

## **Ecofin ministers must face deflationary danger!**

According to an IMF report of 30 June 2003, deflation is incipient in Germany where growth has been negative for three successive quarters. EU Ministers at an Ecofin meeting in Brussels on 16 July appear to accept that something must be done, although prior to the meeting they have unwisely rejected a French proposal that would ease the Maastricht fiscal rules. Instead, Ministers appear to favour an Italian proposal to spend more on EU infrastructure. This is only half a loaf, as I make clear below.



*George Irvin argues that the largest EU states must boost economic growth by increasing fiscal deficits now!*

What is deflation? When consumer demand stagnates and unemployment is high, the economy's excess capacity exercises downward pressure on prices. To counteract deflation, the Central Bank normally lowers interest rates and pumps more liquidity into the economy. But monetary policy alone is not the answer. A good example is that of Japan where the economy has stagnated for a decade despite near-zero interest rates. The Japanese lesson is that only a very robust fiscal stimulus can rekindle growth. Meanwhile, the German locomotive pulling the EU economy has stopped.

### **The Fiscal straightjacket of Maastricht and the SGP**

The Maastricht Treaty of 1992 was informed by good intentions, but economically it is deeply flawed. The European Central Bank's (ECB) brief to target 0-2 percent inflation contrasts unfavourably with that of the US Fed, which by statute must consider both inflation *and* employment. Most important, member states signing Maastricht who wished to accede to the single currency were obliged by the 1997 Stability and Growth Pact (SGP) to lower their budget deficit to 3 percent of GDP and their total public sector borrowing to 60 percent of GDP. Some years ago such a policy was arguably defensible on the ground that for the euro to succeed, conservative rules were necessary to reassure international capital markets. Today these monetary and fiscal rules are not merely archaic but are positively counter-productive.

### **Eurozone stagnation**

German growth in the first two quarters of 2003 was negative, French and Italian growth were barely positive; even in Britain, current growth forecasts are being revised sharply downward. Eurozone growth in 2003 will be less than 1 percent. At present Eurozone inflation is below 2% and Germany's is 1.4%. Unemployment is nearly 11% and its trend is rising in both Germany and France. While Eurozone inflation may rise later this year because of the recent sharp fall of the dollar against the euro, the effect of a strong euro is deflationary; ie, it slows growth.

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\* George Irvin is Professor of Economics at ISS, The Hague.

In early June the ECB cut its main rate by half a percentage point to 2%, a cut which doesn't fully counteract the impact of the strong euro, still less get the Eurozone economy moving. Here is the rub: the ECB cannot cut the nominal rate much further for fear that the real rate will turn negative.

### **The need for Fiscal Stimulus**

Recently, Herr Schroeder announced a package of tax cuts. But because German households, unlike their British and American counterparts, cannot be coaxed into becoming net debtors to maintain their consumption, the tax cut may merely raise household savings further. More generally, once taxes are slashed it is difficult to raise them again, thus weakening the fiscal system.

Ecofin ministers have accepted half a loaf by agreeing to discuss an Italian proposal to raise EU spending on infrastructure. Such spending is good; it helps boost aggregate demand. There are two objections, though. First, capital spending takes time to plan and execute and, secondly, it is regionally specific. A hundred million euros might usefully be spent (say) on improved roads for the 10 new adherents, but this will not necessarily boost household spending in the EU's major economies where it is most needed.

Under conditions of potential deflation, it is absurd to aim at a balanced budget for each member state. Nobody---least of all the financial markets---believes that loosening the Eurozone's fiscal purse strings will lead to hyperinflation. In its 2003 Annual Report, the BIS in Basle urges expansionary fiscal policy. Sadly, the BIS report has been ignored; Pedro Solbes is defending a policy based on the economics of Herbert Hoover.

Increased spending is not a luxury; it is an imperative! High unemployment and low growth leads to social instability and rising xenophobia. That is the fundamental lesson of the 1930s, and that which lies at the heart of the European project.

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