BRIEFING PAPER

How to safeguard general support and legitimacy of monetary policy during times of economic distress in a monetary union?

by

Gustav A. Horn

IMK.
Institut für Makroökonomie
und Konjunkturforschung

Düsseldorf

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Executive Summary

The institutional setting for economic policy in the Euro area is still unique. While there is an aggregate monetary policy that is clearly directed towards aggregate Euro area developments, there is no aggregate fiscal policy so far. There are only rules that limit the leeway of member countries to expand their household deficits beyond limits. But there is no fiscal policy reference to the aggregate Euro area economic situation. In order to overcome co-ordination problems in a sustainable manner, only the creation of a truly European fiscal policy authority would help. This implies a perception of the Euro area market as a purely domestic market for any member country. Several proposals are outlined.

The ECB with its monetary policy could act as a substitute for a European fiscal policy, but then their targets have to be changed. An alternative to this setting is to keep institutions as they are, but establish a co-ordination process via Euro group. However, this could create a very ineffective co-ordination process. A more unrealistic alternative is to set up a truly European fiscal authority. The ideal setting would give the European parliament the political responsibility. The EU- Commission should have executive power for fiscal policy actions. Beyond doubt this proposal is the most unrealistic one of all those presented here. It requires national governments to share power with the EU-Commission that acts no longer as an agency of the member states government, but rather as an European government. It is highly doubtful whether European politics is ready to enter a road to stronger links on a European level.

In the end only marginal improvements seem realistic, but it highly doubtful whether the co-ordination problem can be properly solved this way.

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1. Introduction

The institutional setting for economic policy in the Euro area is still unique. While there is an aggregate monetary policy that is clearly directed towards aggregate Euro area developments, there is no aggregate fiscal policy so far. There are only rules that limit the leeway of member countries to expand their household deficits beyond limits. But there is no fiscal policy reference to the aggregate Euro area economic situation. Every government of the EMU is free to choose its fiscal stance according to its perceived national interests.

This setting has been criticised already for quite some time (v.Hagen, Mundschenk 2003). The basic reason for the critique consists in rejecting the politically predominant view of national economic independence. Governments tend to think that if every government does the right thing from a national perspective it would be the right thing from an EMU aggregate perspective. This is only true, if national economies within the Euro area would be completely independent from each other. In fact they are highly interdependent with varying degrees. The most important channels of interdependence are trade and capital market links. Therefore national fiscal policy of one country will in general affect the economy of other member countries. In this case the assumption that a beneficiary national policy will always lead to of a beneficiary European policy does no longer hold and there is a case for co-ordination. As von.Hagen and Mundschenk have shown even if even governments refrain form discretionary fiscal policy and mechanically rely on automatic stabilisers there is no solution as the effect of automatic stabilisers may differ from country to country. Then again there is a case for co-ordination.

However there are also strong theoretical and in particular practical arguments against co-ordination as Akerholm (2003) has pointed out in his comment on von Hagen and Mundschenk. It is difficult for a national government to distinguish properly between symmetric (common) and asymmetric (national) shocks. All this takes time, too much time to react in time. The same applies to the present co-ordination process for fiscal policy within the Euro group and the Broad Economic Policy Guidelines (BEPG) of the

EU- Commission. Akerholm´s conclusion is that the institutional settings should more or less stay as they are and governments should seek for marginal improvements.

In the following a different approaches will be outlined. Firstly as a combination of realism and some effectiveness change of ECB targets is suggested. Then a more realistic approach with at least marginal improvements is outlined. Finally a setting is described. Finally the first best and highly utopian proposal of a European fiscal policy authority is described.

2. A sensible approach

The present governance system EMU has created a huge domestic market on a European level. But the political institutions still reflect this in an incomplete way. While the ECB is by construction a truly European institution there is no such counterpart on the fiscal policy side. Any institutional setting that assumes a final responsibility for national governments will ultimately run into the difficulties outlined above. In order to overcome the co-ordination problems in a sustainable manner, only the creation of a truly European fiscal policy authority would help. This implies a perception of the Euro area market as a purely domestic market for any member country. A notion that contradicts a competitive policy approach many governments tend to follow. They think if each government follows a fiscal policy stance it considers as optimal, the potentially differing macroeconomic performances of the respective member countries will tell parliaments and voters what is best. Consequently a less successful approach will be changed to a better one. Yet, again the external effects prevent an optimal outcome since the performances mutually influence each other. Then it is not possible to select an optimal strategy on the basis of single country approaches. In sum all considerations lead to a unified European approach.

