Jürgen Stark: Does the euro area need an economic government?

Statement by Mr Jürgen Stark, Member of the Executive Board of the European Central Bank, at the HEC European Executive Campus, Brussels, 22 January 2008.

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I am delighted to be here today to participate in this session on economic policies and governance. The topic of our panel discussion is very well chosen: "Does the euro area need an economic government?" This is indeed an important and highly topical issue.

The advocates of an economic government for the euro area argue that such an institution is needed in order to

1. improve the coordination of national economic policies in the euro area; and
2. establish a dialogue with the ECB in order to discuss the monetary strategy for the euro area.

I will give you my conclusions straight away: I do not agree with these claims. We do not need an economic government for the euro area to improve the coordination of national economic policies. Effective and efficient coordination can be achieved within the current institutional framework if all policy makers respect its provisions and use the existing procedures and instruments more responsibly. Indeed, the idea of establishing a political entity in order to institutionalise a dialogue with the ECB with a view to influencing monetary policy in the euro area represents a fundamental attack on the euro area's monetary policy framework, which has proved very successful over the last nine years.

The institutional framework of EMU is based on clearly specified objectives, a clear allocation of responsibilities to different policy areas and a sound framework for the coordination of national economic policies.

The economic objectives of the Community, which are listed as "tasks" in Article 2 of the Treaty establishing the European Community include "harmonious, balanced and sustainable development of economic activities, a high level of employment […], sustainable and non-inflationary growth, a high degree of competitiveness and convergence of economic performance". The Treaty of Lisbon transformed these tasks into "objectives" and reworded them but made no substantive changes. One noteworthy, welcome, amendment is the addition of price stability to the list of objectives, which further strengthens the focus on stability of the EU's policy framework.

In order to achieve these objectives, the Maastricht Treaty established a clear allocation of responsibilities, reflecting the fact that assigning policy instruments primarily to one single policy objective and making individual policy-makers responsible for one single policy instrument ensures a high level of effectiveness and accountability.

The single monetary policy was given the task of maintaining price stability in the euro area and was assigned to the ECB as an independent, supranational institution. Economic policy deals with the other economic objectives. Responsibility for the various areas of economic policy has largely remained with the Member States, since these policies are best carried out at the national level in order to ensure that they are appropriately tailored to the specific characteristics and needs of the individual countries.

More specifically:

- structural policies in the Member States are supposed to seek to create flexible and efficient structures in product and labour markets with a view to fostering the growth potential of euro area economies and improving the adjustment mechanisms in EMU;

- fiscal policies are supposed to seek to ensure the sustainability of public finances, effectively limiting government deficits and indebtedness, thereby also ensuring that automatic fiscal stabilisers work effectively as an adjustment mechanism in the currency union; and
- wage policies should be compatible with trend developments in productivity in order to foster employment and should take into account the overriding importance of wage flexibility as an equilibrating adjustment mechanism in EMU.

While responsibility for economic policies lies with the Member States, the Treaty requires that such policies be conducted with a view to contributing to the achievement of the aforementioned objectives and in compliance with the principles of "stable prices, sound public finances" and "an open market with free competition". Furthermore, Article 99 of the Treaty explicitly requires that Member States "regard their economic policies as a matter of common concern" and "coordinate them within the Council", reflecting the need for close coordination given the ever closer economic links between the Member States as a result of EMU.

The Treaty's general requirement that economic policies be coordinated is substantiated by a number of specific coordination provisions, such as:

- a framework for avoiding excessive government deficits in the form of the Stability and Growth Pact; and
- a framework for fostering sound structural policies in labour, product and services markets in the form of the Broad Economic Policy Guidelines, the Employment Guidelines and the Lisbon Strategy.

In this context, the Eurogroup, an informal body bringing together the finance ministers of the euro area countries, the Commissioner for Economic and Monetary Affairs and the ECB President, plays an important role by establishing an informal forum for open discussions on all issues relevant to the euro area. The Lisbon Treaty recognises the informal role of the Eurogroup with a view to fostering "ever-closer coordination of economic policies within the euro area" in a new protocol.

Thus, there is a comprehensive governance framework for the euro area establishing a clear allocation of responsibilities, as well as a framework for effective policy coordination. And yet, the advocates of an economic government argue that there are deficiencies in this framework, resulting in inferior economic outcomes, and that these could be remedied by an economic government.

