The Economic and Monetary Union: Past and Present Failures and some Future Possibilities

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Abstract

The Economic and Monetary Union was constructed on poor foundations which sought to impose inappropriate macroeconomic policies. This construction did not pay heed to the differences between countries with regard to their economic position and interests nor to the institutional and historical differences. The EMU was faltering before the financial crisis which highlighted and added to the problems of EMU. The neo- and ordo-liberal constraints on policy and policy reform are indicated. The outline of a policy agenda for prosperity in EMU is given.

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Introduction

The formation of the Economic and Monetary Union (EMU) and the adoption of the euro was clearly a highly significant episode in the evolution of the European Union[1]. It took its place in the aim for an 'ever closer union', and it could be viewed as a final step along the route of removal of barriers to trade between member countries (after customs union, mobility of labour, capital movement and the 'single market'), and as a step in the direction of political union in light of the close relationship between monetary union and political union. EMU was constructed to be irreversible which contributes the possible exit of a member country from EMU as being of considerable political significance and difficulties. The European Commission viewed that 'Although economic in substance, it [EMU] sent a very powerful political signal to European citizens and to the rest of the world that Europe was capable of taking far-reaching decisions to cement a common and prosperous future for a continent that had all too often suffered from wars and economic and political stability' (European Commission, 2008, p.3).

The argument here runs along three basic lines. First, the EMU and its associated economic policies were ill-conceived, and came with a range of 'design faults' (Arestis and Sawyer, 2011). These design faults were for many commentators evident from the start, though others emerged and some became much more apparent with the passage of time (a notable one here would be the relationships between the European Central Bank ECB and national governments – as discussed below). Further, the development of economic policies have exacerbated the faults, notably with the formation of the 'fiscal compact' and the Treaty on Stability, Coordination and Governance (European Union, 2012).

Second, the construction and operation of the single currency owes much to neo-liberal thinking. Arestis and Sawyer (2013a) placed that within the framework of the 'new consensus in macroeconomics', which is viewed as an expression in the macroeconomics arena of neo-liberal analysis. Others have spoken of a Brussels-Frankfurt-Washington consensus (for example, Mitchell and Muysken, 2006). The relationships of the construction of EMU with Ordoliberalism are particularly significant through the ideological basis and that Ordoliberalism is closely tied with Germany, and reflects much German mainstream economics thinking. The significant elements here are the influence which such thinking had on the construction of EMU and the dominance of such analyses in constraining the construction of an alternative EMU.

Third, an alternative policy agenda for the operation of EMU which would be more conducive to

[1] At its formation known as European Economic Community; we use the present terminology of European Union throughout.

high levels of employment and lowering of inequalities and disparities is considered. It is argued that there are alternative policies which are based on a post Keynesian analysis, but consider that for political and institutional reasons making the change to such a policy framework will prove highly unlikely.

The weak foundations of EMU

It is widely recognised (and not just with hindsight) that there were major issues surrounding the formation of the euro as a single currency[2]. One set of issues came from the application of the criteria of 'optimal currency area'[3] which were set in terms of price flexibility, capital mobility and labour mobility[4] to the case of EMU where, at least by comparison with the USA labour mobility was markedly lower. These criteria referred to the ability of economies to respond to shocks in the absence of the exchange rate adjustment possibility.

Another set of issues came from those emphasising the lack of convergence between economies in terms of unemployment, business cycle and living standards, the failure to address the 'one size fits all' problem of a single monetary policy, the inheritance of current account imbalances without any mechanism to resolve them nor to cope with the implications of the corresponding cross-border capital flows. Institutional, political and social differences between countries forming the EMU were not only more difficult to comprehend and quantify, but also it was difficult to gauge the consequences of those differences for the operation of a single currency. Little attention appears to have been given to these differences and how they would impact on the operations of a single currency. There were expressions of hope that there would be some convergence between member countries as a result of the experience of a single currency (alongside the single market). This was particularly applied to the 'optimal currency area' arguments for the fulfilment of the OCA criteria after, rather than before, the formation of a single currency, that is the criteria endogenously fulfilled (Frenkel and Rose, 1998). But there was little by way of policies put in place to encourage convergence, and faith was placed in some form of market mechanisms to bring about convergence.

