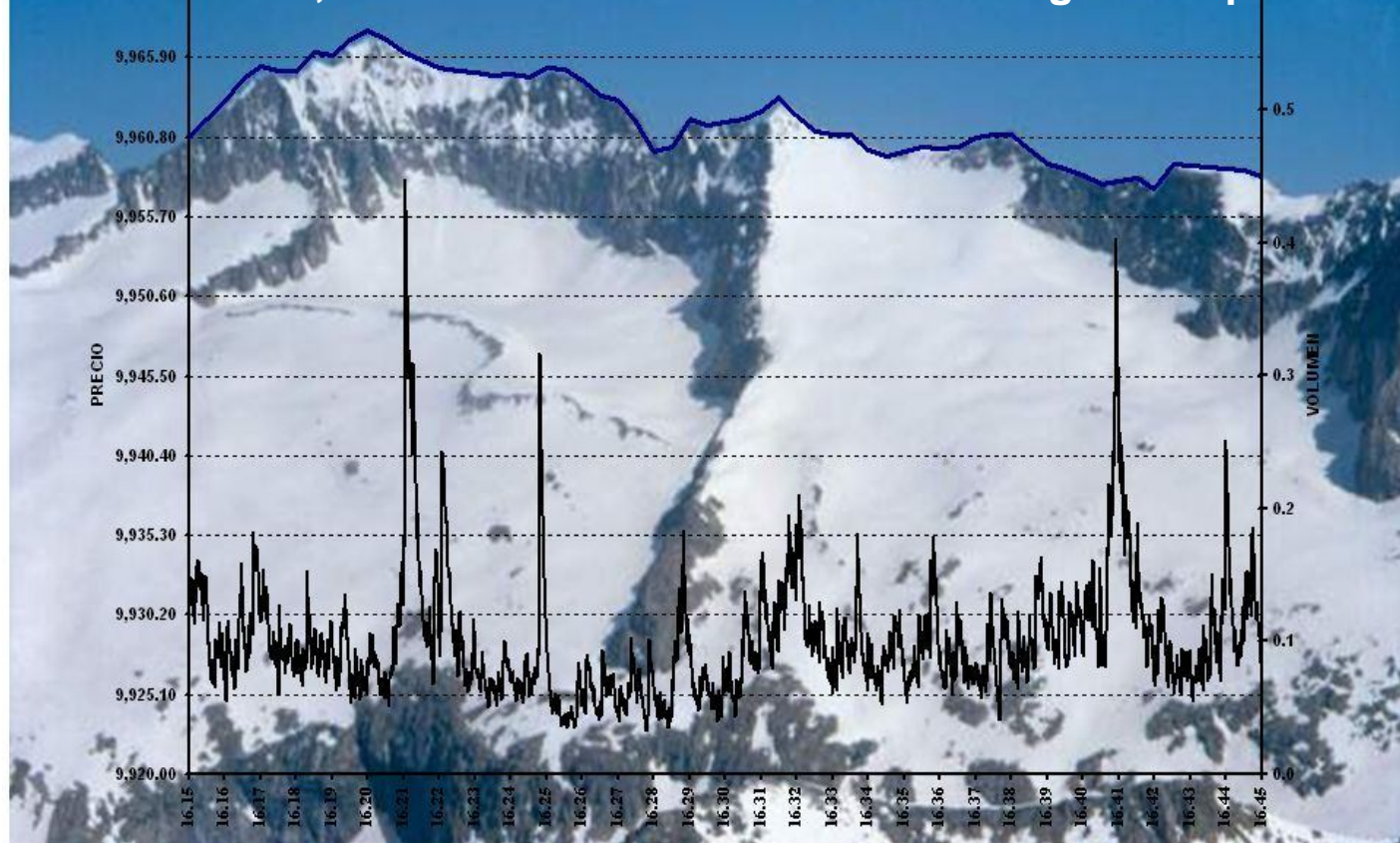


Economics, Finance and Mathematics from a high standpoint



The reform of the economic governance of the eurozone: macroeconomic supervision and coordination

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The reform of the economic governance of the eurozone: **macroeconomic supervision and coordination**

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1. Introduction

Today's economic crisis has highlighted the need to revise the institutions and mechanisms of the economic governance¹ of the European Union, especially in the euro zone. As a part of this process, the European Commission passed a package of legislative proposals² in September 2010, and in October 2010 the European Council endorsed the Task Force's Report on Economic Governance, set up by H. Van Rompuy³. The final decision on the reform of governance should be passed by the Council and the European Parliament in the summer of 2011.

The report which was passed by the European Council proposes reforms which can be grouped together in two large blocks: (i) the supervision and coordination of macroeconomic policies and (ii) the design of mechanisms to manage the financial crisis in the euro zone. The Commission's proposals are mainly focused on the first question, which will be the one we deal with in this paper. Both documents do not totally coincide although there is a wide consensus in fundamental aspects. For this reason we will deal with them together and highlight possible differences whenever this is relevant.

In particular, the reform of macroeconomic governance fundamentally pursues a greater vigilance of fiscal policies and the introduction of a new mechanism to detect other possible imbalances, especially those which appear in current account balances, like those which have appeared, as a matter of fact, since the creation of the monetary union.

After pointing out some characteristic problems in the current framework for economic governance in the Economic and Monetary Union (EMU) we will summarize these proposals and judge them from the perspective of the weaknesses in the workings of the current institutional framework which have occurred in the euro zone (fundamentally the

¹By "governance" we understand "a process of continuing cooperation of national actors and the coordination of national or even subnational economic policies", Heise (2008).

²The package of legislative proposals passed by the Commission includes six legislative acts: four refer to fiscal topics and two refer to the detection and correction of macroeconomic imbalances. See European Commission (2010 a,b,c, and d).

³This Special Group was created under the mandate of the European Council in March 2010. The Final Report can be consulted in European Council (2010).

accumulation of imbalances among countries with current account deficits and countries with surpluses) and the management of economic policies which has been undertaken since the beginning of the crisis.

