

Contents

<i>List of Tables</i>	vii
<i>List of Figures</i>	ix
<i>Notes on Contributors</i>	xi

Introduction: Euroland and the World Economy – Global Player or Global Drag? <i>Jörg Bibow and Andrea Terzi</i>	1
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Part I Euroland on a Collision Course

1. Global Imbalances, Bretton Woods II, and Euroland's Role in All This <i>Jörg Bibow</i>	15
2. Wage Divergences in Euroland: Explosive in the Making <i>Heiner Flassbeck</i>	43
3. Can the Euro Area Play a Stabilizing Role in Balancing Global Imbalances? <i>Philip Arestis and Malcolm Sawyer</i>	53

Part II Policy Coordination and Increased Integration as Means to Properly Steer Euroland

4. Whatever Happened to 'Policy Coordination'? <i>James Forder</i>	75
5. The Economic Rationale of the EMU and the Euro <i>C. Sardoní</i>	91
6. Righting Global Imbalances: Recession, Protection or Reflation? <i>Alex Izurieta and George Irvin</i>	104

Part III Reforming Euroland's Institutional Framework and Macroeconomic Policy Governance

7. Replacing the Stability and Growth Pact? <i>C. A. E. Goodhart</i>	135
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vi *Contents*

- | | |
|---|-----|
| 8. Fiscal Policy and Macroeconomic Performance in the Euro Area: Lessons for the Future
<i>Eckhard Hein and Achim Truger</i> | 154 |
| 9. Germany's Choice and Lessons from Japan: Supply vs. Demand Policy, Fiscal vs. Monetary Policy
<i>Richard Werner</i> | 184 |
| 10. You Can't Always Get What You Want: Why Europe is Not Keynesian-able While the US New Economy is Driven by Financial Keynesianism
<i>Riccardo Bellofiore and Joseph Halevi</i> | 215 |

**Part IV Prospects and Limits of the Euro as a
Global Currency**

- | | |
|---|-----|
| 11. 'Not my fault' or Would Spreading the Maastricht Wisdom beyond Europe Really Do Much Good at All?
<i>Fabrice Capoen and Jérôme Creel</i> | 235 |
| 12. The Role of the Euro in the International Monetary Arena: Present and Prospects
<i>Sergio Rossi</i> | 266 |
| 13. International Payments Imbalances and the Prospective Role of the Euro
<i>Andrea Terzi</i> | 288 |
| <i>Name Index</i> | 304 |
| <i>Subject Index</i> | 306 |

Introduction: Euroland and the World Economy – Global Player or Global Drag?

Jörg Bibow and Andrea Terzi

Three major developments in the global economy may be singled out as characterizing the early years of the twenty-first century. First, launched on the eve of the new millennium and meanwhile including 13 (and soon 15) European countries that have adopted the euro as their common currency, Euroland is a large and economically powerful currency area comparable to the United States, supposedly also creating a new important player in the global arena of trade and finance. Second, the rising of China and a broader South and East Asian region as a new growth centre of the world economy, in its turn shifting the world distribution of trade and investment flows. Third, an increasing polarization in international payment positions that seems at odds with conventional wisdom, with the United States under its economic and financial world leadership running mounting current account deficits that alone nearly offset the current account surpluses of the rest of the world including soaring surpluses across the emerging world.

These on-going changes point to further transformations coming in the next decades, notably with respect to foreign investment, global employment, trade and financial flows. In our minds, there is no question that one key aspect of future world developments will be the capacity of the Euro Area to live up to its own vision and potential, both in fostering Europe's economic performance as well as in enhancing the continents' global role in line with its new economic and monetary leadership responsibilities. Yet, as we are nearing the end of the euro's first decade, Euroland is still struggling on both grounds: internal and external.

On the internal dimension, while satisfactory results have been achieved in terms of average price stability across Euroland (as HICP inflation has averaged just above 2 per cent since 1999), subdued growth has disappointed the high hopes many had previously held for Europe's future under a Maastricht-style Economic and Monetary Union (EMU). One stark fact is that Euroland stands out as the only major world region that did not until very recently participate in the global boom since 2002. Even deflationary Japan has grown faster than Euroland, where recovery only started at the

2 *Euroland and the World Economy*

end of 2005. Euroland seems to be repeating the 1990s' disappointing record, only overcome thanks to the US's 'new economy' boom, which arrived just in time to allow the euro to get off the ground by helping European countries to meet the Maastricht budgetary hurdles at the last minute. We also observe today what seems to be a repeat in the divergent trends seen at the earlier time. At that time, too, the hard currency core (Germany, the EMS's former anchor country) struggled the most to overcome stagnation and then boomed only briefly (in fact, only one year in Germany's case), while others fared better, benefiting from converging, that is, falling, interest rates that stimulated domestic demand. Today's struggling hard currency core includes Germany, Italy, and France, while the new EU member states in central and eastern Europe benefit from the prospect of joining the Euro Area through converging interest rates and capital inflows. One is tempted to comment here that the *prospect* of joining the hard currency area may be better for performance than actually *being in it*. And one may add here that the two old EU members that have continued to conduct their own fiscal and monetary policies, namely Sweden and the United Kingdom, have performed persistently and significantly better than Euroland too. In a way, Spain is the odd man out, as Spain has enjoyed a continuous boom ever since falling interest rates in the mid-1990s kicked-off a virtuous circle of rising employment and falling budget deficits. In fact, on a net basis, Spain accounts for most of the jobs created in Euroland since the mid-1990s. These observations alert us to the existing diversity in performance witnessed across Euroland, with diverging trends viewed with alarm by at least some observers. Yet, it remains unquestionable that the overall GDP and domestic demand growth has been meagre since 2001, similar – if not poorer – to developments in the prior decade.

