Speech

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EMU and economic policy in Europe

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This is not the end.
It is not even the beginning of the end.
But it is, perhaps, the end of the beginning.

Winston Churchill's declaration in November 1942, after the victory at El Alamein, is, I think, applicable—in rather different circumstances—to EMU's consequences for economic policy in Europe after the weekend at the beginning of May.

Several years of intensive preparations for monetary union now lie behind us. This work, steeped in economic policy premises as well as technicalities, has been carried out in many different European settings. Many of the EU Member States have also worked hard both to be ready on time for EMU by fulfilling the Maastricht criteria and to complete the more practical and technical arrangements. It is now roughly a month since these processes were crowned with the historic decisions in Brussels to initiate European monetary union with eleven countries. A couple of days from now, the new European Central Bank will be holding its first meetings.

So there are good reasons to shift our attention and look ahead. The convergence process has been successful in many respects and monetary union is to start in little more than six months time. But once it has started, what challenges will EU's economic policy have to face? What are the rules for this policy? How are the dialogue and decisions likely to develop in the next few years? These are some of the questions that I shall be considering today.

1. Convergence

A natural starting-point for a discussion of the current economic situation in Europe is the convergence reports that the Commission and the European Monetary Institute (EMI) presented at the end of March.

- The price trend for the EU area in recent years is impressive. The disparities in the rate of price increases have diminished and in January this year inflation was below 2 per cent in all the Member States except Greece. This development is fundamentally a consequence of the monetary policy focus on price stability, backed up by economic policy in general. Other factors have been increased international competition and low oil prices.

- The picture of government finances in the EU countries has also brightened. Progress has been made in the process of financial consolidation. However, a number of countries are only just below or at 3 per cent and have qualified thanks to measures of a temporary nature.

- A high degree of exchange rate stability now prevails in most EU countries and tensions in the exchange rate mechanism (ERM) have been moderate.

- The notable convergence of long-term interest rates is another indication of the stable situation and EMU expectations.

All in all, the reports from the Commission and the EMI show that convergence in the Maastricht sense has come a long way. This is important because the chances of the monetary union functioning properly are better if rates of inflation are much the same initially and government finances are under control.

Besides the matters behind the Maastricht criteria, with monetary union imminent there are somewhat different issues that need to be considered. Even when the Treaty was being drafted, many economists pointed out that the criteria by no means constituted the only, perhaps not even the most important, requirements for an efficient monetary union.

There are now two other matters that seem to be particularly important and they will no doubt receive more attention, both in the European economic debate and in the EU decision-making processes in economic policy:

- One has to do with the degree of uniformity in cyclical activity and the possibility of using *judicious fiscal stances* in different parts of the monetary union to make up for the absence of national discretion in monetary policy.

- The other concerns the participant countries' economic structures, not least *how their labour markets function* and to what extent they are sufficiently flexible both to cope with any shocks to stability and to bring unemployment down to more acceptable levels.

If the various political systems fail to prevent large imbalances in government finances, internally as well as between countries in the monetary union, then the ECB will be under strong pressure to consider other objectives than average European inflation. The same applies if unemployment were to remain high or become even higher.

I shall be returning to these questions in my final section and try to paint a picture of how they will be handled in the European Union in the coming years. Before doing so, however, it may be in place to look in somewhat more detail at the structure for economic policy decisions in EU/EMU.

2. Functions

EMU is a historically unique construction, with a common central bank that is to conduct monetary policy across national boundaries. At the same time, however, eleven elected governments are to conduct fiscal policies with eleven different budgets, besides making many other decisions that affect the functioning of their national economies, not least their labour markets.

Monetary policy

In a monetary union, monetary and exchange rate policy is, by definition, a common concern. The monetary policy objective is price stability; without prejudice to this objective, monetary policy is to support the general economic policies in the Community. The more budget policies focus on stability—and wages stay in line with productivity—the greater will be the room to manoeuvre in monetary policy.

The ECB's basic tasks will be to define and implement the single monetary policy, conduct foreign exchange transactions, hold and manage the official foreign reserves of the Member States, and promote the smooth operation of payment systems. The national central banks (NCBs) will be able to have an active influence on policy, participate in its practical implementation and, perhaps not least, communicate it in their respective countries. But the analysis of the euro area will be undertaken centrally to a large extent and the level of interest rates will be decided by the ECB Governing Council, which consists of the members of the ECB's Executive Board and the NCB Governors of the, initially eleven, participating countries.

