The Dysfunctional Nature of the Economic and Monetary Union

Philip Arestis, University of Cambridge, UK, and University of the Basque Country, Spain; Giuseppe Fontana, University of Leeds, UK, and University of Sannio, Italy; Malcolm Sawyer, University of Leeds, UK[*]

Introduction

The Economic and Monetary Union (EMU) is confronted with a multi-headed set of crises – an unemployment crisis, a balance of payments crisis, a banking and financial crisis, a fiscal sovereign debt crisis and an existential crisis. The underlying argument of this paper is that these sets of crises have arisen from or been exacerbated by the ways in which the Economic and Monetary Union (EMU) was constructed, rather than 'bad behaviour' by some member countries. Indeed, the 'euro crisis' can only be resolved through major policy changes, which permit the combination of the continued existence of the euro with acceptable economic performance.

We deal with the design faults of the EMU in section 2 after this very short introduction. Section 3 discusses the economic performance of the EMU, while section 4 looks into the neo-liberalism aspects of the European social model. Section 5 deals with the 'one size fits all problems' of the euro area (a term used interchangeably with EMU). Section 6 provides a critique of the 'fiscal compact' and the Treaty on Stability, Coordination and Governance (TSCG) in the Economic and Monetary Union. Section 7 concludes.

Design faults of the Economic and Monetary Union

The design faults of the construction of the EMU can be seen by reference to the convergence criteria for membership of the euro area. The Maastricht Treaty laid down criteria that should be met by those seeking to join the euro, and indeed all the countries that met the criteria were obliged to join, though Denmark and the UK secured opt-outs from that obligation.[1] The Maastricht criteria included convergence of inflation rate and interest rate in a country with the average experiences of other potential members, and these have a clear rationale in that under a currency union there is a single level of interest rate (as set by the Central Bank) and the clear expectation of similar rates of inflation across countries. But, there was no attempt

[*] Address for correspondence: Malcolm Sawyer, Leeds University Business School, University of Leeds, Leeds, LS2 9JT, UK, phone: 0113 343 4484, email: m.c.sawyer@lubs.leeds.ac.uk

[1] The convergence criteria, applied to each country for membership of the EMU initially under the Maastricht Treaty (Treaty on European Union), available at: http://eur-lex.europa.eu/en/treaties/dat/11992M/htm/11992M.html), can be summarised as follows: (1) average exchange rate not to deviate by more than 2.25 per cent from its central rate for the two years prior to membership; (2) inflation rate should not exceed the average rate of inflation of the three community nations with the lowest inflation rate by 1.5 per cent; (3) long-term interest rates not to exceed the average interest rate by 2 per cent of the three countries with the lowest inflation rate; (4) government budget deficit not to exceed 3 per cent of its GDP; and (5) the overall government debt not to exceed 60 per cent of its GDP.

to assess whether the inflationary conditions in potential member countries were similar, and that was significant in two respects. First, the inflation targeting regime of the European Central Bank (ECB) rested on the following linkage: changes in the interest rate → changes in the level of demand → changes in the inflation rate; and differences in the price and wage determination processes between countries would lead to different outcomes in terms of inflation resulting from a common interest rate. Second, countries differed substantially in their past experiences and future expectations of inflation, and general attitudes to inflation (including the legendary German fear of inflation), which portended differential rates of inflation.

The convergence criteria also included some stability of exchange rate prior to joining, which again had a clear rationale, but no attention was given to the trade and current account positions of each country. This was highly significant as clearly the formation of a single currency, which is the ultimate in fixing the nominal exchange rate between countries, permits no devaluation option to adjust a current account deficit (or revaluation for current account surplus); and as is now readily apparent, a change in the real exchange rate of a country within a currency union can only be secured by internal deflation (or inflation in other member countries), or possibly exit from the euro area.[2] The general proposition is that a trade deficit cannot be sustained indefinitely. It requires borrowing capital from overseas and hence willingness of foreigners to continue to lend capital, though experience suggests that a trade deficit can continue for many years. The borrowing to cover the trade deficit means rising debt and rising interest (and similar) payments on the debt, and then a tendency for the current account (that is trade account plus net income including interest payments) deficit to rise.[3] The creation of the single market, the removal of barriers to capital movement, the removal of exchange rate risk for borrowing between members of EMU all meant that it was rather easier for current account deficit countries to borrow capital to fund their deficits; indeed, many countries have been able to have continual and rising deficits through the 2000s. But the financial crisis presented major difficulties for the continuation of borrowing by deficit countries (and the counterpart lending by surplus countries). The consequences of the continued borrowing and the build-up of debts are now plain to see. The point to be made here is that this arose from a failure to consider current account imbalances at the time of the formation of the euro; and also a failure to have any adjustment processes whereby those current account imbalances could be adjusted (or arrangements for the long-term funding of those imbalances being made). It has long been known that in a fixed exchange rate regime (and a single currency is the extreme version of a fixed exchange rate regime between the member countries) there are severe difficulties in resolving current account imbalances without resorting to deflation in the deficit countries; and EMU is no exception in view of member countries losing their freedom to change the exchange rate of the currency in use.

[2] It should be noted that the exit of a country from the euro area is not discussed in the criteria for countries joining the EMU.

[3] Denote trade deficit (as proportion of GDP) by $(m - x)$, the foreign debt (D) to GDP (Y) ratio as $d = D/Y$, then $dd/dt = (m - x) + d(i - g)$ where i is rate of interest on foreign debt, and g is growth rate of GDP (both in real terms, or both in nominal terms). The debt to GDP ratio will then tend to rise, though it can be seen that there are circumstances in which it would not; for example, g much greater than i, or d itself positive.