An influential view continues to stress the need for deeper and more comprehensive structural reforms. Yet, it is not at all clear that those allegedly all-pervasive structural problems in labour and product markets have really been behind protracted domestic demand stagnation over much of the 1990s and again between 2001 and 2005. Rather, and so far, years of nudging to make product and labour markets more flexible have not been able to create a lasting pattern of growth based on home-grown demand by Euroland's own consumers and companies. It is a fact that Euroland's current recovery did not arise from within, but was – as in 1996–97 – mainly export driven. In Germany, the Euroland member country that had seen shrinking domestic demand for many years, the export boom finally boosted corporate investment, which, together with a revival in construction, explains much of the improvement in the overall situation in 2006.

We find it unwarranted to place exclusive emphasis on the need for more structural reforms when external growth stimuli can miraculously kick-start GDP to grow faster than its *estimated*¹ potential, allegedly held back by all-pervasive rigidities. Structural reforms that address market segmentation,

notably in the financial sector, are desirable; and so are reforms that enhance competition by eliminating unproductive, *rentier* positions. Yet, they have no impact upon what we consider the major issue today in the Euro Area: to make Euroland less dependent on world (namely US) cyclical demand conditions through decisive reforms of macroeconomic policy-making. We do not feel an economic giant like Euroland should, or even could, continue to freeloader forever on successful demand management elsewhere in the world economy, while blaming the emergence of global imbalances, towards which it thereby handsomely contributes, on apparently inadequate policies conducted elsewhere. For these reasons, we asked our contributors to consider a macroeconomic perspective, as a more appropriate framework in assessing Euroland's economic malaise and its global ramifications.

Indeed, we hope that scholars who prefer to focus on structural reforms will find these concerns relevant to the realization of needed reforms. Lacking a coordinated set of macroeconomic growth policies, Euroland's members are facing unnecessary obstacles in carrying through with reforms. Not only is a deflationary environment quite likely to undermine the political feasibility of reforms.² It is also not clear why any willing reformers should have to wait to reap any real gains from boosting *potential* growth until some lucky export boom might accidentally (and perhaps only rather briefly) kick-start an acceleration in *actual* growth. Euroland may require a fundamental overhaul in its macroeconomic governance that ensures better overall policy coordination, a position argued by a number of contributors in this volume.

On the external global dimension, our call for contributions had stressed that the relation between Euroland's performance and trends and global imbalances has so far not been sufficiently explored. On this question, key euro policy-makers believe that because the Euro Area's current account is broadly in balance, Euroland contributes to limiting global financial imbalances.³ They also believe that supply-side structural reforms in Europe will protect Euroland from potentially adverse global developments (such as the unwinding of imbalances) and better enable it to play a positive role in the orderly correction of global imbalances.⁴

Contributions in this volume consider the global role of Euroland from a different perspective. While some pundits view financial imbalances as inevitably leading to instability, with the United States as their supposed culprit, and while other observers view the situation as reflecting a persistent and stable symbiosis between the United States and Asia that is in the interest of both, we believe the role of Euroland cannot be missed. While private indebtedness in the United States has soared over the period in which the world's largest economy often acted as sole global growth engine, the core of Euroland (namely Germany) has relied on foreign demand as its sole sponsor of growth, thereby also creating severe imbalances inside Euroland. In this context, questions to investigate include: what may Euroland's part have been in the emergence of today's imbalances? And will Euroland ever

4 *Euroland and the World Economy*

be a growth engine of the world economy? Recall here that playing a greater global role – more on a par with the United States – is a vision that had provided one key motivation for EMU from early on. And prominent international economists like Bob Mundell welcomed ‘the euro as a stabilizer in the International Economic System’.⁵

The chapters collected in this volume compellingly question, from a variety of angles, many popular beliefs about the road to virtue of Euroland, and provide a comprehensive and fresh framework to address old and new questions. Several themes and lines of research emerge throughout the book, each in more than one chapter, and pointing in several complementary directions. These include: a critical review of the effectiveness and the strategy of monetary policy as structured by the Treaty and as implemented by the European Central Bank (ECB); a critical reading of the limits of the Stability and Growth Pact (SGP) and a search for a more effective reform of fiscal policy; a comparative analysis of the power of US and Euroland institutions in effectively steering the macroeconomy, outlining a contrast between US Keynesianism and European neo-mercantilism; an analysis of the role of Germany as a destabilizing factor within Euroland; an analysis of the dichotomy between formal institutional integration through the creation of common institutional bodies and a declining economic coordination now limited to a mutual agreement to put one’s own house in order; a set of proposals and recommendations for action in broader areas of policy coordination and structural reforms, ranging from wage policy to furthering political integration, from industrial policy to enhanced social welfare and public services; a critical assessment of the vacuum left by the Maastricht Treaty concerning exchange rate policy and the prospects of an increasing role of the euro as an international currency; and the relevance of a scenario of reflation in Europe that would contribute to reverse unsustainable world trends.

All these contributions shed light on the overarching question, which we believe is of vital importance both for the future of Europe itself and the world at large: will the single currency project contribute to world economic dynamism or will Euroland be driven by others’ vigour and vitality? Will Euroland act as a *global player* or as a *global drag*?

* * *

Early drafts of these chapters were first delivered in Lugano at a three-day conference, hosted by Franklin College Switzerland (2–4 March 2006), where participants engaged in thorough and lively discussions that helped to shape chapters into their final form. The 13 contributions have been divided for publication into four distinct but overlapping parts. Contributions in Part I set the scene by investigating some candidate causes of Euroland’s persistent failure to live up to its potential and point to a number of divergences and institutional inadequacies that have put Euroland on a collision course.

Approaching the issue of mounting global imbalances through the angle of the 'Bretton Woods II hypothesis', **Jörg Bibow** argues in Chapter 1 that the popular preoccupation with China's supposed export-led development strategy is misplaced and that, similar to Japan's depression, subdued growth in Euroland for most of the time since the Maastricht Treaty has been of first-order importance in these developments. Germany is identified as being at the heart of the European trouble, with global imbalances reflecting a clash between a highly dogmatic German approach to macro policy-making on the one hand and a very pragmatic Anglo-Saxon one on the other. Bibow argues that the low levels of interest at which the resulting imbalances have been smoothed out financially are a reflection of deficient global demand in an environment of vast supply-side opportunities; a situation to which US macro policy-makers responded appropriately by boosting domestic demand; benignly neglecting the external stimuli thereby unleashed. By contrast, apart from having acted as a notorious drag on global growth ever since the Maastricht Treaty, Bibow argues that soaring intra-Euroland divergences today represent serious dangers for European integration and the long-term viability of EMU.

