Economic Governance and Democratic Accountability

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Outline

- A Problem of Democracy? Institutions
  - The Intellectual Basis of Technocracy
  - The ECB: Accountability and Independence?
  - Fiscal Governance: Government by the Rules
- A Problem of Democracy? Practices
  - The Greek Tragedy
- Discussion

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A Few Elements of History of Thought: Neoclassical Theory

- The Two Main Results of the Theory:
  - Existence - General equilibrium (Walras)
    - It does always exist a vector of relative prices that equates demand and supply
  - Fundamental Welfare Theorems (Pareto)
    - A perfectly competitive equilibrium is efficient.
- Conditions for Welfare Theorems to hold:
  1. Perfect competition
  2. Perfect (symmetric) information
  3. Complete markets
  4. (Price flexibility)
- In a sentence: **No rents!**

A Few Elements of History of Thought: Neoclassical Theory

- Main Policy Conclusions
  - Markets are perfectly capable of determining the “best” equilibrium
  - Provided markets are flexible, the optimal equilibrium is reached through market forces
  - Demand follows supply (Say’s Law)
- Thus, the basic message is that *there is no role for policy*
- Corollary:
  - Money is used for transactions. It is just a ‘veil’, and determines absolute prices (quantity theory). Dichotomy and neutrality

The "New Consensus" Policy Prescriptions

- The struggle between neoclassical and Keynesian economists yields eventually a New Consensus:
  - Short run fluctuations have little, if any, influence on long run growth
  - Structural reforms are the only tool capable of shifting the natural equilibrium through supply side improvements
  - Discretionary policy is ineffective. Rules are more efficient as they help agents form expectations (automatic stabilizers, Taylor Rule)
  - Macroeconomic policy is a matter of technocrats applying rules
  - The preferred tool for policy makers should be monetary policy: Fiscal policy is subject to biases and lags
  - Until the crisis of 2008 struck…

EMU Institutions and the Consensus

- The road to Maastricht and to the Euro coincides with the ascent of the consensus. The result is institutions that embed the preference for rules and ban discretion
  - The Stability and Growth Pact
  - The ECB inflation targeting mandate

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Monetary Policy: The ECB

- Objective

  *‘The primary objective of the ESCB shall be to maintain **price stability**. Without prejudice to the objective of price stability, the ESCB shall support the general economic policies in the Community […].’ (Maastricht Treaty’s Art. 105.1)*

  Article 2. The objectives of European Union are a high level of employment and sustainable and non-inflationary growth.

The Difference with the Fed

- The Fed has a dual mandate (Humphrey Hawkings Act, 1976)
  - Inflation and employment are equally important (Keynesian influence)
  - The mandate defines *the political nature of monetary policy*
  - The choice between conflicting objectives follows the preferences of the policy makers
- The ECB could be a computer algorithm. Nevertheless…
- Hard to argue that monetary policy has no impact on our lives!
- The dual mandate dispels the technocratic illusion

Objectives

- Does the Eurosystem have a target?

*"In the pursuit of price stability, the ECB aims at maintaining inflation rates **below, but close to**, 2% over the medium term."*

Peculiarities:

- Decided by the Governing Council
- Leaves room for interpretation:
  - where below 2 per cent?
  - what is the medium term?

Independence and Accountability

- Arguments for central bank independence:
  - governments tend not to resist to the 'printing press' temptation
  - Independence removes central banks from such pressure.
  - the Bundesbank has set an example.

But…

- Misbehaving governments are eventually punished by voters.
- Nobody punishes Central banks $\Rightarrow$ A democratic deficit?

Redressing the Democratic Deficit

- In return for their independence, central banks must be held accountable:
  - to the public
  - to elected representatives.

