MONETARY AND FISCAL POLICY WITH AND WITHOUT THE EURO

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I consider the options that governments have in the setting of monetary and fiscal policy with and without adoption of the euro. I argue that some issues, such as the role of lender of last resort, have not yet been satisfactorily addressed by the European Central Bank. But on balance, the conclusion reached is that although the adoption of the single currency restricts the ability of a country to use discretionary fiscal and monetary policy, the constraints should work in favour of low inflation and economic stability.

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1. INTRODUCTION

The topic that I have chosen for today can fill the shelves of a library. Monetary and fiscal policy without the euro can mean monetary and fiscal policy with fixed exchange rates, or with flexible exchange rates, or monetary and fiscal policy inside the European Monetary Union but without the euro. Which one should one choose? It is unrealistic to believe that a country aspiring to join or already a member of the European Union can operate a monetary and fiscal policy outside EMU. EMU lays down strict rules for the conduct of monetary and fiscal policy and countries inside the European Union have to observe those rules. Countries outside are allowed to start entry negotiations only if they observe the key pre-requisites for membership of the Union. These pre-requisites, known as the Copenhagen economic criteria, specify mainly reforms that countries need to undertake in order to "cope with competitive pressures and forces within the Union". They require the development of an efficient financial system, the privatization of state-controlled industries and the implementation of structural reforms to increase the flexibility of the market economy. Importantly for our purposes, however, they also require macroeconomic stability. How does one achieve macroeconomic stability and how is it measured? It is here that the EMU restrictions become blurred with the Copenhagen criteria. EMU lays down specific rules for the conduct of monetary and fiscal policy, in order to achieve macroeconomic stability.

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The single currency, in addition, removes the possibility of movements in the exchange rate within the union and takes away the power of national central banks to issue money. It also imposes restrictions on fiscal policy, summarized in the Pact on Stability and Growth.

I begin with a brief review of the institutions of the euro and the new decision making bodies and explain how much flexibility in monetary and fiscal policy remains at the national level. I will then first review the conduct of monetary policy with and without the euro and subsequently the conduct of fiscal policy. For much of my discussion the comparison will be between a country that is a member of the European Union or aspiring to become one, but not a member of the euro, with a country that is a member of both the EU and the euro.

2. THE INSTITUTIONS OF EMU

The introduction of the euro necessitates important changes to central banking in Europe, which were introduced in the Maastricht Treaty. The central banks of the Member States form the European System of Central Banks (ESCB) and a new European Central Bank (ECB) is set up. As an interim measure, the ESCB and ECB do not have jurisdiction over the countries which have not adopted the common European currency but the principle is that all countries will eventually adopt it and come under the jurisdiction of the ESCB. The ECB ensures that the legal obligations of the ESCB are carried out according to the statutes. There are two decision-making bodies, the Executive Board of the ECB and the Governing Council of the ESCB. The Executive Board has six members serving non-renewable eight-year terms and they are in charge of the day-to-day running of monetary policy in the euro zone. The six include the President and Vice-President of the ECB. They are joined by the national bank governors of the eleven countries that are members of the euro zone (the European Union members excluding Britain, Sweden, Denmark and Greece) to form the Governing Council of the ESCB, which formulates policy and advises on its implementation. A third council, the General Council, comprises the members of the Governing Council and the Governors of the non-euro area central banks and is mainly responsible for relations between the euro area and the non-euro area member states. This includes the fixing of exchange rates between the euro and the currencies outside the euro who are members of the European Monetary System.

The decision-making bodies of the ESCB are strongly independent. They cannot take instructions from any government or other European Union institution and they are not allowed to help governments finance a budget deficit by buying their debt. Not many central banks are as independent from their governments as the ECB, though the

German central bank could have claims to as much independence. Independence is a multi-dimensional issue, so it is not easy to construct a single index of the degree of independence but indices in existence show the ECB as one of the most independent.[1] It has final responsibility for the conduct of monetary policy in the euro zone, no government or the European Commission can override its decisions and there is no government official on its board.

Central bank independence is considered desirable by many economists because of current thinking about the role of monetary policy. It is thought by many that the objectives of monetary policy should be simple and transparent and that they should be related to price stability and perhaps exchange rate setting, but not growth or short-run demand management. The objectives of the ECB conform to this thinking. As the Treaty put it, "the primary objective of the ESCB shall be to maintain price stability". But also, "without prejudice to the objective of price stability, the ESCB shall support the general economic policies in the Community". Given the vagueness of the second sentence, it is doubtful whether the ECB will be concerned with much besides price stability in the years to come. The ECB itself defined the price stability objective more precisely by stating that its objective is an inflation rate not exceeding 2% and that it will strive to achieve this in the medium term; in other words, very short-run deviations will be ignored. What is still unclear is whether the policy objective is a range of inflation from 0 to 2% or whether it is an inflation rate not more than 2%. Given Japan's recent experience with recession and deflation, the ECB would be well advised to be more transparent[2] and say explicitly that its inflation target is 0 to 2% and not an inflation ceiling of 2%.