There is no doubt, however, that an immediate consequence of the creation of an economic government seeking close coordination with the ECB would be the blurring of responsibilities. An institution or policy area can be responsible only for a task for which it has the right instrument available. A blurring of responsibilities would lead to every institution being made responsible for everything, which in the end would mean that, amid confusion, no institution was responsible for anything.

The performance of the euro area's policy framework has, in fact, been mixed. On the one hand, the first nine years of EMU have been characterised by low and stable inflation and firmly anchored inflation expectations, vindicating the monetary policy framework laid down in the Maastricht Treaty and bearing witness to the successful monetary policy of the ECB within this framework.

On the other hand, economic policies over the last nine years have not delivered the expected results. With regard to structural policies, the recent cyclical upswing should not

distract us from the fact that unemployment in the euro area is still unacceptably high[1] and trend productivity growth has slowed to a very low level[2]. Some countries have made progress with structural reforms over the past few years, but overall the achievements fall short of expectations. This is also reflected in the mid-term review of the Lisbon Strategy. The European Council re-launched the Lisbon process in 2005, refocusing it on growth and employment. However, this does not, thus far, appear to have given significant fresh impetus to reform efforts in the Member States. On the contrary, reform efforts in many countries have stalled and we are even seeing increases in economic patriotism and protectionist tendencies, which are preventing the goals of the Lisbon Strategy from being achieved, and may potentially threaten the common internal market.

With regard to fiscal policies, in the wake of the cyclical downturn observed between 2001 and 2004, some Member States experienced significant deterioration in their fiscal positions and were, accordingly, subject to the excessive deficit procedure laid down in the Treaty and set out in greater detail in the Stability and Growth Pact. However, rather than complying with the excessive deficit procedure and adjusting their budgetary policies accordingly, policy-makers started heavily criticising the Pact, arguing that it was inflexible and set the wrong incentives. In the end, it was the rules – and not the policies – that were adjusted. In March 2005 the Council agreed on a reform of the Pact. Changes to its corrective arm, which seeks to deter countries from running excessive deficits and ensure their prompt correction, have considerably weakened the EU's fiscal framework by placing greater emphasis on flexibility and discretion. The improvement seen in Member States' fiscal positions since the new Pact was adopted is attributable largely to the recent cyclical upswing, while progress with structural consolidation in countries with budgetary imbalances has generally been disappointing. This lack of ambition as regards fiscal consolidation, which is not consistent with the provisions of the revised Stability and Growth Pact and falls short of the political commitments made, could potentially undermine the credibility of the new Pact. The real test of the new Pact's credibility is still to come, but the indications, particularly from some large Member States, are not very encouraging in this regard.

In addition, also wage policies have often not taken sufficient account of the requirements of the new environment – the fact of having a single currency. In some countries, wage growth has considerably outpaced productivity growth, leading to considerable increases in unit labour costs. Such developments have, in turn, led to significant deteriorations in the cost and price competitiveness in these countries, which will require some sort of re-equilibrating wage adjustments in the future.

A quick glance at the facts thus reveals that there is a need for better coordination of national economic polices in the euro area. But it would be a mistake to infer from this that there is a need for some kind of economic government for the euro area. The economic policy provisions of the Treaty and the EU's framework for economic policy coordination do, in principle, ensure the sound conduct and coordination of economic policies, promoting economic prosperity in the countries of the euro area. The reasons for the lacklustre performance of many euro area countries' economic policies are rooted not in deficiencies in the current institutional framework, but rather in some national governments' lack of willingness to adhere to the rules of that framework. As national governments obviously lack the political will to coordinate their economic policies and adhere to the rules of EMU, could an economic government make a difference? This would potentially involve the transfer to a European institution of national sovereignty regarding economic policy issues and would

[1] In November 2007 the euro area unemployment rate as a percentage of the labour force was 7.2% (seasonally adjusted).

[2] According to Eurostat figures, the average annual growth rate of labour productivity (real GDP per person employed) was a mere 0.8% since the start of EMU. In the third quarter 2007 this growth rate stood at 0.75% (seasonally adjusted).

require a willingness to subordinate perceived national economic interests to the economic interests of the euro area as a whole. But would those politicians who so eloquently call for an economic government be willing to accept real decisions by such an institution that ran counter to the perceived national interests of their country in order to ensure the smooth functioning of EMU? I very much doubt it. In fact, there seems, instead, to be a risk of an economic government at the euro area level potentially being used as a scapegoat for unsuccessful policies at the national level, which would thus even undermine incentives for sound policy and effective policy coordination.