The Stability and Growth Pact (SGP) brought in an attempt to impose a common fiscal policy on all member countries, whatever their economic position. The fiscal policy would have been rather deflationary if it had been implemented with a maximum of 3 per cent of GDP limit on budget deficits and a balanced or small surplus on the budget over the cycle, and this represented a tightening as compared with the 'convergence criteria'. There are a range of criticisms that can be made of the SGP. We would highlight the imposition of an arbitrary figure for the size of the budget deficit without thought for consequences, and an attempt is made to impose a common fiscal position on all countries.

The small scale of the EU budget at around 1 per cent of GDP and the requirement that it is balanced year by year clearly preclude any euro area (or EU) level fiscal policy. This lack of euro area-level fiscal policy precludes fiscal transfers whether as a means of stabilising the euro area economy or to effect transfers from rich regions to poor regions.

The 'independent' European Central Bank has also created a range of problems. We have elsewhere criticised the specific policies pursued by the ECB and more generally the inflation targeting regime (for example, Arestis and Sawyer, 2008). The main point to be made here does not relate to the specific actions of the ECB but rather to the institutional arrangements. We highlight the main argument as follows: first, an 'independent' Central Bank has led to a non-democratic organisation and the only one with EMU level macroeconomic decisions to pursue its own, generally neo-liberal agenda; and in terms of its policy objective the pursuit of price stability and nothing else. Second, co-ordination and co-operation over macroeconomic policies become more difficult with these institutional arrangements. Third, the relationships between the ECB and the national fiscal authorities do not parallel the relationships between a national central bank and a national fiscal authority, even under the arrangements of national independent central banks (another requirement for the country members of the EMU). The ECB may but does not have to operate as lender of last resort. The ECB cannot directly monetise budget deficits but in this regard does not operate differently from many other central banks (e.g. Bank of England). However, it can determine which national government paper it will accept in its open market operations. The underpinning of the debt of a national government comes from a combination of its tax raising abilities, the willingness by its Central Bank to purchase national government debt, and as a final resort its willingness to create money. These underpinnings are reliant on the government debt being denominated in the national currency, which cannot be the case within a single currency area.

The focus of attention in the 'convergence criteria' and then in the Stability and Growth Pact was on the government budget deficit with no attention given to the current account deficit. Yet the current account deficit is a summary measure of what a country has to borrow from outside its borders. There is a further issue which can be seen by reference to the national accounts identity:

(1) Private Savings minus private investment + Government budget surplus + Current account deficit (=capital account inflow) is equal to zero

This relationship is a reflection of the fact that when one economic actor has a surplus of income over expenditure (and is saving and lending) another must have a deficit of income over expenditure (and is dissaving and borrowing).

If countries differ (as they do) substantially in terms of their current account position, then seeking to impose a common budget position on all does not make a great deal of sense, unless it is believed that there are compensating differences in the balance of savings and investment intentions. More generally, in seeking to impose a balanced government budget, recognition must be given to the consequences for the balance between savings and investment and the current account position.

Economic performance of the euro area

The economic performance of the euro area countries over the period since the creation of EMU has been rather lack lustre, even before the 'great recession' struck. Economic growth has been generally sluggish averaging 1.9 per cent in the period 2002 to 2007, though growth rates varied with countries such as Germany and Italy growing much slower (at 1.2 per cent and 1.1 per cent respectively) and others enjoying much faster growth (notably Ireland at 5.5 per cent and Greece at 4.2 per cent). The rate of unemployment also differs significantly amongst countries, and on average remained over 7 ½ per cent throughout the 2000s. It has now though risen to reach over 11 per cent (2012), confounding those who claimed that:

> Employment has risen by almost 15% since the launch of the single currency while unemployment has fallen to about 7% of the labour force, the lowest rate in more than fifteen years. … The bulk of these improvements reflect reforms of both labour markets and social security systems carried out under the Lisbon Strategy for Growth and Jobs and the coordination and surveillance framework of EMU, as well as the wage moderation that has characterised most euro area countries (European Commission, 2008, p. 6).

Unemployment is into double figures in over half of the EMU countries. Inflation has remained low though often breaking the 'below but close to 2 per cent' target of the ECB. There have been continuing disparities in economic performance in terms of unemployment and standards of living, which are of course highly significant as measures of economic well being.[4]

Budget deficits, which under the terms of the Stability and Growth Pact should have been less than 3 per cent of GDP and have been broadly in balance over the cycle, averaged 2.2 per cent of GDP (2002-2007), though 7 of the original 12 member countries at some point exceeded the 3 per cent limit. The average ratio of public debt to GDP for the euro area was near 70 per cent in 2008, and in that year exceeded the intended 60 per cent limit in 7 countries. The 'great recession' pushed deficit levels well beyond the 3 per cent limit with tax revenues falling sharply as economic activity slowed. Whilst in general the Southern

[4] All the statistics quoted in the text have been calculated from data in OECD *Economic Outlook* (various issues).

