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Guidelines for sustained growth in the EU? The concept and consequences of the Broad Economic Policy Guidelines

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Guidelines for sustained growth in the EU?[*]

The concept and consequences of the *Broad Economic Policy Guidelines*

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Abstract

The *Broad Economic Policy Guidelines* contain the answers of the European Commission and the governments of the EU-member countries to the European growth and employment problems. These guidelines have been the major EU-economic policy concept for around ten years now. They can be seen as a synthesis of the economic policy regime dominating the EU since the early to mid 1990s. However, this concept has not been able to generate sustained growth and low unemployment in the EU as a whole. Examining the guidelines we show the weaknesses of the underlying economic policy model and outline an alternative concept which promises more growth and employment for Europe in the long run.

JEL classification: E61, E62, E 63, E 64

Keywords: Broad economic policy guidelines, European Union, monetary policy, wage policy, fiscal policy, policy co-ordination

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1. Introduction

Despite some initial signs of economic recovery, it is currently still not possible to talk of a pronounced upturn within the European Union (EU). The EU-15's growth rate for 2004 of 2.3% remains below that of the USA, and the unemployment rate of over 8% has stayed at a high level considerably above the one in the USA. The figures for the countries in the European Monetary Union (EMU) are even worse, with a growth rate of just under 1.9% and an unemployment rate of 9% (Arbeitsgemeinschaft 2004: 634, 639). Furthermore, it appears that the budgetary consolidation strategy of recent years has failed to pay off. Since 2002, the current budget deficits in Germany and France in particular have exceeded the 3% limit set by the Stability and Growth Pact (SGP).

For several years now, various economic policy measures have been employed at EU level in an attempt to stimulate sustained growth and employment. Since 1993, the key EU economic policy document in this regard has been the *Broad Economic Policy Guidelines*. They provide an overarching model for European economic policy and the policies of the member countries. Structural reforms and a supposedly 'stable' macroeconomic framework are intended to enable the achievement of the Lisbon Strategy's goal of making the EU the world's most competitive and dynamic economy until 2010.

However, these efforts have hitherto met with little success. Is this because the *Guidelines* have been incorrectly implemented, or is it the *Guidelines* themselves that are at fault? In order to answer this question, we begin by describing how the *Guidelines* came about in the first place and the goals which they were designed to pursue. We then provide an overview of the current procedure for drawing up the *Guidelines*, before analysing their underlying economic policy model. Having set the scene in this way, we move on to establish the extent to which the *Guidelines* have achieved their intended goals and consider the extent to which it is actually possible for them to achieve such goals. We show how, far from promoting dynamic growth, implementation of the recommendations contained within the *Guidelines* has resulted in a restrictive policy that in fact acts as an obstacle to achieving the goal of fostering growth and employment. We conclude by outlining an alternative policy approach and associated institutional reforms that could, in our view, lead to a sustained improvement in both short-term and long-term growth.

2. The background

At the end of the 1980s, the difficulty encountered by some currencies in keeping within the exchange rate fluctuation limits set by the European Monetary System (EMS) led to plans for a new single European Union monetary policy that would be complemented by some elements of supranational economic policy co-ordination. The development of this Economic and Monetary Union was entrusted to a working group created at the 1988 Hanover Summit and was led by the then President of the Commission, Jacques Delors (Dyson/Featherstone 1999: 326–342). The remainder of the group consisted of the central bank presidents of the EU member countries (such as Bundesbank President Karl Otto Pöhl and Wim Duisenberg from the Dutch Central Bank), and three external experts.[1] The Delors Report was submitted by the working group on 12 April 1989 and contained proposals regarding economic and monetary integration. These two elements, however, did not receive equal weight, since the proposals for monetary integration went much further than those for economic integration. While on the one hand the report called for the creation of an independent central bank committed to achieving price level stability (Delors Report 1989: 21-3), this was not matched by an integrated economic policy at supranational level – all that was proposed was a form of loosely binding co-ordination.[2, 3] Co-ordination was to take place above all in the area of fiscal policy, in order to ensure that it could not have a negative influence on monetary policy. The report also proposed that, while budgetary policy would continue to be the responsibility of the member countries, national budgets should be monitored with a view to limiting the extent of budget deficits. In addition, the report called for a regular joint evaluation of economic development and guidelines for economic policy (Delors Report 1989: 16-21).

The negotiation and development of the ensuing monetary union framework took place almost entirely without public debate. The EMS had already led to the establishment of a

[1] The three experts were Alexandre Lamfalussy (Bank for International Settlements), Niels Thygesen (Copenhagen University) und Miguel Boyer (Banco Exterior de España).

[2] "A monetary union would require a single monetary policy and responsibility for the formulation of this policy would consequently have to be vested in one decision-making body. In the economic field a wide range of decisions would remain the preserve of national and regional authorities. However, given their potential impact on the overall domestic and external economic situation of the Community and their implications for the conduct of a common monetary policy, such decisions would have to be placed within an agreed macroeconomic framework and be subject to binding procedures and rules." (Delors Report 1989: 14)

[3] The co-ordination concept proposed in the Delors Report had already been around for quite some time. The Treaty of Rome (1957, Article 6) already called on the member countries to coordinate their economic policies.

network amongst the central banks, and despite the official insistence on the parallel development of economic and monetary convergence, individual governments in practice left the negotiations mainly in the hands of their finance ministries. The result was that key policy decisions were taken by a small circle of monetary committee experts or the council of central bank presidents. This accounts for the extremely high level of consensus among the parties involved, all of whom shared the opinion that a single currency area would require an independent central bank in order to ensure price level stability, as well as an institutional means of limiting member countries' budget deficits (Dyson 1999).

There was, however, disagreement regarding the nature and the extent of the EU-level economic policy co-ordination or management that should accompany monetary union. In the following paragraphs, we will discuss four proposals for the EMU framework - by the Commission, the German and French governments, and the Dutch Presidency - that mark the key stages of the debate.[4]

The Commission's proposal concentrates mainly on the monetary policy aspects of integration. The proposals concerning economic policy co-ordination are much more restricted in scope, although they are undoubtedly more comprehensive and specific than the proposals subsequently made by the individual governments. The Commission identifies three instruments or processes for the implementation of a common economic policy (Proposal by the European Commission 1993 [1990]: 199f.). Firstly, it calls for common and country-specific guidelines pertaining to national budgets, wage policy and structural policy to be drawn up and reviewed, thereby providing a blueprint for the subsequent *Broad Economic Policy Guidelines*. Secondly, it proposes a regular joint evaluation of economic development as a concrete means of pursuing the Treaty's goal of harmonising the economic policies of the member countries. Thirdly, the Commission calls for the creation of a Community support programme offering budgetary support or special loans to countries experiencing financial difficulties.

The subsequent French proposal, which was published on 25 January 1991, needs to be understood in the context of an approach to economics that has traditionally tended to place

[4] The first proposal to be examined is the Commission's, which already attempts to bring together the member countries' views. In the ensuing debate, the member countries tended to support either the French or the German position. The Dutch Presidency's proposal was a compromise solution that eventually found expression in the Maastricht Treaty.

greater emphasis on government control (Dyson/Featherstone 1999: 221–230). In line with this *gouvernement économique* approach, the French proposed that the Council of Ministers should co-ordinate member countries' economic policies and should be empowered to cut a country's allocation from the EU's common budget if it failed to comply with the Council's recommendations. Furthermore, as a matter of common interest, economic policy should be jointly evaluated on a regular basis. In addition, while the main goal of monetary policy would remain the pursuit of price level stability, it should also support the EU's overall economic policy (Proposal by the French Government 1993 [1991]: 343 f.). Not least as a result of the Mitterand regime's failed experiment with an expansive fiscal and monetary policy in 1982, the French government's proposals adhere to the fundamental principles of the consensus concerning price level stability and budget consolidation as described above. Nevertheless, in a similar way to the Commission's proposal, they also call for greater co-ordination with a view to concentrating the control of economic policy at EU level.