2. Limitations of the current institutional framework for the monetary union's economic policies.

It goes without saying, that in the euro zone economic policies applied by supranational authorities co-exist – all of those which refer to the single market along with monetary policy - with others which are controlled by national governments (fiscal policy, wage fixing and structural and employment policies). Monitoring and coordination mechanisms have been developed for national policies among different governments in the belief that they are of common interest. These mechanisms include The Stability and Growth Pact (SGP) and other processes developed around the Integrated Economic Policy Guidelines and National Reform Plans which apply the so-called “Open Method of Coordination”⁴.

Beyond the advantages and inconveniences of this institutional structure⁵, here we are interested in highlighting that the design of macroeconomic policies in the euro zone is facing important limitations and according to Arestis and Sawyer (2006, 2011) these stem from the European project's adoption of the neoliberal agenda and are the following:

1. The monetary policy which is carried out by an independent ECB prioritizes price stability. For this reason, monetary policy is not necessarily directed towards promoting sustained growth and full employment, nor is it coordinated by European authorities or national governments to establish the most appropriate policy-mix.
2. The economic crisis has brought to the fore that monetary policy must be supplemented, at times, with active fiscal policies. For example, because the bottom limit of the nominal interest rate is reached or because a fall in interest rates is shown to be incapable of stimulating demand. In a monetary union, this need is even greater since a single monetary policy might not always be appropriate in different economic scenarios in

⁴This type of “weak coordination” of economic policies is characterized by the lack of economic sanctions in the case of failure to comply and is based, instead, on political pressure among equals, and the exchange of information and the adoption of a common “orientation” rather than specific and compulsory regulations.

⁵Watt (2010) offers a summary of this institutional structure and of its evolution in the last decades. And Heise (2008) offers some very appropriate reflections on its limitations in providing certain public goods and of its possible modifications. See also the special issue of the *International Journal of Public Policy*, vol.3, n.1, 2.

different countries. However, the current economic policy framework in the euro zone is characterized by its lack of a European fiscal policy and by the limitations of the SGP's national fiscal policies⁶.

3. The whole process of the constitution of the monetary union has ignored imbalances in current accounts among its member countries, which were considered irrelevant⁷. Two examples are the absence of any reference whatsoever to this objective in the criteria of nominal convergence to gain entry to the EMU or the failure to react to the growing deficits and surpluses which are occurring in some countries.
4. Two aspects which have clearly remained out with the process of coordination of economic policies in the euro zone are fiscal and wage policies⁸. This causes a downwards tendency in tax revenues – especially those which come from capital taxes which is the movable factor – and where low wage growth can be used to gain competitiveness from the rest of its members.

3. Proposals from the Commission and the Council to reform the governance of macroeconomic policies.

We can gather these proposals together in four fundamental areas:

3.1 Greater budgetary discipline via the Stability and Growth Pact. In their proposals, both the Commission and the Council emphasize the importance of an increase in budgetary discipline. For example, as far as the preventive side of the SGP is concerned, the Commission's proposal includes a regulation for growth in public expenditure which was non-existent up to now. Those countries which do not meet their budgetary objectives in the medium term, which generally speaking is a balanced budget, will not be allowed to increase public spending over a prudent estimate of the growth of GDP in the medium term unless they compensate this with discretionary measures on the revenue side. This new criteria will be the starting point when the stability and convergence programs of each one of the member states are analysed. As far as the decision to declare a country in excessive deficit is concerned, it has been proposed to carry out stricter monitoring of the evolution of public debt, on an equal

⁶See Uxó and Arroyo (2007). In this paper, a model of the monetary union is set out that shows the shortcomings of current fiscal policy regulations when dealing with asymmetric shocks and some alternative regulations are proposed.

⁷This affirmation is amply supported in Arestis and Paúl (2009) where the evolution of the discussions held by European authorities and the majority of academic economists on this problem is analyzed.

⁸Despite the formal existence of a process of Macroeconomic Dialogue with the participation of social agents, its real influence on economic policy decision making is very limited.

footing with the evolution of public deficit. Although a ceiling of 60% for the stock of public debt has already been established, in practice this vigilance is centered exclusively on the 3% ceiling for public deficit. For example, from 1999 to 2007, Italy, Greece and Belgium's annual debt was well over this limit (the average was 107%, 100% and 99% of GDP respectively). In order to give an operative character to the limit of indebtedness, the Commission proposes that those countries whose debt exceeds 60% of GDP should adopt measures to reduce it annually by at least a twentieth to reach the difference with the 60% ceiling in the past three years. On the other hand, if the level of debt is higher than 60% and it is considered that the downward path is insufficient, the decision to declare a country in excessive deficit could be taken even with a deficit of less than 3% or a punitive proceeding which was already underway might not be closed .

3.2. Establishment of minimum requirements for national budgetary frameworks.

Experience has shown that well designed budgetary frameworks (systems of public accounting, statistics, precautionary measures, fiscal measures, budgetary regulations, independent budgetary offices and relations at national, regional and local level) are one key to reaching previously established budgetary objectives⁹. And, in the opinion of the Commission and the Council, the national fiscal institutions should meet some requirements. For example: long term budgetary planning, the transparency of the budgetary process by offering detailed information on extra budgetary funds and on liability contingencies, and to apply all of those measures at the different levels of public administrations.

3.3. Creation of a new mechanism for the prevention and correction of macroeconomic imbalances.

One of the main novelties is that economic vigilance will not be limited to public finances but will spread to other areas to prevent and correct macroeconomic and competitiveness imbalances, especially in euro zone countries. This new mechanism will also have a preventive and corrective side to it. As far as preventive aspects are concerned, it is intended to identify economies with potentially problematic imbalances. To do this, a set of indicators¹⁰ has to be defined whose numerical monitoring can set off alarm bells. Following this initial assessment, the Commission can carry out in- depth inspections with the help of experts to determine the seriousness of the threat which these respective imbalances suppose. If a member

⁹Buti (2010).