European countries entered the euro area with significant current account and trade deficits, the Northern European countries entered with surpluses (or small deficits). Germany was a major exception in that it entered it with a small deficit, but with low inflation, depressed real wage growth and improving competitiveness that moved into substantial surplus of around 5 per cent of GDP subsequently. The EMU as a whole has tended to run a current account close to balance, meaning that the current account surpluses of the northern European countries were in broad terms equal to the current account deficits of the southern European countries. Differences in inflation rates and in the evolution of competitiveness were a marked feature of the first decade of the EMU, and were in the direction whereby the current account deficits of the southern European countries widened and the surpluses of the northern also increased (most notably in the case of Germany moving from small deficit to large surplus). There were substantial differences between countries in terms of changes in unit labour costs, which affected competitiveness. In terms of the loss of competitiveness (as measured by unit labour costs) it is estimated to be between 25% and 30% for Greece, Ireland, Portugal and Spain since the creation of the EMU in January 1999. The current account deficits of the southern European countries meant that those countries were borrowing heavily from other countries, and in the main from northern European banks as well as British and American ones. In the context of EMU with its single capital market and with southern euro area countries experiencing much lower interest rates than previously, debts were rapidly built up by the southern European countries. The debts were mainly, though not exclusively, private sector rather than public sector ones. However, when the 'great recession' hit, the borrowing became increasingly government borrowing. For example, in 2007 Portugal had a current account deficit of 10 per cent of GDP and a budget deficit of just over 3 per cent of GDP; by 2010 the figures were 9.7 per cent and 9.2 per cent respectively.

This brief review of economic performance of the euro area indicates that it was lack lustre in growth terms even before the financial crisis, and does not give any support to the notion that the creation of a single currency would stimulate growth. There had been some improvement in the unemployment situation until the crisis, which has been completely reversed by the 'great recession'. Overall, this performance undermines claims that the drive to 'flexible labour markets' has delivered lower unemployment and it highlights the crucial role of aggregate demand in determining the level of unemployment. Targets on the inflation rate were just missed but more significantly differential inflation in prices and unit labour costs showed the 'one size fits all' problems of monetary policy that cannot address such differentials, and which poses problems for a single currency area as some countries gain in competitiveness and others lose. The budget deficit targets were frequently missed which has undermined the 'rules based' approach to fiscal policy and raises the question (to which we return below) on whether balanced budgets are in general achievable. The current account imbalances tended to increase, and the capital flows between member countries (notably the lending flows from northern European countries to southern European countries) built up a debt situation which looks to be unsustainable.

Neo-liberalism and the European Social Model

The policy framework governing the euro can be aligned with a more general theoretical framework, which finds its expression in the 'new consensus macroeconomics' (NCM).[5] The essential features of that theoretical framework are as follows:

(i) politicians in particular, and the democratic process in general, cannot be trusted with economic policy formulation with a tendency to make decisions, which have stimulating short-term effects (reducing unemployment); but which are detrimental in the longer term (notably a rise in inflation). In contrast, experts in the form of central bankers are not subject to political pressures to court short-term popularity, and can take a longer-term perspective, where it is assumed that there is a conflict between the short term and the long term. Policy makers' scope for using discretion should be curtailed and the possibility of negative spillovers from irresponsible fiscal policy must be reduced.

(ii) There is only one objective of economic policy and this is price stability. This objective can only be achieved through monetary policy, and through manipulating the rate of interest in particular.

(iii) inflation is a monetary phenomenon and can be controlled through monetary policy. The central bank sets the key policy interest rate to influence monetary conditions, which in turn through their short-run effects on aggregate demand affect the future rate of inflation. Central banks have no discernible effects on the level or growth rate of output in the long run, which is determined exclusively by aggregate supply factors like technology, capital, and labour inputs. However, central banks do determine the rate of inflation in the long run.

(iv) the level of unemployment fluctuates around a supply-side determined equilibrium rate of unemployment, generally labelled the NAIRU (non-accelerating inflation rate of unemployment). The level of the NAIRU may be favourably affected by a 'flexible' labour market, but is unaffected by the level of aggregate demand or by productive capacity.

(v) fiscal policy is impotent in terms of its impact on real variables (essentially because of beliefs in the Ricardian Equivalence theorem, and 'crowding out' arguments), and it should be subordinate to monetary policy in controlling inflation. There is allowance for the operation of 'automatic stabilisers' as the actual budget surplus or deficit will fluctuate during the course of the business cycle with tax revenues rising in boom and falling in recession, and this provides some dampening of the cycle. The budget should though be set to average balance over the course of the business cycle.

The structure of the ECB clearly conforms to all five points. The sole objective of the ECB is price stability, and decisions are made by a governing body composed of bankers and financial experts. There are, and can be, no involvement by any other interest groups or any democratic body. The only EU level policy from controlling inflation is monetary (interest rate) policy, which presumes that monetary policy is a relevant and effective instrument for

[5] The NCM framework, and its implications for monetary policy, was suggested initially by Goodfriend and King (1997), and Clarida et al. (1999). For an extensive theoretical treatment see Woodford (2003). For a critique, see Arestis (2007), Arestis and Sawyer (2008), and Angeriz and Arestis (2008). Fontana (2009) critically assesses the role of government and fiscal policy in the NCM framework.

the control of inflation. Inflation is in effect targeted by the ECB in the form of pursuit of 'price stability' interpreted as inflation between 0 and 2 per cent per annum. The third point is fully accepted and adopted by the ECB. This can clearly be confirmed by the monthly statements of the Governor of the ECB at his press conferences after the announcement of the decisions on the level of the rate of interest.

The implementation of what is in effect a balanced budget requirement at the national level under the Stability and Growth Pact and the absence of fiscal policy at the euro area level has eliminated the use of fiscal policy as an effective instrument for the reduction of unemployment (or indeed of containing inflation pressures). These balanced budget requirements have been re-enforced in the 'fiscal compact' as discuss below.

