Experiences of Fiscal and Economic Policies in EMU

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I. INTRODUCTION

In 1999, the economist Michael Burda wrote that, with the introduction of the euro, 'the macroeconomic regime has changed in a way it has not in several hundred years in Europe'. In my presentation, I will try to pick up where José Manuel [Páramo] left off by turning to the fiscal and economic policies of the euro area and considering how they are responding to EMU's remarkable regime change.

My intervention is divided into three main parts.

- Firstly, I will recall economists' expectations about the fiscal and economic aspects of EMU in advance of the euro's launch.
- Secondly, I will consider whether euro-area fiscal and economic policies have met these expectations since 1999.
- Finally, I will show how euro-area policy makers are strengthening euro-area fiscal and economic policies in the light of these experiences.

II. EXPECTATIONS FOR FISCAL AND ECONOMIC POLICIES

The launch of the euro in 1999 was an unprecedented step in the history of international economic and monetary cooperation. Consequently, our expectations about EMU at the time were based, to a great extent, on economic theory. Much of this theoretical work looked at the costs and benefits of forsaking national monetary independence. On the benefit side, economists tended to focus on microeconomic issues such as transaction-cost savings, reduced uncertainty, greater price transparency - as well as the macroeconomic benefits of price stability and monetary credibility. On the cost side, one issue - the capacity of Member States to adjust to economic shocks with country-specific effects - dominated.

Today, I would like to focus on the cost side of this equation. This is not because I wish to downplay the significant advantages that EMU has generated for the 310 million people who live in the euro area. Rather, it is because the costs of EMU in general and the issue of adjustment to economic shocks in particular shaped economists' *ex-ante* beliefs about economic and fiscal policies under EMU. Economists' thinking on this issue owes much to the pioneering work of Robert Mundell, Robert McKinnon and Peter Kenen in the 1960s on the theory of optimium currency areas. The crux of this theory is that the loss of national interest and exchange rates under monetary union reinforces the need for alternative mechanisms of adjustment in the face of economic shocks with country-specific effects.

This early theoretical work inspired a rich vein of research in the 1990s on the likely functioning of EMU. Several economists, it should be remembered, expressed reservations about the *ex-ante* optimality of EMU given the low degree of geographical labour mobility in the euro area, the perceived rigidity of its product and labour markets and the absence of a large budget at the EU level. Attempts to use optimum currency area theory as a crystal ball with which to predict the success or failure of monetary unions should be treated with caution. Firstly, there are doubts over whether any monetary union - including the USA - can be truly optimal given the strictness of the theory's criteria. Secondly, monetary unions may become more optimal over time as economic structures and business cycles adjust to the single currency.

Building on the seminal work of Jeffery Frankel and Andrew Rose, many economists in the 1990s focused their research on the *ex-post* optimality of EMU. The key issue here was not whether EMU would be optimal on 1 January 1999 - the day the euro was launched - but whether, over time, euro-area members could increase their capacity to adjust to economic shocks with country-specific effects. For some economists, fiscal policy had a central role to play in this adjustment process, with recommendations ranging from the need to boost national automatic budgetary stabilisers to the creation of an EU-wide system of fiscal transfers to cushion the impact of country-specific demand shocks. For others, focusing more on supply-side disturbances, markets held the key to adjustment under EMU, with the consensus being that structural reforms would be essential to improve the functioning of European product, labour and capital markets.

Over and above the issue of the optimality of the euro area, the focus of EMU's framers was on the macroeconomic stability of the new monetary union. On the fiscal side, the Stability and Growth Pact, which was signed in 1997, announced Member States' commitment to pursue sound budgetary policies over the medium-term. A key aim of the Pact was to allow Member States' automatic budgetary stabilisers to adjust to economic shocks without generating excessive budget deficits that might be harmful to the economic stability of the euro area. On the economic side, the launch of EMU coincided with a greater awareness among EU policy makers of the need for structural reforms to improve the functioning of European product, labour and capital markets. This awareness, coupled with the desire to achieve higher sustainable growth and employment in the EU, gave rise to the ambitious Lisbon structural reform agenda in March 2000.