The launch of the euro (as a virtual currency in 1999, circulating currency in 2002) was surrounded by the hype which has become familiar with any EU steps towards integration. The claims for the 'single market' in the early 1990s with a 6 per cent gain in GDP as a result of the single market was a relatively recent example. After the first decade of the euro, the European Commission (2008) claimed that 'the euro is a resounding success' having 'secured macroeconomic stability and boosted cross-border trade, financial integration and investment'. It did recognize though that 'so far it [euro] has fallen short of some initial expectations' with 'output and particularly productivity growth ...below those of other developed economies and concerns about the fairness of income and wealth distribution' (p.3). There were also emerging concerns over the growing current account imbalances and changing relative competitiveness between the EMU member countries which clearly could not be addressed through a change in a member country's exchange rate. The economic performance of founder members of the euro (EU-12) was lack-lustre before the financial crises of 2007/09, and in growth terms this was particularly pronounced in the larger economies of France, Germany and Italy. There was no evident 'euro bounce' though some economies such as Greece and Spain did expand at a relatively fast pace. There was little to show that trade within EMU countries was stimulated by the formation of a single currency, which is perhaps not surprising given the nature of the European single market[5].

The macroeconomic policy framework of the Stability and Growth Pact (SGP) was not one designed to encourage employment and growth. One key element of the SGP was the intended limits on budget deficits (upper limit of 3 per cent of GDP, balanced over the cycle) and limit on public debt of 60 per cent of GDP. These limits were in the outturn not observed – with budget deficits averaging 2 per cent of GDP up to 2008 and seven countries (of the original 12) exceeded the 60 per cent limit on government debt. These intentions were seeking a 'one size fits all' approach whatever the economic circumstances of a country with regard to issues such as its current account position, its needs for public investment etc.

[2] For some early doubts see, for example, Godley (1992), Feldstein (1997).
[3] The OCA criteria developed from Mundell (1961), McKinnon (1963), Kenen (1969).
[4] It is paradoxical that EMU was found wanting from the OCA perspective through a lack of labour mobility, whereas major political objections come from there being too much labour mobility (a.k.a. migration).
[5] See Arestis and Sawyer (2013) for evidence.

The difficulties with the macroeconomic policy framework have been intensified with the adoption in 2012 of the 'fiscal compact'. This included the requirement for a 'balanced structural budget'. The concept of the structural budget is problematic and involves placing key policy decisions in the hands of those who make estimates of 'potential output' and who seek to calculate what the budget would be if the economy concerned were operating at 'potential output'. Further there is little reason to think that a budget which is in balance when the economy is at 'potential output' is feasible (see Sawyer, 2013b for elaboration). The 'excessive deficit procedure' which would require substantial budget surpluses for those countries with a debt ratio of over 60 per cent imposes strong deflationary pressures on countries and no-one believes that a substantial surplus is suitable for a depressed economy. The requirements of the 'fiscal compact' are for 'balanced structural budgets' to be enshrined into national laws and constitutions thereby constraining future governments to pursue sensible fiscal policies. Those countries under the 'excessive deficit procedure' can have 'structural reforms' imposed on them for which read the neo-liberal agenda for liberalisation, de-regulation and wage reduction (as witnessed by the Greek experience with the nature of the impositions placed on Greece by the Troika[6]).

Another key element was the position and role of the European Central Bank (ECB). The ECB 'shall be independent in the exercise of its powers and in the management of its finances. Union institutions, bodies, offices and agencies and the governments of the Member States shall respect that independence' (Article 245, Treaty of Lisbon). It has been given the objective of 'price stability' (interpreted as inflation between 0 and 2 per cent per annum) along with 'support [of] the general economic policies in the Union in order to contribute to the achievement of the latter's objectives'. As all central banks do, the ECB faces the 'one size fits all problem' of setting a single policy interest rate covering diverse economic regions of a currency union here exacerbated by the size and extent of the diversity of the currency union. More significantly has been the lack of a central fiscal authority which is not required to balance its budget with national fiscal authorities whose budget positions are constrained by the Stability and Growth Pact and now the 'fiscal compact'.

The operations and decisions of the ECB can be scrutinized, and specific decisions critically examined – for example, the speed of response to the financial crisis, delays in the adoption of quantitative easing. But, of course, all policy decisions by central banks and others can be critically examined, and that is not the central purpose here which is focusing on the general mode of operation of the ECB. In terms of the price stability objective, interpreted as eurozone inflation of less than 2 per cent per annum, the target of was consistently missed in the pre-financial crisis period, albeit by a relatively small margin. A more notable feature of inflation was the degree to which the national inflation rates differed and the consequences of those differences for the evolution of the real exchange rate between the member countries of EMU and changing competitiveness. However, these failures come more from the inadequacies of the policy framework than from decisions of the ECB. We have argued (Arestis and Sawyer, 2004; 2008) that the use of the interest rate to seek to guide the overall rate of inflation is a rather ineffectual policy tool, as the policy interest rate has a rather small and unpredictable effect on the pace of inflation. Further, the inflationary mechanisms and the ways in which wages and prices are set differ between countries and the 'one size fits all' problem kicks in as the effects of a change in the ECB's policy interest rate differ between countries. A further aspect from the setting of a single nominal policy interest rate is that the real rate of interest is lower in a relatively high inflation rate country, whereas the operation of monetary policy for inflation targeting is supposed to work along the lines that the real rate of interest is higher under conditions of relatively high inflation.