¹⁰For example the current account balance, the real effective exchange rate, public debt and private debt.

state's imbalance is judged to be serious or could put the workings of the very EMU in danger, the Council can adopt recommendations and take the decision to declare a country in excessive deficit (the corrective phase of the mechanism). In this case, the member state would have to present a plan of corrective measures which would be reviewed by the Council and then the deadline to apply those measures would be fixed. If this did not happen, economic sanctions would be applied. With this regular evaluation of macroeconomic imbalances, apart from the monitoring of the state of public finances, the aim is that situations like those registered in countries like Spain or Ireland during the previous boom period should never happen again, when a sound fiscal position was held according to deficit and debt figures, but simultaneously important imbalances – high credit growth, a bubble in the asset market, high and persistent imbalances in current accounts and continuous loss of competitiveness - were making the growth path unsustainable.

3.4. New economic sanction mechanisms. Both the Commission and the Council believe that to achieve an effective carrying out of all of these measures, it is necessary to introduce changes in the financial and political sanctions which are imposed on states which do not follow these recommendations, whether this be within the framework of the SGP or the new Procedure for Macroeconomic Imbalances¹¹. At the moment, on the preventive side of the SGP, economic sanctions are not applied and recommendations are only published as a form of “naming and shaming”. However, it is now proposed to establish a deposit of 0.2% GDP to generate interests in those countries whose public finances wander from the path of adjustment, even if their deficit is less than 3%. Once the decision has been taken to declare a country in excessive deficit, this deposit would stop paying interests¹². If, within six months, a country did not apply the required measures for adjustment it would be fined. The continued failure to take measures would lead to an increase in the fine, with a variable amount related to the amount of deficit. As far as macroeconomic imbalances are concerned, when a country repeatedly fails to fulfill the Council's recommendations, it will have to pay a yearly fine equivalent to 0.1% GDP. The interests generated by these deposits and fines would be shared out among the

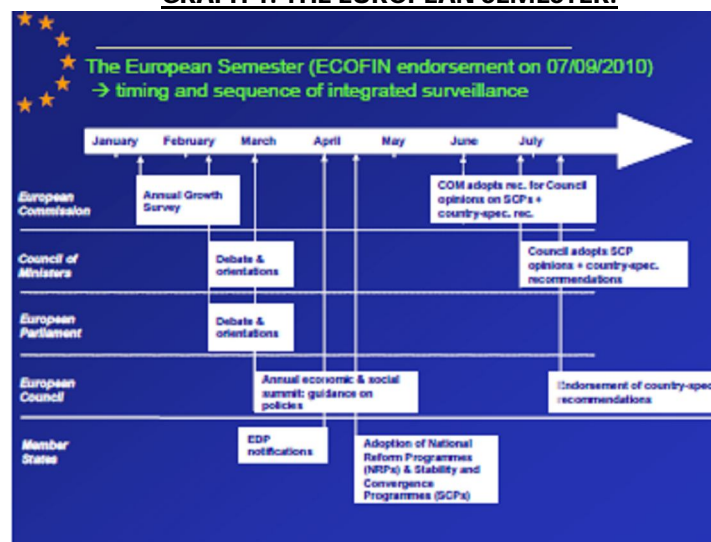
¹¹Given that the level of integration is higher in the euro zone, new economic sanctions will initially be applied to those countries and they will be progressively extended to the whole of the EU.

¹²In the Commission's proposal, this sanction will be automatic for all countries, while for the Council it will only be applied to countries which had been sanctioned in the preventive phase. For those countries that were not in this situation, a recommendation would have to be passed first, unless the situation was especially serious.

member states of the euro zone that were not in a position of excessive deficit nor of excessive imbalance. Apart from the new sanctions, the reform reduces the periods to adopt measures to correct fiscal imbalances and establishes more automatic mechanisms, which are hence less tied to discretionary political nature. In this fashion, an important novelty is the “reverse voting mechanism” whereby the proposal of sanctions presented by the Commission will be considered to be adopted unless the Council rejects them by a qualified majority.

All of these proposals are framed, on the other hand, in a new period of coordination of budgetary and structural policies of the EU member states which has been termed the “European Semester” and which has been in force since January 2011 (Graph 1). The new supervisory period will start in January with the publication of an Annual Growth Survey¹³ by the European Commission. This will serve as the basis for the definition in March, by the European Commission, of the main economic challenges which the EU faces. This will be reflected in strategic orientations of economic policies which member states will have to keep in mind when they present their medium term budgetary proposals in April (Stability and Convergence Programs) and their structural policies in areas like employment and social integration (National Reform Programs). Every July, taking their starting point from the programs presented in April, the European Council and Ecofin will provide political advice before the member states finish their budgetary proposals for the following year.

GRAPH 1: THE EUROPEAN SEMESTER:



Source: European Commission (2010, e)

¹³The first of these reports can be consulted in European Commission (2011).

4. An assessment of the reform proposals based on the experience of the workings of the EMU and the current crisis.

These proposals have been formulated in the backdrop of the most serious economic crisis since the Great Depression. Although it is a global one, it also has some specifically European characteristics which are either behind the origin of the crisis – making other more general factors more serious – or complicate or delay recovery. So, we can set ourselves the following fundamental questions. Are the proposals of this reform really directed towards problems in the workings of the monetary union, and especially those which caused the economic crisis? If they had been adopted before, would we have managed to prevent the economic crisis from reaching its current size? Would the economic policy response have been any better? We will now try to answer these questions.

