Policy Challenges for the Euro Area

Improved economic performance and a sound policy framework in the euro area provide a solid basis for EMU. But important challenges remain: making an eclectic approach to monetary policy transparent, strengthening public finances further, addressing the structural causes of high unemployment, and ensuring an appropriate mix of economic policies.

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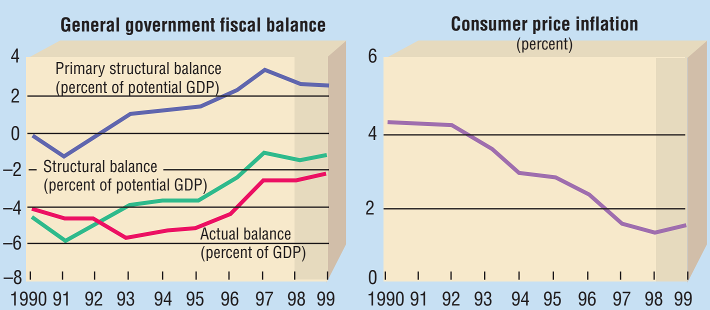
IN PREPARING for European Economic and Monetary Union (EMU), the euro area countries have considerably improved their macroeconomic policy environment from what it was in the early and mid-1990s (Chart 1). Inflation has fallen to very low levels, fluctuating around an annual rate of $1^1/_2$ percent during 1997–98, and there is little sign of inflationary pressure for the period ahead. Public finances are in far better shape than earlier in the decade. Despite lackluster economic growth in the region, the average ratio of government deficit to GDP was reduced by more than 3 percentage points between 1993 and 1997.

Chart 1
Fiscal imbalances and inflation rates in the euro area have dropped



Source: International Monetary Fund, *World Economic Outlook* (Washington, October 1998).
Note: Shaded areas indicate IMF staff projections.

To ensure that EMU runs smoothly—and, especially, to achieve and sustain the higher growth rates that will be necessary to reduce high unemployment rates—euro area countries will need to consolidate and capitalize on these achievements. This will require continued prudent macroeconomic policies combined with reforms aimed at making labor and product markets more flexible. Effective policy coordination will also be needed, because fiscal and structural policies will continue to be designed and implemented at the national level.

Monetary policy

The design and implementation of monetary policy in the euro area will be the preserve of the European System of Central Banks (ESCB), comprising the European Central Bank (ECB), which will make monetary policy decisions, and the national central banks, which will be primarily responsible for implementing those decisions.

The ESCB's mandate clearly gives priority to price stability, which has been defined by the ECB as inflation of less than 2 percent in the euro area as a whole. The emphasis on price stability is reinforced by the high degree of independence given to the ESCB and other provisions that insulate decision makers from political pressures. In pursuing low inflation, the ESCB will be continuing policies already firmly established by the national central banks. Nonetheless, EMU represents a change in the monetary policy regime in two key respects. First, the scope for national monetary and exchange rate policies—already constrained by the European Monetary System's exchange rate mechanism (ERM)—will disappear. Second, the geographic orientation of monetary policy will broaden to take account of conditions throughout the euro area. Until now, because of the anchor role the deutsche mark has played in the ERM, the Deutsche Bundesbank's policies have been the predominant influence on the monetary stance of euro area countries.

This change in regime will produce important challenges for the ESCB. Some of these—such as putting in place the pertinent information and operational systems, or compiling area-wide monetary statistics—are fairly straightforward, if time consuming. Others are more complex. In particular, the ECB will initially be faced with many uncertainties concerning the demand for financial assets and the mechanisms through which monetary policy influences the economy. Of course, even long-established central banks such as the Bank of England, the Bundesbank, and the U.S. Federal Reserve System often have to deal with these problems. However, the difficulties of assessing the impact of policies are likely to be even greater for the ECB—at least initially—because of both the restructuring of financial markets that will accompany the introduction of the euro and the effects of the regime change on product and labor markets.

In this environment, policymakers from diverse national backgrounds will need to demonstrate early on that they are able to reach common positions based on a pan-European perspective in a timely fashion. A workable, well-understood monetary framework will be essential. Approaches based on past behavioral relationships of economic models—whether in the context of monetary targeting or inflation targeting—are likely to be difficult to implement at the outset of EMU, owing to the substantial change in regime. Against this background, the ECB recently agreed on a monetary policy strategy based on three main elements: (1) achieving price stability, defined as an annual inflation rate of less than 2 percent; (2) giving money a prominent role, by adopting a reference value for the growth of a monetary aggregate; and (3) using a range of economic and financial indicators to reach a broadly based assessment of the outlook for future price developments. The euro area's subdued inflation rate will help the ECB pursue this eclectic approach while it builds its reputation. Given the lags between policy action and its effect on inflation, however, the ECB will need to explain its strategy and the factors influencing its deliberations clearly and frequently, especially at the outset.

