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GROWTH AND THE SINGLE CURRENCY: FISCAL POLICY AS A CAUSE OF DISUNITY IN THE EU

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ABSTRACT

The Ventotene Manifesto provided a guide to the future of European unity, yet it did not consider expressly what eventually became a central element of the evolution of the Community: the Single currency project. A confrontation of the ideals of the Manifesto and the implementation of the single currency allows an assessment of the problems currently facing the EU, suggesting that insufficient attention was given to coordinating the Euro with "The truly fundamental principle […] that economic forces must not dominate man, but rather […] guided and controlled by him in the most rational way, so that the broadest strata of the population will not become their victims".

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In celebrating the contribution and foresight of the *Ventotene Manifesto* as providing a guide to the future of European unity, it is perhaps useful to look at what is not mentioned and thus what remains to be done, or perhaps better what has gone wrong because certain areas were not initially assessed in terms of their overall impact on Unity.

The Manifesto identifies a number of crucial areas:

> The truly fundamental principle […] that economic forces must not dominate man, but rather […] guided and controlled by him in the most rational way, so that the broadest strata of the population will not become their victims. […] the content of this guideline, […] and the way it is to be effected, must always be judged in relationship to the premise by now accepted as indispensable: European unity, we would like to emphasize the following aspects:

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> 1. monopolistic activity, and that are therefore in the condition to exploit the mass of consumers, must no longer be left in the hands of private ownership […]
> 2. opportune to distribute property in an egalitarian manner, in order to eliminate parasitic classes and in order to give the workers the means of production that they need, so as to improve their economic conditions and help them reach greater independence.
> 3. state schools ought to offer the effective possibilities of continuing studies up to the highest level to those who merit it.
> 4. potentiality of mass production of goods of prime necessity through modern technology, allow everyone to be guaranteed, at relatively low social cost, food, lodging, clothing and that minimum of comfort needed to preserve a sense of human dignity.[1]

What is missing from this list? Given the history of the development of Europe since the Manifesto it is noteworthy that there is no mention of fiscal policy directed to enhance European Unity, nor to it being made subject to being controlled for the benefit of the broadest strata of the population, or the minimum of comfort needed for human dignity. Even more glaring in historical context is the absence of any discussion of monetary affairs, much less a single European currency. There are many who would argue that the decisions taken on the road to European Economic and Monetary Union lost sight of the Manifesto's guideposts to unity with respect to these two areas and as a result there are now strong forces of disunity at work. Indeed, this presentation will argue that the pursuit of a single money as a prerequisite for unity has had the opposite impact, and precluded the use of fiscal policy in cementing European unity.

To find a possible indication of the role of these issues that is consistent with the Manifesto's support of these issues as a force for unity one might look to the Spinelli draft Treaty on the European Union adopted in 1984.[2] Of particular interest in this this draft is that it included two Articles directed to fiscal policy, never adopted:

> – Article 73: "A system of financial equalization shall be introduced in order to alleviate excessive economic imbalances between the regions. An organic law shall lay down the procedures for the application of this system", and
> – Article 71(2): "The Union may, by an organic law, amend the nature or the basis of assessment of existing sources of revenue or create new ones. It may by a law authorise the Commission to issue loans, without prejudice to Article 75(2) of this Treaty" (Article 75(2) stipulated that "borrowed funds may only be used to finance investment").

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1 This is a composite quote from the Manifesto: www.cvce.eu/obj/the_manifesto_of_ventotene_1941-en-316aa96c-e7ff-4b9e-b43a-958e96afbecc.html (accessed November 2, 2021).

2 Spinelli 1984.

Unfortunately, neither Article survived in the final Treaty revision and there is still no agreed framework to alleviate economic imbalances, aside from the Regional adjustment funds, and there is no progress on the use of EU fiscal policies to provide remedy to imbalances. Indeed, the decisions that were taken subsequently, for example in the Single Act and the Maastricht Treaty have contributed to country imbalances by seeking to impose monetary uniformity in the form of the Single Currency and the European System of Central Banks headed by a single European Central Bank. And these measures have generally not only precluded the use of fiscal measures to deal with imbalances, they have contributed to those imbalances.

The Single Currency and Exchange Rate Stability

A Single European Currency as a prerequisite for European Unity was originally proposed in the Werner Report of 1970. Action was however only taken some thirty years later in 1999 as a reinforcement rather than an enabler of the Single European Act (1987). The Werner proposals were predicated on a global economy of fixed, but adjustable, exchange rates. They were soon made irrelevant by the disintegration of the Bretton Woods system in the mid 1970s. Despite the shift of global institutions to flexible exchange rates, the EEC persisted in its intention to introduce the equivalent of an irreversible fixed-rate system via a single currency, issued by a supra-national monetary authority.