There is considerable evidence supporting the connection between central bank independence and price stability.[3] In the case of the ECB independence solves another problem, if the ECB were not to be independent which authority was to choose monetary policy and how? The absence of a strong central government or other fiscal authority in the European Union would complicate matters.

Central banks of members states outside the euro zone maintain complete sovereignty over monetary policy but the ones who have adopted the euro lose sovereignty to the ECB. The ESCB decides what interest rates should be in the euro zone, through its Governing Council, and advises national central banks how to implement the policy. It is also responsible for decisions about foreign exchange intervention and the management of members' foreign exchange reserves but not about any target level of exchange rate between the euro and other currencies.

The Council of Ministers has been given the power to issue general guidelines of what level the exchange rate should be, if any, presumably because the level of the exchange rate also influences trade performance, which falls outside the ECB's remit. But the exchange rate is of course influenced by the choice of interest rate and in its turn

influences inflation, so there is potential for conflict here between ministers on the one hand and the independent central bank on the other, if the bankers do not agree with the ministers' exchange rate target. In addition, although if a country is outside the euro zone it is free to adopt its own exchange rate policy, those who aspire to entry have to join an exchange rate mechanism, ERM-2, which restricts movements in their exchange rate vis-a-vis the euro within a 15 per cent band.

Although the price stability target of the ECB is now clear enough, instruments are not specified, so the Council is free to set its own (there is also flexibility in setting targets, for example a Council may decide that price stability requires higher or lower target than the 2% currently chosen.) The most conspicuous example of a national central bank that has been following monetary targets was the Bundesbank before the adoption of the euro and a central bank that has been following inflation targets is the Bank of England. They have both been successful in containing inflation. The ECB is given considerable flexibility in its policy choices, provided they are consistent with its primary objective.

How is the ECB to be judged if it has been successful and what mechanisms are there in force if it fails to meet its objectives? This question opens up the issue of accountability, which may conflict with the independence of the central bank. A central bank is governed by appointed officials who expect to stay in office for a long time but their actions influence social welfare. In a democracy the officials have to be accountable to elected representatives for their actions but the elected representatives should not be given the opportunity to dictate to the officials monetary policy. Striking the right balance between independence and accountability is tricky and in a cross-section of countries there does appear to be a trade-off between independence and accountability, with more independent central banks being less accountable (de Haan at al 1999). Given that the public care mainly about policy outcomes, whereas officials are experts in the technicalities of achieving desirable outcomes, a situation where the elected representatives determine the objectives of policy but central bank officials are given freedom to choose the instruments appears the most desirable one. This is close to what the ECB is facing. Accountability on paper does not amount to much: The ECB president is obliged to submit an annual report to the European Parliament but neither the Board nor the Council has to show transparency in their decision making. This contrasts, for example, with current Bank of England practice, where the interest-setting Monetary Policy Committee has to publish its minutes two weeks after the meeting. But the ECB's first President has expressed willingness to appear before the European Parliament and explain the ECB's actions and he has shown in various other ways willingness to publish reports on ECB policy. But the minutes of meetings will not be published. Given what is being offered in reports and representations before Parliament, the only substantial information that the minutes would add would be voting decisions. The ECB has not been prepared to reveal how members of its policy council vote.

National central banks retain the function of overseeing the functioning of financial markets and institutions in their own country. The ESCB can give advice and there is an obligation not to do anything at the national level that will conflict with Community objectives. I will discuss later the implications of this supervision role for relations with the ECB and the potential for conflict.

Fiscal policy is carried out at the national level as before the introduction of the euro. There is (yet?) no fiscal federalism through a US-style central budget and although there are many rules about taxation, there is no tax harmonization yet either. But what is important for our purposes is the "stability and growth pact". The stability and growth pact was negotiated after Maastricht and reflects the fiscal discipline introduced at Maastricht. Member states are required to have budget deficits that are less than 3 per cent of their GDP. If a country exceeds this limit it is fined [the fine is calculated according to the formula: 0.2+0.1(deficit-3), as per cent of GDP], subject to a maximum of half of one per cent of GDP. There are exceptions to the rule. A country that experiences a drop in GDP of more than 2 per cent in a year can run a bigger deficit (it happened only 13 times in euro member states in the last 30 years) and if the drop is between 3/4 and 2 per cent of GDP the Council of Ministers can grant a discretionary exemption. Automatic fiscal stabilizers can still operate but the budget must be balanced on average, otherwise if the limits are breached the country is fined. France wanted the establishment of a Stability Council to coordinate fiscal policies, to provide a counterweight to the ECB, but it has not been agreed.