It is anyway contradictory that on the one hand institutions have been changed between member countries to ensure free flows of goods, capital and on top of this a joint currency has been created. All these are essential elements of a single market. On the other hand fiscal policy approaches do not recognise this except for the rules laid down in the Stability and Growth Pact (SGP). But these refer only to public deficit and public debt and are silent on appropriate fiscal policy stance according to business cycle movements. Consequently up to now, there is no European fiscal policy approach providing optimal reactions to business cycle shocks.

There seems to be an obvious solution. The ECB with its monetary policy could act as a substitute for a European fiscal policy. Then no major institutional change would be required. That would leave the total responsibility for the stabilisation of the Euro area to the ECB. However, the ECB presently has the predominant task to ensure price stability. That is not necessarily a contradiction to stabilisation goals, as long as price pressures have mainly domestic roots. If an economy is booming and employment may grow very strongly, wages will also rise steeply. In this case a cooling down of the economy by a restrictive monetary policy is sensible to stabilise the economy as well for ensuring price stability. The same applies for the symmetrical situation when the economy is slack. A more expansionary monetary policy then helps to stimulate the economy and also to keep prices from a deflationary track. Insofar a European monetary policy could be a substitute for a European fiscal policy. However, this conformity of policy goals is by no means guaranteed. First of all there may be a conflict of timing. Reactions to price movements should be much more forward looking than those for movements of quantities on the goods and labour market. The latter tend to move faster and are more volatile, so one has to decide much closer to the event. Secondly there may be a conflict of extent. The dangers for price stability and business cycle stability may differ. Then it is not clear what stance monetary policy should take. Finally there could even be a fundamental conflict. The present situation is an example. If the origin for inflationary developments, as in the case of oil and energy price hikes, predominantly lies abroad, they tend to be a burden for economic expansion. On the other hand inflation rates may be above target, as presently is the case and adversely affect inflation expectations. The former problem could require lower interest rates, the latter higher.

Presently the ECB would have to solve all these potential conflicts with respect to the price stability target, because of its predominance as ECB policy goal. But then the ECB cannot be a substitute for a European fiscal policy institution at least not under the present institutional setting. If above problems should be addressed properly, a solution could be, to change the policy goals for the ECB. The central bank then could be obliged to give price stability and business cycle stabilisation basically the same weight in its policy considerations. Then given the potential conflicts the ECB would have to seek compromises between its then two targets. That increases communication necessities at times of conflict between the policy goals. The ECB has to explain to the general public what target is addressed first and why it does so. It should be an obligation of the ECB to do so. The way how it is done should be at the discretion of ECB, but one should expect success. Inflation expectations should stay anchored around the inflation target and an economic overshooting in both directions should be avoided.

An increase of the number of meetings at the European parliament does not seem necessary. Since quarterly information on the monetary situation in the Euro area seems sufficient. But the character of the meeting should be changed. It should not be any longer a meeting where the ECB and the Monetary Committee meet on an equal level to exchange information and views. Instead, there should be a hearing, where the ECB has to report to the parliament as the European sovereign. In such a hearing the ECB President has to explain and justify his policy measures. At the same time he should use this opportunity to communicate his signals to the markets. Signals should even become clearer when he is questioned properly by members of the committee. Questions could clarify unclear points and in the end lead to more information for the broader public.

In such a setting the ECB takes charge of a Euro area wide economic stabilisation. A disadvantage of this approach is that on the aggregate Euro level fiscal policy no longer has any stabilisation function. Stabilisation policy is completely overtaken by monetary policy. Hence one renounces on instruments that have proven helpful in the past.

