Economic Prospects for the EU – Doomed to Stagnation?
An analysis of the current crisis and recommendations for reforming macroeconomic policymaking in Euroland

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'It is not too farfetched to say that Europe chose never really to recover from the two worldwide oil-shock, anti-inflation recessions of the decade 1973 to 1982. Europe seems content to return to sustainable growth rates at lower and lower rates of utilization, without ever recapturing the ground lost in those recessions. With chronic double-digit unemployment rates in several members of the EU, the policy might be described as cutting out of the economy large fractions of the population, buying their acquiescence by welfare-state transfers, and then blaming the "structural" unemployment on the transfers. ... I am not enthralled by the recommendations I heard ... that the US follow the European example and gear monetary policy exclusively to price stability. This orientation of monetary policy has been very costly in Europe, and it is likely to be even more costly if it is enshrined as dogma by the Maastricht Treaty' (James Tobin 1994).

Abstract: This paper challenges the view that external shocks caused the 2001 slowdown and subsequent stagnation in Euroland. Instead, the design of macro policymaking arrangements in Euroland is found lacking in providing for sufficient domestic demand growth. In the event, the ECB has failed on its stabilisation role – a rather vital role given that fiscal policy has been and continues to be severely constrained by the Stability and Growth Pact. As a consequence, the EU is today in a rather precarious situation. And under the current regime there is a serious risk of further deterioration. Therefore, this paper urges to reform the regime, recommending a nominal GDP target to be pursued by both fiscal and monetary policies in cooperation. This would provide Europe with the growth anchor that is currently missing.

Key words: policy design and consistency, stabilisation policy, policy coordination

JEL classifications: E61, E63, E65, E66

1. Introduction

After a brief span of relatively strong GDP growth between 1997 and 2000, the eurozone experienced a pronounced slowdown in 2001. With hopes for a quick recovery in 2002 having turned out unfounded, in early 2003, Euroland appears set for yet another year of stagnation, at rising unemployment and a relentlessly growing negative output gap. What went wrong? And how can Euroland pull itself out of the current mess?

This paper attempts to give answers to these questions, questions that seem all the more urgent in view of the prospective enlargement of the European Union in 2004. There is a clear risk that Europe might find itself in a serious crisis by that time unless Euroland's economic engine starts up again soon.

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The analysis proceeds as follows. The next section investigates and rejects the view that the 2001 slowdown in Euroland may have been due to external shocks. The following three findings are striking. First, domestic demand growth began to decline in mid 2000 whereas exports grew strongly through 2000. Second, while both domestic and export demand growth plunged in 2001, Euroland's 'recovery' in 2002 was largely export-driven whereas domestic demand merely stabilised at a depressed level. Third, the ECB thoroughly misjudged developments throughout the slowdown.

These findings direct our attention to domestic factors. Section 3 critically discusses macro policymaking arrangements under the Maastricht regime. It is argued that, if that regime is to be made to work at all, the ECB has to play a rather vital role in stimulating domestic demand and stabilising the economy. The subsequent section 4 then reviews the actual behaviour of the key players. It is found that both social partners and finance ministers essentially played after the rules, whereas the ECB completely failed on its stabilisation role: its all too aggressive interest rate hikes in 2000 where followed by all too 'cautious' rate cuts in 2001-02. As a consequence, the prospects for the EU under the current regime are grim, as discussed in section 5. Therefore, it is urgent to reform the regime. Section 6 recommends that a nominal GDP target should be pursued by both fiscal and monetary policies in cooperation – providing a growth anchor to Europe that is currently missing. Section 7 concludes.

2. The 2001 slowdown: Caused by external shocks?

Raising this question might come as a surprise. After all, a key idea behind EMU was that this would create an economic area under common policymaking nearly resembling a closed economy; a large economic zone sheltered from those recurrent bouts of instability in the rest of the world where economic policies might still be guided by principles other than the 'stability-oriented' ones inspiring policymaking in Euroland.

In line with this thinking, the US economy's severe nosedive in 2000-01 (according to official NBER dating, the US entered recession in March 2001) represented no serious concern to the ECB for quite some time. The first Eurosystem staff economic projections for the euro area of December 2000, based on an unchanged monetary policy stance, showed strong growth for 2001 (2.6 - 3.6%) and 2002 (2.5 - 3.5%). In its Monthly Bulletins of December 2000 and January 2001, the ECB held that medium-term risks to price stability were on the upside. The January Bulletin discussed the US Fed's first 50 basis points cut of 3 January 2001 with reference to increasing uncertainty surrounding the economic growth performance in the US, but in February the ECB declared:

> While this deceleration will have some dampening effects on euro area net exports, the euro area is a large economy in which economic developments are determined mainly by domestic factors. Overall, the fundamentals in the euro area remain broadly favourable (ECB 2001, February MB: 5).

This assessment of the situation was confirmed in March with the ECB stating that:

> The general outlook for this year and next remains positive. Economic activity in the euro area is mainly determined by domestic factors. The conditions on the domestic side, as shown in long-term financing costs and real disposable income developments, for example, have remained favourable. ... This notwithstanding, an element of uncertainty with regard to the outlook for euro area growth continues to be the world economy and its potential impact on euro area developments. However, at this juncture, the are no signs that the slowdown in the US economy is having significant and lasting spillover effects on the euro area (ECB 2001, March MB: 5).

No doubt the ECB believed that US growth was not very important to economic performance in the eurozone, declaring in May 2001 that 'economic growth, supported by domestic demand, will be broadly in line with estimates of potential growth in 2001' (ECB 2001, May Bulletin: 5). Nevertheless, on May 10, the ECB cut its key policy rates by 25 basis points, once again stirring widespread confusion in financial markets.

The ECB then came to appreciate the role of external developments in subsequent months. In fact, soon the ECB explicitly stated that the deceleration of growth was *caused by* external factors, but would be supported by both fiscal and monetary policy in the eurozone:

> Real GDP growth in the euro area in 2001 is expected to come down from the high level reached in 2000 to levels more in line with trend potential growth, primarily as a result of the less favourable external environment. ... At this juncture, however, the contribution to real GDP growth from domestic demand is expected to remain robust. This is consistent with the favourable economic fundamentals of the euro area, the impact of current and planned tax reforms and favourable financing conditions (ECB 2001, June Bulletin: 5)

And in July 2001, when the ECB for the first time related the slowdown to weak growth of domestic demand, declining investment was seen as being linked to adverse influences from the world economy. Weakening consumption was partly due to adverse income effects relating to energy and food price increases, in the ECB's view, predicting that: 'in the course of the year, domestic demand should gradually recover, in view of the sound economic fundamentals of the euro area, previous and ongoing tax reforms and favourable financing conditions' (ECB 2001, July Bulletin: 5).

The ECB's assessment of the slowdown remained the same in subsequent months. A further interest rate cut had to wait until August 30. Only after the September 11 attacks interest rates were cut more decisively, by 50 basis points each on September 17 and November 8. Weakening demand was seen as reducing price pressures. With falling inflation and high uncertainty, these cuts were retrospectively described as 'forward-looking' (ECB 2001, December Bulletin: 5). It forecasted that growth would resume to potential in the course of 2002, particularly as the eurozone was not suffering from any serious imbalances:

> The conditions exist for a recovery to take place in the course of 2002 and economic growth to return to a more satisfactory path. The economic fundamentals of the euro area are sound and there are no major imbalances which would require a prolonged adjustment. The uncertainty currently overshadowing the world economic should diminish over time. Further positive effects on economic growth should stem from the increase in real disposable income caused by the substantial decline in inflation and the impact of tax reductions in several euro area countries. In addition, interest rates across the entire yield curve are now low, meaning that current financing conditions are clearly supportive to economic growth (ECB 2001, November Bulletin: 6).

The degree of synchronicity of the 2001 global slowdown has surprised others too. A consensus view has emerged among international authorities (IMF, BIS, OECD) emphasizing increased international linkages on the one hand, and commonness of shocks on the other. For instance, the BIS's Annual Report (2002, p. 16) states: 'On balance, it seems that the synchronised downturn in 2001 mainly represented the effects of common shocks, reinforced by the high trade intensity of the demand components most severely affected'.

No doubt international linkages exist. A reawakening to the fact that Euroland remains part of an ever more tightly integrated global economy is to be welcomed – especially as Euroland itself is quite big enough to pose risks to the rest of the world too. As I have argued elsewhere (cf. Bibow 2001a,b), Euroland's brief span of prosperity during 1997-2000 owed much to strong external growth, the US's 'new era' growth spur of the late 1990s in particular.[2] Hence a US slump was bound to have a significant impact on the eurozone. And policymakers should have been especially alert to this prospect.

Nor can the commonness factor of certain 'shocks' be denied, particularly the oil price surge since 1999 and IT bubble bursting and general stock market decline after March 2000. Monetary

[2] In an article on the 'characteristics of the euro area business cycle in the late 1990s', the ECB appears to confirm this: 'When foreign demand picked up again in early 1999, extra-euro area exports improved and real GDP growth increased. The exceptionally strong cyclical upturn in extra-euro area exports in 1999 and 2000 benefited from an unusually sharp expansion in the world economic and from the rise in price competitiveness associated with a protracted depreciation of the effective euro exchange rate' (ECB 2002, July Bulletin: 48).

tightening features as another common shock in the BIS's and IMF's account of causes of the global slowdown, for instance:

> As in previous business cycles, monetary policy in G-7 countries was tightened prior to the recent downturn. Given that inflation was relatively low toward the end of the previous expansion, central banks had to raise interest rates by less than usual, which is one factor behind the relatively mild recessions. Relatively low inflation going into the recessions also allowed central banks – especially in the United States, the United Kingdom, and Canada – to cut interest rates aggressively over the past year, helping to set the stage for recovery (IMF 2002, April WEO: 71).

In its euro area survey of 2002 the OECD too refers to 'lagged effects of earlier monetary tightening', describing an interesting link between this factor and inflation and exchange rate developments, a suggested link that will be taken up again further below:

> The sharp hike in oil prices in 1999/2000 reduced purchasing power and squeezed profit margins, while the rise in underlying inflationary pressures led to a tightening of monetary policy by central banks, including the ECB. The continued weakness of the euro and strong monetary growth also added to concerns about the risk to price stability (OECD 2002: 19).

By contrast, in the ECB's assessment of the slowdown its own interest rate policies do not feature. Ex ante interest rate policies never seem to conflict with economic growth in ECB policy communications and assessments. And ex post economic developments do not appear to have been related to interest rate developments either. For instance, throughout the ECB's brisk tightening phase between November 1999 and October 2000, the ECB proclaimed that monetary tightening would not pose any risk to economic growth. Rather, by keeping inflation expectations in check, confidence in price stability would be sustained which, in turn, would stimulate growth, in the ECB's view (Bibow 2002b).

And after the fact too, in comparing the 1998 and 2001 slowdowns in the euro area (ECB 2002, June Bulletin: 41-3), there is a conspicuous silence on two key facts: first, the interest rate conversion process and associated asset price surges since the mid 1990s, a one-off adjustment that boosted domestic demand in the late 1990s in many eurozone countries but had largely run its course by 2001-02, second, the near doubling of ECB policy rates (225 basis points) in less than a year after November 1999. Could it not be that these factors made a difference, restraining (rather than stimulating) domestic demand since 2000?

Given that the ECB's published research on the transmission mechanism in the eurozone shows strong[3] (though allegedly ‘temporary’) real effects of monetary policy, particularly ‘that investment is a main driving force, with a contribution of more than 80 percent to the total response of GDP after three years’ (ECB 2002, 47; see also ECB 2000, Arestis and Sawyer 2002, and Kuttner and Mosser 2002), anything else would be quite surprising. It is noteworthy that the ECB’s comparison does not fail to observe that in the context of the external demand shocks of 1997/98 domestic demand in the eurozone held up quite well whereas domestic demand plunged in the 2001 slowdown.