4.1. At the heart of the Commission's proposals is the toughening up of budgetary discipline, which is unjustified. The public deficit averaged 6.3% of GDP in 2010 for EMU-12, and public debt has grown 18 points since the onset of the crisis to 85% (Graph 2). All of the countries except Luxembourg have punitive proceedings underway. Moreover, the rise in risk premiums has shown that savers do not trust the sovereign debt of border countries. So how can it be argued, then, that reinforcing monetary mechanisms and budgetary discipline is not the priority in the institutional design of the EMU? There are various arguments in this sense:

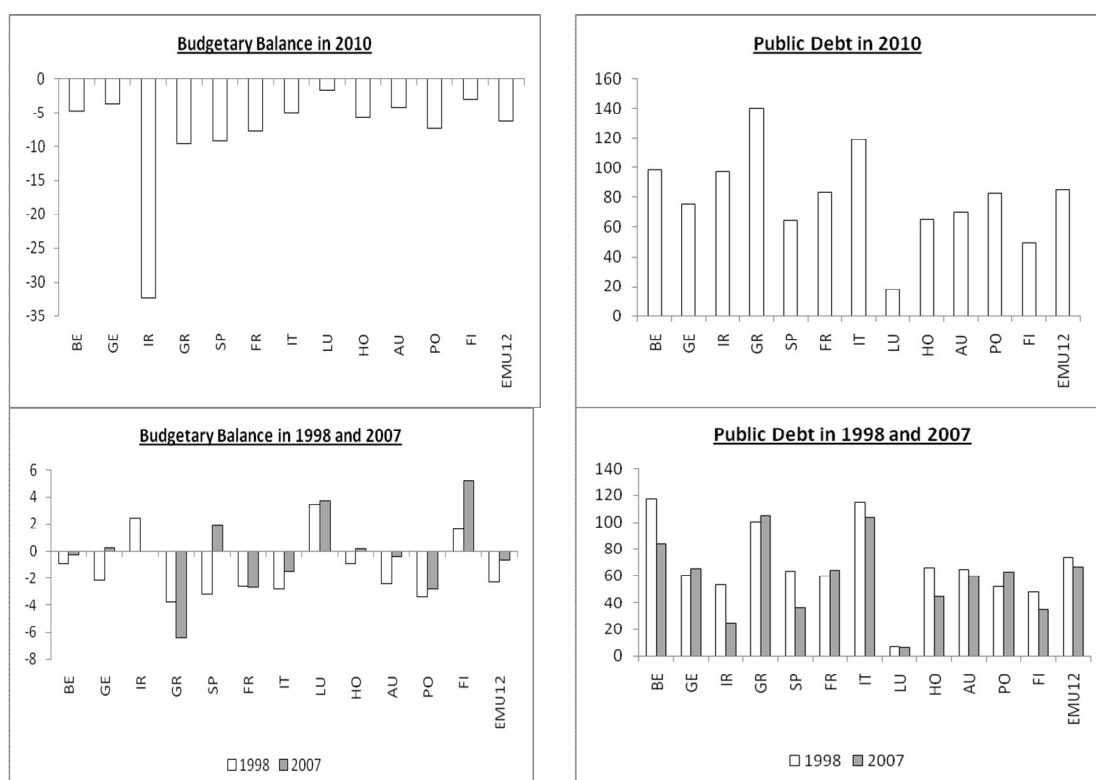
- a. Before the outbreak of the economic crisis, public finance trends in the monetary union did not show up serious problems¹⁴ to the point that the European Commission (2008) highlighted this fact as one of the main success stories of the creation of the monetary union when its first 10 years of existence was assessed. The average budget balance in the EMU in 2007 was -0.7% GDP, which not only represented a lower deficit than the one registered before the creation of the EMU (-2.3% in 1998) but the lowest since the early 70's. It also reduced its level of public debt which in 2007 reached a rate of 66.5% (73.1% in 1998). The greatest part of the improvement in the balance of the total budget is due to discretionary measures taken by governments and not only the effect of automatic stabilizers (the cyclically adjusted deficit went from -2% to -1.2%). Finally, the trend of growing public expenditure was checked. It had risen from 36.5% GDP in 1970 to 52.4% in 1993 to stabilize at 46% GDP before the crisis, 2.4

¹⁴As we will see later, the 3% limit established in the GDP was frequently surpassed. But this limit has no clear economic basis.

points less than in 1998. This global improvement is also reflected in the majority of the countries (Graph 2). In 2007 only Greece had a deficit over 3% (although France and Portugal were close to this limit) and in all of them the budgetary balance improved with regard to 1998, with the exception of Greece and Ireland (although it had a surplus for the whole period). The weight of public expenditure also fell in all countries except Ireland (which started off 14 points lower than the European average) and in Portugal. And the only countries where the level of debt did not fall were Germany, Greece, France and Portugal.

- b. This reduction of the deficit was possible with the current framework of budgetary monitoring which was even reformed in 2005 to make it more flexible. It is certain that failures to keep within the nominal limits established by the Stability and Growth Pact (SGP) were very frequent (Table 1). Until 2007, six countries in the EU-12 underwent the opening of punitive procedures (Portugal on two occasions). Particularly, as a result of the 2001 crisis, systematic failures to keep within these limits occurred in European countries, as was only to be expected because they did not apply procyclical fiscal policies. At the same time, the political unfeasibility of the sanctions was demonstrated and it was necessary to reform the Pact in 2005, in order to incorporate greater doses of realism and flexibility. As we have just seen, the effects of this reform did not lead to a slackening of budgetary discipline in the long term but to a greater coherency between this objective and that of short term stability. In general, fiscal policy contributed to the stabilization of revenue in EMU countries, behaving mainly in an anticyclical way. However, current proposals are really a counter-reform which will not only eliminate the flexibility that was introduced in 2005 but will lead to a stricter version of the original SGP (De Grauwe (2010)).