The Single Currency ran counter to supporting unity in two respects. First in the adoption of an irreversible internal fixed exchange rate system in the presence of an international system of floating rates. It thus not only eliminated exchange rate adjustment for individual member states' trading relations with the rest of the world, but also for adjustments among member states. Second, the single currency was issued by an institution without any direct linkage to any EU national government or government balance sheet, or to an EU Federal entity, thereby eliminating any possibility of direct coordination between creation of liquidity by the central bank and the stance of individual government's fiscal policy. While it was thought that such a system would make intra-EU trade imbalance irrelevant and exchange rate adjustment unnecessary, this was not the case for individual country balances with the rest of the world, which could no longer be remedied by exchange adjustment, now floating at the EU level. Since the former irrelevance only followed from balanced government fiscal policy there could be no EU level fiscal policy; the problem was solved by making fiscal policy subservient to the single currency via the Protocol to Section 104 of the Maastricht Treaty.

However, the global floating rate system had an unexpected impact on performance of individual countries since variations in the rate of the new single currency *vis-à-vis* the other, floating, currencies of international trading partners produced a differential impact on individual countries that were far from having achieved economic convergence and had major differences in the production structure and the structure of external trade.

While variation in the external value of the single currency could provide aggregate adjustment of the Eurozone external balance as a whole, the impact of these changes would not have an equal impact across all members of the Eurozone, while the enabling Protocol provided no formal fiscal policy mechanism to redistribute or offset this impact on productive and social conditions in individual countries. This reinforced the differential impact of uniform monetary policy across countries depending on their particular economic conditions.

At the same time, the redenomination of the sovereign debt of national governments in a currency issued independently of national member governments' budgets or national central bank policy, sharply constrained the ability to use domestic financial policies to offset the differential impact of the exchange rate of the single currency. In essence, government financing of domestic fiscal policy expenditures became formally identical to that of any private institution. Financing of expenditures had to be covered by fiscal revenues or by borrowing from the domestic or foreign private sector or by sale of assets to the domestic private or external sector. If government used borrowing to finance a shortfall of fiscal revenues then to meet debt service on the sovereign debt thus created would require governments to generate tax receipts greater than expenditures, engage in additional borrowing (debt roll over), or sell public assets.

And just as different private borrowers have different credit risks and face different risk-adjusted borrowing rates, 'sovereign' borrowers should have different credit risks determined by the ability of governments to raise revenue as determined by conditions of the domestic economy and institutions. However, after the introduction of the single currency the fact that government borrowing was denominated in the liability of an external central bank appears to have led private lenders to overlook these national risk differentials in the first 10 years of the euro's existence. Thus countries with higher borrowing and debt stocks were little penalized by the market imposing higher borrowing rates leading to an allocation of private sector liquidity within the Eurozone which reinforced economic imbalances and contributed to the European financial crisis after the collapse of US financial markets.

This market anomaly allowed many individual governments to access private market financial support at attractive interest rates to implement domestic income support measures to avoid the implementation of wage/price adjustment mechanisms compatible with the new single currency system. However, when this private sector market anomaly disappeared after the 2008 financial crisis, and economic conditions made it difficult for governments to generate higher fiscal revenues to replace the withdrawal of private financing, maintaining the financial stability of government and private financial institutions required financial support at the EU level in the form of the creation of the ESFS, subsequently replaced by the ESM, the extension of IMF program support, and eventually the direct intervention in government securities markets by the ECB to "do what it takes" to prevent a destructive financial collapse of government bond markets and private financial institutions. The necessity of an EU level response to the crisis should have made it obvious that the existing framework of fiscal policy management at the national level was incompatible with the new system.

This differential impact was further aggravated by the fact that while the single currency eliminated national exchange rate adjustments as a remedy to correct trade imbalances among member states and non-EU trading partners, it shifted policy to internal adjustments via relative domestic wage and price adjustments with Eurozone and non-Eurozone trading partners. And these adjustments also had a differential impact on relative competitiveness within and without the Eurozone, making their impact difficult to determine.

In addition, emphasis on adjustment in domestic wages and prices created the potential for a deflationary bias similar to that prevalent in the prewar gold standard in which deficit countries were under greater pressure and incentive to adjust via measures to reduce relative prices and activity relative to the surplus countries and to their trading partners in the rest of the world. This reinforced the differential impact of uniform monetary policy across countries depending on their particular economic conditions.

Many commentators had already noted the difficulty created by a monetary policy managed by a central institution that was independent of fiscal policies managed at the national level and subject to aggregate constraints. Wynne Godley [3] had very early noted that the Maastricht Treaty explicitly outlined monetary arrangements, but provided no response to the question: "How is the rest of economic policy to be run? As the Treaty proposes no new institutions other than a European bank, its sponsors must suppose that nothing more is needed. But this could only be correct if modern economies were self-adjusting systems that didn't need any management at

[3] Godley 1993: 9.

all". He also pointed out that "the Maastricht criteria for the establishment of 'convergence' were far too narrowly conceived. To fulfil the conditions necessary for a successful currency union it is not nearly enough that member countries agree to follow simple rules on budgetary policy […] They need to reach a degree of structural homogeneity such that shocks to the system as a whole do not normally affect component regions in drastically different ways" [4] noting that

