

Change of Course Required on the Road to Maastricht

European Monetary Union (EMU) is already casting its shadow over the EU countries. As the decision on the future of monetary union draws closer, the process of European integration is coming under ever greater scrutiny. The adjustment pressure perceptible in the run-up to the third stage and the fixing of the criteria for admission in the Maastricht Treaty has rapidly eroded popular acceptance of the entire project. Countries are finding it particularly difficult to meet the fiscal criteria. The resultant restriction of the scope for fiscal policy action has led to monetary union being perceived more often as a threat than as an opportunity.¹

Monetary convergence

The first steps towards a monetary union, initiated primarily by Germany and France, were taken back in the late 1970s. They were characterised by the desire to reduce the then prevailing substantial nominal divergence between the European economies, as reflected particularly in marked differences in inflation rates, interest rate differentials and – in some cases drastic – exchange rate adjustments. In this respect, and taking the monetary criteria of the Maastricht Treaty as a yardstick, considerable progress has been achieved since then (cf. figures 1 and 2).

Differences in inflation rates have been significantly reduced; parallel to this, interest rate differentials have also narrowed. This was in large measure the result of the establishment of the European Monetary System (EMS), the aim of which was to stabilise exchange rates (cf. figure 3). Although the foreign exchange markets have been hit by sporadic turbulence, these were due less to the still prevailing differences in terms of stability than to expectations regarding the orientation of economic policy.

Economic policy makers primarily sought to achieve nominal convergence. This required far-reaching changes in the division of economic policy responsibilities in the various countries. The harmonisation of Euro-

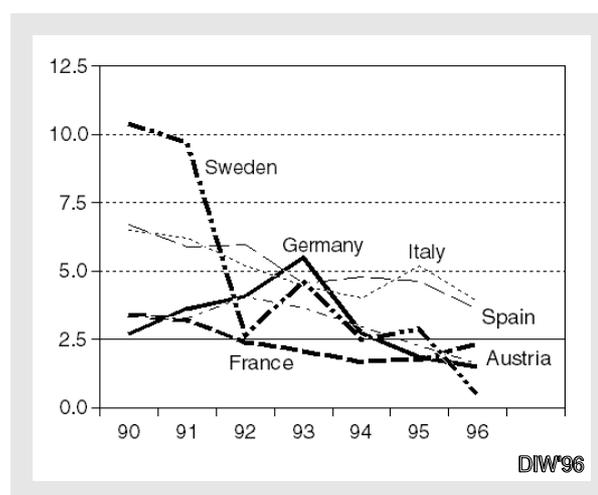
pean monetary policy was a necessary condition for achieving monetary convergence. As Germany, the country with the lowest rates of inflation in the 1980s, to all intents and purposes dictated the stability targets, and the D-Mark, along with the dollar, had taken on the role as an international reserve currency, harmonisation at, as far as possible, unchanged exchange rates largely meant adjustment to German monetary policy. Given fixed exchange rates, the other countries would otherwise have faced a loss of competitiveness.

For those countries with substantial "convergence requirements", i.e. whose inflation rates were significantly higher than in Germany, this policy – due to the employment losses and internal tensions it produced – repeatedly led the markets to expect an imminent devaluation of the currency in question. By virtue of this strategy of adjustment, this Europe-wide uniform monetary policy, "anticipated" as it were the situation in a monetary union: following the introduction of a single European currency there will, by definition, be just one common European monetary policy. This state of affairs will differ from the current one in that it will no longer be possible to return to an independent monetary policy.