GRAPH 2: BUDGET BALANCE AND PUBLIC DEBT IN EMU COUNTRIES (% GDP)



Source: European Commission

TABLE 1: PUBLIC DEFICIT HIGHER THAN 3% IN EMU-12 (1999-2007)

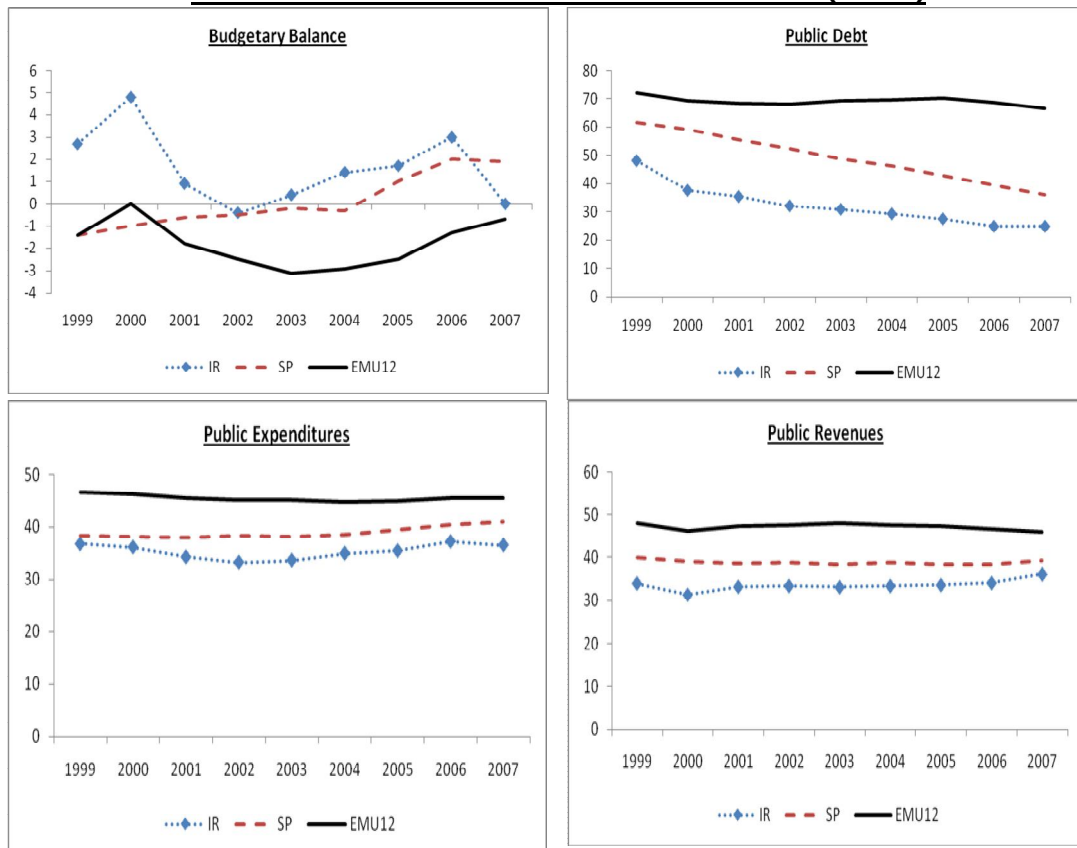
| | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | Nº Years |
|---------------------|----------|----------|----------|----------|----------|----------|----------|----------|----------|----------|
| Belgium | -0,6 | 0 | 0,4 | -0,1 | -0,1 | -0,3 | -2,7 | 0,3 | -0,3 | 0 |
| Germany | -1,5 | 1,3 | -2,8 | -3,7 | -4 | -3,8 | -3,3 | -1,6 | 0,3 | 4 |
| Ireland | 2,7 | 4,8 | 0,9 | -0,4 | 0,4 | 1,4 | 1,7 | 3 | 0 | 0 |
| Greece | -3,1 | -3,7 | -4,5 | -4,8 | -5,6 | -7,5 | -5,2 | -2,9 | -6,4 | 8 |
| Spain | -1,4 | -1 | -0,6 | -0,5 | -0,2 | -0,3 | 1 | 2 | 1,9 | 0 |
| France | -1,8 | -1,5 | -1,5 | -3,1 | -4,1 | -3,6 | -2,9 | -2,3 | -2,7 | 3 |
| Italy | -1,7 | -0,8 | -3,1 | -2,9 | -3,5 | -3,5 | -4,3 | -3,3 | -1,5 | 5 |
| Luxemburg | 3,4 | 6 | 6,1 | 2,1 | 0,5 | -1,1 | 0 | 1,3 | 3,7 | 0 |
| Holland | 0,4 | 2 | -0,2 | -2,1 | -3,1 | -1,7 | -0,3 | 0,5 | 0,2 | 1 |
| Austria | -2,3 | -1,7 | 0 | -0,7 | -1,4 | -4,4 | -1,6 | -1,6 | -0,4 | 1 |
| Portugal | -2,8 | -2,9 | -4,3 | -2,8 | -2,9 | -3,4 | -6,1 | -3,9 | -2,8 | 4 |
| Finland | 1,6 | 6,9 | 5 | 4,1 | 2,6 | 2,4 | 2,8 | 4 | 5,2 | 0 |
| Nº Countries | 1 | 1 | 3 | 3 | 5 | 6 | 4 | 2 | 1 | |

Source: European Commission

- c. Some of the countries that have been more affected by the crisis, in particular Spain and Ireland, had sound public finances. These two countries never had an excessive deficit according to the definition of the SGP and in 2007 registered a fiscal surplus and their debt was following a downward trend (Graph 3) and was clearly below the average in the euro zone (42 points less in 2007 in Ireland's case). It is certain that a great part of the good situation of public finances was due to the development of the housing bubble which led to a growth model which was rich in fiscal revenue. However, in both countries this higher revenue was also accompanied by reductions in

other tax figures rather than increases in government expenditure in relation to GDP. And, on the other hand, the problems in both economies (the housing bubble, excessive growth of credits in the private sector leading to increasing indebtedness) were neither detected by the budgetary monetary system nor would they have been with the toughening up of the SGP which is being proposed now.

GRAPH 3: PUBLIC FINANCES IN SPAIN AND IRELAND (% GDP)



Source: European Commission

- d. Current deficits are really a consequence of the crisis not its cause. We could interpret the proposal to toughen up the SGP at this very moment as obeying to an idea, on the part of European institutions and governments, that current deficits are part of the causes of the crisis. But the problems with public finances which are being registered today are not the result of an excessive lassitude before the crisis (with the only exception of Greece but because it had less than average fiscal revenues, not higher expenditure) but rather of the decision to bail out the financial system, particularly in Ireland, and the fall in the level of financial activity. This latter has meant an important loss in fiscal revenues and an increase in expenditures, as much due to the adoption of

automatic stabilizers as to the adoption of discretionary fiscal stimulation measures, as the very European Commission proposed in November 2008 when it launched its European Economic Recovery Plan. If the proposals which the European Commission is making had been in force, would this have prevented the appearance of these deficits? Probably not, unless European governments had sacrificed their banking systems and economies leaving them to fall into a recession-deflation spiral of unpredictable length and consequences to accomplish the impossible as far as nominal limits of the SGP are concerned.