In the light of these considerations, it would seem that the main reason for the recent calls for an economic government is probably something else, namely a desire to establish political influence on monetary policy in the euro area and thereby to undermine the independence of the ECB. Let me make it clear that this suspicion is unfortunately not a product of the imagination of an overly cautious central banker. It is an immediate consequence of the idea of an economic government establishing a dialogue with the ECB in order to influence monetary policy in the euro area. Article 108 of the Treaty explicitly states that "[t]he Community institutions and bodies and the governments of the Member States undertake […] not to seek to influence the members of the decision-making bodies of the ECB or of the national central banks in the performance of their tasks".

The ECB certainly does communicate with political authorities on a regular basis. In particular, there is regular interaction between the ECB and the national finance ministers. The President of the ECB attends the monthly Eurogroup meetings, and the President of the Eurogroup is invited to attend the meetings of the ECB's Governing Council. This interaction is, however, aimed solely at ensuring a regular exchange of information and views, and does not, therefore, conflict with the independence of the ECB.

The institutional independence of the ECB is a key element of the euro area's governance framework, as it ensures that price stability is effectively achieved and maintained. A necessary condition for the achievement and maintenance of price stability is a credible commitment to ultimately pursuing a price stability-oriented monetary policy. It is universally accepted, on the basis of a vast amount of theoretical and empirical literature, as well as historical experience, that the best means of having monetary policy credibly committed to the pursuit of price stability is to have an independent central bank. It is therefore crucial that the different dimensions of the ECB's independence are fully respected, namely institutional, personal, financial, functional and goal independence.

In this context, it is important to stress the benefits of price stability for economic prosperity and to emphasise the fallacious nature of the view, heard occasionally, that an overriding focus on price stability means that the needs of the real economy are neglected.

The relationship between inflation and economic performance in the long run has been studied extensively. As I have recently argued, one could say that the long-run Phillips curve, describing the long-run relationship between inflation and economic activity, has virtually been rotating in the minds of macroeconomists and policy-makers over the last few decades. Around 35 years ago it was positively sloped, suggesting that a little more inflation would have the permanent effect of giving rise to a little more real income. The experience of the stagflation of the 1970s and the rational expectations revolution in macroeconomic theory led to attention being focused once again on a long forgotten principle, namely the concept of the long-run neutrality of money, the insight that monetary policy measures will, in the long run, influence only the level of prices, leaving growth and employment levels unchanged. Any attempt by central banks to systematically stimulate output and employment is ultimately doomed to failure, the only certain outcome being inflation. The perceived trade-off between inflation and growth will, sooner or later, reveal its true nature. Although it is tempting to believe that such a trade-off exists, it is in fact a mirage.

New empirical evidence and new insights in monetary theory have shown that even moderate levels of inflation have considerable negative repercussions for long-term

economic performance, and maintaining price stability is therefore the best contribution that monetary policy can make to economic welfare, growth and employment. By maintaining price stability, monetary policy fosters economic prosperity by eliminating distortions arising from high and volatile inflation. In particular, contrary to the view, heard occasionally, that a monetary policy that seeks to safeguard price stability will result in excessively high real interest rates, a price stability-oriented monetary policy will actually lead to lower real interest rates by reducing inflation risk premia, thereby promoting growth and employment.

By credibly pursuing price stability, monetary policy also directly contributes to the stabilisation of short-term fluctuations in output and employment. In a monetary policy regime with a clear focus on price stability, inflation expectations are firmly anchored such that increases in inflation are not expected to be long-lasting. As a result, adverse supply shocks, such as an increase in oil prices, have less effect on inflation and unemployment and, at the same time, monetary policy has more leeway to accommodate such shocks.

In this context, it is important to note that the ECB pursues its price stability mandate on the basis of a monetary policy strategy with a strong forward-looking element. The ECB's strategy comprises a definition of price stability as an annual increase in the HICP of below but close to 2% over the medium term and a broad-based analysis of the risks to price stability in the context of our two-pillar framework. Our definition of price stability implies that we do not attempt to fine-tune the inflation rate at very short horizons, but aim at keeping inflation below but close to 2% over the medium term. This medium-term orientation of our strategy has given us the flexibility to respond firmly, and yet with a forward-looking approach, to the series of adverse economic disturbances that have hit the euro area over the last nine years. The firm focus on price stability has ensured that expectations have remained stable even in the face of protracted inflationary shocks, while the forward-looking approach has made it possible to achieve this objective without unnecessary fluctuations in real activity.