3. MONETARY POLICY

EMU takes away the power of the central bank to finance the budget deficit. This is a good thing: historically, the biggest single cause of inflation has been the "monetization" of the debt, namely, the financing of the budget deficit by newly-printed money. I will take a closer look at the two most important functions of a central bank, the supervision and lender of last resort roles, and the setting of interest rates. How do the two functions operate without the euro and how do things change when the euro is adopted?

Supervision

The supervision of banks and other financial institutions in the euro zone remains under national jurisdiction, as it has been and continues to be for the countries outside. This creates a unique situation in euroland, the functional and geographical separation of monetary policy from banking supervision. The functional separation is still unusual, though more and more countries are moving in the direction of taking the supervision

role away from central banks and giving it to independent supervisory bodies (the UK being a good recent example). But the geographical separation is unique: the ECB is responsible for monetary policy in the whole of the euro zone, whereas national banks (or some other national supervisory institution) have independent jurisdiction within their national boundaries.

How is this likely to affect banking operations in Europe? The supervision role is intended to ensure that financial institutions operate according to the law and good financial practice. The law in this case is national law, although many rules and regulations have been adapted to European Union law. The same holds for good financial practice. National banks operate under their own system of regulation but there has been some harmonization of operating principles across the European Union. So the national supervision authorities have to ensure that both national laws and European Union directives are followed. The Maastricht Treaty empowers the ESCB to advise and coordinate supervision, although ultimate power still rests with national authorities. Some observers, however, see the gradual evolution of euro-wide supervision through the increased cooperation between national supervisors on the one hand and the ESCB on the other (see in particular, Padoa-Schioppa, 1999).

The two main questions that arise when supervision is the issue are first, what funds can be used to deal with a problem, if necessary, and second, who is going to act as lender of last resort, a function traditionally performed by central banks. Although the function of lender of last resort is not necessarily part and parcel of the supervision function it is closely associated with it, as central banks often may want to rescue a bank or provide liquidity in the system through this function, having ensured that there has been no infringement of any banking regulations.

The funds for dealing with a crisis situation could come from general taxation, central bank resources or from the market. The introduction of the euro should not affect the use of taxation revenue (though it has to conform to European Union competition law, which prohibits the use of taxation revenue to subsidize local industry). The use of central bank resources becomes more problematic now, as national central banks cannot issue currency and have only limited resources, an issue that we discuss below under the lender of last resort heading. It is therefore not surprising that protagonists of the euro support the use of a "market-based approach", whereby the national supervision authority assures the market that the institution or institutions in question are solvent and are not breaking any standards of good financial practice and therefore make it possible for private lenders to provide the funds needed to deal with the crisis (Padoa-Schioppa, 1999).

A closely related question to the one of crisis dealing is the lender of last resort function of central banks. Two facets of the lender of last resort function may be singled out for separate treatment, lending to a single institution that is in trouble and which has

lost the confidence of the banks and cannot raise funds in the open market, and lending more generally in times of a liquidity crisis. How the lender of last resort function will operate in the euro zone is something that has not yet been entirely resolved.

Imagine a local bank getting into trouble and going to its central bank for help. The central bank looks at the case and decides whether to help it or not. If it decides against help, the story ends here. The euro does not change anything this far. But what if the national bank decides that help is deserving? Two possibilities arise, neither of which is without complications. The ECB may think that the national bank in trouble should not be helped. What then? The answer to this question has not yet been given but it is hard to imagine a situation where a national central bank is not allowed by the ECB to help a local bank in need if it considered it appropriate. But then how does the national central bank finance the help? The ECB in this situation would not be expected to offer any help. The national central bank cannot issue currency to help the local bank and it holds no substantial foreign exchange reserves. Help can only come from taxation revenue or the national central bank persuading financial institutions to lend, despite their presumed unwillingness to do so in the first instance. The latter is, of course, the market-based approach preferred by the proponents of the current system of bank supervision in euroland. It is not hard to see, however, conflict between the national central bank and the ECB arising in situations of this kind.

Suppose, however, that the ECB agreed that help was needed and the market-based approach failed to produce quick results. In this case, if the local central bank was given access to euros to act as lender of last resort, the rest of the euro zone would effectively be subsidizing the rescue of the local bank. But without access to the currency a national central bank cannot perform the function of lender of last resort effectively. The conduct of the supervisory and lender of last resort role in euroland appears to necessitate some transfers from the ECB to member states in financial need.