The focus of the ECB (as with many other central banks) on inflation targeting (in effect even though the ECB declined to use that phrase) comes at the expense of ability to focus on other policy objectives. In this context, the particularly significant omission has been that of 'financial stability'. Whereas central banks such as the Bank of England now have their mandates extended to cover financial stability, the ECB's mandate has remained that of price stability. Setting interest rates in pursuit of an inflation target may have fed into asset price instability – there is no reason to think that the interest rate deemed suitable for

[6] See, for example, Memorandum of Understanding (2015).

inflation target would be that suitable for asset price stability – sometimes it would, sometimes it would not. The ECB lacks the instruments for the pursuit of a financial stability objective.

There had also been (up to the financial crisis) growing current account imbalances between EMU member countries and hence growing capital account imbalances and greater capital flows between member countries on a net as well as gross flow basis[7]. Current account deficits have fallen in many EMU countries in the past five years, but this should be seen more as the effects of internal deflation reducing the imports than a resolution of the deficit situation.

The other side of current account imbalances is, of course, capital account imbalances and corresponding capital flows. In a number of EMU member countries (Ireland and Spain being the notable examples) credit booms associated with housing and construction burst followed by major difficulties in their banking sectors. Credit booms in some countries but not in others could not be addressed by the ECB through any general policy response and the ECB lacked the tools to address credit booms in individual countries and it could be argued that the focus on price stability precluded attention to financial stability.

The 'independence' of the ECB has been a political one in the sense of separation between the ECB and other institutions of the EU, EMU and national governments. The 'independence' has not been an ideological one. Outside of its direct remit, the ECB has continually promoted fiscal consolidation (i.e. austerity), labour and product market deregulation often under the term 'structural reform'. The 'independence' of the ECB limits the possibilities of the co-ordination of macroeconomic policies and of subjecting those policies to democratic inputs.

The ECB does not have an explicit 'lender of last resort' obligation in relationship with the banking system. It is also prohibited from the direct monetisation of public debt. This prohibition of the direct monetisation of public debt is to a large extent in line with central bank practice.

The critique to be made here of the ECB and its role within the EMU is not that it got this or that decision wrong (and particularly not to undertake that with the benefit of hindsight)[8]. It is rather, as others have argued, to point to weaknesses in the structures of the ECB with regard to the effective operation of a single currency. These weaknesses can be summarised in terms, firstly of the effects of the 'one size fits all problem' particularly in respect of price stability and financial stability with a lack of structures and policies which deal with that problem. Secondly, there is a lack of democratic input into the decision making of the ECB, and the limitations on co-ordination of macroeconomic policies. Thirdly, the ECB does not and cannot give the type of support to member governments which would be provided by a national central bank to a national government. And fourthly, there is a general commitment to a neo-liberal ideological agenda rather than to support for the broader economic policies of the EU.

In recent years, after the financial crises, there has been widespread talk of a euro crisis (or similar phrase). It is more a series of interlinked crises. There has been an existential crisis where many called into doubt the continued existence of the Eurozone with its present membership, a crisis which appears to have been averted for the time being. There have been banking crises where the position of the ECB and the lack of a banking union meant the absence of a single mode of bank resolution and bank supervision, some of which should be rectified by the banking union proposals. The removal of capital controls and the role of a single currency is facilitating capital flows were factors in the widening capital account imbalances and growing debt issues. The current account imbalances have been diminished through a vicious deflation but the underlying problems remain and constitute a constraint on the growth of demand and the diminution of unemployment. It was the sovereign debt crisis which attracted most attention, and the impacts on the banking system where much of the sovereign debt was held. The sovereign debt crisis clearly illustrated the errors of constructing a monetary union where the central bank did not have obligations to support the fiscal policies of the member states. The debt crisis was, of course, met with the impositions on Greece of conditions of continuing austerity and quite unreasonable demands on its budget positions. The question which inevitably has to be raised are what are the prospects for any return of prosperity and decline of unemployment within the Eurozone when it has imposed austerity policies on itself in the form of the fiscal compact.

[7] For illustration of this see Sawyer (2014).
[8] See, for example, Arestis (2014), Bibow (2015) for evaluations of monetary policy decisions by the ECB.

