Monetary and Fiscal Policy

A single currency results in greater stability. A fixed exchange rate system between trading partners helps firms and households plan for the future. Businesses need stability for investment, and a single currency helps achieve such constancy. Additionally, a single currency reduces the transaction costs of exchanging money and makes prices within the eurozone more transparent, aiding competition and best value.

Collective fiscal discipline and coordination are essential for a successful monetary union. A country within a monetary union that became unable to finance its debts would need to be supported financially by other member states or international institutions. Or it might put pressure on the European Central Bank to lower interest rates, to help make the debt more manageable. All these scenarios would have adverse effects on the currency and all participating member states – hence the essential need for policy coordination and fiscal discipline. This is what the Stability and Growth Pact aims to achieve.

On January 1, 1999, eleven member states of the European Union adopted the euro, with euro notes and coins subsequently introduced on January 1, 2002. But well before the new millennium, European countries were grappling with how to best conduct monetary and fiscal policy in a highly integrated economic union, as a free trade area works best with a single currency because of the benefits in terms of stability and transparency. In 1992 the Maastricht Treaty began to formalize this process by announcing plans to achieve economic and monetary union by the end of the decade. The goal of economic and monetary union was clear – to foster greater stability and economic growth in the economies comprising the European Union.

For economic and monetary union to work, a degree of convergence and coordination is necessary. Such coordination should stop any member state free-riding on the prudent economic policies of the others. In the United States, this is achieved through a single fiscal policy and strong political union.

In the European Union, mechanisms needed to be put in place to achieve the prerequisite degree of convergence and coordination to ensure that a single interest rate and exchange rate would be suitable for all member states. This is what the Maastricht criteria committed to achieve, and the institutions and rules set up by the Maastricht Treaty were to guide Europe to economic and monetary union and facilitate the system once the single currency was adopted.

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Rules of the Game

A. Pre-Euro: Maastricht Criteria

To be successful, economic and monetary union between sovereign nation states requires a degree of coordination and convergence. The Maastricht Criteria were devised to ensure that countries had brought down debt, budget deficits, interest rates and inflation to low and stable levels for a sustained period of time before they were able to participate in the euro. This involved immense discipline in many European countries that had battled (through the 1970s, 1980s and early 1990s) with high levels of inflation and unemployment since the 1973 oil price shock. However, by the time the euro was adopted in January 1999, all twelve member states of the European Union who wanted to participate in the single currency were allowed to, reflecting the tough policy decisions they had taken to meet the criteria set out at Maastricht.

B. In the Euro

Once in the euro, the setting of the interest rate, previously taken at the national level, was transferred to the European Central Bank (ECB) following monetary union. Nevertheless, the need for fiscal rules continues: a strong and stable currency requires prudent macro-economic policies at the level of the nation state. Without complementary policy decisions at the level of the nation state, one country, or a group of countries, could run imprudent fiscal policies and free ride on more disciplined policies by other member states and the ECB. The risk is that their behavior would undermine the single currency or push up interest rates. The framework for fiscal policy within economic and monetary union is known as the Stability and Growth Pact (SGP), and is possibly the most contentious part of the union at the present time.

C. European Central Bank

The twelve countries of the eurozone have their interest rate set by the Governing Body of the ECB, led by the Bank's President, currently Jean Claude Trichet, and formerly Wim Duisenberg. The primary objective of the ECB is to "maintain price stability". Subject to this, monetary policy should be used to "support the general economic policies of the Community". This is quite similar to the objectives of the Federal Reserve Bank, whose twin objectives are to ensure low inflation and strong economic growth. Within this remit to deliver price stability, the ECB has the right to define its objective more specifically. At its inception, the ECB defined price stability with the "two pillars" for monetary stability: growth of the money supply of 4.5 per cent a year, and an expected inflation rate of below two per cent per year. This is different from the Federal Reserve Bank, which does not define what is meant by low inflation or strong growth. Early in the life of the single currency, the ECB redefined (or "clarified") the inflation target more specifically, explaining that it should be below, but close to two percent. In questioning, Duisenberg admitted that "close to" means 1.5 percent – so the effective range is 1.5 to 2 percent, but this is often surpassed in actual performance. Additionally, the ECB has reduced the emphasis on the reference value for growth of the money supply.

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D. Stability and Growth Pact

Collective fiscal discipline and coordination are essential for a successful economic and monetary union. A country within a monetary union that became unable to finance its debts would need to be supported financially by other member states or international institutions. Or it might put pressure on the ECB to lower interest rates to help make the debt more manageable. All these scenarios would have adverse effects – it could push up the interest rate on euro-denominated debt, could lead to greater currency speculation if traders thought that the exchange rate was unsustainable, and could require more restrictive fiscal policies in other member states to protect the integrity of the system. Hence the essential need for policy coordination and fiscal discipline to avoid free-riding on the responsible countries. This is what the SGP aims to underpin.

The rules that countries were required to meet to join the single currency did not vanish upon the adoption of the currency. Indeed, all countries in the European Union (apart from the United Kingdom, which secured an opt-out) are subject to these rules. The broad thrust of the Stability and Growth Pact is that countries must run responsible fiscal policies that will not undermine the strength and integrity of the single currency. Government debt should be kept at a low and stable level, and budget surpluses should be in balance of surplus over the economic cycle. All countries in the European Union sign up to these broad principles—including the United Kingdom.