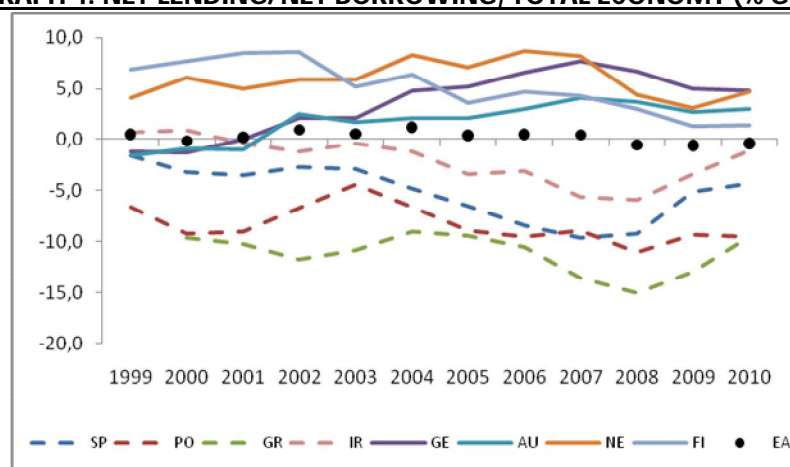
- e. If the proposed measures of adjustment are carried out immediately (establishment of minimums in the velocity of the reduction of deficit and debt) they would have strong restrictive effects. The debate is not whether current levels of public deficit can be maintained indefinitely, the key question is whether drastic fiscal cutback policies in order to achieve a pre established agenda should be carried out rapidly and simultaneously in all of the countries with deficits over 3%, regardless of the effects this could have on short term recovery and on long term employment. Keep in mind, for example, that despite cutbacks which have already been applied, in Spain the debt/GDP ratio will continue to rise in the following years, but the Commission's proposal will demand its reduction. Given the high level of unemployment today, to go more deeply into austerity policies to try and achieve the objectives of the SGP (current and new ones) does not seem to make much sense. It should be remembered what Palley (2005) points out as far as this matter is concerned, that in the past mistaken macroeconomic policies – because they were too restrictive – that were imposed by European governments, explain to a great extent high levels of unemployment rather than microeconomic policies in the labour market, contrary to the idea which is insistently defended by European authorities.

In short, the emphasis which has been placed on greater budgetary supervision, the central element of this proposal, can only be justified by an a priori position (more budgetary discipline is always good) or by an interpretation of fiscal deficits as the cause of the economic crisis, which does not match the facts.

4.2 The proposal to introduce mechanisms for the monitoring of macroeconomic imbalances is the right one, but it should go before budgetary supervision and not be asymmetrical among deficit countries and debtors.

To explain the current crisis and why it has affected some countries more than others, the growth in private debt which has been evolving in peripheral countries since the beginning of the Monetary Union is much more relevant than the situation of public finances. Initially, this indebtedness generated an expansive effect, since it was destined to finance greater expenditure (for example in dwelling houses in Spain). But, nonetheless, in the following years they will have to face the servicing of this debt – interests plus repayments – which turns into a burden on the disposable income of indebted agents, who are reducing spending. To maintain the same level of demand, it is necessary to continually increase the relation between debt and GDP. This process is unsustainable over time, except if savers from other countries are prepared to continually finance this expenditure – which in the end of the day, leads to more imports - or if loans which are received are turned, in their majority, to financing productive investments. But this last has not happened.

GRAPH 4: NET LENDING/NET BORROWING, TOTAL ECONOMY (% GDP)



Source: European Commission

This economic dynamic is reflected by growing current account deficits, like those in Spain, Portugal, Greece or Ireland (Graph 4). But these increases in deficit in current accounts and in the debt have their origin in the private not the public sector (Table 2).

TABLE 2: PRIVATE AND PUBLIC DEBT (% GDP)

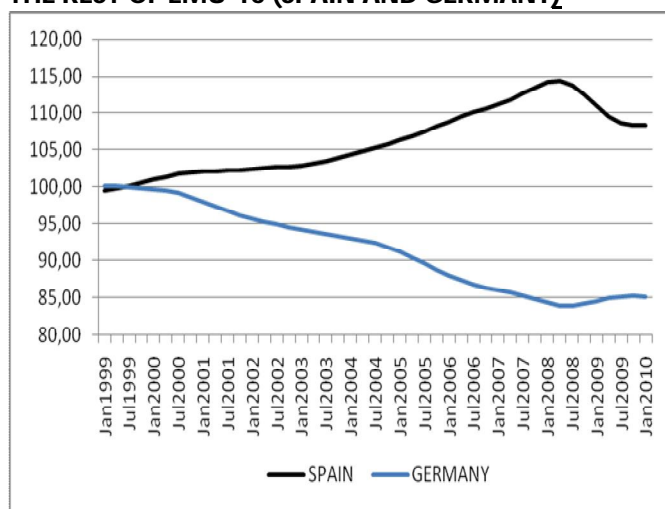
| Sector and country | | % GDP | | | | CHANGE | |
|---|----------|-------|-------|-------|-------|-----------|-----------|
| | | 2001 | 2004 | 2007 | 2009 | 2007-2001 | 2009-2007 |
| Debt of Households and Non-financial Corporations (1) | Ireland | 150,9 | 170,5 | 211,4 | 317,2 | 60,5 | 105,8 |
| | Greece | 63,0 | 77,3 | 106,5 | 123,0 | 43,4 | 16,5 |
| | Spain | 132,4 | 159,9 | 213,7 | 225,1 | 81,3 | 11,4 |
| | Portugal | 187,4 | 198,9 | 229,9 | 259,6 | 42,5 | 29,7 |
| Public Debt (2) | Ireland | 35,5 | 29,4 | 25,0 | 65,5 | -10,5 | 40,5 |
| | Greece | 102,9 | 98,6 | 105,0 | 126,8 | 2,1 | 21,8 |
| | Spain | 55,5 | 46,2 | 36,1 | 53,2 | -19,4 | 17,1 |
| | Portugal | 52,9 | 58,3 | 62,7 | 76,1 | 9,8 | 13,4 |

(1) Total loans and securities other than shares. (2) Definition of the Excessive Deficit Procedure.