One of these divergences is wage dynamics, which **Heiner Flassbeck** finds to be a far greater threat to the sustainability of EMU in Europe than any minor deviations from the SGP. Flassbeck argues in Chapter 2 that EMU can only function if wage increases in member states are in line with the inflation target set by the monetary authorities and, given the close correlation of unit labour cost growth and inflation, if real wage growth in each member state strictly follows national productivity growth. Violations of this rule will cause divergence of national real exchange rates and national levels of competitiveness, bearing serious long-run consequences for the appreciating countries. Worst of all, this could trigger deflation in the Union as a whole. Unfortunately, an aberration of this kind started right at the beginning of the currency union in 1999 (if not before) – with Germany's deflationary wage policy as the main culprit. Without fundamental changes in wage policies throughout Europe, a deflation or a 'transfer union' comparable to developments in Germany after unification is an imminent danger.

Facing these shortfalls, Euroland seems ill equipped to either adequately stimulate domestic demand or to alleviate the problem of international financial imbalances. Analysing the theoretical framework of Euro Area policymaking, **Philip Arestis** and **Malcolm Sawyer** find that in the context of global imbalances, Euroland should prepare itself for further dollar depreciation, namely by establishing better coordination of fiscal and monetary policies and more centralized wage-bargaining arrangements. Yet, Euroland's current institutional structure has no room for maneuver. In Chapter 3 Arestis and Sawyer focus on the theoretical model that is thought to prevail in the Euro Area and provide a comprehensive analysis of the current policies pursued in the areas of monetary policy, fiscal policy and

6 *Euroland and the World Economy*

labour market reforms. They criticize various aspects of this framework, including the notions that monetary policy is ineffective to stimulate real growth, that the growth of monetary aggregates and inflation are correlated in the long run, that labor market reforms for flexibility are correlated with higher growth. Finally, they also question the 'ECB-handicap hypothesis', according to which interest rates would have less of an effect on output in Euroland than in the United States. They conclude that changes in institutions and policies are desperately needed to improve Euroland's performance in future, whereby Euroland would also contribute to reducing international imbalances.

Contributions in Part II investigate how policy coordination and increased integration could help to provide proper steering to Euroland's economy within the global context.

The intellectual roots of Euroland's macroeconomic policy regime are investigated by **James Forder** in Chapter 4, focusing on the changing conception of policy coordination, and how it has fallen prey to disinflation priority. He stresses Hamada's model where policy coordination in a fixed-rate regime is necessary to prevent countries from underexpanding and seeking to free ride on others' expansion. Forder argues that while the idea of policy coordination proper had at least some influence on the creation of the European Monetary System as an attempt to prevent Germany from diverging by carrying on deflationary policies, the EMS was later on turned into little else but a lever for strengthening the arm of anti-inflationary forces, where countries should follow the credible, price stability leader (Germany). The evolution of the EMS is thus also the story of how the 1970s conception of policy coordination was replaced by one emphasizing the benefits of disinflation and the need to enforce good policy on bad governments. With the creation of the Euro Area, coordination has taken the form of the SGP, designed to enforce 'sound finance' (based on some notion that the interests of prudent people should be protected from bad policy). Forder's chapter sheds some important light on how this policy refocusing has contributed to Europe's malaise. Transferred to the global stage, this shift in vision and corresponding policy refocusing might threaten macroeconomic stability more widely too.

The rationale and intellectual climate behind the creation of the euro and its institutions is further investigated by **Claudio Sardonì** who stresses a contradiction between the historical development of the single currency as a process primarily driven by political forces and a model of institutions based on theories that consider the political process as an unwelcome interference with the economic sphere. Sardonì argues in Chapter 5 that the establishment of a single currency area at the end of the 1990s can be seen as the final step in a long process to ensure stable exchange rates in Europe following the collapse of the post-war monetary system in the 1970s, and in view of a modified optimum currency area theory that stresses the endogeneity of

optimality conditions. The scene was set by theories that alleged the ineffectiveness of discretionary fiscal policy and suggested that giving an independent central bank with a single ('conservative') priority of price stability control over monetary policy would provide a stability anchor. While too 'cautious' monetary policies have played a role in manoeuvring Euroland into a vicious circle of stagnant domestic demand in 2001–05, in Sardoni's view the most serious flaw in regime design is identified as lying in the area of fiscal policy. Sardoni suggests that decisive steps need to be taken towards political and fiscal integration, which would require abandoning the obsession with the inflationary impact of public spending.

The importance of policy coordination is further stressed by **Alex Izurieta** and **George Irvin**, namely as a means to put Euroland securely back on a demand reflation track, as well as to correct international financial imbalances. Using a macroeconomic model of the world economy, their contribution (Chapter 6) examines the peculiar structural characteristics of global current account imbalances, which reflect financial imbalances in the personal sector rather than the public sector (as used to be the case in the past). After exploring alternative ways to adjust unsustainable global imbalances, including dollar depreciation, a US recession, or US protectionism, these are all found impracticable. Then, assessing the role of the institutional constraints on fiscal and monetary policies in Euroland, the United Kingdom and the United States throughout 1990s, Izurieta and Irvin argue that Europe's emphasis on public sector financial discipline has contributed to a new structure of global demand, which is found to be unsustainable. A number of strategic scenarios for the mid-term are then analysed, including one of demand reflation in the Euro Area that features a new emphasis on policy coordination and a more effective reallocation of global surpluses. The authors conclude that new policy coordination, highly needed in the Euro Area for its own good, is also needed globally.

Contributions in Part III then investigate how Euroland's key institutions and policies should be reformed so as to improve on current discipline rules and allow for better economic performance in the future.