Ordoliberalism and neo-liberalism and the policy framework

In Arestis and Sawyer (2013) we argued that the framework of macroeconomic policies of the EMU were essentially neo-liberal and could be understood by reference to the 'new consensus in macroeconomics' (NCM). It was neo-liberal in the sense that there was an underlying assumption of the efficiency of markets and their ability to secure macroeconomic stability and high levels of employment. Markets are viewed as inherent stable around a supply-side determined levels of output and employment which in the NCM are represented by potential output and the non-accelerating inflation rate of unemployment (NAIRU). Monetary policy is assigned the task of targeting inflation (through the use of policy interest rate) through a (politically) independent central bank, thereby elevating bankers' decision making above democratic decision making. Fiscal policy is viewed as impotent though its role as something of an automatic stabiliser is recognized. Although it does not feature prominently in the NCM, employment (and hence unemployment) and output are much dependent on the structures of labour and product markets with the belief that liberalised and unregulated markets are conducive for low levels of unemployment and high levels of output.

In the context of the Economic and Monetary Union (EMU), its policy structures can be viewed through the lens of ordoliberalism. Dullien and Guerot (2012) 'outline some of the essential features of German *Ordnungspolitik* such as price stability, central bank independence, state-market relationships and regulatory state interference in markets' (p.2) which is contrasted with the 'position more predominant in Anglo-Saxon debate and in international institutions'. They continue by saying that 'ordoliberalism differs from other schools of liberalism (including the neo-liberalism predominant in the Anglo-Saxon world) in that it places a greater emphasis on preventing cartels and monopolies. At the same time, like neo-liberalism, ordoliberalism opposes intervention into the normal course of the economy. For example, it rejects the use of expansionary fiscal and monetary policies to stabilise the business cycle in a recession and is, in that sense, anti-Keynesian' (p.2). As Aziz (2015) notes 'ordoliberalism distinguishes itself … in its focus upon rules and order, and defining the government's role in terms of establishing a strict order around which the market can exist and flourish' which leads into 'notions of rigid monetary policy focused exclusively on price stability' (and much more besides). Young (2014) argues that 'the conservative German Bundesbank and many traditional economists adhere to a rule-based legalistic ordoliberal doctrine to prevent a more Keynesian alternative that would challenge the austerity discourse'. Further, 'measures such as the strict adherence to fiscal discipline through a 'fiscal compact' which stipulates a constitutionally mandated 'debt brake' to limit the fiscal debt of all EU-countries, its defense of the independence of the Central European Bank (sic), its strict adherence to price stability, and its support for recapitalizing banks through the European Stability Mechanism (ESM) (only on condition that the ESM would control banks which gain access to bail-out funds), reflects the ideas of *Ordnungspolitik*' (Young, 2014, p.278).

The particular significances of looking through the lens of ordoliberalism are perhaps self-evident. Ordoliberalism is a doctrine closely related with Germany and its macroeconomic policies with many aspects of that doctrine having wide political acceptance in Germany (Young, 2014).

The policies which are closely associated with ordoliberalism in the field of macroeconomic policies are anti-Keynesian. With regard to fiscal policy, the German constitution required that the current budget be in balance allowing for borrowing for public investment purposes. These requirements broadly speaking applied at both the Federal level and the Lander level. This led to a German budget position which was generally in deficit with significant levels of public investment, and a debt ratio of around 60 per cent. As many pointed out at the time of the Maastricht Treaty, the figures in the convergence criteria of 3 per cent budget deficit to GDP ratio and 60 per cent debt to GDP ratio were rather close the German experience. However, the 'debt brake' introduced as a change to the German constitution in 2009 with full implementation over the period 2016 to 2020 switched to the overall budget being in balance or surplus, and again applicable at the Federal and the Lander level. The rationale for such a switch is difficult to find though it did reflect the interpretation of the Stability and Growth Pact (under the Treaty of Amsterdam) that the budget should be balanced over the cycle.

In respect of monetary policy, the notion of a politically independent central bank and the focus of monetary policy on inflation and price stability have been important ingredients. In this regard the

Bundesbank had long operated as in effect an independent inflation targetter, ahead to the general switch to independent central banks which characterised the 1990s.

