Growth and Jobs, "CCC" and Macroeconomic Policy

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In the year 2000 European leaders committed the EU to becoming by 2010 a dynamic, knowledge-based economy, capable of sustainable economic growth with more and better jobs and with greater social cohesion. In that context it is reasonable to emphasize that jobs and growth belong to the ultimate objectives of the EU. New momentum to economic growth should be based on enhanced competition and cohesion as both processes are supposed to be instrumental for achieving the economic and social progress. Simultaneously, both competition and cohesion depend, to a large extent, on the appropriate coordination, or governance, i.e. on a rule of law – based set of principles and procedures for institutions, including the process of law enforcement. And thus we arrive at our "CCC" concept.

Progress in jobs and growth, achieved through strengthening of "CCC", can have different ingredients. The pursuit of structural reforms is among major ingredients leading to more jobs and growth. However, **macroeconomic policy** is also of vital importance. Stable macroeconomic framework is a necessary, although not sufficient, condition for economic growth; it doesn't ensure growth by itself but the lack of a stable macroeconomic framework may destroy growth possibilities.

It is a monetary union which implies a distinct and radical change in macroeconomic policy. The model of a monetary union is derived from the concept of the optimum currency area ("OCA") and considers a single currency (and related single monetary and exchange rate policy) to be successful when economies of member countries are exposed to mainly symmetric shocks or have mechanisms in place for the adjustment to asymmetric shocks. These mechanisms include price and wage flexibility, factor mobility and fiscal transfers. Such a monetary union provides potential for an enhanced "CCC" leading to more growth and jobs.

Increased trade is considered to be the conventional factor channeling potential benefits from "OCA" – structured macroeconomic policy to economic growth. According to a study of A.

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Rose, a currency union membership nearly doubles trade with currency union partners and this would lead to raising GDP, although estimates of GDP gains differ substantially, from 1% to 20% over 20-year period.[2]

Positive trade effects in a currency union are produced, among others, by an increased **competitiveness.** Currency union, through less macroeconomic risk (as an exchange rate risk is eliminated) as well as through the increased financial market integration, contributes to strengthening of confidence of market participants. Confidence is also built up by the improved quality of macroeconomic policy which is enforced by a currency union. Both strengthened confidence as well as underlying lower interest rates, help attract foreign direct investment and technology, therefore stimulate economic growth.

Potential gains from a currency union may be, however, realized at the expense of potential costs. The latter are associated with giving up monetary policy as a tool for stabilization and exchange rate as a shock absorber. These costs increase as currency union members experience asymmetric shocks. That brings serious demands and challenges for macroeconomic policy inside a currency union as well as in countries aiming to join the union.

A need for **cohesion** originates, primarily, from regional disparities which may be associated with different level of development and of competitiveness (e.g. agricultural vs. industrialized regions); with different sectors leading local activities (e.g. sunrise vs. declining industries); or with geographic location (peripherial vs. centrally located regions).

There are diversified linkages between a currency union and cohesion. An adoption of a stability-oriented macro-policy approach inside a currency union alters government and financial market behavior, most pronounced for those who have to change most, with need for policy learning. Increased regional specialization within a currency union may affect cohesion in an either way. It initially favors core regions but also creates potential opportunities fro low cost areas. Monetary union – related market opening brings potential threats to less

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[2] A. Rose, *The Effect of Common Currencies on International Trade: Where Do We Stand?,* Occasional Paper 22/2002, University of California, Berkeley

competitive regions and is likely to widen disparities.[3] Those examples suggest complex and ambivalent effects of a currency union on cohesion.

A currency union involves, however, also a **coordination** issue. It is necessary to find an appropriate and efficient institutional framework for macroeconomic policies, which need to be coherent in order to be able to create an environment favorable for growth and jobs.. Coordination is a prerequisite for competition and cohesion and, consequently, for economic growth. The significance of coordination becomes reinforced when we allow for the process of an enlargement of a currency union which implies building contacts between current members and candidate countries seeking for the adjustment to the union. Coordination needs a permanent improvement as (e.g. external) conditions for a currency union change all the time. Coordinating institutions should never be complacent on their performance.

To sum up, a substantial change for the macroeconomic framework is brought by a monetary union. Macroeconomic policies have also implications for different "C's" and, ultimately, for growth and jobs. Not only three "C's" (competition – coordination – cohesion) are affected but the new "C's" (like confidence, coherence, convergence, complacence) also emerge. Following sections will illustrate some of those linkages with the example of the EMU.

Macroeconomic Performance in the EMU

There are several components of macroeconomic performance in the EMU.

