



UNIVERSITY OF
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ECONOMIC POLICIES IN THE EMU

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EMU COUNTRIES

- # AUSTRIA, BELGIUM, CYPRUS,
- # ESTONIA, FINLAND, FRANCE,
- # GERMANY, GREECE,
- # IRELAND, ITALY,
- # LUXEMBERG, MALTA,
- # NETHERLANDS, PORTUGAL,
- # SLOVAKIA, SLOVENIA, SPAIN.



EMU COUNTRIES

Countries using the euro as their official currency but are not members of the EMU/EU:

ANDORRA, KOSOVO

MONACO, MONTENEGRO

SAN MARINO, VATICAN CITY

All in all 320 million Europeans use the euro as shown above.



Presentation

- # Theoretical Underpinnings of the EMU Model;
- # Requirements for Effective Monetary Union;
- # Problems with Current EMU Arrangements;
- # Required Changes in Economic Policies;
- # Summary and Conclusions.



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Theoretical Underpinnings of the EMU Model

- # We argue that the EMU approach is of the NCM variety. As such, its key elements are as follows:
- # The market economy is viewed as essentially stable, and 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.



Theoretical Underpinnings of the EMU Model

- ⌘ Monetary policy has emerged as one of the most critical government responsibilities. It is a most 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.
- ⌘ Fiscal policy is no longer viewed as a powerful macroeconomic instrument. Monetary policy has, thus, been upgraded and fiscal policy has been downgraded. Fiscal policy can only serve to achieve a balanced budget.



Theoretical Underpinnings of the EMU Model

- Monetary policy can be used to meet the objective of low rates of inflation (which are always desirable in this view, since low, and stable, rates of inflation are conducive to healthy growth rates).
- 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. Such a bank would also have greater credibility in the financial markets and be seen to have a stronger commitment to low inflation than politicians do.
- Credibility is recognised as paramount in the conduct of monetary policy to avoid problems associated with time-inconsistency.



Theoretical Underpinnings of the EMU Model

- # The EMU theoretical framework entails the view that inflation is best tamed through interest rate manipulation without at the same time forgetting money supply: there is, thus, the 'close to 2 per cent from below' and the reference value of 4.5 percent for M3 money supply in place.
- # This, it is hoped, improves communication between the public and policy-makers and provides discipline, accountability, transparency and flexibility in monetary policy.
- # The EMU model contains two features: an economic analysis and a monetary analysis:



Theoretical Underpinnings of the EMU Model

- # The ECB economic analysis is an assessment of price developments and the risks to price stability over the short to medium term.
- # The range of indicators includes: “developments in overall output; aggregate demand and its components; fiscal policy; capital and labor market conditions; a broad range of price and cost indicators; developments in the exchange rate; the global economy and the balance of payments; financial markets; and the balance sheet positions of euro area sectors”.



Theoretical Underpinnings of the EMU Model

- # The ECB monetary approach analyzes monetary developments for the information they contain about future price developments over the medium and long term, exploiting the long-run link between money and prices. A 4.5 percent reference value for the M3 monetary growth has been imposed. Deviations from the reference value would 'signal risks to price stability'.
- # Monetary analysis is utilized by the ECB as a 'cross check' for consistency between the short-term perspective of economic analysis with the more long-term perspective.



Theoretical Underpinnings of the EMU Model

- # The rationale of the ‘two-pillar’ approach is based on the theoretical premise that there are different time perspectives in the conduct of monetary policy that require a different focus in each case.
- # There is the short to medium term focus on price movements that requires economic analysis.
- # There is also the focus on long-term price trends that requires monetary analysis.



Theoretical Underpinnings of the EMU Model

- # In this analysis, there is the strong belief by the ECB in the long-term link between money (M3 in this case) and inflation. This focus, of course, reflects the notion that inflation is a monetary phenomenon to be tackled by both manipulating the rate of interest and watching movements in M3.
- # Short-term volatility of inflation is allowed but not in the long run, reflecting the view that monetary policy affects prices with a long lag.



Theoretical Underpinnings of the EMU Model

- # 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.
- # 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 and the money stock.



Theoretical Underpinnings of the EMU Model

- # The essence of Say's Law holds, namely 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).
- # These general principles can be formalised under what has come to be known as the NCM.



Presentation

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- # Summary and Conclusions.