- The Bank of England for example is given an inflation target by the Chancellor. It is free to decide how to meet the target, but must explain its failures (the 'letter')

- Power of the ECB depends also on what it faces: "*One monetary giant and 19 fiscal dwarfs*"

The Eurosystem’s Weak Accountability

- The Eurosystem must report to the EU Parliament.
  - The Eurosystem’s President must appear before the EU Parliament when requested, and does so every quarter.
- Nevertheless,
  - The EU Parliament cannot change the Eurosystem’s independence and has limited public visibility.
- The American Congress and Senate have more power over the Fed

Conclusion: An Almighty ECB

- The ECB is (in theory) shielded by political choice by its mandate: Technocratic illusion
- It has considerable autonomy in defining its objective
- It has very little accountability
- It faces 19 (divided and constrained) governments
- The result is *monetary dominance*

Accountability Needs to be Made Stronger

- If monetary policy is political, accountability and independence become even more important
- The introduction of a dual mandate would need to be carefully crafted within a wider institutional reform
- The central bank should be made accountable through constant dialogue with other political bodies.
- Independence would be best served if dialogue (and accountability) happened mostly with the parliament
- To conclude, the dual mandate can encompass inflation targeting and has no specific flaw. **It is therefore a superior institutional arrangement**

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The Maastricht Convergence Criteria

- Inflation:

  not to exceed by more than 1.5 per cent the average of the three lowest inflation rates among EU countries.

- Long-term interest rate:

  not to exceed by more than 2 per cent the average interest rate in the three lowest inflation countries.

- ERM membership:

  at least two years in ERM without being forced to devalue.

- **Budget deficit:**

  deficit less than 3 per cent of GDP

- **Public debt:**

  debt less than 60 per cent of GDP

The Stability and Growth Pact (SGP)

- Amsterdam Treaty (1997) and reform of 2005
- Meant to avoid discretion and to only allow automatic stabilization.
- Requirement to attain a position of close to balance or in surplus in the mid-run (which implies what, in terms of debt-to-GDP-Ratio?)
- Excessive Deficit Procedure (EDP) makes permanent the 3 per cent deficit and 60 per cent debt ceilings and foresees fines.
- Final word remains with ECOFIN, and countries avoided fines so far.

A Crucial Distinction: Automatic vs. Discretionary

- Automatic stabilisers:
  - tax receipts decline when the economy slows down, and conversely
  - welfare spending rises when the economy slows down, and conversely
  - no decision, so no lag: nicely countercyclical
- How large are automatic stabilizers?
  - public sector size
  - progressivity of the tax and benefit system
  - levels of unemployment benefits
  - sensitivity of unemployment to economic fluctuations

Automatic Stabilisers

- Percentage of fluctuations smoothed by automatic stabilization

	Bundesbank model (1)	QUEST model (2)	NiGEM model (3)	INTERLINK model (4)
France	19	23	7	14
Italy	14	21	5	23
Netherlands	14	20	6	36
UK	24	18	n.a.	30
Germany	23	17	18	31
Unweighted average	18.8	19.8	9.0	26.8
Std error	4.8	2.4	6.1	8.5

Source: Creel and Saraceno (2010)

How the Pact Works

- A limit on acceptable deficits: 3% of GDP
- A preventive arm
  - "Stability programmes" and peer pressure
  - Aims at avoiding reaching the limit in bad years
  - Calls for surpluses in good years
- A corrective arm
  - 'Early warning' when deficit is believed to breach limit + recommendations
  - EDP procedure for excessive deficit: recommendations, to be followed by corrective measures, and ultimately sanctions

The SGP Fines

- The sum is retained from payments from the EU to the country (CAP, Structural and Cohesion Funds).
- It is imposed every year when the deficit exceeds 3 per cent.
- The fine is initially considered as a deposit:
- if the deficit is corrected within two years, the deposit is returned
- if it is not corrected within two years, the deposit is considered as a fine.
- The fine starts at 0.2 per cent of GDP and rises by 0.1 per cent for each 1 per cent of excess deficit

Size of deficit (% of GDP)	Amount of fine (% of GDP)
3%	0.2%
4%	0.3%
5%	0.4%
6% and above	0.5%

The Fiscal Compact

- Evolution/tightening of the 1997 Stability Pact: Budget balance and sanctions. Effective January 1st 2013
- It is an intergovernmental pact, introduced in the legislation of the 25 signing member at the constitutional level
- Provisions :
  - Structural balanced budget. Deficit net of cyclical components needs not to be larger than 0.5%. *Attention: this has important consequences on debt ratios!*
  - Contrary to the Stability Pact, sanctions are automatic. A majority of the Council can suspend them
  - Additional requirement of returning to 60% Debt/GDP in 20 years

Why Constrain Discretionary Fiscal Policy?

