European economic trends and economic policy in 2005: renewed disappointment on outcomes, incremental improvements in economic governance

Introduction

Both whole-hearted supporters of European integration and, from their different perspectives, the various critics of that project are broadly agreed that it has been characterised – and to some extent also driven – by a steady increase in the degree of economic integration of the economies of Europe. This shows up in a whole range of indicators of cross-border movements of goods, services, capital and labour. This process has been extended to the former Communist countries of central and eastern Europe, especially since EU enlargement in 2004, but actually much earlier. Clearly the integration process has gone furthest in the 12 countries which, since 1999 have shared a common currency (1).

This integration process has been accompanied by an on-going debate on, and actual institutional changes in, European economic governance. This term is used as a catch-all to describe the sum of the institutions, legal mechanisms, and other informal norms (2) under and within which national and European actors and policymakers interact transnationally to set important parameters of economic policy. Examples of these

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1 The euro has de facto existed since 1997 when exchange rates were fixed irrevocably; the 12th country, Greece, joined in 2000.

2 “Institutions” in this case is used in a narrow sense; sometimes the term is used in such a way as to encompass also legal mechanisms and other norms.
three constituent elements of “economic governance” include: the European Central Bank (ECB) (institution), the Stability and Growth Pact (SGP) (legal mechanism), and deliberations between the social partners on economic policy (informal norm).

The aim of this article is to set out both the debates on these issues and actual policy changes that occurred in the area of economic governance during 2005 (3). The emphasis is on the euro area, but the reader should be aware that, for instance, the Stability and Growth Pact applies, with some qualifications, to all EU Member States, while the Macroeconomic Dialogue is, in theory at least, also an EU-wide institution. The article begins by briefly reviewing economic developments, including wage developments, in Europe as the backdrop against which the debates took place. It then looks in turn at the performance of fiscal and monetary policy, and draws conclusions regarding the role of macroeconomic policy in explaining the outcomes described. It then proceeds to describe policy reforms and debates during 2005, focusing on the reforms to the SGP enacted in the spring, and the debates on governance and the policy mix that occurred in the context of the review of the Lisbon strategy, the rejection of the Constitutional Treaty, and the meetings of the Macroeconomic Dialogue.

1. Economic developments in 2005: renewed disappointment

The economic recovery that, in western Europe, began in 2004 ran aground already in 2005. Higher oil prices in the course of the year – they peaked at around USD75 a barrel in the late summer, following a series of hurricanes that disrupted the oil industry in the Gulf of Mexico – were a major cause, along with the lagged impact of previous appreciation of the euro. Domestic consumer demand and investment continued to disappoint, not least reflecting anxiety regarding employment and pension prospects, and sluggish wage growth. The only bright spot was a further boost to net exports. Both the USA and

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3 This article focuses on macroeconomic policy issues. Employment policy questions, in particular, and the Lisbon strategy more generally are dealt with in the article by Philippe Pochet in this volume.
the New Member States of the EU also suffered a similar reversal of growth compared with 2004, but maintained their substantial growth advantage over the EU15 (around 2 and 2½ percentage points respectively). It was only because of very sluggish productivity growth that this poor economic growth performance in western Europe actually translated into a small rise in employment and a marginal decline in unemployment rates in 2005 compared with 2004.

Figure 1: Growth performance in the EU and the USA (real GDP)

![Graph showing growth performance in the EU and the USA](source: AMECO)

For 2006 prospects are set to improve in western Europe, however, whereas there are increasing signs that the US economy is slowing, as house prices there cease to rise and households become more concerned about rising levels of personal debt. Indeed, on the basis of once again more optimistic forecasts and confidence indicators at the end of the year, the European Central Bank raised interest rates in December 2005.
Figure 2: Real GDP growth 2005

Source: AMECO.
It is noticeable that all the eight central and east European NMS grew faster than all the EU15 countries, except for Luxembourg and Ireland in 2005, marking the continuation of an established trend. The large west European Continental economies (IT, DE, FR) continue to languish at the bottom of the rankings (and because of their size drag the EU12 and 15 averages down); however, recently-successful Portugal and the Netherlands performed even worse. The three Baltic states again recorded the fastest growth. The UK’s 2005 growth rate virtually halved compared with the previous year, leading to a substantial fall in the rankings; the UK faces similar imbalances to those in the US. Against the background of the overall growth slowdown, the differences in national economic growth rates widened further compared with 2004: five countries did not manage 1% growth – Italy virtually stagnated – while at the same time the best-performing countries put on an additional spurt, raising their already-high 2004 growth figures by more than one percentage point.

More generally there is evidence that relatively high-income countries in the EU25 have a low growth rate, and vice versa, implying a generalised trend towards convergence; notable exceptions are Ireland and Poland respectively.