The ECB is the only EU level economic institution, and it operates with the objective of attaining low inflation. There are three points of note here. First, this key institution is undemocratic in nature (indeed it is barred from taking instructions from democratic organisation) and operates in a secretive and non-transparent way – for example, the minutes of the decision-making process are never published before a great number of years is passed. The ECB decision makers are central bankers, and there is no representation of other interests (e.g. industry, trade unions) in the decision-making process. It is only the interests of bankers and the financial sector, which are represented.

Second, the only objective addressed through macroeconomic policy (and then that is monetary policy) at the EU level is price stability (with inflation of just less than 2 per cent, a target which has been generally missed over the years). Employment targets have been set by the EU, as part of the European Employment Strategy, and are to be achieved through measures such as increased labour market flexibility, life-long learning, etc., and more generally adoption of 'flexicurity'. There is no macroeconomic policy, based on fiscal or monetary policy, designed to create high levels of employment. Indeed the general tenor of macroeconomic policy runs counter to the creation of high levels of employment. It is also relevant to note that as the ECB's only objective is that of price stability, there is then no mention of objectives of financial stability or similar.

Third, this policy operates according to the notion that monetary policy is the relevant policy for the control of inflation. Yet, monetary policy has become interest rate policy, and the linkages between changes in interest rates and changes in inflation are at best weak and at worst controversial (see, for example, Arestis and Sawyer, 2004, 2008).

The term European Social Model (and similar phrases such as Social Europe) does not have a universally accepted meaning, and it could be said (whether as something, which actually exists or is an aspiration) to have the feature of standing in contrast with the American model (or perhaps the Anglo-Saxon one). However, although the [European Social Model] is far from being a well-developed analytical concept, in essence it is characterised by three main features: 1)the universalistic character of welfare provision, a high degree of coordination between economic actors, 2) the acknowledgement that workers need special protection and have a right to collective interest representation, and 3) widespread public ownership,

especially in public services (Hermann, 2009, p. 88). The main point made here is that the policies advocated within the Economic and Monetary Union particularly with regard to the labour market run rather counter to the notions associated with the European Social Model. The ECB has been at the forefront of calling for more 'flexible' labour markets and for changes in the pension arrangements.

> The Governing Council [of the ECB] …urges all euro area governments to decisively and swiftly implement substantial and comprehensive structural reforms. This will help these countries to strengthen competitiveness, increase the flexibility of their economies and enhance their longer-term growth potential. In this respect, labour market reforms are key, with a focus on the removal of rigidities and the implementation of measures which enhance wage flexibility. In particular, there is a need for the elimination of automatic wage indexation clauses and a strengthening of firm-level agreements so that wages and working conditions can be tailored to firms' specific needs. These measures should be accompanied by structural reforms that increase competition in product markets, particularly in services – including the liberalisation of closed professions – and, where appropriate, the privatisation of services currently provided by the public sector, thereby facilitating productivity growth and supporting competitiveness (ECB, 2011, p. 7).

The European Commission has argued along similar lines.

> Member States should design benefits to reward return to work or incentives to go into self-employment for the unemployed through time-limited support, and conditionality linking training and job search more closely to benefits. Member states need to ensure that work pays through greater coherence between the level of income taxes (especially for low incomes) and unemployment benefits. Member States need to adapt their unemployment insurance systems to the economic cycle, so that protection is reinforced in times of economic down-turn. … all Member States … should keep public expenditure growth firmly below the rate of medium term trend growth' (European Commission, 2011).

Second, there are in reality a number of 'social models' and more generally the national economies have different institutional, social and political arrangements. With specific regard to the labour market and its institutions, there are clearly substantial differences between the member countries of EMU (see, for example, Van Veen, 2006, for identification of four distinct models, which he labelled Nordic or social democratic, Continental European conservative corporatist, Mediterranean or tradition rudimentary, and Anglo-Saxon or liberalist-individualistic model).

These differences have two points of significance here. First, these differences between countries and models interact with macroeconomic policies and events. The impact of say a downturn in economic activity will have different impacts on unemployment and its consequences across countries depending on, inter alia, 'hire and fire' practices. The determinants of wage inflation may well vary between countries and may help understand the

differences in inflationary experience indicated above. The effects of demand and economic activity (and changes therein) will differ. Countries differ in their use of forms of incomes policy, and the more corporatist countries have tended to have lower rates of inflation than the 'traditional' model.

Second, the different models and the different historic traditions have produced different inflation trajectories. There may be underlying differences between the models as to the underlying rate of wage inflation which is generated, and the relationship between productivity increases and wage increases. These differences would not be sustainable, but are not addressed by the existing policies on wage and price determination.

One size fits all problems

The EMU has suffered from a number of 'one size fits all' problems, most notably in the operation of monetary policy and the attempts to impose common fiscal policies on all countries under the Stability and Growth Pact.

It is in the nature of monetary policy that it suffers from the 'one size fits all' problem – monetary policy has by its nature to be uniform across a currency union. Yet, the economic issues and problems, which are being addressed by monetary policy, vary across the currency union, e.g. by region or in the EMU by country and by region. The severity of the 'one size fits all' problem is much reduced if the conditions in the member regions are closely correlated (e.g. over the movements of output, inflation) and if the responses of economic variables of relevance to the policy instruments (interest rate) are similar between member regions.