- Decision lags are long: tax and expenditure changes have to go through a lengthy parliamentary decision-making process. Monetary policy is almost instantaneous.
- The political character of fiscal policy decisions makes it much harder to revise decisions when circumstances change
- Fiscal policy has other central goals than stabilization, e.g. income distribution.
- The risk of an expansionary bias is much larger for fiscal policy (political cycle) than for monetary policy, as the latter has been delegated to independent central banks, which can take a more long term view.

Fiscal Policy in the EMU

- The SGP has proven to have many flaws
- Countries have often had deficits above 3%
- Sanctions have never been imposed
- The reform of 2005 increased discretion and arbitrariness, making the imposition of sanctions even less probable
- So, why bother?

A Tale of Two Policy Approaches

Macroeconomic policy has been proactive in the US, and very inertial in the EMU

Table 5: Interest Rates Descriptive Statistics 1999-2010

	Fed Funds	Repo
Mean	3.12	2.90
s.e.	2.00	1.03
Max	6.5	4.75
Min	0.25	1

Source: Datastream

Monetary Policy

Fiscal Policy

Table 6: Fiscal Impulse : Descriptive Statistics 1999-2010

	GER	ITA	ESP	FRA	EU4*	UK	USA	JAP
Mean	0.12	-0.01	0.21	0.24	0.14	0.84	0.75	-0.35
s.e.	0.81	0.88	1.89	0.58	0.58	1.63	1.35	2.24
Max	1.68	1.44	5.25	1.15	2.89	4.63	2.89	2.72
Min	-0.79	-1.44	-1.16	-0.47	-0.76	-1.00	-0.81	-4.70

Source: Datastream

*EU4 is weighed with GDP

A Dismal Performance

- Since 1999, the EMU lagged behind the US in terms of output. And did slightly better in terms of inflation

CPI and GDP Yearly Change: US vs EMU

	CPI			***GDP***		
	99-15	99-07	08-15	99-15	99-07	08-15
USA	2.4%	2.8%	1.5%	2.3%	2.9%	1.4%
EMU	1.9%	2.2%	1.3%	1.3%	2.2%	0.1%