First, a record on macroeconomic stability, which is emphasizing low inflation and sound public finances, is relatively successful. Inflation rate, measured with the CPI index, was brought down from 6,7% in 1980 to 2,7% in 1991-1998, and further to 2% in 1999-2004. Pronounced period of slow EMU growth in 2002-2004 has helped containing inflation, whereas some energy and food price increases pushed inflation upwards. Limited potential second-round effects on prices from the oil shock in 2004 and 2005 as well as strong euro allow to keep price expectations close to or below 2%. The most recent ECB forecasts for the euro area predict an inflation rate at the level of 1,9% for 2005 and 1,6% for 2006.[4]

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[3] I. Begg, *Is Full Paricipation in EMU Likely to Favor or Slow Real Convergence",* paper presented to a seminar *Successes and Failures in Real Convergence,* National Bank of Poland, Warsaw, 23-24 October 2003.
[4] *Euroland. European Economic Flash,* Goldman Sachs Economic Research, 7th March 2005, p.1.

EMU brought a strengthened consensus on the need for governments to aim at sound public finances. Regardless of the problems with budgetary discipline in some EMU economies, it should not be forgotten that during the 1990's a substantial degree of budgetary consolidation was achieved and, consequently, current budgetary trends in the EMU compare favorably with the past. General government fiscal deficit amounted to 4,4% of GDP in 1991-1998 and in the consecutive years of the period of 1999-2003 was brought down to, respectively, 1,3%; 0,9%; 1,7%; 2,3% and 2,8%.[5]

Secondly, the euro turned out to be – on balance – a relatively shock-resistant currency. Over six years of the EMU, exchange rate fluctuations of the euro were visible (e.g. 1,14 euro per US dollar in 2001 shifted into 0,78 towards the end of 2004) but those changes were always gradual and under control of the EMU monetary authorities. It should be emphasized here, that, over time, the euro has strengthened its international role, both in the private use (in international debt securities; foreign exchange markets and in international trade) and in the official arrangements (with the participation of governments and central banks using the euro as an anchor or a reserve currency).[6] This trend reflects an increased **confidence** in the single currency and in the improved macroeconomic stability which is underpinning the euro. Today the EMU is a zone of low inflation with a gradual, although painful, process of a consolidation of public finances and with low interest rate levels last seen a long time ago.

Third, in terms of economic growth, the EMU record has been, on average, rather disappointing, particularly when it is compared with the US and Asia. Over the past ten years, GDP growth rate in the EMU averaged 2,1% vs. 3,1% in the US. Since the crisis of 1997-1998, growth indexes for developing Asia are close or over 6%. It has also to be stressed that during a global economic slowdown in 2001-2003, the slowdown of EMU economies was protracted whereas the following recovery is still relatively weak. During first two months of 2005 the ECB has lowered its central 2005/2006 GDP forecast for the EMU by a cumulative 0,4%.[7] Employment remains one of the Europe's weakest points. An average employment

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[5] IMF, *World Economic Outlook September 2004,* Washington DC 2004, p. 13.

[6] E.g the share of the euro in international debt securities increased from less than 20% in the run-up to the launch of the euro to 31% in 2004, while in global foreign exchange reserves – from 15% to 20%. In the course of 2003, the share of the euro as an invoicing or settlement currency in international tarde of EU candidate countries has increased markedly. L. Papademos, *The Euro After Five Years: Assessing Its Performance and Global Role,* speech at the 13th International Monetary Symposium, Tokyo, 12 November 2004.

[7] *Euroland. European Economic Flash,* op. cit., p.1.

rate, at 84% of the US level, remains low whereas rates for women and older workers are stagnating at visibly low levels.

The position of the European Commission is that a lack of economic dynamism in the EMU is not due to failures in macroeconomic policies but rather to the insufficient progress in structural reforms.[8] In that context the original Lisbon Strategy is referred to as a path towards not only sustainable economic growth with more jobs but also to a **competition,** knowledge-based economy and greater social **cohesion** by 2010. The strategy envisaged for the average annual economic growth around 3%; increasing the employment rate from 61% in 2000 to 70% by 2010; promoting social inclusion and working toward environmentally sustainable future.

However, the EMU underperformance in terms of economic growth, comes not so much from the differences in labor productivity, i.e. in **competitiveness** as well, *vis a vis* the US, but is for mainly by demographics, i.e. by the difference in the growth of working-age population. Over the past ten years, the labor productivity growth rates for EMU and US amounted to, respectively, 1,8% and 2%, whereas working-age population rates – to 0,4% and 1,2%.