Figure 1 ***here***

It is thus crucial to get the empirical record straight. Figure 1 captures the broad situation over the last five years, showing (year-on-year) quarterly growth of real GDP, domestic demand, and exports at annual rates. In the late 1990s domestic demand grew at 3 to 4% per year. After slowing only mildly and temporarily in the course of 1999, a marked and protracted deceleration started in mid 2000, turning negative in late 2001. Recovering from the 1997/8 crises, exports grew briskly in 1999 and through 2000. Export growth then plunged in the first half of 2001, long after the domestic situation had turned for the worse.

Figure 2 ***here***

Figure 2 shows the behaviour of the main GDP components and further underlines this. Growth in both private consumption and gross fixed capital formation started to decline in mid 2000 pulling down imports along with them, plunging earlier and faster than exports. Government consumption, broadly stable over 1999-2000, increased slightly over 2001-02.

Figure 3 ***here***

A comparison with the US is illuminating. In the US too, the situation turned for the worse in mid 2000, as figure 3 shows. However, US exports plunged earlier and far more severely than their eurozone counterpart. A look at the contributions to GDP growth shown in figure 4 is most revealing. Clearly, the US experienced a severe contraction in 2001. But if the slowdown was mainly domestically-driven, both final domestic demand and inventories, so was the recovery in 2002. The drag on US GDP growth due to net exports briefly paused in 2001, but quickly reemerged with the recover. The picture for the eurozone looks very different. As figure 5 shows, Euroland’s ‘recovery’ in

[3] A temporary increase of 100 basis points (lasting for two years) in policy-controlled interest rates is estimated to contract GDP by 0.2 to 0.4% in the first year and by up to 07% in years two and three (effects in later years are not reported). See ECB 2002 (October Bulletin: 45).

2002 was solely driven by net exports.

Figure 4. ***here***

Figure 5. ***here***

In conclusion, it seems farfetched to blame the current stagnation in the eurozone on external developments. In so far as 'common shocks' were at work in the 2001 global slowdown, Euroland's downturn since mid 2000 helped to drag the world economy down, representing a cause and propagation mechanism rather than the opposite. Clearly, then, explanations for the economic situation in the eurozone have to focus on domestic demand developments and macro policymaking in the eurozone. This is all the more pressing as the 'recovery' in 2002 was exclusively driven by external developments whereas domestic demand merely stabilised at a depressed level. In the case of a large economy, that means stagnation.

Before analysing actual macroeconomic policymaking in the eurozone before and since the 2001 slump, it is useful to briefly revisit the design of Euroland's macroeconomic policymaking regime, or 'Maastricht regime', and its underlying rationale.

3. Macroeconomic policymaking and the rules of the Maastricht regime

A fundamental imbalance in economic policymaking represents the outstanding characteristic of the Maastricht regime. The EU has created a common market, and a majority of members have adopted a common currency, both controlled by supranational EU institutions. But fiscal policy remains under national control – there is no supranational European Treasury.

As laid down in Articles 98 and 99 of the EU Treaty though, member states have to 'regard their economic policies as a matter of common concern and coordinate them within the Council', with policies to be geared at the common objectives defined in Article 2 and conducted in compliance with the principles set out in Article 4. Objectives feature a high level of employment and of social protection and sustainable and non-inflationary growth. Guiding principles for close policy coordination are: stable prices, sound public finances and monetary conditions, and a sustainable balance of payments.

Annual 'broad economic policy guidelines' [BEPGs] form the basis for the foreseen close policy coordination and multilateral policy surveillance within the EU. In addition, the 'Luxembourg process' was devised to improve the functioning of labour markets and coordinate employment policies of member countries, and the 'Cardiff process' to improve the functioning of product and capital markets. Both processes are seen as means to raise the eurozone's growth potential and reduce its high level of unemployment. Finally, the 'Cologne Process' initiated a *dialogue* between the main macroeconomic players, including social partners as well as the ECB – coordination by dialogue. In the field of budgetary policies, the principle of sound public finances was firmly engraved right from the start in the Treaty's 'excessive deficit procedure' of Art. 104, prescribing limits for public debt and deficits.[4]

For fiscal discipline is held to be vital for safeguarding macroeconomic stability and dealing with the risk of spillovers. The original rationale was that individual member states might otherwise face incentives to spend and borrow too much, putting upward pressure on the union-wide level of interest rates and downward pressure on the external value of the common currency. Apparently, market discipline was considered insufficient in this respect. To further strengthen fiscal discipline the 'Stability and Growth Pact' [SGP] procedure was introduced in 1997. The SGP defines the exceptional conditions under which deficits above the 3 percent of GDP (Maastricht) limit would not be considered excessive. And it commits member states to respect the new medium-term objective of budgetary positions of 'close to balance or in surplus'. Towards this end, since 1999, member states draw up (and update annually) national 'stability programmes' [NSPs], laying out a stability-oriented route to a balanced budget by (originally) 2004 (see Artis and Buti 2000).

The official rationale for the SGP is twofold. First, a medium-term balanced budget rule is held to secure the automatic stabilisers, providing flexibility for dealing with short-run instabilities without breaching the 3 percent limit, and preferably in non-discretionary ways. Second, a balanced budget sets the debt ratio on a rapidly declining trend, reducing the interest burden to make room for long-run demographic pressures on public finances.

Another rationale for fiscal discipline are memories of historical 'printing press' experiences. If money matters, so does history. The Maastricht regime is essentially a product 'made in Germany'. In order to induce Germany to surrender its beloved deutschmark, and lure the Bundesbank to hand over its monetary reign over Germany (and Europe) to the ECB, the regime simply had to be drawn up along German lines.[5]

This is not the occasion to delve into German economic history at any depth to find out why the

[4] See OECD 2002 for an overview.

[5] Dyson and Featherstone 1999 provide the most comprehensive account. See also: Kenen 1995, Padoa-Schioppa 1994, and Tietmeyer 1991, 1994.

Bundesbank's independence became associated with price stability and a 'hard' currency, and these in turn with prosperity, in the German public opinion. The 1950s 'Witschaftswunder' and prosperity of the 60s occurred under the Bretton Woods regime. After its breakdown, attempts at stabilising the economy in response to OPEC I were judged a failure in Germany – an experience not to be repeated. By contrast, Germany's fiscal consolidation of the 1980s, now as ERM anchor, was held a success – a strategy to be continued (despite unification). Meanwhile much of this peculiar national wisdom has become conventional wisdom at the EU's key policymaking institutions, the ECB and the European Commission. On the role of sound public finances and the SGP the latter body declares:

> Achieving and sustaining sound positions in public finances is essential to raise output and employment in Europe. Low public debt and deficits help maintain low interest rates, facilitate the task of monetary authorities in keeping inflation under control and create a stable environment which fosters investment and growth. ... The Maastricht Treaty clearly recognises the need for enhanced fiscal discipline in EMU to avoid overburdening the single monetary authority and prevent fiscal crises which would have negative consequences for other countries. Moreover, the loss of the exchange rate instrument implies the need to create room for fiscal policy to tackle adverse economic shocks and smooth the business cycle. The stability and growth pact is the concrete manifestation of the shared need for fiscal discipline (European Commission 2000, p. 1).

There were lessons to be learned from past mistakes and mal-developments:

> Strong emphasis on fiscal prudence and stability in the Maastricht Treaty derived from the belief that the deterioration of public finances was an important cause behind the poor economic performance of many EU countries since the early 1970s. The subsequent decades taught Europe a salutary lesson of how economic prosperity cannot be sustained in an unstable economic policy environment. Inappropriate fiscal policies frequently overburdened monetary policy leading to high interest rates. On the supply-side, generous welfare systems contributed to structural rigidities in EU economies and fuelled inappropriate wage behaviour. The net effect was a negative impact on business expectations and on investment, thus contributing to a slower rise in actual and potential output. As a result, employment stagnated (ibidem, p. 9).

Note: the hoped-for improvements in economic performance are supposed to arise through two main channels. First, fiscal discipline will secure the success of stability-oriented monetary policies, i.e. lead to price stability, and this will, through lowering interest rates, stimulate investment and growth, and hence employment as well. Second, fiscal consolidation will lead to a smaller, i.e. better, state, which – through reducing the tax burden and improving the supply side – stimulate investment, growth and employment along this route too. As the two channels might be conceived as being self-reinforcing, the plan is to initiate a cumulative process, a virtuous circle, reversing the vicious one of earlier decades.

The part to be played by Europe's finance ministers is thus made clear: fiscal policy is focussed on the overriding objective of fiscal consolidation. In particular, while member states with a balanced-budget position may allow automatic stabilisers to work freely under adverse conditions, any pre-sound ones still labouring en route to a balanced budget may be severely constrained in coping with Keynesian effects of fiscal retrenchment 'in the short run'. There is no coordination of national fiscal policies other than through the imposed discipline to cut deficits and balance the budget. And there is no discipline in place to prevent countries from attempting to be too thrifty, free-riding on other member states' less restrictive fiscal stances.

The part to be played by social partners is also indicated in the above: appropriate wage behaviour. In the BEPGs this is further specified as real wage increase conducive to employment growth and nominal wage increases that do not conflict with the ECB's understanding of price stability. As to the ECB's part in the game, the BEPGs remain quiet and the Treaty in Art. 105 merely says that its primary objective is that of maintaining price stability and, without prejudice to price stability, to support the community's other objectives laid down in Article 2. It was left to the ECB itself to decide on the role it wishes to play.

I have argued elsewhere (Bibow 2001a[6]; see also Allsopp and Vines 1998, Kregel 1999, Arestis and Sawyer 2001, and Hein 2002) that – effectively – the Maastricht game *requires* the ECB to play quite a vital role. With uncoordinated national fiscal policies, especially if these are constrained by not-as-yet attained balanced-budget targets, monetary policy is the only instrument available for managing aggregate demand. And certainly as long as wage inflation remains calm, monetary policy is also perfectly free to fulfil its stabilisation role. In fact, with price stability secured by social partners, focussing monetary policy on price stability too, means wasting the only instrument available to manage aggregate demand.

Is this 'too Keynesian' an assessment of the Maastricht game? The point is: no matter how committed Europe might be to fiscal consolidation, this will not magically steer interest rates towards levels conducive to growth and employment. Rather, if that regime is to be made to work at all, it is the ECB's interest rate policies which would have to stimulate and manage aggregate demand, so as to

[6] The analysis in that paper was carried out before the fact and first presented in the autumn of 1998.

produce growth and employment – and *thereby* to allow the aspired fiscal consolidation in the first place. Growth-oriented monetary policies are a necessary precondition. Only by sufficiently stimulating private spending and employment growth will consolidation be made possible at all. By contrast, if the ECB fails to play its proper role, attempts at consolidation are doomed to fail. Worse, they might even backfire, and public deficits and debts rise still further in a stagnating economy.

In *The General Theory*, Keynes (1936) compared two regimes. In his preferred Keynesian regime, monetary policy is applied flexibly towards managing aggregate demand, while prices are anchored by a stable wage unit. By contrast, the opposite regime features aggregate money wage flexibility, while monetary policy is stabilised. In Keynes's analysis, at least as a tendency, an automatic monetary stabiliser is at play, namely, through the working of labour market forces and their effects on the liquidity situation and interest rates.