At the same time, within the euro area there are worrying signs of increasing divergence, in terms of intra-EMU competitiveness, raising important questions for economic governance in the currency area.
Figure 3: Real effective exchange rates (1998 = 100)

Source: AMECO.
Economic and monetary union was supposed to lead to increased *convergence* between the participating countries: intensified trade links and competitive pressure would, it was argued, force a convergence of price (including wage) trends. Within a monetary union (i.e. in the absence of an exchange rate) this means that the competitive position – technically the “real effective exchange rate” – of each member state vis-à-vis the others would remain broadly constant. Figure 3 shows that, far from leading to convergence via competitive pressures and intensified trade, EMU appears to have led to increasing divergence.

Wages and prices in Germany have been relentlessly driven down compared with the EMU average, raising German competitiveness within euroland by more than 10%. Austria initially followed the same path, but more recently has corrected, moving back towards the average. Meanwhile Spain and Italy have steadily (and Ireland has more recently) lost competitiveness against the average to about the same extent (10-15%). This was initially the case with the Netherlands, but more recently a downward correction has occurred.

Worryingly, this seems to indicate that cumulative causation effects in both directions (vicious and virtuous circles) take fast and slow-growing economies in opposing directions for considerable periods of time. (Example: a fast-growing economy has higher inflation and thus, given a common nominal interest rate, lower real interest rates, which stimulates its economy further. This phenomenon is sometimes called the Walters’ critique.) A correction via deteriorating and improving trade balances, in fast and slow-growing economies respectively, takes considerable time and can only reliably be expected to work in small countries (Austria, the Netherlands).

If the EMU is not to come under intolerable strain, it seems unavoidable that prices will have to rise considerably faster in, notably, Germany, while the rate of increase in Spain and Italy will have to decline (4). There are some faint signs that, finally, Germany is

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4 One reason why this might not be the case is that the higher inflation in, say, Spain is needed to bring up the price *level up* towards the EMU average (and vice versa in, say, Germany). To some extent this may reflect the Spanish situation, but not the German, nor the Italian.
recovering, and with it also the pace of nominal pay rises (5). Spain has been overheating and slower wage and price growth there is both needed and should be manageable. The real “problem child” is Italy, where prices have been steadily rising faster than the EMU average, despite very slow growth. Necessary unit-labour-cost (i.e. wages with respect to productivity) and price moderation may require an outright and painful recession, unless the Italian social partners can resolve the situation with a concerted prices and incomes policy (and/or measures to boost productivity growth). Italy is not usually considered a corporatist country in which social partner agreements could achieve the necessary outcome. However, the experience of the mid-1990s, when the country was desperate to fulfil the criteria for EMU accession – and the Italian Left was in power – shows that, under certain circumstances, such agreements are possible. Already voices have been raised calling for Italy to withdraw from EMU. It would be an understatement to say that this would throw not only the EMU, but also the European integration project as a whole into a major crisis.

This raises questions about the conduct of monetary policy, as it sets the overall benchmark (for inflation and implicitly growth) around which the member countries oscillate. If that is too low, the countries at the bottom of the distribution will be flirting with lasting recession and disinflation. More urgently, though, it poses questions to national fiscal policymakers, and the European fiscal framework within which they operate. We turn to this below. Yet those responsible for wage (and price) setting at national level – in short “the social partners” – and again any European-level framework within which they may act, are also clearly a key element in this problematic. This section concludes by briefly reviewing wage trends and collective bargaining, reflecting the relevance of wages both for the “competitiveness” issues just discussed

5 It should be noted that, here and in the following discussion, it is not absolute wage increases that are key, but rather wage growth with respect to productivity growth (i.e. unit labour costs), and that with respect to the change in the other EMU countries, Italian wages need not fall. The growth of Italian unit labour costs must be less than that in other countries. In theory this could also be achieved by boosting labour productivity while keeping wage growth constant.
and “social” issues that are the focus of other contributions to this volume.

Within the context of slow growth, described above, high unemployment and employer demands for wage moderation with reference to competitive pressure from Asian countries or low-cost locations within Europe itself, collective bargaining on wages was a difficult process for trade unions in 2005, as in previous years. As a result, the real value of wages agreed in collective agreements has been under considerable pressure.

In most countries, in 2004–2005 total real wage growth was equal to or higher than collectively agreed wages, but: in Germany, Slovakia and the UK total wage growth was below that of collectively agreed wages. In 2005, only three countries achieved overall real wage growth above 3%: wage growth is again highest in some of the new Member States (Czech Republic, Hungary) and in candidate Bulgaria. In six countries wages grew by less than 1 per cent, and they were negative in Germany, Belgium and the Netherlands.

It is often argued that real wage growth should be determined by productivity improvements. To what extent is this the case? Figure 5 shows the change in real unit labour costs: this indicator measures total real wage growth (including employer contributions) against productivity growth. A negative number indicates that real wages have failed to keep pace with productivity growth (and, at the macroeconomic level, implies a shift in national income away from “labour” in favour of “capital”).