With ordo-liberalism, economic policies are embedded into law, and even more into a constitution which limits the ability to change those policies. The major examples relevant for this paper come from placing fiscal and monetary policy into a constitutional framework which thereby shifts policy from discretionary to rules. This is rather more than the ‘rules’ verses ‘discretion’ debates which ran through much macroeconomic policy debates. In that context, the ‘rule’ (e.g. say Taylor’s rule for monetary policy) was not embedded into law, and it was recognized that ‘rules’ vs. complete ‘discretion’ were two ends of the spectrum, and in practice there were always strong elements of discretion, not least related to the assessment of the economic situation (e.g. in Taylor’s rule, what was the output gap, what is the expected rate of inflation?). The placing of rules into a constitution (or equivalent) makes them difficult to change. If the chosen rule is believed to have universal validity then this may not constitute a problem. But in the context of macroeconomic policies, the rules reflect specific forms of economic and political analysis (consider for example the rule of independent central bank), and the general acceptability of the underpinning analysis changes over time. Whilst the general notion of an independent central bank was accepted in Germany in the form of the Bundesbank, it did not come into wider use until the mid-1990s. Even then, governments often have reserve powers to give instructions to the Central Bank (e.g. in UK), and the objectives given to the central bank have changed: using the UK example from inflation targeting to also include ‘financial stability’. It also can place the interpretation of economic policies into the courts, as was seen by the challenge to ‘quantitative easing’ operated by the ECB where the German Federal Court challenged its legality in the European Constitutional Court of Justice, arguing the ECB was acting beyond its mandate, effectively financing government deficits[9]. As we argued before (Arestis, Fontana and Sawyer, 2014) the ‘rules’ based approach adopted within the EMU suffers from the inflexibilities for policy change when those rules take on the force of law and that the rules which have been adopted are the wrong ones (in our view based on our broadly post Keynesian analysis).

It is not our purpose here to evaluate the claims which relate the ideas of ordoliberalism with the actual policies pursued in Germany or with the perceived success of the German economy. Young (2014) argues that ‘little work has been done to question the ordoliberal assumptions and whether these ideas were in fact important for the German economic growth, first during the period of the 1950s and then as the ideational foundation for the Rhenish model as the present German leadership seems to imply.

- that ordoliberal ideas alone had ushered in the *Wirtschaftswunder* of the 1950s?
- that ordoliberal ideas are the ideational foundation of the Soziale Marktwirtschaft, which in turn is used to explain the success of the Rhenish model of capitalism, or whether it is a myth due to a ‘represessed history of origin’ …?
- that Germany’s turnaround for the ‘sick man’ of Europe in the 1900s to the present power engine of economic growth is the result of implementing ordoliberal ideas?
- that the much hailed ‘ordoliberal success story’ of Germany can be a model for southern Eurozone countries in order to become more competitive?’ (Young, 2014, p. 282).

Germany has a relatively good record on the unemployment front (between 5 and 6 per cent after the financial crisis) (with discretionary fiscal policy playing its role in limiting the rise in unemployment in 2009 and 2010). Its growth performance has been far from outstanding with a growth rate averaging just over 1 per cent per annum from 2001 through to 2014, much below that which it had in earlier decades. The outstanding features of the recent German economic performance have been its growing export surplus and its declining wage share. These may have some interconnections (along with the likely effects of euro membership and relatively low inflation for Germany’s real exchange rate) of the shift against wages and the growing trade surplus with the implementation of the Hartz labour market reforms. In turn the perceived success of those labour market reforms which would come under the heading of ‘structural reforms’ feed into

[9] ‘EU lawyer approves ECB bond-buying programme’ 14th January 2015, http://www.bbc.co.uk/news/business-30810137

the further promotion of such 'structural reforms' within the 'fiscal compact'.

Varieties of Capitalism

The Optimal Currency Area (OCA) debates focused on features of the constituent member countries which would facilitate adjustments to asymmetric shocks in the absence of the exchange rate adjustment possibility. Other concerns were expressed over the extent of convergence and of disparities between the national economies – over issues such as convergence of business cycles. There were notable failures to consider disparities over major issues such current account positions and mechanisms to enable the resolution of the disparities in such positions, failures which came to undermine the functioning of the EMU. Whilst there were requirements for the convergence of inflation prior to acceptance of a country into membership there was no concern expressed over what could be termed inflationary conditions in a country which would be influenced by institutional arrangements for wage and price determination, experiences of inflation, political attitudes to inflation and any trade-offs between inflation and economic performance. This is an illustration of some of the issues in the operation of a currency union which arise from diversity of economic and institutional structure, legal frameworks, policy attitudes, etc. between the members of the currency union. There are always elements of such diversities within a currency union even when the currency union is the nation state. There will be differences between the constituent regions in terms of, for example, industrial structures, and in a Federal system differences in legal structures, industrial relations legislation.

The varieties of capitalism literature should be a strong reminder that there are institutional etc. differences between forms of capitalism and hence between what may be called national economies. This is not to accept the duality of the liberal vs coordinated economies, and indeed any relatively simple classification of different forms of capitalism. Authors have sought classifications of different varieties of capitalism. Van Veen (2006), for example, with regard to labour market models uses a four way classification of Nordic or social democratic model, Continental European or conservative corporatist model, Mediterranean model or traditional rudimentary model, Anglo-Saxon model or liberalist-individualistic model. The key questions here are not whether these are complete representations or how different countries should be groups. They are rather here mentioned in the context of labour markets (and more generally employment and social provision) that countries differ in their institutional histories and the ways in which their labour markets and employment operate and perform. As mentioned above, these differences can have significant macroeconomic implications – for example how prices and wages respond to a single monetary policy and whether inflation rates and unemployment experiences converge across countries. Further, the question has to be raised over the compatibility between a single currency and the differences, in this case, in labour market institutions etc.