One final point to note here is that no economist believed in the 1990s that Member States would increase their capacity to adjust to economic shocks with country-specific effects over night. Firstly, several Member States entered EMU with budget deficits of close to 3%, leaving limited room for budgetary manoeuvre. Secondly, given the complexity of Europe's product and labour market institutions and the novelty of EMU's macroeconomic framework, achieving responsive prices and wages would, it was clear, entail a prolonged period of policy learning.

III. EXPERIENCES OF FISCAL AND ECONOMIC POLICIES

How have euro-area fiscal and economic policies faired over the last seven years in relation to these expectations?

The initial experience of euro-area fiscal policy appeared to be positive on the surface, with the consolidated budget of euro-area countries posting a positive balance in 2000 for the first time since the 1970s. Beneath the surface, however, it is clear that the Stability and Growth Pact, as originally conceived, failed to lock in sound budgetary policies over the medium-term in all Member States. Analysis suggests that fiscal policy during the pre-EMU period tended to be pro-cyclical during economic upturns and a-cyclical during economic downturns. This was due to a concerted effort on the part of some Member States to deal with earlier fiscal crises and consolidate their budgetary positions in advance of EMU. A different picture emerges after the introduction of the euro, with the economic upturn of 1999-2000 being characterised by a pro-cyclical loosening of the fiscal stance. This suggests, among other things, that reform fatigue may have set in after the large budgetary adjustment in the run up to EMU.

The failure of some euro area Member States to consolidate their budgetary positions in 1999-2000 left little room for budgetary stabilisers to take effect while respecting the 3% of GDP threshold for government borrowing envisaged by the Maastricht Treaty. The result was that when economic conditions slowed in 2001, this threshold was violated by a number of Member States. This outcome entailed economic costs in so far as excessive budget deficits fuelled concerns over the sustainability of public finances and the consistency of euro-area fiscal policy with a smooth functioning EMU. It was also costly in political terms as the failure of some Member States to address persistent budget deficits damaged the Stability and Growth Pact's credibility. This led to a *de facto* suspension of the Pact in November 2003, followed by a reform of EMU's budgetary rules in March 2005.

How have expectations faired as regards economic policies under EMU? Data collected by the Italian Fondazione Rodolfo DeBenedetti, for example, finds not shortage of labour market reforms in the euro area since the launch of EMU. In particular, there has been an increase in the number of labour market reforms in the areas of unemployment, non-employment, employment protection legislation and migration policies. Likewise, the OECD database on product market reforms shows that the overall degree of regulation in euro area countries has declined over the period 1998-2003. This is mainly due to a decline in state control (via a reduction in price controls and in direct government control over businesses) and the elimination of barriers to trade and investment (via lower tariffs and fewer restrictions on foreign investment).

From the point of view of adjustment, what matters is not the quantity of structural reforms but their impact on the responsiveness of prices and wages to economic shocks. The need for structural reforms to go further in this respect is reflected in, among other things, the persistence of growth and inflation differences across euro-area Member States. In 2005, for example, the gap between the fastest and slowest growing countries in the euro area stood at 4½ percentage points and the gap between the highest and lowest inflation rates stood at 3 percentage points.

Growth and inflation differences are, of course, a normal feature of monetary unions. They can reflect a variety of benign factors, including differences in population growth and the effect of catching-up by less-rich Member States. Cyclical differences have been substantially reduced in recent years, thanks to a closer alignment of cycles and the reduction of policy errors due to better macroeconomic-policy coordination. This is a positive development for EMU. However, the decreasing importance of cyclical factors means that structural factors now account for a high share of the growth differences that remain.