The European System of Central Banks (ESCB) has been given a highly independent status so as to be in a position to conduct a monetary policy for price stability without short-run political considerations. But its independence does not relieve the ECB of the duty to inform and communicate. On the contrary, it accentuates the need for a dialogue and exchange of information. The European Parliament has displayed a high profile in these matters and worked to establish a basis for discussing and monitoring monetary policy continuously.

The ECB will be obliged to make difficult decisions in various matters. One problem may arise from cyclical disparities between euro-area countries. While these disparities may diminish over time, they are unlikely to disappear completely. Meanwhile, the ECB has to set a single instrumental rate for the whole monetary union. The common interest rate will normally not be ideal in relation to the economic situation in every country.

The national financial structures also differ considerably, which means that, for instance, interest rate sensitivity varies. There are countries where a large proportion of borrowing is arranged at a variable interest rate; the national tax systems differ, for example as regards tax relief for interest expenditure; and the time required for bank interest rate adjustments varies. All this means that the impact of a change in the monetary union's interest rate will differ from country to country. In Italy, for instance, lending to households is arranged at variable interest rates to a greater extent than in Germany and the Netherlands. EMU will probably speed up the ongoing integration in these respects, too, so the ECB's problems may be greatest initially.

Many matters to do with the ECB's working procedures have already been decided. The broad structure is in place. But in many respects, the way in which the ECB and the ESCB will operate and develop in practice is still an open question. Some observers are concerned that national interests will be excessively influential at the expense of a union-wide perspective. They point out, for example, that the NCB Governors make up a larger proportion of the Governing Council than is the case with the regional FED Governors in the United States. Another argument is that the ECB has a limited staff at its disposal. Personally, I do not find this particularly convincing. The performance of a clearly defined task—maintaining price stability—in a way that is good for the union as a whole will be a heavy responsibility for each member of the Governing Council; in this sense they are all in the same boat. There are also many signs that power will gradually shift towards the centre and this in turn will affect recruitment. My guess is that the ECB will be able to attract personnel who are qualified, which in contexts like this is more important than their number.

Fiscal policy

Fiscal policy is a national concern but the national room to manoeuvre is conditioned by various EU regulations. The Treaty has general provisions to the effect that economic policy is to contribute to the achievement of Community objectives in accordance with the principle of an open market economy with free competition. The Member States are to regard their economic policies as a matter of common concern and are explicitly required to coordinate them but the decisions are to be made on a national level.

Then there are more specific agreements on matters like the scale of rates for value-added tax, government subsidies and rules for public procurement. These agreements, which are a limited constraint on the construction of taxes and public spending, have been concluded mainly for purposes other than stabilisation policy—to promote competition and establish a single market for capital, goods, services and labour.

The fiscal policy rules that have attracted most attention are those for government budgets and debt. The Maastricht Treaty stipulates that budget deficits are not to exceed 3 per cent and that the government debt-to-GDP ratio ought not to exceed 60 per cent. This was intended to make monetary union candidates put their public finances in order prior to participation.

The Stability and Growth Pact has clarified what will apply once monetary union has begun. The Pact can be said to consist of two parts: a surveillance mechanism for detecting at an early stage that a country is starting to have budgetary problems and is in danger of incurring an excessive deficit, and a mechanism for sanctions on errant countries. The first mechanism covers all the EU countries and requires them to present a fiscal policy programme. The sanctions mechanism, on the other hand, applies only to countries in the euro area. The purpose of the Pact is to strengthen political mechanisms at union level so that budget discipline is permanently maintained. There has been underlying concern that otherwise a country might be strongly tempted to shift a part of the adjustment costs for consolidating government finances onto the other countries.

The Pact requires every Member State to aim for a medium-term budgetary position close to balance or in surplus. If the 3 per cent limit is exceeded, the Commission and the Ecofin Council are to follow a specified plan of action: examination, opinion, recommendation, publication and, as a last resort, sanctions. The Pact has been constructed with a view to generating so much pressure on Member States to put government finances in order that sanctions will never be necessary.

