EU between Monetarism and Keynesianism

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Abstract

To address the current economic disagreements and issues, the EU is hovering between economic and political arguments of their resolution (theoretically speaking, between monetarism and Keynesianism) in order to remove the main obstacle to the integration process it presently faces, which is the growing gap between the “rich” and “poor” in its own backyard. And since this stratification is one of the most adverse implications of the current stage of globalization, the EU, as one of the metaphors of the globalization process, is facing a great challenge. It is becoming increasingly clear these issues cannot be solved by economic logic alone, which is the basis of austerity policy, i.e., monetarism. Primarily, this is because the EU is not simply an economic integration, but is increasingly becoming a political integration as well, so its development cannot be determined solely by economic factors, no matter how economically justified they are. Every country in the world, and especially the less developed ones, has a more advanced and a more underdeveloped part. One of the primary tasks of each state is to maintain political stability in each part, and this is achieved through their economic convergence. Evidently, this cannot be done simply by means of the market, i.e., economic measures, not even by means of political measures—put simply, by transferring parts of its GDP from developed to developing regions. This can be achieved by various measures, particularly fiscal, which is being criticized by businessmen from the more developed parts, even though they know that this helps develop their markets, because otherwise the developing regions would not be able to buy their products. This paper suggests how the EU could find an optimal middle ground between these two concerns, that is, between the practices of monetarism and Keynesianism.

1. Introduction

When it comes to strengthening the EU integration process, it should be pointed out that this is pioneering work in international economy, because the EU is the first and so far the only international integration that has ever existed in the world. Although the term “international integrations” is employed in many economic and political discussions, it is misused, because many commercial and security associations cannot be defined as integrations, but simply alliances, particularly from an economic point of view. For example, after the recognition of Croatia’s independence, the term “Euro-Atlantic integration”, referring to the EU and
the NATO, has become widely adopted in the political-diplomatic vocabulary of the language. This is incorrect, even unprofessional, because the NATO is an alliance. A group of countries can be considered to be integrated if they have agreed on a common economic policy, common market, economic and monetary union, which is not the case with the NATO and other trade and security alliances around the world. The EU, on the other hand, is an integration, especially after its transition from Community to Union at the 1992 Maastricht conference, particularly through the adoption of the convergence criteria.

Following the adoption of the convergence criteria at the Maastricht conference in 1992, there was awareness in the EU that, after the adoption of the strategic objectives on the convergence of member states’ macroeconomic stability, strategic steps toward their achievement should be undertaken meticulously. There were two principal tasks: a. the implementation of constitutional, institutional and administrative reforms, which was the only way to apply the common political and economic strategy of the Union; and b. the adoption of a common foreign and defence policy, a prerequisite for the establishment of a unified political community. Without such a strategy and specific implementation decisions, all efforts to consolidate the integration would be inadequate.

2. The Issue of Political and Economic Reforms

The institutional structure of the Union has not changed since the signing of the so-called Treaty of Rome in 1957, which established a community comprising only six states. It was assessed that the institutions of an enlarged Union, possibly incorporating more than thirty countries, would not be effective in making and implementing decisions transferred to their jurisdiction. This would particularly affect the political unity of the Union and inhibit the achievement of the strategic objectives of integration, both politically and economically. The Intergovernmental Conference held in Nice in 2000 partially addressed and solved certain sensitive institutional issues such as the number of Commission members, the number of votes in the Council allocated to a particular state in a qualified majority vote, the number of seats in the European Parliament and other EU bodies, etc. When making decisions on ‘quotas’ allocated to particular states within a particular EU body, solutions referred to all 28 states, some of which were only candidates at the time.

The main goal of these adaptations was to ensure not only the political unity of the EU, but also greater efficiency in decision-making. For a period of time, the principle of consensus in decision-making served as the main incentive for accession, as it assured the Members that they would not have to make any decision under duress and that they would not be outvoted. Therefore, the procedures of transitioning to further stages of integration were often slow, negotiations were long and exhausting, settlements were often reached through compromise, but as it turned out in the end, this only consolidated the integration. Usually, when a long resisted and painstakingly negotiated decision is finally willingly accepted, such a decision tends to be respected.

