

Co-operation in EU economic policy-making is underutilized

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Fiscal policy and the significance of the short term

The global economic crisis, which started in 2008, has visibly accentuated how important it is that politicians find ways to effectively stabilise the demand in the economy. Interest rate cuts and other monetary policy interventions are used all over the world and very speedily. It goes slower with fiscal policy.

It appears to be very difficult to achieve effectiveness of fiscal policy measures during the crisis, due inter alia to great household pessimism in the EU, including Sweden. There is obviously a risk that a great deal of household-targeted stimulative measures is not consumed, which is the actual need. Instead, these measures lead to increased saving for security among households, owing to the difficult crisis situation in the labour market and too weak safety nets, i.e. unemployment insurances, for individuals.

A famous quote by the British economist John Maynard Keynes reads as follows: “In the long run, we are all dead”. The best long-term development of a country’s welfare should weight heavily for the choice of which economic policy to be pursued in the short run. Both governments and central banks are provided with a wide scope for different interpretations of what impact short-term measures have in the long run. Decision-makers’ approach to the latter can be crucial to how well this crisis is dealt with in the EU. So far, the fact that fiscal policy stimulus packages have been delayed and partly too limited has been a disquieting sign. In Sweden the right-wing Government has put approximately 1.3 percent of GDP in unfinanced reforms for 2009, which does not appear nearly enough, given a very sluggish development in the labour market and the pace of redundancy notices that has for four months stayed at the same level as at the beginning of the 1990 economic crisis. The Government package is too limited, despite the fact that Sweden is one of the countries that initially had the very best public finance situation in the EU, with non-existent net public indebtedness and many years of budget surplus. The estimated fall in employment is at least 100,000 in 2009, unless further measures are applied by the Government during the spring of 2009. Unfortunately, the fall will probably be much higher than that, due to the lack of political will to use the Government budget to a greater extent in order to timely deal with the impact of the crisis on production and employment.

A highly relevant question is why our right-wing Government in Sweden abstains from pursuing a strong conjunctural policy via Government budget in order to deal with the employment crisis in the short run – also with the possibility of substantial economic gains in the long run. A most likely explanation is that the Government does not want to risk to, in an election year, have to deal with a discussion on the need of increased taxes in order to recover a budget deficit which would occur due to a correct, more extensive fiscal expansion in the early stage of the crisis. This trend is called by economists “election cycles” – fluctuations in the economic situation caused by politicians’ concerns about being re-elected. In countries where researchers find such cycles, they normally lead to an unreasonably high budget expansion prior to and

under the election year. In Sweden, it seems that the right-wing Government can be faced with too slow fiscal expansion during the crisis. At an OECD seminar in late 2008, the Swedish Minister of Finance Anders Borg stated that the long term and structural policy were of the most crucial importance in the economic policy. It was surprising in the situation when there was a need for conjunctural policy in the Swedish economy. It was however ideologically clear.

Furthermore, the right-wing Government has – through structural reforms of the tax system and cuts in unemployment benefit – considerably reduced the impact of the automatic rule-governed fiscal policy on the budget (the so-called automatic stabilisers). This has increasingly called for active political decisions on fiscal anti-crisis measures by the Government and the Parliament. During the 1990 crisis the demand was to a much greater extent accumulated automatically, owing to the regulations of for instance unemployment insurance. Active labour market policy also functioned more as a “semi-automatic” stabiliser, since unemployed-targeted schemes developed quickly. Wage-earners felt more secure and were able to better anticipate their income in case of unemployment.

The ideological approach of the right-wing Government plays probably an important role for the stabilisation level in the Swedish economy right now. Other (particularly right-wing) politicians probably think in similar ways in the entire EU, which can have an impact on how effectively the crisis will be managed in Europe during 2009 and 2010. There are risks in terms of doing too little and waiting too long. According to the LO economists’ opinion, it is a necessary and correct strategy when politicians allow, when the need arises, the budget deficit to grow in a country, even substantially below the EU’s three per cent threshold, in order to seek to prevent a very deep fall in employment and production. Cameralism is no principle for macroeconomic policy.

During the 1930s John Maynard Keynes advocated that the economic policy should manage the short term better than earlier and he presented a coherent theoretical frame around these ideas. Today there is consensus among economic researchers on the fact that changes in the aggregate demand affect production in the short run. This is the basis of why stabilisation policy is necessary.