In the context of the EMU particularly with its insistence on common budget obligations the configuration of sectoral balances is significant. One representation of this is the identification of 'three types of regimes under the conditions of financialisation, namely a debt-led private demand boom, an export-led mercantilist and a domestic demand-led regime' (Dodig, Hein and Detzer, 2015). These authors relate these different regimes with different forms of instability and the generation of financial crisis. Of particular significance here is that each of the regimes can be unsustainable in different ways, reflect different policy outlooks and have implications for the appropriate budget position. Germany has been viewed as the key player in the pursuit of a neo-mercantalist export surplus approach (Sawyer, 2014), though it would not be along among EMU members in that. One clear aspect of the widening current account imbalances amongst EMU countries prior to the financial crisis was the ballooning export surpluses of some Northern European countries.

These brief remarks on country differences are made to raise the following issues, and to indicate some of the difficulties which the construction of policy alternatives face. The first is how close in institutional structures, economic policy outlooks and industrial structures do countries need to be in order for a currency union to operate effectively. It can be argued that countries need to be close enough such that, for example, there are similar generating processes for inflation and that the use of policy instruments to constrain inflation have similar effects. Drawing on the OCA criteria, it could be said that the institutional arrangements are conducive to support price flexibility and factor mobility. The second is the difficulties which differing institutional arrangements pose for the construction of union-wide policies. The 'one size fits all' problems of monetary policy have been well-rehearsed. The SGP and the 'fiscal compact' have sought to impose a single budget policy on economies with different structures. The construction of a banking union has to cope with the different banking structures.

Alternative Policy Agenda

The present policy structures of EMU have severe design faults (Arestis and Sawyer, 2011) and represent a pessimum set of arrangements in the sense that a more integrated (along the lines sketched below) and a less integrated (e.g. return to national currencies) monetary system could operate more successfully (as judged by the prosperity and employment of European citizens). The present arrangements combine a lack of attention to historical, institutional and policy outlook differences between the member countries and the imposition of a deflationary policies (e.g. in the form of the fiscal compact). The alternative policy agenda which is now sketched is one which moves in the further integration direction. In effect there are strong elements of *de facto* political union involved, e.g. the development of a Federal level fiscal policy, which echoes the point often made that monetary union without political union does not have a happy history (Arestis and Sawyer 2013b). And that presents one of the major reasons for thinking that the type of policy agenda outlined here will not be implemented.

The policy agenda which is now outlined draws on Arestis, McCauley and Sawyer (2001) where an alternative Stability and Growth Pact was proposed, Sawyer (2013b), and influenced by papers such as by Hein and Detzer (2015)[10].

The type of proposals outlined below are far from being politically feasible given the present balance of political forces. Insofar as the proposals would require amendments to The Treaty of Lisbon changes have to be agreed on a unanimous basis which can form one major obstacle, though the Treaty on Stability, Coordination and Governance indicated some possibilities to avoid amendment to the Treaty of Lisbon. However, the obstacles to change from an institutional/political perspective are formidable. More major obstacles come from a recognition of the degree to which the present arrangements reflect neo-liberal and ordo-liberal agenda and that the alternative proposals come from the pursuit of a quite different (more post Keynesian) analysis. The neo-liberal agenda is firmly embedded into the European institutions and the thinking of a number of major players. Any policy adopted may conform to the interests and approaches of some countries but not to the interests and policy approaches of others. The fiscal compact is a clear example of this where the interests and analyses of some major players (notably Germany and the European institutions) were imposed to the detriment of others: a budget surplus conforms to the requirements of the German constitution and appears possible in Germany through its large export surplus but does not meet the interests of many other countries. It could also involve considerable fiscal transfers between regions and countries provoking obvious points of resistance.

In the context of the Economic and Monetary Union, the development and implementation of an alternative policy agenda faces three major, and close to insurmountable obstacles. The first comes from the rather obvious statement that policy alternatives are located in an understanding of how economies work and what problems art to be addressed. A neo-liberal (say dynamic stochastic general equilibrium) analysis which portrays market economies as being close to full employment has no need of demand management or supply side policies in order for full employment to be achieved. Our policy alternatives are firmly based on a heterodox post Keynesian analysis. What makes any policy transformation particularly difficult is that the neo-liberal agenda is so firmly implanted into the fabric of the EMU and in the mind-set and operations of the policy making institutions of the European Central Bank and EcoFin.

