Mr Remsperger evaluates the role of monetary policy in a macro policy mix

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Broadly defined topics have both advantages and drawbacks. On the one hand, they mean that the speaker has greater room for manoeuvre. On the other hand, he is then spoilt for choice between the different aspects of his topic. In order to minimise the complexity of my topic, I should like to focus on the policy mix in the euro area. In addition, the main thrust of my remarks is to be directed towards discussion of the role of monetary policy.

In the euro area, monetary policy is centralised, but the other fields of economic policy are not. They remain national responsibilities. Hence the topic "The policy mix in European monetary union" has two fundamental dimensions. In the first dimension, attention is focused on one policy area in each of the EMU member states. In the second dimension, attention is concentrated on the mutual relationships of the individual policy areas, i.e. on the "assignment of responsibilities". The two dimensions are frequently combined under the heading of "coordination". Then, however, a distinction should be drawn between coordination across countries for any given policy area and coordination across policies.

I have no wish to bore you with a flood of definitions. Even so, I think it makes sense to distinguish between explicit and implicit coordination.[1] Any form of commitment to undertake joint decisions by separate actors should be called explicit coordination. If this coordination moves in the direction of a single policy decided by a single institution, coordination becomes relatively strong. But there are also less ambitious forms of explicit coordination. One form of coordination consists in the setting of joint rules by which the decision-making bodies have to abide. A rather looser form of coordination occurs when the decision-makers exchange information in a kind of dialogue. Such a dialogue can, after all, also result in "coordinated" decisions.

"Implicit coordination" relates to the assignment of the individual policy areas. If the objectives and instruments are each clearly assigned to the individual policy areas, the overall outcome of the policy mix is implicitly coordinated as well.

My proposition is that, under the terms of the Treaty of Maastricht, the policy mix in European monetary union amounts at bottom to the model of implicit coordination, and thus to a division of labour in the field of economic policy. This gives rise to a number of questions of principle. I should like to address two of them in more detail today, namely, first: is such implicit coordination, and especially the monetary policy assignment, justified? And second, does implicit coordination at European level necessitate a cross-border coordination of fiscal and wage policy?

The role of monetary policy

Let me begin with the assignment for monetary policy. The Treaty of Maastricht sets a clear objective for the European System of Central Banks (ESCB): "the primary objective of the ESCB shall be to maintain price stability" (Article 105.1). As part of its "stability-oriented monetary policy strategy", the Eurosystem has defined price stability as a "rise in the Harmonised Consumer Price Index (HCPI) of less than 2%". In this context "price stability must be maintained over the medium term".[2] At the same time, the Maastricht Treaty provides that monetary policy "shall support the general economic policies in the Community" as far as is possible "without prejudice to the objective of price stability".

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1 See Artis and Winkler (1998).

2 Europäische Zentralbank (1999, p. 51).

Alongside the specification of the objective of price stability, the formulation and announcement of the stability-oriented monetary policy strategy of the Eurosystem constitute a further key element of implicit coordination. In strategic terms, though not in tactical terms, monetary policy is calculable. The other economic policy makers know that the ECB's policy is geared to two pillars: in the first place, to the reference value for the money supply and, secondly, to the broadly based assessment of the prospects for future price developments. The second pillar takes due account not only of the money stock but also of other indicators. In this context, I would like to emphasise that the euro exchange rate is one of the indicators for the inflation outlook of the ECB.

The inclusion of the strategic response function of the central bank may contribute to a stance of fiscal and wage policy that is consistent with stability. Implicit coordination is bolstered by an intensive exchange of information between the ECB, the European Council and the European Commission (Article 109b of the Treaty).[3] Moreover, the ECB is required to draw up an Annual Report every year and to present and explain it to different European bodies. In addition, there are numerous other channels through which information can be disseminated by the Eurosystem, not least the press conferences held by the ECB President. Altogether, the exchange of information not only ensures that the actors in other economic policy areas can assess monetary policy more effectively, but the Eurosystem likewise obtains information on planned activities in other policy areas.