Emphasizing the Euro Area's unique structure, namely its separation between a federal monetary policy and national fiscal and social policies, **Charles Goodhart** argues in Chapter 7 that this peculiar policy regime has proved responsible for numerous problems that have arisen in recent years. In Goodhart's view, the SGP has added to these problems since it leaves countries that are suffering from asymmetrically adverse economic conditions with no significant instruments of demand management once they have run up against their SGP deficit limit. Asking how monetary and fiscal issues may be brought into better balance within the Euro Area, Goodhart develops two main proposals for replacing the SGP and supporting the federal monetary policy. First, he argues that some degree of fiscal centralization is required to perform effective stabilization policies and sustain

8 *Euroland and the World Economy*

EMU. In particular, drawing upon an earlier study undertaken in preparation of EMU in the early 1990s by an academic expert group of which he was a member, Goodhart suggests that a relatively small shift of competences from the individual nation states to a, somewhat enlarged, federal budget in Brussels could bring a significant improvement in stabilizing economic activity. Second, Goodhart argues in favour of channelling market forces in support of sound public finances through financial re-regulation. Toward this end, he proposes a redesign of prudential capital requirements of financial intermediary holders of debt of the constituent member states, so as to marshal stronger market mechanisms to deter the emergence of unsustainable fiscal policies.

Starting from the SGP's proven failure to deliver on both fronts, namely fiscal sustainability and economic growth, in Chapter 8 **Eckhard Hein** and **Achim Truger** analyse fiscal policy and its macroeconomic impact both for the Euro Area as a whole and for selected countries in comparison to US fiscal policy, with a special emphasis on the period 2001–05. The authors provide ample evidence of the largely superior macroeconomic performance in the United States, which they explain as owing to its different macro policy regime. They find that whereas US fiscal policy has acted in a strongly counter-cyclical way, stabilizing the economy, in the Euro Area fiscal policy has been both much more restrictive as well as pro-cyclical, with destabilizing effects in numerous countries. The authors provide evidence of a negative impact of fiscal contraction dictated by the SGP on economic growth, evidence corroborated by the finding that countries that undertook fiscal expansion grew more rapidly. As a possible solution for the future, Hein and Truger discuss replacing the SGP by expenditure path rules as a coordination tool that, in their view, can actually deliver stability and growth, along similar lines to those followed in the United States. Such fiscal reform would also require a parallel adaptation of the ECB reaction function and less decentralized wage policies.

Richard Werner tackles head on the conventional wisdom (or, ECB view) that weak economic performance in a number of Euro Area countries, such as Germany, has been due to structural problems that would require supply-side structural reforms. With reference to the macroeconomic experience of Japan, another large economy where this argument held sway during the 1990s, it is found that the supply-side argument is without merit and that demand-side policy is more likely to improve Euroland's economic performance. Werner emphasizes the supply of credit as the overarching budget constraint on economic activity and discusses policy options to stimulate credit supply. Given important links between monetary and fiscal policies and the crucial need to coordinate them, Werner argues in Chapter 9 that the key to higher economic performance and fiscal prudence in Euroland presently lies with monetary policy. In case of non-cooperative central bank behaviour, the author identifies ways for governments to stimulate credit supply.

The dichotomy between formal institutional integration through the creation of common EU bodies and a declining economic coordination is noted and considered by **Riccardo Bellofiore** and **Joseph Halevi**, who argue in Chapter 10 that the only true Keynesian phase in European economic policy was the 1950s when the European Payments Union scheme relieved the balance of payments constraint. Since then, major European economies have essentially shifted back to neo-mercantilism. Bellofiore and Halevi argue that the large-sized surpluses of Germany, Sweden, and Switzerland, which have no means to be recycled through the rest of Europe, prove the impossibility of European-wide Keynesianism. In contrast, the United States has adopted a financial form of Keynesianism that includes demand management, combined with de-localization, low wages, and job insecurity. Bellofiore and Halevi consider it an idealistic belief that Keynesian policies can be adopted in Euroland given the economic and political relations in which institutions are embedded. Europe and Euroland are, in this sense, non-Keynesiable. True change would only be possible if reforms of macroeconomic policies in a Keynesian style were combined with profound structural reforms including demand-side and supply-side industrial policy, a full employment goal, greater job security, better public services and a public social security system, all characteristics of what Bellofiore and Halevi consider 'structural Keynesianism', which in their view is currently far from sight.

Finally, contributions in Part IV turn more directly toward investigating the prospects and limits of Euroland as a global player, particularly from the viewpoint of the external value and the international role of the euro.

The difference between exchange rate policies in the United States and Euroland is critically assessed in Chapter 11 by **Jerome Creel** and **Fabrice Capoen**. Denying the self-defiant view that Euroland's problems may be due to external factors rather than being essentially homemade, the authors argue that the institutions that have been associated with the euro – namely limits on public deficits and a relatively conservative central bank – have actually jeopardized the efficiency of this new exchange-rate regime. They appraise the pros and cons of the European institutions in terms of macroeconomic stabilization and exchange-rate swings, drawing on different scenarios. After introducing a theoretical and empirical framework for their discussion, Creel and Capoen present a dynamic four-country model to study the effects of different policy styles on the dollar–euro exchange rate. They find that institutional differences explain why the euro has largely moved pro-cyclically, thus amplifying rather than moderating Euroland's cycle. Under current arrangements, the United States gains and Euroland loses from its supposedly 'stability-oriented' institutions. Creel and Capoen then simulate the consequences of the United States adopting European-style policymaking, namely by assigning a higher weight to the inflation target as opposed to the output growth target. Simulating a variety of shocks that hit European countries, the authors

10 *Euroland and the World Economy*

study how European performance would differ if the United States adopted Maastricht-style macro policy institutions. Their results are remarkable: while the United States was generally made better off by Europeans adopting their more conservative policies, should US policy become more similar to current Euroland policy too, European countries would actually be even worse off. In sum, Euroland institutions seem to have more favourable effects on countries that do not adopt them than on countries that do. Their results thus underline the general tenor of this volume that Euroland's macro policy institutions should be adapted.

