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The Conduct of Macroeconomic Policies in the Euro Area

With the adoption of the euro, the formal and material macroeconomic ‘constitution’ of the countries in the European Monetary Union (EMU) has changed considerably. The two major instruments used to regulate the economic cycle – namely, monetary and fiscal policy – were distributed differently among the various economic policy authorities of the EMU, thus creating an unprecedented asymmetry of powers and competences. Indeed, monetary policy is centralized and is left to an independent Central Bank, while fiscal policy remains decentralized and under the responsibility of the national authorities of the member states, though it carries an overall set of common rules.

The different competences correspond to a clear-cut division of tasks. The European Central Bank (ECB), carries out monetary policy, looking at the euro area as a whole and attaching the greatest priority to the control of inflation within the EMU; and, second, considering the evolution of economic activity, provided price stability is safeguarded. Conversely, fiscal policies are aimed at regulating national economic cycles and correcting unsustainable behaviour (overheating or recessions) specifically concerning individual economies as a consequence of asymmetric shocks.

The smooth functioning of this structure requires a complex co-ordination effort, which may be more or less intense but which must exist between fiscal and monetary policies, as well as between the various national fiscal policies contributing to a definition of the overall fiscal stance of the euro area. That need derives from the interaction between policy-makers and from the slight awareness of decentralized authorities of the effects of their public finance decisions on European inflation and economic activity. The existence of the externalities of governments’ choices and the need to avoid free riding on the part of
individual countries – which might transfer the consequences of their ‘non-virtuous’ economic policy decisions on to other partners – strongly urges co-operation and co-ordination.

On top of this, macroeconomic policies constructed for the EMU are more likely to function smoothly, the closer the convergence of the economies of the euro area member countries (in their market organization, development, institutions and so on) and, in particular, the more consolidated the process of public finance adjustment in the euro countries. In other words, the framework of macroeconomic policies seems to work better – which means the minimizing of friction and tensions between individual countries – in a fully-operating monetary union not only in terms of definition of general rules, but also in terms of the homogenization of economic-institutional structures of the member states.

In the transition towards a ‘fully-fledged’ EMU, the euro area is still quite heterogeneous, in that individual economies do maintain important differences in their structures and even in their citizens’ preferences, while public finances in many important countries have not yet completed the budget adjustment process that should eventually enable them to fully recover budget policy to an anti-cyclical role.

This chapter examines the monetary and fiscal policies in that delicate transition phase, in the light of the first years of life of the euro. In this period, the macroeconomic policy instruments of the EMU – though not hit by significant asymmetric shocks – were strongly stressed by some major changes in the global scenario; indeed, in 2000, the world and the European cycles reached peaks of expansion followed by a period of strong slowdown. In that same year, oil prices registered a considerable rise, hitting all the importing countries, including those in the euro area. After the terrorist attacks of 11 September 2001, consumer confidence has briskly decreased at the international level by undermining the possibility of a rapid recovery and urging policy-makers throughout the industrialized world to adjust economic policy responses to the new scenario.

The analysis of the euro area monetary policy in the three-year period 1999–2001 undertaken in the first section shows that – while the ECB pursues price stability in the EMU as its prime objective – its behaviour mirrors the influence of the real economic cycle too. Indeed, the profile of the official interest rate ‘historically’ adopted by the ECB does not differ very much – with the exception of a short phase of a (perhaps) excessive monetary squeeze in 2000 – from the theoretical one obtained through a reaction function (identified through the Taylor Rule), whereby