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How to Safeguard General Support and Legitimacy of Monetary Policy during Times of Economic Distress in a Monetary Union?

Jean-Paul Fitoussi

Executive Summary

The two recent macroeconomic shocks that hit the world economy - the surge of oil and food prices and the subprime crisis – have revived the attention of policy makers and economists on the consequences of shocks, symmetric and asymmetric, and on the appropriateness of the EMU institutional framework to respond to these shocks. The briefing paper outlines the doctrine that underlies the ECB response to the shock, i.e. an exclusive focus on inflation, and argues that this policy is likely to be ineffective, while it will certainly have deep distributional consequences, having the same analytical effect as of a regressive tax on low income wage earners. The paper then discusses in more general terms how the European institutions face difficulties in the classical instrument/objective assignment problem, which stems from an excess of confidence in market adjustment mechanisms. This contrasts with the case of the US, where market forces and policy interventions complement each other in a virtuous way. The paper then concludes with a number of proposed changes in the economic governance of Europe, which would make the policy reaction to shocks easier and more effective.

In the past months two major sources of uncertainty loomed on the world economy. First, the recent turbulences on the financial markets, triggered by the subprime crisis, whose effects seem not to be over, and are beginning to spill to the real sector through increased credit constraints and deteriorating private agents' confidence. The second element of uncertainty, even more dramatic, is the steep increase of food and raw materials prices[1] that depends on both structural and contingent factors, and whose social consequences are causing increasing concern.

The combined macroeconomic effect of these two crises is quite visible. Growth forecasts for the years 2008-2009 are being revised downwards for most countries and economic zones, and the debate is still heated as of how lasting the effects of this twin crisis will be.

An important effect of this period of turbulence is the revived attention on the consequences of shocks on the economy, and on the appropriate policy responses. This is particularly important in the European Monetary Union, where the treaties have left a good deal of ambiguity in the objectives/instruments assignment. How to safeguard the general support in macroeconomic policies in general and in particular monetary policy during times of economic distress in a monetary union is hence a very relevant question. Monetary policy being the main federal policy of the EU, general support in it is crucial for its legitimacy.

This moment of crisis becomes then an occasion to assess whether the current institutional framework of the EMU is appropriate to respond to the different types of shocks that hit the European economies, and to assess its effectiveness and credibility.

This paper will at first outline the doctrine that lies behind the current European institutional framework, and then argue that while coherent, such framework may be inappropriate to respond to a number of shocks; in particular, in the current situation the policies followed by the European governments and by the ECB are likely to exacerbate the problems faced by the European economies, and by low income wage earners in particular. I will conclude that a more pragmatic approach is desirable, and that the example of the United States may prove helpful.

[1] The ECB forecasts international food prices to increase by 44% in 2008. See *ECB Monthly Bulletin*, June 12th 2008, p 81.

1. The Design of the Institutions for European Economic Governance

In my briefing paper of March 2007[2] I described at length the theoretical framework that influenced the creation of the Maastricht institutions. That discussion may be briefly summarized as follows:

1) Once public intervention has coped with externalities, clearing and complete markets that are populated by rational agents usually yield the best possible outcome in terms of resource allocation and growth.

2) When that is not the case, the responsibilities lie with frictions and market failures.

3) The role of economic policy is then simply to remove or minimize these frictions on the supply side (through structural reforms and a reduction of government's size).

4) Any active intervention on the demand side is useless, if not harmful. Once conditions on the supply side are established, the economy will attain the most efficient position unless distorted by public intervention.

5) This has important consequences in terms of policy: if tradeoffs do not exist, the policy maker is not confronted by choices, and there is no role for activist macroeconomic policies. Fixed rules are the preferred tool for conducting policy because they prevent biases in policy makers' actions and constitute an anchor for private expectations. Hence the search for price stability and the obedience to a fiscal rule (the SGP) is more than enough to take care of demand.

Coherently with this conclusion, the European institutional setup, de facto, gives up discretionary economic policy. Monetary policy is delegated to an independent monetary authority, the European Central Bank, which is not accountable to any political body. Fiscal policy is strongly constrained by the Stability and Growth Pact, which barely leaves space for automatic stabilizers to work.

Within this framework, whenever a shock hits the economy the bulk of the adjustment relies on market forces (wage and price flexibility, factor mobility, etc etc), while fiscal and especially monetary policy have a limited role. In particular, barring very particular cases monetary policy has to focus on its primary objective, inflation.