Requirements for Effective Monetary Union

- # History teaches us that monetary unions require economic integration to survive. If not, then political integration is paramount.
- # See Table



Requirements for Effective Monetary Union

- # **TABLE: MONETARY UNIONS**
- # **STILL SURVIVING BUT WITH POLITICAL UNION**
- # British monetary union between England and Scotland: From 1707
- # Italian monetary union: From 1861
- # US Federal Reserve system: From 1913
- # German unification: From 1990



Requirements for Effective Monetary Union

STILL SURVIVING WITHOUT POLITICAL UNION

Belgium – Luxembourg union: From 1923

West and Central African CFA Franc Zone: From 1948

Eastern Caribbean Currency Union: From 1983



Requirements for Effective Monetary Union

- # **FAILED ONCE POLITICAL SYSTEM COLLAPSED**
- # Roman monetary union: 286-301
- # German monetary union: 1857-1918
- # Soviet system: 1917-1993
- # Yugoslavia: 1919-1992
- # Czechoslovakian Republic: 1919-1994



Requirements for Effective Monetary Union

- # **FAILED ONCE ECONOMIC LINKS COLLAPSED**
- # British monetary union between England and Ireland: 1926-1979
- # **TEMPORARY MONETARY UNIONS**
- # Latin monetary union: 1865-1926
- # Scandinavian currency union: 1873-1921
- # East African Currency Area: 1922-1972



Requirements for Effective Monetary Union

OTHER CURRENCY PEGS

Gold standard: 1870-1931/36

Bretton Woods: 1944-1973

ERM: From 1979-1999

Asian currency crisis: 1997



Requirements for Effective Monetary Union

- # Requirements for effective political union:
- # EMU-level of expenditure programmes; taxation; and a social security system;
- # A common social security system, which would enhance labour mobility and would involve elements of redistribution;
- # Fiscal policy would likewise aid economic integration and would involve significant fiscal transfers between countries and regions;



Requirements for Effective Monetary Union

- # The common currency of the EMU involves a degree of political agreement. The ECB is already the only macroeconomic policy maker;
- # But EMU requires considerable central government to operate fiscal and social security policies across the euro area;
- # We deal with economic integration and current arrangements, more generally speaking, in the rest of this contribution.



Presentation

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Problems with Current EMU Arrangements

- # Conditions for ‘Optimal Currency Area’ (OCA):
- # Factor mobility and openness of markets;
- # Relative price flexibility across countries and thus similar inflationary tendencies amongst them;
- # Fiscal transfers within the monetary union;
- # OCA considerations played little role in the formation of the euro area and since then they do not seem to have been met;
- # The euro area then does not appear to be an OCA.



Problems with Current EMU Arrangements

- # Current EMU arrangements suffer from a number of major defects:
- # If inflation is of the cost or supply shock variety, then there are problems; current arrangements are meant to tackle demand inflation;
- # Changes in interest rates have only a limited impact on aggregate demand. We have surveyed elsewhere the results of simulations of the effects of monetary policy using macroeconomic models. The conclusion of that survey is that the effects of interest rate changes on inflation tend to be rather small – typically a 1 percentage point change in interest rates may dampen inflation by 0.2 to 0.3 per cent after two years;



Problems with Current EMU Arrangements

- # Both monetary and fiscal policies are of the ‘one policy fits all’ approach; but there are differences in inflationary experience across the euro area countries, and differences in terms of fiscal needs;
- # The two-pillar approach sends different and contradictory signals;
- # We proceed to discuss at some more length under a number of headings, beginning with monetary policy.



Problems with Current EMU Arrangements

- ⌘ Monetary Policy:
- ⌘ ECB monetary policy was initially assigned a quantitative definition of price stability in the form of a 0-2 per cent target for the annual increase in the Harmonised Index of Consumer Prices (HICP) for the euro area. The ‘two-pillar’ monetary strategy was adopted from the beginning;
- ⌘ the ‘first pillar’ was the monetary analysis, which stipulated a 4.5 per cent ‘reference value’ for M3. As such there was no mechanistic commitment to correct deviations in the short term, although deviations from the reference value would indicate ‘signal risks to price stability’;
- ⌘ the ‘second pillar’, the economic analysis, was a broadly based assessment of the outlook of price developments and the risks to price stability.