Fiscal policy convergence

It is no coincidence that, since Maastricht, it has been the fulfilment of the reference values for the budget deficit and government debt, and thus fiscal policy in general, that has increasingly moved to the centre of atten-

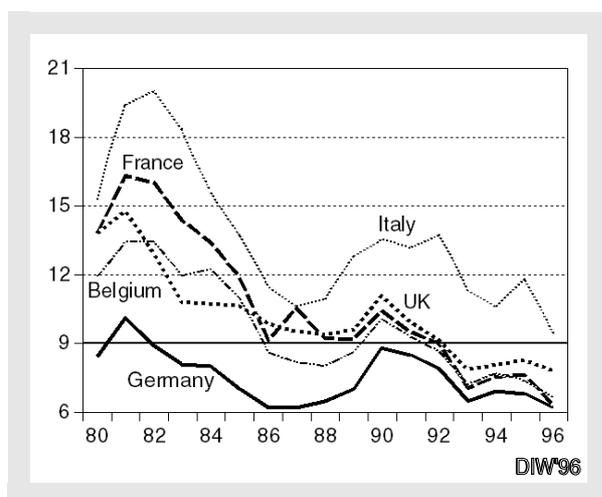
Figure 1
Consumer Prices, 1990 to 1996
% change on previous year



The darkest line indicates the inflation criterion set by the Maastricht Treaty (under prevailing conditions)
Source: OECD, main economic indicators.

¹ This article is based on: Horn, Zwiener: Beschäftigungsentwicklung im Zuge der Europäischen Währungsunion, *Gutachten im Auftrag des DGB und der Hans-Böckler-Stiftung*, Berlin 1996.

Figure 2
Long-term Interest Rates, 1980 to 1996
of 10-year government bonds



The darkest line indicates the inflation criterion set by the Maastricht Treaty (under prevailing conditions)
Source: OECD, main economic indicators.

tion.² Setting a limit on the deficit as a percentage of GDP forces the EU countries to move towards fiscal policy convergence, just as the inflation, interest and exchange rate criteria ensure monetary policy convergence, and thus imply a loss of autonomy. For countries such as Belgium or Italy, whose outstanding government debt far exceeds the 60% reference value, a reduction implies that current fiscal policy must achieve budget surpluses over a period of many years. Even the current deficit requirement, which is in principle easier to meet, requires in periods of recession that countries pursue a fiscal policy that runs counter to the need to stabilise the economy. This is because the Maastricht Treaty fails explicitly to distinguish between cyclical and structural deficits.

Although a trend towards deficit convergence is apparent in the leading European Union countries, this is at a markedly higher level than 3%. Over the last ten years Italy and Belgium have managed to reduce their current deficits as a share of GDP. On the other hand the deficits in France, Great Britain and Germany have risen – for cyclical reasons – over the past five years (cf. figures 4 and 5). There is considerable evidence for the view that it has been precisely the fact that most coun-

² The following is based on the more extensive discussion of the convergence criteria, in particular the fiscal policy criteria, in earlier editions of the Economic Bulletin: cf. Fritz Franzmeyer, The Maastricht Convergence Criteria from a German Perspective, *Economic Bulletin* vol. 32, no. 9, September 1995; Marcel Stremme, How Important are the Fiscal Policy Convergence Criteria?, *Economic Bulletin*, vol. 33, no. 3, March 1996.

tries have concentrated on meeting the monetary criteria – inflation, interest and exchange rates – that has made it more difficult to achieve the fiscal reference values. In order to meet the monetary criteria all the countries were forced to maintain a restrictive monetary policy stance. The dampening impact of this on economic activity led to a deterioration – via declining tax revenues and rising welfare spending – in the fiscal position. In this respect there is a conflict between the monetary and the fiscal criteria.

If the partner countries in monetary union are to meet the deficit condition in its strict form they must maintain a highly restrictive fiscal policy course over the next two years. This could endanger the cyclical recovery in Europe without, at the end of the day, necessarily solving the fiscal problems.