Source: European Commission – Fred

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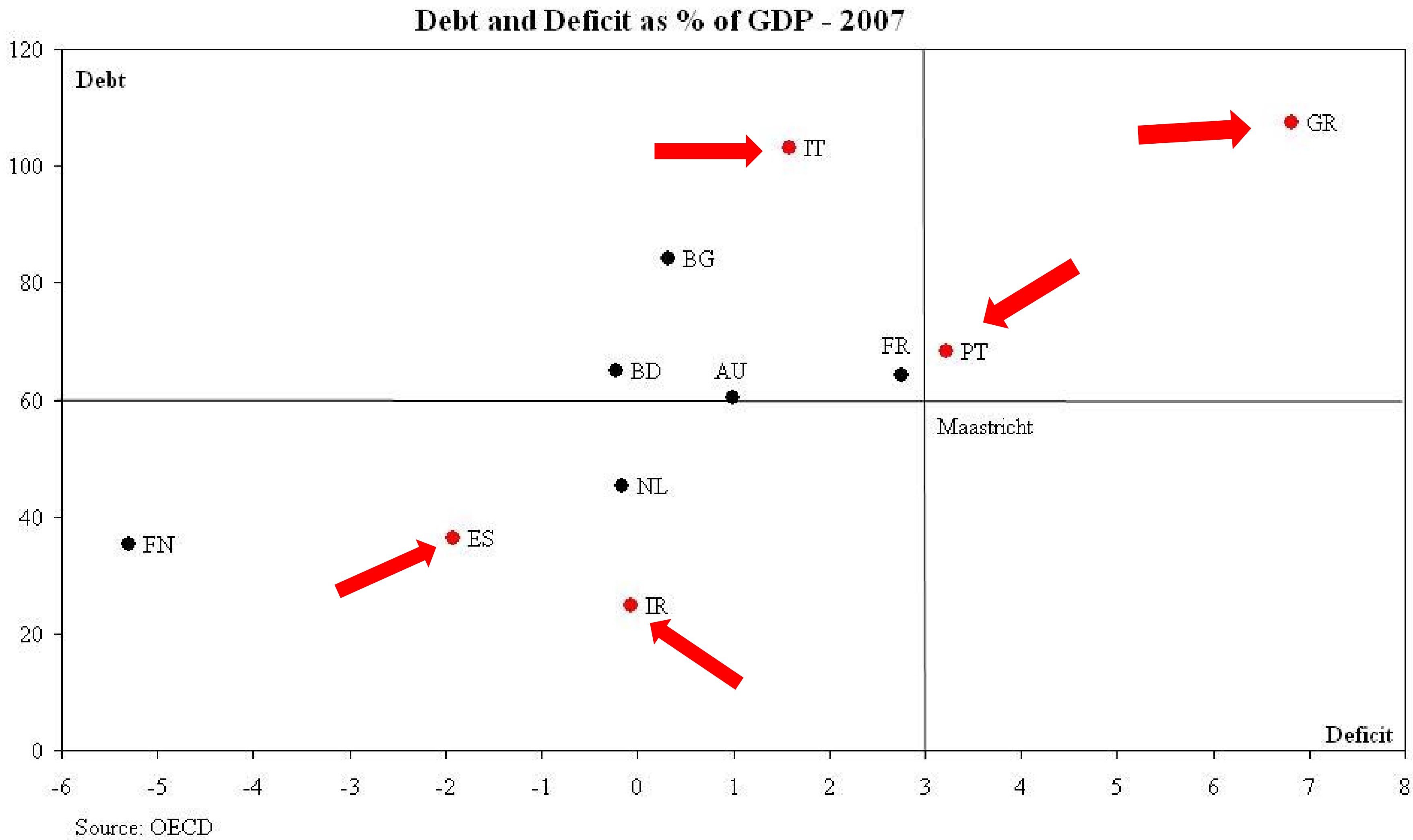
The Berlin View

- The intellectual reference is the market efficiency hypothesis
- No role for fiscal or monetary policy in boosting growth: Importance of fiscal discipline
- Exports rather than domestic demand should be the basis for growth
- Club-Med countries had out-of-control public finances
- As a consequence, blame, and adjustment is only on countries in difficulty. Fiscal Consolidation!
- Structural reforms allow competitiveness to be restored