Competitiveness is influenced, among others, by the degree of liberalization of the economy. 2005 ranking of the world's freest economies shows that five EU members are more free than the US whereas another five are very close to US position.[9] All EMU members, except Italy and Greece, are also high on the list of the most competitive economies in 2003, with Finland being the top performer.[10]

These data suggest that attributing weak economic growth in the EMU entirely to the low competitiveness should be taken with caution. Regardless the working-age population factor, the difference in EMU economic dynamism *vis a vis* the US is, to some extent, also due to methodology; many productivity comparisons include – for EMU – the whole economy basis while for the US – "non-farm business sector" basis (having stripped out low-productivity

[8] K. Regling, *EMU After Five Years,* speech at the conference on *EMU and Economic Governance,* Brussels, 28 September 2004.
[9] The Heritage Foundation; the Conference Board.
[10] Global Competitiveness Index (GCI) of the World Economic Forum. GCI has three components: macroeconomic stability, the level of technology and the quality of public institutions.

farming and government). It is also remarkable that when we compare the growth rates of GDP per capita instead of those of GDP, the gap between the US and EMU is reduced.

In terms of **cohesion,** it is reasonable to say that EMU has brought some improvement at the average country level. For small economies, a monetary union provides incentives to pursue sound fiscal policies which may contribute to speeding up economic growth. Some EMU members, Ireland and Spain being the most prominent examples, have used this opportunity and, wisely absorbing cohesion and structural funds, have closed the standard of living gap towards better off partners or even outperformed them.

A synchronization of business cycles between countries is also a sign of the increased cohesion. The process has been progressing within the EMU until 2002 and since then it has actually reversed. According to deutsche Bank, in the latter period the standard deviation of quarterly growth rates has increased whereas the patterns of GDP growth have been increasingly different, e.g. in France growth has been coming mainly from consumption with the negative contribution from net exports while in Germany net exports were the only engine of growth. Research on cohesion has, however, to be extended and disaggregated to the regional, intra-country level and to the different social and professional groups to find out whether the most vulnerable components are better protected or included.

Turning to the **coordination** issue, we have to return to macroeconomic policies.

First, this coordination has some flaws in principle as combining single monetary policy with decentralized fiscal policy – when business cycles are not yet fully synchronized while labor force and wage rigidities remain – poses a potential threat to competitiveness, cohesion and to growth and jobs. In those circumstances, ECB interest rates in 2003 turned out to be too restrictive for Germany and too loose for Spain and Ireland. EMU shows a weakened policy **coherence** here; an establishment of a coherent fiscal policies at the EMU level would help optimize the monetary and fiscal policy mix.

Secondly, for coordination to be efficient it is better that each decision maker works out and executes its own plan of action on which he has an entire responsibility and doesn’t try to blame the partner and tell him what he should do. Regarding the EMU, there is an evidence of

the ECB focusing on critics of governments and of insufficient structural reforms whereas some politicians were criticizing ECB policies as too restrictive.

Third, coordination includes both fundamental rules and their enforcement. It is likely better when rules are relatively flexible whereas enforcement is strict and not the other way round. In that regard, it is useful to mention the EMU experience with fiscal policies and with the Stability and Growth Pact. They basically do not encourage big economies to run prudent public finances while enforcement in the Pact is flexible and allows for different interpretations. It is not surprising that big economies (mainly Germany and France, partly Italy) have breached the Pact and they were able to escape sanctions provided by the Pact.

Fourth, the previous experience with the Stability and Growth Pact as well as with the Lisbon Strategy shows that there is a need to strengthen **the framework for coordination** between the EU and national levels. As long as governments pursue their own, largely uncoordinated, policies and there is a lack of **ownership** at the national level, such initiatives will hardly work. To prevent this, national, but non-political, bodies could be involved in the monitoring and assessment of EU level initiatives. These bodies would act as a counterbalance to existing EU bodies (like the ECB) and would avoid the short term perspective typical for politicians. It remains significant not only for fiscal policies but also for revitalized and streamlined Lisbon Strategy.

EMU Enlargement Perspective

Ten new member states of the EU will ultimately have to join also the EMU. This objective will:

- Bring substantial opportunities and challenges for their macroeconomic policies, with linkages to competitiveness and cohesion;
- Require an appropriate coordination among new member states as well as between them and the EMU/EU.

The whole group of new member economies is by no means homogenous; following remarks will refer mainly to Central European countries. It is also assumed – and hardly arguable – that EMU accession is, on balance, clearly beneficial for central Europe. Therefore we focus

on the process leading towards achieving the euro and not on desirability of introducing single currency in new EU member states.

A substantial gap between Central Europe and the EU, in terms of GDP per capita, illustrates the challenges for **cohesion** process inside the enlarged EU. Those differences are sharpened when we include specific remote areas or disadvantaged groups ni Central Europe. It is likely that EU-related restructuring and modernization of the economies of Central Europe, enhanced by an intensified **competition,** may push up unemployment, particularly in regions with ailing industries. It has also to be emphasized, however, that GDP per capita gap is decreasing over time as Central European economies show relatively strong (also vis a vis the US) productivity and GDP growth. This growth is driven, among others, also by **competitiveness,** influenced by relatively cheap and well educated labor force, favorable structural shifts and low tax rates in Central Europe.