In Chapter 12 a different perspective is undertaken by **Sergio Rossi**, who lays down a proposal for an international role of the euro, building on its expanding regional role. The author first draws a distinction between a single supranational currency that replaces domestic currencies and a common currency that serves as an international means of payment between nations. Rossi views the aspired use of the euro in this latter sense. This would not actually require any new institutions, but simply a new function to be performed by the ECB: that of an international settlement bank. Neighbouring countries in the wider 'euro bloc' could continue to use their domestic currencies and also adopt the euro as an international means of payment, without either having to abide by the (deflationary) EMU convergence criteria or enter into an exchange-rate arrangement (the ERM II). Emerging countries in the Barcelona process could especially benefit from an international settlement institution while keeping their own independent monetary and fiscal policies. Rossi does not propose or even address the question whether the euro should rival the dollar as the world key currency. Rather, he designs a monetary architecture that would provide a system for settlement of international transactions that he finds in the spirit of Keynes's proposal for an international currency unit used to settle international transactions only.

Addressing the question whether the euro meets the conditions to count as a challenger to the dollar as the world key currency, **Andrea Terzi** responds in the negative. Moreover, Terzi argues in Chapter 13 that a dollar crisis driven by global imbalances would be more likely to result in a global rescue of the dollar than in the euro acquiring more global prominence. A fragmented capital market where sovereign bonds are not backed by either governments or the ECB, and the lack of a single decision-making body that implements effective macroeconomic governance are among the reasons that the author lists as major limits to a global role of the euro. At the same time, Terzi argues that Euroland's powerful economic and financial position as well as the quality of the euro as a stable currency that competes with the dollar in international portfolios mean that Euroland faces a much softer balance of payments constraint than the one faced by any individual pre-euro countries. This changed global position should be the premise for a coordinated action aiming at a profound change in its macro governance institutions, namely to establish a proper growth policy in Euroland without fear of running current

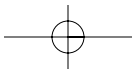
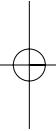
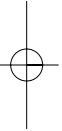
account deficits. Accepting its new responsibility as an important global player, Euroland would thereby also act as an engine of growth and play a balancing and stabilizing role in the world economy.

Notes

1. Needless to say, since conventional measures of potential growth are essentially averages of actual growth, such measures do not provide any evidence in support of the structural theme.
2. There is of course the view that deliberately creating or tolerating such conditions would add force to pushing through with structural reforms. This approach is not only questionable for political reasons (shedding some dubious light on the role of independent central banks in particular) but also lacking sound economic theory and evidence. See Mabbett and Schelkle (2007).
3. Cf. Stark (2006).
4. Cf. Commission of the European Communities (2006).
5. Cf. Mundell and Clesse (2000).

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Name Index

- Ahearne, A. 32, 33
 Allsopp, C. 84, 85
 Almunia, J. 32, 40

 Balls, E. 128
 Barro, R. J. 194, 197
 Bayne, N. 78
 Bergsten, C. F. 83, 88
 Bernanke, B. S. 211, 260
 Bibow, J. 39, 40
 Blanchard, O. 52, 247
 Blecker, R. 302
 Blinder, A. S. 196, 200
 Brown, G. 120, 128
 Buti, M. 180

 Carlin, W. 101, 102
 Clinton, W. 222
 Coats, D. 65
 Cohen, B. J. 299
 Congdon, T. 211
 Cooper, R. N. 38, 76, 88, 302
 Corden, M. 84
 Christ, C. 196
 Creel, J. 239, 241, 243, 245, 260

 Davies, G. 84
 DeGaulle, C. 31
 De Grauwe, P. 67, 97, 101, 102
 Delors, J. 78, 150
 Dooley, M. P. 20, 302
 Duisenberg, W. 39, 59
 Dyson, K. 39

 Evans, O. 79

 Featherstone, K. 39
 Feldstein, M. 83
 Fisher, I. 210
 Fitoussi, J.-P. 237
 Flassbeck, H. 52
 Folkerts-Landau, D. 20, 302
 Frankel, J. A. 83, 101, 151
 Friedman, M. 210

 Fritsche, U. 179
 Fukao, K. 209

 Garber, P. 20, 302
 Gaulier, G. 261
 Ghosh, A. 69
 Giavazzi, F. 247
 Giscard d-Estaing, V. 39, 77
 Godley, W. 231
 Goodhart, C. A. E. 98–9, 102, 138, 198,
 270, 299
 Gordon, R. J. 209
 Gourinchas, P.-O. 28, 39
 Greenspan, A. 39

 von Hagen, J. 32, 33
 Hamada, K. 75–7
 Handa, J. 210
 Hansen, B. 196
 Hawtrey, R. 207
 Hayashi, F. 209
 Henning, C. R. 29–31, 84

 Irvin, G. 118–19
 Issing, O. 32, 52, 69
 Italianer, A. 141–2
 Izurieta, A. 115, 119, 129

 Jabko, N. 96
 Jenkins, R. 77–9, 88
 Jorgenson, D.W. 209
 Juncker, J.-C. 40

 Kalecki, M. 219, 230
 Keegan, W. 128
 Kenen, P. 94, 96, 101
 Kennedy, J. 39
 Kennedy, J. F. 206
 Keynes, J. M. 24, 76, 84, 210, 217, 219,
 227, 229, 268–9, 277, 292, 296
 Kindleberger, C. 231
 Kitano, Y. 196
 Kleinknecht, A. 69
 Kohl, H. 39

- Kregel, J. A. 296
 Krugman, P. 52, 197
 Kydland, F. 247

 Lahreche-Revil, A. 261
 Lamfalussy, A. 150
 Lane, P. 52
 Lawson, N. 126
 Lerner A. P. 200, 202, 210
 Lescure, R. 142
 Ludlow, P. 81

 Mabbett, D. 136
 McKinley, T. 119, 129
 Meade, J. E. 76
 Mejean, I. 261
 Mélitz, J. 137, 143
 Milesi-Ferretti, G. M. 302
 Mitterrand, F. 82
 Motohashi, K. 209
 Mundell, R. A. 4, 76
 Mussa, M. 39