Milton Friedman's (1960, 1968) famous '*k*-percent rule' may be understood as representing the latter-type regime. For instance, in a downturn, falling wage inflation push for monetary easing, perhaps sufficient so as to counterbalance the falling off in demand. If it is further believed that the monetary rule anchors prices and inflation expectations, aggregate money wage flexibility would seem to pose no risk. The crucial point is: in Friedman's *k*-percent regime the central bank has no hand in manipulating interest rates. That is, faith in the efficient working of flexible labour markets is paired with faith in the efficient working of financial markets, unguided by some central bank leader (Bibow 2002d).

Clearly, then, the Maastricht regime is *not* designed along monetarist lines. Not because of Euroland's legendary inflexible labour markets, but for the plain fact that the ECB sets interest rates. Once central bankers set interest rates, any idea (or pretence) that they do not thereby engage in fine-tuning aggregate demand is an illusion – as Friedman made clear.[7]

Of course, this is not to suggest that any such monetary fine-tuning attempts will necessarily be successful. Far from it. Both Keynes and Friedman, to name only two serious economists, have warned us of the intricacies of controlling the economy by monetary policy. While Keynes thought there was no way around this problem, Friedman designed a regime in which the monetary villains' (i.e. central

[7]There is no denial of the fact that the current practice of monetary policy all over the world follows the Keynesian reaction function approach and the theory of monetary policy has clearly gone this way too. See Blinder 1998, Allsopp and Vines 2000, for instance. Of course the popular time-inconsistency literature has sparked a lot of confusion in this regard (see Bibow 2001d, and Forder 1998, 2002). For early sceptical views on the ECB see Begg and Green 1998 and Buiter 1999, for instance.

bankers') hands would be tied in chains.

The Maastricht regime is not only peculiar for the fact that the task of demand management – *inevitable*, in Keynes's view – is not explicitly looked after at all. It is also quite grotesque for featuring the world's most independent central bank at its core – the exact opposite to Friedman's prescriptions.[8] I have dubbed the firmly institutionalized *unbounded discretion* in the conduct of the eurozone's common monetary policy the *Maastricht paradox*: 'Starting from an overriding principle of disciplining policymakers as the foundation of stability, the ECB ended up as the "benevolent dictator" in the scheme' (Bibow 2002b, 33).

Among other things unbounded discretion includes scope for playing games with finance ministers: 'if you seem to question consolidation, we will hike', 'if you mention interest rates, this will keep us from cutting them' etc. Unbounded discretion also includes the option of punishing social partners for inflation, or even any perceived inflation risk, not related to their behaviour – if this is perceived as fostering its own prestige in the ECB's view.

The next section will scrutinize how things have played out in practice. Of particular interest is whether either social partners or fiscal policymakers have failed on their respective roles, thereby jeopardizing the goal of price stability and, hence, curbing Euroland's monetary policymaker's required role as key stabilization instrument.

4. The Maastricht regime at work: What has gone wrong?

Figure 6 ***here***

Figure 6 shows annual percentage changes in compensation per employee in the business sector, illustrating the degree of wage disinflation that occurred over the 1990s. Since 1995 a 2 percent trend has emerged, way below the implicit Maastricht parameter of a 5 percent nominal GDP trend. A gap in compensation growth has opened up vis-à-vis the US since the mid 1990s (far exceeding any labour productivity gap). The rise in compensation growth in Euroland since 2000 was very mild compared to the quadrupling of headline inflation between January 1999 and mid 2001, staying well below 4 percent (i.e. the nominal GDP trend rate implicit in the ECB's monetary reference value).[9] If the quick drop in

[8]It is also of interest, although not at all surprising, that Friedman (2003) suggested scrapping the SGP.

[9]The ECB's indicator of "negotiated wages", reflecting the direct outcome of the outcome of bargaining between social partners and unaffected by changes in social security contributions or working hours, 'confirms the

US compensation growth in 2001 reflects the legendary ‘flexibility’ of US labour markets, do not overlook that a corresponding drop would have pushed Euroland into deflationary territory straight away. From a Keynesian perspective a stable wage anchor paves the way for a flexible monetary policy. Euroland’s wage anchor has been remarkably stable since the mid 1990s, and at such a low level though that any prospect of aggregate downward flexibility poses a serious risk.

Figure 7 ***here***

Turning to public finances, figure 7 shows the evolution of debt ratios in Europe and the US during the 1990s. Starting from debt ratios of 60 and 66 percent in the early 1990s, the US’s debt ratio peaked at 76 percent in 1993-4, and declined afterwards to reach 60 percent by 2000. By contrast, Euroland’s debt ratio peaked at 80 percent in 1996-7, reaching 72 percent by 2000. That is, over the decade the US has seen its debt ratio decline by six percentage points, whereas Euroland’s has risen by double that.

The rise in Euroland’s debt ratio is often blamed on German unification. That is wrong, both for Germany and Euroland as a whole. Only about a third of the 20 percentage points rise in Germany’s debt ratio is directly attributable to unification (cf. Bibow 2001c) – roughly equivalent to the excess of the rise in Germany’s debt ratio over the Euroland average. For instance, France’s debt ratio increased by 30 percentage points between 1990 and 1998.

Figure 8 ***here***

While the truly massive budgetary swing that has happened in the US since 2000 dwarfs occurrences in the early 1990s, qualitatively the contrasting approaches to fiscal policy in Euroland and the US were quite the then and now. At issue here are automatic stabilisers and the timing of fiscal consolidation. In my view, these vital matters in fiscal policy provide an important part of the answer to the different degrees of success in fiscal consolidation in Euroland and the US during the 1990s. As figure 8 shows, starting from deficit ratios of around 5 to 6 percent in the early 1990s in both the US and Euroland, the US’s structural primary deficit increased further during the 1990-91 recession, and consolidation then started in 1993 – after the recovery (and start of the long prosperity of the 1990s) had asserted itself.

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overall picture of relatively moderate and stable wage increases between 1997 and 2000, with the average annual growth rate of negotiated wages remaining just above 2%’ (ECB 2002, September Bulletin, 38). In 2001, negotiated wages may have risen about half a percentage point faster.

By contrast, Euroland embarked on consolidation in the fateful year of Maastricht – as countries were either in or heading for recession. Quite similarly to the US, though, structural primary surpluses of around 3 percent were attained in Euroland between 1997 and 2000. Alas, in Euroland, this achievement came at a high price in terms of growth. GDP growth is rather vital for both employment growth and debt sustainability. We will return to this issue in the next section in the context of discussing the economic prospects for the EU.

Here we note that finance ministers played according to the Maastricht rules. Holding out for them the overriding objective of fiscal consolidation, they inflicted a severe fiscal tightening on their economies over the 1990s. Have their ambitions lost momentum after taking the Maastricht hurdle of 3 percent in 1997-98? Have they failed to take advantage of the upswing in pushing their objective further? Two things must not be overlooked here.

First, in the light of economic theory, it is conceivable that growth recovered in Euroland between 1998-2000 partly because fiscal stance was switched to neutral after long years of fiscal tightening and subdued growth. Second, the budgetary position attained by 1997-98, equivalent to the US's in terms of structural primary balances, was sufficient to set debt ratios on a decline. It is not clear at all that more ambitious attempts at consolidation since 1998 were either necessary nor that they would have actually improved the budgetary position. After all, the upswing was brief and not exceptionally strong. For instance, in Germany's case, strong (2.9%) GDP growth lasted for one year only. Put differently, it is unsafe to assume that GDP growth would have been the same, if Euroland had continued its attempted consolidation after 1997 at the same pace as in previous years.

Be that as it may, the crucial point here is that there was no case of irresponsibly loose fiscal policies that risked an overheating of the Euroland economy and might have required a 'stabilisation crisis' to be deliberately engineered by the ECB in order to prevent run-away inflation. The economic situation in 2000 was tame both at the wage and fiscal fronts. There were neither excessive wage pressures emerging from labour markets, nor excess demand emerging in good markets. For the first time in a decade, Euroland was on its way to close its protracted negative output gap. So why, then, did the ECB hike interest rates so aggressively – a near doubling (and total rise of 225 basis points) in less than a year?

Inflation obsession and a remarkable disrespect for economic growth is the short answer. The longer answer will show how very counterproductive the ECB's policies really were. Starting from the extremely low level of 0.8% in early 1999, headline inflation subsequently increased and peaked at 3.4% in May 2001, staying above the ECB's price stability definition of 'below 2 percent' most of the time during the last three years. Some commentators (see CEPR 2001, 2002, for instance) see this as a sound justification for the ECB's policies, given its primary objective of maintaining price stability. Euroland may be in a mess, but at least inflation has not exceeded 2 percent by much. The ECB is demanding praise for its inflation performance, the rest, it proclaims, was none of its business. Should we agree?

No, is the answer, in the light of economic theory. The rise in headline inflation since 1999 was due to a number of factors, neither excess demand nor excessive wage inflation though. Using monetary policy to depress aggregate demand represented a clear case of mis-medication. Rather, rising oil prices, seasonal food prices, and animal diseases represented one-off price level shocks. Temporary shocks, moreover, except for the possibly more lasting factor of rising oil prices. The theory of monetary policy[10] says that central bankers should ignore such price level shocks, at least as long as they do not provoke excessive wage inflation. The ECB was rather too keenly focussed on its sole goal – ignoring what the textbooks say but punishing finance ministers and social partners no less so.

But this verdict still ignores the euro's plunge: until October 2000 the euro lost a third of its initial value against the US dollar, a 20 percent drop in effective terms. Protracted euro weakness – lasting until the spring of 2002 – was a key to pushing up headline prices first, and then core inflation too. The euro's plunge was also a key factor driving the ECB's aggressive interest rate hikes – after all central bankers' traditional weapon to defend the currency.

The trouble was: market climate in the late 1990s was one of growth enthusiasm. With inflation calm all round, monetary policy actions and communications were assessed in this light. The markets were not welcoming to an excessive keenness with regard to inflation risks paired with complete disrespect for growth risks. And the ECB ran into a time-inconsistency trap as its aggressive rate hikes were perceived by the markets as representing growth risks. Hiking interest rates to unsustainable levels led to a general downgrading of euro-denominated assets, and the outlook for the euro's future external value faltered. This backfired on the euro spot rate – the euro did not strengthen, but weakened; with the ECB's 'price stability above all else' anthem proving rather conducive to this outcome. In short, the

[10] See Cecchetti 2000, Clarida et al. 1999, and Taylor 1997, for instance.

euro's plunge reflected the markets' thumbs-down for inflation obsession (Bibow 2001b, 2002a,b,c).[11]

The ECB did not succeed in tightening monetary conditions in the short run. The span of easy money through interest rate convergence and the DM's plunge after 1995 was extended by the euro's plunge. Further skewing aggregate demand towards exports, the its rate hikes took their toll on domestic demand though – the slowdown in domestic demand, particularly investment spending, since mid 2000 was not a pure coincidence. Whatever might have been the case in the US, there was no case for crunching domestic demand in Euroland. Yet, despite indications of an imminent slowdown emerging since early 2000, the ECB even continued tightening until October 2000. Perversely, in view of its intentions, by pushing the euro down, the ECB thereby pushed import prices and inflation up – above 2 percent. Making matters worse still, with inflation above 2 percent, the ECB subsequently proved extraordinarily slow in cutting rates in the context of deteriorating economic conditions.

The ECB's misjudgements of developments in 2001, and policies based thereupon, were reviewed in section 2 above. We will continue here reviewing developments in 2002. This will prepare us for assessing the prospects for the EU in the next section.