Yet if fiscal policy makers were to refrain from meeting the fiscal reference values, they might well endanger the start of monetary union. Last autumn Germany's six leading economic research institutes indicated a way out of this dilemma:

"With a view to maintaining economic stability, the Institutes do not recommend attempting to prevent a cyclical rise in the deficit beyond target values by implementing sharp cuts in public spending or tax increases. Consequently it is not the current deficit that should be used as a criterion to determine whether or not a country should be admitted to monetary union, but rather the deficit adjusted for cyclical influences, the structural deficit."³

The federal government and the Bundesbank are still insisting on a strict interpretation of the fiscal reference values. Yet it seems likely that even Germany will fail to meet them. This makes it all the more difficult for Germany to lend its support to a less strict interpretation, however sensible this might be from an economic point of view, as it implies the danger of a loss of credibility vis à vis partner countries which have a far further distance to travel in order to meet the values.

The impact of a tougher restrictive stance

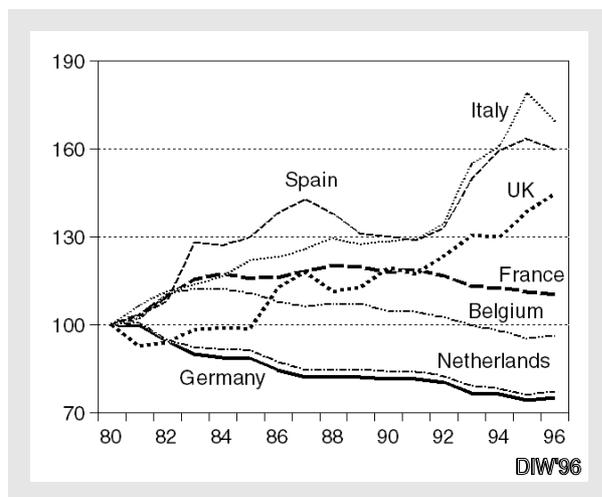
A strict interpretation of the fiscal reference values implies the need for consolidation measures that, in some cases at least, go far beyond those already announced and implemented.⁴ With the help of econo-

³ The World Economy and the Germany Economy in the Autumn of 1995 in: *Economic Bulletin*, vol. 32, no. 11, November 1995.

⁴ The rest of the analysis ignores the reference value for outstanding government debt and assumes that it is sufficient for countries to meet the current deficit reference value.

Figure 3
Exchange Rates

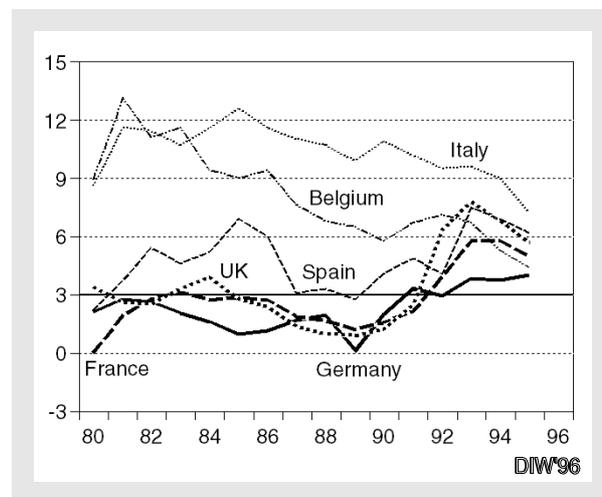
Index of national currencies to the ECU, 1980 = 100



Sources: German Bundesbank; ECU-change rates, DIW calculations.

Figure 4
Deficit

as a % of GDP



The darkest line indicates the reference value for the deficit set by the Maastricht Treaty

Source: OECD, Economic Outlook, no. 59.

metric model simulations conducted with a multi-country model, the Oxford Economic Forecasting Model, the DIW has calculated the austerity measures that would be necessary for all countries to meet the deficit reference value in 1997 "to the letter".⁵ In order to keep the simulations as simple as possible, cuts in public spending were assumed to apply exclusively to government consumption (i.e. not to transfers or capital spending). Under this approach consolidation attempts that cut social transfers – at least in Germany – are counted only incompletely.⁶ Government consumption is reduced to such an extent that the countries in question would meet the deficit criterion. In some cases this leads to public spending targets that go far beyond any realistic austerity strategy. Consequently the simulations are purely hypothetical in character. Yet they do enable a judgement to be made on the feasibility of a monetary union under a strict interpretation of the criteria set out in the Maastricht Treaty.