The German proposal for the Maastricht Treaty, which was published one month after the French one, follows an economic policy approach that focuses on price level stability, in keeping with the Bundesbank's established tradition. Unlike the French proposal, it makes no mention of placing constraints on monetary policy in order to support the EU's overall economic policy. In contrast to the other proposals described above, the German alternative devotes a lot of attention to German 'Ordnungspolitik' issues such as free price formation in markets and privatisation. It is true that the German proposal also considers economic policy co-ordination to be a matter of common interest, but it refrains from talking of economic policy 'guidelines', preferring instead to use the term 'orientations'. Moreover, the specific details of this co-ordination are confined to the prevention of budget deficits. The proposal does provide for cuts in a country's allocation from the EU's common budget as the sanction of choice, but only in case of a country failing to pursue an appropriate budgetary policy (Proposal by the German Government 1993 [1991]).

The Dutch Presidency's proposal of 28 October 1991 contains the first formulation of what would later become the convergence criteria (Proposal by the Dutch Presidency 1993 [1991]: 230). Like the German proposal, it envisages a central bank modelled on the Bundesbank, and it also follows the German position in setting no fixed deadline for joining the monetary union, stating instead that countries may only join once they have met the convergence criteria. However, it also reflects the positions of the Commission and the French government through the inclusion of extensive passages concerning economic policy co-ordination which, in addition to mentioning budgetary control, also refer to the regular drafting of economic policy guidelines.

The Dutch compromise proposal brought the two sides closer to an agreement, and the ultimate results of the negotiations are well known. The independence of the ECB is enshrined in the Maastricht Treaty and is complemented by co-ordination procedures aimed mainly at controlling budget deficits (Treaty of Maastricht: Art. 103-109).[5] Despite Germany's opposition, the stronger term of economic policy 'guidelines' (as opposed to 'orientations') was chosen (Treaty of Maastricht: Art. 103 or Art. 99 of the current consolidated version of the EC Treaty. See also Dyson/Featherstone 1999: 412–416, 425) and the Treaty established an automatic mechanism for joining the monetary union (Treaty of Maastricht: Art. 109j or EC Treaty: Art. 121).

How did these results come about? Clearly, a monetary union without the region's key currency, the Deutschmark, would have been unthinkable, and this put Germany in a strong position in the negotiations. Furthermore, the high level of independence enjoyed by the Bundesbank compared to central banks elsewhere in Europe was seen as a model for the planned European Central Bank not only by the Bundesbank but also by the central banks in other countries. Consequently, there was widespread support right from the start for a strong ECB and for a budgetary control system. The convergence criteria and the irreversibility of the EMU process served as a solution to the problem of what to do about those who held opposing views regarding whether or not there should be a monetary union at all and who should participate, although the German delegation was not at all happy about having to accept this automatic mechanism. The Germans suffered another defeat with regard to the degree of planned co-ordination when they were forced to agree to the use of guidelines, thereby paving the way for the *Broad Economic Policy Guidelines*. These concessions can be attributed to the fact that, after reunification, the German government was very keen to use monetary union as a clear and unequivocal sign of Germany's place at the heart of Europe, and was therefore prepared to compromise (Dyson/Featherstone 1999: 363–369, Garrett 2001: 118–123).

[5] In 1996, the European Council further strengthened the co-ordination of national budgets when it introduced the Stability and Growth Pact.

3. Procedure and drafting

Pressure from the European Commission and France thus led to the legal enshrinement in the Maastricht Treaty of a new procedure for economic policy co-ordination in the shape of the *Broad Economic Policy Guidelines* (EC Treaty Art. 99).[6] The *Guidelines* are unique among EU-level co-ordination procedures, since they contain recommendations pertaining to *all* the policy areas that influence the economy, and because all the other co-ordination procedures are required to deliver results that are in line with the content of the *Guidelines*. Consequently, the *Guidelines* are the key reference point for the European Union's common economic policy and as such represent the economic policy consensus at EU level.

The 1993 *Guidelines* were drafted by the Commission and only had a few pages. Their main topic was the co-ordination of fiscal policy, and a supplementary document also dealt with structural reforms and wage policy. The Council of Ministers amended the Commission's document to include extracts from the 'White Paper on Growth, Competitiveness and Employment' (European Commission 1993) that had been drawn up under Jacques Delors, President of the Commission from 1985 until 1995. The first *Guidelines* followed the same fundamental approach to economic policy that has continued to be adopted to the present day and is based on a combination of a 'stable macroeconomic framework', low inflation and balanced budgets, together with structural reforms designed to foster growth and employment.

Although reference to the situation in individual member countries is made as early as 1994 in the Commission's draft versions of the *Guidelines* and from 1995 onwards also in the version approved by the Council of Ministers, it was not until the 1998 *Guidelines* that country-specific recommendations were explicitly made for the first time, while more detailed country-by-country recommendations were only made from 1999 onwards. In 1994, the Commission started monitoring the extent to which the previous year's proposals had been complied with, and from 1996 it began including an assessment of implementation of its proposals for the *Guidelines*. By 1997 it was issuing its own brief report on the implementation of the *Guidelines*, and this report started to appear in more detailed form from 2000 onwards. In 1998, the sections dealing with structural reform of the goods, services and

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[6] Other more general legal points of reference for economic policy co-ordination are Articles 2, 4 and 98 of the EC Treaty.

labour markets were expanded and complemented by observations regarding the financial markets. The year 2000 saw the addition of passages relating to the knowledge society and the ageing of the population. Furthermore, following the decision taken at the Barcelona European Council, the scope of the recommendations contained in the *Guidelines* since 2003 has been expanded to cover a three-year period rather than just the following year (Broad economic policy guidelines 2003, European Commission 2002b). These medium-term recommendations are expanded and updated annually, for the first time in 2004 (Broad Economic Policy Guidelines 2004).

Contrary to expectations, in 2005 the procedure has already changed again as a reaction to the ongoing debate on the Lisbon strategy of the 2000 summit. Aiming at a reduction of unemployment and a rising participation rate in the labour market, the results of the Lisbon strategy were mixed and not satisfactory after five years. Therefore the Commission prepared a relaunch by streamlining and simplifying the procedures (European Commission 2005). This Commission document served as a basis for the presidency conclusions of the Brussels Summit in 2005 (European Council 2005). One of the main effects of the revision of the strategy is the integration of the *Broad Economic Policy Guidelines* and the *Employment Guidelines* into one document, the so called *Integrated Guidelines for Growth and Jobs* (Integrated Guidelines 2005). Both guidelines are still separate texts but they are issued simultaneously for the same three-year period, and they are interlinked by cross reference where meaningful.

The process by which the *Guidelines* are drawn up has changed as well with the revision of the Lisbon strategy and the orientation towards a three-year period. From 2005 on, the governance cycle starts with the new *Integrated Guidelines* being drafted by the Commission in April of the first year of the three-year period, endorsed by the European Council in June and adopted by the Council of Ministers after that. In autumn the member countries have to draw up newly introduced *National Reform Programmes* for three years describing their reform measures in order to meet the demands of the *Guidelines*. Each year the member countries as well as the Commission will report on the implementation in *National Lisbon Reports* on the side of the countries and a *Progress Report* covering all countries' developments on the side of the Commission. If necessary, annual updates of the *Integrated Guidelines* will be published by the Commission.

