palgrave macmillan

Alternative Perspectives on Economic Policies in the European Union

Edited by

Philip Arestis and Malcolm Sawyer

International Papers in Political Economy

International Papers in Political Economy Series

Series Editors: Philip Arestis and Malcolm Sawyer

Titles include:

Philip Arestis and Malcolm Sawyer (*editors*)
ALTERNATIVE PERSPECTIVES ON ECONOMIC POLICIES IN THE EUROPEAN UNION

FINANCIAL LIBERALIZATION
Beyond Orthodox Concerns.

International Papers in Political Economy
Series Standing Order ISBN 978-1-4039-9936-8

You can receive future titles in this series as they are published by placing a standing order. Please contact your bookseller or, in case of difficulty, write to us at the address below with your name and address, the title of the series and one of the ISBN quoted above.

Customer Services Department, Macmillan Distribution Ltd, Houndmills, Basingstoke, Hampshire RG21 6XS, England

Alternative Perspectives on Economic Policies in the European Union

Edited by

Philip Arestis

and

Malcolm Sawyer

palgrave
macmillan

Softcover reprint of the hardcover 1st edition 2006 978-0-230-01891-4

First published 2006 by
PALGRAVE MACMILLAN
Houndmills, Basingstoke, Hampshire RG21 6XS and
175 Fifth Avenue, New York, N.Y. 10010
Companies and representatives throughout the world

PALGRAVE MACMILLAN is the global academic imprint of the Palgrave Macmillan division of St. Martin's Press, LLC and of Palgrave Macmillan Ltd. Macmillan® is a registered trademark in the United States, United Kingdom and other countries. Palgrave is a registered trademark in the European Union and other countries.

ISBN 978-1-349-28516-7 ISBN 978-0-230-62735-2 (eBook)
DOI 10.1057/9780230627352

This book is printed on paper suitable for recycling and made from fully managed and sustained forest sources.

A catalogue record for this book is available from the British Library.

Library of Congress Cataloging-in-Publication Data

Alternative perspectives on economic policies in the European Union/
edited by Philip Arestis and Malcolm Sawyer.
p.cm.—(International papers in political economy)
Includes bibliographical references.

1. European Union countries—Economic policy. 2. European Union countries—Economic conditions. I. Arestis, Philip, 1941 - II. Sawyer, Malcolm C. III. Series.

HC240.A78284 2006
337.1'42--dc22 2006046166

10 9 8 7 6 5 4 3 2 1
15 14 13 12 11 10 09 08 07 06

Contents

List of Tables

List of Figures

Preface

This is the second volume of the new series of *International Papers in Political Economy* (*IPPE*). The new series will consist of an annual volume with four to five papers on a single theme. The objective of the *IPPE* will continue to be the publication of papers dealing with important topics within the broad framework of Political Economy.

The original series of *International Papers in Political Economy* started in 1993 and has been published in the form of three issues a year with each issue containing a single extensive paper. Information on the old series and back copies can be obtained from Professor Malcolm Sawyer at the University of Leeds (e-mail: mcs@lubs.leeds.ac.uk).

The theme of this second volume of five papers is alternative perspectives on the political economy of the European Union in the aftermath of the rejection of the proposed European Constitution.

1
Macroeconomic Policy and the European Constitution

Philip Arestis
University of Cambridge and the Levy Economics Institute

Malcolm Sawyer
University of Leeds and the Levy Economics Institute

Abstract

The draft European Constitution sets out in considerable detail the economic thinking of the European Union. In this chapter we reflect on macroeconomic policy in the European Union (EU); in particular, how it is embedded in the draft constitution and to make proposals for a different approach. We focus on four questions, which have particular significance for the conduct of macroeconomic policy. These are: What should the objectives of economic policy be? What is the underlying 'model' of the policies which are in the draft EU constitution? Should there be a federal Europe or a collection of nation-states? And how can the democratic deficit be corrected?

The chapter proceeds by putting the European Constitution in context, and then reviewing the objectives of macroeconomic policy. We then discuss critically the neo-liberal agenda underlying economic policies in the EU. We then turn our attention to the single currency and a federal Europe, and with democratising the European Central Bank (ECB). The remaining sections discuss issues on the euro exchange rate, and policies for the achievement of full employment.