The almost exclusive focus on inflation explains the choice to focus on a headline inflation objective, that is to react to price increases even when they do not directly depend on domestic conditions. In the June 2008 ECB Monthly Bulletin, the ECB explains its strategy as follows:

"*The Governing Council emphasises that maintaining price stability in the medium term is the ECB's primary objective in accordance with its mandate. The Governing*

[2] Jean-Paul Fitoussi, *Wage Setting and Price Stability,* Briefing paper prepared for the Committee For Economic and Monetary Affairs, no 2007-1, March 2007. The interested reader may also look at Fitoussi and Saraceno (forthcoming).

Council is monitoring very closely all developments. It is in a state of heightened alertness. By acting in a firm and timely manner, the Governing Council will prevent second-round effects and ensure that risks to price stability over the medium term do not materialise. It is its strong determination to secure a firm anchoring of medium and long-term inflation expectations in line with price stability. […] *Against this background* [of increased oil and non energy commodity prices hikes,], *it is imperative to secure that medium to longer-term inflation expectations remain firmly anchored in line with price stability. All parties concerned, in both the private and the public sector, must meet their responsibilities. Wage-setting needs to take into account productivity developments, the still high level of unemployment in many economies, and price competitiveness positions. Moderate labour cost increases are particularly necessary in countries which have lost price competitiveness in recent years. Broadly based second-round effects stemming from the impact of higher energy and food prices on price and wage-setting behaviour must be avoided. In this context, the Governing Council is concerned about the existence of schemes in which nominal wages are indexed to consumer prices. Such schemes involve the risk of upward shocks in inflation leading to a wage-price spiral, which would be detrimental to employment and competitiveness in the countries concerned. The Governing Council therefore calls for such schemes to be avoided.*"[3]

To summarize, the ECB argues that it has to tighten its stance (or not to ease it, which during times of economic distress amounts to the same) in reaction to domestic and imported inflation pressures alike, because the latter risks triggering wage-price spirals (second-round effects). The possible deflationary effects of such a stance are not a major concern of the ECB, whose primary objective is price stability. This is in stark contrast with the US Fed, which has to balance the objective of price stability with the support to economic activity, and thus focuses on core inflation (excluding oil and food prices). The result of these two different views in the past months has been a significant drop of US interest rates (from 5.25% to 2%), while the ECB rate remained rock-steady at 4%.

2. The Dilemmas of Economic Policy in the Eurozone

The ECB theoretical framework, and the strategy that it follows coherently with this framework, are today running into two related dilemmas. The first is the one I already mentioned above, and that has been the subject of other briefing papers, between the inflation and growth objective. Only three months ago[4], writing about the subprime crisis, I challenged the ECB explicit assumption, that inflation is always a monetary phenomenon, and that the interest rate instrument should be devoted exclusively to dealing with inflation pressures.

[3] *ECB Monthly Bulletin*, 12 June 2008, pp. 4-5.

[4] Jean-Paul Fitoussi, *ECB Objectives and Tasks: Price Stability vs. Lender of Last Resort*, Briefing paper prepared for the Committee For Economic and Monetary Affairs, no 2008-1, March 2008.

The second dilemma, that is much less debated but at least as important as the first, is related to the redistributive effects of shocks and monetary policy's reaction. The impact of the current shocks on prices is more important for low and fixed income categories, who spend a much larger share of their income in the goods that have seen their price explode (oil, primary goods, etc), and who are unable to transfer these increases on other categories.

As a consequence, the burden of these price increases falls disproportionately on the shoulders of low income categories, and these shocks are analytically equivalent to regressive tax increases. This explains why according to many surveys purchasing power is the main concern of households in many countries across Europe.

If we keep in mind this fact, the ECB argument that restrictive monetary policy should also be used against imported inflation in order to fight second round effects, acquires a new meaning. Acting as the watchdog of wages (the very last sentence of the citation above is revealing in this respect) the ECB controls inflation, but in doing so it exacerbates the redistributive effects of imported inflation that disproportionately affects low income categories. In other words, to avoid a price inflation spiral, the "external tax" due to the increase in oil prices in particular should be paid only by the wage earners. Then the decrease in purchasing power of the median worker would calm inflationary pressure helping the ECB to reach its inflation target. To that mechanism will cooperate also the decrease in purchasing power due to the increase in food prices. Thus, inflation controls come at the price of an increasing income inequality, and depressed domestic aggregate demand, thus linking the two dilemmas in a vicious circle.

Furthermore, even abstracting from considerations about inequality and growth, we can raise doubts on the effectiveness of this strategy. Both the subprime crisis and the oil and food price increases are shocks that hit the entire Euro zone, but whose effects are different in the different countries depending on a number of factors like the productive structure, the energy mix, the response of the labour market, the distribution of income, etc. While purely asymmetric shocks (e.g. a natural disaster, a social conflict) are much easier to identify and tackle, the real difficulty lies in the diagnosis of asymmetric effects of common shocks. Once again we can rely on simple textbook analysis to show that using the common monetary instrument to address country specific inflation problems is useless, so that it risks hampering the credibility of the institution.