 Naastepad, C. W. M. 69
 Niehans, J. 76
 Nixon, R. 217
 Nyberg, P. 79

 Obstfeld, M. 94, 100
 Orszag, P. R. 295, 297

 Padoan, P. C. 136
 Padoa-Schioppa, T. 31, 33, 38, 96, 101,
 146, 147
 Palazzi, P. 98
 Palley, T. 179
 Papaspyrou, T. 141
 Parboni, R. 219
 Park, C.-Y. 39
 Phillips, S. 69
 Pisani-Ferry, J. 52, 144, 146, 259
 Pöhl, K. O. 83
 Prescott, E. C. 209
 Prodi, R. 51, 64, 220, 225
 Purvis, D. D. 245
 Putnam, R. D. 78, 84

 Razin, A. 302
 Rey, H. 28, 39
 Robinson, J. 76, 230

 Rochon, L.-P. 285
 Rockett, K. 83
 Rodriguez, M. J. 136
 Rodrik, D. 24
 Rogoff, K. 94
 Rose, A. K. 101
 Rossi, S. 285
 Rotondi, Z. 302
 Rubin, R. E. 297
 Rueff, J. 272

 Sa, F. 247
 Sardonì, C. 98
 Sawyer, M. 229
 Schabert, A. 202
 Schacht, H. 206
 Schelkle, W. 136
 Scheremet, W. 180
 Schiller, K. 206
 Schmidt, H. 77–8, 81–2, 88
 Sinai, A. 297
 Sinn, H.-W. 39
 Smith, S. 138
 Solow, R. M. 179, 196, 200
 Soskice, D. 101
 Spiecker, F. 52
 Spindt, P. A. 210
 Sterdyniak, H. 239, 241, 243, 260
 Stiglitz, J. 69, 206
 Summers, L. H. 24, 38, 40

 Tanaka, H. 196
 Terzi, A. 180
 Trichet, J.-C. 40, 53

 Ungerer, H. 79

 Vaciago, G. 302
 Vanheukelen, M. 141
 Vines, D. 84–5
 Volcker, P. 82
 Vori, S. 137, 143

 Waigel, T. 142, 151
 Werner, R. 197–9, 200, 206,
 210
 Williamson, J. 272
 Wray, R. 202, 210, 231
 Wriston, W. 148
 Wyplosz, C. 31, 36

Subject Index

- Asia, Emerging Asia
 Asian crisis 23–4, 29, 191, 292, 302
 Currency appreciation 296–7
 Current account 30, 37, 54, 105, 290–2
 Export-led strategy 20, 295
 Trade account region 23, 26
 Asset price bubbles/bursting of 19, 113–14, 222
 Austria 46–8, 163
- Barcelona Process 280–2, 286
 Beggar-thy-neighbour policies 34–6, 38, 44–5, 51, 297
 Belgium 49
 Bretton Woods
 Bretton Woods II (BWII) hypothesis 20–1, 26–8, 37–8, 302
 Regime, establishment and collapse of 76–7, 93, 216–17, 267–8, 292–3
 Bundesbank (Deutsche Bundesbank)
 Creation of EMS 81, 220
 ECB and 31–2, 241
 ‘Emminger letter’ 81
 EMS anchor 83, 86
 German unification and 44
 Maastricht regime and 39–40
 Price stability focus 220
 Tensions with government 78, 81
 Wisdom of 31–2, 39, 96, 147
- Capitalism
 Anglo-Saxon variety 224–5
 Franco-German core 225
 Social democratic Scandinavian model 225
- China, Peoples’ Republic of
 Current account 21–2, 25–6, 37, 209
 Dollar-renminbi peg 22, 37
 Foreign exchange holdings 23
 Precautionary saving 23
 Renminbi revaluation 23
 USA bilateral trade 22, 54
 Crowding out 194, 196
- Current account
See also global imbalances
 Deficit sustainability 289–90
 Income identities and 54–6, 108, 290ff.
 Macroeconomic meanings 16
 Surplus-seeking countries 20
 Surplus re-cycling 293
 USA 16, 108–9
 USA-China bilateral trade 22
 USA-Euroland bilateral trade 33
 USA-Japan bilateral trade 24
- Deflation, risk of 51–2, 109, 168–70, 221, 277, 296–7, 299
- Demand
 Domestic demand stagnation 119
 Global aggregate demand 119
 Injections and leakages 107, 110
 Structure of 105
 Wage restraint and 169
- Dollar
 ‘benign neglect’ 26–9, 239
 Crisis 114, 295
 Depreciation 28, 53, 82, 113, 115
 Key world currency 26–9, 37, 224, 289, 295
 Plaza and Louvre Accords 83, 127, 220
 ‘strong dollar’ policy 27
- Economic and Monetary Union (EMU)
 in Europe
See under Euroland
 EU *see under European integration*
- Euro
 Anchor currency 278
 Appreciation 33
 Fiscal backing, lack of 31, 146–7, 299
 Invoicing and settlement currency 278
 Reserve currency 30–1
 Rivaling the dollar 297ff.
 Vehicle currency 266
 Volatility 237–45