The second comes from the economic, historical and institutional diversity of the EMU. In economic terms the GDP per head at the NUTS regional level within EMU varies by the order of richest region having

[10] The annual publication of the Euromemo by the Euromemorandum Group contains alternative progressive policy agendas (available at http://www.euromemo.eu/euromemorandum/index.html).

GDP per head over six times that of the poorest region. Unemployment rates vary from 3 per cent to over 30 percent. EMU has often operated ignoring these differences and thereby creating 'one size fits all' problems. This is close to inevitable with monetary policy, but it is also extended to fiscal policy. The suitability of a particular budget position target depends on the current account position, the investment and savings behaviour as well as the requirements for public infrastructure investment.

The third, and related to the second, is that almost all currency unions being coincident with the nation state operate as a fiscal union with fiscal transfers. It is well-known that national governments have a major role in the re-distribution through fiscal transfers between regions of a country. It is inevitable that a tax regime, whether by design and whether in ways which may be deemed beneficial, re-distributes between individuals and thereby between regions. A tobacco tax redistributes from smokers to non-smokers and from regions with high level of smokers to regions with low level of smokers. In addition, there are specified patterns of expenditure which re-distribute between regions and communities. In a Federal system (USA, Canada, Australia for example) these are generally conducted through negotiations between the Federal and the States/provinces. Some examples of the degree of fiscal transfer.

The policy agenda for the reconstruction of EMU could be viewed in two (complimentary) dimensions. First, what are the policy measures required to aid the effective functioning of a currency union? Second, how should the policies be designed?

Under the first question, we may consider the range of policy structures which exist within a nation state and which go alongside and complement the functions of the currency union. Those policy structures are in effect taken for granted and rarely considered in terms of a currency union, though the effectiveness or otherwise of the policies pursued will be much debated. Some of those policy structures make an appearance in the optimal currency area (OCA) literature. The most notably example in this context would be labour mobility. There are, of course, no legal constraints on the movement of people within and between countries in the broader European Union and in term in the form of migration has generated political resistance often taking the form of the rise of right wing anti-immigrant political movements and parties. While there have been the removal formal barriers to labour movement, and encouragement through, for example, interchangability of qualifications, there have not been serious attempts to create what could be viewed as a European labour market. What has not been addressed within the EU (and hence within the EMU) to any real extent is the development of an EU-wide social security system and income support, or even much on developing some degree of compatibility between the national social security systems.

A step in the direction of a Federal social security system and one which would also aid stabilisation would be the adoption of a European level unemployment insurance scheme.[11] 'A basic European unemployment insurance scheme would provide a limited and predictable short-term fiscal stimulus to economies undergoing a downturn in the economic cycle – something that every country is going to experience sooner or later. With its automatic and countercyclical character, a basic European unemployment insurance scheme could boost market confidence in the EMU and thus help to avoid repeating vicious circles of downgrades, austerity and internal devaluation in the eurozone. It would help to uphold domestic demand and therefore economic growth in Europe as a whole' (former European Commissioner for Employment and Social Affairs, László Andor)[12].

Fiscal policy can play a significant role in the stabilisation and achievement of high levels of economic activity. There should be two basic principles underlying the approach to fiscal policy within EMU. First, the fiscal stance should be set to enhance the levels of output and employment, and not set in order to achieve some arbitrary budget target when that target may not be achievable. There must not be any attempt to impose a 'one size fits all' fiscal policy on national government in the sense of imposing the same numerical limits on the scale of budget deficits (where a zero limit or any other). The fiscal policy and resulting budget position should be tailored to the requirements of the country concerned: some countries will require budget deficits whereas others may be able to operate successfully with budget surpluses. The

[11] See, for example, a forum on 'Designing a European unemployment insurance scheme' *Intereconomics* July 2014, Volume 49, Issue 4, pp. 184-203, with contributions by László Andor, Sebastian Dullien, H. Xavier Jara, Holly Sutherland and Daniel Gros; also Davis, Konstantinidis and Tripodis (2015).
[12] At p. 185 of the forum referred to in fn. 1

current account positions vary substantially across countries and allowance must be made for that.

Many have long recognized the role of Federal fiscal policy in monetary unions such as the United States, and seen the need for the substantial EMU (or EU) budget much larger than the current EU budget (of just over 1 per cent of EU GDP, and with a requirement to be balanced). What would be a significant step in the direction of political union, there would be important features of tax raising powers, undertaking public expenditure and ability to run budget deficits (or surpluses) as required for stabilisation purposes. Further it would require the support of the ECB in the operation of fiscal policy and willingness to buy where the bonds issued by that Federal authority. It is well-known that a progressive tax system applied across EMU would help as an automatic stabiliser. It would, of course, serve to transfer resources from low income to high income countries, and therein lies one of the major political obstacles to a Federal fiscal policy.