Source: European Commission

The appearance of these growing levels of private and foreign debt, associated to high levels of current account deficits, should have been detected as a fundamental problem for the workings of the monetary union. But the interpretation of this situation which was made at the time by national and European economic authorities¹⁵, and also in good part by academic economists, was that they were the normal result of the convergence process between economies, or that they really reflected the microeconomic decisions of a multitude of individual economic agents (lenders and debtors) without macroeconomic consequences once national currencies had disappeared. Subsequent experience has shown that this vision was wrong and, for this reason, the proposal for a new mechanism to detect situations of macroeconomic imbalances should be welcomed.

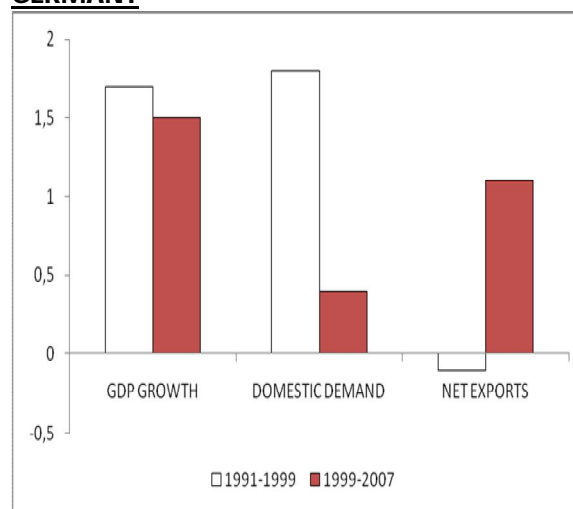
GRAPH 5: REAL EFFECTIVE EXCHANGE RATE VERSUS THE REST OF EMU-16 (SPAIN AND GERMANY)



REER deflated with ULC.

Source: European Commission

GRAPH 6: CONTRIBUTIONS TO GDP GROWTH, GERMANY



Source: European Commission

¹⁵ When, at the beginning of the 90's, the first steps in the design of the EMU were being taken, the very same European Commission rejected the relevance of current account imbalances within the monetary union. European Commission (1990).

In Spain's case, specifically, this imbalance obeys two factors. First, Spanish GDP grew faster than its competitors: between 1999 and 2007 the average rate of growth of the Spanish economy was 3.8% compared to an average 2% in the rest of the EMU-12 countries. Second, Spain lost competitiveness in opposition to these countries¹⁶: nominal wages grew more in Spain (23 percentage points) and the real rate of exchange, deflated by unit labour costs, rose by 14 percentage points (Graph 5).

However, it is important to interpret these figures – and their possible correction – within the context of global imbalances in the euro zone. Between 1999 and 2007 the current account balance in the monetary union with the rest of the world did not undergo important changes, registering an average surplus of 0.5% GDP. In other words, deficits like those of Spain are mirrored by the surpluses which have occurred in Germany, Austria, the Netherlands and Finland¹⁷.

The improvement in the foreign trade balances of these countries, especially in Germany, is related, first, to the dynamism of its exports that arise from the growth in international trade¹⁸. This rise in exports, and hence in income, should also lead to a rising growth of internal demand (consumption and investment) and of imports. But this has not happened, for which reason the growth in the surplus of current accounts can be fundamentally explained by an exceptionally low growth in internal demand (Graph 6).

An important factor, to explain this behaviour of the German economy, is its policy of very moderate wage growth – below the total growth in productivity as well as the ECB's inflation target – which has allowed it to gain competitiveness with relation to the rest of the euro zone countries. In other words: the responsibility for the evolution in competitiveness since 1999 does not only fall to countries which have accumulated current account deficits but also on surplus countries – which with deliberate low growth wage rises have limited the dynamism of their internal demand, but have avoided higher unemployment by exporting to other countries¹⁹.

On the other hand, it is also relevant that the very design of the monetary union generates this accumulation of imbalances going in the opposite way in some countries or others, for example, when an asymmetric shock happens. If this shock leads to lower inflation in some countries and higher in others, the real interest rate will rise in the first ones and will fall in the second ones, so that the gap will tend towards rising instead of falling. It is certain that, at the same time, the first ones will be improving their competitiveness, which will have an expansive

¹⁶ European Commission (2010f).

¹⁷ See Paúl (2008) for an analysis of current account imbalances in the heart of the EMU.

¹⁸ European Commission (2010g).

¹⁹ Busch (2010).

effect which will tend to cancel out the first effect, and that in the second countries the opposite will happen. However, experience has shown that this “competitiveness channel” is weaker than the “real interest channel”, and that diverging dynamics can consolidate themselves.