One reason for persistent growth and inflation differences in the euro area is that cost and price competitiveness among euro-area members is adjusting too slowly to changing economic circumstances. This is true in Greece, Ireland, Italy, Portugal and Spain, in particular, which have experienced a sustained loss in competitiveness over the last five to seven years. Sluggish productivity growth and/or wage growth that is out of line with productivity developments are among the factors driving this declining competitiveness. In Italy, for example, the persistent decline in intra-euro-area competitiveness has been associated with productivity growth that has been consistently below and, wage growth that has been consistently above, the euro-area average since 2003. In contrast, Germany has recovered its competitiveness following the unification shock through wage growth that has been consistently below the euro-area average since 1999.

Structural reforms could help to speed up competitiveness adjustment in the euro area in two ways. Firstly, the process of wage determination in euro-area countries must give greater regard to productivity developments. This would allow greater wage flexibility that should complement aggregate wage moderation which has increased in most Member States in recent years. Secondly, labour market reforms should go hand in hand with measures to boost competition in the market for goods and services and address non-price factors weighing on export performance. Enhancing productivity growth and removing the remaining barriers to trade and fostering competition in the Internal Market are key parts of this strategy.

IV. LEARNING FROM THESE EXPERIENCES

How have euro-area policy makers learned from these early experiences of fiscal and economic policy under EMU?

On the budgetary side, Member States learned from the limitations of euro-area fiscal policy by agreeing on a reform of the Stability and Growth Pact in March 2005. This agreement enhances the economic rationale of the Pact and gives greater attention to long-term sustainability and the need for structural reforms. The reform also draws lessons from the past mistakes by encouraging Member States to avoid pro-cyclical budgetary loosening when growth conditions are benign. To this end, it is expected that Member States that have not yet achieved their medium-term budgetary objectives will do more to improve their cyclically-adjusted budgetary positions during the good times.

Our initial experiences with the revised Pact have been encouraging. Six cases where countries have breached the rules have been dealt with under the revised Pact during the last twelve months. In all cases, the response has been to apply the rules according to the letter and spirit of the Stability and Growth Pact. As economic conditions in the euro continue to improve, the resolve of Member States to learn the lessons of the late 1990s by pursuing sound budgetary policies is being put to the test.

In the economic domain, Member States have learned that structural reforms must go hand in hand with euro-area membership. The EU's new-look Lisbon Strategy, which was launched in March 2005, identifies a range of reforms to improve the functioning of product, labour and capital markets. It has also invited the individual Member States to draw up National Reform Programmes for growth and jobs with a view to promoting greater national ownership over reform efforts. The Commission has welcomed the commitment shown by euro area Member States in their National Reform Programmes to achieving sustainable public finances, bolstering labour productivity and raising employment and participation rates while respecting the imperatives of sustainable development. Nevertheless, it also called for euro area Member States to go further to ensure well-functioning goods, services, labour and capital markets. Key priorities in this regard include stepping up the pace of R&D in the euro area and promoting greater competition in services and network industries. In short, implementing with determination the revamped Lisbon agenda of structural reforms would not only help to boost growth and employment, but also to enhance adjustment within the euro area.

V. CONCLUSIONS

In conclusion, fiscal and economic policies for a smooth-functioning EMU have, as expected, not been achieved over night. There have been positive achievements, such as the remarkable budgetary consolidation achieved in the run up to EMU. At the same time, the pro-cyclical fiscal loosening during the economic upturn of 1999-2000 and the slow workings of the competitiveness adjustment mechanism imply that euro-area countries must go further to secure an optimal mix of fiscal and economic policies.

Recent reforms have enhanced euro-area fiscal and economic policies in several respects. The revived Stability and Growth Pact has learned from the mistakes of 1999-2000 by, among other things, encouraging Member States to do more to consolidate their budgetary positions during the good times. The revamped Lisbon Strategy recognises that the pace of structural reform in the EU needs to be stepped up and that Member States must show greater ownership over the reform process.

Sound fiscal and economic policies are important not only in the medium-term but also in the short-term. According to the Commission's recent interim forecast, euro-area GDP is expected to grow this year by 2.5% - its fastest rate since 2000. To make the most of the good times and sustain the economic recovery, it is essential that euro-area members undertake the necessary improvements in their budgetary positions and press ahead with structural reforms.

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