Although the process of political reform is not conditioned solely by the process of Eastern enlargement, this fact has nevertheless fundamentally affected its acceleration.

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* Convergence criteria are: a fixed interest rate level, a high degree of price stability achieved through exchange rate stability, limits on budget deficit (3 per cent of GDP) and public debt (60 percent of GDP).
* † Although introduced at the Maastricht conference as a very important issue, broader security integration is not the subject of this analysis.
Democratic decision making among 10 members is one thing, but a completely different matter when it is done among 28 members, let alone 30 in a more distant future. Furthermore, reaching agreement among members with similar levels of economic development and civilization values, and among members where this is not the case, may differ significantly. This is especially true for the current situation of considerable change in the paradigm of international relations, compared to the one from the very beginnings of the EC, as well as from the period when the EC was at its peak (1950s and 1960s). At that time, the prevalent paradigm was one of bipolarism, accompanied by the growth of multilateralism, whereas currently it is the paradigm of American unilateralism, where other pretenders to the position of strategic partners in establishing a new form of multilateralism stand at the very beginning of their endeavours. Among them is the EU (together with the People’s Republic of China, Russia, Brazil, India—the so-called BRIC countries—with the addition of Turkey and South Africa, or countries with similar characteristics such as large markets and abundance of cheap labour) which, in order to become a credible partner of the United States, must firstly improve the efficiency of its decision-making process. The issues of complexity and slow progression served as a motivating factor in times of bipolarism, while in times of unilateralism they act as a limiting factor.

At the 2001 Laeken Summit, the “Convention for the Future of Europe”, colloquially known as the “European Convention”, was established, with the aim of drafting a new EU Constitution which would further consolidate the political and international sovereignty of the Union. Together with the adoption of a single currency, the euro, at the beginning of 2002, and accompanied by the previous “abolishment” of borders between Member States (Schengen Agreement), the new constitution would represent the final political stage of economic and monetary union, i.e. the Union could, after a long period of economic and monetary unity, become an international political entity. Therefore, the adoption of the EU Constitution should have been a ground-breaking step in its development and, according to many, the fundamental guarantee of the Union’s continued existence. The discussion on individual elements of this document revealed the complexity and subtlety of this act: for the first time in history a constitution of an international integration, thus a group of States, and not a single state, was being adopted. Naturally, this document cannot contain all the elements constitutions of individual countries contain because it does not represent a single people living in a particular area and sharing a common vision of political and socio-economic development and goals. Still, certain elements exist since the EU consists of various peoples living in different areas who do share a common vision of political and socio-economic development, the model of liberal democracy.

This shared vision is increasingly becoming the main cohesive bond, not only between long-time Member States, but also between the new ones, as well as other candidates who expect to be granted full membership in the subsequent rounds of enlargement. Only a common vision and shared goals can neutralize or alleviate the conflicts that will inevitably arise due to institutional reforms, the adoption of a new constitution being one of them. If we accept the fact that the EU, in the context of new challenges in international relations,
can survive only by becoming a strong political integration, then it will have to fulfil such conditions identified in the functioning of traditional forms of government, namely decision-making, common foreign and security policy, etc. Decision-making processes will be the first testing ground, as it was made obvious during the discussion on the new constitution, which proposes faster and more efficient decision-making processes favouring larger (or “more equal”) member states, in contrast to the consensus. Smaller countries, especially new candidates, may feel neglected, so a lengthy process of harmonization and agreement lies ahead, where each country will weigh the costs and benefits of its further participation. As no member of the EC, nor the EU, has so far regretted entering the integration, it is likewise expected that both the old and the new member states will recognize, guided by the vision of achieving liberal democracy, that the benefits of accession outweigh the costs of isolation. This is especially true in a dynamic sense.