How much should the ECB be allowed to transfer and is any transfer a desirable situation? This is partly a political decision that members of the euro will have to resolve. But there are also economic arguments. For example, both the events that led to the bank getting into trouble and the subsequent rescue package may give financial gain to the citizens of a single country. Without the euro, a national government may counter this by financing the rescue package out of general taxation. But if the ECB is providing the funds, the national government will have less incentive to provide the funds. There is at present no agreement, statutory or otherwise, about forcing governments to provide funding for rescue packages. Would a national government be prepared to come to the rescue of a bank when the ECB is so uncompromisingly independent? The answer remains to be seen.

The second situation where the lender of last resort function may be called upon is one where the system as a whole needs more liquidity. Here a distinction needs to be

made between a national need, say arising from a national shock, and a euro-wide need, arising from a shock to the system. In the case of a national need the argument made above about the need of the national central bank to have access to funds carries even more force. The potential for conflict here between the national central bank and the ECB is greatest, since any liquidity transferred by the ECB to the national bank will be a transfer from the euro zone as a whole to a single country. But the case that has attracted most attention is the one of systemic risk, namely a euro-wide shock that increases the need for liquidity in euroland as a whole. Such shocks are more likely to take place in future as integration of financial markets continues. Clearly, in situations of this kind, national central banks cannot be expected to provide independent rescue packages, nor is it desirable if the terms of those packages are to vary. There is need of coordination of policy across euroland in this case, which would effectively turn the ECB into a lender of last resort for euroland as a whole.

Of course, there is no reason why the ECB should not perform this role, and there is nothing in the statutes to stop it from doing so. But the ESCB has been criticized as been inadequately prepared for situations of this kind (see for example Schinasi and Prati, 1999). It is certainly the case that although the Treaty refers to cooperation in the supervision and lender of last resort function, what is needed here is more than cooperation. The ECB will need to act as lender of last resort in cases where there is systemic risk. The difficulty is with identifying such cases and in the implementation of such a policy, even if one was decided. There is currently too much ambiguity in European Union law about the way that the ECB will tackle a euro-wide crisis situation should the need arise.

Interest Rates

The most celebrated role of central banks is the setting of official interest rates, which influence market rates. The objectives of monetary policy vary across central banks. The instruments also vary but to a lesser degree. Setting the official interest rate is one universal instrument. In small open economies with international capital mobility, central banks have very limited powers in the setting of interest rates. The rate of return on the country's assets has to bear a close relation to the rate of return on the assets of other countries with developed financial systems. Within Europe, the rate of return on the assets of a country outside the euro will have to bear a close relationship to the rate of return on the euro. To a first approximation, international investors will force an equality between the net rate of return on assets throughout Europe, irrespective of whether a country is inside or outside the euro.[4]

The countries that have joined the euro have given up the power to set the national interest rate. The short term rate on the euro is set by the European Central Bank and the long rate by market forces, on the basis of the short rate and the expected future

path of inflation and interest rates in euroland. The countries outside still have discretion in the choice of short-term interest rate. Here is where it makes a difference whether a country is inside the euro or outside. A country inside the euro has to follow the euro rate, both at the short end and the long end of the spectrum. A country outside, however, can deviate. However, given the degree of development and integration of financial markets in the European Union, and the freedom of movement of capital, if a country outside the euro decided to adopt a different interest rate from the euro rate it would have to compensate international investors for the interest rate differential by anticipated gains or losses from movements in the exchange rate. A country with an interest rate above the euro rate has to have an overvalued exchange rate and one with interest rates below has to have an undervalued exchange rate. International investors would then be compensated for the interest rate differentials through the holding of "expensive" or "cheap" currencies.[5]

Given this reality, when would the power to set interest rates outside the euro make a difference and is it important? It would make a difference if a country wanted to change interest rates temporarily, say to increase them to choke off an increase in demand that is not matched by a similar increase in euroland. The national central bank outside the euro would then increase its interest rate and force a jump in the value of its currency. The jump has to be big and the currency perceived to be temporarily overvalued in relation to its steady-state value against the euro. International investors would then know that the currency would sooner or later depreciate and so be indifferent between the higher rates outside the euro zone and the lower rates inside.