After negative domestic demand growth for three quarters in 2001, at the start of 2002, the year of the euro cash changeover, the ECB saw the prospect of a gradual recovery in the course of 2002 as 'no fundamental economic imbalances have built up in recent years in the euro area which would require a long correction process' (ECB 2002, January Bulletin, 5). The ECB thus quickly dissipated any hopes in financial markets for further interest rate cuts. Already in late January, Otmar Issing, the ECB's chief economists, was keen to give indications that the next move would rather be in the upward direction, and perhaps not that far off (Financial Times Deutschland 30 January 2002).

The ECB's mood became increasingly more bullish in subsequent months. In April it was noted that the 'persistence of excess liquidity in the economy could become a concern once the economic recovery in the euro area gathers pace' (ECB 2002, April Bulletin, p. 5). And in May another indication for preparing a hike came when the ECB observed that 'the prospects for price stability appear to be somewhat less favourable than they were towards the end of last year [when rates had been cut preemptively]' (ECB 2002, May Bulletin, p. 5). The reasoning behind the ECB's optimism is

[11] Officially sanctioning my reading of events, the BIS's 2002 Annual Report (see also the previous year's report) states: 'Repeating a pattern observed in 1999 and 2000, but in stark contrast to the 1980s and most of the 1990s, monetary policy decisions and interest rate differentials appeared to influence exchange rates mostly through their effect on growth expectations' (BIS 2002: 86). See also Corsetti and Pesenti 1999.

revealed in its repeated insistence that

> the conditions for a sustained upswing in domestic demand, including favourable financing conditions, continue to be in place. The more positive international environment should stimulate euro area exports, thereby fuelling aggregate demand in the euro area. Finally, sound fundamentals and the absence of major imbalances support the positive outlook for the euro area economy (ECB 2002, May Bulletin, 5).

One cannot deny that the ECB was taking a forward-looking approach to real economy developments, at this juncture. In view of the conditions prevailing at the time, any idea of hiking interest rates seemed premature to say the least. As GDP growth stabilised in late 2001, a positive net trade contribution overcompensated a still negative domestic demand. Moreover, in April the euro had started to appreciate strongly against the US dollar. The Swiss National Bank cut interest rates. Alan Greenspan emphasised the risk of continued economic weakness. Yet, the ECB seemed to seriously contemplate hiking rates soon.

Perceptions changed in the summer. Plunging stock markets and accounting scandals (Enronities) were part of it. The US Fed signalled further cuts. Recovery hopes dwindled. In September the ECB declared that the acceleration in economic activity towards potential growth was postponed until next year rather than the end of 2002. It took until December for the ECB to shave another 50 basis points off its policy rates last changed in November 2001:

> The decision reflected the Governing Council's assessment that the evidence has increased that inflationary pressures are easing, owing in particular to the sluggish economic expansion. Furthermore, the downside risks to economic growth have not vanished (ECB 2002, December Bulletin, 5).

In conclusion, it seems hard to escape the impression that the ECB might be wholly unaware of the vital stabilization role it is required to play under the Maastricht regime. With fiscal policy constrained, the stabilisation burden rests squarely on the central bank's shoulders – say the textbooks. In 2002, Horst Köhler, the IMF's head and one of the chief architects of the Maastricht regime, even reminded the ECB of this role when he explained that monetary policy was 'the first line of defence'. Mr Duisenberg's response was that he had never heard of that. More often than not the ECB appears to be at a certain loss in grasping developments in the economy under its monetary reign. Not only did it take some convincing that Euroland was not a closed economy. The ECB also misjudged the impact of its aggressive interest rate hikes on both domestic demand as well as the euro's exchange rate (and hence inflation). While choking off Euroland's brief upswing through careless monetary tightening lacked any sound rationale in the first place. As the economy took a dive, the ECB was outstandingly slow to ease policy stance. Having failed to cut rates aggressively in time, in the spring of 2002, the ECB nevertheless contemplated hiking them – the slump progressed and Euroland's recovery never materialised. Largely due to the ECB's impressive record of policy blunders, the EU is today in a rather inconvenient situation.

5. The current situation and prospects for the EU under its current regime

To see just how precarious the situation is, it is useful to start with Germany. In the aftermath of its unification and in the spirit of the Maastricht Treaty, Germany engineered a severe fiscal tightening in 1992 and subsequent years – despite protracted domestic demand weakness. As noted previously, growth is key to the issue of debt sustainability. The higher the rate of GDP growth, the higher the maximum tolerable deficit ratio compatible with a non-rising debt ratio. 'Maximum stability balances' [MSB], so defined, provide a straightforward definition of public debt sustainability. If consolidation is the aim, then crunching growth is not the way to go.

Figure 9 ***here***

Figure 9 illustrates the point, showing that stability-oriented macro policies have squeezed Germany's nominal GDP growth to a 2 percent level in the course of the 1990s. For illustrative purposes a *hypothetical* growth rate of zero was assumed for 2003. Zero growth requires zero net debt issuance (i.e. a balanced budget) to prevent any given debt ratio from rising. The trouble is: while MSB shrink in line with GDP growth, actual deficits might not. Note: Despite – or because of? – more than a decade of attempts at consolidation, Germany is today in a far worse budgetary position than at any time since unification. Crunching growth is not conducive to 'sound public finances'.

Being Europe's largest economy, Germany's performance is bound to have a significant impact on Europe as a whole. It is of particular interest also for the fact that Germany was disadvantaged during the run-up to EMU compared to other EU countries. It neither got any relief from interest rate convergence, a factor that stimulated domestic demand and reduced the interest burden on the public debt in various EU countries since the mid 1990s. Nor could it be denied that deutschmark appreciation in 1992-3 came at Germany's expense in terms of competitiveness. By now these factors of divergence and one-off benefits may have largely run their course though. Today the rest of EU may be in a situation more similar to Germany's in the recent past. Alas, still leading the pack, Germany is getting sicker rather than better, having meanwhile slipped into a deflationary spiral.

As in the previous year, in 2003 Germany is once again enforcing the wisdom of the SGP by raising taxes and social security contributions in response to the ongoing recession and a soaring budget deficit. Real disposable incomes declined in Germany last year, and so did real consumption expenditures. In fact, GDP growth was slightly above zero only for the fact that a positive net exports contribution compensated a negative domestic demand one. Bankruptcy rates have entered unchartered territory. Employment is falling and unemployment back to were it was five years ago. Yet, in the name of 'stability and growth', Germany is implementing more fiscal tightening of some 0.5% to 1% of GDP.

Apart from further crunching disposable incomes and business revenues, falling public investment and rising social security contributions create ever more 'structural problems' too. Most perversely of all, perhaps, ever new rounds of indirect tax hikes keep inflation up which, in turn, helps to forestall monetary easing. These phenomena are not new. They could be witnessed in Germany over the 1990s (cf. Bibow 1998). But Europe's supposed economic powerhouse is now being sent off the cliff edge, it seems. Even if wages and prices are not falling yet, Germany clearly is in a contractionary spiral and heading for 'it'. Might European partners not send out a lifeboat?

Figure 10 ***here***

Apparently, the situation in Euroland as a whole is not quite as dramatic yet. But things are critical enough. According to the OECD's latest forecast shown in figure 10, Euroland's deficit ratio is projected to shrink and its debt ratio supposed to decline again this year – *if GDP growth resumes* as forecasted. Before critically assessing the likelihood of this outcome, it is interesting to note that the US is in a fairly similar budgetary position; according to the latest OECD forecasts shown in figure 11.

Figure 11 ***here***

Certain differences are of great interest. After the 'new era' boom of the late 1990s ended in 2000, US growth undershot Euroland's for exactly one year, namely, in 2001. This constellation was quickly reversed again in 2002, as domestic demand grew at a 3 percent pace in the US (with net exports once again holding back GDP growth), whereas no recovery took hold in Euroland ((with a positive net exports contribution providing a lifeboat). Whether the US's legendary flexible labour markets contributed anything to the US's quick turnaround (other than through sparking deflationary fears as the unemployment rate quickly jumped from 4 to 6 percent) seems rather doubtful. Instead, mainly two factors explain the superior US performance. First, since early 2001 the US Fed has led a monetary easing process that was quick even by its own historical record. Second, between 2000 and today the Bush administration, without much ado, has engineered a dramatic fiscal easing: a budgetary swing of about 5 percent of GDP.[12]

Despite massive efforts to spur growth, the situation in the US remains fragile – not least because the world economy's weakness continues to act like a drag on US growth.[13] It is in this context that the ECB's notorious assertion has to be seen that no major imbalances have accumulated within the eurozone; a situation it likes to contrast with 'existing imbalances elsewhere in the world economy' (ECB 2002, August Bulletin: 5). For to every buyer there must be a seller. If the US has accumulated an international imbalance, the rest of the world has too. In particular, Euroland enjoyed all too many years of free-riding on US growth, including the export-driven 'recovery' in 2002. While its own domestic policies were firmly geared at stagnation, the external growth anchor held up well – with imbalances piling up.

Alas, with the previous external anchor now in drifting mode, Euroland's systemic failure to stimulate domestic demand-driven growth might hit back with a vengeance. It is quite wrong to believe that Germany is the only EU country operating in a fiscal straitjacket that calls it to respond perversely to recession. Today, France and Italy are in budgetary positions not all that different from Germany's about a year ago or so. According to Mr Duisenberg the three laggards just need to hurry up a bit and quickly make up what the majority of member states has long accomplished. What he fails to mention though, 'the big three' make up 70% of the eurozone.

As the big three currently miss the SGP target by a large margin, the balanced budget deadline by 2006 implies that another round of severe fiscal tightening will be inflicted upon Europe in coming years. Especially some of the smaller members are today vigorously pressing the big three for more fiscal retrenchment. They might soon come to regret it. Consolidation attempts by the big three will have spillovers in good and labour markets across the EU – and beyond. There may be other 'headwinds'

[12] Just to get an idea of the magnitudes involved, between 1989 and 1991 and in the context of its unification, Germany had a budgetary swing of 3 percent of GDP. Regarding the relevance to the world economy, one also has to bear in mind that the US economy is five times bigger than Germany's.

[13] See Godley and Izurieta 2002a,b on the current dilemma. Falling on deaf ears in the 'new era', Wynne Godley had pointed out early on that developments in the US and world economy were unsustainable. See Godley 1999, Godley and Wray 1999, Godley and Izurieta 2001. Internally, the successful US consolidation had its necessary counterpart in private spending outpacing disposable incomes, with private debts piling up accordingly. Externally, a rising US current account deficit reflected the fact that the US was pulling a deflationary outside world along with it, further magnified by dollar strength.

too – and only weak relief factors.

First of all, budgetary savings due to falling interest rates, quite important during the brief phase of apparently successful consolidation between 1997 and 2001, will be more limited in the future. Next, as the ECB has refused to stimulate domestic demand for long enough, employment growth went into reverse in 2002. Rising unemployment is spelling additional trouble for budgetary positions and disposable incomes. Finally, the ECB's unwillingness to play its proper part may no longer be the key obstacle blocking the possibility of successful fiscal consolidation; as in the 1990s era of strong US growth and dollar strength. Today, another question is whether the ECB could really do so, even if it wanted to.

Figure 12 ***here***

Figure 12 pinpoints the problem, showing the development of monetary conditions since 2001. Some thirty months after the business cycle turning point in mid 2000, real interest rates have come down by some 150 basis points from their early 2001 peak. Clearly, the ECB was in no hurry to foster recovery. The latest cut in December 2002 just about compensated for the fall in inflation in 2002. In fact, most strikingly, monetary conditions have actually tightened significantly since early 2002. If the ECB in late 2001 believed that it had responded appropriately to the 2001 slowdown, a truly remarkable complacency followed in 2002: monetary conditions tightened in an environment of a deteriorating state of the economy. Despite an ever gloomier outlook, the ECB chose 'to keep its power dry'. This once again demonstrated a conspicuous asymmetry in its approach to monetary policy. As no such 'caution' could be detected back in 2000 when the ECB was in hiking mood. Even if the ECB were to cut again soon, say in March or April, this would do no more but belatedly reverse some of the unwarranted tightening in monetary conditions that has built up until early 2003.

