Defining a European Macroeconomic Policy

Europe has suffered a long spell of below capacity growth. This has entailed a substantial loss in output. As a result, unemployment has been stubbornly high for more than a decade, and its recent reduction has been partial. A detrimental side effect has been a significant loss of economic dynamism. Trend growth, in other words, has been negatively impacted by this underperformance. With unprecedented turbulences in credit and financial markets becoming more widespread, spilling over into the real economy (through the increased cost of capital as well as impeded access to funds), the United States appears to be on the verge of a substantial downturn. As a consequence, those economies that had been largely relying on the consumer-of-last-resort, which US households had played for the better part of the last decade, are in for trouble as well.

The prevailing diagnosis of Europe's economic malaise, the so-called Frankfurt–Brussels consensus, is that Europe's economies are afflicted with all sorts of rigidities and hindered largely by structural flaws. The low responsiveness of relative prices, in particular wages, and overly generous welfare systems have been blamed for preventing European economies from adjusting smoothly to unavoidable disturbances. All this has made for a very protracted recovery from the shocks that hit the world economy at the beginning of the new century, in particular the bust of the new economy and the consequences of the September 11, 2001 terrorist attacks on the United States. A direct corollary of this diagnosis has been to curb the welfare state, that is, to strengthen incentives to work (by lowering reservation wages, for example) and to relax labour protection rules (dismissal laws, severance pay, and so on), thereby capping labour's implicit as well as explicit costs.

What is missing from this diagnosis is any reference to macroeconomic phenomena and, consequently, the use of macro-policy instruments. In Continental Europe, Gross Domestic Product (GDP) is perceived as being on its medium-run equilibrium most of the time. In fact, there is no policy-relevant difference between actual and potential output. In alluding to the sub-par growth in output and the resulting output gap, in particular amongst the larger member states of the EMU, such as Germany and France, the Frankfurt–Brussels consensus deserves to be challenged. Against a backdrop of slow growth, or worse, and therefore at best mediocre demand perspectives, companies are reluctant to invest in building additional capacity. At the same time, households, confronted with uncertain job and income perspectives, become rationally cautious when consuming.

Following a joint movement towards central bank independence and monetary convergence, the European Central Bank (ECB) has been responsible for setting the price of money for all of the Euro zone since January 1999. The ECB has been accused of being excessively conservative, favouring above all price stability to the detriment of economic activity, when it was simply following its mandate. The criticism to which the ECB is victim comes no doubt from the expectations placed upon it; its ability to act, however, remains limited. First, the ECB is institutionally constrained by the primacy of its price stability objective over business cycle stabilization, and it does not look as if a European consensus may be reached any time soon on balancing the priori-

ties of inflation containment and output stabilization (a US type of dual mandate). Second, the ECB can only respond to symmetric shocks, that is, those that affect the entire zone. Its actions are thus limited against asymmetric shocks, which call for specific policies.

As supply-side policies mainly display middle-term effects, some of them controversial, and as monetary policy is out of reach for EU member states, fiscal policy is the only remaining independent instrument for macro-economic stabilization. The Stability and Growth Pact (SGP) has put great constraints on fiscal policy, tightening the terms of the Maastricht Treaty: in theory, public debt must not exceed 60 per cent of GDP, and the current budget deficit 3 per cent of GDP. In practice, it is the current deficits, not the debt, that are closely monitored by the European Council and European Commission and that may be subject to coercive procedures. If the 2005 reform of the SGP slightly relaxed the Commission's terms of evaluation as to the nature of "excessive" deficits by member states (taking into account, in particular, the business cycle position of each country as well as their innovative investments), it has not changed its stance. During periods of weakened economic activity, as we are confronted with today, the SGP imposes that member states reduce their deficits in the short and medium term, an action that is fundamentally pro-cyclical.

Counter-productive in application, the "budgetary discipline" formulated in the SGP is also erroneous in principle, as nothing in economic theory or history suggests that EMU countries should adhere to it. There exist sensible reasons for thinking that excessive public debt could be detrimental to the economy. Such is the case when the sustainability of the debt is brought into question, that is, when member states' capacity to raise the taxes necessary to finance their non-interest expenditures is challenged (but no EU country has come even remotely close to this extreme situation). Excessive public debt can also induce fiscal distortions that are susceptible to slowing down activity and growth, thus running counter to a country's best interests. Finally, one may fear a crowding out of private investment through an increase in real interest rates, which would hinder the ECB from implementing an appropriate monetary policy. Incorporating a criterion on public debt in the Stability and Growth Pact thus appears justified (though the question of its desirable level remains open).

The priorities of the SGP should be reversed: the European Council and European Commission should monitor the levels of public debt, not the deficits, for their sake. At the least, EU countries should be able to allow the automatic stabilizers full play and never be constrained to austere budgetary policies during a business cycle downturn. They must also be able to implement expansionary discretionary policies through public spending when these stabilizers prove insufficient. The experience of the United States shows that discretionary fiscal policy is efficient for stimulating economic activity without leading to an irreversible drift in the public debt. Across the Atlantic, long-term debt is stable while the budget deficit varies over the short term. There is no reason to assume that this flexibility in using macroeconomic stabilization policy that prevails in the United States cannot be imported to Europe.

The desired fiscal policies are those that stimulate demand while, at the same time, carrying the seeds of their own sustainability. Thus, any tax expenditure package should be phased out as the economy recovers, making it possible to return to a satisfactory debt/GDP ratio. Tax reduction, for example, should then focus on the agents who are most inclined to consume, in other words, those who have the lowest incomes. Next, in addition to its role of stimulating demand, an increase in public spending should allow for increased production capacities and the long-term well-being of European populations. The energy and environmental sectors have a high potential for improving how the European economy functions. The positive externalities have an effect on the whole economy and could be reinforced through coordination between the member states of the Euro-zone.

It is thus urgent to rehabilitate national fiscal policies and discuss the possibility of coordinating them at the European level when the expected benefits clearly outweigh the political and managerial costs.

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