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Mr. Sarkozy and the EMU

It is hard to keep track of the many ideas, initiatives and moves of the new and ubiquitous French "hyper-president" Nicolas Sarkozy. Besides saving the European summit, having his wife rescue Bulgarian nurses in Libya, placing a Frenchman at the helm of the International Monetary Fund and many domestic initiatives, he has made some remarkable moves in the area of European economic policy. Mr. Sarkozy ensured that "free and undistorted competition" was removed as a goal of the European Union, he demanded that the European Central Bank (ECB) lower the interest rate in order to increase employment and growth in Europe, and he requested from EcoFin (the body of European ministers of Finance and Economics) that they accept a delay in France's obligation to reduce its deficit. Finally, he revived an earlier French proposal, going back to President François Mitterrand who vented the idea in 1990, that a counterweight to the independent ECB be created – a European Economic Government that could preferably issue directives to the ECB or at least influence the monetary policy of the Frankfurt institution.

The answers to all these proposals have been quick and – from his point of view – not very encouraging. The president of the ECB, fellow Frenchman Jean-Claude Trichet, has rejected attempts to influence the policy of the ECB, and EcoFin has also made clear that it requires a reduction of French deficits on schedule. This time even the Germans, who not too many years ago formed a coalition with France that resulted in both countries' violating the Growth and Stability Pact, sided with the majority and demanded of France that it play by the fiscal rules of the EMU. Likewise, the idea of an economic government fell on deaf ears. Thus, Mr. Sarkozy is quite isolated on these matters.

Of course, Mr. Sarkozy is clever enough to know that most of what he demanded, especially an influence on ECB policy, has no chance of being implemented. As Mr. Trichet pointed out, Article 108 of the Union Treaty ensures the complete independence of the ECB; it is not even *allowed* to take instructions from politicians. So there is virtually no way, except by changing the Treaty, to see Mr. Sarkozy's proposal implemented. (A change in the Treaty, of course, requires that all member states agree, which is rather unlikely.) So one might surmise that this particular initiative is chiefly due to his intention of impressing domestic voters rather than to a real conviction that he can be successful here. It may be possible that he is using this merely as "smoke and mirrors" to implement necessary structural reforms in France which might otherwise be harder to implement. If so, this is good for France and for the rest of the EU.

In any case, the proposal concerning the ECB cannot be taken very seriously and one should not worry too much about it. What he does with the Stability and Growth Pact (SGP) is more problematic. When, if not now, is the time to reduce deficits? Europe is growing much faster than in recent years, unemployment is coming down and tax revenues are increasing. This, obviously, is the time for a counter-cyclical fiscal policy to abolish deficits and reduce debts. Unfortunately, Mr. Sarkozy is not alone in postponing the reduction of deficits to a time when the economic situation may again be less friendly for consolidation policies. Mr. Steinbrück, the German minister of finance, is also enjoying a flood of unexpected tax-money because of the boom in the German economy (leading some even to talk prematurely of a third German *Wirtschaftswunder*), but he is not very ambitious when it comes to reducing deficits. Instead of doing so now, he is praising himself for planning a balanced budget for the year 2011. It will be interesting to see if this promise can be kept when Germany's boom has come to an end (which of course it will eventually) because his projections are based on a continuing boom after 2008. Mr. Steinbrück's predecessor, Hans Eichel, also started out as a deficit hawk but lost his shine very quickly when the economy slowed down, and he ended up fighting the excessive deficit procedure that the

EU Commission wanted to place on him. It might well be the case that Mr. Steinbrück will suffer the same experience.

All this, of course, flies in the face of the SGP. Lest anybody forget: the SGP in its original incarnation demanded a budget close to balance in ordinary times and deficits up to 3 per cent in bad periods. Finance ministers quickly reinterpreted this as meaning that a deficit of up to 3 per cent is okay in normal times and demanded that more than 3 per cent be allowed in not-so-rosy times. France and Germany pushed this interpretation most aggressively and succeeded, although a reformulation of the SGP in 2005 not only allowed more deficits in recessions but also stressed that booms should be used to reduce debts and deficits. Alas, it seems that this part of the SGP has been quickly forgotten.

Mr. Sarkozy's policy is bad for the credibility of the EU and its monetary union and, worse, it fails to acknowledge that most European public purses are in bad shape indeed: most countries face huge obligations from pension and social security payments that are estimated to increase in the next two to three decades due to demographic change. A recent projection by the International Monetary Fund for the G-7 countries concludes that none of them have done enough to prepare themselves for the expected strong increase in pension payments; this would require not only an immediate reduction in deficits but positive fiscal balances. Yet despite a clear and present need for a big and quick change in fiscal policy, Mr. Sarkozy and his colleagues in other European countries are ignoring this problem.

Finally, the idea of an economic government does not make much sense. In fact, rivalries between European governments concerning mergers and acquisitions show that the idea of further integration does not currently have many friends. The borders of Europe seem to have been reached and the idea of further expansion has been shelved for the foreseeable future. How could anybody in this situation believe that a common economic policy would find enough support? Common taxation, full integration of labour markets, the pursuit of the Lisbon Agenda of further liberalisation and market integration are probably not what Mr. Sarkozy has in mind with his economic government. And a mere counterweight to tell the ECB how to set monetary policy is, in addition to being ruled out, not very realistic either. Currently, the EMU is characterised by big differences in growth rates, rates of unemployment and even rates of inflation. It is hard to see how member states should be able to agree on a common course of monetary policy. While some countries like Ireland and Spain are growing faster than the rest of Europe, others like Portugal and Italy lag behind. How should all these countries agree on an expansionary or contractionary monetary policy? Setting a common monetary policy is hard enough even for the independent central bank; how should this work if politically motivated ministers of finance try to set monetary policy? In fact, this only shows how sensible a decision it was to make the ECB one of the most independent central banks in the world, allowing it to define its own inflation goal. Even the target rate of inflation would give rise to endless discussions among ministers of finance and taking this out of their hands is the basis for successful monetary policy.

One can only wonder what Mr. Sarkozy has in mind with all these initiatives. He must know that they have virtually no chance of being implemented. So why squander political capital and international goodwill on these ideas? Given his big ambitions to shape the future of Europe, he might consider making more realistic proposals. European integration is not doing well at the moment and these proposals do not help.

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