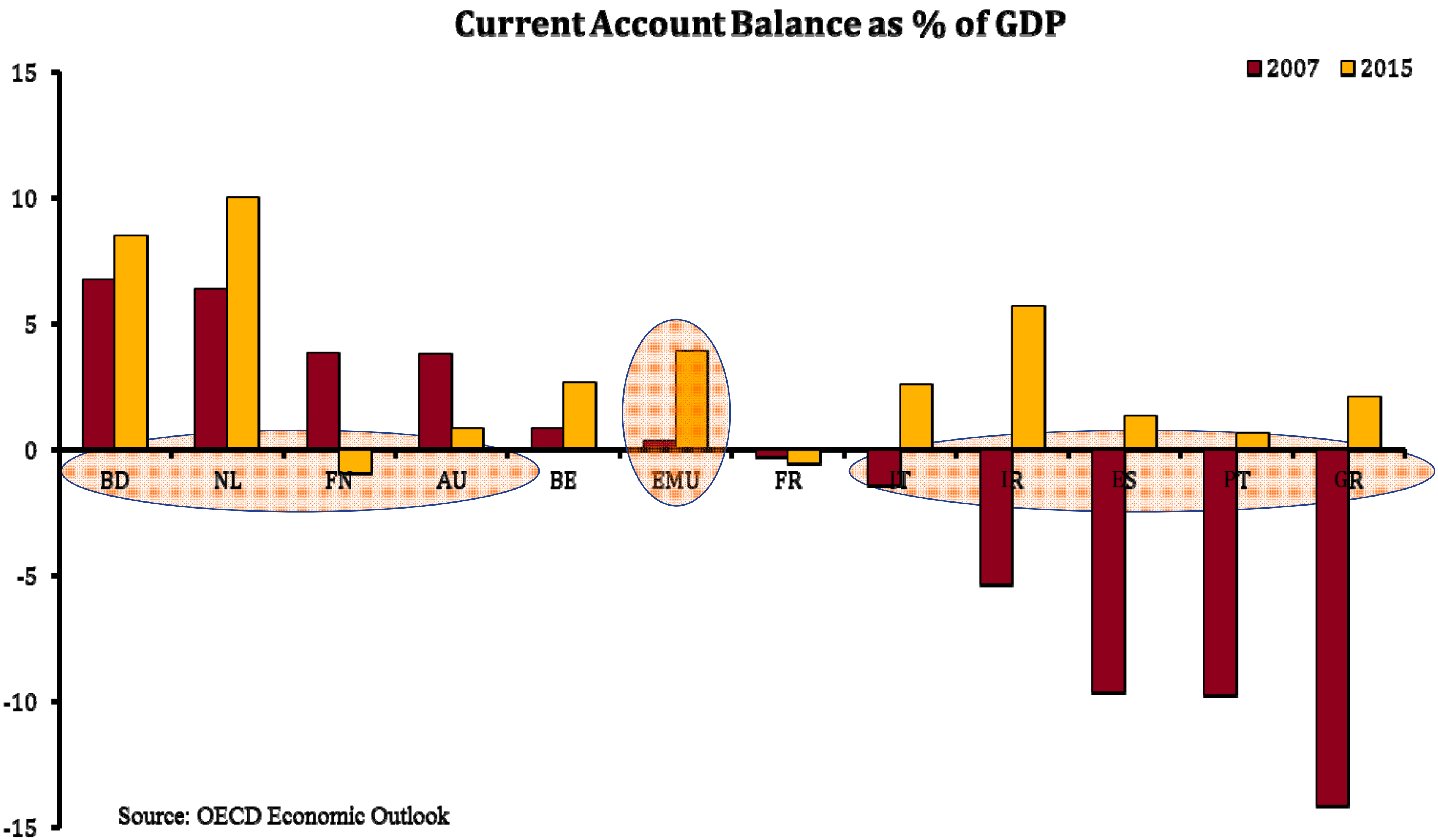
The Berlin View

- The institutional consequences of the Berlin view
  - EMU fiscal coordination happens from the bottom, through strict fiscal discipline (the « fiscal compact » as a fiscal union)
  - Monetary policy should limit itself to price stability. No role for OMT's, insurance, and so on. The best for growth is a stable inflation environment
- Notice that the Berlin View is nothing else than the Washington (Brussels) consensus, and is already embedded in the Maastricht treaty.
  - Stability and Growth Pact limits fiscal policy to automatic stabilization
  - The ECB mandate, contrary e.g. to the Fed, is limited to the inflation objective