Problems with Current EMU Arrangements

- # In May 2003 two important changes were introduced: the definition of inflation is now near to 2 percent but from below (thought to be around 1.9 percent) and the two pillars have been reversed (the first now is the economic analysis pillar and the second is the monetary analysis pillar).
- # The management, operation, communication and potential efficacy of monetary policy within these institutional arrangements by the ECB have entailed many problems.



Problems with Current EMU Arrangements

- ✦ In terms of the management aspect, the timing of monetary policy decisions has been very slow.
- ✦ The ECB's methods of operation and communication have been confusing to the financial markets.
- ✦ In the 'two-pillar' strategy, there is uncertainty as to the value attached to the M3 reference value. The target has rarely been met, and yet this does not seem to impact on official strategy. This may well have undermined the ECB's credibility, rather than added to it.
- ✦ There is, indeed, the question of whether the 2 per cent inflation target is not too restrictive, and it suffers from not being symmetrical. It becomes more and more obvious that this target is by far too low;



Problems with Current EMU Arrangements

- # The problem with the ECB's methods of operation and communication is partly the bank's secretiveness, for it does not publish minutes of its meetings;
- # Also the ECB personnel has not always learned to communicate its methods of operation: the speeches of different ECB officials often give different signals regarding ECB policy;



Problems with Current EMU Arrangements

- # The press conference after each meeting of the rate-setting governing council takes place too soon without any indication of the debate that has taken place during the meeting;
- # There is the impression that markets should be steered at all times; words such as ‘vigilant’ to signal a policy shift was used in the past but when abandoned unnecessary confusion prevailed.



Problems with Current EMU Arrangements

- ⌘ A number of reservations may be raised in terms of the efficacy of this monetary policy.
- ⌘ First, considerable doubt may be cast on the effectiveness of monetary policy in terms of responding to recession and as a means of controlling inflation: the ECB has failed to meet its inflation target of 2 per cent; has presided over widely differing inflation rates within the euro area; and has been reluctant to cut interest rates promptly in the face of the ‘great recession’;
- ⌘ Second, in terms of the impact of interest rates on expenditure, there are questions relating to the magnitude of the impact, timing and variability of the time lags involved;



Problems with Current EMU Arrangements

- # Third, since interest rate policy has a range of effects, such as on aggregate demand, on the exchange rate, distributional effects etc., the objectives of monetary policy should reflect that, and should, thus, be recast to include growth and high levels of employment alongside inflation.



Problems with Current EMU Arrangements

- ✦ Fiscal Policy is dictated by the ‘Stability and Growth Pact’:
- ✦ The core elements of SGP are three:
 - ✦ to pursue the medium-term objectives of budgetary positions close to balance or in surplus;
 - ✦ the submission of annual stability and convergence programmes by the member states; and
 - ✦ the monitoring of the implementation of the stability and convergence programmes.



Problems with Current EMU Arrangements

- ⌘ Even if it is accepted that the budget should be balanced over the cycle, there is little reason to think that the extent of the swings in the budget position will be similar across countries;
- ⌘ What reason is there to think that a swing in the deficit to a maximum of 3 per cent of GDP is relevant for all countries?
- ⌘ Countries will differ in the extent to which their GDP varies in the course of a business cycle and in the extent to which the budget position is sensitive to the business cycle.



Problems with Current EMU Arrangements

- # The SGP seeks to impose a ‘one size fits all’ fiscal policy –namely that over the course of the cycle national government budgets should be in balance or slight surplus with a maximum deficit of 3 per cent of GDP. It has *never* been shown (or even argued) that fiscal policy should be uniform across countries.
- # what reason is there to think that what is in effect a single fiscal policy is appropriate for all?



Problems with Current EMU Arrangements

- ✦ Minor changes implemented in March of 2005 cannot deliver more than the original SGP.
- ✦ **Overview of decisions relating to the Stability and Growth Pact**
- ✦ **February 2002:** European Commission recommends that early warning be given to Portugal for having missed its budget target for 2001 by a wide margin (projected deficit for 2001 was 2.2 per cent). Also to Germany whose projected deficit for 2001 was 2.6 per cent.
- ✦ **February 2002:** ECOFIN Council decided not to endorse the European Commission's recommendation, thereby abrogating the 'early warning' signal. That was based on the commitment by Germany and Portugal to take action to avoid the occurrence of excessive deficits in the future.