- Euro Area
See under Euroland
- Euroland
 Actual GDP growth 33, 155–6, 236
 Aspirations, global 30–1
 Asymmetric shocks 135, 144–6
 Compared to the USA 97, 155
 Current account 26, 30, 33, 60, 121, 291, 297
 Debt-to-GDP ratio 159–60
 Domestic demand stagnation 2, 33, 60, 99, 155–6
 Economic policies 59–64, 224
 Economic policies, theoretical framework 57–9
Euro, see under: euro
 Eurogroup 40, 146
 Exchange rate policy 31–2
 Export-led growth 33, 67, 295
 EU and 146, 301
 Financial stability 146–7
 Fiscal integration/centralization 137, 301
See also Fiscal policy in Euroland
 Global imbalances and 30–3, 300–1
 Internal imbalances 3, 34, 36, 38, 50
 ‘island of monetary stability’ 31
 Labor market reforms 64–6
 Labor market rigidities 65–7
 Maastricht convergence criteria 2, 33, 95
 Maastricht regime 36, 38, 84–6
 Monetary policy 61–2
 ‘no-bail-out’ provision 149, 152
 Openness 239
 Optimum currency area theory 94–6
 Policy coordination 87, 136, 177–9
 Recovery, belated 1–2, 33
 Small-country mindset 36, 38, 299
See Stability and Growth Pact
 Unit labor costs and inflation target 50
 Unity undermined 36, 38
 USA bilateral trade balance 33
 Wage/incomes policies 98, 168
 Wages and real exchange rates 35, 43
- European Central Bank (ECB)
 Anti-growth bias 166, 180
 Bundesbank and 31–2, 87, 147
- Effectiveness (handicap hypothesis) 67
 Fiscal policy stance and 178
 Independence 32, 61, 99, 205–6, 240, 276
 Interest-rate policies 62, 166
 Prudential and lender-of-last-resort role 32, 147
 As settlement institution 282
 Stability-orientation ‘above all else’ 32
 Structural reform agenda 209
 ‘two-pillar’ approach 61–2
- European Coal and Steel Community (ECSC) 216
- European Commission
 SGP and 171
 Advocating labor market reform 176
 Preparation to EMU 94–5, 137–9
 View of fiscal discipline 63, 97
- European integration, process of
 Balance-of-payments constraint and 218
 Barcelona Process 280–2, 286
 Central-eastern Europe 2, 225
 Common market 216
 Convergence process 155
 European Coal and Steel Community (ECSC) 216
 European Payments Union (EPU) 217–18
 Fiscal integration 96ff
 Income distribution 218–19
 International context 216ff.
 MacDougall report 138–9
 Marshall Plan 216
 Neomercantilism 219
 Path to the euro 93
 Political dimension 96, 299
 Werner plan 77
- European Monetary System (EMS)
 Creation and design of 77–80, 93
 Crises and collapse 93
 Divergence indicator as a means to prevent free-riding 79–80
 D-mark as EMS anchor 2, 46, 50, 83
 D-mark overvaluation hypothesis 46–50
 D-mark real exchange rate and undervaluation 43–4, 48–9, 51, 218–20

308 *Subject Index*

- European Monetary System
(EMS) – *continued*
‘Emminger letter’ 81
ERM II 236, 267
Failure of the ‘snake’ 80
Forerunner of euro 31
Founders 39, 77
‘hardening’ of 83
‘locomotive theory’ 78, 88
Means to control inflation
81–2
Means to coordinate expansion
78–81
Means to reduce European
unemployment 79
Non-cooperative policy 77
European Payments Union (EPU)
217–18
Exchange rates
Dollar-euro 20–1, 33
Dollar-renminbi peg 22, 37
Euro-linked regimes 279
Strategies of the Barcelona partner
countries 281
Wage divergences and 35, 43
Exorbitant privilege 28
Export-led growth strategy 20, 22,
26, 79, 100, 109, 112, 115
- Federal Reserve
Aggressive policy easing 18, 27, 37,
166, 222
Effectiveness of policy 67
- Finance
Asset market bubbles/bursting of 19,
113–14, 222
Bank regulation 148–51
Capital mobility 276–7
Credit creation principle 200ff.
Credit expansion 105, 114
Credit risk weighting 150
Emerging economies’ ‘original sin’
148
Globalization of 106, 113
Household indebtedness and net
worth 18, 113, 223
Mortgage equity withdrawal 18
- Fiscal policy
Automatic stabilizers 58, 62, 140,
149, 172–3
Balanced-budget commitment in
federal states 136
Credit-financed 206
Effectiveness/Multiplier 194ff.
Endogenous output gap 161
Fiscal sustainability 97–8, 151
Inter-regional fiscal transfers 143, 149
Monetary policy and 198, 200,
206–7
Non-cyclical components 172ff.
Non-Keynesian effects 165
Ricardian equivalence 197
Stabilization mechanism 143
Stabilization role 107
State budgets and central budget in
federal nations 137, 141, 149
- Fiscal policy in Euroland
And economic divergence 173
Automatic stabilizers 172ff.
Compared with the US 162–3, 176–7
Coordination 173
Expenditure path concept 172ff.
Fiscal centralization 137–8, 226
Fiscal policy stance in member states
and growth 163–5
Fiscal transfers and structural reforms
144
Nation states’ default 150–1
Overall fiscal policy stance
1991–2005 161–2
‘Stable Money-Sound Finances’ Report
138ff.
Trends of deficit-GDP and debt-GDP
ratios 157–9
See also Stability and Growth Pact
- France
Debt-to-GDP ratio 159–60
High-inflation tradition 47
Failure of Mitterrand’s expansionary
policy 82
Fiscal policy 163–4
Weekly working time reduction 251,
261
- German Democratic Republic 220
Germany, Federal Republic of
1951 Balance-of-Payments crisis 218
‘bazaar economy hypothesis’ 39
Beggart-hy-neighbour policy 34, 36,
38, 44–5, 51