The assignment for European monetary policy has repeatedly been criticised in the past. However, the critics have not all adopted the same position. Whereas some critics have objected that European monetary policy is acting too much in the tradition of the allegedly overly stability-oriented Bundesbank, others have deplored a supposedly too pronounced orientation towards short-term business activity. Only a short time after the launch of monetary union, there was talk of a "paradigm change" compared with the earlier Bundesbank policies.

I would like to address the critics calling for a stronger orientation of monetary policy towards business activity. Three lines of argument are discernible here:

A first group of advocates of a monetary policy geared to business activity regards the risks to the prevailing price stability as being negligible. That group would now like to make monetary policy responsible for fostering growth and employment as well.

A second group of critics is arguing on the basis of economic shocks. Monetary policy should respond to demand shocks. They believe that the objective of price stability should be met by the central bank only in the medium or long term.[4] The currently discernible weakness of economic activity in the euro area serves the advocates of this approach as evidence of the existence of such a demand shock. In their view, it makes an expansionary monetary policy response imperative.

A third group, finally, prefers quite a different assignment for monetary policy. While price stability should be reached primarily by means of a productivity-oriented wage policy, monetary policy should actively encourage growth and employment. Hence this approach reflects the strongest form of orientation towards economic activity.[5] Unlike the first two approaches mentioned, it postulates not so much a temporary as a permanent responsibility of monetary policy for business-cycle policy.

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[3] Article 105.4 of the Maastricht Treaty explicitly provides for a right of the ECB to be consulted on all acts within its field of competence.

[4] By stressing the long-term orientation of the objective, Fischer (1996, pp. 28 and 29), for instance, sees scope for pursuing a short-term, anticyclical monetary policy: "Long-run price stability should be the primary goal of the central bank ..." And "... emphasising the long-run ... allows ... a little leeway for short-term countercyclical policy." Bofinger (1999, p. 7 ff.) likewise emphasises the active role of monetary policy in the event of demand shocks.

[5] The approach is based mainly on work by Flassbeck (see, for instance, Flassbeck (1998, p. 278 ff.); Flassbeck et al. (1992, p. 222 ff.); and Flassbeck and Spiecker (1998, p. 52 ff.)).

To evaluate these alternative assignments for monetary policy, one might initially try to devise a welfare-theory approach. The best assignment would distinguish itself by maximising social welfare. However, since such an abstract concept cannot help very much in the practical debate, one might ask, instead, to what extent monetary policy makers are actually able to perform the role to which they have been assigned. At the same time, it is essential for monetary policy makers to have an incentive for playing their role as envisaged (the criterion of incentive compatibility). Thus, it is a question both of the "ability" and of the "volition" of those responsible for monetary policy decisions.

The decision-makers are being confronted in European monetary policy with two problem complexes. Besides the problems which beset monetary policy quite generally, there are, in addition, some problems which are due specifically to European monetary union. The advent of a completely new monetary regime necessarily increases insecurity. Furthermore, the monetary policy makers are obliged to operate in a monetary area which is very far from homogeneous.

I am convinced that it would overburden monetary policy if responsibility for business-cycle policy and employment policy were assigned to it as well. It is, for instance, to be doubted whether monetary policy is able lastingly to raise employment. Not only monetarists refer in this context to the "natural rate of unemployment", i.e. the unemployment rate that reflects the structural characteristics of the goods and labour markets.[6] In the long run, unemployment tends towards that rate. It cannot be reduced durably by "flashes in the pan" kindled by monetary policy. Besides, there would then be a risk of accelerating inflation rates.

It is of course difficult to quantify the "natural rate of unemployment". But there is a general consensus that a large part of the unemployment currently prevailing in Europe is structural in origin.[7] Overall, the scope for monetary policy to exercise an impact on unemployment is therefore very limited. To reduce unemployment, primarily structural policy decisions by the individual member states of the monetary union are needed. They will have to ensure, not least, that their labour markets become more flexible.