In fact, the key risk is that the euro's sharp appreciation since April 2002 might choke off Euroland's last lifeline – net exports – while domestic demand shows ever less liveliness. Of course, dollar depreciation is the right medicine from a US perspective, trimming the US's current account deficit and reversing the negative contribution of net exports to US GDP growth into a positive one. From a Euroland perspective, though, a drying up or even reversal of external growth stimuli makes the OECD's forecasted resumption of growth in Euroland look all the more unlikely. To Euroland euro strength means an uphill struggle for growth. A mix of fiscal tightening, currency appreciation, and 'cautious' and backward-looking monetary policy orientation is unlikely to render a healthy macroeconomic policy cocktail.

There is little hope that the ECB might be up to the challenge anyway. Ignorant of what the situation would require, it seems, the ECB's assessments continue to be marred with manifold confusions that stand in the way of sound policymaking. A peculiar obsession with structural reform is a case in point. That Euroland requires structural reforms to raise its growth potential is of course conventional wisdom. Given that monetary policy is solely related to aggregate demand and actual growth, according to a conventional neutrality postulate (on this see Mankiw 2001), it has always seemed strange that the ECB focussed its policy communications on potential growth; particularly as Euroland's actual growth notoriously undershoots its potential. But in recent times, the ECB has exhibited both creativity and courage in boosting the notion of structural problems to real super-status – distracting attention from what even conventional wisdom views as the proper role of monetary policy. For instance, as the promised 2002 upswing – unsurprisingly – failed to materialize, the ECB was ready to declare in September 2002 that structural reforms

> would help to foster consumer and investor confidence in the long-term growth and employment opportunities in the euro area, thereby having a *positive effect on consumption and investment decisions in the short and medium term* (ECB 2002, September Bulletin, 7; italics added).

And a month later the ECB went even further and declared that

> further delays in tackling, with greater determination, the underlying reasons for limited growth in potential output over the medium term, *and for only partially exploiting the current potential,* are costly (ECB 2002, October Bulletin: 7; italics added).

No doubt, the structural shibboleth offers a convenient excuse for all sorts of matters. Needless to say, though, the above declarations involve heroic assumptions neither backed by mainstream economic theory nor part of conventional wisdom. Puzzlingly, the ECB never seems to be too worried that 'further delays in cutting interest rates' might at all be related to Euroland's only partial exploitation of its current potential. Moreover, the ECB ignores that structural reforms might also pose important risks, particularly in the current environment.

For if structural reforms, especially liberalising Euroland's legendary rigid labour markets, raised growth potential, this would further increase Euroland's negative output gap, huge and rising anyway. In other words, more deflationary pressures would be unleashed by getting rid of labour market rigidities. If Otmar Issing, the ECB's chief economist, can deny the existence of deflationary risks on grounds of Euroland's all-pervasive labour market rigidities, it is all too clear that, effectively, the ECB is free-riding on these very rigidities. You can't have the pudding and eat it, as the old saying goes. Does the ECB have enough dry powder in store in case structural reforms were carried out under current conditions?

Mr Issing is worried about something else though. When others might fear the world economy's fragility. Mr Issing (cf. Financial Times Deutschland, 3 December 2002) is concerned that the 1970s phenomenon of stagflation, that is, stagnation accompanied by ongoing inflationary pressures, might return, posing a dilemma to monetary policy. The OECD (2002) too found Euroland's inflation persistence in the 2001 slowdown puzzling. Once again, the idea is that structural reforms might increase the responsiveness of inflation to weak economic activity. A number of factors might help explaining the apparent puzzle.

First, inflation persistence might be related to the ECB's uniquely stringent definition of price stability itself. As the US Fed, for instance, is content with somewhat higher inflation on average, US inflation is bound to come down quicker when the economy weakens. Too low inflation might cause the very rigidities that give rise to inflation persistence; representing the other side of the coin called inflation obsession. Second, it is also not surprising that the inflationary pressures that stemmed from protracted euro weakness fed through to core inflation with some lag, even though the increase in wage inflation was remarkably small. It is hard to deny that the 'euro puzzle' too was directly related to monetary policy itself.

A third factor is of particular interest. Different from the other two, it represents a peculiarity inherent in, and probably unique to, the Maastricht regime. The point is that, by causing a budgetary squeeze, an economic downturn is prone to provoke inflationary pressures – given that the rules of the SGP might force finance ministers to raise indirect taxes and social security contributions and cut public investment. The first measure pushes up headline inflation directly. The second – similar to direct tax hikes – not only causes structural problems, but might enkindle wage inflation too (especially if social partners reckon that wage restraint is not being rewarded by other players). Finally, cutting public investment jeopardizes productivity growth. If Mr Issing is worried about stagflation, then he might wish to bear in mind that, at least in Euroland, too tight money is prone to provoke inflationary risks.

Inflation obsession came at a high price for the eurozone. The actual working of the Maastricht regime in recent years has exemplified this rather well. Damages reach way beyond the eurozone though. Economic prospects for the wider EU are just as bleak.

Of the three pre-ins, the UK's experience outside, but next to, the eurozone is of great interest.

Since sterling's ERM departure in September 1992, the UK has run its own monetary policy regime. Moreover, the UK did not participate in the continental Maastricht-inspired consolidation crusade. Instead, the UK allowed a huge (ten percent of GDP) budgetary swing in the early 1990s recession, followed by growth-based consolidation as the economy recovered. By 2000, the UK achieved a budget surplus – the only large EU country to do so.

No doubt the UK's rather impressive performance since 1992 owes much to its sound macroeconomic demand management, contrasting with the eurozone. Alas, it was rewarded for its far more successful macro policy regime by a severely overvalued currency after 1996, increasingly unbalancing the economy in the late 1990s. Even so the UK coped with the 2001 slowdown much better than its continental peers. Due to the Bank of England's flexible and symmetric policy approach and discretionary public spending increases, consumption spending remained strong as property prices and household indebtedness soared.

Similar to the US, another downside to sustaining domestic demand growth within a deflation-prone world was a growing current account deficit. It would be rash to conclude that the UK could have avoided this by adopting the euro. Participating in the Maastricht regime would have prevented the UK's successful macro performance that provided the basis for the overvalued pound in the first place. Today, the UK is vulnerable, both due to its own success and the fact that it is too close to a big deflationary neighbour.

As to the EU accession countries, so far most of them have survived the 2001 slowdown remarkably well too. Of course, their exports were severely hit by the slowdown in the EU, destination of some 70 percent of their exports. But at the same time they benefited from interest rate convergence stimulating domestic demand, similar to the situation in some current members in the 1990s. So far huge current account deficits have found their counterpart largely in huge foreign direct investment inflows. A benign endgame scenario would be a continuation of this state, allowing further employment growth and ongoing budgetary consolidation together with an appreciating currency that reduces inflation. The 'twin deficits' might quickly unravel though in a vicious scenario, with monetary and fiscal policies – geared at reducing inflation and budget deficits in compliance with the Maastricht convergence rules – magnifying macroeconomic instability. Clearly, accession countries are vulnerably exposed to stagnation in the EU.

No doubt, then, much is at stake: continued stagnation represents a threat to the whole process of European integration. Alas, under the current regime ongoing stagnation in the eurozone seems the most likely outcome. Some miracle might happen of course. Or, perhaps Ecofin might prove creative enough to find ways around the 'Instability and Stagnation Pact' in the short run; defiant France is pushing the case[14]; Iraq provides a perfect excuse.[15] And even the ECB – enjoying all the discretion it takes to improve its conduct – might eventually learn about the age-old Wicksellian fallacy of mistaking 'low' rates of interest as an indicator of monetary ease.[16] A thorough reform of the Maastricht regime is the safer way to go though.

6. Suggestions for reforming the Maastricht regime: theory and best practice

As to the role of social partners, despite the fact that there are currently no coordination procedures in place at the central level, noone can deny that wage inflation was both very tame (some would say too tame) and rather stable since the mid 1990s. Certainly social partners complied with what the BEPGs laid down for them. The rise in wage inflation in 2001-02 was minor, particularly when compared with soaring headline inflation, and did not warrant the punishment that was actually enacted. If anything, the slowdown itself has played a causative role in pushing labour costs up – partly due to the peculiar working of the Maastricht regime, partly due to common feature that unit labour costs first tend to rise when the economy tanks.

If divergence is an issue, Germany is the conspicuous outlier. German wage inflation is on a 1 to 2 percent trend, unit labour costs are falling. If this looks like a recipe for deflation, do not overlook the awkward fact that Germany has a huge trade surplus, also vis-à-vis its EU partners. By contrast, domestic demand has been stagnant for a decade and is now shrinking. Some might view German-style

[14]Currently France is on collision course with the Commission by ruling out an austerity package to get its deficit back below 3 percent of GDP (Financial Times, 25 February 2003), while the UK's spending plans have led to a clash within Ecofin too (Financial Times, 14 and 20 February 2003). Contrasting fiscal philosophies came to the surface at the recent G-7 economic summit. Rather than showing their gratitude for providing the 2002 stimulus package that just about kept Euroland afloat, absurdly, Euroland's finance ministers and central bankers criticized US fiscal policies as a risk to the world economy (Financial Times, 23 February 2003).

[15]While the Commission has even given some signals in this direction, Euroland's central bankers outright reject any such idea. Apart from alleging damage to the credibility of the pact and confidence in the euro, their economic analysis does not reach beyond the mere counting of countries that do or do not meet the SGP (Financial Times, 17 and 19 February 2003).

[16]It is somewhat amusing that Knut Wicksell's fundamental insight, first published in German in 1898, has become part of US conventional wisdom on sound monetary policy (see Fed Governor Bernanke's (2002) observations on this point), while Euroland's central bankers got stuck in the simple Fisher theorem, due to the American economist Irving Fisher (1896).

wage restraint as appropriate for adjusting relative prices and leading back towards equilibrium. Others see it as risky beggar-thy-neighbour and deflation export par excellence, creating fundamental imbalances within the EU on the way.

In my view, in would be desirable to establish a wage norm at the union level focussed on productivity growth plus some desired inflation trend, replacing the *asymmetric* BEPG's. Wage inflation would thereby be tied to nominal GDP growth or, rather, prices be anchored by wages – and thus monetary policy be free to focus on things that really matter. This opportunity has de facto prevailed since the mid 1990s, except that the monetary policymaker has refused to play its part in the deal. At any rate, it would be safer to institutionalise the arrangement. Of course, this should include sufficient scope for flexibility in relative wages at the national, regional, industry and firm levels, as the situation might require. It is key to stabilize aggregate wages and prevent beggar-thy-neighbour behaviour. This requires symmetric coordination and mechanisms to enforce symmetric discipline.

A fundamental overhaul of Euroland's fiscal and monetary policy arrangements is urgently required. Experience has clearly shown that current arrangements are malfunctioning. They are not at all conducive to growth, but prone to give rise to stagnation and crisis. The key issue is to make sure that both arms of the macro policy-mix act as partners rather than opponents, as is currently the case, in achieving common objectives. A nominal GDP target should be laid down as the common starting point of macro policymaking – *providing the growth anchor for Euroland that is currently missing*. It is therefore vital that the hegemonic position of the ECB and unbounded discretion in monetary policy must end. The ECB's position must be clearly defined as instrument independence only. Noone has any need for despotic central bank politicians following their own agenda. Euroland yearns for competent central bank technicians practising their constrained discretion at targets laid down for them. Since the role of monetary policy in this mixed double depends on the part to be played by fiscal policy, if the latter's contribution to the shared stabilisation burden is constrained, the primary responsibility of monetary policy in this respect has to be made clear to everyone.