A knotty problem when constructing the Pact was how to make the requirements sufficiently strict without placing undue restrictions on national fiscal policies. This is all the more important when monetary policy is no longer available at national level, so that the task of adjustment falls more heavily in practice on fiscal policy. OECD estimates indicate that in a “normal” economic downturn, the cyclical budget balance in EU countries weakens by 1–1.5 per cent of GDP. Some budgetary discretion is therefore needed so that there is a margin for automatic stabilisers to act when activity is falling. The conclusion is that the trade-off seems reasonable but the Pact does make it necessary to achieve a balanced budget or a surplus relatively soon. Under these circumstances, the Swedish Government's ambition to establish an annual budget surplus of 2 per cent over the business cycle is commendable.

Fiscal policy accordingly faces new challenges and it is not all that easy to tell just what may happen. When monetary policy ceases to be a national instrument, fiscal policy will have to play a greater part in stabilisation policy. At the same time, the scope for budget policy will be curtailed in a sense by the Stability and Growth Pact, though this need not be so much of a restriction in practice as long as the objective of medium-term balance or surplus is met. A stronger challenge is to be expected from the ongoing integration in the European Union which EMU may accentuate. This process can be rather rapid, not least in financial markets. In markets for goods, pricing in a single currency may accelerate the existing trend towards smaller differences in consumption taxes, for example.

Structural and labour-market policy

Finally some words about structural and labour-market policy. This policy field is much less clearly defined than the two I have already considered. It is affected by many different rule systems at both national and EU level, besides belonging to the competence of many different ministers and commissioners. The common agricultural policy and tax harmonisation are two examples.

The components of structural policy that concern the internal market—competition laws, the whole of the market for goods and services, the mobility of capital, and labour market mobility—are largely regulated at EU level. The competition laws are one example here.

Another component of structural policy is the regulations and other matters that apply to the labour market. Many initiatives here have recently been taken at EU level in order to speed things up and comply with political requirements in the Union. In these matters, however, most decisions have to be made at the national level. But the connection with conditions for monetary policy is evident: the better the economy can be made to work, the higher the growth that can be achieved without this generating increased inflation.

Monetary union is likely to accelerate the process towards increased integration in Europe. In this way it will also contribute to new demands for structural adjustment. One of monetary union's primary purposes is, in fact, to stimulate competition and structural changes, primarily to the benefit of consumers in the EU area. At the same time, such a development will probably entail a greater degree of joint action and harmonisation in the Union.

3. Interaction

As I have outlined, monetary union involves a central direction of monetary policy and a broadly national direction of budget policy, though discretion in budget policy is demarcated by the Maastricht Treaty and the Stability Pact, for instance, and is being further curtailed by the gradual extension of international integration. At the same time, structural policy is to varying degrees a common EU concern. This raises the question of how a balanced policy can be constructed in such an environment.

Bodies for decision-making and cooperation

One approach to this question involves describing the EU institutions that have been set up for economic policy decision-making and cooperation.

– Ecofin, as the decision-making body for the ministers of finance and economy, is the principal forum in the field of economic policy. It is in this group that, for example, many of the decisions were taken so that monetary union could start on time. The budget policies of the Member States have also been monitored here and this will continue under the Stability Pact. Moreover, Ecofin draws up an annual “budget statement”, the Broad Economic Policy Guidelines, containing the principles for economic policy in the EU area.

– Most of the matters on the Ecofin agenda have been prepared by the Monetary Committee, which besides representatives for each of the fifteen Member States (normally an under-secretary of state or a deputy central bank governor) includes representatives for the Commission and, more recently, for the EMI. When monetary union starts, the name of the Monetary Committee will be changed to Economic and Financial Committee but at present it seems that its composition will be unchanged apart from the EMI being replaced by the ECB.

Work on monetary union has been a heavy burden for these bodies in recent years. Meetings have been protracted and business has ranged from major issues like the Stability and Growth Pact, the new European exchange rate system (ERM2) and legislation for monetary union to matters such as the design of the European coinage.

Some of the structure is now changing with the advent of monetary union but not its basic features. The preparatory work is over, as is a good deal of the work connected with ERM. A number of processes, such as those concerning government finances, are being modified. But this is accompanied by an increased need to discuss issues raised by the fact of monetary union.