And yet, despite the fact that our monetary policy strategy evidently works very well, revisions to our strategy are advocated from time to time. For example, it is sometimes proposed that we should abandon our two-pillar framework for the analysis of risks to price stability and instead adopt a full inflation targeting approach. Another proposal that is sometimes made is that we should have our inflation goal or a new inflation target endorsed by the Eurogroup. I disapprove of these proposals. First, having our inflation goal endorsed by the Eurogroup would require the ECB and the Eurogroup to reach a consensus in this regard, which would not be compatible with our independence in the pursuit of our mandate to maintain price stability. Second, the proposal to switch to a full inflation targeting framework disregards what are by now the well-known short-comings of this approach. Inflation targeting is a policy framework that aims at keeping inflation at a clearly specified target level over a clearly specified time frame, usually up to two years. Thus, inflation targeting represents a narrow framework focusing on the risks to price stability only at relatively short horizons, but largely ignoring potential longer-term risks to price stability. Our two-pillar framework, with the important role played by monetary analysis, helps us to take account also of these longer-term risks emanating from the well-documented close link between monetary developments and trend inflation. In particular, the close link discovered more recently between monetary developments and evolving imbalances in asset and credit markets means that our broad-based monetary analysis enables us to detect these imbalances at an early stage and to respond to the implied risks to financial, economic and price stability in a timely, forward-looking, manner.

A monetary policy geared to the maintenance of price stability is also conducive to external stability, helping to reduce exchange rate volatility and preserve confidence in the currency. And yet, growing concerns about the cost and price competitiveness of national economies in the wake of the recent appreciation of the euro have, in some euro area countries, led to the virtual rediscovery of the exchange rate as a policy instrument. Not surprisingly,

therefore, exchange rate policy is also one of the key aspects of the current debate about the pros and cons of an economic government.

The governance framework of the euro area as regards exchange rate policy is specified in Article 111 of the Treaty. The Treaty authorises the Council to conclude formal agreements on an exchange rate system for the euro and to formulate general orientations for exchange rate policy – after consulting the ECB in order to ensure that any decision is consistent with monetary policy's overriding objective of price stability.

Thus far, and with good reason, neither of these procedures has been implemented. During the preparations for EMU it was decided that the euro would be a freely floating currency and I do not see any convincing arguments in support of a departure from this principle.

However, my scepticism with regard to the implementation of an active exchange rate policy in the euro area does not mean that developments in the exchange rate of the euro are neglected in the ECB's deliberations on monetary policy. On the contrary, we at the ECB are well aware of the role played by the exchange rate as a source of external shocks in the euro area and as an important link in the monetary transmission mechanism. Movements in the euro's exchange rate are duly taken into account in the ECB's economic analysis of the short to medium-term risks to price stability. There is therefore no reason to be concerned that the ECB is neglecting the implications of exchange rate developments for the euro area economy.

In this context, there are, however, a couple of issues that need to be borne in mind. It is important to note that, with the introduction of the single currency, the importance of the exchange rate for the cost and price competitiveness of an individual euro area country has declined significantly. Nowadays, more than 50% of the euro area countries' external trade is with other euro area trading partners and is therefore not affected by exchange rate developments. Changes in the euro's exchange rate therefore have a much smaller effect on a country's competitiveness than changes in the exchange rate of that country's former national currency prior to the adoption of the single currency.

Furthermore, people often overlook the fact that a strong currency also has beneficial effects. It reduces the price of imported consumer goods, thereby boosting the purchasing power of consumers. A strong euro also lowers the price of imported production inputs, such as crude oil, which are denominated in US dollars in the world market and may, therefore, even have a favourable impact on the price competitiveness of the euro area economies.

Does the euro area need an economic government? I have argued that it does not. The institutional framework established by the Maastricht Treaty provides for effective and efficient monetary and economic governance for the euro area. If all decision-makers act in accordance with their mandates, this will implicitly give rise to a policy mix that is beneficial to growth, employment and prosperity.