BRIEFING PAPER

Treaty Reform: Consequences for Monetary Policy

by

Gustav A. Horn

Institut für Makroökonomie
und Konjunkturforschung

Düsseldorf

September 2007

Executive Summary

Treaty Reform: Consequences for Monetary Policy

The reformed treaty as far as it is known has met stiff resistance by the ECB and many scholars of monetary policy. The subtle change of the institutional setting that enumerates the ECB among “other institutions and advisory bodies” is seen as an attack on the independence of the central bank. Moreover, the implicit demand for more cooperation within the euro area has also been received sceptically. In the following a different view will be outlined. Basically the reforms of the treaty point into the right direction. Present information on the reformed treaty indicates that the governance structure will be improved after its adoption. However, much remains to be done until the euro area in particular achieves an optimal governance structure. The main problem is that national interests still dominate. Given that the internal market is now of *European* nature, this framework does not fit any more. What is needed is a truly European form of governance.

Introduction

The reformed treaty as far as it is known has met stiff resistance by the ECB and many scholars of monetary policy. The subtle change of the institutional setting that enumerates the ECB among “other institutions and advisory bodies” is seen as an attack on the independence of the central bank. Moreover, the implicit demand for more cooperation within the euro area also has been received sceptically.

In the following a different view will be outlined. Basically the reforms of the treaty as far as known point into the right direction, although – in terms of clarity – it would have been preferable if a lot fewer issues had been tackled in the treaty. The basic idea is to strengthen the political institutions of the EU, which seems to be achieved. However, both the EU and the euro area are still far away from an optimal setting. Much remains to be done in this respect.

The next section deals with the role of the ECB in the reformed treaty. The subsequent one is devoted to the euro group, followed by section on euro area coordination issues. Finally conclusions will be drawn.

1. Is the ECB Treated Correctly?

Some scholars and observers interpreted the inclusion of the ECB into the group of other EU institutions as a degradation of the central bank. This would be correct, if one saw the ECB as an institution that must be superior to all other agencies and have no political accountability whatsoever. But this is a mistaken perception of a central bank. Needless to say, a central bank should be independent. This means it should have full freedom to conduct its monetary policy in order to meet the monetary targets. No political interference should be permitted. In such a setting inflationary pressures originating from governmental pressure on the ECB should not become effective. Thus, any attempt to create high inflation by printing money to bail out excessively indebted governments is inconceivable. But this important point had already been taken care of in the old draft. It is also included in the reformed one.

Apart from its general independence there is no need to treat the ECB differently from any other institution. Independence as defined above does not mean that the ECB should not be held politically accountable for what it is doing. This is expressed, although in a very incomplete manner, by the fact that the ECB president has to report to a quarterly meeting of the Monetary Committee of the European Parliament. The expression “meeting” suggests that here is no hierarchy, but this is wrong. The parliament is the representative of the people in the EU as are the different governments in the Council of Ministers and it is therefore in charge of the political control of all EU bodies and agencies. It is a mistake of the treaty not to put more emphasis on the democratic legitimation of EU institutions

Only if this fundamental aspect is ignored, it may seem that the ECB is inappropriately treated in the same way as any other EU institution. However, as far as political accountability is concerned this treatment is correct and fully corresponds to the present institutional framework.

It is also correct from an economic point of view. The ECB is responsible for the conduct of monetary policy. Its success is measured against its target, which is primarily to preserve price stability. It is not the ECB’s responsibility to define targets, although it tends to do so by setting its own inflation target. Rather, it is the task of political institutions to set the target. Otherwise the ECB could easily evade any sound judgement on its performance by changing targets. Consequently, the ECB should be listed among other bodies that are also being held politically responsible to the European Parliament and the Council. In this context it is remarkable and unwise that the reformed treaty – like its predecessor – narrows the ECB’s target to price stability. Political preferences as well as the academic assessment may change and lead to a broader set of targets. Under the present treaty, these changes seem to be impossible, even if politically desired or economically optimal. All in all the reformed treaty does not provide optimal provisions for the ECB, but the given ones are in line with existing economic and political settings.

2. The Institutional Emergence of the Euro Area

Although the existence of an internal European market is considered a matter of course, its consequences are still incompletely taken into account. The same applies to the division of the EU between members of the euro area and non–members. First of all it is simply logical that only members of the euro area should deal with most monetary issues. The inclusion of all EU members in the monetary decisions for the euro area is based on the somewhat unrealistic assumption that all members will join the euro area sooner or later. Given the present situation and a realistic outlook, a clearer stance on this issue is advisable. A two-tier EU with members of different status already exists. Insofar the definition of a euro Ecofin group is logical against the backdrop that some countries like the UK, Sweden or Denmark will not join the euro area for the time being. In this setting only those countries should be involved in decision making on the euro that are affected by these decisions.

This is necessary since the euro area has its own economic developments that are different from those in the rest of the EU. The main characteristic is the absence of an exchange rate mechanism between the individual economies. That ties the economies closer together since trade relationships become much more intensive. At the same time trade imbalances can no longer be corrected by exchange rate adjustments. Therefore differences in competitiveness affect the respective economies to a much larger extent than economies with an exchange rate.