In practice, most politicians seem to agree that fiscal policy has an important role to play in order to make production and employment increase in the short run to a high and stable level. Few politicians can abstain from taking measures via national budget when a major crisis occurs. During the current crisis, the expansion of public expenditures (e.g. Government investment expenditure, state grants to municipalities, labour market policy) is the most effective measure targeted towards a more stable development), but – despite this - politicians use relatively large tax cuts.

Most interesting reasoning is that the increased significance of financial markets – as part of economic activity and far-reaching international market integration – can cause the requirements for stabilisation policy to change. With potentially more frequent and larger financial fluctuations, the need for stabilisation policy may increase. Fluctuations in exchange rates can be large and rapid and occur inter alia as a result of how foreign exchange markets function.

Fluctuations in the financial economy may have an impact on the real economy – production and employment – in a more far-reaching and rapid way than was the case earlier, and in that case they must be dealt with more efficiently in the future. Costs in terms of terminated production and unemployment already seem to be high due to credit restraint in this crisis, as seen from a wide wage-earner perspective in the entire EU.

Stabilisation policy in the EU

The EU Stability and Growth Pact aims to monitor public finances and coordinate the economic policy. The objective of fiscal policy determined in the Stability Pact is to be close to balance or in surplus in the medium term and that a country's annual budget deficit must not be higher than 3 percent of GDP, unless exceptional circumstances occur. These circumstances are specified in the Treaty in terms of falling growth rate that is not caused by a regular economic downturn. Today many Member States can exceed the ceiling.

The EU Stability and Growth Pact was reformed in 2005 to allow – to a greater extent – a higher budget deficit than 3 percent of GDP. The reform was caused by difficulties to get the economies going during economic downturns. The present recession is just such a time when Member States face a relaxation of the rules. Many Member States have reached or clearly exceeded the highest deficit ceiling allowed.

To a varying degree the EU Member States have resources to apply budgetary measures aiming to mitigate the recession. Therefore, with the exception of a few countries, it can unfortunately not be expected that either cuts in taxes or public consumption are used to a sufficient extent to boom the economy. This is an important reason why the EU Member States need to expand in mutual co-operation. If they for example co-ordinate a temporary VAT cut in order to stimulate consumption, the cut needs to be only half as large to obtain the same stimulating effect. Budget deficits may thus be less affected and increase in debt will be slower. This has unfortunately taken place to a far too limited degree in the current crisis and the gains of the co-ordination of the EU economic policy are thus underutilized. It is an important issue for EU politicians to discuss in the future.

There has been much focus on the deficit in the public finances of Member States. The positive connection between an expansionary policy and the employment rate - and thereby also the public income - has far too often been ignored. Besides the deficit, we should also look at the other side of the coin: the increasing surplus in private savings which also has a restraining effect on investments and consumption in Europe.

One explanation for the increase in private savings is that citizens do not have enough confidence in the system. In simple terms this means that individuals' social security is deficient and there is anxiety about the economic development.

The European Council, at its meeting in December 2008, agreed on a European Economic Recovery Plan, corresponding to 1.5 per cent of the European Union GDP (about 200 billion Euro). It consists of measures on both national and EU levels. They include, inter alia, increased investments by the European Investment Bank, a

possibility for Member States of applying reduced VAT rates, action by the European Social Fund to reinforce employment, a State guarantee for banks' lending operations (inter-bank financing) during the coming five years and the possibility of nationalising banks, when the need arises.

In addition, the European Commission has due to the extraordinary situation approved the different "rescue packages" of individual Member States, which are aimed at counteracting the crisis' negative effects on the real economy, particularly by means of promoting increased credit flux. For instance, extensive banking stimulus packages have been acknowledged in Germany, Great Britain, France and the Netherlands. It is the task of each country to take measures, as the EU does not have any common fiscal policy and, moreover, as the effects of the financial crisis in each Member State vary.

Previously, however, Member States have been urged by the European Commission to observe the budget deficit criteria laid down in the Stability and Growth Pact of the EU. Thus the message by the Commission as regards sanctioned national measures has been slightly ambiguous, even if the Commission has showed capacity to act and willingness to assume active responsibility for the economic recovery of the EU. It is however desirable that the EU Commission and the Council of Ministers clearly indicate that Member States are allowed to use the existing fiscal margin for stimulus measures, as there are bigger risks involved for the real economy in downturns similar to the current one, if the measures taken are too modest than if they are too extensive.