Problems with Current EMU Arrangements

- # **October 2002:** European Commission recommends that excessive deficit exists in Portugal; deficit in 2001 of 4.1 per cent and in the absence of a rectifying budget, the 2002 deficit could be above 3.5 per cent.
- # **November 2002:** ECOFIN Council decides that Portugal has excessive deficit; the 2001 deficit was revised to 4.1 per cent.
- # **November 2002:** European Commission recommends to give early warning to France; in fact, France refuses to start cutting deficit in 2003, thereby breaking promises made under the SGP; European Commission projects deficit of 2.7 per cent (2002) and 2.9 (2003).



Problems with Current EMU Arrangements

- # **January 2003:** European Commission recommends that excessive deficit exists in Germany (in October 2002 Germany admits that it will break SGP for the first time).
- # **January 2003:** ECOFIN Council decides that excessive deficit exists in Germany; deficit in 2002 expected to be 3.8 per cent. ECOFIN Council also decides to give an early warning to France.
- # **May 2003:** European Commission recommends that excessive deficit exists in France; in 2002 deficit is 3.1 per cent and forecasts for 2003 estimate it to be 3.7 per cent.
- # **June 2003:** ECOFIN Council decides that excessive deficit exists in France.



Problems with Current EMU Arrangements

- # **October 2003:** France admits of breaking the SGP for third successive year in 2004. European Commission gives it until 2005 to comply. Germany confirms it will also break pact for third year.
- # **November 2003:** Germany tries to draw the SGP's remaining teeth by calling for countries that 'co-operate' to be exempted from possible sanctions.
- # **November 2003:** ECOFIN Council suspends disciplinary procedures against France and Germany. European Commission shows grave concern.
- # **January 2004:** European Commission pledges to take ECOFIN to the European Court of Justice for allowing France and Germany to flout the SGP rules. The ECB in the words of its President 'respects the Commission's decision to seek legal clarity' (Trichet, 2004).



Problems with Current EMU Arrangements

- # **July 2004:** European Court of Justice condemned ECOFIN for ‘suspending’ the SGP’s recommendation on deficit reduction, but upheld the right of national governments to ignore these recommendations and all the disciplinary procedures that were so painstakingly attached to them in 1996.
- # **September 2004:** European Commission announces proposals for the reform (although the Commission prefers to call them ‘an evolution’) of the SGP (in response to the June, 2004, European Council call for proposals by the Commission that strengthen and clarify the implementation of the SGP).



Problems with Current EMU Arrangements

- **March 2005:** The European Commission proposals are adopted formally by the EU Finance ministers (ECOFIN), subsequently endorsed by the European Council. The agreement went through marathon meetings with a great deal of acrimony, which nearly put a hold to the reformed SGP;
- The main points of the agreement are: more budgetary consolidation in good times; more flexibility in reducing deficits in bad times; more focus on cutting the debt to GDP ratio; more room for manoeuvre for countries carrying out structural reforms; countries with sound finances allowed to run small deficits to invest.
- These changes aim “to improve governance, strengthen the preventive arm, and improve the implementation of the corrective arm” (ECB, 2005b, p. 60) of the original SGP.



Problems with Current EMU Arrangements

- # The cosmetic changes, introduced in March 2005, entail some flexibility but do not address the underlying issue, namely;
- # The imposition of arbitrary arithmetic limits on budget deficits with the pursuit of balanced budgets over the business cycle.



Problems with Current EMU Arrangements

- # Further changes emerged in view of the euro crisis;
- # **November 2008:** The EU package, ‘European Economic Recovery Plan’ (EERP), is introduced. A fiscal stimulus that amounted to 1.5 per cent of EU27 GDP should be implemented in 2009, and applied through national policies under their total discretion. The EERP aggregate fiscal input would be consistent with the SGP deficit ceiling of 3 per cent of GDP for the euro area as a whole. The GDP escape clauses introduced in 2005 would apply;



Problems with Current EMU Arrangements

- # **December 2011/March 2012:**
 - # The European Leaders agreed in principle at their meeting in Brussels on the 8th/9th of December 2011 to adopt tougher sanctions on the euro area countries that break the ‘new’ rules of the SGP;
 - # What is so-called ‘fiscal pact’ originally, now called the ‘fiscal compact’ (FC);
-



Problems with Current EMU Arrangements

- # This is an inter-government treaty, not a change to the EU treaties. Its main ingredients are three as follows;
- # First, a firm commitment to ‘balanced budgets’ for the euro area countries, defined as a structural deficit of no greater than 0.5% of gross domestic product;
- # The latter should be written into the national constitutions;