Furthermore, there is a common interest of all members to meet the inflation target. All these are issues that do not directly affect the non-members of the euro area. In addition, they are able to react to these decisions by adjusting their exchange rate against the euro. Therefore they should not be involved in decisions that only affect the euro area. The risk of this strategy is that it may prove politically divisive, since the ideal of a uniform EU membership is given up. However, from an economic point of view, governance is improved by the existence of a euro Ecofin group.

4. Economic Policy Coordination in the EU

Currently, economic policy coordination exists only for monetary policy and – in a looser manner – for fiscal policy. In the case of monetary policy coordination is perfect, since there is only one policy maker, i.e. the ECB. Fiscal policy is basically still conducted at the national level. However, the Stability and Growth Pact (SGP) requires budgets that show surpluses or are at least balanced in the longer run. For most member states such a rule implies a fiscal policy path that tends to be restrictive not for national but for European reasons. In the case of wage policy European coordination is completely non-existent. This is sub-optimal governance with respect to a stable macroeconomic development in the euro area. The reason is that economic policy in the present setting for the euro area is not able to respond optimally to economic shocks especially if they are of adverse nature, and to internal imbalances.

If the euro area is hit by a positive shock triggering buoyant growth, high employment and the danger of overheating, monetary policy can pull the brakes and raise interest rates to cool the economy down. Inflation can thus be avoided. But monetary policy works only slowly and the impact will be felt only after some time. The danger is that by then expectations will already have adjusted to a higher inflation path and an additional cooling down is required. The cooling down could occur faster if fiscal policy could be supportively restrictive at the European level. However, since fiscal policy is of national responsibility, this is by no means guaranteed. Only if national fiscal policy makers behave optimally with respect to their national cycle, one would get an appropriate euro area fiscal policy stance. Then fiscal policy would be restrictive in those member countries, where growth is particularly buoyant, and less so in countries, where this is not the case. On an aggregate level the result would be optimal .But if national policy makers think more in terms of a beggar-my-neighbour policy, things turn out to be different. Then national fiscal policy makers may try to avoid a restrictive course hoping that other countries will be restrictive enough to stabilise the euro area economy. In this case fiscal policy will be too expansionary from a euro area perspective. If the ECB expects such a kind of behaviour, monetary policy is forced to adopt a more restrictive stance right from the beginning.

In case of an adverse shock the outcome may be even more problematic. Again monetary policy can act as necessary. But an expansionary monetary policy takes even more time to become effective than a restrictive one. The support of fiscal policy would therefore be particularly helpful. However, the support of fiscal policy is unfortunately more doubtful than in the reverse case. Apart from the beggar-my-neighbour lines of reasoning mentioned above, the SGP limits the leeway for an expansionary fiscal policy. There is the threshold of 3 % and the debt ratio of 60 % as well as the general requirement of balanced budgets. Therefore, an additional wage coordination would also help. If inflationary pressures result form excessive wage increases, a coordinated wage policy would help to fight inflation fast. In other words, a macroeconomic dialogue on a tripartite level between ECB, Ecofin and the social partners would be a useful tool to stabilise the euro area. There are already forms of such a macro dialogue. But the ECB in particular has not acknowledged its importance so far. Therefore the economic policy governance of the euro area still is in a particularly bad shape for times of recession and economic slack.

More fiscal flexibility and more fiscal coordination would help. In principle the SGP has provided more flexibility since its reform.. It would be helpful, if at times of economic slack the Ecofin could decide on an expansionary fiscal policy stance for the euro area as a whole to support the ECB in its stabilisation efforts. The macro dialogue would be equally effective in a situation of overheating. This kind of coordination would enhance growth and employment in the euro area, while keeping inflationary pressures at bay. So the proposed changes in the reformed treaty should be welcomed as a step towards the right direction. However, it is not sufficient to overcome the existing severe internal trade imbalances.

For this purpose either wage coordination or fiscal policy coordination would have to be implemented. The first option would address diverging competitiveness directly. If wage increases in all member countries more or less followed national productivity paths, inflation rates would converge. Real exchange rates and consequently the relative competitiveness of member states would be stabilised. In order to reverse the existing divergences, higher wage rises in Germany and Austria and lower ones in Italy and Spain would be necessary. Currently there is no institutional structure that ensures such a kind of wage convergence. Hence it seems highly unlikely that such a process can be achieved in the short run.

For this reason an indirect method of fiscal policy coordination is advisable for the time being. In those countries facing a significant wage restraint like in Germany a looser fiscal stance is recommended than in those member countries where higher wage increases prevail. As a result growth and employment expansion should be stronger in the former leading in the end to the desired wage dynamics. This indirect method would definitely take longer and may lead to a conflict with the requirements of the SGP. This shows that there is not yet any sound solution for the coordination problem in the euro area. Any institutional framework that facilitates such cooperation would enhance stability in the euro area.

5. Conclusion

Currently available information on the reformed treaty indicates that the governance structure will be improved after its adoption. However, much remains to be done until the euro area in particular achieves optimal governance. The main problem is that national interests still dominate. However, a truly European internal market calls for truly European policies. Therefore the institutional framework which the EU has had up to now does not fit any more. A European Monetary Union can only be economically successful, if there are truly European governance structures. That would also help to stabilise the national economies.