However, since EU enlargement and overall development are taking place in turbulent political, and particularly economic times, the Union is facing new problems which they must address as they go. Firstly, the proposed Constitution was rejected in referendums in France and the Netherlands, and so the formal legal basis for these changes was lost. After lengthy negotiations, a new legal basis was created to replace the Constitution for the time being—the Lisbon Treaty, adopted in 2009. But then a new problem emerged, the global financial and debt crisis, casting doubt on the future of the eurozone, because the debts of certain member states (Greece at the moment, but similar problems could occur in Portugal, Italy, Spain and even Croatia, although it is not yet in the eurozone) might threaten the stability of the single currency, the euro. In such difficult times, the biggest problem single currency faces is the uncoordinated fiscal policy. Only indirect taxes are common at the EU level, while direct taxes (income and profit tax, discretionary measures) are still under the authority of individual member states. For some of them, fiscal policy is one of the last bastions of state sovereignty, and it is guarded possessively. Economic history has shown that it is difficult to maintain a single currency without a common fiscal policy, and all of this calls into question the survival of the euro and, consequently, some believe, the survival of the EU itself. In times of economic growth, this can be ignored for a while due to sufficient capital to fill the gaps arising from such discrepancies, but when the global financial crisis arose, this problem came to light in its entirety.

3. European Semester and the Fiscal Compact

All relevant EU bodies deal with this problem; they look for sources of funds to help the indebted countries, but it is clear to everyone that the solution to the problem calls for long-term measures to replace the current desperate actions. As one of such measures, the European Union has established an annual cycle of coordination of economic policies, called the European semester. Each year the Commission carries out a thorough analysis of plans for budgetary, macroeconomic and structural reforms of the Member States and provides recommendations for the following 12 to 18 months.

The European semester starts when the Commission adopts its Annual Growth Survey, which is usually at the end of the year. This document outlines the EU’s priorities to stimulate economic growth and job creation. The Commission simultaneously publishes the
Alert Mechanism Report in the context of macroeconomic imbalance procedures. Based on a scoreboard of its indicators, the Report evaluates which Member States require further evaluation in the form of an in-depth review in order to determine whether imbalances exist, and what they are.

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Based on the initial experience with the implementation of the European Semester, the Annual Growth Survey for 2015 presents proposals for the simplification of the European semester procedure, which is carried out in several stages. In October, Member States submit draft budgetary plans for the subsequent year. The Commission then provides an opinion on each Member State’s plan in November, as well as an overall assessment of whether the draft budgetary plans are in accordance with the requirements of the Stability and Growth Pact.*

The overall macroeconomic situation and progress in achieving the objectives of the Europe 2020 strategy are being estimated at the European Council March meeting, and policy guidance for fiscal, macroeconomic and structural reforms is provided. To encourage member states to adhere to this agreement, the Treaty on Stability, Coordination and Governance in the economic and monetary union, known as the fiscal compact, was adopted and signed on 2 March 2012. Since there was no consensus to implement this through changes to the Treaty on the EU, it was achieved by signing an intergovernmental agreement. The contracting parties were not only Great Britain and the Czech Republic. Under the terms of the fiscal compact, national budgets must be balanced or in surplus. The structural budget deficit shall not exceed 0.5 percent of GDP, and public debt, 60 percent of GDP. The Contracting Parties were given one year, until January 1, 2014, to transpose the balanced budget rule into their constitutions or national legal systems with constitutional force.

It is important to note that there is a difference between actual and structural budget deficits. Structural deficit is the type of deficit which filters out the effects of the business cycle and potential one-off items (discretionary measures†). In the EU, it has been set to 0.5 percent of GDP. The EU defines the actual budget as excessive when it is greater than 3 percent of GDP. The actual budget deficit shows actual cash expenditures, revenues and deficits in a given period, i.e. the difference between actual revenue and expenditures. This demonstrates the importance of fiscal harmonization. Direct taxes directly affect budget revenues of a country, and if they are not balanced, it is difficult to monitor which Member States abide by the structural deficit set at 0.5 percent.

* In order to further emphasize the importance of the Maastricht criteria, the European Commission adopted the so-called Lisbon Strategy in January 2002, promoting the Stability and Growth Pact, exclusively in relation to the then members of the EU. It was becoming increasingly clear that not even those members could consistently comply with the Criteria, despite being developed and having fewer problems than the candidate countries.