Problems with Current EMU Arrangements

- # Second, automatic sanctions for any euro area country whose deficit exceeds 3% of GDP;
- # Third, a requirement to submit their national budgets to the European Commission, which will have the power to request that they be revised;



Problems with Current EMU Arrangements

- # In effect the FC retains the principles of the previous ‘fiscal pact’ versions but with the added one that countries that break the deficit rules may actually be punished;
- # The limits of the revised and old SGP are in effect to balance overall budget over the cycle and limit the national budget deficit in any year to a maximum of 3 per cent of GDP;



Problems with Current EMU Arrangements

- # In place of the previous threat of 0.2 per cent of GDP as a ‘fine’ (though never implemented even though there were 40 cases where the 3 per cent limit was breached), there is now a change as follows;
- # Euro area states' budgets should be balanced or in surplus;
- # This principle will be deemed respected if;



Problems with Current EMU Arrangements

- # And, as a rule, the annual structural deficit does not exceed 0.5% of gross domestic product;
- # This is to be written into national constitutions. In the case when a euro area member state is in breach of the 3% deficit ceiling, the old SGP ceiling, there will be automatic consequences, including possible sanctions;



Problems with Current EMU Arrangements

- # Unless a qualified majority of the euro area states opposes it;
- # The rule of the old SGP of 60 percent debt to GDP ratio is retained. Any excess should be eliminated at an average rate of a 20th of the excess each year;
- # For example, a country with debt at 80 percent of GDP would be required to reduce this ratio at 1 percent of GDP each year;



Problems with Current EMU Arrangements

- # Unlike previous treaties, the ‘fiscal compact’ only needs to be ratified by 12 out of 17 euro area members;
- # With the European Stability Mechanism (ESM) commencing its operations in October 2012, only countries that have ratified the ‘fiscal compact’ treaty could get loans from it;



Problems with Current EMU Arrangements

- # The ‘fiscal compact’ was signed on 1 March 2012 by all EU members, with the exception of the UK and the Czech Republic;
- # The treaty was ratified by individual parliaments and, in the case of Ireland, by a referendum – which has confirmed it;



Problems with Current EMU Arrangements

- # It is now renamed as the Treaty on Stability, Coordination and Governance (European Commission, 2012);
- # And entered into force on 1 March, 2013;
- # Clearly the ‘fiscal compact’ treaty reflects the notion that the euro crisis was due to fiscal indiscipline; consequently more discipline is the only solution;



Problems with Current EMU Arrangements

- # Such principle is clearly misleading. The FC, like the old SGP, seeks to impose without any justification a balanced budget and poses restrictions in the use of fiscal policy in the face of economic crises;
- # Even more, the ‘fiscal compact’ requires countries to in effect run surpluses;



Problems with Current EMU Arrangements

- # In all these, though, there is no central power with sufficient discretionary means to organize some sort of fiscal transfer;
- # Indeed, not only does the fiscal compact not provide a concrete answer to this question, but it does not even hint whether fiscal transfers are likely to happen or not;



Problems with Current EMU Arrangements

- # **May 2013:** European Commission decided to give four of the EMU's largest economies wavers on EU budget rules in view of recent 'market calm';
- # France and Spain were given extension by two years to reduce their budget deficits to less than 3% of GDP;
- # Netherlands and Belgium were given another year for the same purpose.



Problems with Current EMU Arrangements

June 28/29 2012:

- # The EU summit meeting, 28/29 June 2012, took a number of further decisions:
- # Banking licence for the ESM that would give access to the ECB funding and thus greatly increase its firepower;
- # Banking supervision by the ECB;



Problems with Current EMU Arrangements

- # A ‘growth pact’, which would involve issuing project bonds to finance infrastructure;
- # Two long-term solutions are proposed;
- # One is a move towards a banking union and a single euro area bank deposit guarantee scheme;



Problems with Current EMU Arrangements

- # Another is the introduction of eurobonds and eurobills;
- # Germany has resisted the latter two proposals, arguing that it would only contemplate such action only under a full-blown fiscal union.