It is also the case that a numerical target is introduced for budget deficits without any rationale, other than to proclaim an overall zero budget deficit. An alternative rationale for the size of a budget deficit, drawing on the 'functional finance' view (for example, Arestis and Sawyer, 2011, Sawyer, 2011) would be to use the budget deficit to ensure a high level of economic activity. Then, for the target budget deficit to be in line with private savings minus investment plus current account deficit, which would be forthcoming at that high level of economic activity. On that basis, the appropriate scale of the budget deficit depends on a range of factors including the average propensities to save, propensity to invest, to import and the scale of exports. Countries vary in their savings and investment behaviour and in their net export position, and hence the appropriate budget deficit would vary from country to country. The SGP fiscal policy then also suffers from a rather severe 'one size fits all' problem.

Although inflation targeting is focused on the interest rate/inflation dimension via demand linkages, it has become widely acknowledged (particularly since the financial crisis) that interest rate can have effects on asset prices and on exchange rates. The 'one size fits all' issue feeds into aspects of the financial crisis. A relevant example is Spain, where the economy had expanded considerably prior to the 'great recession', as a construction boom developed, which (at least with hindsight) was unsustainable. This construction boom no doubt had a range of causes, but low real interest rates were supportive of such a boom. If the Spanish authorities had wished to dampen down the boom or to have coped with the bust

through the use of interest rates, and monetary policy more generally, it was completely powerless to do so. Further, the ECB was charged with the price stability objective and paid no regard to financial stability nor to dampening credit booms.

The 'fiscal compact' as a 'fiscal suicide pact'

The fiscal compact

The remedy to the euro-area crisis, which is currently being brought into force, is embodied in the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG)[6] of which the 'fiscal compact' is the central part on which we focus here.[7] The argument here is that the 'fiscal compact' cannot work on its own terms and will bring considerable economic damage, and could be more accurately labelled a 'fiscal suicide pact'.

The essential features of the 'fiscal compact' and the Treaty are:

1. The imposition of a 'structural budget deficit' rule such that the structural deficit does not exceed 0.5 per cent of GDP. Under Article 1, it is maintained that the budgetary position of the general government of a Contracting Party shall be balanced or in surplus. This is interpreted as the annual structural balance of the general government at its country-specific medium-term objective, as defined in the revised Stability and Growth Pact, with a lower limit of a structural deficit of 0.5 % of GDP at market prices. Furthermore, it is argues that'the Contracting Parties shall ensure rapid convergence towards their respective medium-term objective. The time-frame for such convergence will be proposed by the European Commission taking into consideration country-specific sustainability risks(European Union, 2012).
2. A stricter policy imposed on countries with debt ratio exceeding 60 per cent of GDP. The Treaty (following the 'Six Pack') makes it possible to open an EDP [excessive deficit procedure] on the basis of the debt criterion. Under article 4, member States with government debt ratios in excess of 60% of GDP should reduce this ratio in line with a numerical benchmark, which implies a decline of the amount by which their debt exceeds the threshold at a rate in the order of 1/20th per year over three years. 'If they do not, they could be placed in EDP depending on the assessment of all relevant factors and taking in particular into account the influence of the cycle on the pace of debt reduction.' ((European Union, 2012,). The precise impact of this would depend on the rate of nominal growth, and the imposition of the EDP is

[6] (reference to be provided at proof stage, now: http://european-council.europa.eu/media/639235/st00tscg26_en12.pdf)

[7] There is also the so-called 'six pack' of measures which **e**ntered into force on 13 December 2011, and involved five Regulations and one Directive (hence 'six pack'), which constitutes EU secondary law. It applies to all 27 member states, with some specific rules for EMU members. The six-pack covers not only fiscal surveillance, but also macroeconomic surveillance under the new Macroeconomic Imbalance Procedure. The crucial aspects of the 'six pack' appear in the Treaty and are discussed under that head. For further information see http://ec.europa.eu/economy_finance/articles/governance/2012-03-14_six_pack_en.htm

possible rather than mandatory. However, in a slow growth economy with a debt ratio of say 120 per cent of GDP, this approach would involve a budget surplus of the order of 3 per cent of GDP (and a primary surplus which was substantial greater when interest payments on debt considered).

3. The deficit requirement is to be written into a country's national constitution or equivalent. Under article 3 (2) of the TSCG, it is maintained that the rules set out shall take effect in the national law of the Contracting Parties at the latest one year after the entry into force of this Treaty through provisions of binding force and permanent character, preferably constitutional, or otherwise guaranteed to be fully respected and adhered to throughout the national budgetary processes. This means that the Contracting Parties shall put in place at national level the correction mechanism on the basis of common principles to be proposed by the European Commission. These principles are especially concerned with the nature, size and time-frame of the corrective action to be undertaken, also in the case of exceptional circumstances, and the role and independence of the institutions responsible at national level for monitoring compliance with the rules set out. 'Such correction mechanism shall fully respect the prerogatives of national Parliaments.' (Article 3 (2) TSCG)).

The 'fiscal compact' could be viewed as a development of the Stability and Growth Pact in which the intention to balance the budget deficit over the cycle is superseded with a balanced structural deficit rule, with the addition of the stricter policy rule as under (ii). Further, the sanctions for breaking the 'fiscal compact' are re-enforced after the failures under the Stability and Growth Pact for the rules on budget deficits to be followed. The attention to the 60 per cent debt to GDP ratio remains, even though it has been widely disregarded in practice under the SGP. No rationale has been produced for 60 per cent rather than any other, and any debt ratio is sustainable from the condition for a stable debt ratio that the debt ratio is equal to the deficit ratio divided by growth rate (hence a deficit ratio of 3 per cent of GDP with a nominal growth rate of 5 per cent would lead to a 60 per cent debt ratio). There is an inconsistency between a 60 per cent debt to GDP ratio and a budget on average near balance remains.