The problems associated with implementing sufficiently far-reaching savings measures are particularly

acute in Italy, Sweden and Spain. Yet for Germany and Austria, too, it is extremely unlikely that government consumption could be reduced sufficiently.⁷ The magnitude of the savings required results from the interaction between a reduction in government consumption, economic growth and budget deficits. Because an even tougher austerity policy reduces GDP, the cuts in government consumption must be drastic in order to more than compensate for the negative growth impact.

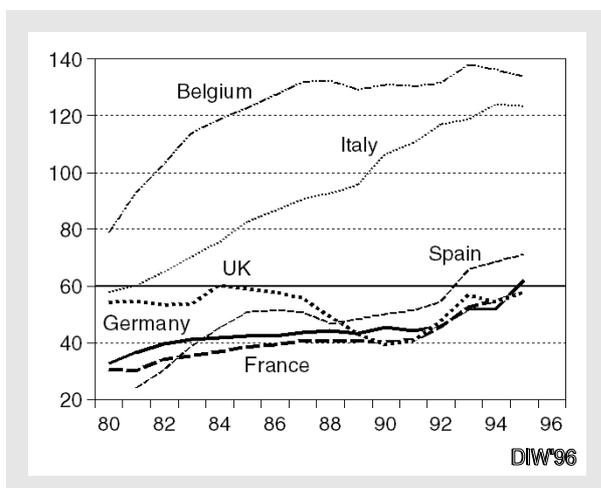
In the light of the reactions on the capital market observed in the past, the hope that the reduction in budget deficits and thus in government borrowing would lead to a substantial decline in interest rates on capital markets is unlikely to be fulfilled. This is because the link between a budget deficit and the interest rate level on capital markets is very weak. Although a narrowing of a budget deficit does reduce government demand for capital, and this, of itself, has the effect of reducing interest rates, a reduction in public-sector demand tends to dampen sales, output and incomes. This leads to a decline in the supply of capital, which, of itself, has the effect of raising interest rates. The simultaneous reduction in the demand for, and the supply of, capital leads capital market interest rates to react ambivalently to a consolidation policy. On top of this comes the fact that long-term interest rates are formed as a result of transactions on the global capital market, in which developments in Europe are only one factor among many. It is therefore to be expected that the

⁵ In interpreting the following results it should be noted that, compared to the prognosis presented by the six leading German economic research institutes – published in the last edition of the *Economic Bulletin* – the cyclical trend assumed for the majority of European countries is less favourable; an exception here is France. As a consequence, relatively large cuts in government consumption had to be imposed for several countries in order for them to achieve the reference values.

⁶ In principle it would also be possible to simulate cuts in public transfers and capital spending. Yet this differentiation would require information on the distribution of the spending cuts, on which only incomplete data are available.

⁷ The World Economy and the German Economy in the Autumn of 1996 in: *Economic Bulletin*, vol. 33, no. 11, November 1996.

Figure 5
Government Debt
as a % of GDP



The darkest line indicates the reference value for government debt set by the Maastricht Treaty.

Source: OECD, Economic Outlook, No. 59

decline in capital market rates is much too weak to stimulate the investment demand of private investors to such an extent that the reduction in public sector demand would be compensated. This puts a question mark against the rationale behind the concept of fiscal consolidation usually put forward.

In order to achieve an interest rate cut sufficient to offer a lasting stimulus to economic development, it is necessary for the restrictive fiscal policy to receive support from European monetary policy. What is required is that central banks, through low base rates, significantly reinforce the impulse towards lower capital market rates by means of a restructuring of the supply of capital in favour of long-term assets, thus providing a perceptible stimulus to investment.⁸ Only in this way can the demand shortfall created by the savings measures be dampened, as lower interest rates can be expected to increase the propensity to invest. It is a combined consolidation of this type that is depicted in the simulations.