Problems with Current EMU Arrangements

- # **July 2012:** The ECB would do ‘whatever it takes’ to save the euro, Mario Draghi promised then;
- # This is considered as a turning point in the euro area sovereign debt crisis;



Problems with Current EMU Arrangements

- # The ECB developed the ‘Outright Monetary Transactions’ (OMT) bond-buying tool to back up that pledge, which was unveiled in September 2012;
- # The OMT has not been tested yet. There is also the problem of unknown finer details of the programme;



Problems with Current EMU Arrangements

- # In addition, there is the condition that under OMT the ECB could buy unlimited amounts of short-maturity bonds in the secondary market of any country that signed up to fiscal conditions and for austerity-and-reform programme.



Problems with Current EMU Arrangements

- # Labour Market Reforms:
- # Evidence suggests that these reforms are not important in creating jobs and promoting growth;
- # Inflexible labour markets do not appear to be as important as the notion of insufficient aggregate demand in explaining the euro area's inability to increase income and employment;
- # If at all important, they are so in the long run;
- # Let us look at the 'labour market reforms' argument at some length:



Problems with Current EMU Arrangements

- # The relevant hypothesis under this case is the ECB-handicap hypothesis. This hypothesis suggests that monetary policy in the euro area is ineffective in influencing output since its effect is transmitted quickly and completely into prices. This is explained by the existence of labour-market rigidities, which, in the words of the ECB (2004), “limit the pace at which an economy can grow without fuelling inflationary pressures” (p. 21).
- # Thus, if the ECB lowered the rate of interest in an attempt to expand economic activity in the euro area economy, this would merely be translated into higher prices with only limited effects on real economic activity. By contrast, in view of the US being less rigid, the Fed can actually stimulate the economy without causing inflation.



Problems with Current EMU Arrangements

- # In fact, an ECB study (Angeloni et al., 2003) concludes that a one-percentage point increase in the short-term interest rate tends to have a substantially significant stronger output effect in the US than in the euro area.
- # Their explanation rests on the view that the US monetary policy has a stronger impact on consumption than the ECB monetary policy has on the euro area consumption. This latter conclusion concerning the ECB monetary policy has been labelled as the ECB-handicap hypothesis (De Grauwe and Costa Sorti, 2005).



Problems with Current EMU Arrangements

- # The study by De Grauwe and Costa Sorti (op. cit.) investigates further the ECB-handicap hypothesis and reaches different conclusions. The authors of this study utilise a ‘meta-analysis’, widely used in medical sciences but not so frequently in economics. The way meta-analysis is employed by the study is “first to statistically analyse the estimated effects of monetary policy shocks on output and prices, and second to identify the factors that can explain the differences in these estimated effects” (p. 4);



Problems with Current EMU Arrangements

- # They employ 83 studies, which report on the impact of interest rates on inflation and output. Four different parameters that measure the effect of monetary policy are examined: short-term effects on prices and output; and long-term effects on prices and output (effect after one year measures the short term; effect after five years measures the long term);



Problems with Current EMU Arrangements

- # Since many of the 83 studies employed report results for more than just one country, 278 parameters that measure the short-term and long-term effects on output are obtained, while only 185 parameters are possible to obtain for the short-term and long-term effects on the price level.
- # An econometric equation explaining these different parameters is employed. The purpose is to control for a number of variables that can affect the size of the estimated coefficients (different estimation methods, different time periods, etc.).



Problems with Current EMU Arrangements

- # It is concluded that the euro area and US coefficients are of the same order of magnitude, that the short-term effect on the price level is very small, while the long-term effect on prices is significant. Short-term and long-term effects on output are significant.
- # The ECB-handicap hypothesis is, thus, not upheld. It is, thus, simply not true that the ECB cannot affect output because of the existence of rigidities especially in the labour markets. There may be good reasons why monetary policy might not be an effective means of affecting output. But rigidity in the labour markets is not one of them.



Problems with Current EMU Arrangements

- # Exchange Rate Policy:
- # It may be that the poor performance of some of the EMU countries since its formation can be attributed to an inappropriate exchange rate;
- # The euro has become the second major currency in the world after the dollar;
- # The exchange rate between euro and dollar has become particularly important for a large proportion of international trade;



Problems with Current EMU Arrangements

- # The volatility of the euro:dollar exchange rate becomes significant not only for the euro area and the USA, but also for those countries who have linked their currency to either the euro or the dollar;
- # These problems strongly point towards the development of mechanisms, which could help to stabilise the euro exchange rate.