Another argument against active business-cycle management by monetary policy is the long and variable time-lags involved. They prevent any fine-tuning of real business activity by means of monetary policy. On the other hand, monetary policy does have appropriate instruments for influencing price movements over the medium or long term. One of the few facts which are uncontested among economists is the perception that inflation is a monetary phenomenon.

Monetary policy affects prices by no means only through the money stock and aggregate demand but also via the expectations of economic agents. A major advantage of a monetary policy credibly committed to the objective of price stability, over an active monetary policy, is that the central bank can take advantage of that transmission channel relatively easily. If monetary policy embodies the stability objective credibly, it simultaneously fosters wage settlements that are in line with stability. In this way, it creates a good basis for its own success.

In my view, it would be a grave error if the central bank were to be made responsible for employment policy as part of a schematic two-tier approach: first the attainment of price stability, then an orientation towards employment. For one thing, that disregards the economic management problems deriving from the time-lags involved in monetary policy. For another, it would stand seriously in the way of the accumulation of a reputation by the central bank.

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6 See Friedman (1968, p. 8).

7 See e.g. OECD (1998, p. 172 ff.) or IMF (1997, p. 39 ff.). For Germany, see e.g. Sachverständigenrat (Council of Economic Experts) (1998, para. 422 ff.) and Dohse et al. (1998, p. 109 ff.). Regarding the Phillips curve trade-off, Weber (1994, p. 91 ff.) comes to the conclusion for the G-7 countries (other than Italy) that they all exhibit long-term vertical Phillips curves.

Thus, a large part of the recent theoretical debate on the problem of the time inconsistency of monetary policy is based on the initial hypothesis that the central bank should pursue a (particularly ambitious) output or employment objective in addition to the goal of price stability. Without such an orientation towards two objectives, the credibility problem is less serious. It must therefore be in the best interests of a stability-oriented central bank not to have excessive demands made on it. The orientation towards the objective of price stability meets with widespread approval, particularly among representatives of central banks. Price stability does a great deal to help monetary policy makers to gain a high reputation.[8] An economic policy strategy that disregards this incentive pattern and, instead, commits monetary policy to rapidly effective employment successes is likely to give rise to substantial problems. In order to ensure that short-termism does not spread to monetary policy, the Treaty of Maastricht provides for the independence of the European Central Bank and of all national central banks. This crucial institutional regulation ensures a continuous monetary policy, geared to the objective of price stability.[9]

Yet the commitment to price stability and the independence of the European Central Bank do not imply that the Eurosystem’s monetary policy is wholly irrelevant to business activity. A medium-term-oriented monetary policy, such as has been pursued by the Bundesbank in the past, and has been incorporated, in the form of a reference value for monetary growth, in the “two-pillar strategy” of the Eurosystem, is also apt to smooth out economic activity. As part of a monetary strategy designed to achieve continuity, interest rate movements “breathe” in line with business activity; in a sense, they thus act as a “built-in stabiliser”.

Central bankers may feel gratified about an increase in employment, especially if it is the fruit of a consistent stabilisation policy. In the process, however, they must not forget the limits set to the potential impact of monetary policy. This is why Mervyn King, alluding to a phrase coined by Alan Blinder, has written that central bankers “need soft hearts and hard heads”.[10]

Now that I have drawn attention to the general problems associated with economic management by means of monetary policy, I should like to address the specific difficulties posed by the environment of monetary union.[11] In particular, those uncertainties are to be considered which are connected with the transition to Stage Three of monetary union. The change of regime may engender severe alterations in the behaviour of economic agents in the participating states. That applies not only to the financial sector, in which monetary union has its most immediate impact, but also to the other sectors of the economy.