- No clear public finances pattern for the PIIGS



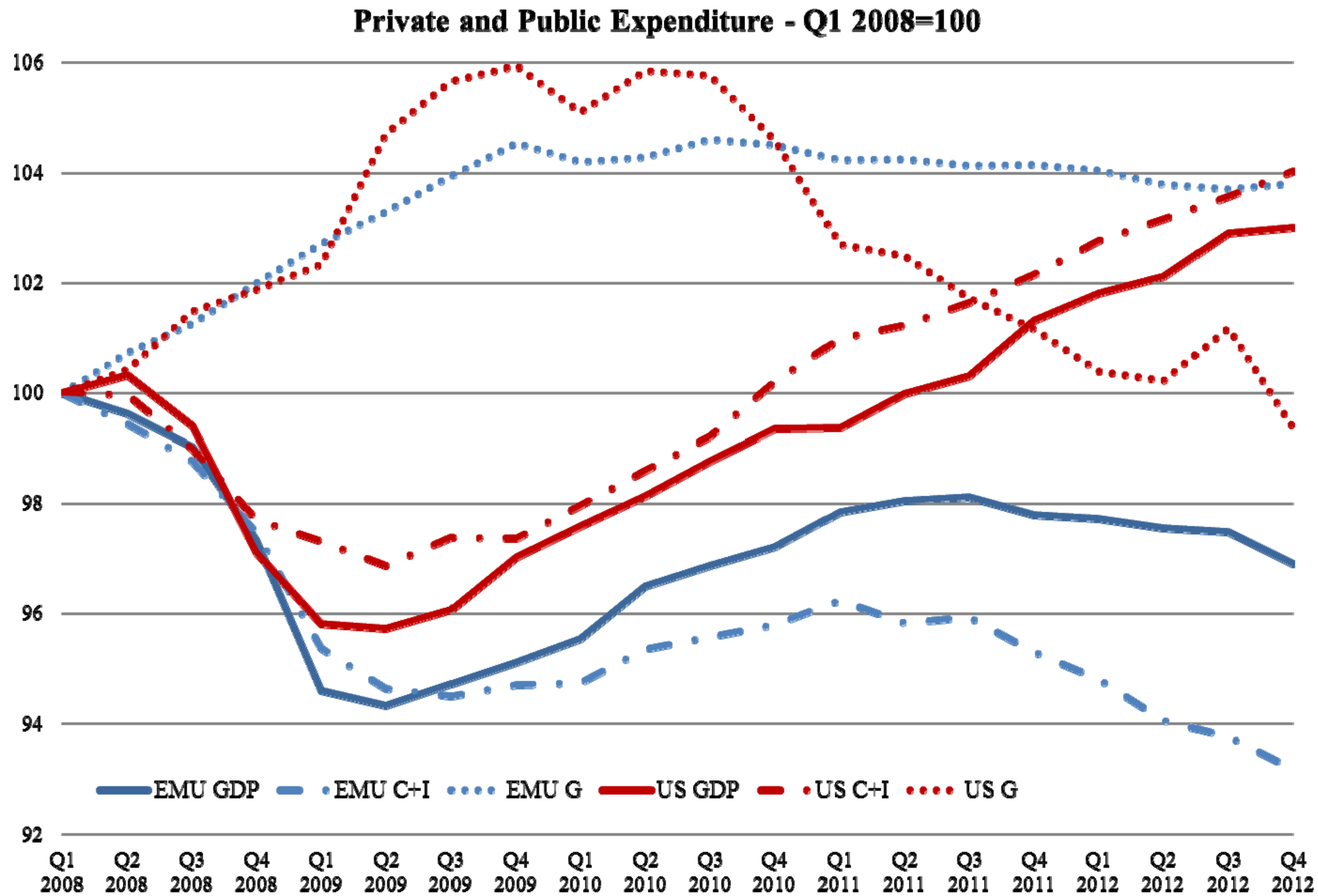
- But a pattern can be spotted in external imbalances