Even so, the savings measures would lead to a significant overall dampening of economic growth throughout Europe (cf. table 1). Not until 1998 is a renewed expansion to be expected under these conditions. The contraction would leave an indelible mark on the already overstrained European labour market: during the consolidation phase the unemployment rate would be expected to rise from 11.5% (1996) to 13.2% (1998).

⁸ Cf. Economic Trends 1996/97 in: *Economic Bulletin*, vol. 33, no. 7, July 1996.

For countries such as Great Britain that do not participate in monetary union, and which therefore do not have to adopt a restrictive fiscal policy course, only a slight decline in economic growth is to be expected. Although export growth is dampened due to the weaker economic development in the rest of Europe, investment is stimulated by the European-wide cut in interest rates.

In Belgium and the Netherlands, where the consolidation requirements with respect to the current deficit are relatively minor, the weak economic expansion would continue at a slightly lower rate. Although compared with the reference trend – i.e. without the intensified austerity policy – export growth would be expected to almost halve, as domestic demand in many countries declines drastically as a result of the austerity measures, the interest rate cuts would enable investment to expand more or less along the reference path in spite of sales difficulties on foreign markets. Here, too, the importance of a suitable combination of fiscal and monetary policy is evident.

In the absence of interest rate cuts France would not be able to meet the deficit criterion – due to weaker economic growth – and would have once more to intensify its austerity policy. The weaker growth would mean that there would be no improvement in the already unsatisfactory state of the French labour market. The unemployment rate would stagnate at around 12%.

The consequences facing those countries whose consolidation requirement is greater would be still graver. If Italy were to meet the deficit criteria a deep recession in 1997 with a fall in GDP would be inevitable. Substantial output losses would be experienced in Germany and Austria. In Spain and Sweden, weak economic growth would be feasible at best. Clearly, the problem of unemployment would be significantly exacerbated in all these countries by an intensification of the consolidation pol-

Table 1
Scenario of an Intensified Consolidation
% growth of real GDP on previous year

| | 1996 | 1997 | 1998 |
|----------------|------|------|------|
| USA | 2.2 | 2.2 | 1.6 |
| Japan | 2.1 | 2.0 | 2.6 |
| Europe | | | |
| EU 15 | 1.4 | 0.2 | 1.7 |
| United Kingdom | 2.1 | 2.0 | 0.6 |
| Germany | 0.6 | -0.2 | 1.8 |
| France | 1.6 | 1.6 | 2.6 |
| Italy | 1.8 | -3.6 | 1.1 |
| Spain | 2.4 | 1.2 | 2.8 |
| Netherlands | 1.7 | 2.0 | 2.1 |
| Belgium | 1.2 | 1.6 | 1.6 |
| Sweden | 1.7 | 0.9 | 0.9 |
| Austria | 0.8 | 0.0 | 2.3 |
| G7 countries | 1.8 | 1.4 | 1.7 |

Source: DIW model calculations.

icy. In Germany the level of employment would decline by 1% in 1997 and, due to the time lags before employment trends adjust to changes in output, by more than 2% in 1998; the unemployment rate would rise to more than 13%. Italian unemployment would exceed 16%.

These findings show that, even against the background of relatively favourable monetary policy conditions, a strategy of forced budgetary consolidation would cause grave economic and social damage. This path to monetary union is thus blocked. There are two ways out of this dilemma. Firstly, monetary union could initially be restricted to those countries from which the deficit criterion can be met without too great a burden on the economy. The second option is to adopt a more moderate interpretation of the deficit criterion, as proposed by the six leading German economic research institutes. This approach would create the scope for a more realistic consolidation strategy.