Other bodies participate in this process in an advisory role, for example the Economic and Financial Committee and the Economic Policy Committee. Preparatory work undertaken by the member countries is also incorporated, and the European Parliament issues an opinion on the Commission's draft of the *Guidelines*. The *Broad Economic Policy Guidelines* are therefore a Commission policy document that has been discussed with and agreed upon by several other bodies. It is thus a document that represents the economic policy consensus (or perhaps it would be more accurate to say a 'compromise' on economic policy) at European level and is approved by the Council of Ministers as the body representing the governments of the EU member countries. The member countries are committed to implement the recommendations contained in the *Guidelines*, although in contrast to the budgetary control measures of the *Stability and Growth Pact*, countries that fail to implement them cannot be sanctioned. As such, the *Guidelines* are a form of 'soft co-ordination' that relies on voluntary compliance by national governments and peer pressure.

4. The economic policy model underlying the *Guidelines*

The policy model underlying the *Broad Economic Policy Guidelines* has remained unchanged since 1993, its basis being the combination of a supposedly 'stable' macroeconomic framework with structural reforms. There have nevertheless been some shifts in the nature of their content over time, and these are examined below. We will be mainly concentrating on the *Guidelines* for the period 2005–2008 as the first part of the newly introduced *Integrated Guidelines* (Broad Economic Policy Guidelines 2005). The current version is the Commission recommendation which one would normally expect to be very similar in content to the final version approved by the Council of Ministers.

Until 1999, the key goals of the *Guidelines* were sustained, non-inflationary growth and high employment in accordance with Art. 2 of the EC Treaty. Since the Lisbon Summit, however, the goals agreed on in Lisbon has been adopted. In the 2003–2005 version of the *Guidelines* the wording is identical with the central passage of the Lisbon strategy. The main goal is

"(...) to become the most competitive and dynamic knowledge-based economy in the world capable of sustainable economic growth with more and better jobs and greater social cohesion" (BEPG 2003: 59, see also European Council 2000).

This orientation was recently approved by the integration of the *Broad Economic Policy Guidelines* and the *Employment Guidelines* into a single document serving as the main governance instrument for the Lisbon strategy.

The main idea of the *Broad Economic Policy Guidelines* is that structural reforms should be used to boost growth potential in order to achieve the above goal. According to the *Guidelines*, 'sound' macroeconomic conditions should enable the economy to realise this potential. The resulting growth would in turn lead to more and better jobs. It can thus be said that since the year 2000 the *Guidelines* have given concrete expression to the complementary relationship between macroeconomic policy and structural reforms for the first time. This is very explicit in the current version which is divided into two sections, section one containing macroeconomic guidelines concerning the macroeconomic framework and section two covering microeconomic guidelines dealing with the proposed structural changes.

The core elements of the structural reforms are deregulation and liberalisation of goods, services, financial and labour markets, on the one hand (BEPG 2005. Integrated Guidelines 3, 4, 7–11), and investment in Research & Development and innovation policy, on the other hand (Guidelines 12–15). The bulk of investment is supposed to come from the private sector, with the rest being obtained from the redeployment of public budgets. Furthermore, measures should be taken to expand the labour supply, increase the adaptability of the workforce and improve education. This is, however, no longer part of the *Guidelines* but it is treated in the second part of the *Integrated Guidelines*, the *Employment Guidelines* (Integrated Guidelines 16–23).

In order for the (supposedly) higher growth potential resulting from these structural reforms to be transformed into actual growth, it is argued that 'sound macroeconomic conditions' should prevail. These conditions are defined by the *Guidelines* as a stable monetary framework, fiscal discipline and modest wage increases (Integrated Guidelines 1, 2, 5, 6). The *Guidelines* consistently stipulate an assignment of the macro-political players in the fields of monetary, fiscal and wage policy and the instruments at their disposal to the economic policy targets. This approach strengthens the ECB's focus on its primary goal, the creation of price stability, although once this has been ensured, the central bank is also supposed to support the EU's economic policy. The job of fiscal policy, meanwhile, is to achieve a super-cyclically balanced budget. Wage growth should not exceed the sum of inflation and trend productivity growth and in addition should take into account workplace productivity.

The *Guidelines* assume that the ECB's monetary policy automatically concurs with the recommendations and have nothing further to say on the matter. They fail to question the ECB's target of "medium-term inflation below but close to 2%" (ECB 2003: 89), which is, in fact, quite restrictive for a heterogeneous economic area with different growth rates and markedly divergent inflation rates; nor do they make any criticism of the asymmetrical and ultimately growth-unfriendly policy pursued by the ECB in the past. By the time of the 2001 downturn, if not before, it had become clear that the ECB was not prepared to use its interest rate policy to contribute to economic recovery. Despite the fact that wage trends posed no threat to the achievement of the bank's restrictive inflation target, the ECB was not willing – unlike the American Federal Reserve – to radically cut interest rates. The reason the bank gave for this was that inflation was still above its target. However, this was not a result of the other macro-political players pursuing policies that threatened stability, something that the ECB would have had to act against. Rather, it was due on the one hand to exogenous shocks (rises in the price of oil and epidemics such as BSE and foot-and-mouth disease) and on the other to the fall in productivity growth resulting from the economic downturn, for which the ECB co-shared the blame. The ECB's monetary policy thus failed to comply with its remit of supporting the EU's economic policy at times when price levels are not at risk (EC Treaty Art. 105).[7]

In accordance with the *Stability and Growth Pact*, the *Guidelines* require fiscal policy to be used to ensure that, in the medium-term, member countries have either balanced budgets or current budget surpluses. On the one hand, this is intended to ensure that national fiscal policies are protected against future recessions and are in a position to allow the automatic stabilisers to take full effect. On the other, it should free up financial resources to address the funding problems associated with demographic change and the ageing of the population. Despite the fact that greater public investment in research, education and infrastructure is urged, the recommendations do not mention borrowing as a means of financing this spending. On the contrary, management of the budget to obtain sustained current surpluses will involve reducing public debt to zero, which implies a rejection of what was until recently widely

[7] For a more detailed critique of the ECB's policy, see for example Allsopp/Artis (2003), Bibow (2002, 2003), Hein (2002b), Hein/Truger (2005a, 2005b), Heine/Herr (2004) and Janssen (2005).

accepted as the ‘golden rule’ of fiscal policy, i.e. the principle of borrowing to fund the public capital stock. The *Guidelines* make no attempt to question the consolidation measures required by the SGP even during recessions, despite the fact that at the same time they urge that the automatic stabilisers should be allowed to take effect and that pro-cyclical policies should be avoided. Those member countries that have not reached their budgetary objectives should reduce their cyclically-adjusted deficits by 0.5% of GDP each year and should pursue higher improvements in good times. If such cuts were to be made in a recessive phase, however, they would have a marked pro-cyclical effect and would in fact exacerbate economic stagnation.