Now that the countries which will be participating initially in monetary union have been singled out, moreover, an informal group—the Euro 11 Group—is being set up for discussions among the ministers of finance and economy in the euro area. The idea is that this group will concentrate on matters which concern just the participating countries and cater to the greater need for dialogue and cooperation which they perceive in connection with the inception of monetary union. However, this is not a decision-making body and all matters considered by Euro 11 are prepared by the Monetary Committee, on which all fifteen EU Member States are represented.

The crucial institutional change is, of course, that as of next year the conduct of monetary policy will be fully centralised. The Treaty explicitly states that the ECB is not to be swayed by political considerations; its task is to concentrate on monetary policy. But naturally a dialogue will be needed with the governments in the EU and euro areas, in the first place with the ministers of finance and economy. The Treaty actually provides for this in that the Ecofin president may participate in meetings of the ECB Governing Council and even submit motions. Moreover, representatives of the NCBs and finance ministries will continue to meet in the Economic and Financial Committee.

Monetary union raises many other institutional questions that I will not be taking up today. Not the least of these is relations with countries and organisations outside the European Union. Where, for instance, does the primary responsibility for the exchange rate lie in Europe and what about relations between euro-area countries and the International Monetary Fund?

I now want to hark back to the issues I touched on earlier: fiscal policy in relation to the business cycle, and how the labour market functions. How will these matters be handled in the system for economic policy decisions?

Cyclical disparities and fiscal policy

The past year has seen a general strengthening of economic activity in the EU area. This has helped improve government finances and provided better conditions in other respects for the start of monetary union. But it has been accompanied by increased cyclical disparities between the future euro countries. This is clear from a look at how observers have revised their growth predictions as compiled, for example, in “consensus forecasts”. A look at the euro countries, divided into two groups with higher and lower predicted GDP growth, respectively, shows that in the past year the gap between these groups has widened. The same applies in terms of predicted inflation.

One should not make too much of this; the differences have grown but are still small and assessments for 1999 suggest that they will narrow again. But the picture does illustrate a problem that will have to be addressed. The single monetary policy is incapable of both stimulating the economy in some countries and curbing it in others. Pressure on fiscal policy will accordingly vary across countries. For one thing, differences in automatic stabilisers and thus in cyclical sensitivity will automatically lead to country differences in budget trends. For another, different degrees of active fiscal policy will be needed to manage tensions that may arise from a single interest rate throughout the monetary union.

This question has been deliberated informally for some time by economic policy decision-makers in the European Union. It also underlies the discussions that are now held on EU's broad economic policy guidelines. In a way, it also contributed to the initiative from the German finance minister before the weekend at the beginning of May, when some further reinforcement of budget policy in the coming year was achieved by agreeing on an earlier implementation of the Stability and Growth Pact's objective and an earlier production of the annual convergence and stability programmes.

This is ultimately a question for which each country is responsible. Countries that fulfil the Stability Pact's criteria will be entitled to a fiscal stance that is more expansionary than the ideal for European inflation. Today, moreover, there is cause for concern that current fiscal policy may be too expansionary in some countries. But it is also clear that the costs of such a policy mainly fall on the countries themselves. Higher domestic inflation eventually weakens competitiveness; with exchange rates irrevocably fixed, once a cost crisis is there, it may be difficult to rectify. Improved productivity can provide a remedy but achieving it is not easy. In practice, this presumably leaves either fiscal tightening at a later stage to retard the rate of wage increases or an adjustment of labour taxes, neither of which is simple.

For the credibility of the EMU project it is important that no country is already in such a situation at the start. Countries with a risk of high inflation are therefore likely to experience strong pressure in various processes, for example in Ecofin. On the whole, it seems to me that the question of adjusting fiscal policies to the ECB's monetary policy will be a major issue. The same applies to how any fiscal adjustments are to be allocated across countries.

Labour market problems

It is an established fact that the functioning of the labour market is a problem in many Member States. A solution to the employment question clearly presupposes that the European labour market is made to work more smoothly than before. The matter is also directly connected with monetary union. There will no longer be any possibility of using a national monetary policy to deal with labour market shocks. It is then all the more important that the labour market functions properly.