- Germany, Federal Republic of – *continued*
 Bundesbank wisdom 31–2
 Competitive devaluation 36, 169
 Credit crunch 205
 Current account balance 22, 25, 30,
 44–5, 188, 226–7
 Debt-to-GDP ratio 159–60
 Deflationary wage policy 43, 135
 D-mark as EMS anchor 2, 46, 50, 83
 D-mark overvaluation hypothesis
 46–50
 D-mark real exchange rate and under-
 valuation 43–4, 48–9, 51, 218–20
 Domestic demand stagnation 2, 25
 ‘economic miracle’ 206
 Fiscal policy 163–4
 German Monetary Union 43
 Productivity 187–9
 Regulation and neoclassical welfare
 economics 189–91
 Unemployment and structural reforms
 185, 189
 Unit labor costs 44, 48
 Unit labor costs and inflation target 50
 Global Imbalances 16, 30, 32, 37–8,
 100, 288–90
 Bretton Woods II hypothesis 20–1,
 26–7, 37–8
 Euroland’s contribution to built-up
 32–4, 38, 124–5
 Europe-led reflation 119–20, 124
 ‘global capital flows paradox’ 24
 Official lending 19
 Protectionism 115–17, 124
 Savings glut hypothesis 105
 Systematic deficiencies in the
 international monetary system
 24, 37
 And the dollar 296
 ‘twin deficits’ 17, 54
 Unwinding and correction 28, 36,
 60, 68, 87, 115, 120–2, 294–7,
 300–1
 And US domestic goals 26–7,
 293
 Gulf Cooperation Council 278
 International Monetary Fund (IMF) 30
 Financial programming 126
 International coordination 114
 Views on global imbalances 30,
 293–4
 Inflation
 Inflation differentials and monetary
 policy 166
 Inflation trends 155–6
 US inflation, key role of 293
 Interest rates
 Convergence of 157
 Crowding out 196–7
 And debt burden 150, 157
 Euro and US compared
 166–7
 Historically low rates 27, 34, 37
 Lower interest rates to accompany
 structural reform 144
 Taylor rule 166
 US interest rates 34
 International monetary order
 Missing internal stabilizing
 mechanism 292
 ‘non-system’ 272
 Supranational and international
 currency 268ff.
 Systemic deficiencies and global
 imbalances 24, 31, 37
 International policy coordination
 Case against 83
 Game theoretic approach to
 77, 84
 As a means to prevent
 underexpansion under
 fixed exchange rates
 80–1, 84
 Rhetoric of 86
 With no collective benefits 84
 And world reserves growth
 76–7
 Italy
 Exchange-rate crisis and devaluation
 48–9
 High-inflation tradition 47
 Fiscal policy 163, 173
 Industrial decline 227–8
 Interest rate policy and industrial
 restructuring 227
 Lack of competitiveness 145
 Neomercantilism 221
 Productivity 227
 Wage policies 51

310 *Subject Index*

- Japan
 Bad debt problem 204–5
 Bank of Japan's policy 204–5
 Contribution to global imbalances 30, 37–8
 Credit-based model of growth 200ff.
 Crowding out 196–8
 Current account balance 24, 37
 Domestic demand weakness 25, 60
 Fiscal stance and growth 194–6
 Foreign exchange reserve holdings 24
 Government borrowing and debt 196
 Structural reforms and neoclassical welfare economics 191–3
 Yen 38
- Keynesianism
 Financial 222–4
 Hegelo-Keynesian approach 229
 Military 222
 Structural 229–30
- Maastricht regime of EMU 31
 MacDougall report 138–9
 Marshall Plan 216
 Middle East and Northern Africa (MENA) 280, 285
- Monetary policy
 And asymmetric shocks in a monetary union 176
 Central bank independence 205
 Credit expansion 200
 Credit view 199
- Money
 Bank money 271
 Central bank money 271
 ECB's monetary reference value 61
 Means of final payment 269ff.
 Quantity equation 197–9
 Real-time-gross-settlement system 271
 Seignorage 27, 142, 151, 271, 273
- NAIRU 59, 161
 Neomercantilism 219
 Netherlands 49, 226
- New consensus macroeconomic paradigm 57–9, 238
- Oil
 Price boom 25, 120
 Energy efficiency on Europe's agenda 120–1
 Exporters 25–6, 290
- Optimum currency area
 Criteria 94
 Endogenous criteria 95, 98
 Fiscal policy compensating for asymmetric shocks 96–7
 Political dimension 95–6
- Seignorage 27, 142, 151, 271, 273
- Spain 2
- Stability and Growth Pact (SGP) 63–5, 155–7
 Alternative to 172
 And asymmetric shocks 142
 Balanced-budget principle 62, 136, 157
 Bound to fail 136
 And countries' self-stabilization 144
 Deflationary effects 112
 And Europe's industrial restructuring 225
 'excessive deficits' 45, 99–100, 157, 159–60, 184
 Fiscal flexibility 149
 Non-credible penalties 145, 157
 Pro-cyclical, destabilizing effects 162, 165, 256
 Public investment 98
 Rationale 84–5, 127, 135
 Reform of 64, 171
 Social outcomes 226
 'sound' public finances 63
 Stability programmes 157
 'stupid' 64, 225
- Structural reforms
 And domestic demand stagnation 2
 And fiscal transfers 144
 Needed but what kind? 229–30
 Testing the case for 186ff.
 Sweden 2
 Switzerland 26, 39

- Unemployment 155–6
- United Kingdom (UK)
 - Euro Area entry 138
 - Exchange-rate peg and crisis 47–8
 - ‘golden rule’ 119, 127
 - Performance 2
- United States of America (USA)
 - Balance-of-payments, investment income 27
 - Bilateral USA-China trade balance 22
 - Bilateral USA-Euroland trade balance 33
 - Borrowing constraint 289
 - Current account position 16, 54, 108–9, 291–2
 - Dollar, see under Dollar*
 - Domestic demand and GDP growth 27–9
 - ‘exorbitant privilege’ 28
 - External-debt-to-GDP ratio 28
 - Financial Keynesianism 222–4
 - Fiscal integration 97
 - Fiscal policy 26–7, 106, 119, 163–4, 176–7
 - Global growth engine 3, 29–30, 224
 - Goldilocks economy 118
 - Government budget balance 16, 54, 107
 - Household indebtedness and net worth 18, 113, 223
 - Housing boom 18, 114
 - International investment position 28, 57, 113
 - Macroeconomic policy pragmatism 26, 37, 223
 - Monetary policy 18, 27, *see also under Federal Reserve*
 - Mortgage equity withdrawals 17
 - ‘new economy boom’ 2, 21, 33, 222
 - Personal saving and spending 18–19, 26, 53, 106
 - Recession 26, 28, 106, 162
 - Saving and investment 26
 - Seignorage 27
 - Short dollar position 28
 - Treasury securities 29
 - ‘twin deficits’ 17, 54, 223
- Wage policies
 - Beggar-thy-neighbour strategy 34–6, 38, 44–5, 51, 297
 - Central wage-bargaining arrangements 68
 - Divergences and real exchange rates 35, 43
 - And income distribution and demand 168–9
 - And monetary policy 166–8
 - Wage increases and growth 218–19