According to the *Guidelines*, wage policy or wage trends[8] have to contribute to macroeconomic stability. It is therefore argued that wage trends in the member countries should be consistent with price level stability and trend productivity. Further explanations make clear that this is an upper limit and not a target. Wages should reflect workplace productivity, in other words there should be greater wage differentiation than in the past, and more important, wages should allow for a rate of profit that enhances productivity, capacity, and employment. In places, the *Guidelines* talk positively about the role of the social partners and even adopt a decidedly favourable tone with regard to collective wage bargaining. For example, they recommend that the social parties should agree to pursue a policy of wage moderation via the Macroeconomic Dialogue, a forum established by the Cologne Process in order to achieve a consensus among the players in the fields of monetary, fiscal and wage policy. In so doing, the *Guidelines* favour the corporatist approach to wage bargaining and, notwithstanding all their proposals regarding clauses allowing companies to diverge from collective agreements and the decentralisation of wage bargaining, they still support the principle of the social parties being responsible for negotiating wages. However, they completely fail to take into account the fact that a policy of promoting company-level wage settlements and wage differentiation actually undermines the social parties’ ability to act strategically in order to ensure wage trends that meet macroeconomic requirements, however these may be defined. They also neglect to consider whether, in the current stagnation scenario, wage increases below the combined figure for productivity gains and the ECB’s inflation target may, in fact, accentuate the EU’s macroeconomic problems by resulting in

[8] No explicit mention is made of the term wage policy, and the only term actually used is wage trends. The reason for this choice of words is the British government’s view that there cannot and should not be any such thing as wage policy, a view which needs to be understood in the context of the UK’s decentralised wage bargaining system (Koll 2005: 132, footnote 8).

sluggish domestic demand and deflationary tendencies in Europe's largest economy (Germany).[9]

Contrary to former issues of the *Guidelines* the recent one does not deal with the question of co-ordination of policies. In the penultimate *Guidelines* by contrast a better co-ordination of monetary, wage and fiscal policy was demanded in order to achieve wage restraint, avoid public deficits and implement structural reforms (BEPG 2003: 67f.). As such, what is meant by co-ordination is gaining a commitment by the players to the programme outlined in the *Guidelines*, including the clear assignment of economic policy goals to the individual macro-political players and the instruments at their disposal. However, the *Guidelines* do not understand co-ordination to mean that the players from different policy areas are heavily dependent on each other in order to achieve their policy goals, because the effects of individual policies are interdependent and it is therefore impossible for one policy area's goals to be achieved without co-ordination with the other players. As has already been stated above, the *Guidelines* adopt an assignment approach that prescribes clearly defined responsibilities for the players in each policy area and operates on the assumption that they will be able to achieve these goals individually.

In summary, it can be said that for more than a decade now the policy mix recommended by the *Guidelines* for the EMU has followed an economic policy model that Arestis et al. (2001) aptly describe as 'new-monetarist', the theoretical basis of which is a mixture of new-classical, monetarist and new-Keynesian economic policy assignment (Hein 2002a). This model can be summarised in four points:

1. The private sector is stable in the long term. Say's Law applies in the long term as does the classical dichotomy between nominal and real variables. Discretionary economic policies have a destabilising effect, and consequently economic policy decisions should be taken independently of the democratically elected political regime and should be subject to clearly defined rules.
2. Inflation is a purely monetary phenomenon in the long term. The role of independent central banks is to maintain price level stability, and they can use interest rate policy to control inflation without real economic costs.

9 For more on the deflationary pressures in Germany and Europe, see Hein et al. (2005).

3. Unemployment fluctuates around an equilibrium level determined by supply-side factors that is known as the NAIRU (Non-Accelerating-Inflation-Rate-of-Unemployment). This is independent of effective demand on goods markets and can be reduced by creating more flexible labour markets.
4. Fiscal policy has no long-term effect on growth and employment and should therefore be subordinated to the goal of price level stability. Within the context of the business cycle, however, it should passively accept budget surpluses and deficits within certain limits.

This policy model also underlies all the other institutions and economic policy regulations of the EMU, for example the provisions concerning monetary policy in the EC Treaty (Art. 105), the ECB’s monetary policy strategy (1999, 2003), the EC Treaty’s provisions with regard to fiscal policy (Art. 104), the *Stability and Growth Pact*, the Employment Chapter of the EC Treaty (Art. 125-130), the annual *Employment Guidelines* (Luxembourg Process), and the reform of goods and capital markets (Cardiff Process). To some extent, the *Guidelines* bring together the different strands of this approach.[10]

5. Macroeconomic effects

Now that the *Broad Economic Policy Guidelines* have been largely responsible for determining the direction of economic policy within the EU for a period of some ten years, the time has come to analyse the macroeconomic effects of the associated policy model. We are of course not suggesting that the recommendations contained in the *Guidelines* have always been implemented to the letter. However, we do believe that they provide a very accurate reflection of the fundamental direction followed by economic policy in the EU or at least in the EMU. For this reason and because of the limited space available, this section will not seek to provide an in-depth discussion of each individual policy area but will concentrate instead on analysing the fundamental approach taken with regard to economic policy. A comparison will be made of the evolution of macroeconomic target variables and some indicators of the policies implemented in the EMU countries between 1994 and 2003 with the period from 1984 to 1993. This will enable us to compare two ten-year periods that both

[10] See European Commission (2002a) for an overview of economic policy processes within the EMU. See also Hein/Truger (2005a, 2005b) for a detailed analysis of the EMU’s restrictive policy mix.

include a recession in the end. Trends in the EMU will also be contrasted with developments in the USA, which constitutes an economic area with a single currency that is comparable in size to the EMU. Although the *Guidelines* apply to all the EU member countries, our empirical analysis will be confined to the EMU countries that have, since 1999, been directly subject to the centralised single monetary policy of the ECB as well as the Stability and Growth Pact's regulations regarding fiscal policy.

There is a broad consensus that the key macroeconomic target variables are economic growth, high employment and price level stability (Table 1)

Table 1: Real GDP growth, unemployment and inflation in the EMU and the USA, annual averages for 1984-1993 and 1994-2003, in %

	EMU		**USA**	
	1984-1993	1994-2003	1984-1993	1994-2003
Real GDP growth	2.7	2.1	3.3	3.3
Unemployment rate	8.7	9.6	6.6	5.1
Inflation rate (private consumption)	4.5	2.1	3.8	2.4

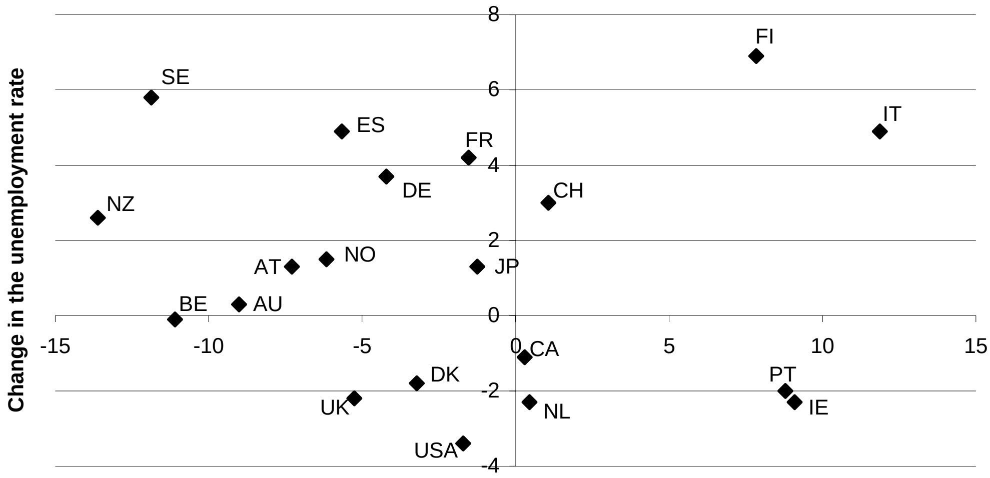
Source: OECD (2004), own calculations

As far as GDP growth is concerned, it can be seen that the overall figures for the EMU were lower between 1994 and 2003 than for the period 1984 - 1993. While the average annual growth rate between 1984 and 1993 was 2.7%, it fell to just 2.1% between 1994 and 2003. Meanwhile, the USA experienced a stronger average growth rate of 3.3% in both periods. The unemployment figures reflect this falling GDP growth in the EMU countries and the fact that growth was lower than in the USA. Unemployment rose from an average of 8.7% between 1984 and 1993 to an average of 9.6% in the period 1994 - 2003. In the USA, on the other hand, the average unemployment rate fell from 6.6% between 1984 and 1993 to 5.1% between 1994 and 2003, remaining below the EMU figure throughout the entire period under investigation. As far as the real target variables of growth and unemployment are concerned, the EMU countries' performance since the introduction of the *Guidelines* has undergone a marked deterioration both in comparison with the previous ten years and with the USA. On the other hand, there has been an improvement with regard to the nominal target variable of price level stability. The average annual inflation rate in the EMU countries fell from 4.5% between 1984 and 1993 to 2.1% in the period 1994-2003. This figure is slightly below the USA's average of 2.4% for the same period, while the average inflation rate in the USA between 1984 and 1993 stood at 3.8%. Overall, it can be said that since 1994, the USA has been much more successful than the EMU countries in achieving a combination of high growth, low unemployment and price level stability.