JEL Classification: E60, E61, E63

Key words: European Constitution, European Union, macroeconomic policy

1. Introduction

The draft European Constitution sets out in considerable detail the economic thinking of the European Union (EU). The 'no' votes in France and the Netherlands in mid-2005 have provided for a 'period of reflection', and we intend to use that period to reflect on macroeconomic policy in the EU; in particular, how it is embedded in the draft Constitution and to make proposals for a different approach. In doing so, we focus on four questions which have particular significance for the conduct of macroeconomic policy. The questions are:

(i) What should the objectives of economic policy be?
(ii) What is the underlying 'model' of the policies which are in the draft EU Constitution, and is a neo-liberal agenda being imposed?
(iii) Should there be a federal Europe or a collection of nation-states?
(iv) How can the democratic deficit be corrected?

It has often been argued (not least by the British government) that the proposed Constitution was no more than a 'tidying up' exercise with administrative changes to ease decision-making in an enlarged EU. It is also argued that many features of the proposed European Constitution to which objections were raised did not represent changes from the previous Treaties of Amsterdam and of Nice, and that a vote against the new Treaty would merely mean the status quo in which the features objected to remained. We have to recognise that is the case, and notably in the context of this chapter the Stability and Growth Pact (SGP) and the 'independence' of the European Central Bank (ECB) are prime examples.

Section 2 attempts to put the European Constitution in context, while Section 3 turns its attention to the objectives of macroeconomic policy, and Section 4 discusses critically the neo-liberal agenda. Section 5 turns attention to the single currency and a federal Europe, with Section 6 focusing on democratising the ECB. Section 7 considers issues concerning the euro exchange rate, and Section 8 outlines policies for the achievement of full employment. Finally, Section 9 summarises and concludes.

2. The European Constitution in context

The work of the European Convention in 2003 and 2004 provided a timely opportunity to fundamentally reform the macroeconomic policy-making frameworks of the euro area. The first years of the euro, and indeed the years preceding the launch of the euro, have not seen the most favourable economic performance in the euro area countries, and the deflationary climate created by the economic institutions of the euro area has been a major factor in this. Macroeconomic performance had been sluggish since 2001 (and this has continued through to the end of 2005 as we write) with slow growth and rising unemployment, which have been particularly pronounced in Germany and Italy. The recent economic performance of the eurozone and some of the major countries is outlined in Table 1.1.

When the European Convention began its work drawing up the draft Constitution, the strains and problems of the SGP were becoming clear to all, with many countries having exceeded the 3 per cent GDP budget deficit limit laid down in the SGP in time of economic slowdown. The drawing up of a constitution presented a considerable opportunity to make fundamental changes to the SGP (and macroeconomic policy more generally) both in terms of the objectives of macroeconomic policies and of the instruments of policy. But that opportunity was spurned.

Table 1.1 Recent macroeconomic performance

	2001	**2002**	**2003**	**2004**	**2005**
Eurozone					
Growth rate	1.9	0.9	0.7	2.1	1.3
Unemployment	7.9	8.3	8.7	8.9	8.6
Inflation	2.4	2.3	2.1	2.1	2.3
Germany					
Growth rate	1.2	0.1	–0.2	1.6	0.8
Unemployment	7.4	8.2	9.0	9.5	9.5
Inflation	1.9	1.3	1.0	1.8	2.0
France					
Growth rate	2.1	1.2	0.8	2.3	1.5
Unemployment	8.4	8.9	9.5	9.6	9.6
Inflation	1.8	1.9	2.2	2.3	2.0
Italy					
Growth rate	1.8	0.4	0.3	1.2	0.2
Unemployment	9.1	8.6	8.4	8.0	7.7
Inflation	2.3	2.6	2.8	2.3	2.2

Note: Growth rate is per cent change in GDP; unemployment is rate as per cent of civilian labour force; inflation is per cent change in the harmonised index of consumer prices. Figures for 2005 are forecasts as of November 2005

Source: Economic Forecasts, Autumn 2005–2007: growth picks up, *European Economy*, No. 5. 2005, Office for Official Publications of the EC, Luxembourg, KC-AR-05-005-EN-C.

From the reports of the working groups of the Convention there appears to have been no serious consideration of alternatives.