It is to be expected that competition will intensify on the goods and factor markets upon the disappearance of the currency barriers in the euro area. Consumers and investors may well behave differently. For instance, foreign trade between the participating states might increase. Or goods are bought which have cheapened owing to the stronger competition. Overall, it can be assumed that the patterns familiar from the past will change. A monetary policy that, in an aggressively active economic management, relied on the old patterns might well enhance, rather than mitigate, the cyclical fluctuations.

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8 Fischer (1996, p. 23 ff.) draws attention to opinion polls according to which the citizens of most European countries, at least in the early mid-nineties, still felt inflation to be a major problem. Correspondingly, fighting inflation contributes to the accumulation of a reputation.

9 It is in this sense that Alesina and Gatti (1995, p. 198 ff.) understand the justification of central bank independence. In their view, it is only such independence that can effectively prevent monetary policy from being the cause of politically induced business cycles.

10 King (1999, p. 93).

11 On the difficulties at the start of Stage Three, see e.g. Europäische Zentralbank (1999, p. 49 f.).

The uncertainty surrounding the effects of the single European monetary policy on the real economy will actually be increased by possible differences in member states' national transmission mechanisms. It cannot, however, be said with sufficient certainty how significant these differences are for practical monetary policy. Although the divergent financing patterns, wage-bargaining systems and labour and goods-market regulations in the member states provide grounds for supposing that a single central bank rate will have differing effects,[12] on closer inspection it transpires that the direction and scale of the deviations between the individual countries depend, among other things, on the concrete method of empirical analysis used.[13]

Moreover, it cannot be conclusively inferred from the differences that they are statistically significant. If the criterion of statistical significance is taken into account, the differences ascertained may be modified.[14] The extent to which the existing differences will diminish in the near future is likewise disputed. On the one hand, a higher degree of specialisation and diversification is expected in the euro area on account of the ongoing economic integration. That would tend to result in more fanning-out of the structures. On the other hand, a greater convergence of economic structures is expected owing to the single monetary policy and the increased harmonisation of the other economic policies.[15] Altogether, however, the uncertainties surrounding both the national effects of the Eurosystem's monetary policy measures and the persistence of such differences stand in the way of an aggressively active monetary policy, especially one oriented towards the short term.

However, it is now being claimed that not only the monetary policy of the Bundesbank but also the policy of the European Central Bank could be explained more effectively by the "Taylor rule" than by any medium-term-oriented monetary strategy. I do not share that view. The monetary policy strategy of the Eurosystem is based just as little on the Taylor interest rate as was the former strategy of the Bundesbank.

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12 Regarding this supposition, see e.g. Hughes Hallett et al. (1999, p. 6 f.). The historical differences in financing patterns are described, for instance, by Borio (1995, p. 77). For example, in Germany, France and the Netherlands in 1993 over 80% of the credit was extended at medium to long term. In Italy, by contrast, 51% of the credit was extended at short term.

13 In the literature, differences in national transmission mechanisms are analysed as part of major macroeconomic models (especially those of central banks), structural VAR models and small macroeconomic models that can be reduced to a central estimating equation. Regarding the macroeconomic models of the various central banks, see e.g. BIS (1995). Hughes Hallett et al. (1999) and Hughes Hallett and Piscitelli (1999) use, as an alternative, specific multi-country models. Structural VAR models are used by Gerlach and Smets (1995), Ramaswamy and Sloek (1997), Ehrmann (1998) and Holstein (1999). Simple "single-equation systems" are used by Dornbusch et al. (1998), Brookes and Massone (1998) and Britton and Whitley (1997). For a survey of the literature, see Kieler and Saarenheimo (1998) or Baumgartner and Url (1999).

14 This is the conclusion reached by Kieler and Saarenheimo (1998, p. 23 ff.) for Germany, France and the UK. The International Monetary Fund (1997, p. 55 f.) arrives at the following assessment: "The evidence indicates that there have been differences in the response of activity to monetary policy across the EU countries, but they are not so significant as to suggest that substantial problems would arise in the operation of a common monetary policy."

