10: The European Monetary Union
The importance of credibility

- The theory OCA leaves out the issue of credibility in the conduct of monetary policy.
- Inflation depends on the expectations of economic agents (explain via wage setting and SR Philips Curve)
- Governments which have to be reelected tend not to resist the “printing press” temptation and so are not credible as inflation fighters.
- Credibility is earned through time: governments with inflationary traditions have greater difficulties in fighting against inflation.
- A single currency can help if it is in the hands of credible authorities.
The Maastricht Treaty

- A firm commitment to launch the single currency by January 1999 at the latest
- Guarantee independence of national central banks
- A list of five additional criteria for admission to the monetary union (convergence criteria).
- The excessive deficit procedure (applies once you’re in)
The Maastricht treaty

• 1/1/1999 euro is a reality. National currencies fractions of the euro. But still not in circulation. This happens on the 1/1/2002.
• In 1999 4 member states are not members:
  – Greece since it did not satisfy criteria. It became a member on January 2001.
  – Denmark and UK opted out.
  – Sweden did not opt out but did not meet the criteria on purpose.
• With the addition of Slovenia, Cyprus, Malta and Slovakia the euro-zone currently consists of 16 members.
The Maastricht convergence criteria

- **Inflation**
  - Not to exceed by more than 1.5% the average of the three lowest rates among EU countries

- **Long-term interest rate**
  - Not to exceed by more than 2% the average interest rate in the three lowest inflation countries

- **ERM membership**
  - At least two years in ERM without being forced to devalue

- **Budget deficit**
  - Deficit less than 3% of GDP

- **Public debt**
  - Debt less than 60% of GDP

  - NB: observed on 1997 performance for decision in 1998
Interpretation of the convergence criteria: inflation

- Straightforward fear of allowing in unrepentant inflation-prone countries
Interpretation of the convergence criteria: long-term interest rate

• A little bit too easy to bring inflation down in 1997 – artificially or not – and then let go again
• Long interest rates incorporate bond markets expectations of long term inflation
• So criterion requires convincing markets
• ERM criterion has the same logic as the long-term interest rate: need to convince the exchange markets
Interpretation of the convergence criteria: budget deficit and debt (1)

- Historically, all big inflation episodes born out of runaway public deficits and debts (government borrows to spend)
- Hence requirement that house is put in order before admission
- How are the ceilings chosen?
  - Deficit: the German golden rule (deficit acceptable if corresponds to public investment on roads and other infrastructures and this is around 3%).
  - Debt: the 1991 EU average
Interpretation of the convergence criteria: budget deficit and debt

- Problem No.1: a few years of budgetary discipline do not guarantee long-term discipline
  - The excessive deficit procedure will look to that once in euro area (more on this later)
- Problem No.2: artificial ceilings so their enforcement may be compromised
The debt and deficit criteria in 1997

Maastricht fiscal criteria 1997

Deficit (% GDP)

Public Debt (% GDP)
The ECB

• European Central Bank (ECB): Central bank of the Euro-area which together with NCBs of participating member states makes up ESCB.

• Governing Council and Executive Board
  – Governing Council all presidents of NCBs which are members of the euro area plus members of the Executive board.
  – Executive board: President, Vice-President and 4 other members.
  – Decisions by absolute majority (50%+1).
Objectives of the ECB

• The Maastricht Treaty’s Art.105

“The primary objective of the ESCB shall be to maintain price stability. Without prejudice to the objective of price stability, the ESCB shall support the general economic policies in the Community with a view to contributing to the achievement of the objectives of the Community as laid down in Article 2 [economic growth and employment].”

• In clear:
  – Fighting inflation is the absolute priority
  – Supporting growth and employment comes next (Article 2).
Objectives (2)

• Definition of price stability:
"Price stability is defined as a year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below 2%. Price stability is to be maintained over the medium term."

• Leaves room for interpretation:
  – Where below 2%
  – What is the medium term?
Comparison with other strategies

• The US Fed
  – Legally required to achieve both price stability and a high level of employment

• Inflation-targeting central banks (Czech Republic, Poland, Sweden, UK, etc.)
  – Announce a target (e.g. 2.5% in the UK), a margin (e.g. ±1%) and a horizon (2-3 years)
  – Compare inflation forecast and target, and act accordingly
  – ECB is more ambiguous.
Does one size fit all?

• With one monetary policy, particular national conditions cannot be attended to

• This is another version of the asymmetric shock concern of the OCA theory.

• Monetary policy may also affect differently different countries
  • Labour market institutions and wage setting (centralized and decentralized wage setting most « realistic»)
  • Credit markets (fixed versus variable interest rates).
  • Marginal propensities to consume/save.