On the other hand, trade integration of Central Europe with the EU is already strong (it is stronger than in the case of EU "southern enlargement") and should further increase due to expected EMU accession. This should be instrumental tot he business cycle synchronization and, consequently, to the cohesion or convergence, in the enlarged EU. Among Central European countries, only Hungary and Poland have achieved relatively high degree of synchronization with the EU for GDP, industry and exports but not for consumption and services.[11] While consumption represents an important share in the aggregate demand it could be argued that fast euro adoption would restrict the room for maneuver in macroeconomic policy in Central Europe as it would involve giving up sovereign monetary policy.

Macroeconomic challenges for Central European countries are focused on the timing and coordination of the process of euro adoption. There are few, main challenges.

First, an appropriate, i.e. prudent, fiscal policy is an obvious prerequisite for the stability of Central European currencies and for the successful EMU accession. General government deficits in Central Europe are high (from close to 4% in Slovakia to over 7% in the Czech Republic) while the composition of fiscal expenditures is unfavorable, with too large share of fixed spending, like interest payments in Hungary or social entitlements in Poland or Czech

[11] Z. Darvas, G. Szapary, *Business Cycle Synchronization in the Enlarged EU,* Magyar Nemzeti Bank and Corvinus University, Budapest 2004, p.30.

Republic. This composition results in a limited flexibility of fiscal policies. EU structural funds require financial matching from Central European national budgets; those budgets have also to prepay EU agricultural subsidies, to be reimbursed one year later. Net EU-related fiscal effects for Central Europe are slightly negative at the beginning of EU membership and the necessary fiscal consolidation becomes a more difficult task.

Secondly, in order to be eligible for the euro adoption, Central European countries are also required, under ERM-2 mechanism, to simultaneously stabilize both inflation and an exchange rate. It is not an easy task, particularly for economies – like those in central Europe – having quite strong appreciation and inflationary pressures.. In such circumstances, these two targets are becoming increasingly mutually inconsistent.

Third, Central European countries will have to restrain a very rapid bank credit growth. There is a substantial scope for bank credit expansion in those countries as they catch up to the euro area ratios of bank credit for the private sector relative to GDP.

Macroeconomic efforts towards sound policies in central Europe need, however, to be complemented by an appropriate **coordination** from the EMU/EU side. This coordination includes both principles of adopting the euro (Maastricht criteria) as well as their implementation.

Taking into account macroeconomic challenges in Central Europe during the process of the euro adoption, Maastricht criteria are, admittedly, very demanding. As they were established for economies different from those in Central Europe, and for different time (when there was no monetary union around), it might be reasonable to consider revisiting some of these rules.

First, fiscal rules (which focus around 3% general government deficit and 60% public debt ratio) are punishing for economies which – like those in central Europe – have stronger potential economic growth. Including by the EU the budgetary costs of pension reforms (implemented e.g. in Poland) into general government deficit is arguable as those reforms are not equivalent to a lack of fiscal discipline.

Secondly, current benchmark for inflation (an average of three EMU best performers plus 1,5 percentage point) is too demanding for Central European economies as they have structurally,

i.e. productivity-based higher inflation (which illustrates Balassa - Samuelson effect). An inflation benchmark could rather be adjusted towards the ECB inflationary target.

EU cooperation with Central Europe goes beyond the rules to the enforcement of the process of the euro adoption, in particular when Central European currencies enter and stay within ERM 2 mechanism. For example, it is of vital importance, what level of the conversion rate will be accepted by the ECB; which fluctuation bands will be applied; how the ECB will help in interventions designed to maintain an exchange rate stability.

And last, but not least, it has to be emphasized that today only few EU “old” member states have completely opened their doors to immigration from the Central Europe. As mentioned earlier, a monetary union brings more benefits when labor mobility is not restricted. Allowing for more migration would encourage Central Europe to early adoption of the euro.

Summary

To sum up, several main conclusions can be drawn.

1. In the EU, it is not only “competition – coordination – cohesion”, but also other “C’s” – like confidence, coherence or convergence – which are vital for increasing growth and jobs.

2. Coordination seems to be an important prerequisite for other “C’s”. In the EU, coordination is being exposed to a strong debate which includes also critics (e.g. a debate on the Lisbon Strategy or on Stability and Growth Pact).

3. Coordination should be based on clear, relatively flexible rules and on strict enforcement procedures.

4. Each decision making body has to focus on its own responsibilities instead of blaming partners.

5. In the EU policy coordination there is too much national government thinking.

6. All these remarks are also valid, although to a reduced extent, for the EMU and its enlargement.