Employment growth in the EU area has been weak and unemployment in many countries has been high for a long time compared, for instance, with the United States. Labour force mobility is also lower than in the United States. But we also know that the Member States differ considerably. Some, such as the Netherlands and the United Kingdom, have been comparatively successful in generating new jobs. Others have done considerably worse. The remedies chosen by the successful countries vary, too. Some have adopted highly decentralised solutions and extensive deregulation. Others have sought to build up a consensus and make minor changes in some public systems.

The question of how labour markets in Europe work and how they can be improved is already very much a part of the European agenda. There have been political initiatives in a variety of contexts in recent years, including national action plans for employment. These plans include the analysis of labour market laws, effects of tax systems and business conditions. Processes are being built up, inspired by the Maastricht Treaty's successes with budget policy. The annual employment guidelines require each Member State to present a national action plan with a view to improving people's employability, entrepreneurial spirit, flexibility and equality. These national action plans are to be specific, with goals and time schedules, so that they can be evaluated. Good examples are to be highlighted so that other countries, if they wish, can adopt them.

Structural questions have been brought to the fore during the British Presidency and there have been somewhat more concrete discussions in various committees about how to get Member States in step here as well. One approach involves finding good examples in different fields, just as in the case of employment, and analysing the structural problems of each country. This process generates what the British call peer pressure, which can also contribute to the desired national changes coming about.

Once again, however, the decisions in this field largely have to be made at national level. But to perhaps an even greater extent than with fiscal policy, the major benefits of a successful national policy will accrue to the country in question. By itself, this seems hopeful and should facilitate changes, At the same time, the political resistance in most EU countries is strong.

Some believe that the very fact of monetary union will generate desired reforms in labour markets. Possibly but not necessarily; when high unemployment rates in recent decades in many EU countries have failed to produce changes, why, it may be asked, would monetary union be more successful? In conclusion, I consider that much work at EU level will be invested in political education and a search for methods to gain support for changes in this field. But I do not foresee the same pressure in the joint processes as in the case of fiscal policy; there is less need of a common approach.

Laborious but successful process

I should like to conclude with a summary and some tentative conclusions about the future course of the economic policy debate in the European Union.

1. There are important interfaces between monetary policy, fiscal policy and structural policy. Problems concerning the composition of fiscal policy or the workings of the labour market affect the room to manoœuvre in monetary policy. This suggests that a vital dialogue will be needed between different parts of EU's economic policy decision-making system that are involved in such matters. More of a joint appraisal will presumably emerge. New processes and institutions are also likely to develope.

2. The growing need for dialogue and a joint appraisal has already led to new tasks and developments for a number of EU institutions. Many observers consider that this is true of Ecofin, which as a leading actor in the construction of EMU has responded to new requirements. One example of a completely new structure is Euro 11, which is designed for the handling of joint issues by the euro area's finance ministers. There are many other opportunities for dialogue, so those who fear that the ECB will be operating in something of a vacuum are likely to be mistaken.

3. Issues concerning fiscal policies in EU/EMU and labour markets have also arrived on the agenda in other ways, for example at the Monetary Comittee. This is partly because many consider than monetary union has accentuated the need for a joint European discussion. With monetary union soon to be launched, moreover, the agenda has more room for other matters. The Stability

and Growth Pact is one example of earlier initiatives in connection with EMU. Various processes have likewise been started to bring the problem of unemployment into the limelight.

4. There are strong grounds, in the fields I have discussed, for keeping decision-making essentially at a national level. The effects of the policies, for instance in the labour market, mostly occur in the country in question. There are also considerable country differences in such matters as the premises for fiscal policy, the structure of government finances, labour market regulations and so on. Still, the ongoing integration of markets, which monetary union may stimulate, is presumably exerting increased pressure for reform.

The process that monetary union is now driving onwards is, in fact, fairly typical of EU cooperation in general. The European Union is a highly decentralised organisation. Power and political legitimacy are essentially located at the national level. The joint budget is limited. Matters move forward in a process where external events, for instance in the global economy, and political initiatives modify the agenda. Problems are often managed with arduously negotiated compromises between sovereign states. Each new initiative and decision forms a platform for the next phase. Monetary union, which is now leading to the appearance of new items on the agenda, is after all largely a consequence in its turn of earlier decisions, for instance on the internal market.

This process may sometimes appear to be rather random and it often provides instances of uncertainties and risks. But it is a process that has gradually brought the EU countries closer together. And monetary union is a another, major step.

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