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6 The following paragraphs draw on empirical work in Keune (2005).
Figure 4: Total real wage growth (2004-2005)

Source: Keune (2005).
Figure 5: Real unit labour costs, change over 2001-2005

Note: Ratio of compensation per employee to nominal GDP per person employed.

Source: AMECO.
Over the period 2001–2005, for the EU25 real unit labour costs declined by almost 2 per cent. The largest decline took place in Poland, followed by Spain and Malta. Major labour cost declines of about double the average can also be observed in Germany, Belgium, Austria and Hungary. These countries indeed improved their competitive position, as reflected – for the EU12 – in Figure 4 and the discussion above. Only in four countries do we observe an increase in real unit labour costs of more than 2 per cent over this five-year period. And even here this is not always linked to wage increases. For example, in Italy increased unit labour costs – and its loss of competitiveness – stem first of all from a decline in productivity.

Whatever the cause, these diverging wage-minus-productivity trends are what is largely driving the divergence within the common currency area identified above. The specific problem for EMU countries is that, in the absence of an exchange rate, and thus the ability to depreciate the currency, competitive balance can only be (re)attained via changes in actual wages and prices. Countries needing to reduce their wage/price level with respect to the other EMU countries basically have two analytically distinct options. (In practice they are combined in various ways). Either they use the national Phillips Curve or they must reach agreement on wage (and possibly price) moderation between national social partners and make it stick.

The former strategy simply means allowing (or even causing) a recession or at any rate slower economic growth in order to reduce wage and price claims. Clearly this has huge costs in terms of output and employment. The “effectiveness” of such a strategy can be enhanced by implementing “structural reforms” of the neo-liberal variety (reducing unemployment benefit, employment protection legislation, etc.). Countries with strong bargaining institutions, on the other hand, have the option of reaching agreement on wage moderation (and limiting price increases) while maintaining demand growth. In the past countries such as Ireland, the Netherlands and Austria have made use of this approach.
2. The role of macroeconomic policy

The standard explanation for the failure of western Europe, and especially the large eurozone economies, to grow fast enough to meaningfully reduce their high levels of unemployment is, of course, that these economies are sclerotic and in urgent need of labour market and other “structural” reforms. Space constraints prevent a detailed critique of that position here. Instead Figures 5 and 6 suggest the need to look for a complementary, if not alternative, explanation of the persistent failure of the euro area to recover from the 2001 downturn, and thus also the disappointing performance in 2005, in adequate macroeconomic policy. They compare the extent to which monetary and fiscal policy were used in the euro area, the US and the UK to offset the crisis. (For a fuller analysis of the role of macro policy see the contributions in Watt and Janssen, 2006).

2.1 Fiscal policy

Figure 6 shows the extent to which governments consciously reduce taxation or increase spending in order to offset an economic downturn (the “cyclically adjusted” figures take out the effect that the downturn itself has in raising spending and reducing revenues, the so-called “automatic stabilisers”). Faced with a major downturn, euro area governments barely reacted with discretionary fiscal policy measures: the cyclically adjusted deficit increased by only around 1 percentage point (p.p.) of GDP (a large part of which came in 1999/2000 when the economy was still doing well, and was thus actually pro-cyclical). Indeed, discretionary fiscal policy actually tightened in 2003 and 2004, despite the persistent weakness of economic growth, and this was maintained in 2005. By contrast the British and US governments responded energetically, swiftly expanding demand by a substantial 4-5 p.p. of GDP; in the US this was primarily the Bush tax cuts (and the so-called “war on terror”), in the UK higher government spending on public services. Even allowing for the larger “automatic stabilisers” in the euro area – where welfare states are more developed than in the English-speaking countries, and so public revenues and spending are more sensitive to the economic cycle – the difference in reaction by fiscal policymakers is striking.
2.2 Monetary policy

If anything, the picture is even clearer with respect to monetary policy, at least comparing the euro area and the USA. The aggressive interest rate cuts by the US Federal Reserve led to a sharp fall in short-term interest rates there; moreover this was supported by a substantial decline in the external value of the US dollar. As a result the monetary conditions indicator (MCI – see technical note) in the US plunged from 103 at the end of 2000 to just 95 in early 2004, giving the US economy a huge monetary boost that helped (together with expansionary fiscal policy) to pull the US economy out of its downturn. Once the economy stabilised, the Fed began raising interest rates (and the dollar appreciated during 2005), leading to a progressive tightening of the monetary conditions, while remaining well below their initial level.
Figure 7: Monetary conditions indicator
(1st quarter 1999 = 100)

Source: Own calculations: date ECB and BoE.