A monetary union of "core countries"

For the analysis of a monetary union of core countries it is assumed that Italy, Spain and Sweden, the countries with the greatest difficulties in reducing their budget deficits, do not initially participate in monetary union and thus do not intensify their efforts at fiscal consolidation.

Strictly speaking, Germany and Austria, which face problems of a similar order of magnitude as Spain in meeting the conditions for participation, would also be unable to join a monetary union. However, commencing monetary union with France as the only large country is politically unfeasible and would also run counter to the underlying aim of reinforcing monetary cohesion in Europe. A monetary union between core countries only seems realistic if Germany participates. This consideration was incorporated into the analysis, and Germany and Austria – given that the exchange rate between the schilling and the D-Mark has been held constant for many years – were included in the simulation as members of a common currency area.

Under these conditions the drastic contraction caused by the intensified consolidation measures could in part be avoided. In 1997 the European economies would grow at 1.5%, i.e. the weak rate of expansion in the current year would continue (cf. table 2).⁹ The situa-

⁹ This figure is almost one percentage point lower than that forecast in the Six Institute Report in the autumn. This is partly due to the assumption of a markedly more restrictive fiscal policy and partly because this simulation is based on a weaker underlying cyclical trend.

Table 2
Scenario of a
Monetary Union of Core Countries
% growth of real GDP on previous year

| | 1996 | 1997 | 1998 |
|----------------|------|------|------|
| USA | 2.2 | 2.2 | 1.6 |
| Japan | 2.1 | 2.0 | 2.6 |
| Europe | | | |
| EU 15 | 1.4 | 1.3 | 2.0 |
| United Kingdom | 2.1 | 2.2 | 0.8 |
| Germany | 0.6 | 0.0 | 1.9 |
| France | 1.6 | 1.9 | 2.7 |
| Italy | 1.8 | 1.5 | 1.9 |
| Spain | 2.4 | 2.5 | 2.6 |
| Netherlands | 1.7 | 2.2 | 2.2 |
| Belgium | 1.2 | 1.8 | 1.8 |
| Sweden | 1.7 | 2.2 | 2.4 |
| Austria | 0.8 | 0.3 | 2.3 |
| G7 countries | 1.8 | 1.8 | 1.8 |

Source: DIW model calculations.

tion on the European labour market would not deteriorate so severely, but even so the expected rate of unemployment would be one percentage point higher.

In contrast to the previous scenario, the economic situation in those countries which, in the case of a core monetary union would not be subject to the stiff fiscal constraints, would improve significantly in the run-up to monetary union. Italy, in particular, would achieve growth of around 1½% in 1997 instead of a drastic contraction of output. Spain and Sweden, too, would experience a much stronger increase in economic activity than if they were to join monetary union from the start and meet the deficit criterion in the strict sense. Developments in the countries joining monetary union would be only slightly better than under intensified consolidation efforts, a fact explained by the improved export opportunities to those countries not belonging to the core.

Thus, at first sight, implementing monetary union in stages appears to offer considerable advantages. Yet it must be recognised that progress in deficit reduction in those countries no longer obliged to meet the criteria by 1998 would then slow or cease altogether. Fiscal policy in these countries would consequently face the – in some cases significantly – heavier burden of debt service payments than if they were rapidly to fulfil the deficit criterion. In addition these countries would initially forego the advantages of monetary union.

A realistic consolidation strategy

The second way out of the economic policy dilemma opens up if the criteria are interpreted less strictly and

greater account is taken of cyclical developments. Compared to the intensified consolidation stance, most countries would then be able to pursue a much more moderately restrictive course. In an additional simulation this course was defined in such a way that – similarly to the situation in the USA at the start of the 1990s – government consumption remains constant in real terms over a period of several years. Combined with an expansionary monetary policy this led, in the USA, to a marked cyclical upturn and, in its wake, to a sustained reduction in the fiscal deficit.