National fiscal policy should focus on asymmetric shocks that affect single countries only. A reliable identification of asymmetric shocks is not easy. The EU –Commission and national government institutions should provide a standardised set of diagnostic instrument to achieve it as reliable as possible.

This framework constitutes a coordinated fiscal and monetary policy approach for the Euro area without the need to establish a complicated and slowly working coordination process. In fact the ECB would internalise coordination by its double target structure and national governments are restrained in their action since only limited shock can justify any action. Politically this coordination is based on a stronger position of the European parliament at the expense of Euro group and national governments. It remains to be seen whether these institutions are ready to renounce on some of their powers. Given the present political situation with a lot of distrust with respect to European institutions it does not seem highly likely. But it may be an option for the future.

3. A more realistic alternative

An alternative is to keep institutions as they are, but establish a co-ordination process via the Euro group. In this case national governments should find a common Euro area fiscal policy strategy that is aimed stabilising the Euro area. It means the Euro group has to discuss and decide according aggregate Euro needs. They have to consider the interdependencies between the economies and decide upon the stance of their respective fiscal policy. The ECB should be part of the coordination process. Since any conflict between monetary and fiscal policies has to be avoided. The decision should be taken on the basis of a standardised diagnostic framework provided by the EU – Commission. In addition to that each government will have its own analysis. However, for a decision only arguments referring to the state of the Euro area economy as an aggregate are valid. Fiscal policy should in this respect follow the same rules as the ECB.

Such a setting requires national governments to restrain from national arguments when deciding upon European fiscal policy. Given the fact that they are depending on their domestic voters only, the task becomes very demanding. By no means an appropriate outcome is guaranteed. Political bargaining is highly likely. In the end nobody can be held responsible for mistakes, since the Euro group is not depending on any democratic vote. However, if working properly the outcome would be a coordinated fiscal policy approach that satisfies the needs of the Euro area without any unlikely and probably only in the longer run feasible institutional changes. I

4. A more unrealistic alternative

A more unrealistic alternative is to set up a truly European fiscal authority. The ideal setting would give the European parliament the political responsibility and ECOFIN may be acting as a kind of a second chamber with minor rights than the Parliament. The EU-

Commission should have executive power for fiscal policy actions. To be able to do so the EU Commission should receive Euro area wide tax revenues based on corporate taxes. Corporate taxes are very well suited since they often give incentives to shift revenues of firms between countries just searching for tax breaks. If there is an Euro area wide corporate tax this incentive would be considerably diminished. Furthermore revenues from corporate taxes are highly cyclical and make it hence possible to save them during good times and spend them during bad times. Good and bad times are defined on an aggregate Euro area level. Given all this the Commission could develop contingent plans under approval of the parliament what should be done when an area wide fiscal stimulus is needed. They financial means can even be used to overcome external effects of un- coordinated national fiscal policies. With such a setting the Euro area would have an aggregate fiscal policy as it has an aggregate monetary policy. In this setting a non –cooperative fiscal policy is largely avoided, since there is a central authority. As in the first proposal, national fiscal policy should focus on asymmetric shocks.

Beyond doubt this proposal is the most unrealistic one of all those presented here. It requires national governments to share power with the EU-Commission that acts no longer as an agency of the member states government, but rather as a European government. It is highly doubtful whether European politics is ready to enter the road to stronger links on a European level. Nevertheless an appropriate institutional setting for a truly domestic European market requires just that. Only then external effect of un-coordinated fiscal policy can be avoided and fiscal policy can be used properly to stabilise the economy.

5. Conclusion

The present institutional setting of the Euro area is not optimal as far stabilisation requirements are concerned. There are considerable external effects of non- co-operative national fiscal policies. Therefore a change in the setting is required. There has to be an institution that takes responsibility for a European stabilisation policy beyond monetary stabilisation. This can - the most realistic but least effective approach – be the Euro group. More realistically one could change the target for the ECB. By extending its responsibility to the business cycle stabilisation problems would be tackled in better way. The most appropriate but highly unrealistic approach is to create a fiscal policy authority on a European level. But there is good reason to assume the political circumstances presently will not allow this.

References

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