Technical note on MCI: The index is calculated using quarterly values for the percentage change in the nominal effective exchange rate and percentage-point changes in short-term interest rates. In line with econometric estimates of the expansionary effect on the euro area economy of a 1% fall in the NEER and a 1 p.p. fall in the interest rate, they are given a weight of 0.15 and 0.85. Clearly this weighting will differ for the US and the UK: the NEER is likely to have a smaller effect in the larger, more closed US economy, and a somewhat larger effect in the smaller, relatively open UK. However, experimenting with other weightings produced results that did not differ significantly from those presented in the graph using the same weighting for all three countries.

The euro area, by contrast, has been characterised by a roughly three-year initial gradual loosening of the monetary conditions – initially driven very largely by the sharp depreciation of the euro – but only
down to 98 points. This was equally gradually reversed over the subsequent three-year period, the index returning almost exactly to its starting point. Thus monetary conditions in the euro area began to tighten, despite the downturn, a full two years before this occurred in the US; in the UK the expansionary trend of the monetary conditions continued for 18 months beyond the euro-area turning point. On top of this come the very different magnitudes of the changes in the MCI in the US and the euro area, prima facie evidence of a more “activist” policy approach in the US (7). In the euro area 2005 saw a marginal loosening during the first three quarters, reflecting primarily the (surprising) depreciation of the euro against the US dollar.

As shown in Figure 8, in December the ECB raised interest rates for the first time in more than two-and-a-half years. Although the quantitative impact of a 25 point rise in base rates should not be exaggerated, the start of what is expected to be a series of rate hikes at this early stage in the recovery is clearly significant. Economic activity in the euro area as a whole has only just begun to recover and is still erratic (e.g. after a strong third quarter, fourth quarter figures disappointed). While headline inflation (HICP) is indeed above target and recently increased somewhat, this largely reflects higher oil prices, and HICP inflation has already fallen significantly. Even more importantly, core inflation, which strips out the volatile energy and food-related items, is substantially below target. On the basis of these growth and core inflation figures – the key indicators in a Taylor-rule type approach to analysing monetary policy decisions – the hike seems hard to justify when interest rates were not raised in the spring of 2004, for instance, when both growth and core inflation were higher than now.

7 While the ‘magnitude’ of the policy change in terms of economic effects cannot simply be equated with that in the MCI, because the impact of a given change in interest rates (or the exchange rate) varies from country to country, it is usually said that, in fact, a given change in monetary policy is more effective in the English-speaking countries due to the greater proportion of owner-occupied housing and the prevalence of variable mortgage rates there.
Figure 8: ECB main refinancing rates, inflation and real growth (1999-2005)

Source: ECB.
Of course monetary policy must be forward looking. The decision not to raise rates in spring 2004 proved justified by the renewed downturn in both growth and inflation. Yet the current outlook for recovery is also very uncertain. While confidence is up, the hard data are very mixed. There are many downside risks linked to global imbalances and possible euro appreciation, while the fiscal stance is expected to tighten noticeably at the start of 2006, when Germany (30% of the euro area) raises VAT by a massive 3 percentage points.

Figure 9: Output gaps

Source: OECD.

The impact of the different use of macroeconomic demand-side polices clearly shows up in the figures for the output gap. Put simply, this indicator – here, as estimated by the OECD – shows the “gap” between actual output and the level of output that, in the short run, the economy can produce without causing inflation to rise. The output gap has been negative since 2002 and is expected to remain so until and beyond 2007! This has nothing to do with structural factors – which, if at all, affect the rate of potential output growth – but solely the inability or
unwillingness of monetary and fiscal policymakers in the euro area to expand demand sufficiently to offset negative external influences and overcome sluggish domestic demand. The US was clearly hit harder by the global economic downturn, which originated in the US, but aggressive macro policies were much more successful, ensuring above-trend growth and thus a closing of the output gap within around three years.

Europe may well have structural issues that need to be resolved, and some painful reforms may indeed be necessary. But it is – to say the least – hard to understand the constant focus on such reforms when Europe is repeatedly sacrificing growth and employment opportunities simply by failing to deploy – painless! – tools of aggregate demand policy. This confirms the widely held belief that Europe is suffering not least from inadequate “economic governance”, that the institutions, legal provisions and norms established at EU level for the conduct of macroeconomic policy are inadequate. The remainder of this article discusses the debates and reforms in this area during 2005.


3.1 A new SGP?: the changes as of March 2005

As so often in economics, changes in policy came about less by force of intellectual argument than by (negative) developments in the real economy and, in this case, the political crisis that resulted from the stand-off between Commission and Council, and the deep split among Member States that reached a head at the end of 2003, concerning whether or not to open excessive deficit proceedings against Germany and France. The proposed solution to the crisis came in the form of European Commission proposals for reforming the Pact that were endorsed by the Council in March 2005 (9).