Since the Convention's work ended, the strains on the SGP have increased, with more countries breaking the budget deficit limits, and disquiet with the SGP has also increased. The precise operation of the SGP was eased in the agreement of March 2005, but the central features of the SGP remain and the ECB expressed its 'serious concern'. The following give a flavour of the limited changes which were made. 'The two nominal anchors of the Pact – the 3% of GDP reference value for the deficit ratio and the 60% of GDP reference value for the debt ratio – have proven their value and continue to be the centrepiece of multilateral surveillance. However, the European Council noted in June 2004 the need to strengthen and to clarify the implementation of the Stability and Growth Pact, in order to foster transparency and national ownership of the EU fiscal framework and to improve enforcement of its rules and provisions. . . . The Pact has to be applied across countries in a fair and consistent way and be understood by public opinion. The Council reaffirms that a rules-based system is the best guarantee for commitments to be enforced and for all Member States to be treated equally' (Council of the European Union, 2005, p. 22). 'In making the proposals for a reform of the Stability and Growth Pact, the Council gave due consideration to enhance the governance and the national ownership of the fiscal framework, to strengthen the economic underpinnings and the effectiveness of the Pact, both in its preventive and corrective arms, to safeguard the sustainability of public finances in the long run, to promote growth and to avoid imposing excessive burdens on future generations' (Council of the European Union, 2005, p. 23). 'The Member States, the Council and the Commission should reaffirm their commitment to implement the Treaty and the Stability and Growth Pact in an effective and timely manner, through peer support and peer pressure, and to act in close and constructive cooperation in the process of economic and fiscal surveillance, in order to guarantee certainty and effectiveness to the rules of the Pact' (Council of the European Union, 2005, p. 24).

The draft Constitution often managed to combine statements which are poorly defined but which are rather menacing. In Article III–69, it is stated that there shall be compliance with 'the following guiding principles: stable prices, sound public finances and monetary conditions'. At one level this sounds eminently sensible, for who could be in favour of unsound finance?. But at another level it is an almost meaningless phrase for what constitutes 'sound finance': What does it imply for the balance between revenue and expenditure, or for the level of and rate of change of public debt? In Article III–92, there is talk of 'the sustainability of the government financial position; this is apparent from having achieved a government budgetary position without a deficit that is excessive' which is close to a tautology but also it is not realised that any government deficit is sustainable in the sense that the debt to GDP ratio does not explode.[1] We would advocate that the finances of the governments of the EU be designed to achieve the highest sustainable level of economic activity and to overcome deficient private aggregate demand, and that this will often require budget deficits. Budget deficits in those circumstances are sustainable and can be financed, and we would regard that as 'sound finance'. But we suspect that 'sound finance' is used here as a euphemism for a budget in balance or surplus. Thus, it is intended as a way of bringing in anti-Keynesian and deflationary policies based on an outmoded ideology.

The neo-liberal agenda of the Constitution is well illustrated by the reference to 'an internal market where competition is free and undistorted' (Article I–3.2), though many would question whether competition can ever be 'free and undistorted'. But later there is reference to 'a highly competitive social market economy' (Article I–3.3), which in no way defines what is meant by a social market economy. By implication there is no indication on which range of activities will take place outside of the market, or whether the market is to control all of economic life.

In the context of the EU, where the agreement of 25 countries would be required to implement any change, the Constitution should be limited to the expression of general principles. We would argue that any specifics of economic policy should not be included in a constitution.

3. Objectives of macroeconomic policy

There are (at least) two questions which arise in connection with the SGP (and economic policy more generally). The first one is whether the instruments and objectives of economic policy should be included at all in a constitution. Putting the instruments of economic policy into a constitution is highly restrictive, and limits the development of alternative instruments. For example, the 'independence' of the central bank is a current economic policy fad, and enshrining that in the Constitution makes unnecessary difficulties when the current fashion changes.