Looking at the SGP's flaws offers a good starting point as to some vital issues in fiscal policy reform. Most fundamentally, it makes no economic sense to focus fiscal policy on an endogenous variable governments cannot control – the budget deficit (ratio). Targeting some arbitrary values for deficit and debt ratios is both senseless and hopeless, particularly when the strategy pursued completely ignores the key variable in the play: growth. A balanced budget rule implies a debt ratio that is converging to zero in the long run, a goal which is lacking any basis in economic theory. But a balanced budget rule also spells trouble while we are still alive – by causing economic havoc in the short run. Propagating the SGP as a means to safeguard sustainability of public finances in view of prospective demographic developments is misleading when its actual effect is to crunch the very variable that really matters to the prosperity of future generations: capital accumulation (including infrastructure investment).

'Sound finance' has inflicted truly gigantic real damage upon Euroland in the first half of the 1990s. Only briefly interrupted, mainly due to the US's 'new era boom' and one-off factors, we are now back on track for more of that. Continued cuts in public investment and a contractionary fiscal stance regardless of the economic situation will neither lead to stability nor growth, but further impoverish Europe and foster its demise. Paradoxically, as it may seem, by trying to save too much, we end up saving (rather, investing) too little. By depressing the economy and allowing the infrastructure to rot, a larger unemployment bill has to be picked up in the end. It is vital to prevent a continuation of these developments.

At the very least public investment has to be excluded from any balanced budget guidelines and due consideration be given to cyclical positions and debt (ratio) levels. Proposals along these lines imply a move towards the UK's fiscal regime. No doubt a focus on balancing structural budgets excluding public investment and with some flexibility depending on the level of the debt ratio would significantly improve on the current state.

A probably preferable alternative involves a more fundamental shift away from today's deficit ideology and towards variables directly controlled by governments: tax rates, the rules underlying entitlement spending, and the volume of discretionary spending. US experience after the Budget Enforcement Act of 1990 provides an example along these lines (see Blinder and Yellen 2002). Essentially taxes and entitlements were grouped together in a separate pay-as-you-go pool. The rule applied that the budget must balance *at the margin*, that is, policy-induced changes have to be compensatory, while endogenous changes in the budget owing to the state of the economy did not require any fiscal policy response. Budgetary discipline also applied to discretionary spending – through annual 'caps' on permissible increases.

In the EU context, a more symmetric rule for discretionary spending may be warranted. The ideology underlying the SGP is preoccupied with one risk only: excessive public spending and borrowing, and the spillovers in financial markets this might have. But we must not ignore the opposite risk of excessive thriftiness, with its associated spillovers in good and labour markets. A thrift campaign in Germany, for instance, is bound to depress activity in the EU. Similarly, a spending boost in France, for instance, will benefit its neighbours too; while French taxpayers alone will have to pick up the bill. In view of this free-riding problem fiscal discipline needs to be imposed symmetrically. Linking discretionary spending to the nominal GDP target might solve the problem. Particularly public investment should be based on long-term planning and be spared the kind of vagaries that characterise the current regime.

As to the pay-as-you-go part of the budget, the important point to bear in mind is that currently high tax rates and social security contributions are largely a reflection of prevailing levels of unemployment broadly defined. Moreover, two decades of disinflation and tight money was the senior partner in pushing up debt ratios and the interest burden. Bringing down unemployment and abstaining from the tight money excesses of previous decades would do wonders to European public finances – and solve many a 'structural problem' on the way.

The proposed fiscal regime outlined here would offer the flexibility that seems most pertinent under current conditions: endogenous budget deficits would no longer be at the forefront of all planning, but quietly take a backseat.[17] Of course in the medium to longer run deficit and debt levels must follow along reasonable and sustainable paths and as such be part of our nominal GDP targets. The crucial point is: without growth that will never be the case. The key issues are to stimulate domestic demand, get unemployment down, and prevent renewed tight money excesses which would ruin any idea of keeping public finances under control. If fiscal policy remained passive, but at least no longer counterproductively retards growth, it would be left to the ECB to stimulate domestic demand sufficiently – at last.

While linking wage inflation to nominal GDP growth is designed to look after the usual tight money excuse for crunching the economy. Monetary policy has to be made an integral positive part of any nominal GDP strategy that can succeed. Germany's experience during the 1990s – that is, *when it could no longer rely on its European partners behaving differently from itself* – illustrated the risks of asymmetric monetary policy well. The Bundesbank squeezed inflation down from four percent to zero between 1992 and 1998, gaining public prestige despite the fact that nominal GDP growth was

[17] See also Arestis et al 2001.

crunched to 2 percent on the way. The ECB is trying hard to emulate the Bundesbank success story. It must be stopped.

The most obvious course of action is to lay down an nominal GDP target for the ECB and require it to pursue a transparent nominal GDP targeting strategy. In practice, the US Fed with its high employment and price stability objectives on an equal footing comes close to this regime (and criticisms of the fact that US monetary policy in the 1990s became overburdened with both pay-down-the-public-debt hysteria as well as external free-riding by the eurozone, for instance, should not be laid at the Fed's door). A key issue is that a 'let bygones be bygones' attitude with respect to negative output gaps condemns unemployment to become 'structural' (Ball 1997, 1999), while actual as well as potential growth get permanently depressed. Like the Bundesbank, the ECB seems always content with formulating some optimistic prospect that actual growth might, at some point at least, return to growth potential. Growth potential represents no binding supply-side constraint at all, though, when negative output gaps yawn – as has notoriously been the case in Europe for decades.[18]

In practice, as the example of the Bank of England shows, an inflation-targeting regime might even approximate our proposed regime, at least under two key conditions. First, policy conduct must be truly forward-looking and ignore temporary price shocks. Second, the inflation target must not be too low. The first condition is required to make sure that any slowdown in demand growth or any wage restraint will elicit the appropriate *pre-emptive* monetary easing response, the second to make sure that inflation does actually have some room to fall without immediately hitting the danger zone.[19] The trouble is that the ECB's conduct has starkly conflicted with both conditions, and continues to do so.

There has been widespread criticism of the ECB's peculiar definition of price stability, being both too ambitious and asymmetric (Fitoussi and Creel 2002, Svensson 2000, 2002). A symmetric inflation target of, say, 2.5 (Bank of England) or 3% (US Fed) would probably be right for Euroland and an enlarged EU too. Beware, though, while changing the ECB's definition of price stability in the upward direction would make Europe a safer place, this measure alone would not have prevented the monetary policy blunders seen in recent years. If we had started out from 1.8% rather than 0.8% inflation in 1999 and if the ECB had adopted a 'below 3 percent' price stability definition, arguably,

[18]Tobin (1994) puts it all in a nutshell in the quotation at the start of the text. Of course, there are also easy ways of 'closing' negative output gaps by estimating them away.

[19]See Akerlof et al 1996, Fuhrer and Madigan 1997, and Summers 1991, for instance.

things would not have played out much differently. More than that is required to end stagnation-oriented monetary policies. The Maastricht paradox needs to be tackled head on. To get symmetric and growth-oriented monetary policies in future, it is vital to enforce discipline upon the ECB. Without that, Euroland *is* doomed to stagnation – or worse.

7. Conclusions

Eurozone authorities are well-advised to look for internal causes of the 2001 slowdown and subsequent stagnation. While it may be true that today external demand forces – all-too long relied upon – no longer exert their former pull, the current crisis is essentially a homemade one. The domestic situation in Euroland turned for the worse in mid 2000. Domestic macro policies, either deliberately or carelessly, not only caused a recession that was perfectly needless in the first place. They have also failed to reignite domestic demand – until today.

Neither social partners' nor fiscal authorities' behaviour conflicted to any significant degree with what the BEPGs, the Maastricht regime's central coordination mechanism, prescribe for them. Instead, the current crisis is largely due to the ECB's ongoing refusal to play the part it is required to play, if the Maastricht regime is made to work at all: namely, to sufficiently stimulate domestic demand. The eurozone is too big a place to free-ride on external growth forever. And with fiscal policy in a straitjacket, according to mainstream theory, the stabilisation burden rests squarely on the ECB's shoulders. Clearly, blaming slack domestic demand on 'structural problems' is a shallow excuse when even the world's most flexible (US) economy relies foremost on flexible fiscal and monetary policies to reignite domestic demand – and quite successfully too.

Ultimately, current troubles stem from the Maastricht regime's failure to explicitly assign responsibilities for stabilisation policy, together with the peculiar flaw of granting the ECB unbounded discretion. Prospects for the EU are grim. Not only does the ECB appear ignorant of its vital lead role in the field of stabilisation policy. Thanks to its previous policy blunders the ECB is now facing some important 'headwinds' too. With falling employment and further rounds of fiscal consolidation in the pipeline, the euro's appreciation since March 2002 raises doubts about whether the ECB's ammunition, the powder it has preferred to keep dry for all too long, may still be explosive enough to lift Euroland out of the doldrums – even if it chose to try, at last.

Debates are under way on reforming fiscal policymaking in Euroland, and for good reason. The

Maastricht regime does need thorough reform. Our recommendations centre on a nominal GDP target to be pursued by both fiscal and monetary policies in cooperation – ending the current gridlock between these two players. In the area of fiscal policy, this would involve moving away from the single-minded focus on budget deficits, an endogenous variable not under governments' control, and towards longer-term expenditure and tax planning in line with the set nominal GDP target. However, without the ECB's proper share in the play, this strategy would be doomed to failure; just as the current consolidation strategy was doomed right from the start. Therefore, the ECB's unbounded discretion must end and its lead role in stabilisation policy, if fiscal policy is to remain passive, be endorsed. Complemented by a symmetric wage inflation norm, monetary policy has to be symmetric and growth-oriented in future, and discipline be enforced upon the ECB accordingly.

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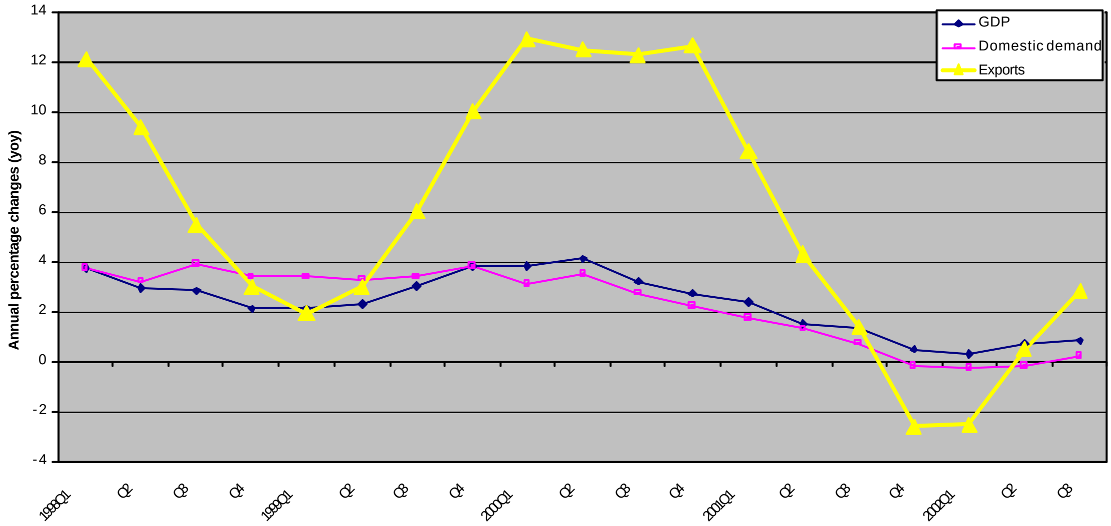
Figure 1. Have exports caused Euroland's 2001 slowdown?