Monetary policy outside the euro succeeds in this case to be "independent". Despite the existence of the euro and the absence of restrictions in international capital mobility, the country's interest rate can be maintained above the euro rate. The argument works, of course, in reverse too. But how important is this independence? Because the interest rate differential can be maintained only at the cost of overvaluation or undervaluation, there is a potential of "destabilizing" changes in trade flows. In the case of monetary tightening the currency appreciates and exports become unduly expensive, a poor scenario for manufacturing known as the Dutch desease. So the independence gained by staying outside the euro is not without its costs. Also, because the interest rate differential requires appreciations or depreciations, the interest differential cannot be sustained for long periods of time without something else having to give. For example, the bands imposed on fluctuations if the country joins an exchange rate mechanism with the euro, such as ERM-2, could become unsustainable. But of course, a differential could always be present if the country is outside the euro, if it was sometimes positive and sometimes negative. Once again, however, this could only be achieved at the cost of excessive volatility in the exchange rate, as it would have to jump from overvaluation to undervaluation to support the interest rate differential.

So a country outside the euro is faced with the dilemma of either to follow the euro interest rate as if it were part of the system or to tolerate excessive exchange rate volatility. In the latter case the interest rate may be made to respond to country-specific conditions but the exchange rate loses the power to allocate resources efficiently. It is used merely as a tool to compensate international investors, not as a guide to exporters and importers about international market conditions for their products.

Whether this is a good thing or a bad thing is a political decision. The important point to note is that having the power to set one's own interest rates is not necessarily a good thing when there are large international capital flows. Large exchange rate movements can do damage to a country's trade patterns that can offset the benefits from the independent interest rate policy. But then having no power to set one's own interest rate can also work against a country's interests if conditions are different in a member state than in the rest of euroland. There is clearly a trade-off here which needs to be resolved by the country's political process.

Can the economist say anything more about the circumstances that favour one regime over the other? The answer is yes, and this has been the topic of a lot of debate in the European Union, leading up to the introduction of the euro. If a country is of similar structure and subject to the same external forces as the rest of euroland, it will not need to use monetary policy differently from the rest of euroland. In these circumstances the country does not lose out from tying its monetary policy to that of euroland. But if the country is subject to frequent shocks that do not affect the rest of euroland, it may want to preserve its independence to set its own interest rate policy. The latter possibility is the one known as the case of asymmetric shocks. With asymmetric shocks the case for the euro is less compelling.[6]

How important are asymmetric shocks in Europe? In the past there have been important cases of asymmetric shocks, the most celebrated of which was German unification. This was a massive shock affecting only one country in euroland. The shock was one that increased interest rates in Germany and despite the existence of the ERM the German currency appreciated. But even in the absence of the single currency and with national discretion in the setting of interest rates, other European interest rates also increased, though this was probably due to Germany's dominant position within Europe. Had Germany been a smaller country we could have had a situation where both its interest rate and currency were maintained above the European average until economic equilibrium in a unified Germany was restored. Of course, if German unification happened after the introduction of the euro, other euro members would have been forced to pay more of the (indirect) costs of unification than they did under the EMS, with obvious political tensions developing.

Of course, German unification was a unique event unlikely to be repeated. But smaller asymmetric shocks may not be so rare. The current position of the United

Kingdom vis-a-vis the rest of the Union is a case in point. The argument of the UK government against immediate adoption of the euro is that Britain is at a different phase of the business cycle, perhaps because the Thatcher reforms had a bigger impact in Britain than reforms on the Continent, or perhaps of the forced exit from the ERM in September 1992 and the subsequent depreciation of sterling. Whatever the cause, the argument goes that because Britain is ahead in business cycle terms it needs to have tighter monetary policy than the rest of Europe. British interest rates are therefore higher than euro rates and sterling is overvalued vis-a-vis the euro. Expansion in Britain is, however, coming to an end and its interest rates are converging down to euro rates, at which point the effects of the asymmetric cyclical shock will be worn off and British monetary policy will be in a position to tie itself to the euro.

Several authors who have investigated this problem have concluded that large asymmetric shocks are not very likely but perhaps Europe needs more flexibility in its labour market to avoid large scale unemployment and other problems associated with adjustments to smaller asymmetric shocks. But a core of countries centred in Germany, consisting of the Benelux countries, Austria, France and possibly Denmark, do appear to satisfy the criteria for a successful monetary union. The other countries are not as closely integrated with the core but they are not far away. Also, it has been argued that with closer integration in Europe and ever closer ties from trade and policy coordination, shocks are likely to become more interconnected, with more economic benefits from integration.[7]

4. FISCAL POLICY

The objectives of fiscal policy are to raise revenue for the financing of "public goods", such as defense, roads, education, health etc. They are also redistribution, which can be achieved as a byproduct of the revenue-raising objective, by making taxes more progressive, giving tax exemptions to low-income groups etc. EMU or the euro do not affect the operation of these objectives. Fiscal policy, however, is often used for stabilization purposes as well and large budget deficits are sometimes run for economic or political reasons. Is it a good idea to use fiscal policy to this end and what is the role of the euro stability pact?