What are the reasons for the EMU countries' unsatisfactory performance? Is it that the extent of the structural reforms called for by the *Guidelines* and the speed at which they were implemented were insufficient? Or were the recommendations for the macro-political players ultimately counterproductive? Based on a comprehensive data set assembled by Baker et al. (2004) that covers the development of indicators for labour market institutions and social security systems in 20 OECD countries between 1960 and 1999, Hein/Truger (2005c) developed a total index of the rigidity of labour market institutions and the welfare state and compared their development with that of the unemployment rate in the countries in question.[11] This global index covers employment protection, the benefit replacement rate, benefit duration, union density, the degree of co-ordination of wage bargaining and the tax wedge. Much of the more recent literature on labour market theory predicts that these partial indicators will, to a greater or lesser extent, have a negative influence on employment (Nickell/Layard 1999, Nickell 1997). Figure 1 compares the changes in the total index of institutional sclerosis from 1995/99 against 1980/84, with the associated changes in unemployment rates in 20 OECD countries.

[11] For more on the relationship between labour market and welfare state institutions, on the one hand, and employment, on the other hand, see Hein/Truger (2005c).

Figure 1: Change in the unemployment rate and in the total index of institutional sclerosis from 1980/84 to 1995/99 (20 OECD countries)



Source: Hein/Truger (2005c)

On the one hand, it is clear that there is significant variation in the extent to which 'structural reforms' have been implemented in the EMU countries. The rigidity of the labour market and social security systems in Finland, Italy, Portugal and Ireland increased significantly, while it remained more or less the same in the Netherlands and decreased considerably in Germany, Denmark, Spain, Austria and Belgium. On the other hand, it is equally clear that, on the whole, there is no unequivocal relation between the rigidity of labour market institutions and the welfare state on the one hand and the unemployment rate on the other. For example, although both Germany and the UK implemented structural reforms in similar measure, unemployment rose by almost 4 percentage points in Germany while in the UK it fell by more than 2 percentage points. Meanwhile, the significant fall in unemployment witnessed in the USA was achieved with a minimum of structural reforms.

There is thus no conclusive proof that structural reforms have a systematically positive influence on economic performance. As such, it makes sense to consider whether the causes of the EMU countries' unsatisfactory macroeconomic performance can be traced to the macroeconomic policy approach recommended in the *Guidelines.* In the following paragraphs, the indicators for the monetary, wage and fiscal policy models will therefore be analysed (Table 2).

Table 2: Indicators for monetary, wage and fiscal policies in the EMU and the USA, 1984-1993 and 1994-2003				
	EMU		USA	
	1984 - 1993	1994 - 2003	1984 - 1993	1994 - 2003
Monetary policy				
Real GDP growth rate minus short-term real interest rate (percentage points)	-2.3	-0.1	0.0	1.2
Wage policy				
Growth in nominal compensation per employee (%)	5.2	2.3	4.4	3.5
Growth in nominal unit labour costs (%)	4.4	1.5	2.9	1.7
Labour income share (% of GDP at factor costs)	70.7	67.6	68.6	67.5
Fiscal policy				
Number of years with a pro-cyclical fiscal policy	7	4	5	2
Real public investment as a share of real GDP (%)	2.9	2.5	3.3	3.1
Source: European Commission (2004), OECD (2004), own calculations				

As far as monetary policy is concerned, it is important to consider the relationship between the real short-term interest rate and the real GDP growth rate. While it is true that the central bank only directly controls the short-term nominal interest rate, it nevertheless also determines the real short-term interest rate, owing to the fact that it sets its nominal rate with an eye to inflation. If the real interest rate is above the real GDP growth rate, the result is a redistribution of wealth from debtors to creditors, and the risk of debtors becoming over-indebted increases. This is an unfavourable scenario in terms of growth and economic activity, since it encourages investment in financial assets as opposed to real assets.

Even between 1984 and 1993, the average difference between GDP growth and interest rates in the USA was 0.0 percentage points, indicating a markedly less restrictive monetary policy than in the future EMU countries, where monetary policy was dominated by the Bundesbank and the average difference stood at -2.3 percentage points. Although both economic areas witnessed a trend towards a more expansive monetary policy in the period 1994 - 2003, policy in the USA did much more to promote growth and economic activity than in the EMU. In the USA, the average difference between GDP growth and interest rates during this period was 1.2 percentage points, as opposed to just -0.1 percentage points in the EMU countries. This is the more remarkable, because until 1999 the EMU countries were still benefiting from the reduction in their interest rates to the lower level found in Germany, the region's key currency country.[12] The ECB's more restrictive approach to monetary policy compared to the Federal Reserve once again became particularly apparent after the 2001 recession. While the Fed managed to promote a growth-friendly constellation with a positive difference of 1.95 percentage points between real GDP growth and short-term real interest rates on average between 2001 and 2003, the ECB proved much more reluctant to act because in the Euro area this difference remained still slightly negative with -0.04 percentage points on average.

The wage policies pursued by the social parties, or the wage settlements arrived at on the labour market, determine the nominal wage rate and hence also nominal unit labour costs, when labour productivity is considered to be given or following an exogenous trend. Insofar as businesses pass on unit labour cost fluctuations directly to prices, wage policy influences inflation. If these changes are not passed on fully, there will also be changes in functional income distribution, which is measured here by the labour income share. A combination of high unemployment, labour market deregulation and the emergence of national competitive social pacts that govern collective bargaining has caused a significant decline in the growth rate of nominal compensations per employee in the EMU countries from 5.2% on average between 1984 and 1993 to an average 2.3% between 1994 and 2003. Therefore, average unit labour cost growth in the EMU countries fell from 4.4% between 1984 and 1993 to 1.5% between 1994 and 2003.[13]

In the USA average annual growth of nominal compensation per employee also declined from the first to the second period from 4.4% to 3.5%, hence to a much lesser extent. A reduction was also seen in the nominal unit labour cost growth, albeit also a more modest one than in the EMU from 2.9% to 1.7%. In both regions, modest wage increases made a key contribution

[12] For a more detailed analysis, see Hein/Truger (2005b).
[13] For more on the causes and consequences of the modest wage increases in the EMU countries, see Hein (2002b), Hein/Schulten (2004) and Hein et al. (2005).

to the sharp fall in inflation described above. While wage trends in the EMU countries between 1984 and 1993 were at times still clearly inflationary and thus not conducive to stability, in the period between 1994 and 2003 they no longer posed a threat to low inflation, nor did they put the achievement of the ECB's inflation target at risk from 1999 onwards.[14] Even the fact that unit labour cost growth has risen slightly above the 2% mark since 2001 is more a consequence of the fall in productivity growth resulting from the cyclical downturn than of a wage policy that fails to promote stability (Hein/Truger 2005a). Consequently, wage trends could have allowed for a much more expansive monetary policy than that pursued by the ECB without unleashing inflationary pressures.