Fiscal policy

The budget of the European Union (EU), at a little more than 1 percent of its member countries' GDP, is relatively small, and the fiscal policy role of EU institutions has consisted primarily of the surveillance of national fiscal policies. In this context, the Stability and Growth Pact (SGP), which was agreed in June 1997, enhances the fiscal policy framework for EMU. It does this, in part, by establishing more clearly than the Maastricht Treaty the principle that countries that fail to correct deficits judged to be excessive will be subject to financial sanctions. Equally important, it strengthens the medium-term framework for surveillance. In the pact, countries have committed themselves to attaining medium-term budgetary positions that are close to balance or in surplus, so that they will be able to deal with the normal fluctuations of the business cycle while keeping the general government deficit below 3 percent of GDP. Countries will submit medium-term "stability" programs once a year to the EU's Council of Ministers, on the basis of which the Council will assess the compliance of countries' budgetary strategies with the SGP's medium-term goal.

There has been considerable discussion as to whether budgets need to be balanced on a structural basis (that is, after the cyclical effects on the budget have been removed) in order to provide countries with adequate room to deal with normal cyclical fluctuations while keeping their deficits below 3 percent of GDP. Using past output fluctuations as a guide, it seems that most countries would be able to achieve the latter two objectives by ensuring that the deficit does not exceed 1 percent of GDP at normal levels of capacity utilization. However, other considerations—including uncertainties regarding future output volatility, the desirability of allowing adequate scope for discretionary countercyclical policies, and the vulnerability of some countries' fiscal positions to interest rate shocks or a reduction of EU structural funds, as well as the practical difficulties inherent in the measurement of output gaps—might argue for a more ambitious goal. Moreover, fiscal pressures associated with the aging of the euro area's population underline the benefits of substantially reducing the ratio of public sector debt to GDP, and thereby the burden of interest spending. There is considerable uncertainty surrounding the estimates, but annual pension and health spending in the euro area could rise by as much as 7 percentage points of GDP over the next 30 years if countries do not reform their current programs. Taking all of these considerations into account, the SGP's objective of fiscal balance or a small surplus in the medium term appears to be reasonable, though a more ambitious goal may be warranted in a few countries.

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At one level, the task facing fiscal policymakers in the euro area seems quite modest. The general government structural deficit for the euro area in 1998 is estimated to be a little over 1 percent of GDP. Moreover, interest spending for the area as a whole is projected to fall by $^1/_2$ to $^3/_4$ of 1 percent of GDP over the next three to four years, reflecting declining debt levels and lower interest rates, with the second of these factors especially significant in those countries that in the past experienced large differentials between their interest rates and those of Germany and the other "core" members of the ERM. As a result, the adjustment needed to achieve a balanced structural fiscal position is much smaller than the estimated structural deficit for 1998 would seem to indicate. This said, the improvements needed in the fiscal balance understate the extent of spending reform required, in view of the need to reduce distortions in the tax system, especially those that discourage the creation of jobs or weaken incentives to work. Government revenues are high in the euro area—nearly one-half of GDP, on average. The rate of increase in non-interest spending will need to be much less than the trend growth of GDP if countries are to reduce taxes significantly while achieving the medium-term fiscal goal set out in the SGP.

There is a danger that fiscal policies will fall short of requirements. Despite stronger economic growth and falling interest burdens in the euro area, the fiscal position is projected to improve only slightly in 1998, with a significant weakening in the primary structural balance (the structural balance net of interest payments). Admittedly, fiscal performance in 1998 should be seen in the context of the very large adjustment made during 1996–97 and the need in some countries to replace temporary measures adopted in 1997 with more permanent measures. Nevertheless, there is a risk that, now that they have qualified to be part of the euro area, governments will be tempted to loosen their fiscal belts. This often happens during cyclical upswings because governments confound improvements in actual fiscal positions with improvements in the underlying position. It is not unusual at cyclical peaks for output to exceed its cyclically normal level by 3–4 percent; at such levels of resource utilization, actual budgetary positions would, in most countries, have to be in surplus by about 2 percent of GDP to be consistent with balance at normal levels of capacity utilization.

Against this background, governments need to provide convincing evidence in their policies in 1999 and their medium-term stability programs that their fiscal strategies are in line with medium-term needs, emphasizing strict control of spending based on forward-looking reforms. Inadequate fiscal policies would reduce the ECB's room for maneuver, resulting in higher interest rates than would otherwise be needed. Moreover, should the euro area economy falter, countries could be forced to override the automatic stabilizers and to tighten policies in order to prevent general government deficits exceeding 3 percent of GDP.

Structural policies

European labor markets have adapted poorly to changes in the global economic environment over the past three decades. Between 1970 and 1997, unemployment in the euro area rose by 10 percent of the labor force, compared with no increase in the United States and a much smaller increase in other industrial countries outside the euro area (Chart 2). The euro area's rate of job creation has compared even less favorably: its labor-force participation rate has remained unchanged (despite rising female participation), while rates have increased in other industrial countries.