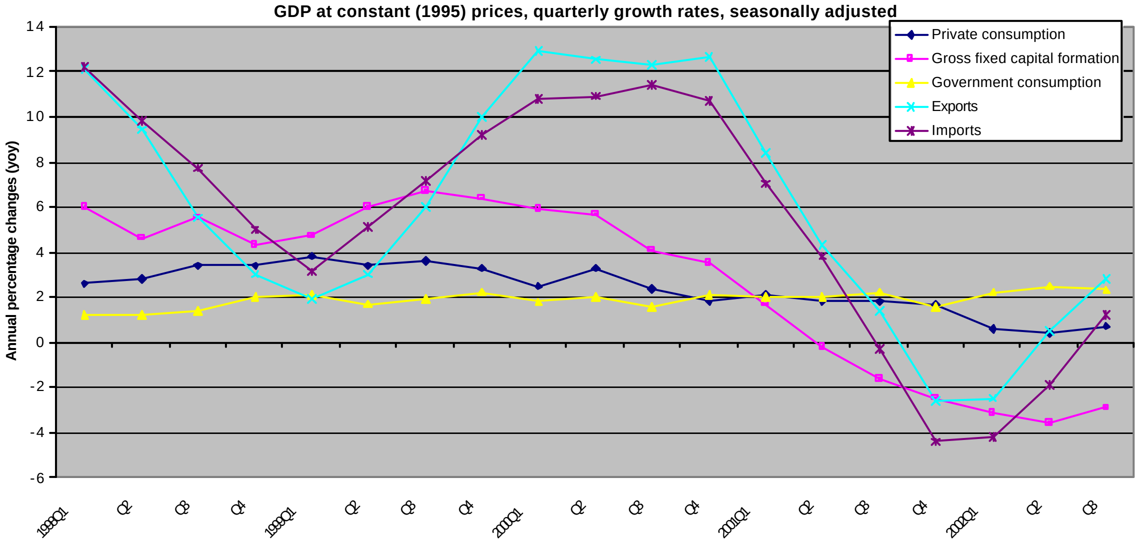
GDP at constant (1995) prices, quarterly growth rates, seasonally adjusted (1998-2002)



Source: Eurostat

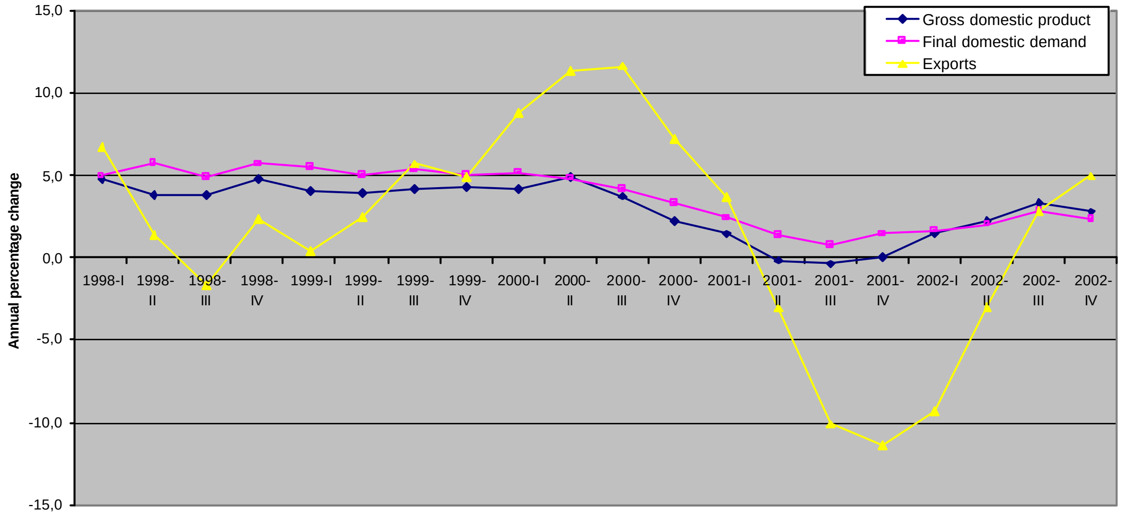
Figure 2. Euroland GDP growth by component

GDP at constant (1995) prices, quarterly growth rates, seasonally adjusted



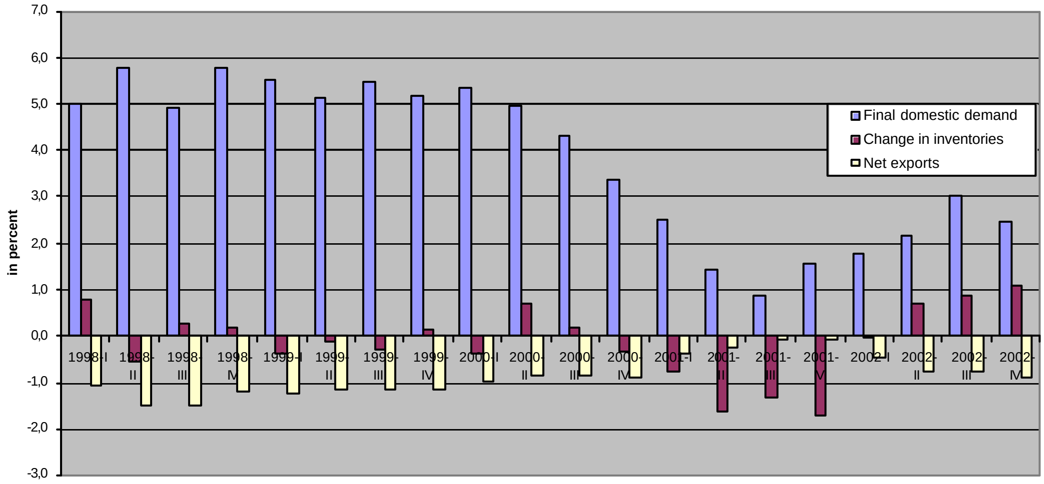
Source: Eurostat

Figure 3. The 2001 global slowdown seen from a US perspective
Seasonally adjusted in 1996 chained dollars



Source: BEA

Figure 4. Pulling the world economy along - for how much longer?
Contributions to real GDP growth

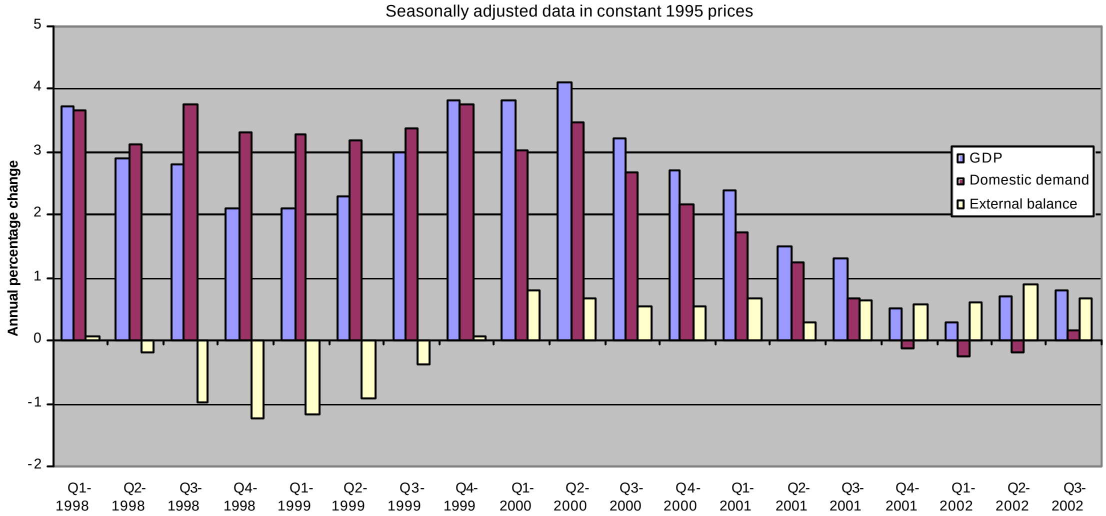


Source: BEA

Figure 5. Contributions to GDP growth in Euroland (1988-2002)

As domestic demand slumps net exports prevent outright recession

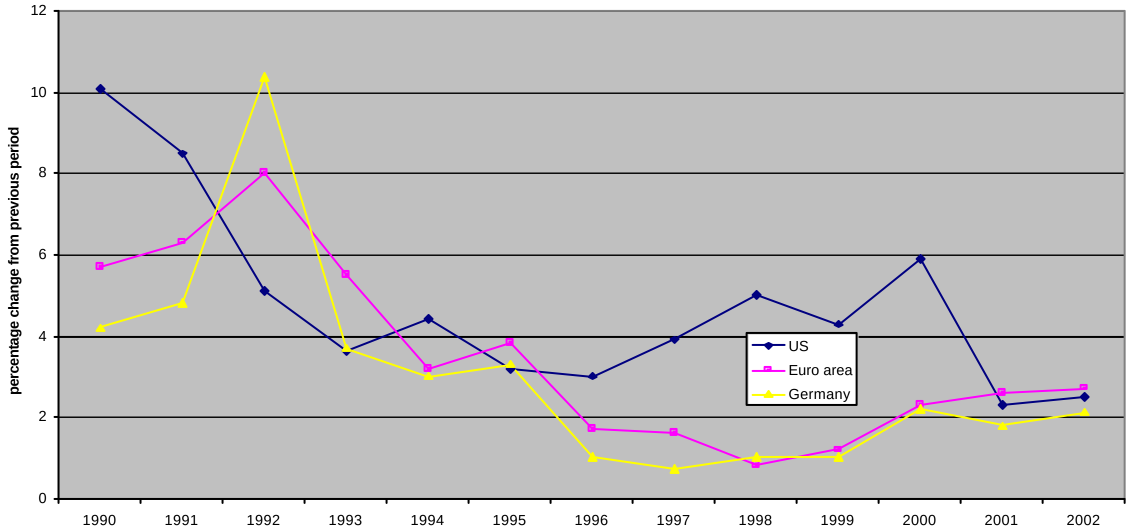
Seasonally adjusted data in constant 1995 prices



Sources: Eurostat, ECB

Figure 6. Are Euroland's employees asking for too much?