• Read: *A Tail of Two Countries*: Taylor rule interest rate is that consistent with price stability so if Actual less Taylor rule interest rate<0 it means that actual interest rate is too low for price stability)
Independence and accountability

• Current conventional wisdom is that central banks ought to be independent
• But misbehaving governments are eventually punished by voters
• What about central banks? Independence removes them from such pressure
• A democratic deficit?
Redressing the democratic deficit

• In return for their independence, central banks must be held accountable.
  – To the public.
  – To elected representatives.

• Examples
  – The Bank of England is given an inflation target by the Chancellor. It is free to decide how to meet the target, but must explain its failures (the “letter”).
  – The US Fed must explain its policy to the Congress, which can vote to reduce the Fed’s independence.
The Eurosystem weak accountability

- The Eurosystem must report to the EU Parliament.
- The Eurosystem’s President must appear before the EU Parliament when requested, and does so every quarter.
- But the EU Parliament cannot change the Eurosystem’s independence and has limited public visibility.
- ECB statutes can only be changed via Treaty Changes (unanimity).
The record so far

- A difficult period
  - An oil shock in 2000
  - A worldwide slowdown
  - September 11
  - The stock market crash in 2002
  - Afghanistan, Iraq
  - Sub-prime crisis
Inflation: missing the objective, a little
The euro: too weak first, then too strong?

The euro/dollar exchange rate
Asymmetric shocks?

Inflation

GDP growth
The Stability and Growth Pact

• First it's important to understand the concept of automatic stabilizers:
  – Tax receipts decline when the economy slows down, and conversely
  – Welfare spending rises when the economy slows down
  – No decision, so no lag: nicely countercyclical
  – Rule of thumb: deficit worsens by 0.5% of GDP when GDP growth declines by 1%
The Stability and Growth Pact

- Formally, the implementation of the Excessive Deficit Procedure (EDP) mandated by the Maastricht Treaty
- The EDP aims at preventing a relapse into fiscal indiscipline following entry in euro area
- The EDP makes permanent the 3% deficit and 60% debt ceilings and foresees fines
How the Pact works

• Emphasis on the 3% deficit ceiling

• Recognition that the budget balance worsens with recessions:
  – Exceptional circumstances when GDP falls by 2% or more: automatic suspension of the EDP
  – When GDP falls by 0.75% - 2%, country may apply for suspension

• Precise procedure that goes from warnings to fining
The procedure

- When the 3% ceiling is not respected
  - The Commission submits a report to ECOFIN
  - ECOFIN decides whether the deficit is excessive
  - If so, ECOFIN issues recommendations with an associated deadline
  - The country must then take corrective action
  - Failure to do so and return the deficit below 3% triggers a recommendation by the Commission
  - ECOFIN decides whether to impose a fine
  - The whole procedure takes about two years
The fine

• The fine starts at 0.2% of GDP and rises by 0.1% for each 1% of excess deficit

• The sum is retained from payments from the EU to the country (CAP, Structural and Cohesion Funds)

• The fine is imposed every year when the deficit exceeds 3%

• The fine is initially considered as a deposit
  – If the deficit is corrected within two years, the deposit is returned
  – If it is not corrected within two years, the deposit is considered as a fine
Stability Programmes

- Emphasis on precautionary measures to avoid warnings and fines: the stability programmes
- Under these, each year, each country presents its planned budget for the next three years, along with its growth assumptions
- The Commission evaluates whether the submission is compatible with the Pact
Issues raised by the Pact (1)

• Decisions are taken by the ECOFIN, a political grouping
  – France and Germany treated leniently in 2003-4
  – The Stability Pact was modified to accommodate their excessive deficits;
    • Public spending on education, R&D, defense, aid to 3rd countries, and spending which contributes towards European unification does not count.
• Imposition of a fine can trigger deep resentment
  – Are fines credible?
  – If not, what is left?
Issues raised by the Pact (2)

• Does the Pact impose procyclical fiscal policies?
  – Budgets deteriorate during economic slowdowns
  – Reducing the deficit in a slowdown may further deepen the slowdown
  – A fine both worsens the deficit and has a procyclical effect

• The solution: a budget close to balance or in surplus in normal years
Issues raised by the Pact (3)

• What room left for fiscal policy?
  – If budget in balance or surplus in normal years, plenty of room left for automatic stabilizers
  – Some limited room left for discretionary action

• In practice, the Pact encourages
  – Aiming at surpluses
  – Giving up discretionary policy

• The early years are hardest
  – Takes time to bring budgets to surplus
The early years (before slowdown)
Further controversies

• Discipline imposed from outside
  – A further erosion of sovereignty?

• Arbitrary limits
  – Why 3% (Golden Rule)
  – What about the debt ceiling of 60%?

• Asymmetry
  – The Pact binds in bad years only

• A budget forever close to balance or in surplus would drive debt/GDP ratio to 0