8 For a more extended discussion see Watt (2005a).

9 The text (Annex II) can be downloaded from http://europa.eu.int/european_council/conclusions/index_en.htm
Five areas for improvement in the working of the Pact were recognised as necessary by the Commission: the need to improve the “economic rationale” of the Pact, improve “ownership” (read: willingness to comply), avoid pro-cyclical policies in upturns and in downturns, and pay greater attention to debt and sustainability issues. This showed a recognition of at least the most obvious failings of the Pact and of the main elements of the sustained critique by economists of its operation.

Based on this diagnosis, the following key changes – alongside a number of more technical issues (more reliable data, better forecasts etc.) – were introduced:

- The medium-term objective (MTO) is no longer to be “close to balance or in surplus” for all countries; instead account is to be taken of national specificities (especially debt, potential growth and investment expenditure), leading to differentiated MTOs for each country. However, this is limited to allowing an MTO of a 1% cyclically adjusted deficit (in other words the leeway is just 1 p.p. of GDP).

- The convergence period to the national MTO has been extended and clothed in woolly language: while a benchmark adjustment of 0.5% of GDP each year is reiterated, more is expected in “good” and less in bad times. Moreover, Member States will only have to “explain” deviations from the recommended adjustment path.

- Major “structural reforms” that raise potential growth and improve public finances in the longer run may justify deviations from the national MTO. Pension reforms – the introduction of funded elements requiring tax incentives, and thus higher government deficits, in the short run – are explicitly mentioned as a case in point. However, the 3% reference limit remains valid.

- In applying the excessive deficit procedure, the Council has specified the “relevant factors” to be used in determining whether a country exceeding the 3% limit “really” has an excessive deficit.

  * The previous exception of a severe economic downturn has been softened to allow for an accumulated loss of output due to protracted very slow growth
* Spending on the Lisbon agenda, especially R&D and innovation policies
* Debt sustainability – which is to be given greater relevance – and public investment
* Financial contributions to international solidarity and European unification
* Pension reforms are again specifically mentioned as justifying a deficit, an allowance being made for up to five years for countries introducing fully funded systems.

- Last but not least, the deadlines before identifying excessive deficits, taking action following a policy recommendation, and for the deficit to actually be corrected have all been extended.

3.2 Evaluation: good for fiscal policy but not necessarily for economic governance

The response to the Council decisions was largely hostile. Many of those mainstream commentators that had criticised the Pact’s rationale began to argue that it was no longer worth the paper it is written on.

In my view the evaluation is mixed. The reform has addressed some of the most obvious failings of the SGP as originally designed. There is no economic justification for a 3% limit. While that limit has been reiterated, countries facing difficulties in meeting the 3% ceiling or the close to balance medium-term target now have a whole range of possible factors that they can call upon to justify their inability to meet the targets. Considering fiscal policy alone, this is almost certainly a good thing: Europe has suffered job and output losses in past years as governments have tightened their belts in an already difficult situation and/or have failed to give an adequate fiscal boost when needed to bring the economy out of stagnation. The additional scope created to invest public money – as required under the Lisbon Strategy! – in areas such as infrastructure and education is an important step; it is disappointing, though, that controversial policies to “privatise” pension systems are specifically endorsed under the changed Pact as a means for governments to justify deficits.
However, fiscal policy cannot be considered alone. On the contrary, the Maastricht architecture is one in which it is the monetary authority that ultimately determines the level of nominal demand in the economy, based, amongst other things, on the stance taken by (or expected to be taken by) the fiscal authorities in aggregate. The ECB reacted very critically to the reforms announced. There must be concern – although there is little evidence that the fiscal stance plays a large part in ECB interest rate decisions – that real or imagined “fiscal uncertainty” will be used to justify tighter monetary policy. A looser fiscal but tighter monetary policy would be a bad deal for the European economy and particularly for non-owners of financial assets (i.e. most workers).

On the Left there were voices welcoming the “death” of the Pact in terms of (social democratic) governments throwing off the shackles of Brussels and being freer to pursue Keynesian fiscal policies. Yet, it needs to be underlined that the social-democratic vision for Europe is one of increased policy coordination and the establishment of Europe-wide “rules of the game”. Allowing national governments (of whatever political colour) to do what they will in such an important area as fiscal policy is incompatible with that vision. The Left in many countries will be glad of an ally in Brussels when right-wing governments are seeking to give tax cuts to their wealthy patrons.

What would have been the alternative? It would have been preferable to indicate clearly in advance those areas of spending which are considered to be public investment and then to exclude such spending from the deficit calculation: the remaining spending would have to be met from taxation over the economic cycle (i.e. a balanced cyclically adjusted current budget). This is the “golden rule” as practised, successfully so far, in the UK. In order to emphasise the rationale of the Pact (preventing inflationary pressure leading to tighter monetary policy) the national inflation rate – specifically whether it is above or below the ECB target – should have been emphasised as a central indicator of whether countries should be running tighter, or are able to loosen their, fiscal policy. Similarly, the savings behaviour of the national private sector is also important. Countries with high private savings – such as Germany – have more scope than those – such as the US or UK –
where private savings are low (or even negative). Indeed, they must run fiscal deficits, unless they get a major boost from net exports (10).