In the Keynesian era of the 1950s and 1960s it was unthinkable to suggest that fiscal policy could not or should not be used for stabilization purposes. Persistent budget deficits were even seen as a good thing if they were accompanied by full employment. Two problems were largely overlooked. The first concerns timing and the extent to which fiscal policy can get it right. Given the speed with which economic conditions change and the slowness by which fiscal measures are introduced and changed, it is unlikely that fiscal policy can be used to fine tune the economy. Perhaps at times of

severe depression, such as the one in the 1930s in the industrialized world or the one in Japan today, fiscal policy could have a positive impact, but not in normal conditions. The second problem concerns the build-up of debt. Persistent fiscal deficits give rise to debt and future interest obligations. Countries with large debt obligations find themselves in the unpleasant situation of having to keep taxes high in order to pay for the interest on past accumulated deficits.

It is best practice in the conduct of fiscal policy to balance the budget at least over the business cycle; that is, even if there are deficits and surpluses at times in response to changes in the economic environment, on average there should not be either deficit or surplus. Some economists argue that there should be a balanced budget at all times but this is an extreme position that is not supported by many. Nor is it likely to benefit an economy. Given the progression that is usually built into tax systems, balancing the budget at all times would require an increase in tax rates in recessions and a decrease in the boom, which would destabilize further the economy. At the very least, the automatic stabilizers of the fiscal system should be allowed to operate and run small deficits and surpluses over the course of the business cycle.

It is less clear whether a government should use discretion in the conduct of fiscal policy, by changing tax rates or the volume of its expenditure in response to economic conditions. Traditional Keynesians of course would answer in the affirmative.[8] In my view, discretion should be used as little as possible and only in response to extreme and well understood conditions. If discretionary policy does not get it exactly right in terms of requirements and timing, the fluctuations that it tries to correct can be exacerbated. This was almost certainly the case with the British stabilization programmes from the mid 1950s to the 1980s. But cases where discretionary fiscal policy, either expansionary or contractionary, clearly helps can still be found. The case of Japan today is one in point. But it is less clear whether discretionary expansionary policies can do much for Europe's current unemployment problem. It is my belief, in fact, that discretionary fiscal expansion currently in Europe can do more harm than good.

We have seen that EMU without the euro does not impose restrictions on fiscal deficits, beyond the general one that there should be macroeconomic stability. Participation in the euro, however, imposes fines on countries whose deficit exceeds 3 per cent. What would happen to economic performance if countries did not observe these guidelines? First, there is a real chance that countries will get it wrong and make things worse with the use of fiscal policy. Second, even if they get the timing and intensity right, a large fiscal deficit will put pressure on domestic interest rates and can do one of two things. One, if international investors have confidence in the country's ability to control inflation, will want to invest in the country to take advantage of the high returns. This will give rise to appreciation of the currency, a rise in the price of exports and to a deficit in the balance of payments. The best example of this is Ronald

Reagan's "twin deficits" of the early 1980s, when his tax cuts led to a fiscal deficit, to an appreciation of the dollar and to a balance of payments deficit. It is only recently that the United States government has succeeded in reducing the budget deficit and gradually correcting also the (structural) balance of payments deficit. Two, however, if international investors have no confidence in the country being able to repay its debts, they demand more and more compensation to buy the country's assets, increasing interest rates further. This often leads to domestic recession and depreciation of the currency and unless large-scale fiscal reform is implemented, the country in question ends up with a heavy fiscal burden and inflation. Italy in the 1980s, leading up to EMU, is a good example of a country that suffered from high interest rates, depreciating currency and large tax hikes in response to large fiscal deficits in previous years.

Clearly, in the longer term neither of the outcomes of large deficits is desirable. But the sceptics might still argue that the requirement of a balanced or near-balanced budget with no discretion is a sledgehammer employed to crack a nut. They may have a point, to a degree. Prudent use of discretionary fiscal policy may indeed not lead to large debt build-up. But on balance the strict requirements of the stability pact is better than no restriction on the fiscal balance. I have already mentioned the problems encountered in trying to get it right. With our current knowledge of the economy, even well-meaning policy makers are as likely to get it wrong as they are to get it right. But unfortunately not all politicians are well meaning, at least form the benevolence point of view. Politicians are also party leaders and representatives of group interests. They are often elected by well defined groups of the population and they operate within political constraints that are often set by their political adversaries. Running budget deficits and allowing the build-up of debt is sometimes the outcome of these political considerations.

