

Micro- and Macro reforms: two sides of the same euro

The European Council recognises the special importance of enhanced structural reforms in Member States of the Euro Area and stresses the necessity of effective policy coordination within this area, i.a. as a requirement to more effectively deal with asymmetric economic developments within the monetary union.

(European Council Conclusions, March 2006)

Policy-makers and commentators across the board agree on the need to boost employment and growth in the Eurozone. What they do not agree on is how to achieve it. Some argue that high levels of unemployment and low growth are a matter of a faulty macroeconomic set-up (including monetary policies and rules of budgetary consolidation), which is thought to be too deflationary, stifling aggregate demand and growth-enhancing public investment. For others the problem lies solely on the supply-side of the economy, with overly regulated markets hampering economic innovation and the ability to adjust in the face of global economic changes.

It is important to recall that within the Eurozone not all countries are doing equally badly or well. Individual countries persistently diverge in their growth and inflation performances. For example Ireland, Greece and Spain have growth rates well above the euro average, while Germany, Italy and Portugal having very low levels of aggregate demand and growth. Equally, rates of competitiveness diverge, with the export performances of Germany and Ireland standing out not merely at the European but even at the global level. All the Eurozone countries are subject to the same central monetary regime from the European Central Bank. There must obviously be other factors in the economies of individual countries which make them more or less successful over time.

1. The euro: only for the agile ?ⁱ

The literature on 'optimal currency areas' suggests that an important part of the functioning of a currency union is determined at the microeconomic level. Micro-level mechanisms concerning the wage and price formation process are on this analysis crucial for economies to be able to adjust to both short-term economic shocks and to long-term intercountry differences. Individual euro countries can no longer manipulate their relative economic standing by way of changing their (nominal) exchange rate with their neighbours or by interest rate changes; necessary adjustments have to happen 'the hard way' via the real exchange rate and changes in prices and wages. For example, Germany has considerably improved its cost competitiveness over the past 5 years – reflected in high levels of net export – by way of moderate wage settlements. On the other hand, Italy's loss of competitiveness has arguably been exacerbated by EMU's single macroeconomic framework and the narrow choice of policy instruments to adjust (the country being formerly renowned for its frequent currency devaluations).

It is generally accepted that under any given macroeconomic framework (such as that of the ECB's central monetary policy) growth and unemployment will be assisted by micro-economic reforms that increase the responsiveness of the economy to economic changes such as variances in relative levels of competitiveness and demand or supply shocks. Opinions differ as to the relative importance to be attached to the micro-economic and macro-economic aspects of this equation; for some commentators, micro-economic ('supply-side') reforms are by far the most important economic weapons in the armoury of national governments, while for others their significance is marginal compared with the importance of setting the right macro-economic framework. Two factors seem to have pushed the European Union's governments in recent years towards the enhanced pursuit of micro-economic reforms: fear of secular uncompetitiveness in the face of emerging Asian economies and the growing realisation that the combination of an independent European Central Bank and the Growth and Stability Pact anyway leave national European governments very little room for manoeuvre in setting the macroeconomic framework of their national economies.

2. The politics of structural reform

Over the past five years, an intellectual and political climate has existed in the European Union which on the face of it was increasingly favourable to supply side reform of the domestic economies within the EU member states. This apparent consensus found its particular expression in the 'Lisbon Agenda', with the considerable, although not exclusive emphasis it laid upon structural reforms to make the Union's economies more flexible. However, the step from abstract acceptance of the need to reform to the realised implementation of potentially unsettling policies has proved politically extremely difficult. Recent evidence suggests that public support is hard to win for structural reforms: France's against the CPE, the unpopularity of the last German government and the inability of the Berlusconi government to translate its liberalising rhetoric into reality are all cases very much in point. Luxembourg's Prime Minister Jean-Claude Juncker summarises the dilemma that policy-makers face succinctly: 'we know what needs to be done. We just don't know how to win election once we've done it'.

The politics of reform create a difficult game for policy-makers to play: reforms often have a long-term payoff structure and losers may demand some form of short-term compensation. The political viability of reforms may be increased if they are flanked by additional policies to help societies adjust in the short-term. This can traditionally be done either in the form of more expansionary monetary policy or active social policies. However, that is precisely the difficulty of Eurozone countries: any country considering structural reforms can obviously no longer use national monetary looseness as an instrument to ease the pressure on aggregate demand. Furthermore, given most Eurozone countries' current fiscal positions touching the Stability and Growth Pact's ceilings, they have little room to use further fiscal stimuli or increase spending on (active) social policies to compensate losers in the short-run. This means that, on the one hand, most Eurozone member states accept in theory the pressing need for structural reforms. On the other hand, the scope for these reforms to be implemented is apparently reduced for each individual country in the Eurozone.