The second question is: What should be the objectives and nature of macroeconomic policies at the European level be? We will spend the rest of the chapter seeking to answer that question. But given what we have just said, we do not consider that macroeconomic policies should be embedded into any form of the Constitution. It would be appropriate for a constitution to set out the enduring objectives of the EU, and for those to include those of full employment, equitable income distribution and the elimination of poverty, and the pursuit of sustainable development. The pursuit of the achievement of those values would come from, *inter alia*, macroeconomic policies; but macroeconomic policies inevitably change over time. A quick comparison of the thinking on macroeconomic policies in say the 1960s with those of the 1980s and the current ones would illustrate the speed with which changes in thinking on macroeconomic policies occur. A constitution in its nature cannot be readily changed, and that is reinforced in the context of the EU where a change to the Constitution would require the agreement of all 25 countries.

We then have two basic objections to the form which the Constitution took with regard to economic policies. First, a constitution is not the relevant place for setting out economic policies. Second, the policies which are set out in the draft Constitution are wrong-headed and detrimental to the population of the EU (and one might add detrimental to the development of the EU itself). The European Constitution imposes as a constitutional requirement that national governments balance their budget over the cycle and are subjected to the upper 3 per cent limit, even though many countries have broken this limit repeatedly. It would be much more appropriate if the Constitution imposed the objectives of economic policy, including full employment and sustainable economic development.

The key objectives of macroeconomic policies, in our view, are the achievement of full employment, the promotion of sustainable and equitable growth, the removal of poverty and a less unequal distribution of income. The achievement of these objectives require, among other matters, the use of macroeconomic (monetary and fiscal) policy to secure high levels of aggregate demand and the building of adequate productive capacity. Calls for more 'flexible' labour markets are largely irrelevant where full employment is concerned, which requires high levels of demand and of capacity. Thus, we argue for a reorientation of macroeconomic policy with the major objectives of full employment and sustainable growth, with a full role being played by fiscal and monetary policy in the pursuit of those objectives.

4. The neo-liberal agenda

The Economic and Monetary Union (EMU) is a major experiment in the use of a pre-Keynesian, or indeed new Keynesian, variety of macroeconomic policy, in effect what has come to be known as the 'new consensus' macroeconomics (see, for example, Arestis and Sawyer, 2005). The present policy and institutional framework for the euro area can be readily summarised. The ECB, which is 'independent' of the political authorities in the European Commission and national governments and of the European Parliament, is entrusted with using monetary policy to pursue 'price stability', which has been interpreted as inflation below but near to 2 per cent per annum and that 'it shall support general economic policies in the Union in order to contribute to the achievement of the Union's objectives'. The monetary policy instrument is the use of interest rates and it foregoes forms of monetary policy such as credit controls.

There is a requirement for the EU budget to be balanced each year and hence no fiscal policy is exercised at the EU level (and the EU budget is itself rather small at just over 1 per cent of EU GDP). The fiscal policy of national governments is (in principle) subject to conformity with the SGP. The SGP imposes an upper limit of 3 per cent of GDP on budget deficits, with the view that budgets will be broadly in balance or in small surplus over the business cycle. An automatic exemption is in place for falls of GDP of more than 2 per cent and discretionary exemptions for falls in output of between 0.75 and 2 per cent, which would represent very major recessions. A system of non-interest-bearing deposits, which could turn into fines, is also in place, but it has not been invoked despite a number of budget deficits exceeding 3 per cent (in the face of economic slowdown but not of declining output).

The ECB is the only federal economic agency, but its remit is the control of inflation, which has been persistently above the target level. The ECB appears to have been slow to recognise the beginnings of the slowdown in economic activity, and when it did recognise the slowdown it did not cut interest rates in an aggressive manner on a par with the US Federal Reserve System. But the ECB has been faced with inflation at or above its target level alongside an economic slowdown. The attention paid to its mandate and its religious focus on establishing 'credibility' with the financial markets pushed it towards maintaining a tight monetary policy.

It is unlikely that economic policy pursued by any government or institution is fully consistent either internally or with some theoretical paradigm. However, in view of the approach adopted by the EMU, and the theoretical positions put forward by its officials (see, for example, Issing, 2003, and European Commission, 2000, for recent expositions), it can be thought of as embedded in the 'new consensus' macroeconomics paradigm. We argue that the approach can be viewed as 'new consensus' through its emphasis on the supply-side determined equilibrium level of unemployment (the 'natural rate' or the non-accelerating inflation rate of unemployment, or NAIRU), its neglect of aggregate demand (particularly in the long run) and of fiscal policy, and the elevation of monetary policy at the expense of fiscal policy.