Politicians in power are often "weak", in the following sense. They have to go through a lengthy and often unsuccessful process before they can raise taxes; they have to explain their actions to groups that supported them, win votes in a hostile parliament. Coupled with this weakness, there is pressure from the groups that supported them to increase spending. Politically hostile groups with the power to stop taxation measures might demand favours before they can agree to a tax reform. Governments in this position often resort to borrowing as the only viable alternative and give in to the temptation and increase spending without a matching increase in taxes. The outcome is either build-up of debt or inflation.[9]

Equally bad for budget deficits are governments that are not "durable". These are governments that do not have a solid base in parliament and yet their support depends on parliamentary vote. Support of politically hostile groups is usually gained by spending bribes, namely, the granting of funds for the benefit of the groups in question without matching taxation, which could bring the government down. In both these

instances debt or inflation builds up. There are plenty of examples of governments that went wrong because of these political considerations. Belgium, Italy and Greece in the 1970s and 1980s all had either weak or unstable governments which resulted in large debt build-up. The United States has a durable government but one that is often weak, especially when the President does not control congress, and this again is a reason behind its inability to reduce the deficit for many years. But the weakest and least durable governments are the ones whose leader is elected by a Parliament with broad electoral representation (i.e. where small groups of the electorate are represented by deputies).

It is when considerations of this kind enter the picture that the EMU restrictions on budget deficits make more sense. "Brussels" acts as a higher authority to which weak and unstable governments put the blame for strict fiscal discipline. Of course, the reason for the introduction of the restrictions by the signatories of the Maastricht treaty were different - and still desirable because of the political pressures that the Union is likely to come under when a member state runs large deficits. Moreover, the political pressures are likely to increase with the single currency.

Think first of a country with its own government and currency and flexible exchange rate. If this government lets its debt increase to a degree that tax financing of interest payments becomes politically infeasible, it has the option of reducing the debt burden by inflation. Its currency will then depreciate and its real taxation burden will also fall. The costs from this action are high inflation and more specifically the loss of credibility in the government's ability to run a stable economic policy. It is a situation that cannot go on indefinitely but can work effectively as a corrective measure for a short period, provided credible fiscal reforms are introduced at the end of the inflationary push that remove the possibility of it happening again in the future. Some economists, for example, recommend this policy as a solution out of Russia's current debt problems. Many countries have followed this solution in the past. It is what is known as monetization of the debt. The sufferers from this are the country's citizens, who have to live with the high inflation and interest rates and the austerity programmes that inevitably follow.

What if this country is a member of the euro? Suppose again there are no controls on its borrowing and the government lets debt increase to unsustainable levels. A number of scenarios could follow, virtually all of which involve a political cost to the other nations in the euro. First, total euro debt could increase to the extent that the whole of euroland becomes risky to hold, with an increase in interest rates in the whole of the euro area. Second, political pressure from the country in question could lead to a soft monetary policy and to inflation and depreciation of the euro. Although this is not allowed by EMU rules, there is nothing to stop the Council of the European Central Bank from increasing the money supply if it sees a need. Third, the country in question could be faced with bankruptcy, as New York City was a few years ago. Political

pressure again could lead to unpalatable solutions for euroland as a whole, where, even of no unconditional bailing out was forthcoming, some form of help and tortuous political negotiations would be instigated.

The build-up of debt by a member state of euroland inevitably spills out to other members. It is absolutely essential that no bailing out of a member in trouble is allowed. But even without it, it is difficult to see a member quietly bearing the full costs of its own fiscal ineptitude within the euro. It is this possibility that the founders of the euro have tried to avoid by introducing the restrictions on debt and deficits associated with the stability and growth pact.[10]

5. CONCLUSIONS

Open economies with highly developed financial systems, like the economies of Europe, have to live with a lot of constraints on policy, necessitated by international considerations. The adoption of the euro adds to those constraints. But the argument that I have tried to put across in this presentation is that the constraints imposed by the euro are on the whole designed to increase macroeconomic stability. Although one might quarrel with some of those constraints, taken as a package they are on the whole well thought out. Let me summarize briefly what these constraints are.

The most effective discipline on domestic monetary and fiscal policy is not provided by the euro but by international capital mobility. The lifting of restrictions in international capital movements across the world is fairly recent and many countries still have them. The European Union requires the lifting of such restrictions. Some economists argue that the targeting of restrictions to short-term movements to discourage large speculative flows is advisable. But even this recommendation, with all its qualifications, is not something that is widely supported or is likely to succeed. Financially developed countries have accepted that they have to live with the constraints imposed by international capital movements. Good domestic policy can benefit a country from the liquidity that foreign capital movements can bring.