15 While Hughes Hallett et al. (1999, p. 6 ff.) postulate strongly diverging structures on the basis of the theorem of "comparative advantages", Frankel and Rose (1998, p. 1009 ff.) advocate the opposite view. And that seems understandable, particularly with regard to the differences in financing patterns. For instance, in the course of the decline in inflation in Italy, the above-mentioned 51% share of short-term credit has probably decreased in the past few years. As the single monetary policy also applies to Italy, an even greater harmonisation of financing patterns is to be expected in the future. In proportion as the pressure in monetary union to effect consistent structural reforms in the member states increases, wage bargaining and market flexibilities may also converge as additional causes of the differing transmission of monetary policy stimuli.

The Taylor rule makes the short-term interest rate dependent on current inflationary and cyclical developments. Orientation to the Taylor interest rate would have implied greater interest rate movements than the Bundesbank actually allowed on the basis of its concept.

Only in the longer term are the behaviour of the day-to-day money market rate and the behaviour of the Taylor interest rate quite similar. At first glance, this largely parallel movement appears to be very surprising since the output gap did not play an explicit role in Bundesbank policy. It is less surprising, however, if the similarities between the Taylor rule and monetary targeting are taken into consideration. The potential-oriented monetary targeting policy, too, has an automatic anticyclical component. Furthermore, monetary targeting likewise reacts to deviations of the inflation rate from "normative inflation".

In the Eurosystem, consideration is given to the fact that the monetary policy environment cannot be characterised solely by current price movements and the output gap. Instead, the broadly defined money supply, as well as a number of other monetary, financial and real economic indicators, contain information on the future trend in inflation. Ignoring these would not be appropriate for a central bank oriented towards the objective of price stability.

Hitherto, I have tried to make clear that the concentration of monetary policy in the monetary union on the objective of price stability is appropriate. That objective is to be attained by a central decision-making body, the ECB Governing Council. No problem of coordinating independent national monetary policies arises in the European monetary union.

Instead of a close interlocking of various policy areas, the Maastricht Treaty envisages an unequivocal goal for monetary policy, in the shape of price stability. In the sense of "implicit coordination" in the policy mix it is likewise desirable to assign clear fields of responsibility to fiscal and wage policy as well. The main tasks of fiscal policy lie primarily in the provision of services which cannot be supplied at all, or adequately, via the market, and in the adjustment of the income distribution resulting from the market process.[16] Correspondingly, the key responsibility for employment should be assigned to wage policy. This (neo-classical) assignment is consistent with the practical possibilities of the various policy areas at the national and European level, and also takes due account of the incentive patterns of decision-makers. At the same time, it must be borne in mind that the Treaty of Maastricht envisages the cross-border coordination of economic policy. The Treaty states that the member states are to regard their economic policies as a matter of common concern.[17] But the single European monetary policy remains unaffected by this coordination precept.

The object of such economic policy coordination is the monitoring of economic developments and economic policies in the member states. That includes, besides the surveillance of budget policies, especially the observation of structural policy measures in the goods, services and labour markets, of cost and price movements, and the promotion of tax reforms.

If one enquires rather more carefully into the relationship between the single monetary policy and the other policy areas in European monetary union, it must be said, to begin with, that politicians are prohibited from issuing instructions to the ECB and the national central banks. Similarly, the ECB and national central banks are prohibited from requesting instructions from politicians. Thus, according to the Maastricht Treaty "coordination from above" is not permissible in the Eurosystem.

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[16] See Sachverständigenrat (Council of Economic Experts) (1974, para. 397).

[17] Article 102a of the Maastricht Treaty provides for the gearing of the economic policies of member states to the objectives of the Community, as defined in Article 2 of the Treaty. In the text of the Amsterdam Treaty, these are "a harmonious, balanced and sustained development of economic activities, a high level of employment and of social protection, the equality of men and women, sustained, non-inflationary growth, a high degree of competitiveness and of convergence of economic performance, the raising of the standard of living and quality of life, and economic and social cohesion and solidarity among member states."