† Discretionary measures are: organization of public works, public employment projects, changes in tax rates, all of which make clear the fact that fiscal coordination is not possible without harmonization of such measures at the EU level.
Also, it is becoming increasingly evident that the financial crisis affecting the whole of the EU, and especially some of its “southern” countries (Greece, Spain, Italy, Portugal and Croatia), does not favour the consolidation of its integration processes, primarily because it threatens the convergence of macroeconomic policies. The macroeconomic situation in individual member states is becoming so diverse that it is all the more difficult to find a common denominator to reduce the differences. The so-called austerity policy, based on the theory of monetarism of the Chicago school of economics, one of the founders of which was the late Nobel Laureate American economist Milton Friedman, was supposed to serve as a common ground, espoused by the more developed northern member states (notably Germany, Scandinavian countries and even France to an extent). The Chicago School of Economics is known as the birthplace of contemporary monetarism and the renewal of liberalism. Its basis is a firm belief in the efficacy of the market and the need for limiting government intervention in the economy, the expansion of economic analysis and other areas of social life. The main message of the School is, in crude terms, that everybody has to live according to their ability; if they spend more than what they earn, it must be covered by future earnings.

States can borrow, but they need to pay the price—the price of money being the interest rate—and repay their debts on time. Many EU Member States have found it difficult to pay their debts, and they are seeking reprogramming, even write-offs. In doing so, they are invoking similar cases from the past. For example, in the interwar period, the United States wrote off loans given to governments of sixteen European countries for the purpose of repairing the consequences of the First World War. In the early 1930s, most of them declared insolvency, so the US President Hoover instituted a moratorium on their debts. The Americans were never repaid those loans. Britain and France, for example, were forgiven a debt totalling nearly a quarter of their GDPs. A similar scenario ensued in the aftermath of World War II under the London Agreement of 1953, when the victorious countries wrote off more than 50 percent of Germany’s reparations accumulated after the two world wars. It was then decided that Germany would pay off the rest of the debt once it achieved a trade surplus with the rest of the world, with instalments not exceeding 3 percent of their export value. In this way, the creditor countries were encouraged to import more German products because this guaranteed repayment of the remaining debt. As an old “loan shark” saying goes, the debtor shall not be destroyed, we must come to their aid to help them stand on their two feet. Experience also shows that, when a debtor owes 100 kuna, that is their problem, but if they owe a million kuna, it is the problem of creditors.

There is another market reason why it is not only the debtor’s fault to find themselves in a crisis, not being able to repay their debts. It is being discussed lately in the context of the Greek government requesting benefits, including a certain debt write-off, pointing out that granting loans to Greece and to other countries in similar situations “was not solidarity, but a cynical transfer of bank losses” (a statement by the Former Greek Finance Minister Yanos Varoufakis to creditors), probably alluding to the fact that in pre-crisis times, bankers from “northern” Member States had a strong interest in “inserting” more credit into the Member States that needed it in order to earn as much as they could in interest. Now that debt repayment is stumbling, they are solving their problems at the expense of the debtors, making it more difficult for them to service their loans.

4. Theory and Practice

When these phenomena are placed in the context of monetary theory, we can see that it is a classic conflict of the schools of monetarism and Keynesianism. Monetarism is perhaps
somewhat simplistically considered as promoting a restrictive monetary policy, while Keynesianism\(^*\) is said to insist more upon an expansionary monetary policy. Drawing on this theoretical context, it can be said that austerity policy represents a restrictive policy, while debt relief represents an expansionary monetary policy.\(^\dagger\) Indebted countries repeatedly claim that austerity does not produce results, which is supported by numerous world economists. This is not entirely true; according to some experts,\(^\ddagger\) economic consolidation by means of austerity measures is yielding results, and it can be seen across the board. Economies of Spain and Portugal are experiencing growth; Portugal, unlike Greece, is no longer under the EU financial umbrella. Another, even more successful example is Ireland, which is no longer receiving financial assistance but yielding excellent economic results. Even in Greece, the situation is improving. Another good example is France; its government, after hesitating for a long time, finally initiated some reforms deserving of the name, although economic indicators are as bad as ever. Paris switched to the “Berlin course” rather late. Some believe that Greece is “a special case” in the eurozone because of the severity of its problem and the necessity of transformation, and that it is too early to predict the success or failure of the new government in Athens. In this view, the Syriza victory is relevant at the domestic level, but it can only have a limited impact on the whole of Europe.