Another consequence of the wage restraint practised in the EMU countries since 1994 has been a further fall in the labour income share from an average of 70.7% between 1984 and 1993 to a figure of 67.6% between 1994 and 2003. While the labour income share in the USA also fell from 68.6% to 67.5%, this fall was far less pronounced than in the EMU. In the EMU countries, a lower proportion of the fall in unit labour cost growth was passed on to commodity prices than in the USA, as can be seen from a comparison of the annual averages for inflation and unit labour cost growth in Tables 1 and 2. If the propensity to consume out of labour income exceeds the propensity to consume out of profit income, it can be assumed that the redistribution to the detriment of labour will have a negative impact on consumer demand, which is the largest element of aggregate demand. This will also negatively affect GDP growth, unless the redistribution in favour of profits leads directly to increased investment or the improvement in price competitiveness on international markets achieved by wage restraint leads to a major increase in export surpluses. It is clear that neither of the above has happened in the EMU since 1994, at least not to a sufficient degree.

The extent to which fiscal policy exerts a stabilising or destabilising influence on the economy can be assessed by comparing changes in the output gap and the structural budget balance (Figs. 2 and 3). The output gap serves as an indicator of the current state of economic activity. If it is positive, then capacity is being outstripped, if it is negative, this means that

[14] It should be noted that the combined figures for the EMU countries hide considerable differences with regard to national unit labour cost and inflation trends (Hein/Truger 2005b). Thus, since the mid-1990s, unit labour cost growth and inflation in Germany have been significantly below the EMU average. This has meant that the EMU's largest member has been exposed to major deflationary pressures, as recognised by the IMF (2003), and has also been heavily constrained in its ability to achieve economic growth owing to the fact that, now that nominal interest rates are the same across the EMU, real interest rates in Germany are significantly higher than in the other EMU countries (Hein et al. 2005, Hein/Truger 2005c).

capacity is not being fully utilised. Consequently, a positive change in the output gap indicates a cyclical upturn whereas a negative change points to a cyclical downturn. While the overall budget deficit or surplus is the result of macroeconomic processes and cannot therefore be controlled by fiscal policy, the structural, i.e. cyclically adjusted, budget balance can be controlled by policy and can therefore be seen as a fiscal policy instrument. If there is a negative change in the structural budget balance, then structural deficits rise or structural surpluses fall, and fiscal policy provides an expansive stimulus to aggregate demand. If there is a positive change in the structural budget balance, then structural deficits fall or structural surpluses rise, and fiscal policy provides a restrictive stimulus to demand. If the structural budget balance remains the same when there is a change in the output gap, then fiscal policy is neither expansive nor restrictive and the automatic stabilisers are simply left to take effect.

Figure 2: Change in the structural budget balance and in the output gap to previous year in the EMU, 1984-2003

Source: OECD (2004)

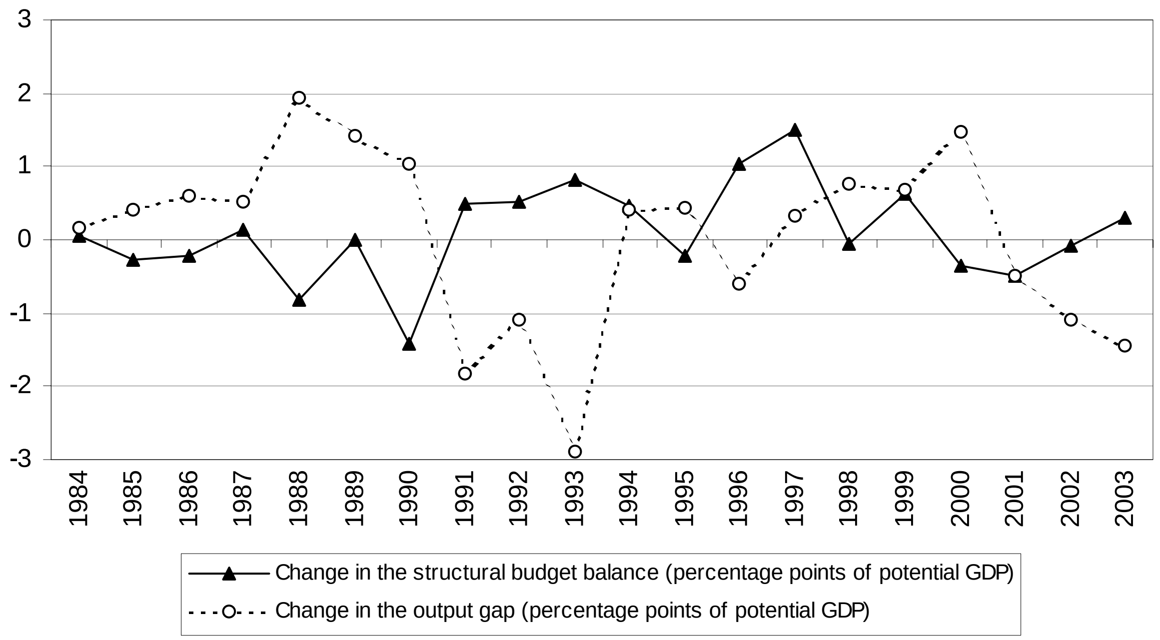
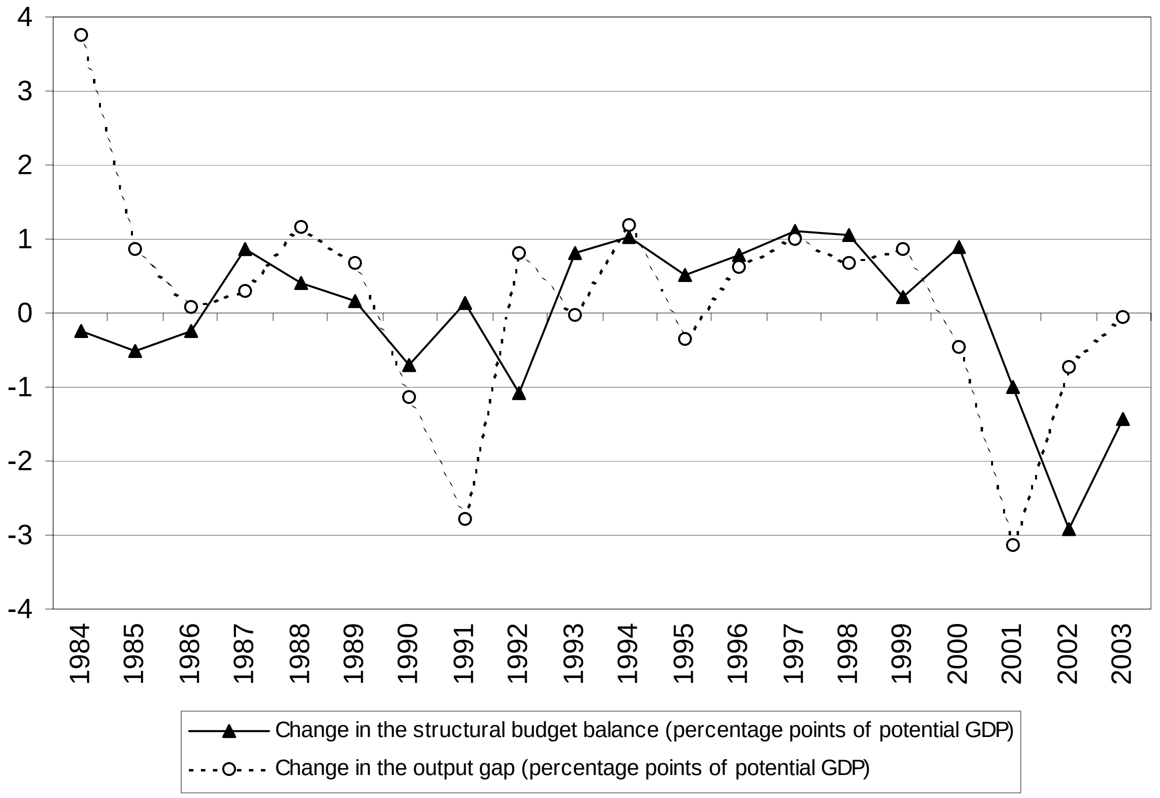