The recent compromise on the SGP is imperfect but marks a step forward: it reflects a more realistic way of thinking about the economy over the previously dominant neo-liberal view. Having said that, fiscal policy is a secondary battle-ground. It is in a sense unfortunate that the SGP has attracted so much attention. Monetary policy is the core of the Maastricht system, and progress in European employment and economic growth depends on a growth-oriented monetary policy. If that is to be achieved without sparking higher inflation, improved coordination between monetary and fiscal policymakers and wage and price-setters – in short better “economic governance” – will be necessary.

4. Economic governance and Macroeconomic Dialogue: no end of debate

4.1 The review of the Lisbon Strategy

The spring of 2005 saw the culmination of a number of initiatives to revitalise the EU’s Lisbon Strategy – dealt with more fully by Philippe Pochet – with the publication of the Commission report “Working together for growth and jobs: A new start for the Lisbon Strategy”, adopted by the Brussels Summit of the European Council. The five-year review of the Lisbon Strategy should have been an occasion to reflect also on issues of macroeconomic policy and governance. After all, the role of macroeconomic policymaking (the “policy mix”) was explicitly mentioned as a key condition – one of three mentioned in paragraph 5 of the Lisbon Presidency conclusions (11) – for the success of the strategy. Moreover, in paragraphs 22 and 23 “stimulating growth and employment” was explicitly stated as a goal of macroeconomic policies.

10 This is because of the mathematical identity that net private-sector savings (savings minus investment) plus the government deficit must be equal to the current account balance (cf. Godley et al., 2005).

alongside “preserving macro-economic stability”; the importance of the Macroeconomic Dialogue (see below) in ensuring policy consistency was emphasised, as was the contribution of fiscal policy to growth and employment (reducing the tax burden on labour, raising public investment). In an attempt to push the issue up the political agenda, the ETUC held a major conference devoted to the role of macro policies in achieving the Lisbon targets shortly before the Brussels Summit (cf. Watt and Janssen, 2006).

Yet instead of an evaluation of the role of macro policies, the Commission document clearly revealed a further downplaying of the role of macroeconomic policy since the strategy was launched in 2000. There are merely two ritualistic references to “stability oriented” and to “sound” macroeconomic policies in the Commission report. The second reference calls for their “continued pursuit”. But if, as is implied, they have been pursued in the past, why is it the case that, although they have not brought the required results in terms of growth and employment in the first five years of the Lisbon Strategy, they are expected to do so in the second five? There is no discussion of monetary policy, the SGP, reorienting fiscal policies towards greater investment, adjusting the Community budget or the Macroeconomic Dialogue. One must assume that either these are not considered important for attaining the Lisbon goals, or they are already optimal. Given the analysis above, neither position appears tenable, all the more so as they were part of “Lisbon anno 2000”.

4.2 Implications of the rejection of the Constitutional Treaty for economic governance: Eurogroup strengthened anyway

2005 was also notable for the rejection of the Constitutional Treaty in ratification referenda in France and the Netherlands (although it received parliamentary or popular approval in a number of countries). In terms of economic governance issues, however, the implications of this are extremely limited, for a number of reasons. First, it had proved very difficult to reach a consensus within the European Convention’s working group on economic governance on changes in the Maastricht architecture (Schubert, 2003; Watt, 2005b), so that the reforms proposed in this area by the Convention were of a marginal nature. Arguably the only significant change is the formal establishment of the
Eurogroup – the group that brings together the finance ministers of the 12 EMU member states prior to monthly meetings of the ECOFIN Council – which until then had been little more than a gentlemen’s agreement, and the creation of an elected Eurogroup President, with a 2½ year term (rather than the former 6-month rotating presidency).

Second, the heads of state and government could not agree at the Rome Summit, at the end of 2003, on the draft proposed by the Convention (cf. Schubert, 2003); the text finally adopted by heads of state and government (July 2004) contained a number of amendments compared with the original draft, almost all of them of a regressive nature in terms of moving towards a “Social Europe” (ETUC, 2004). Noteworthy in the present context is, in particular, the inclusion of “price stability” as one of the goals of the European Union. This substantially bolsters the position of the ECB, as it now also has its primary goal, namely stable prices, as part of its secondary goal (promoting the goals of the Union), thus virtually immunising it from criticism that it has not paid enough attention to the real economy.

Thirdly, having said that, the failure to ratify the Treaty – as important as it may be in political terms – has, in turn had little effect in the area of economic governance. For it is striking that the one important change – the formalisation and strengthening of the Eurogroup – has been put into practice despite the failure to ratify the Treaty. It is one of those numerous Treaty provisions that have been enacted anyway on the basis of unanimous agreement in the Council.