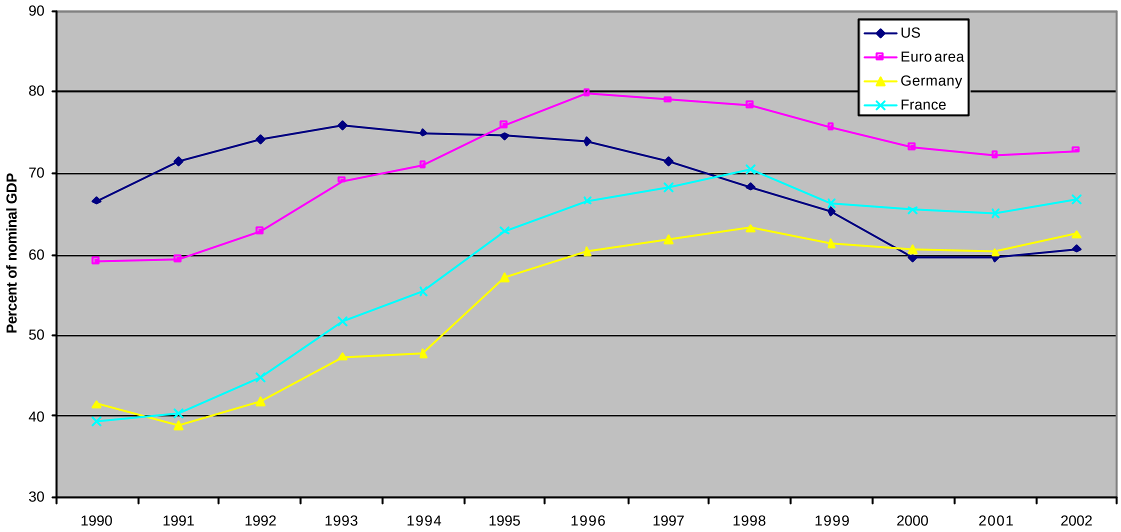
Compensation per employee in the business sector



Sources: OECD WEO No. 72, December 2002, Annex Table 12

Notes: German spike in 1992 reflects wage developments in former East Germany

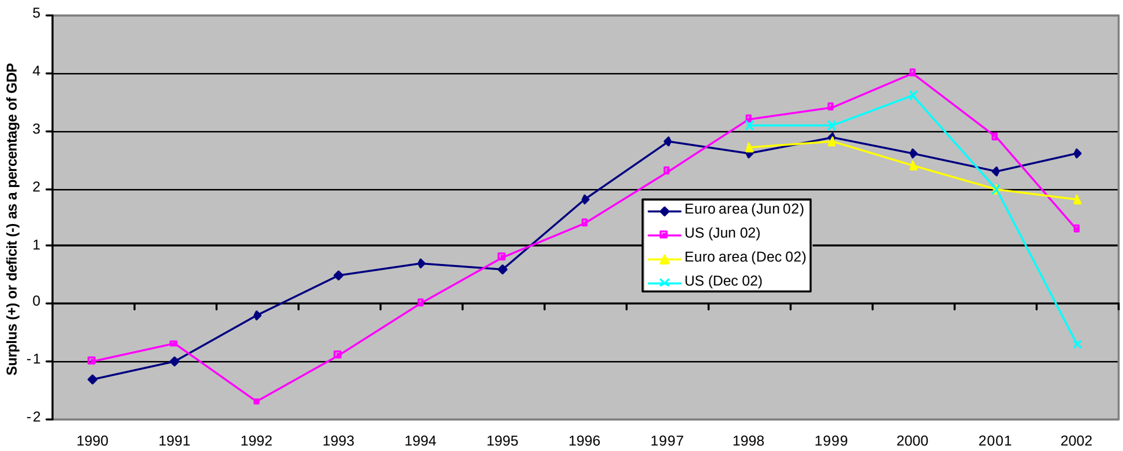
Figure 7. Getting the debt ratio under control - or not



Source: OECD Economic Outlook No. 72, December 2002

Figure 8. Fiscal consolidation: too little, or too much, and how about timing?

General Government structural primary balances [SPB]

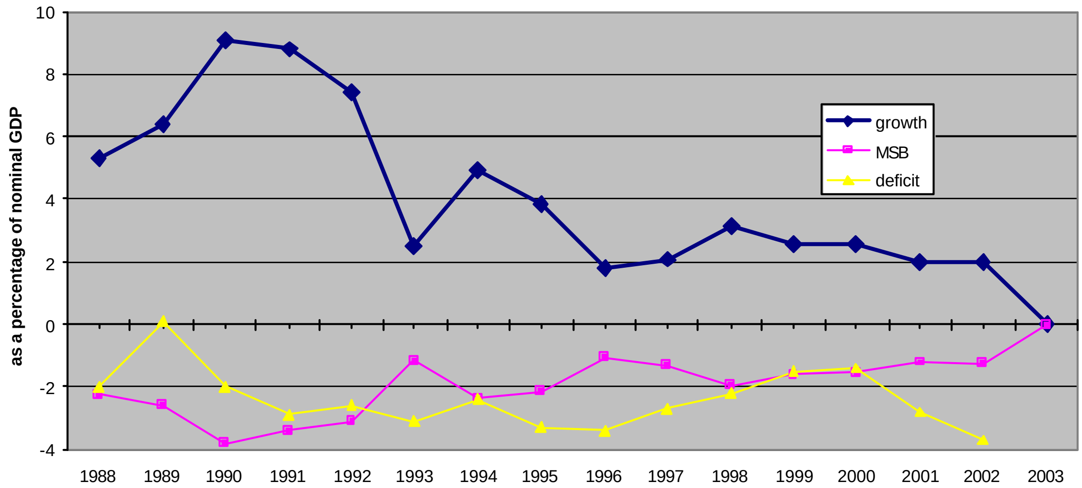


OECD Economic Outlook Nos 71 (June 2002) and 72 (December 2002), Annex Table 31

Notes: The SPB is the cyclically-adjusted budget balance ex. interest payments. For years 1998 and later, both the June and December 2002 OECD estimates are shown.

Figure 9. The German way - or leading the way into a cul de sac

Attempted consolidation and the collapse of GDP growth

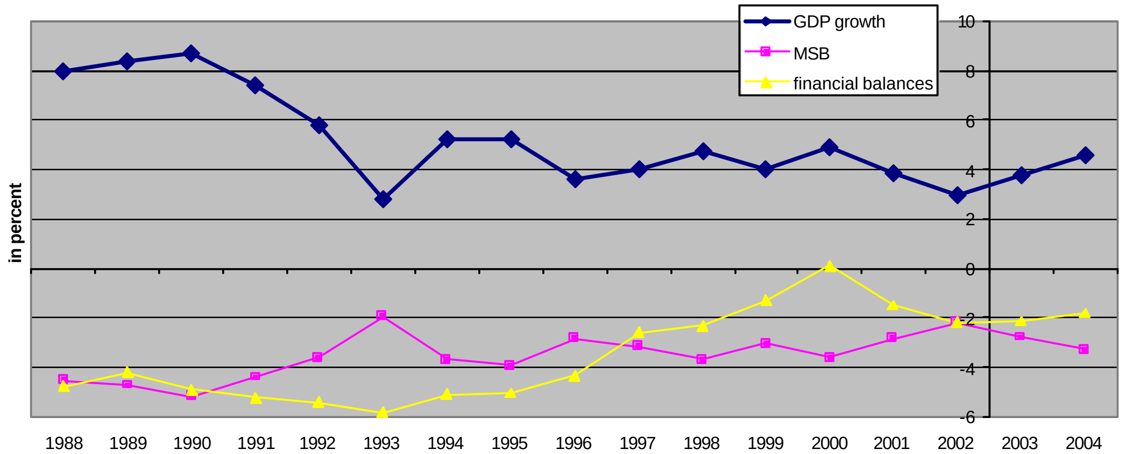


Sources: OECD Economic Outlook no. 72

Notes: financial balance for 2000 exclusive of one-off revenues due to UMTS licenses

Figure 10. Euroland at the crossroads: stagnation or ...

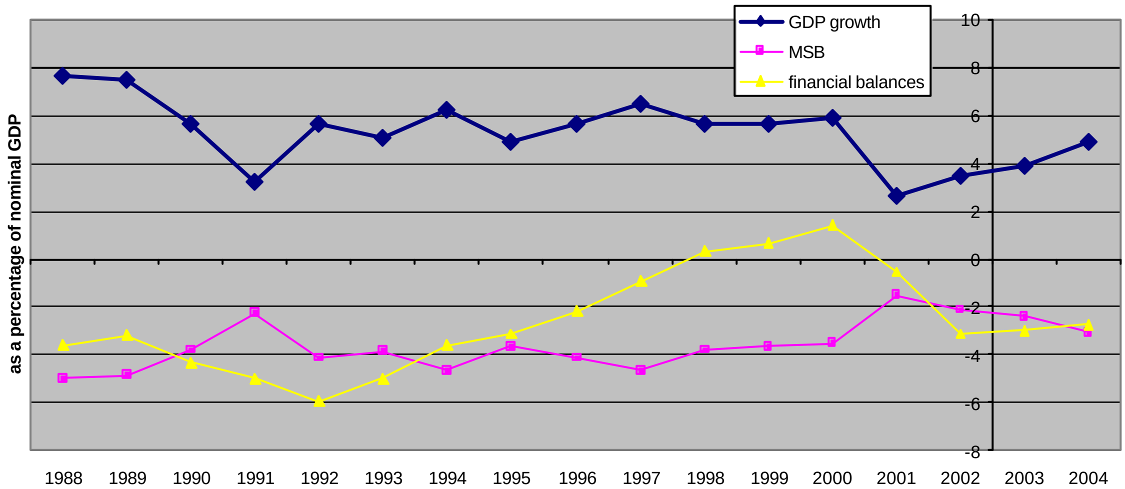
How much longer can stability-oriented policies be survived?



Sources: OECD Economic Outlook no. 72, December 2002

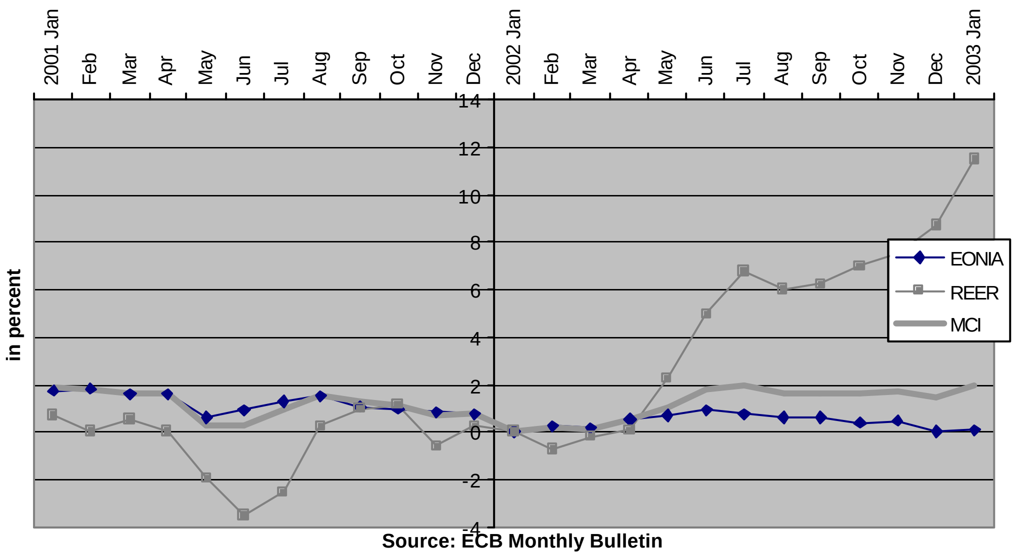
Notes: Financial balances not exceeding 'maximum stability balances' (MSB) imply public debt sustainability. Financial balance for 2000 inclusive of one-off revenues due to UMTS licenses.

Fig 11. US-style consolidation and GDP growth
Perhaps flexible fiscal and monetary policies may be effective after all?



Source: OECD Economic Outlook no. 72, December 2002
Note: Deficit ratios not exceeding "maximum stability balances" (MSB) imply public debt sustainability (defined here as a non-rising debt ratio)

Figure 12. Monetary conditions in €land
(Base: January 2002)



Source: ECB Monthly Bulletin
Notes: EONIA deflated by HICP, REER (CPI, broad), MCI based on 6:1 weighting.