Figure 3: Change in the structural budget balance and in the output gap to previous year in the USA, 1984-2003
Source: OECD (2004)



Between 1984 and 1993, the fiscal policy of the future EMU countries, which at this time was not yet subject to co-ordination, was pro-cyclical in seven of the ten years in this period. In four of these years (1985, 1986, 1988, 1990) it acted to reinforce a recovery and in three years it accentuated a cyclical slowdown or recession (1991, 1992, 1993). Between 1994 and 2003, the fiscal policy of the member countries was now ‘co-ordinated’, initially as part of the EMU convergence process and latterly through the SGP, and this served to make it somewhat less pro-cyclical. It was only pro-cyclical in four of the ten years in this period, reinforcing a cyclical recovery in two years (1995, 2000) and accentuating a downturn in a further two years (1996, 2003). However, fiscal policy, too, fares poorly in comparison with the USA. While between 1984 and 1993, US fiscal policy was pro-cyclical in five years, only exacerbating a downturn on one occasion (1991), between 1994 and 2003 it was only slightly pro-cyclical in two years, reinforcing a cyclical slowdown in 1995 and 2000. However, the cyclical downturn in 2001 was met with decisive expansive measures even before the year was out. Particularly during the 1990s, therefore, US fiscal policy constituted an example of budget consolidation without pro-cyclical measures, and as is well known the US achieved budget surpluses at the end of the upturn.

If we accept that public spending on infrastructure, education, etc. is a key requirement for private investment, and if we use public investment as a percentage of GDP as an indicator of the extent to which fiscal policy fosters growth, then once again the USA fares better than the EMU countries. Throughout the whole of the period being investigated, public investment as a percentage of GDP in the US remained comfortably above 3%, showing only a slight reduction from 3.3% on average to 3.1% between the two ten-year periods. In the EMU countries, on the other hand, the figure was lower than in the USA for the entirety of the study period, and fell from an average of 2.9% between 1984 and 1993 to an average of 2.5% between 1994 and 2003. Consequently, not only did the EMU convergence process' and SGP's drive to achieve budget consolidation force countries to implement a more pro-cyclical fiscal policy, but it also had a particularly negative impact on public investment and hence damaged future growth prospects.

In summary, differences in the macroeconomic policy mix offer a plausible explanation for the growth slowdown and the increase in unemployment in the EMU since 1994 and for the divergent macroeconomic performance of the EMU countries and the USA.[15] Even in the period 1984 - 1993, the USA's approach to monetary and fiscal policy and its wage trends did much more to promote economic activity and growth than in the European countries included in this study. This difference was accentuated between 1994 and 2003 as a result of the EMU convergence process and the Maastricht macroeconomic regime encapsulated in the *Guidelines*. The economic policy recommendations contained in the *Guidelines* can thus be described as inadequate and largely counterproductive.

6. Institutional and policy changes for sustained higher growth

If we accept the view that, since the 1993 recession, the disappointing growth and employment trends in the current EMU member countries can largely be attributed to the

[15] For more on why the USA's significantly above-average performance compared to other countries can be put down to its macroeconomic policy mix, see Fritsche et al. (2005), Kalmbach (2000), Schulmeister (2001) and Solow (2000).

policy mix recommended in the *Guidelines*, then in order for the EMU economies to be revitalised it will be necessary to abandon the policy of structural reforms aimed at boosting growth potential and implement instead a U-turn in macroeconomic policy, with a new monetary, wage and fiscal policy mix.

The *Guidelines* will only be able to contribute to this if the overall guidelines and the country-specific recommendations are thoroughly reformed. Such a reform would involve substituting a new model for the new-monetarist economic policy model described above, with its associated assignment approach. The Keynesian or post-Keynesian concept of a co-ordinated macroeconomic policy offers a model that would to a large extent respond to the issues analysed above. The key elements of this concept can be summarised in the following four points:[16]

1. In a monetary production economy, Say's Law and the classical dichotomy between the real and monetary spheres do not apply, neither in the short nor the long term. The private sector is unstable and therefore needs to be stabilised by a policy that controls effective demand in both the short and long term. In order for this to be achieved, medium to long-term co-ordination of monetary, fiscal and wage policy is required.
2. The central bank's interest rate policy influences effective demand, in particular private investment. In the long term, it also has an impact on functional income distribution. Consequently, monetary policy has significant short-term and long-term real effects. Its short-term effects, however, are asymmetrical. While the central bank is able to stop booms by raising interest rates, it is not able to put an end to recessions by cutting interest rates at times when profit expectations are depressed. In such cases, it is heavily reliant on support from fiscal and/or wage policy.
3. The nominal wage policy of the bargaining parties has no direct influence either on the level of employment or on income distribution. What it does influence is nominal unit labour costs for a given level of labour productivity and the price level once the mark-up in firms' pricing is given. Changes in distribution are only possible if allowed by the factors that influence the mark-up, for example the level of competition on the goods markets or the long-term interest rate. Employment levels are determined by the level of effective demand on the goods market, the evolution of which is largely governed by

[16] For a more detailed analysis, see Hein (1998, 2002a), Hein/Truger (2005a), Heine/Herr (1999: 315 ff.).

private investment. This in turn is dependent on the relationship between the profit rate expected by businesses and the interest rate.

4. In the short term, fiscal policy can stabilise the economic cycle by accepting cyclically determined deficits and surpluses. In the long term, effective demand can be increased and growth potential boosted if a policy of investment-oriented borrowing is pursued. In addition, the government's taxation and social policy will modify the distribution of disposable income, meaning in turn that consumer demand, which is the largest element of aggregate demand, can be influenced. The government's competition policy affects the level of competition on the goods market and hence also influences mark-ups and functional income distribution.

Owing to the interdependencies related to the deployment of the instruments at the disposal of the economic policy players and the fact that the target variables are all influenced by several different instruments, the Keynesian or post-Keynesian model rejects a strict assignment of players and instruments to a single specific economic policy goal, and consequently calls for co-ordination with regard to the deployment of the instruments. The nature of this co-ordination can be either implicit, i.e. where the players all take the interdependencies into account individually, or it can take the shape of explicit, institutionalised ex-ante co-ordination. Either way, the key is for the players to be aware of the interdependent nature of their actions and for there to be a consensus with regard to the likely effects of their deploying the instruments at their disposal. Accordingly, co-ordination requires at least a minimum degree of consensus concerning the analysis of economic causalities, the diagnosis and prognosis of the economic situation and the economic policy goals to be pursued (Priewe 2002).