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Required Changes in Economic Policies

- # Monetary Policy:
- # Reformulation of the objectives of the ECB to include high and sustainable levels of employment and economic growth, in addition to price stability (and indeed these objectives should also be firmly embedded in the European Constitution);
- # The two-pillar strategy should be abandoned to avoid the serious problems discussed above, which can easily lead to loss of credibility, especially when the two pillars provide contradictory signals;



Required Changes in Economic Policies

- # The ECB must be made accountable to the European Parliament;
- # Regular publication of the minutes of its rate-setting governing council is necessary to enhance transparency and accountability; even members of the ECB governing council have recently called for publication of the minutes;
- # ECB statutes changed so that it can clearly be involved in the co-ordination of fiscal and monetary policies;



Required Changes in Economic Policies

- # Ultimately ECB should be ready to take instructions from other European bodies, such as the ECOFIN;
- # The ECB should undertake explicitly the role of lender of last resort, and should be made responsible for the stability of the EMU financial system;
- # In this respect, the ECB should be responsible for all deposit insurance.



Required Changes in Economic Policies

- # Fiscal Policy:
- # Coordination of fiscal policy across member countries;
- # Budget deficits should be used in pursuit of economic objectives such as high levels of employment. This approach views fiscal policy as one of the instruments of economic policy, which can be used to strive for specified economic objectives;



Required Changes in Economic Policies

- # A budget deficit or surplus (or indeed balance) is not then sought to meet some predetermined figure but rather is used in conjunction with other policies to maintain high levels of demand in the economy;
- # This would imply the need for an EMU budget, which is not constrained to be balanced as at present and which can be utilised for EMU wide stabilisation purposes;



Required Changes in Economic Policies

- # Ultimately the development of an EMU fiscal policy should be introduced. This would require a large increase in the scale of the EMU budget and the ability of the EMU to operate a budget deficit, or indeed a budget surplus. This would imply the need for an EMU budget, which is not constrained to be balanced as at present and which can be utilised for EMU wide stabilisation purposes.



Required Changes in Economic Policies

Co-ordination of Economic Policies:

- Full co-ordination of the major policies is important;
- Monetary and fiscal policies both effect the level of aggregate demand, exchange rate and perhaps the rate of inflation, and that points towards coordination between monetary and fiscal policies;
- Not forgetting financial stability;



Required Changes in Economic Policies

- # There should be changes in the objectives of the ECB to include that of the external value of the currency, and interest rates would have to be set with regard to their effects on the exchange value of the euro;
- # The target exchange rate would be set by the Council of Ministers of the Eurogroup, and the ECB would be required to support that policy (through its interest rate policy and through interventions in the foreign exchange markets);



Required Changes in Economic Policies

- # The objectives of the ECB would have to be changed to include that of support of the external value of the currency;
- # Interest rates would have to be set with regard to their effects on the exchange value of the euro;
- # It is very important for the EMU to formulate an official exchange rate policy and abide by it;



Required Changes in Economic Policies

- # Finally, the achievement of full employment without inflationary pressures should be the ultimate objective;
- # This does require an appropriate high level of aggregate demand, and the creation of sufficient capacity to support full employment, and the substantial reduction of regional disparities;
- # The enhancement of the functions of the European Investment Bank (EIB), or a similar institution, to ensure high rates of capital formation, across the EMU becomes relevant.



Required Changes in Economic Policies

- # The achievement of high levels of economic activity without inflationary pressures requires two additional elements:
- # first, institutional arrangements for collective wage determination and price setting, which are conducive to low inflation. Wage determination within the EU is currently undertaken on a decentralised and fragmented basis;



Required Changes in Economic Policies

- # Second, the present disparities in regional unemployment levels (and also in labour market participation rates) within the EU would suggest that even if full employment were achieved in some regions, there would still be substantial levels of unemployment in many others;
- # There is, thus, a need for regional economic policies; a revamped EIB would be very important on this score.



Presentation

- # Theoretical Underpinnings of the EMU Model;
- # Requirements for Effective Monetary Union;
- # Current EMU Arrangements;
- # Required Changes in Economic Policies;
- # **Summary and Conclusions.**



Summary and Conclusions

- # Discussed conditions for convergence as they emanate from history;
- # Assessed current economic policies in the EMU;
- # Suggested changes;
- # Essentially euro area economic policies with proper co-ordination of them;
- # What amounts to political integration.