However, there is increasing support for the “loosening” of austerity policies. For example, although he continues to believe in the necessary radical economic reforms and a drastic reduction in budget deficits, Former President of the European Commission José Manuel Barroso claims that such policies must be politically and socially acceptable, which is now being called into question. “While I think this this [austerity] policy is fundamentally right, I think it has reached its limits in many aspects. A policy to be successful not only has to be properly designed, it has to have a minimum of political and social support. We have to have tailor-made solutions for each country, we cannot apply a one-size-fits-all programme to the European countries”, Barroso said recently speaking in Brussels at a meeting of European think tanks.

Some believe that Barroso’s statement is a new sign that Brussels is ready to give countries such as France, Spain and Italy more time to implement unpopular economic reforms and reduce their budget deficits. At the same meeting, the Former President of the European Council, Herman Van Rompuy, assessed that the economic crisis is lasting too long. He stressed the need for faster implementation of reforms that affect growth most directly. Barroso espoused the deepening of the European integration. “Further integration is essential to our economy to protect us from international disasters and help retain the confidence of markets and investors,” he said.

\(^*\) English economist John Maynard Keynes was one of the architects of the Bretton Woods agreement of 1944. It was the time when the International Monetary Fund and the World Bank for Reconstruction and Development were established and the process of the GATT was launched, in order to reduce protectionist barriers to world trade. Keynes is also known as the creator of state capitalism, which advocates state intervention when the financial sector in a country requires it, which actually represents monetary expansion.

\(^\dagger\) Debt forgiveness can have similar effects as expansion in money supply because it releases part of the funds that would otherwise have to be used for debt servicing for other purposes, even investment.

\(^\ddagger\) Former Croatian Finance Minister Martina Dalić at the roundtable “Budget and fiscal policy in the following three years – a way out?”, Zagreb, 20 November, 2014
From these statements one can clearly see the main problem of the conflict between the two monetary theories—austerity does have a dark side to it, and this is that it does not favour growth. It could even be argued that these warnings are reasonable to a certain extent. Expansionary monetary policy can only succeed if it is accompanied by structural reforms. This creates a new value which can be the basis of new development. If there are no reforms, but the expansionary monetary policy is used only to cover bad debts, then problems occur later in the form of increased financial and economic instability and increased inflation, only exacerbating economic problems.*

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So the keyword is reforms, after which expansionary monetary policy can make sense. It follows that in the present economic crisis in the EU, the strongest integration factor is the combination of “loosened” austerity policies and structural reforms. Certainly, each member state requires a different set of reforms according to the state of the national economy. In Greece, for example, internal reforms are more imperative than reforms related to foreign debt, because there is plenty of leeway for, e.g. broadening the tax base, increasing the efficiency of administration, reducing the gap between the rich and poor and so on. Only by approaching the reforms seriously can the new government expect foreign creditors to express more understanding of their difficulties.

The so-called Juncker’s investment plan to revive the economies of EU member states should be understood in such circumstances. As is already known, the Plan will include the purchase of government bonds of the eurozone countries that have investment grade credit rating, in the amount of 60 billion euros a month, effective from March 2015 year until September 2016. The bond purchase program will include countries such as Greece, which have previously received assistance to avoid bankruptcy, but they will have to meet specific criteria. However, the critical issue has been emphasized repeatedly by Mario Draghi, President of the European Bank for Reconstruction and Development: “Monetary policy can create the basis for growth, but investments require trust and trust requires necessary structural reforms.”