> if Europe is not to have a full-scale budget of its own […] you will still have, by default, a physical stance of its own made up of the individual budgets of component states. The danger, then, is that the budgetary restraint to which governments are individually committed will impart a dis-inflationary bias that locks Europe as a whole into a depression it is powerless to lift. The useful comparison can be made with the US. […] The analogy is useful because United States does so obviously need a federal budget as well as a federal bank, and the activities of the two authorities have to be coordinated. If there is a recession remedial (expansionary) fiscal policy at the federal level is the only proper response; it is inconceivable that corrective action should be left to component states, which have neither the perspective nor the coordinating machinery to do the job. If there is a federal budget there must obviously be a legislative and executive apparatus that executes it, and is democratically accountable for it.[5]

Prominent members of the Bundesbank had also noted this mismatch between monetary policy imposed on the level of the EU and fiscal policy left to decisions of member states within the constraints in support of the single currency. Otmar Issing, a member of the German Bundesbank and eventual chief economist of the ECB, noted in a review of the Maastricht process that "historical experience shows that national territories and monetary territories normally coincide […] the relevant legislation, as a rule, defines monetary sovereignty in relation to a national territory. […] In contrast to the normal rule, the Maastricht Treaty implies a clear discrepancy between the intentionally rather modest political integration and monetary integration".[6]

The experience of the 2009 financial crisis highlighted this difference between a EU level monetary policy and fiscal policy decisions left to the decisions of the member states, but independent of the differential conditions that the single currency and exchange rate produce in economic performance, differences that would normally be met by fiscal policy measures appropriate to individual conditions but which were constrained by

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[4] *Ibid.*

[5] Godley 1997: 24.

[6] Issing 1966.

the conditions to support the single currency. Even if the earlier critiques were ignored, the most recent experience should have suggested the need for an alternative mechanism of financial support for government policies to respond to macroeconomic imbalances that were compatible with the concern to avoid government default and maintain the integrity of the euro.

Instead the response was to strengthen the constraints on individual government's domestic expenditure policies to the support the stability of their fiscal balance and thus to the stability of the Euro, rather than the stability of the macro economy. However, this simply reinforced the recessionary bias that was already implicit in the relation of the new single currency and its issuance by a central bank without a political/institutional base and made it more difficult to offset the impact on domestic economic conditions of international changes in exchange rates. While the single currency eliminated national exchange rate adjustments as a remedy to correct trade imbalances among member states and non-EU trading partners, it shifted policy to internal adjustments via relative domestic wage and price adjustments with Eurozone and non-Eurozone trading partners. However, these adjustments would have a differential impact on relative competitiveness within and without the Eurozone, making their impact difficult to determine.

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While the formal specification of these constraints on government expenditure contained in the Protocol to section 104c(2) of the Maastricht Treaty and subsequent reinforcements in the Stability and Growth Pact in response to the crisis, e.g. the Six pack (2011), the two pack (2013), plus Title III of the Fiscal Stability Treaty (the Fiscal Compact) that are considered necessary conditions for the stability and success of the euro were introduced in order to improve coordination of national fiscal policies, they also reduced the flexibility of national governments in responding to financial crisis and intra-EU imbalances created by the single currency in a global floating exchange rate system. This mismatch in monetary and fiscal policy decisions, the former at the EU level, and the latter at the national level, and the mismatch in the flexibility of monetary policy management relative to the increasingly rigid fiscal policy objectives, create potential financial instability in the euro area and undermines the operation of monetary policy.

Minsky's analysis of financial fragility may provide a guide to the paradox of measures to support euro stability leading to national financial instability. The extensions of the prior fiscal constraints in the recently introduced Fiscal compact imply that most governments should always have financing profiles that generate fiscal balance or surplus. The fiscal compact is the equivalent of a policy of imposing what Minsky defined as hedge financing as a common EU policy. That is, always having more than sufficient resources to meet financial commitments without recourse to external financing. In Minsky's approach this financial profile should provide extreme financial stability as governments will always have the resources to finance their expenditure commitments on current expenditures and on debt service.

However, this condition contains a paradox, and a virtual impossibility theorem for countries that currently have debt and deficit ratios above the SGP limits, as this requires not only budget balance, but a rising fiscal surplus that can only be achieved through a combination of higher growth and taxation. Since governments cannot produce this growth through appropriate demand management policies, it must come from either domestic consumption and investment or from net foreign demand. But increased domestic expenditures cannot be generated by reducing government expenditures or raising taxes to generate the required fiscal surplus, since this only reduces domestic demand. Improving the external account can not longer be achieved by exchange rate adjustment but must involve domestic wage and price adjustment, which also exerts a negative impact on domestic incomes and investment incentives. Further, these adjustments must be relative to major trading partners who may also be engaged in domestic price adjustments, making the required adjustments even greater.

The lesson to be drawn can be that of the German 'economists': that monetary union should have only followed convergence of economic performance which would have precluded the necessity of a centralized EU fiscal policy to offset imbalances. Alternatively, it could have been the adoption of Spinelli's Draft Articles on to embed EU fiscal policy as a force for unity. In the end, neither path was followed, but with the same results and the persistence of imbalances which provided a source for disunity.

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