The European Central Bank ECB has expressed that the current situation of economic crisis must not hamper continuous structural reforms in the EU Member States. The reason referred to is that the results of the reforms will be needed when there is a turn in the economy. Although, the accomplishment of structural change is easiest in times of economic boom. Persisting with structural reforms in the prevailing situation can turn out to be inefficient. Nor can structural policy replace the demand-led policy, which is the most important instrument during crises similar to the one the world's economies are faced with today.

In addition to the dynamic of the automatic stabilisers, fiscal policy has a decisive roll in limiting the negative effects of the financial crisis and in complementing the instruments for monetary governing. European governments, the EU Commission and the ECB must to a greater extent than before take into account the coherence of the policy pursued.

In order to bring about a constructive discussion on coordinated stabilisation policy, both macroeconomic and microeconomic factors have to be taken into account, as well as the monetary conditions. While evaluating the Lisbon process, structural factors have often been stated as main reason for the (too low) growth rate in the EU. Statements of that kind must however be seen in the light of the monetary policy pursued. During the last few years, inflation in the EU has stayed on the ECB target level but several Member States have periodically manifested an inflation rate inferior to the target, as well as a deficit in demand - factors that have had consequences for the growth rate.

The ECB as well as the EU Commission tend to consider the risk of overheating of economy as being more immediate than the risk of downturns. Often, this has been manifested by calls for preparedness in view of future demand shocks. The economic cycles must be evened out but the main problem of the EU has so far – at least since the launching of the Lisbon process – consisted of difficulties in raising the long-term growth rate on a broad front and in obtaining adequate stabilisation in all countries in times of recession. Periods of downturn require preparedness as well.

The EU has certain problems of supply which exist, inter alia, in the labour market. Policies, however, are too one-sidedly oriented to structural problems. There is now an obvious need for active fiscal policy and expansionary monetary policy. In addition, wherever possibilities exist to obtain increased efficiency by coordination, they must be used.

Concluding remarks

The financial crisis that started in the USA and Great Britain in 2008 has now turned into a global economic crisis of historical dimensions. The negative impacts are to a great extent perceptible all over the EU and politicians now face a difficult task of crisis management during the coming years, aimed in the first place to stopping a drastic decline in production and employment which can affect welfare in the long run.

The serious problems with credit restraints and malfunctioning loan markets are undoubtedly an aggravating factor of the current recession in the world economy. Wage-earners face at least two very difficult years ahead in the labour market. Also, the fall in the value of household assets entails in the long run negative effects for pensions for instance.

Unfortunately, remedying the crisis will probably take a long time and politicians are most uncertain about which measures are most effective as regards credit and banking systems. This is partially due to the fact that finance companies only fragmentarily disclose the details and dimensions of their problems. Governments do not have any efficient means to get specified and timely information about anticipated losses in private finance companies.

Governments, national central banks and the ECB have decided about many different measures in order to stop credit restraints and to facilitate increased bank lending (for instance by means of additional owner contributions and state ownership of banks). Furthermore, extensive stimulus packages in the framework of fiscal policy, as well as other measures have been introduced by governments in many European countries.

Many governments in the EU have unfortunately not made proof of good leadership in the crisis management. The first mistake was the creation, already in October, of a voluntary guarantee programme for banks. Very few banks have joined it and a large number of other programmes have been needed thereafter.

A number of cuts in interest rates have been carried out, inter alia in coordination with the USA. The ECB has however acted with a wait-and-see approach and somewhat tardily. In the autumn of 2008 however, rapid action was taken by the ECB to

counteract the liquidity crisis, by means of allocating extensive resources to the banking sector for day-to-day lending.

Better coordination could have in our opinion been a way to increase effectiveness in the stabilisation of employment and production. The problem in this context is that Member States are sovereign as regards the outlining of fiscal policy. Fiscal policies vary – and must do so in the name of democracy – depending on the political colour of governments and on Member States' choice of social model. This is on one hand a dilemma for the common economic policy of EU but on the other a self-evident democratic pattern. It should however be possible to overcome this dilemma somewhat better, by improved coordination of situation assessments and increased political goodwill based on the insight on how largely our economies are inter-dependent in the EU.

It would be a fore-sighted contribution by the EU decision-makers if they could find more efficient forms of coordinating the fiscal policies in times of crisis, as well as indicators for the follow-up of the construction of more extensive automatic stabilisers in a larger number of member states. It would be to the benefit of wage-earners now and in the future periods of economic downturn.