The implementation of rules for economic policy decision-making raises two crucial issues which are particularly relevant to the 'fiscal compact' rule of a balanced structural budget. The first is that economic decision-making of relevance is forward looking, and often involves the adjustment of policy variables in response to forecast future economic events. The policy decisions will then depend on forecasts and assessments of the economic future. The second relates to the validity of the policy-making rule which is being set in place – specifically is the rule feasible and would the operation of the rule achieve the desired end. As an example of the latter problem we would cite the operation of Taylor's rule in the setting of interest rates[8] and the question as to whether the use of interest rate can indeed lead to effective control of inflation and without impacting on other key economic variables such

[8] Taylor's rule states that the policy interest rate set by a central bank is based on deviation of inflation from a target level and on output gap (difference between actual output and potential output).

as asset price bubbles and exchange rate. The balanced structural budget rule of the 'fiscal compact' is a case we would argue that the achievement of the rule is likely to turn out to be not possible (as set out below) and striving to meet the rule would have deflationary effects and unemployment.

We have previously argued (Arestis and Sawyer, 2006) that the inclusion of economic policy matters in what was intended to be the European Constitution was inadvisable, and the argument carries over to the Treaty of Lisbon. Apart from the concerns expressed above on the nature of the economic policy structures (the 'independence' of the European Central Bank, for example), we would point to the difficulties of making variations to the Treaty, which would require the unanimous approval of national governments. The particular issue with regard to economic policies and institutions is that ideas on economic policies and the role of institutions (the independence of the central bank being a key example) are contentious and ideas on what constitutes the right policy framework change over time. Economic policies are subject to fads and fashions and inclusion in such a Treaty inadvisable. The TSCG takes this a step further by imposing the achievement of a structural balanced budget into the national constitutions or equivalent, which combines as we argue below an often unachievable objective with one which will be difficult to change. But, of course, the reality is that economic policies and institutions are included in the Treaty, and serve as a major constraint on making future changes in a sensible direction. It is a folly to incorporate ideas which some, but no means all, think are appropriate policies into a document which is difficult to change, especially when those ideas are controversial if not mistaken. This has been an underlying problem in the EMU context with the Treaty of Lisbon and its predecessors including independence of central bank with price stability as objective: when, as in our view it should, be changed to financial stability there are many hurdles in changing the Treaty to be surmounted.

It can also be seen as an attempt to tie the hands of the electorate and future governments on economic policies – what is the point of a party presenting a manifesto committed to raising public expenditure when the constitutional court would rule the implementation of such a commitment illegal. All tiers of government operate subject to a budget constraint in the sense that expenditure (current and capital) minus revenue has to be covered by borrowing, and for many tiers of government limits are placed on the scale of borrowing (e.g. limited to cover capital expenditure, subject to approval by higher tier of government). The limits on borrowing may be imposed by 'higher authority' (e.g. national government over local government) or may be self-imposed. Placing such limits on borrowing is not inherently undemocratic, and depends where the effective decision-making lies. The features of the 'fiscal compact'**,** which are troublesome in this regard**,** are, first, the ways in which policy decisions are being imposed on national governments. Most clearly this has been the case for Greece already, but further the Treaty seeks to impose a specific range of policy decisions ('structural reforms') as a condition of membership of EMU. Second, the writing of the 'fiscal compact' conditions into national constitutions unnecessarily binds future governments and future perspective governments with regard to issues of taxation and public expenditure. It must be questioned whether economic policies should be embedded into

constitutions or quasi-constitutional legislation**,** which limit the necessary flexibility to change economic policies as conditions and ideas on policies change. The ideas of 'independent central banks' and of 'balanced structural budgets' are not universal panaceas, and indeed many of us would argue that the idea of 'independent central banks' is highly problematic. It is also an idea**,** which could be viewed as a current fashion whose attraction is fading. If an economic policy is to be given the force of law, it should be capable of precise definition such that whether the policy has been implemented can be accurately judged. Further, it should be a policy which is capable of being achieved.

Second, the implementation of a balanced structural budget requirement will be made difficult by disputes over the measurement of the structural budget position. The implementation of a requirement that there be a balanced annual budget (as is the case with the European Union itself) does not face such difficulty as the annual budget outcome can be readily measured, though it is the *ex post* annual budget**,** which can be measured but not the ex ante budget. The structural budget is 'structural' public expenditure (that is some 'normal' level of expenditure excluding any one-off forms of expenditure) less the tax revenues**,** which would be generated from the 'normal' set of tax rates when the economy operates at some 'average' level (which will be described as 'potential output' in line with the economics literature). Each of the elements of the structural budget is a matter of estimates and dispute, and notably what constitutes 'potential output', as we discuss in subsection below.

The preamble to the Treaty notes the intention of the European Commission is 'to present further legislative proposals for the euro area concerning, in particular, *ex ante* reporting of debt issuance plans, economic partnership programmes detailing structural reforms for Member States under an excessive deficit procedure as well as the coordination of major economic policy reform plans of Member States' (European Union, 2012, p. 3). Under Article 5, it is maintained that a Contracting Party that is subject to an excessive deficit procedure 'shall put in place a budgetary and economic partnership programme including a detailed description of the structural reforms which must be put in place and implemented to ensure an effective and durable correction of its excessive deficit.' (European Union, 2012).