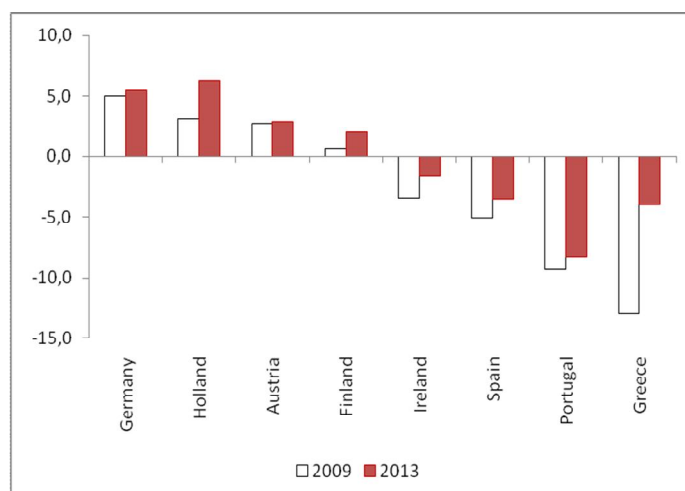
We can obtain some important implications. First, the solution for current imbalances (or preventing new ones from appearing in the future) should not only come from the side of deficit countries – trying to regain competitiveness – but also from the side of surplus current account countries, that also have a greater margin of fiscal manoeuvres than average²⁰. If these countries maintain a policy of low wages and slow growth for their internal demand, it will be impossible to solve this imbalance for those deficit countries except at the price of a deep recession and deflation, which would actually end up endangering the repayment of past debts. Second, the countries in the monetary union cannot base their growth strategies on stimulating exports derived from wage competitiveness with the rest of the euro zone countries.

The updating of Stability Programs which European governments presented for the 2010-2013 period, however, does not leave much room for optimism. Not only the countries which register a deficit situation hope for improvements in their foreign trade sector but also the surplus countries hope to increase exports, continuing with their growth strategies oriented towards exports (Graph 7). But both things cannot take place at the same time, unless the foreign trade balance of the euro zone with the rest of the world improves notably with regard to what has happened in the last years²¹.

²⁰This “symmetrical approach for the solution of imbalances within the EMU has been defended, for example, by Goodhart and Tsomocos (2010), Pisani-Ferry (2010), Dadush and Eidelman (2010) and Stockhammer (2010). On the contrary, Wplosz (2010^a, b) and Bundesbank (2010) argue in favour of an “asymmetrical approach, in which the greatest part of the correction would be achieved with policies applied in deficit countries.

²¹ See Brecht et al. (2010) for a more indepth analysis of this subject.

GRAPH 7: CURRENT ACCOUNT (% NATIONAL GDP)



Source:European Commission

Therefore, it is necessary to design institutional instruments for economic policy which can be used to counter this type of accumulative imbalances in the future. Like, for example, the establishment of certain deficit and surplus ceilings for current account balance which implies the need to correct the evolution of internal demand²², a greater coordination of wage policies²³ at the European level or automatic levels of income transfer. Looking at things from this perspective, the current proposals of the Commission and Council's, although they are positive, are totally insufficient and asymmetrical, because they seem to consider that the only economic imbalance is the current account deficit, while a surplus is a demonstration of economic efficiency and virtue. For this reason, the burden of the adjustment and the imposition of sanctions fall exclusively to those countries which register current account deficits²⁴.

²² Dullien and Schwarzer (2009) propose a similar monitoring system of current account deficits and surpluses in the private sector and in financial systems which they term the External Stability Pact and which would complement the SGP.

²³ In this sense, a proposal, could be that during the process of adjustment of competitiveness that is necessary to eliminate the current imbalances, the objective for the euro zone's inflation would increase. Deficit countries would, at the same time, pursue their own national objectives below the average rate, and surplus countries over the average. In this way, the deflation of peripheral countries would be avoided. Once the adjustment of real interest rates was concluded, wages would rise in each country to the rate of the sum of growth in productivity plus the objective for inflation for the whole of the euro zone. Febrero and Uxó (2011).

²⁴ This vision of current account imbalances and their solution is described in European Commission (2010, g).

4.3 The coordination of fiscal policy among European countries and between fiscal and monetary policies should also make up a substantial part of the current reform of the institutional framework of economic policies in the euro zone.

The Commission's current reform proposal should be extended to include greater coordination with relation to national fiscal policies depending on European needs. One example of the limitations of the current coordination framework is the European Economic Recovery Plan passed in December 2008. The fundamental part of fiscal stimulation plans should fall to national governments, but no definite undertaking with regard to quantities or deadlines, nor any mechanism in the geographic distribution of fiscal stimulus, was established a priori. Another example is the current situation, where budgetary readjustment plans are going to be applied simultaneously, which would increase their restrictive effect. This reform of the fiscal framework should also include decisive steps towards a greater integration of European fiscal policies, designing, for example, instruments for the automatic transfer of funds in case asymmetric shocks occur, or the possibility of the European Treasury emitting shares. Finally, the coordination between fiscal and monetary policy also implies the need to reconsider the role of the ECB, its objectives and participation in the financing of the debt, at least in exceptional situations like the current one.

5. Conclusions

The experience of the working of the Monetary Union, before and after the crisis, has highlighted the need to reform the institutional framework for economic policy. In particular, the importance of the accumulation of imbalances in current accounts – deficit and surplus – has been minimized. However, these imbalances are among the causes of the crisis, and certainly they are an added difficulty for its solution. In this sense, the proposal for a mechanism to detect these imbalances is valued very positively, although it has an asymmetrical character – the adjustment only falls to deficit countries – which should be modified to include limits in current account surpluses or institutional mechanisms to avoid wage competitiveness among countries (or rather amongst their working classes).

The central character which the Commission and the Council grant to the toughening up of the SGP also seems inappropriate, since increases in public deficit are by no means the cause of the crisis, rather a consequence of it. For this reason, a reform improve global coordination of fiscal policy would be more justified or sets out explicitly the role that the ECB should play in a debt crisis like the current one, beyond its current monitoring of the inflation objective. However, none of this is reflected in the current proposals.

This said, we cannot ignore the difficulties which the reforms proposed here face. These difficulties are institutional (the objectives and even the design of fundamental aspects of economic policy instruments, like the independence of the ECB or fiscal austerity, are currently part of the European Union Treaty) as well as ideological. But at the same time, as Arestis and Sawyer (2011) highlight, without these changes the outlook for the next years is not very rosy: *“The faults lie in the neo-liberal design of the euro Project, now embedded in the Treaty of Lisbon, and where there is little prospect of serious change because of the unanimity requirements for change. But without basic and fundamental change, many (perhaps all) euro area countries face a bleak economic future”*.

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