4.1. Main theoretical elements of the EMU model

We postulate that the economics of the EMU can be understood as based on the following elements listed below, which we would argue justify the description of a New Consensus Macroeconomics (NCM) variety. These elements are as follows[2]:

(i) The market economy is viewed as essentially stable, and it is argued that macroeconomic policy (particularly discretionary fiscal policy) may well destabilise the market economy. Markets, and particularly the financial markets, make well-informed judgements on the sustainability of economic policies, especially so in the current environment of open, globalised, capital and financial markets.

(ii) Monetary policy is taken as the main instrument of macroeconomic policy, with the view that it is a flexible instrument for achieving medium-term stabilisation objectives: it can be adjusted quickly in response to macroeconomic developments. Indeed, monetary policy is the most direct determinant of inflation, so much so that in the long run the inflation rate is the only macroeconomic variable that monetary policy can affect (see, for example, ECB, 2003c). Fiscal policy is no longer viewed as a powerful macroeconomic instrument (in any case it is subject to the slow and uncertain legislative process). It is recognised that the budget position will vary over the course of the business cycle in a counter-cyclical manner (i.e. deficit rising in downturn, surplus rising in upturn), which helps to dampen the scale of economic fluctuations (i.e. act as an 'automatic' stabiliser). But these fluctuations in the budget position take place around a balanced budget on average over the cycle. The budget (at least on current account) can and should be balanced over the course of the business cycle. Fiscal policies 'based on clear mandates and rules reflect a macroeconomic policy design that is generally preferable to the ad-hoc discretionary co-ordination of day-to-day policy action in the face of shocks' (ECB, 2003c, p. 37). Monetary policy has, thus, been upgraded and fiscal policy has been downgraded.

(iii) Monetary policy can be used to meet the objective of low rates of inflation (which are desirable in this view, since low, and stable, rates of inflation are conducive to healthy growth rates).[3] However, monetary policy should not be operated by politicians but by experts (whether banks, economists or others) in the form of an 'independent' central bank (ECB, 2003c, pp. 40–41). Indeed, those operating monetary policy should be more 'conservative', that is place greater weight on low inflation and less weight on the level of unemployment than the politicians (Rogoff, 1985). Politicians would be tempted to use monetary policy for short-term gain (lower unemployment) at the expense of long-term loss (higher inflation). An 'independent' central bank would also have greater credibility in the financial markets and be seen to have a stronger commitment to low inflation than politicians do.[4]

(iv) Credibility is recognised as paramount in the conduct of monetary policy to avoid problems associated with time-inconsistency. This is an argument that reinforces the requirement of central bank independence. It is argued that a policy which lacks credibility because of time-inconsistency is neither optimal nor feasible (Kydland and Prescott, 1977). The only credible policy is the one that leaves the authority no freedom as to how to react to developments in the future, and that even if aggregate demand policies matter in the short run in this model, a policy of non-intervention is preferable. It is precisely because of the time-inconsistency and credibility problems that monetary policy should be assigned to a 'credible' and independent central bank. Such a central bank should be given as its sole objective that of price stability.

(v) Inflation targeting is preferred to money supply targeting. Inflation targeting is neither a rule nor discretion (in practice only degrees of discretion prevail): it is rather a framework for monetary policy whereby public announcement of official inflation targets, or target ranges, is undertaken along with explicit acknowledgement that low and stable inflation is monetary policy's primary long-term objective. This improves communication between the public and policy-makers and provides discipline, accountability, transparency and flexibility in monetary policy. Inflation targeting has been described as 'constrained' or 'enlightened' discretion, in that inflation targets serve as a nominal anchor for monetary policy. As such, monetary policy imposes discipline on the central bank and the government within a flexible policy framework. For example, even if monetary policy is used to address short-run stabilisation objectives, the long-run inflation objective must not be compromised, thereby imposing consistency and rationality in policy choices (in doing so, monetary policy focuses the public's expectations and provides a reference point to judge short-run policies). Although the ECB allegedly does not pursue an inflation targeting policy (Duisenberg, 2003; Issing, 2003; see also below in this contribution), it does, nonetheless, pursue a monetary policy strategy with 'the clear commitment to the maintenance of price stability over the medium term', which 'implies a stable nominal anchor to the economy in all circumstances' (ECB, 2001, p. 49).