Since the Eurosystem is responsible for ensuring price stability, that responsibility must not be jeopardised by any coordination, no matter of what kind.

Against this background, I should now like to address the second question of principle which I raised at the beginning of this paper: does implicit coordination between monetary, fiscal and wage policy at European level necessitate cross-border coordination in fiscal and wage policy?

The role of fiscal policy

In the recent debate, the necessity for the greater convergence of fiscal policy within the euro area has usually been justified by reference to business-cycle policy. In this context it is argued that the greater likelihood of spill-over effects in the event of purely national stabilisation policies makes convergence essential.[18] The single internal market and the single currency facilitate imports and exports, so that domestically oriented stimuli on the part of individual member states spill over to their respective neighbours.

However, if the focus of fiscal policy action is held to be less in the stabilisation function, but primarily in the allocative and distributional function, stabilisation-policy spill-over effects carry less weight as arguments in favour of coordination. In line with the principle of subsidiarity, which argues in favour of the decentralised provision of the vast bulk of public spending, the balance then swings against marked coordination (and centralisation) in the field of fiscal policy.

Even so, in the sphere of fiscal policy there is one perfect example of cross-border coordination by means of joint rules. The Stability and Growth Pact defines a code of good practices for national budget policies. In this connection, attention should be drawn not only to the fiscally relevant variables of a maximum debt level of 60% of GDP and a deficit limit of 3% of GDP, which became known as the “Maastricht criteria”, but also to the “obligation” to reach a budget position which is almost in balance or even in surplus in the medium term. Meeting this target will enable all member states to cope with normal cyclical fluctuations and to keep the public sector deficit at or below the level of the reference value of 3%.

Although the Stability and Growth Pact can be substantiated by reference to the spill-over effects of national fiscal policies, when the Stability and Growth Pact was drawn up the primary intention was not to concentrate forces in order to perform a joint stabilisation task. The aim was, rather, to protect both the single monetary policy and the fiscal policies of member states of the European Union from the unsound budgetary policies of particular member states. As it could not be taken for granted that the financial markets, as the sole disciplining factor, would ensure fiscal stability, the countries concerned agreed on a minimum standard of fiscal discipline, in the form of the Stability and Growth Pact.[19] To that end, the member states must present medium-term “stability or convergence programmes” once a year. If it transpires after a few months that such a programme is based more on hopes than on realistic assumptions, it comes as no surprise if the markets respond with jitters and disappointment.

The role of wage policy

The starting point of my observations on the role of wage policy in the policy mix of the European monetary union is once again the model of implicit coordination. According to that model, wage

18 For this view, see e.g. Flassbeck (1998a, p. 557), who demands an institutionally based coordination of fiscal policies.

19 Further arguments in favour of the Stability and Growth Pact are spelled out by Eichengreen and Wyplosz (1998, p. 71 ff.). Among other things, they regard the Stability and Growth Pact as the first step towards an (in their eyes desirable) ex ante mutual coordination of national fiscal policies and of fiscal policy with monetary policy (p. 77 f.).

policy is assigned to the objective of employment. The key question is whether such assignment calls for cross-border coordination of wage policy.

Concern about a pan-European wage-cutting race is one argument used in favour of a close interlinking of national wage policies. What is feared in this case is that the level of wages will be used as a factor to create jobs in the domestic market to the detriment of other member states, in the style of “beggar thy neighbour” policies. The upshot of such a “disastrous wage-cutting race” could only be a general process of deflation.[20] To prevent such a development, the parties to pay settlements should be committed to wage rises that are oriented towards the growth of productivity.[21] Wage policy would then be coordinated by means of a “joint rule”, i.e. by orientation towards the growth of productivity.