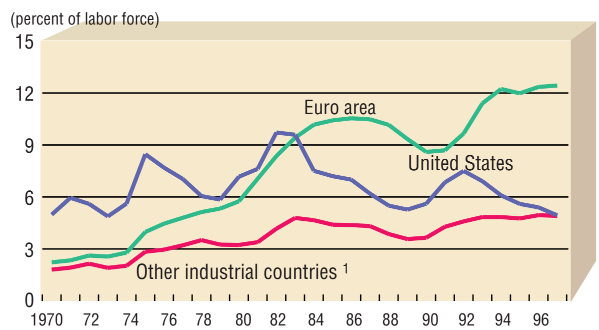
To ensure the long-term success of EMU, structural policies will need to effect a sea change in the performance of European labor markets. Structural reform is imperative not only because of the economic waste and social costs associated with high unemployment but also for a number of other reasons. Without the possibility of recourse to the exchange rate instrument, flexible markets will become even more important in enabling countries to adjust to shocks, especially asymmetric ones. The persistence of high unemployment could erode public support for prudent macroeconomic policies, and many may question whether EMU was worth the effort unless it sets the stage for a lasting and marked reduction in euro area unemployment. Moreover, higher employment ratios—along with spending reforms and the reduction of public debt—will be needed to help offset the fiscal impact of aging populations.

It is widely recognized that Europe's structural problems have complex and wide-ranging sources—social benefit systems that often provide inadequate incentives to work, tax systems that distort incentives, excessive labor market regulations, and product market regulations and subsidies that weaken competition. While the required mix of reforms varies from country to country, most euro area countries need to address issues in each of these areas.

EMU members will need to resist pressures for wages and social benefits to converge across the euro area before productivity has converged. To counteract such tendencies, it will be important to address factors that delink wage behavior from local labor market conditions, particularly policies

Chart 2

The unemployment rate has increased more in euro area than in other industrial countries



Source: Organization for Economic Cooperation and Development.
[1] Australia, Canada, Japan, and New Zealand.

and institutions that give power to insiders—for example, rigid employment protection legislation and subsidies or market support for selected enterprises and sectors.

Although progress is being made with structural reform, in most countries it has not been enough to make a noticeable dent in structural unemployment. To speed this process, the EU has introduced labor market surveillance procedures, which provide for the Council of Ministers to issue annual guidelines on employment policies and assess countries' performances in this context. Enhanced EU surveillance provides an opportunity to reinforce the case for reform. It should also aim to ensure that measures such as reductions in the work week are implemented flexibly so as to guard against, among other things, raising employers' labor costs. It will also be critical to maintain the pressure for reform, as there is a danger that the attention paid by national policymakers to the labor market may diminish as cyclical unemployment declines.

Economic policy coordination

Under EMU, monetary policy will be geared to economic conditions in the euro area as a whole, but, in contrast with national monetary areas, primary responsibility for fiscal and structural responsibilities will be decentralized. One of the advantages of this decentralization is that individual countries will be able to adapt fiscal and structural policies to their own specific problems. However, it will complicate the task of achieving the appropriate policy mix at the euro area level, because inadequate national policies, through their implications for the single monetary policy and the exchange rate for the euro, will inevitably have spillover effects on other countries. For example, where fiscal policies in more cyclically advanced countries are exacerbating, or providing an inadequate counterweight to, cyclical divergence, they will tend to push up the average interest rate for the entire euro area, to the detriment of less cyclically advanced euro area countries. More flexible markets are another tool for attenuating cyclical divergences and their adverse effects, especially on the less cyclically advanced countries, limiting the extent to which downward rigidities in wages hamper adjustment.

The differences in cyclical positions in the euro area on the eve of EMU are significant, with countries falling into two groups, although with considerable variation within each group. For the group of more cyclically advanced countries—Austria, Finland, Ireland, Luxembourg, the Netherlands, Portugal, and Spain—which account for about one-fourth of euro area GDP, the output gap in 1998 is estimated to be negligible, while the average gap for the less cyclically advanced economies—Belgium, France, Germany, and Italy—is estimated at 2 percent. In a number of the cyclically advanced countries, fiscal policy is not playing a strong enough role in restraining demand, while in most euro area countries, structural policies are not yet adequate to temper divergences. Fortunately, the more cyclically advanced countries have only a moderate weight in the euro area economy and differences in cyclical positions among the three largest euro area countries currently are not large. Nevertheless, the current situation underlines the potential for cyclical divergences, if not properly handled, to cause strains that would affect the economic performance of the entire area.

In a resolution adopted in December 1997, the European Council (the name given to the regular summit meetings of EU heads of state or government) emphasized the need for enhanced policy coordination. It envisaged that economic policy coordination would be effected through the various surveillance instruments provided for in the Maastricht Treaty. In particular, the European Council called for the EU's annual broad economic policy guidelines to be developed into an effective instrument for ensuring sustained convergence. The guidelines should be more concrete and country-specific than in the past and should give more attention to structural issues. The European Council also emphasized the importance of early warnings of fiscal policy concerns under the SGP. In addition, it was agreed that ministers of the euro area countries can meet as the Euro-11 group to discuss issues related to the single currency; however, EU surveillance decisions will be taken by the full Council of Ministers, in whose deliberations all 15 EU members participate. F&D

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