(vi) The level of economic activity fluctuates around the NAIRU, and unemployment below (above) the NAIRU would lead to higher (lower) rates of inflation. The NAIRU is a supply-side phenomenon closely related to the workings of the labour market.[5] The source of domestic inflation (relative to the expected rate of inflation) is seen to arise from unemployment falling below the NAIRU, and inflation is postulated to accelerate if unemployment is held below the NAIRU. However, in the long run there is no trade-off between inflation and unemployment, and the economy has to operate (on average) at the NAIRU if accelerating inflation is to be avoided. In the long run, inflation is viewed as a monetary phenomenon in that the pace of inflation is aligned with the rate of interest. Monetary policy is thus in the hands of central bankers. Control of the money supply is not an issue, essentially because of the instability of the demand for money that makes the impact of changes in the money supply a highly uncertain channel of influence.

(vii) The essence of Say's Law holds that the level of effective demand does not play an independent role in the (long run) determination of the level of economic activity, and adjusts to underpin the supply-side determined level of economic activity (which itself corresponds to the NAIRU). Shocks to the level of demand can be met by variations in the rate of interest to ensure that inflation does not develop (if unemployment falls below the NAIRU).

The main theoretical elements of the NCM can be put together to form a more formal model amenable to further analysis, to which we now turn.

4.2. A formal new consensus macroeconomics model

Most of these general ideas can be seen as formalised (explicitly or implicitly) in what has become known as the 'new consensus' of macroeconomics (see, for example, Arestis and Sawyer, 2004a). This 'new consensus' can be summarised in the following three equations:

$$Y_t^g = a_0 + a_1 Y_{t-1}^g + a_2 E(Y_{t+1}^g) - a_2[R_t - E_t(p_{t+1})] + s_1 \quad (1.1)$$

$$p_t = b_1 Y_t^g + b_2 p_{t-1} + b_3(p_{t+1}) + s_2 \quad \text{(with } b_2 + b_3 = 1) \quad (1.2)$$

$$R_t = RR^* + E_t(p_{t-1}) + c_1 Y_{t-1}^g + c_2(p_{t+1} - p^T) \quad (1.3)$$

where Y^g is the output gap, R the nominal rate of interest, p the inflation, p^T the inflation target, RR^* the 'equilibrium' real rate of interest (i.e. the rate of interest consistent with zero output gap which implies from Equation (1.2) a constant rate of inflation) and s_i (with $i = 1, 2$) the stochastic shocks.

Equation (1.1) is the aggregate demand equation, Equation (1.2) is a Phillips curve and (1.3) is a monetary policy operating rule which replaces the old LM curve. There are three equations and three unknowns: output, interest rate and inflation. This model has a number of additional, and relevant, characteristics. Equation (1.1) resembles the traditional IS, but expenditure decisions are seen to be based on intertemporal optimisation of a utility function. There are both lagged adjustment and forward-looking elements; the model allows for sticky prices (the lagged price level in the Phillips-curve relationship) and full price flexibility in the long run. The term E_t (p_{t+1}) in Equation (1.2) reflects central bank credibility. A central bank that credibly signals its intention to achieve and maintain low inflation will be 'rewarded' by lower expectations on the rate of inflation. The inclusion of term E_t (p_{t+1}) in Equation (2) indicates that it may be possible to reduce current inflation at a significantly lower cost in terms of output than otherwise. This is an important element in ECB monetary policy (see, for example, Duisenberg, 1999; Issing, 2003). The operating rule implies that 'policy' becomes a systematic adjustment to economic developments rather than an exogenous process. Also, it contains no stochastic shock implying that monetary policy operates without random shocks. It contains the neutrality of money property, with inflation determined by monetary policy (i.e. the rate of interest), and equilibrium values of real variables are independent of the money supply. The final characteristic we wish to highlight is that money has no role in the model; it is merely a 'residual', and this is more extensively discussed in Arestis and Sawyer (2003a, 2003b; see also 2003c).

The three relationships that summarise the 'new consensus' contain all the essential elements of the theoretical framework of the EMU (see