Linked to this, two Council committees (the Economic and Financial Committee and the Economic Policy Committee), both of which prepare various aspects of the work of the EcoFin Council, have established “Eurogroup working groups”. This can be seen as a further small sign of incremental institutional progress in the area of economic governance and a further slight differentiation between the governance mechanisms for those countries in and those out of EMU.

4.3 Positions around the Macroeconomic Dialogue (MED)

The Macroeconomic Dialogue (MED) was established in 1999, just after the start of EMU, under the German Presidency (for a detailed description of the MED see Koll, 2005). It remains a little-known
institutions. Its main characteristics can be set out briefly as follows. The MED forms part of the European Employment Pact – the other two pillars being the coordinated strategy for employment (focused on the employment policy guidelines in the so-called Luxembourg process) and the economic reforms (Cardiff process); thus its aim is to contribute, via an improved macroeconomic policy to a “sustainable reduction of unemployment” (Presidency conclusions), where sustainable can be translated into “consistent with price stability”. The specific contribution of the MED is to institute a dialogue between the actors responsible for the policy mix – monetary, fiscal and “wage” policies – to promote positive interaction between the actors. Importantly, the MED is the only institution that brings together all the relevant macro actors to discuss the policy mix.

The MED takes place twice a year at political level, in each case prepared by a meeting at technical level. The discussions are confidential and there is currently no provision for issuing formal statements or reports as an institution: “The substantive core of the MED is an exchange of information and ideas” (Koll, 2005: 183). In particular actors discuss their analysis of the economic situation and prospects, formulate their own intended responses to the unfolding situation with a view to the goals of higher employment and non-inflationary growth and, lastly, state their expectations of how other actors should respond. At no time is the autonomy of any actor called into question.

**Macroeconomic developments and positions**

Against the background of disappointing incoming data for the fourth quarter of 2004, concerns about the medium-run effects of the sharp euro appreciation of 2004, and uncertainty about the economic outlook in 2005, especially given major global imbalances, the ECB pointed in official statements to concerns on the inflation front from the pace of

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12 The reader is advised that both the technical and political level meetings are “confidential” in the sense that no official statements are issued. The following therefore merely gives some of the basic ex ante positions taken by different actors, as perceived by this author, and as represented also in public pronouncements. Disproportionate space is given to ETUC views.
credit growth and house-price increases in some areas. The social partners were united in taking a more sceptical view of the prospects for recovery. The ETUC rejected a focus on individual credit and real-estate markets, and emphasised the key role of wages and unit labour costs for the medium-run inflation outlook: collective agreements in important sectors pointed to continued wage moderation in 2005, while past wage moderation had led to a major increase in the profit share without, so far, leading to higher investment. Thus it was essential that interest rates were not raised, as exchange rate appreciation – which was expected to continue (13) – had significantly tightened the monetary conditions (see above).

Against the background of the Commission’s SGP recommendations, discussed above, there was substantial public debate on the SGP and economic governance issues. Opinions differed considerably on the need for reform of the Pact. The key ETUC demand was to “Lisbonise” the Pact, i.e. to enable member states to raise spending on the Lisbon priorities, without this being considered an infringement of the excessive deficit constraints. Under a common monetary policy, countries needed more, not less, scope to run fiscal policies appropriate to national conditions. On financial sustainability issues raising the pace of economic growth and employment rates was put forward as the best contribution to ensuring longer-run sustainability. There was some support for SGP reform along these lines from amongst the employers’ associations, particularly to permit greater public investment. On SGP reform the ECB forcefully expressed its concerns that SGP reform would lead to Member States running more expansionary fiscal policies. The Commission drew attention to a number of practical difficulties in reforming the Pact, such as how to address the trade-off between allowing for country-specific factors and ensuring equal treatment of countries by the Commission.

13 Virtually all commentators were convinced that 2005 would see further euro appreciation and a decline – perhaps precipitous - in the value of the US dollar. In the event the euro fell back substantially during 2005 from a high of around USD 1.36 to below USD 1.20 (around 12%).
In the Autumn discussions took place in the shadow of the sharp rise in oil prices during the summer. There was concern that the dual effect of such rises – depressing demand and growth while raising prices and possibly also inflation expectations – would make the task of setting monetary policy, but also negotiating appropriate wage increases, more difficult. There was general agreement that higher oil prices should not be factored into higher wages (“second-round effects”), but equally that monetary policy should not be tightened in an attempt to curtail oil-induced price rises, unless there was evidence of such second-round effects. But so far, there was no sign of such effects.

The social partners were to a very large degree united in emphasising the downside risks (to output) rather than the upside risks (to prices), and calling on the Bank to delay interest-rate rises for as long as possible. The Bank stated in a number of press releases and statements that ongoing wage moderation had helped to ensure that the expansionary stance of monetary policy had been maintained despite upward pressure on the headline rate of inflation. Once again, though, developments on financial and credit markets were seen as a risk, and it was vital that the ECB did not lose the price-stability “capital” it had built up (low longer-run inflation expectations).