Within the Treaty, 'structural reforms' are not defined. But there can be little doubt as to what is in mind. In an interview with the *Wall Street Journal*, Mario Draghi, President of the ECB stated that amongst the most important structural reforms were 'first … the product and services markets reform. And the second is the labour market reform which takes different shapes in different countries. In some of them one has to make labour markets more flexible and also fairer than they are today'.[9] This echoes the sentiments**,** which have been repeatedly expressed by the European Central Bank in their *Monthly Bulletin*. For example, writing in December 2009, the ECB argued that:

> With regard to structural reforms, most estimates indicate that the financial crisis has reduced the productive capacity of the euro area economies, and will continue to do so for some time to come. In order to support sustainable growth and employment, labour

[9] Available at: http://www.ecb.europa.eu/press/key/date/2012/html/sp120224.en.html, accessed 20th March 2012.

> market flexibility and more effective incentives to work will be needed. Furthermore, policies that enhance competition and innovation are also urgently needed to speed up restructuring and investment and to create new business opportunities' (ECB 2009, p. 7).

The nature of the intended 'structural reforms' can be also seen by reference to those imposed on Greece in terms of privatisation and labour market 'reforms' (notably drastic reduction of minimum wage).[10]

There is here the underlying neo-liberal assumption that 'structural reforms', which are directed towards labour market de-regulation, reduction of employment and wage protection measures, privatisation and product market de-regulation, will have beneficial effects on the economy concerned and serve to reduce the size of budget deficits, which is the centre of policy attention. However, that case is far from being established, and we would argue along with Glyn, Howell and Schmitt (2006) that the evidence linking various indicators of the implementation of labour market reforms and unemployment is unconvincing. In a similar vein, Whyman *et al.* (2012) conclude their extensive literature survey that 'there are a large number of studies which have found little or no significant impact arising from labour market deregulation' (p. 229). The effects of labour market reforms may well be to reduce rather than increase employment. For example, Tridico has recently argued that:

> the flexibility agenda of the labour market and the end of wage increases…diminished workers' purchasing power. This was partly compensated with increased borrowing opportunities and the boom of credit consumption, all of which helped workers to maintain unstable consumption capacity. However, in the long term, unstable consumption patterns derived from precarious job creation, job instability and poor wages have weakened aggregate demand. Hence, labour market issues such as flexibility, uneven income distribution, poor wages and the financial crisis are two sides of the same coin.' (Tridico 2012, p. 17).

The ambiguity of the structural budget

The structural budget deficit appears to be left without a precise definition in the 'fiscal compact', and lacking any clear indication of the methodology to be used in its estimation; this is a serious omission. However, it can be viewed as the deficit that would result from the application of current tax rates and prevailing public expenditure levels if the economy were operating at some 'normal' level of output, which has come to be linked with the level of 'potential output'. We put inverted commas around 'potential output' to signify that this term is used in a specific way in this literature as explained further below, and does not correspond to the everyday usage of the term potential, which would signify capability and capacity. We use the term structural budget deficit (*SBD*) below though cyclically adjusted budget deficit is also used in the 'fiscal compact' and elsewhere, and the two are treated as synonymous. Thus the structural budget deficit (*SBD*) is given by:

$$(1)\quad SBD = G^* - t(Y^*)$$

[10] See European Commission (2012) for discussion of the measures imposed on Greece.

where G^* is underlying ('structural') level of government consumption and investment, t as tax function relating to prevailing tax rates with income transfers regarded as negative taxation and Y^* 'potential output'. There would generally be some issues over exact measures of G^* as to elements**,** which could be regarded as temporary or discretionary and hence not included. In a similar vein, there would be issues over the tax function to be used to reflect prevailing tax rates – for example, with an income tax system involving tax free allowances and tax rates which vary with the level of income, what is assumed about the adjustments of the tax free allowances and levels of taxable income at which tax rates change in the face of inflation and changing aggregate income levels. Here we leave those issues on one side to focus on the more major issues.

There are two key major measurement issues here, and the interactions of them (combined with measurement issues over 'potential output') generate considerable ambiguity over the measurement of structural budget deficit such that it is not a suitable concept to embed in law.

The first is that a structural budget deficit is a hypothetical calculation and the question as to whether a consistent estimate of the SBD can be made (for some measure of potential output). The difficulty here can be readily seen by reference to the national accounts relationship which is here written as:

(2) $G - T = S - I + M - X$

where G is government expenditure, T tax revenue, S private savings, I private investment, M imports and X exports (including net income). In terms of outturns, a balanced budget with the left hand side equal to zero would require the right hand side to be similarly equal to zero.

Suppose the SBD in conditions appertaining at time t was calculated as equal to α. For reasons of consistency and sustainability this would mean that:

(3) $S_1^* - I_1^* + M_1^* - X_1^* = \alpha$

Where a (*) after a variable signifies the level of the variable which would correspond to 'potential output', e.g. S^* is intended level of savings which would be forthcoming at potential output.

Now consider the case where the policy intention is to change the *SBD* through changes in tax rates and levels of public expenditure, and the target is β. Then it not only would $SBD = \beta$, but the following equation would also need to hold:

(4) $S_2^* - I_2^* + M_2^* - X_2^* = \beta$

This would be possible if there were relevant changes in 'structural' savings, investment, imports and exports, e.g. if for example intentions to save diminished between (3) and (4) (in the case of $\alpha > \beta$). This could arise with a strong form of Ricardian equivalence – the intention to reduce a structural budget deficit would be exactly matched by corresponding changes in private expenditure.