Lessons from the Crisis

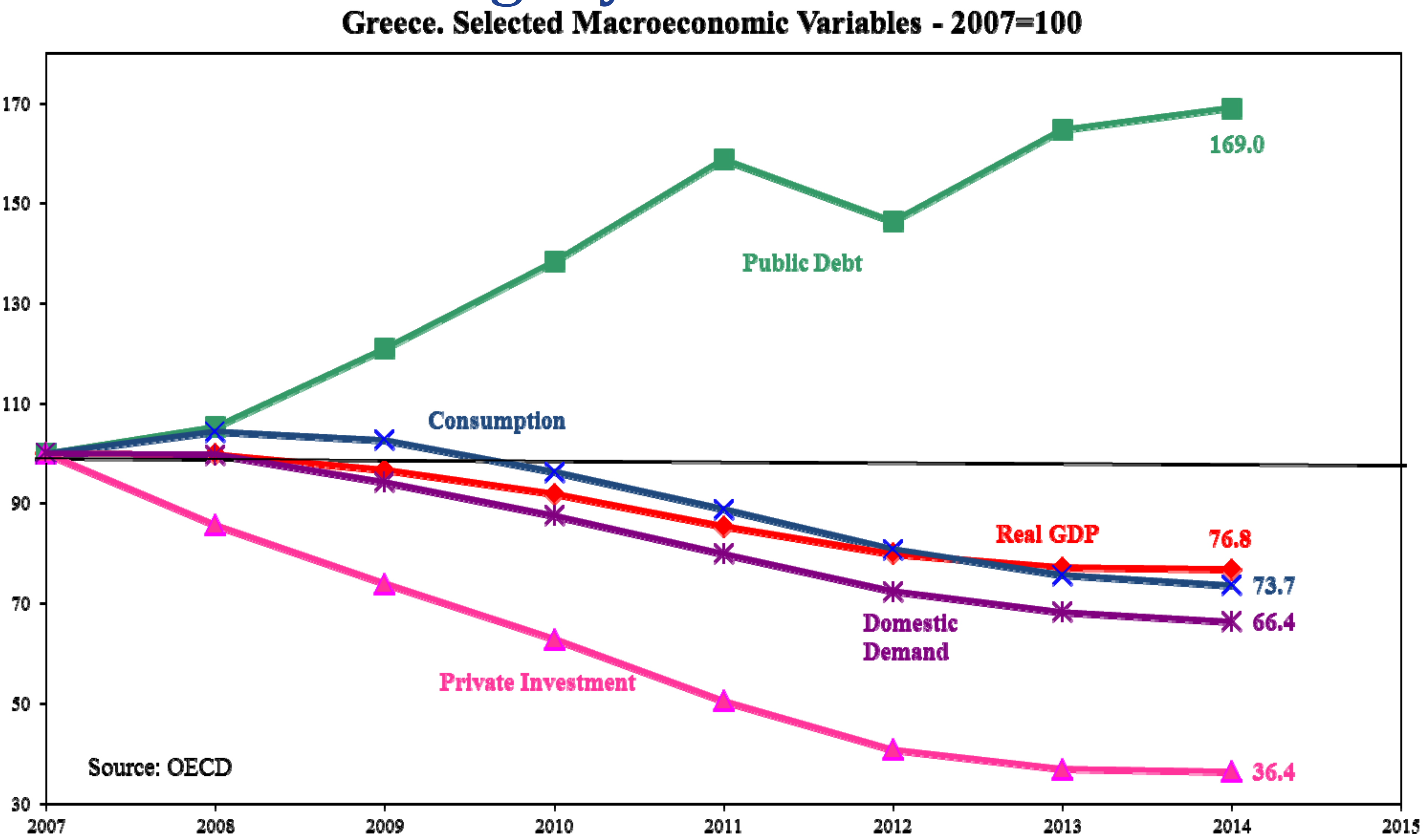
- Suggestive evidence does not support the Berlin View
- If anything, it points to structural imbalances
  - Excess expenditure and debt were private (Spain, Ireland), or public (Greece Portugal)
- Yet, the Berlin View won the policy debate
  - Adjustment is only carried on in the peripheral countries
  - Austerity is generalized to core countries
  - The entry into force of the fiscal compact tightens the rules aimed at preventing discretionary fiscal policy