Thanks to cooperation between the Institut für Makroökonomie und Konjunkturforschung (Düsseldorf) and the European Trade Union Institute, the ETUC was, for the first time, able to present its own economic forecast to the meeting, in “competition” with those from the Commission, ECB and UNICE. On the basis of, amongst other things, a less sanguine forecast for the strength of the recovery in 2006 and different views on the extent to which (or whether) “potential growth” has declined, the trade unions called on the ECB to underpin the recovery and swiftly close the output gap by cutting its base rates (with fast-growing euro area economies offsetting by tightening fiscal policy).

Other discussions between MED actors
The year 2005 saw two technical-level meetings on the economic and employment situation between trade union and employer representatives and one top-level bilateral meeting between the ETUC and the ECB. All these meetings are informal in nature, but they are to be pursued in coming years and, it may be hoped, will contribute to
cementing a more trust-based relationship between key actors responsible for the macroeconomic policy mix at European level and, in tandem with the MED, potentially opening up scope for a more cooperative approach to policymaking.

4.4 Exchanges between policymakers through the media

Discussions on the economic developments described above, and more specifically on the interaction between the three central macroeconomic policy areas – monetary, fiscal and wage policy – also took place between policymakers in and via the media. The media debate broadly followed a long-established pattern, with some nuances during 2005.

Statements in the media tended to consist of appeals to other actors to “live up to their responsibilities”. The ECB, in its monthly press conferences and on other occasions called on the social partners to stick to the policy of moderate wage increases and on governments to promote structural reforms under the auspices of the Lisbon agenda and, in particular, to keep their fiscal house in order. Specifically the ECB was highly critical of the reform of the SGP described above. An ECB press release (21 March) stated that the Bank was “seriously concerned about the proposed changes to the Stability and Growth Pact” and insisted on the need to “implement the revised framework in a rigorous and consistent manner conducive to prudent fiscal policies”.

On the other hand a number of high-profile members of the Eurogroup took a strong public position during the last few months of 2005 that the ECB should not raise interest rates. They included the Eurogroup President, Jean-Claude Juncker, but also the French, German and other finance ministers. Ultimately, however, such efforts were to no avail: the ECB raised its main refinancing rate in December 2005.

It is tempting to interpret the proclivity of policymakers to make suggestions on the appropriate behaviour of other actors through the media as a sign that the institutional structures of policy coordination are not adequately developed in the EMU. Certainly such exchanges are not characteristic of the economic governance regime in, say, the UK.
Conclusions

The year 2005 marked yet another disappointment for the European economy, and another lost year in the attempt to reach the Lisbon employment targets and become “the most competitive” economy in the world by 2010. The analysis above suggests that inadequate stimulation from the side of macroeconomic policy was an important part of the reason for this, rather than the real or supposed lack of “structural reforms” beloved of mainstream discourse. This, in turn, lends credence to criticisms of the economic governance system in Europe, and especially in the EMU, as sub-optimal and part of Europe’s problem, rather than part of the solution. Perhaps the “structural reform” that Europe needs most urgently is reform of its economic governance structures? There are some signs that some former proponents of the Maastricht architecture, in the financial media, in academia and among some policymakers, have started to become disenchanted with economic governance structures and more open to debate on their reform.

And indeed, the review of policy developments and debates in the second part of the article did point to some incremental progress in 2005, most notably in the area of fiscal policy and the Stability and Growth Pact. In terms of fiscal policy itself, SGP reform is welcome; however, it cannot gloss over the fact that, at the aggregate level, it is monetary policy that largely determines the pace at which aggregate demand can expand. If the monetary authority offsets a looser fiscal with a tighter monetary policy, nothing will have been gained (indeed, on the contrary).

The Macroeconomic Dialogue remains, in principle, a useful forum for the sort of discussions between the actors responsible for the policy mix that are necessary if Europe, and especially EMU, is to enjoy faster economic growth while maintaining price stability. The concrete impact of this little-known institution is hard to measure, however, nor is it evident that it was strengthened in 2005, although some threats to it appear to have been thwarted.

Having kept interest rates flat for an extended period at a low level, at the end of 2005 the ECB took the first step on what is widely expected
to be an extended tightening cycle. It remains to be seen how strongly the European economy will recover from its long torpor, and how resilient that recovery will be to the shocks expected or possible in coming months. One thing is clear: the Lisbon employment targets will never be met if economic policy, out of exaggerated fears about inflation (and its supposed costs), prevents the dynamic growth of domestic demand in Europe. Without that, all the “structural reforms” in the world – and Europe has seen a lot of them in recent decades – will be of no avail in the battle to reduce employment and ensure decent, meaningful work, that promotes social inclusion, for all.

References