The standard argument that the ECB opposes to these criticisms is that market forces would be able to take care of these asymmetric shocks through relative price and wage changes, migration etc. The International Policy Group that I coordinated at OFCE[5] had already warned in the early 1990s, that even in the US, where cultural and economic obstacles are much lower than in the Euro zone, persistent differences across states would show that market mechanisms alone were not able to absorb shocks. Thus, we suggested that asymmetric shocks would result, in absence of policy reactions, in

[5] Fitoussi *et al.* (1993).

increased unemployment and labour market tensions, an argument that was further validated by the works of Blanchard and Katz (1992), and Decressin and Fatas (1995).

We can add a few further considerations on the inadequacy of market flexibility and structural reforms as the ***sole*** answers to asymmetric shocks. First they may result in competition among member states (for example tax competition), triggering a race to the bottom that risks hampering the solidarity among countries that was the basis of the European construction. Second, reforms are not implemented in one day. Measures aimed at increasing flexibility, especially in the labour markets, will most likely result in long transitions during which reforms may have countercyclical effect, exacerbating the effects of shocks.

Our Policy Group also suggested that, following a standard textbook analysis, the loss of monetary sovereignty linked to the EMU should be compensated by a reinforced fiscal autonomy, and that the European institutions in the making (that later resulted in the Stability and Growth Pact) were actually going in the opposite direction and did not adequately respond to the standard objective/instrument assignment. Thus, I could only observe with preoccupation the slow but inexorable drift of the European institutions toward a restrictive interpretation of the SGP that we observed in the past few months, with increased focus on the medium term objective of a balanced budget rather than on the ceiling of 3%. What is puzzling is the autonomous dynamic of the stability pact which despite reforms to allegedly increase its flexibility seems to become more and more rigid. The focus of the Commission is by now much less on the level of the deficit than on its medium term evolution towards zero! Many European economists are now advocating the introduction in national constitutions of a fiscal rule whose effect will be to constrain countries to obey the stability pact. Notice that outside Europe almost no economists, or politicians are pleading for such a move, and that inside Europe but mezzo voce many politicians are criticizing the stability pact.

It is nevertheless reassuring that today, after a decade of policy inertia that was among the causes of disappointing macroeconomic performances for the Euro zone, we are asked to reconsider the issue of appropriate responses to macroeconomic shocks. I see this as an implicit acknowledgement that policy should be given a more active role.

3. What Institutions for a More Effective Economic Policy?

I see the main problem of the current institutional framework in its global coherence with a theoretical approach that confines macroeconomic policy to a marginal role in the management of the economy. In this respect, the US may serve as a model in that their institutions rely on the complementarities between market based adjustments and discretionary fiscal and monetary policy. Thus I would strongly argue in favour of a *global* reappraisal of policy intervention.

For what concerns *monetary policy*, the present times of economic distress shed light on an essential problem, which is more or less hidden in normal circumstances: the political nature of monetary policy decision. We have seen that monetary policy affects four variables

which usually are considered as primary objectives of any government: inflation, growth (and thus employment), the degree of inequalities, and through exchange rate variations the external balances. (And I skip wealth which is obviously affected by the rate of interest). A robust result in economics is that when an instrument is used to reach several objectives, the policy maker has to make trade-offs. In a democratic regime, trade-offs have to be made by the elected representatives of the population: they imply political choices and thus political responsibility. They can't be left to a technocratic body. It may well be that a government proceeds exactly to the same choices than those of the ECB, but it will then bear full responsibility for this choice.

In saying that, I am not criticizing the ECB. It has indeed no other choice than fulfilling its mandate which has been politically designed. But one has not to be an expert to understand that in making it such a way that a "technocratic body" has to bear responsibility for a political choice, it may loose its legitimacy. These remarks belabour the obvious which is that full responsibility can only be born by the political structure, and that "independent body" have to be accountable.

As for *fiscal policy*, while maintaining some form of peer pressure to avoid free riding and spillovers within the EMU, I strongly argue for a renewed role of discretion for governments that already lost the monetary instrument with the Euro. Scrapping the objective of a balanced budget over the cycle, introducing some form of *golden rule* of the type implemented in the UK, increasing the number of exceptions to the 3% ceiling, or raising the ceiling altogether, are all measures that would allow European governments to recover some room for policy in their action.

To better deal with asymmetric shocks a solidarity fund could be envisioned, to which countries would contribute in good times.

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