Austerity, or Pro-Cyclical Fiscal Policy



Source: Eurostat
Seasonally adjusted quarterly data

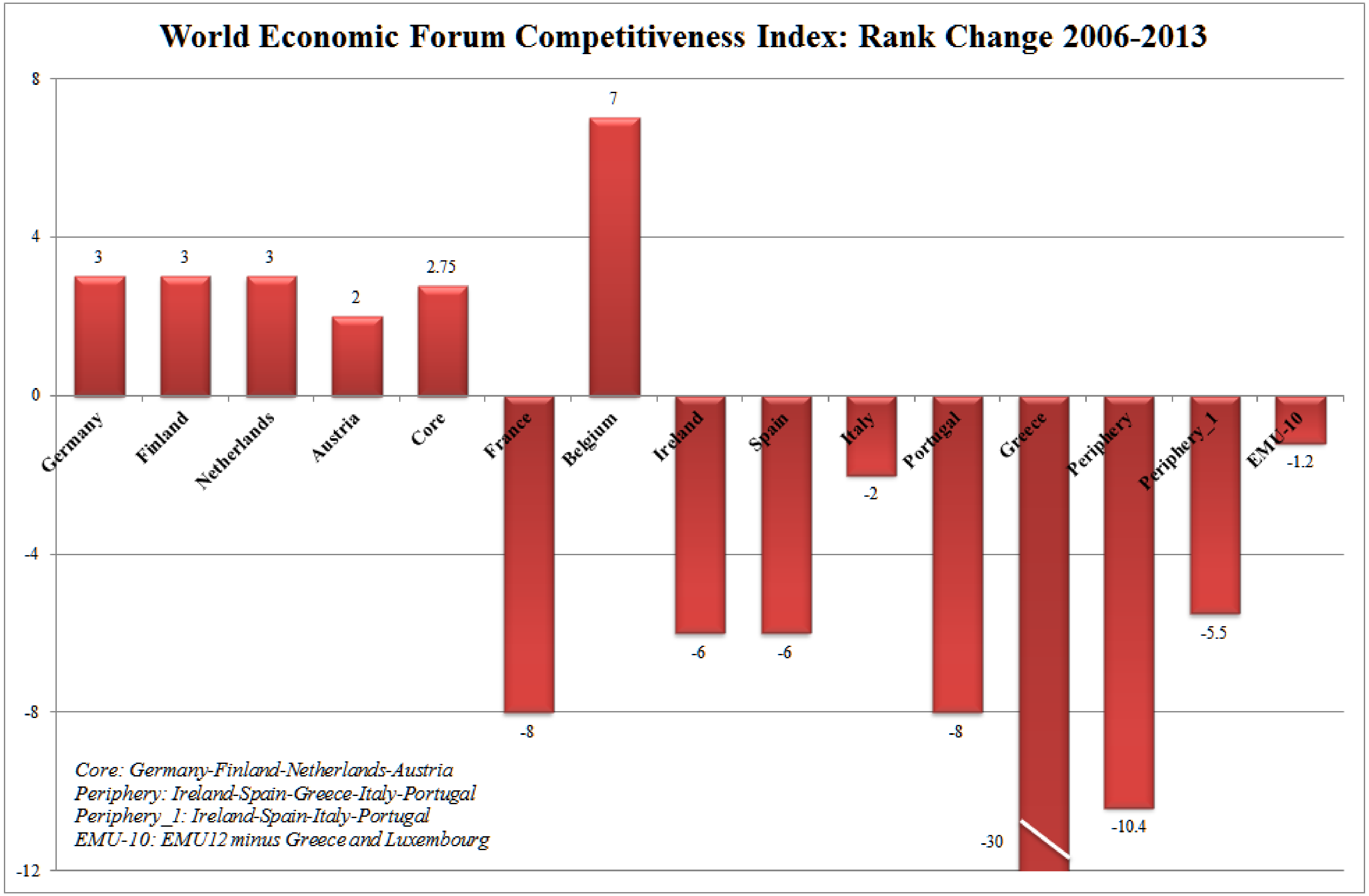
The Greek Tragedy



http://fsaraceno.wordpress.com

Short Term Pain for Long Term… Pain

- More competitive thanks to Austerity?



Why did Germany Win the Policy Debate?

- Institutions already embedded the Consensus
- Creditors are always right
- « all animals are equal, but some animals are more equal than others»

A European Paradox

- The US institutional setup (freely chosen) is consistent:
  - Extreme market flexibility and weak collective insurance
  - Fluctuations are smoothed by proactive macroeconomic policies
- The EMU on paper is also consistent
  - Strong welfare state and automatic stabilization
  - Constraints to discretionary macroeconomic policies
- What about the EMU in reality?
  - Increased flexibility and decreased protection
  - Constraints to macroeconomic policies
  - No clear choice given to citizens

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