Draghi has actually made a quintessential comparison between this financial package and the Marshall Plan (after World War II), which also represented the so-called “seed money” (initial capital), that is funds that had yet to be “fertilized” in order to produce results. From an economic point of view, such a move is considered praiseworthy, but it is already becoming clear that it will be more beneficial to those countries that have already implemented structural reforms, because only they can “fertilize” the initial capital to their advantage. Countries that have not enforced reforms would spend the capital only to cover bad debts and would be left

* Although the Croatian National Bank is often criticized for allegedly following a restrictive monetary policy, many experts argue that it is not the case. Relying on the interest rates on the capital market, Velimir Šonje claims that CNB actually follows an expansionary monetary policy, while the Governor of CNB Boris Vujčić shows that each time monetary policy is loosened, companies with new funds first cover bad debts, rather than investing in development.
with insufficient capital for new investments, or new values.' This concludes the economic side of the story, the story of the “harmful” austerity policy.†

"If the EU wants to become a stronger political factor in the world, it must ensure political stability throughout its territory."

However, when it comes to the current political and economic situation in the EU, it is becoming increasingly clear that these issues cannot be solved by economic logic alone, which is the basis of austerity policy. First of all, this is because the EU is not simply an economic integration, but is increasingly becoming a political integration as well, so its development cannot be determined solely by economic factors, no matter how economically justified they are. Every country in the world, especially the less developed ones, has a more advanced and a more underdeveloped part. One of the primary tasks of each state is to maintain political stability in each part, and this is achieved through their economic convergence. Evidently, this cannot be done simply by means of the market, i.e., economic measures, but also by means of political measures—put simply, by transferring parts of its GDP from developed to developing regions. This can be achieved by various measures, particularly fiscal, which is being criticized by businessmen from the more developed parts, even though they know that this helps develop their markets, because otherwise the developing regions would not be able to buy their products.

This problem is one of nation-states, but in the case of the EU, it is one of 28 integrated states. Therefore, if the EU wants to become a stronger political factor in the world, it must ensure political stability throughout its territory. It must not be forgotten that the current stage of the EU is one of economic and monetary union, which is only a step toward a common state in any given form. Despite the convergence criteria of the 1992 Maastricht Treaty, the economy of the EU member states is obviously not balanced, but rather displays a difference between northern and southern parts of the future common state. As has always been the case in history, the developed North criticizes the developing South for working too little and spending too much, and hence being excessively indebted. Countries of the developing South accuse the developed countries of the North of a "perpetual debt bondage", because financiers of the developed North, by means of servicing “southern” debts, make even more money without contributing to the development of the poor. The accusations go back and forth, the representative example being the relations between Germany and Greece, now assuming political connotations as well. Furthermore, according to estimates of the Greek Finance Ministry, Greece is expected to indicate slight increase in economic activity this year, which should significantly accelerate to 2.9 percent next year.‡ Still, considering the recent events, the Greeks are no longer eager to wait for the improvement of their standards,

* This is comparable to the effect of pre-bankruptcy settlements in Croatia. In order to succeed, the companies that were thus given more time to improve their position on the market should use it to reform its operations. However, as demonstrated by an analysis of the Economics Institute, only an insignificant number of companies took advantage of this respite to reform their management, business methods etc., so all of their troubles will recur, only this time at a considerably higher and broader level.
† We reiterate the fact that many economic conferences both in Croatia and abroad have confirmed that austerity policy produces results in a number of countries, even in Greece, whose economy is beginning to indicate positive growth rates.
‡ This is yet another indication of austerity policy yielding results.
so they have shifted the whole problem to a more political level, threatening to destabilize the EU politically if they are not granted certain concessions. They did get something—a four month extension of the current debt repayment agreement, but the conditions remain the same, which is, it would seem, the only thing the EU is willing to do to prevent the political situation from deteriorating, at least for the time being. This has heralded new political problems, because the countries that went through the same arduous process and are now slowly recovering (Portugal, Italy, Ireland, Spain) wonder why the EU did not show similar understanding in their respective cases.

5. Conclusion

The EU is currently hovering between economic and political arguments (theoretically speaking, between monetarism and Keynesianism) in order to remove the main obstacle to the integration process it presently faces, which is the growing gap between the “rich” and “poor” in its own backyard. And since this stratification is one of the most adverse implications of the current stage of globalization, the EU, as one of the metaphors of globalization process, is facing a great challenge.

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