However, some weighty objections can be raised against these ideas. For instance, orientation towards productivity growth as a guideline for wage policy appears to me to make little sense at times of heavy unemployment. In the first place, it is reasonable to expect that, with the relative cheapening of the production factor labour, substitution processes in favour of higher employment are triggered.[22] Secondly, in the event of heavy unemployment it is essential for wage rises to lag behind the growth of productivity, if only because the statistically recorded average productivity of labour may increase as a result of a reduction in the labour input.

The notion of a distribution of given jobs among all EMU countries – such as ultimately underlies the argument of wage-cutting competition – disregards the supply-side potential improvements in momentum on the labour and goods market. EMU-wide wage restraint aimed at making more output profitable on the cost side need not by any means be a zero-sum game in which one country loses precisely the number of jobs that another gains.[23]

Some authors believe that centralised, corporatist wage-bargaining systems are likely to exert favourable employment effects. Such hopes are based largely on the assumption that, in the context of centralised wage negotiations, the parties to wage settlements will take due account of the effects of wage rises on prices and employment, which, it is thought, is not true in the case of industry-specific wage negotiations, on account of a free-rider attitude in stabilisation and employment policy.[24]

But the institutional regulations affecting the labour market – and thus the structure of the wage-bargaining systems as well – differ considerably between the individual EMU member states. Unlike small, comparatively homogeneous Austria or the Netherlands, which are often cited as examples of a successful corporatist approach, the euro area is a large economic zone of pronounced structural diversity. In addition, it is likely to be particularly difficult to implement a common European policy in those countries in which the responsibility for wage bargaining is highly decentralised, e.g. located at enterprise level. In macroeconomic terms, however, that is not a drawback.

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[20] See Horn et al. (1997, p. 99 ff.) or Horn and Zwiener (1998, p. 551 ff.).

[21] See Horn and Zwiener (1998, p. 554). For concrete nominal wage settlements, the following formula should be used: “nominal wage rise = productivity growth + target inflation rate of the Eurosystem.” That would not only prevent the “disastrous wage-cutting race” but also protect the monetary policy of the Eurosystem from inflationary pressures due to wage policy. That would create employment-policy scope for monetary policy.

[22] At all events, this seems to be the case for Germany (see e.g. Lapp and Lehment (1997, p. 67 ff.) or Rottmann and Ruschinski (1998, p. 10). The fact that wage restraint in Germany was unable to fulfil all the employment-policy expectations pinned on it may owe something to very vigorous job-shedding on account of the unavoidable consolidation of the public sector budgets, the adjustment of the economic structure in the new Länder and the tailing-off of the construction boom.

[23] In the simulation account of Horn and Zwiener (1998, p. 555 ff.), coordinated cuts in nominal wages in all EMU countries exert distinctly favourable employment and growth effects.

[24] See in particular Calmfors and Driffill (1988).

In my opinion, the road to more employment leads less via centralised wage negotiations at European level than via structural changes on the labour markets. Programmes of wide-ranging structural reforms have been elaborated by the OECD, among others.[25] What has been lacking so far is the political will to implement such reforms. Hence the main significance of the European employment pact lies in enhancing the will to implement reforms and to initiate structural changes.

Another factor mitigating against coordination in wage policy is that, owing to monetary union, monetary policy can definitively no longer function as a national “shock absorber”. Moreover, in most member states fiscal policy can likewise perform this function only to a very limited extent at present. Since the budget deficits and/or debt levels in most member states are still pretty high, the relevant provisions of the Stability and Growth Pact curb fiscal policy’s scope. That is another reason why a distinctly higher degree of flexibility on the labour markets is needed. Otherwise, adverse economic shocks will be reflected directly in higher unemployment figures.