Under these conditions the recession in the European economies that was associated with an intensified consolidation would be avoided. Instead of stagnation, growth of around 2% would be possible in Europe in 1997 (cf. table 3). This figure is around half a percentage point higher than that in the previous scenario, as the more moderate fiscal restriction means that the demand shortfall is substantially less severe than in the previous simulations. A moderate consolidation course combined with an expansionary monetary policy would at least not be expected to exacerbate the problems on the European labour market; the European unemployment rate would remain virtually constant, despite the fiscal consolidation. This means that the dampening of economic activity that would otherwise be expected in the run-up to monetary union would not occur.

A moderate consolidation strategy substantially eases the pressure on those countries, in particular, whose consolidation requirements with respect to the Maastricht Treaty are particularly large. In Italy, for example, growth of almost 2% would be achieved instead of a recession with a GDP contraction of almost 4%. In Germany, Austria, Spain and Sweden, too, economic trends would be considerably more favourable,

and, although they would not overcome the prevailing labour market problems, they would at least not exacerbate them.

Although the moderate consolidation strategy would mean that not all the countries seeking to participate in the European Monetary Union would meet the reference value, the more favourable growth trend and the resultant increase in tax revenues means that fiscal deficits would come down. In Germany the deficit would, exceed 4% of GDP in 1997,¹⁰ but it would decline by half a percentage point in each successive year. In Italy, too, the deficit would decline from more than 6% (1996) to 5½% of GDP (1998). In Sweden the deficit would narrow even more significantly, falling from almost 6% in 1996 to just 3½% in 1998. In other words these trajectories are compatible with the position, sketched out above, that the goal of fiscal consolidation can be achieved even if the criteria of the Maastricht Treaty are interpreted in such a way that cyclical factors are taken into account.

Conclusion

Calculations by the DIW show that most countries should no longer have great difficulty in meeting the monetary criteria for participation. In this respect considerable success has been achieved in Europe. The calculations show, however, that meeting the fiscal policy criteria within the time allowed constitutes an insuperable barrier for some countries. Moreover, if a tough austerity policy is pursued throughout Europe, serious growth losses are likely, which would further exacerbate the already unsatisfactory labour market situation in the EU countries. Such an approach would probably endanger the entire project. It would therefore be better to apply a less stringent interpretation of the fiscal criteria – one which takes account of cyclical trends – and thus to adopt a moderately restrictive fiscal policy course. It is of central importance that such a course is accompanied by a monetary policy that, through lower interest rates, stimulates investment activity. It is only by means of such a combined strategy that the demand shortfall resulting from the – necessary – consolidation of government budgets can be offset, and it is only then that the deficits will slowly narrow without this posing a danger to macroeconomic stability.

Gustav A. Horn and Rudolf Zwiener

Table 3
Scenario of a Realistic Consolidation Strategy
% growth of real GDP on previous year

| | 1996 | 1997 | 1998 |
|----------------|------|------|------|
| USA | 2.2 | 2.2 | 1.6 |
| Japan | 2.1 | 2.0 | 2.6 |
| Europe | | | |
| EU 15 | 1.4 | 2.1 | 2.2 |
| United Kingdom | 2.1 | 2.3 | 1.0 |
| Germany | 0.6 | 2.1 | 2.3 |
| France | 1.6 | 1.8 | 2.6 |
| Italy | 1.8 | 1.9 | 2.4 |
| Spain | 2.4 | 2.6 | 2.8 |
| Netherlands | 1.7 | 2.4 | 2.3 |
| Belgium | 1.2 | 2.2 | 2.1 |
| Sweden | 1.7 | 2.6 | 2.5 |
| Austria | 0.8 | 1.6 | 2.7 |
| G7 countries | 1.8 | 2.1 | 1.9 |

Source: DIW model calculations.

¹⁰ This figure is around half a percentage point higher than the value forecast in the recent Six Institute Report in which the impact of the recent package of government cutbacks was incorporated.