3. The case for Eurozone co-ordination

The case for co-ordinated action on structural supply side reforms throughout the European Union is a result of the level of interdependence between different economies in a single currency area. Lower structural unemployment and higher productivity in one country (particularly a large one) have a benign impact on the general economic environment and particularly on inflation in the Eurozone as a whole. But the converse is also true. Economic disequilibria resulting from diminishing competitiveness and rising inflation may prompt the European Central Bank to a less accommodating monetary stance for the Eurozone as a whole. Thus the micro-structural environment of one country can affect the macro-economic environment for all countries within the currency union.

At the same time, the ECB's reaction function is relatively unresponsive to micro-economic reforms in individual Eurozone countries (the Bank tackles aggregate levels of economic indicators for the Eurozone as a whole). It has been argued (with some plausibility) that it might act as a 'reform trap', making it more difficult for individual countries to perform their intrinsically desirable agendas of structural reform. As individual national fiscal stances cannot increase beyond what is allowed by the Stability and Growth Pact, one possibility might be to co-ordinate economic policies so that governments can embark on concerted reform efforts with the ECB supporting the effort with an appropriate monetary reaction, principally by lower interest rates for the Eurozone as a whole. Boosting aggregate demand by way of lower interest rates for the Eurozone as a whole might reduce the political costs of reform in the short-run. It might well be an appropriate task for a European 'economic government' to act as the partner in discussions with the European Central Bank on the right combination of European-wide structural reform and an accommodating monetary policy by the Bank to facilitate this reform.

4. Lisbon: A European strategy to boost employment and growth

The main EU effort to co-ordinate economic policies supporting employment and growth is the Lisbon Agenda. In March 2000, the European Council resolved to make the EU 'the most competitive and dynamic knowledge-driven economy by 2010'. This

move reflected the view that reforms were needed to guarantee the sustainability of the European economy and the concern that national-level reforms were not proceeding fast enough. Key elements of the Agenda were the objective to create a knowledge-based economy by investing in education and research, boosting innovation and labour productivity; to reduce market rigidities and regulatory burden; and to raise employment rates by reducing disincentives to work.

However, the mid-term assessment in form of the Kok Report came to disappointing conclusionsⁱⁱ: its main criticisms were that the Lisbon strategy suffered from a lack of focus, a lack of political commitment on part of the member states and a weakness of the main instrument of the agenda, non-obligatory benchmarking. In consequence, it was decided in 2005 to relaunch the Agenda: the focus was narrowed to 'jobs & growth' as key to the future prosperity and sustainability of the European economy. It was decided to differentiate more clearly between EU and nation-level responsibilities, with the new governance regime resting almost exclusively on National Reform Programmes (NRPs). Whether these NRPs will be transformed over the coming years into political and economic reality will depend, as their names imply, primarily upon the interplay of specifically national factors. It is a justified criticism of the Lisbon Agenda that it holds itself out to be a programme of the European Union without providing any material or legislative resources at the European level to encourage the implementation of the programme. The systems of 'bench-marking' and 'peer review' on which the Agenda has relied have proved feeble weapons when compared to the pressing constraints of domestic politics against which background national politicians have to take their decisions.

Conclusion: the missing links

The preceding analysis seems to suggest that a successful reform agenda should look at the macroeconomic background to this proposed reform as well as the more obvious micro-structural elements of the economy – and especially at the effects that one has on the other.

The European agenda for improving economic growth and employment has been described as resting on 'two arms': the 'Maastricht arm', dealing with monetary policy and budgetary consolidation, and the 'Lisbon arm', looking at micro-structural adjustment and tackling the functioning of markets. Yet while both issues have recently regained political weight (with the reform of the SGP and the relaunch of the Lisbon agenda respectively), the existence of the vital interlinkages between these two arms is only now starting to be discussed. That these two related processes should have proceeded so far with no more than an occasional crossing of the paths of the two agendas is an illuminating comment on the developing structure of the Eurozone's economic governance. At the European Council this March, it was acknowledged that it is time to recognise this missing link between structural reforms and the Eurozone's macro-economic framework. The national governments of the Eurozone could profitably work among themselves to co-ordinate better common approaches to the economic and political challenges of structural reform; and in the pursuit of structural reform it is surely better that the Council of Ministers and the European Central Bank should act in their respective spheres with full knowledge of each other's thinking than that they should act wholly separately. Quite apart from the likelihood that an objectively better policy mix will emerge from such a process, electors, investors and other economic actors would be likely to find it reassuring that leading players of the Eurozone's governance drama are taking their decisions in harmony rather than conflict with each other.

ⁱ For a concise exposition of the point see A Ahearne and J Pisani-Ferry, 'The Euro: only for the agile', February 2006, available at www.bruegel.org.

ⁱⁱ Report from the High Level Group chaired by Wim Kok, 'Facing the challenge. The Lisbon strategy for growth and employment, November 2004, available at http://europa.eu.int/growthandjobs/pdf/kok_report_en.pdf