The specific rules indicate that no country should run an excessive deficit – defined as a ratio of actual or planned government spending to GDP of more than three per cent. The second is that the ratio of government debt to GDP should be below, at, or declining toward 60 percent. The Council of Ministers has the right to issue recommendations to a country in breach of the rules for getting fiscal policy back on track within a time frame fixed by Council regulation. Alternatively, it can issue an early warning if it thinks that the rules will be breached. If no action is taken by the member state in question, the Council can issue fines of up to 0.5 per cent of the country's GDP. These mechanisms are known as the Excessive Deficit Procedure. When judging whether a country is in breach of the rules laid out in the SGP, the Council of Ministers are required to consider the macro-economic environment. If GDP contracts by more than 2% in a year, then a country is permitted to run a deficit of more than 3% of GDP, and the Council of Ministers can also take account of how the government spends its money. As of March 2005 the Council of Ministers is able to allow greater consideration to be taken of the economic conditions in a particular country, even if it is not technically in recession.

E. Fiscal and Monetary Coordination

The importance of policy coordination within a framework of monetary union has already been emphasized. Moreover, coordination between fiscal and monetary policy is necessary to ensure the appropriate mix of fiscal and monetary policy.

At the same time, with a single currency, and hence a fixed exchange rate and a single interest rate within the union, fiscal policy (specifically fiscal stabilization) is arguably more important than it is outside of a union. In the face of country-specific shocks or

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shocks that have an asymmetric impact on member states, fiscal policy is the only instrument available to policymakers for facilitating market adjustment. The alternative policy instruments – a revaluation of the currency, or a change in interest rates – are not available. It is important that the fiscal framework adopted to achieve policy coordination does not impede a country's ability to use fiscal policy in this manner. That is, automatic stabilizers, and in the event of larger shocks, discretionary stabilizers, must be able to kick in to action. This needs to be done without undermining the long term fiscal position of the member state, and without undermining the currency, but the scope should exist.

A Critique of the SGP

The economies of Europe have been successful in recent years in bringing down their budget deficits and debt burdens. This is in large part due to peer pressure and the desire to enter in to a successful monetary union. To that end, it is easy to point to the success of the Maastricht criteria and later the SGP. Furthermore, despite a volatile start, the euro is proving to be a strong and popular currency.

However, there has been mounting criticism of the SGP, from both participating and non-participating members of the single currency. The UK government decided not to enter the single currency at its inception in 1999. Behind this decision was the assessment that the economic conditions for UK membership were not right. The UK Treasury Department has also often been critical of the Stability and Growth Pact, preferring instead its own rules on borrowing. The rules for the UK insist on a balanced budget over the economic cycle, but with the proviso that the government should be allowed to borrow in order to fund investment in public services.

A key criticism of the SGP is that it does not provide sufficient flexibility. By prohibiting borrowing of more than 3% of GDP, except in very exceptional circumstances, the SGP is missing the point of fiscal rules – which should concentrate on the sustainability of public finances over the medium and long term, not the annual borrowing requirement. That said, it is a step in the right direction with its emphasis on the debt to GDP ratio, and the scope to consider country specific economic circumstances.

The range of debt to GDP ratios in the eurozone is high, and the average is around 70% of GDP – above the 60% reference value. On top of this, the sustainability of public finances will be influenced by any future pressures – for example, those imposed by an aging population, especially if state pensions are not fully financed.

Despite this, all countries in the eurozone face the same rules governing the amount they can borrow on an annual basis. Although this might aid transparency, it is not necessarily the most economically sensible rule. Furthermore, governments borrow for a variety of reasons. Governments may borrow to fund a tax cut, or to build new railway infrastructure. It is fairly easy to make the case that the latter might be wise investment, which would reap returns in later years, while the first is irresponsible and will have to be paid for at a future date. The SGP in its early format does not differentiate. Again, although this lack of differentiation might aid transparency, it does not function as a very flexible or economically robust framework. Since March 2005, greater flexibility has been allowed. In practice it is a case of getting the balance right between the need for fiscal discipline and the need for countries to be able to tackle economic downturns and investment in public services.

Whether the framework enshrined in the SGP is credible is also an open question. France and Germany have been in breach of the rules on budget deficits for several years. Portugal and Italy have also breached the rules. France does not plan to bring its budget back into line for several years, while Germany argues that the costs of re-unification create unique problems for its economy, and so the rules should be interpreted more leniently for them. Both France and Germany argue that since their own debt burdens are substantially less than those of other economies within the eurozone, they should be able to run larger deficits in the short run.

The ECB itself is not immune to criticism either. The inflation target is criticized for being too low, and biased towards deflation. In addition, the one-size fits all interest rate has been criticized for delivering interest rates that are too low for booming economies such as Ireland, but too high for depressed economies such as Germany. Outside monetary union – so the argument runs – interest rates would be better tailored for the individual economies.

None of these criticisms has been borne out as clearly as their proponents expected. Although France and Germany were in breach of the fiscal rules for much of the early 2000s, they managed to bring their deficits back under control toward the end of the decade – as did more problematic countries like Italy and Greece. The ECB may have announced a strict inflation target, but the medium-term focus of its objective meant that actual inflation was often higher than the norm, but without major destabilizing effects on wages and, through wages, again on prices. Finally, it is not clear that other countries are benefiting from the ability to set their own interest rates or that borrowing costs are higher within the eurozone than they would be in eurozone countries under different circumstances. Indeed, when the possibility was raised that Italy might choose to leave the euro, the cost that this implied in terms of higher interest rates left little doubt but that they would not.

Summary

In its first decade, the fledgling euro currency has been a big success. It is now used by twelve countries, and is the second most used currency in the world after the US dollar. It is held as a reserve currency by central banks and businesses across the globe, and has gained in value against the dollar since it was first traded.

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To work successfully, member states must abide by a set of rules that govern their fiscal policies, and a central bank must consider the union as a whole rather than the special interests of one country, region or industry. However, the specific rules governing fiscal policy within economic and monetary union in Europe have received the most criticism. These rules are clearly evolving, and they will continue to evolve over time as participating countries and the Council of Ministers consider policy in light of experience and the needs of member states.

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