In order for such a co-ordinated macroeconomic policy to be implemented within the EMU, it will by definition be necessary for the key players to abandon the policy orientation that has hitherto been recommended by the *Guidelines*.[17] In order for wage policy to be able to exert a nominal and real stabilising influence as outlined above and to avoid exacerbating regional disparities within the EMU, nominal wage increases in the individual member countries should be equal to sum of long-term national productivity growth and the ECB's target inflation rate. Consequently, as much attention should be paid to avoiding wage dumping

[17] For a more detailed version of the following arguments, see Hein/Truger (2005a).

between the member countries as to preventing inflationary wage settlements that require restrictive intervention by the central bank. In order to achieve a nominally stabilising wage policy, what is required is effective co-ordination of wage bargaining systems not only nationally but also, in particular, at EMU level. This in turn requires trade unions and employers' associations at national level that are able to bargain and develop strategies effectively and are in a position to conclude and ensure the implementation of settlements oriented towards the economy as a whole (Kittel/Traxler 2001). Key instruments to this end are multi-employer collective bargaining and the universal extension of collective agreements. The decentralisation of collective bargaining and promotion of individual company-level wage settlements recommended in the *Guidelines* are as diametrically opposed to these requirements as a further deregulation of the European labour market. However, for wage policy in the EMU to be able to fulfil its role as part of a co-ordinated macroeconomic policy, in addition to the need for economic policy completely to abandon the current strategy of labour market deregulation and decentralisation of collective bargaining, increased efforts by the trade unions to achieve effective European-level co-ordination of their wage demands will also be required (Schulten 2002, 2004, 2005).[18]

In the context of a co-ordinated macroeconomic policy, monetary policy also assumes responsibility for growth and employment, especially when there is no inflationary pressure from wage policy or fiscal policy. Consequently, monetary policy should not be treated as sacrosanct, as is currently the case in the *Guidelines*. The ECB should therefore make much more fundamental changes to its monetary strategy than in the last review in May 2003, by formulating its inflation target as a point or corridor target that is to be pursued in a symmetrical fashion.[19] This means that, in contrast to what it has done hitherto, the ECB should not only combat upward deviations from its inflation target but should also fight downward deviations equally vigorously. Additionally, the inflation target should be raised in order to take account of the fact that the EMU member countries have different long-term growth trends and correspondingly different rates of inflation. Furthermore, the ECB should pay more attention to the growth and employment targets, occasionally testing the growth potential of the euro zone by means of a controlled monetary expansion, along the lines of

[18] In the EMU, a co-ordination approach such as this must be based on existing national co-ordination mechanisms and should seek to network these trans-nationally. Such a decentralised approach might, for example, involve the trade unions in the metalworking industry taking on the role of wage leadership at European level, too. This would mean that the collective bargaining policy of Germany's IG Metall in particular would play a central role. Cf. Traxler/Mermet (2003) for details of such an approach.

[19] Cf. Meyer (2001) for different monetary strategies.

what the US Federal Reserve did in the second half of the 1990s (Allsopp 2002). Such a policy takes account of the fact that growth potential and the NAIRU are not exogenously determined variables, but are in fact jointly determined by real GDP growth and employment trends both of which are also influenced by monetary policy (Fontana/Palacio-Vera 2005, Hein 2002b, 2004, Lavoie 2004, Sawyer 2002).

At present, any use of fiscal policy in the EMU to stabilise the economy, combat regional asymmetries and improve the long-term growth trend would contravene the current SGP regulations that are endorsed by the *Guidelines*. The pressure to achieve budget consolidation imposed by the SGP has been at its greatest during times of recession and has forced the adoption of a pro-cyclical fiscal policy with its particularly negative effects on public investment. At the same time, there have been no consolidation regulations for economic booms. Notwithstanding this, co-ordination of national fiscal policies in the monetary union is necessary so that the automatic stabilisers can be allowed to take effect in economic downturns, to avoid free-riding by individual member countries, and to prevent inflationary budgetary behaviour by some member countries during economic booms. As part of a co-ordinated fiscal policy in the EMU, therefore, individual countries should be obliged to allow the automatic stabilisers to operate symmetrically, i.e. during both downturns and upturns. To this end, further reforms than those agreed upon by the ECOFIN and endorsed by the European Council in March 2005 are required.[20] The countries should draw up country-specific expenditure paths for non-investment, non-cyclical public spending, which would be funded in the long term by current tax revenue. Cyclical spending should then be allowed to float freely around this target without being constrained by budget deficit limits. In a downturn, increases in expenditure and falling revenue lead to budget deficits that are financed by borrowing, thus increasing the level of debt. In an upturn, on the other hand, budget surpluses are generated, which can then be used for consolidation purposes. Alignment of the expenditure path with a growth rate below that of the nominal potential GDP path can

[20] These reforms do neither question the 3% of GDP deficit criterion for the public budget and the 60% of GDP criterion for public debt nor do they change the goal of a balanced budget in the long term (ECOFIN 2005). There is also no change in the treatment of public investment within these targets. The reform of the SGP rather recommends to take into account the level of debt, the extent of structural reforms, public investment, and payments to international organisations and to the EU when it comes to the excessive deficit procedure. Excessive deficits shall not only be allowed when real GDP goes down by more than 2% but already with negative real growth or with a persistent output gap.

therefore contribute to a revenue-side budget consolidation if a structural deficit requiring consolidation existed at the outset.[21]

The possibility of borrowing to finance public investment should exist as a matter of principle (the Golden Rule). Each EMU member state should therefore be able to decide for itself on the level and funding method of public investment. Even if the other current SGP regulations were maintained, this alone would be enough to mean that consolidation pressure would no longer continue to force down the level of public investment (Blanchard/Giavazzi 2003). Member countries could use public investment to stabilise long-term effective demand at a level compatible with high employment (Allsopp 2002). Public investment in infrastructure could be used to increase growth potential and to accelerate the productivity catch-up between countries.

The outlined approach to monetary and fiscal policy, together with a re-orientation of wage policy, would constitute a move away from the restrictive new-monetarist policy mix hitherto recommended in the *Guidelines* and would involve implicit co-ordination, in that the interdependencies of economic policy would be taken into account. This could in turn make a considerable contribution towards stimulating growth and reducing unemployment in the EMU. However, since a co-ordinated macroeconomic policy requires a minimum level of consensus between the players with regard to economic causalities, the diagnosis and prognosis of the economic situation and the goals to be pursued, the efficiency of any such co-ordination could be increased significantly if there were to be explicit *ex ante* co-ordination among the players regarding deployment of the instruments at their disposal. Accordingly, in addition to the reformed *Guidelines*, the *Macroeconomic Dialogue* could act as a forum for promoting consensus between the monetary, fiscal and wage policy players, assuming a role as the key institution of a co-ordinated, employment-oriented European macroeconomic policy.[22]

[21] This formed the basis of the US budget consolidation in the 1990s (Horn/Scheremet 1999). On a similar proposal for Germany, see Bartsch et al. (2002) and Eicker-Wolf/Truger (2003).
[22] For more on the Macroeconomic Dialogue, see Niechoj (2005).

7. Summary

The *Broad Economic Policy Guidelines*, which were created as a policy instrument for fostering growth and employment and intended to act as a counterbalance to purely monetary integration, have failed to fulfil this remit. This is not because their policy recommendations have been incompletely or wrongly implemented. Rather, it is the fault of the policy recommendations themselves and the economic policy model on which they are based. We have shown how, over the last ten years, this model, which is based on structural reforms and strict assignment of the macro-political players and the instruments at their disposal to individual goals, has resulted in a consistently poorer macroeconomic performance in the EMU countries compared with the preceding ten years and with the USA. We have also outlined the principles of an alternative policy model that is based on the co-ordinated deployment of monetary, wage and fiscal policy with a view to achieving steady growth and high employment whilst at the same time maintaining price stability. Moreover, this policy model avoids the further undermining of social cohesion that is resulting from the current unilateral focus on structural reforms.

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