Significant changes would be required in the operations and objectives of the European Central Bank. Its policy objectives should be broadened beyond the price stability objective to include level of economic activity including a high and sustainable level of employment. In saying that it would be recognized that the policy instruments at the disposal of the ECB, namely the policy interest rate (supplemented by quantitative easing) are not particularly effective, and specifically suffer from 'one size fits all' problems. The policy objectives should also be broadened to include financial stability (as has been undertaken for the Bank of England). A further step is to redesign the constitution of the ECB such that its policy measures are coordinated with those of the Economic and Monetary Union and its member governments, which would involve ending the 'political independence' of the ECB. Specifically, the ECB must act to support rather than undermine the fiscal policies of the member countries (and in due course that of the Federal EMU budget). In effect, the ECB must come to act relative to the national government in the manner in which a national central bank generally in respect of support of their government's fiscal policy through the required supply of central bank money and purchase of government bonds. The ECB should on all occasions stand ready to operate as 'lender of last resort'. It should always accept the bonds and bills issued by national governments (within EMU) as part of open market operations in the way in which a national central bank would always accept the bonds of its government. It should also stand ready to directly lend to national governments (in exchange for bonds in euros of that government) if required. The general proposition is that the ECB should support the fiscal policies determined by EMU national governments, whether or not those policies involve deficits of which the ECB disapproves.

There is no current policy to address inflation differentials, and the current monetary policy makes it worse (by there being low if not negative (high) real rates of interest in countries with high (low) inflation rate. There is a need for a co-ordinated approach and common inflation target to be addressed by national policies. This would not be 'inflation targeting' if that term is understood to mean an inflation objective pursued by an independent central bank through interest rates, but rather a co-ordinated attempt by the member states of EMU to use their own national policies to achieve a common rate of inflation to avoid the inflation differences. This could take form of using fiscal policy to vary demand – not to be recommended but possible. This could take form of national agreements on incomes etc. What has to be avoided is competitive devaluation of real exchange rate (between EMU member countries) achieved through hyper-low inflation.

The return to prosperity within the EMU in a way which includes all countries and regions requires that the current account imbalances be resolved. The move towards a sustainable pattern of current account positions would involve some form of effective devaluation and revaluation within the EMU, even if there is scepticism over the effectiveness of devaluation in addressing a current account deficit, not to mention the costs and difficulties in securing such devaluation through internal deflation. Since in the context of EMU having an overall current account position close to balance one country's surplus is another country's deficit a further requirement would be a degree of agreement on the pattern of current account positions.

A significant feature of the *Treaty on Stability, Coordination and Governance in the Economic and Monetary Union* is the role given to 'structural reforms' (for which read de-regulation, liberalisation and privatisation) and the associated view that there is 'best practice' and the suitability of a single set of policy measures on labour and product markets. The starting point for alternative policy framework would be the removal the general presumption of the superiority of neo-liberal policies.

The single currency obviously imposes the ultimate in a fixed exchange rate regime, and the supply-side policies have to take cognisance of that. In the area of labour market policies, this would suggest (as above) a degree of co-ordination across countries with regard to wage and price increases. The major differences between nations in the institutional arrangements and historical experience suggest that attempts to impose a common set of policies is inappropriate and liable to fail, but that it cannot be left to 'market forces' to iron out inflation and competitiveness differentials.

The current account imbalances within the EMU have been the major source of economic difficulties, and have to be addressed through co-ordinated approach to supply-side issues. First, there should be a requirement to co-ordinate prices and wages policies between countries to seek to address the differential developments in competitiveness which have been evident. This could also enable the development of more general counter-inflationary policies in light of the relative failures to achieve inflation targets, and (as argued above) the re-assignment of the objectives of the ECB to financial stability rather than inflation. Second, there should also be developed what may be termed regional and industrial policies at the EMU level to address the differences in competitiveness between countries and to enable a resolution of the current account imbalances through capacity construction in deficit countries.

Concluding comments

The Economic and Monetary Union exhibits high levels of unemployment, particularly youth unemployment, with wide disparities in unemployment rates between regions. It appears to have entered a period of lower growth than experienced hitherto. It has become locked into a deflationary 'fiscal compact' which imposes a 'one size fits all' policy regime without regard to the circumstances of countries and one in the form of balanced budgets which are not generally attainable. An alternative policy regime is required, but the possibilities for the adoption of an alternative regime are bleak. An alternative policy regime would require not only Treaty changes but also a massive shift away from the neo-liberal frameworks which currently dominate economic thinking. It would also likely require moves towards elements of a *de facto* political union and fiscal transfers between member states. A bleak future beckons the Eurozone!

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