International capital mobility necessitates a close association between rates of interest across the world. If a country tries to deviate by following an independent monetary policy, it introduces instability in its exchange rate with a poor outcome for its trade performance. The instability may be a price worth paying if there are many asymmetric shocks that require diverse monetary policy. But as the economies of Europe become more closely integrated, large asymmetric shocks become less likely and exchange rate volatility more prominent.

A country outside the euro also has a lot more flexibility in the conduct of fiscal policy than one inside. But this flexibility is more often than not put to ill use.

Membership of the euro requires essentially balanced budgets, with small deficits and surpluses allowed during economic cycles due to automatic stabilizers. The constraints imposed by the euro are flexible enough to allow a government to design a fiscal package that stabilizes the economy in the normal course of events; but it does not easily allow a weak government to exploit its position and build up debt.

So, monetary and fiscal policy inside the euro can be different from policy outside; but with the strengthening of economic ties across Europe, countries choosing to stay outside the euro will increasingly find that their power to run an independent monetary and fiscal policy is more apparent than real.

NOTES

1. See Cukierman (1992), Cukierman, Webb and Neyapti (1992) and the update of the Eijffinger and Schaling (1993) index of central bank independence by de Haan, Amtenbrink and Eijffinger (1999).
2. Given that it has not said explicitly what it would do in the event of deflation.
3. See the first two references in footnote 1 and Rogoff (1985).
4. Given present conditions and reputations, a country outside the euro will almost certainly have to offer a premium on the euro rate, to compensate international investors for a potential inflation risk.
5. Of course, the argument here is that given the size of the countries in the euro and given the structure of financial markets in Europe, the countries remaining outside are small open economies confronted with perfect capital mobility and flexible exchange rates vis-a-vis the euro. For an analysis of this and other situations with specific reference to Europe and some simulations, see Calrberg (1999).
6. The argument in the text refers to the question of whether Europe forms an optimal currency area or not. See Mundell (1961) and McKinnon (1963) for the original statements, and Krugman (1990), de Grauwe and Vanhaverbeke (1993) and Bayoumi and Eichengreen (1997) for discussion with specific reference to Europe.
7. See Bayoumi and Eichengreen (1997), Artis and Zhang (1998) on the general issues, Frankel and Rose (1997a,b) on the endogeneity of the criteria for an optimum currency area and Pissarides (1997) for the need for more labour market flexibility.
8. For a discussion of optimal policy rules and the role of discretion see Chari and Kehoe (1999).
9. For a discussion of political theories of debts and deficits see, among others, Alesina and Drazen (1992), Alesina and Tabellini (1990) and Grilli, Masciandaro and Tabellini (1991). See also the survey by Persson and Tabellini (1999).

10. Whether the stability and growth pact is the best way of achieving the fiscal discipline that the euro countries have decided to impose on themselves is a question that we did not address. For a discussion of the pact with some criticisms see Eichengreen and Wyplosz (1998) and for an innovative idea how to make it more effective see Casella (1999).

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EFFICIENCY WAGE vs INSTITUTIONAL HYPOTHESIS: *A DISAGGREGATED STUDY ON THE WAGE DETERMINATION PROCESS OF THE GREEK INDUSTRY (1980 - 1995)*

YANNIS PANAGOPOULOS*

The aim of this paper is to formulate a disaggregated wage model which will be next applied on twenty different sectors of the Greek industry (for workers and clerks separately). This model is an eclectic one with a particular focus on different types of wage spillover effects (wage relativity). More analytically, it is the product of the combination of the efficiency wage and the institutional theories. The empirical results suggest that the efficiency wage theory seems to fit better into the labour markets of the Greek industry. Moreover, no sector (or leading group of sectors) "sets the tone" of wage increases during the bargaining process.

JEL classification: J 41

1. INTRODUCTION

The main scope of this paper is firstly to discuss the wage determination process and secondly, if possible, to reveal the existence of any leading sector or group of sectors in the labour markets of the Greek Industry. Due to the disaggregated nature of this study, the importance of wage relativity constitutes inevitably the main issue among others.

The significance of wage relativity on wage formulation was first established by Keynes (1936) in the *General Theory.* Following the Keynesian way of analysis, as Tobin (1972) said:

> "workers, individually and in groups, are more concerned with relative than absolute real wages. They may withdraw labour if their wages fall relative to wages elsewhere, even though they will not withdraw any if real wages fall uniformly everywhere. Labour markets are decentralised and there is no way money wages can fall in any one market without impairing the relative status of the workers there ".

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