Notwithstanding the calls for greater coordination, in actual fact competition between the regions should be used as a coordination mechanism. Issing has formulated this finding as follows: “Precisely *because* monetary policy can no longer respond to national conditions the exact opposite of greater centralisation and harmonisation may be required in other areas. Talk of uniform European wage-setting or of an ambitious social union is going in the wrong direction; different productivity and real economic conditions across the euro area must be taken into account more than ever.”[26]

Concluding remarks

The single European monetary policy is currently being accompanied both by a fiscal policy which has largely remained a national responsibility and by a wage policy which is coordinated, at most, at national level. In my view, however, this policy mix should not be deplored, as there is anyway little to be said for more far-reaching coordination across policies at European level. Any coordination extending beyond implicit coordination would pose two problems:

First, there would be a danger of economic policy engendering destabilisation, rather than economic stability, owing to a one-sided orientation towards a policy of short-term stabilisation of business activity. What I have said about monetary policy showed how difficult a short-term-oriented policy is in the presence of long and variable time-lags. This problem would certainly not be mitigated by going further than the implicit coordination of the various policy areas.

Second, ex ante coordination across policies would also involve the risk of responsibilities becoming blurred and incentive patterns destroyed. Any attempt to orient *all* policy areas towards *all* objectives may well lead to a situation in which ultimately *no* area seriously tries to reach even *one* objective. A strategy of “relying on someone else” may perhaps promise an easier life, and a policy of “drawing attention to the failure of someone else” longer political survival, but without an unequivocal objective, there can ultimately be no clear accountability. This moral hazard problem may not only result in a threat to price stability, but also be counterproductive in terms of employment policy.

The reservations about explicit ex ante coordination in European economic policy do not imply that that policy should entirely forgo any form of coordination. Elements of implicit coordination and macroeconomic dialogue are already evident at European level.

For instance, a certain coordination of the single monetary policy with national fiscal policies occurs under the Stability and Growth Pact. Compliance with the fiscal standards laid down in that Pact relieves the Eurosystem of political pressure to facilitate the financing of massive budget deficits by means of durably low interest rates. In that way, the Stability and Growth Pact helps to ensure that the

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25 See e.g. the job studies of the OECD.

26 Issing (1999, p. 10).

Eurosystem can always exhibit the “staying power” in its stabilisation policy efforts that is required for successful monetary policy.

It is the mandate of monetary policy to maintain price stability in the euro area. This clearly defined objective takes due account of the opportunities presented by, and limits set to, monetary policy. In terms of reputation, this is at the same time in line with the incentives afforded to central bankers. Finally, the clear assignment of functions facilitates accountability.

Fiscal policy should, first and foremost, perform its allocation and distribution function; wage policy should be assigned the primary employment-policy responsibility. Instead of the vague assignment of functions and the blurring of areas of responsibility associated with explicit or ex ante coordination, this clear-cut separation of responsibilities promises effective implicit coordination.

If one wonders, in conclusion, whether there is no room left at all in this approach for the stabilisation of demand, I should like to draw attention, first, to the automatic stabilisation effected by a monetary policy geared to the medium term. Moreover, it is in the best interests of monetary policy if the public budgets, too, exert smoothing effects on business activity. That, however, will not really be possible again until the structural budget deficits have been reduced. Provided fiscal accounts are balanced in normal times, the full endogenous reaction of national fiscal structures to downturns should not be hampered by the Stability and Growth Pact, even during severe recessions. By contrast, starting from deficits of around 2% of GDP – about the euro area’s 1998 average – would imply either systematically stifling the operation of automatic stabilisers in the event of recessions, or moving into excessive deficits with a high probability. At all events, growing structural deficits do not help to smooth the movement of incomes across the various phases of a business cycle.

In recent decades, fiscal structures have become encrusted. They must now be broken open again. There is a need for speed. The adjustment of the deficits is an indispensable element in such structural reforms, which should tackle the expenditure side of public budgets. Delays or dilutions are unacceptable. They will be penalised by the markets. After all, it should not be forgotten that the ratio of public spending to the gross domestic product in the euro area is still over 51%!

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