The second issue relates to the concept of 'potential output' itself. It must first be said that the term 'potential output' is used in a number of different ways which need to be distinguished, and that it is a theoretical notion for which there may not be a counterpart in the real world. Further, any estimation of 'potential output' (for a given definition) is inevitably backward looking in the sense of using past data, but the measure of 'potential output' which is relevant for policy is the current and future levels.

The term 'potential output' is generally linked with the supply-side of the economy. In common usage the term potential would suggest some form of maximum output. When we speak of someone's potential we are thinking of the most they could achieve or be capable of. In economic terms 'potential output' can be linked with productive capacity. As such 'potential output' could be interpreted as the (sustainable) physical capacity output, though more usually some notion of costs would be involved such as the level of production at which costs would start to rise 'sharply'. This approach to 'potential output' is closely related to some upper limit to the level of output. However, the notion of 'potential output', which is common in the current dominant paradigm in macroeconomics, that is the 'new consensus in macroeconomics' is more akin to some average level of output around which the economy fluctuates, and more recently has tended to be aligned with the level of output at which inflation would be constant (Arestis, 2007)

It is also apparent that the estimation of 'potential output' requires data – that is the estimation can only be conducted after the event, but to useful in policy decisions estimates of 'potential output' need to be available prior to the decision. As output tends to grow over time, this would clearly involve not only scaling potential output against actual output, but also deriving estimates of the growth of potential output. This can only be highly speculative in a world of uncertainty where the future cannot be readily foretold from the past.

The more general theoretical framework within which 'potential output' is cast is one of the independence of demand and supply factors (Arestis, 2007, Fontana, 2010). The actual level of output is viewed as determined in the short run by the level of aggregate demand, whereas potential output is set on the supply side of the economy, and in general that the growth of 'potential output' is unaffected by what happens on the demand side, and that the level of demand fluctuates around potential output (and hence output gap tends to average out as zero).

The impossibility of balanced structural budget

The question here can be simply posed in terms of the conditions for a structural balanced budget (the argument would apply with minimal adjustment to conditions for a structural budget deficit of say 0.5 per cent of GDP). Drawing on the national accounts equations above, the condition for a structural balanced budget would be:

$$(5)\quad G - t(Y^*) = S^* - I^* + M^* - X^* = 0$$

In other words, the savings, investment, net exports, which would be forthcoming at 'normal' savings, investment rates and when output is at the potential level are consistent with this equation. The 'fiscal compact' asserts in effect that condition is always fulfilled – at each

point in time and for every country (at least those within the Economic and Monetary Union). The actual budget deficit could diverge from this balanced position as private aggregate demand fluctuates – for example, through a change in the propensity to invest, leading to change in level of output, and thereby in tax receipts. But it is asserted that if investment demand were at some 'normal' level (along with savings and net export behaviour correspondingly) then equation (5) would be satisfied.

The key argument here is that there is little reason to think that equation (5) would indeed be satisfied. In Sawyer (2012) the argument is developed at length. One part of the argument is that of historic experience. The occurrence of budget deficits has been the norm in many countries without clear evidence of 'overheating' and the average budget has been in deficit – indeed government debt levels of the order of 40 to 80 per cent of GDP would not have been the norm within EMU countries without a history of budget deficits. Another part of the argument is the absence of forces which would equate savings and investment at a high level of economic activity. The pace of investment is closely linked with the pace of growth of the economy: in the simple case the net investment ratio to GDP will be around the capital-output ratio times the growth rate. Savings depends on the desire of households to save, often linked with pension provision, and the saving by corporations. The forces at work on investment and those on savings are rather different, and there is little reason to think that there will be factors bringing savings and investment into line.

Fiscal suicide pact

The 'fiscal compact' seeks to impose the achievement of an ill-defined objective ('structural budget balance') applicable across all countries regardless of their economic conditions. It is for many countries an unachievable objective in that there is little reason think that a balanced budget and economy operating where output is at potential output are mutually compatible. Each country striving to achieve that objective threatens to create further austerity in not only its own country, but in the other member states (in light of the extent of trade between member countries). As each country strives to reduce budget deficit, it makes it more difficult for other countries to do so. The 'fiscal compact' also threatens to impose a programme of neo-liberal 'structural reforms', where there is little evidence that those reforms would improve employment and economic performance. As indicated above, EMU countries in general failed to reach the budget deficit requirements of the Stability and Growth Pact. One interpretation of that would be a lack of political will which can be overcome by a more stringent application of the balanced budget requirements as under the 'fiscal compact'. Our interpretation is more that the balanced budget requirements were unachievable and that countries used, where required, budget deficits to support the level of demand.

Summary and conclusions

We have argued in this paper that the present 'euro crisis' arises from the way in which the EMU was constructed, rather than 'bad behaviour' by some member countries, and can only be resolved through major policy changes, which permit the combination of the continued existence of the euro with acceptable economic performance.

The paper has briefly reviewed the economic performance in EMU in the years of the euro, and highlighted the relatively poor economic performance, the degree to which objectives on fiscal deficits and inflation were not met, and the continuing and growing current account imbalances. The policy responses to the euro crisis, which are being brought in through the 'fiscal compact', will do nothing to address either the current account imbalances nor the unemployment crisis; indeed, it will fail to achieve its own objectives in terms of a balanced structural budget.

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