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Common Monetary Policy, Different Fiscal Policy: How Will Europe React to Crises in the Future? An Analysis Looking at Germany, France and Poland as Examples

Matthias Schäfer, Astrid Pape¹

The Takeaway

- The Eurozone's Stability and Growth Pact constitutes the institutional framework for fiscal policy, forming the basis of a stable currency. Attitudes within the individual countries in the euro area as to what stable finances look like vary considerably, however.
- The differences are reinforced through financially divergent economic trends, which bring a fiscal policy reaction to each country's respective national situation into conflict with the collective stability of the eurozone as a whole. Germany's economic strength makes growth-oriented fiscal policy less urgent at the present time; yet, in France the stagnating economy is acting as the driver for fiscal stimuli. In Poland, indeed, they act outside the euro regime in this respect yet are still bound by the fiscal regulations.
- In an illustrative analysis of France, Poland and Germany, fundamental differences in economic stability are evident. The variation is apparent in both the control over fiscal decision-making (political vs. automated) and the economic and political objectives (economic recovery vs. stable finances).
- These differences are not only reflected in political reactions to proposals for greater integration but also in the views held by the public. Even where a general commitment to reform exists, there is still disagreement as to what shape this should take.
- A Europe that cannot agree on shared political solutions and regulations is weakened on an international level. The perspective disclosed by the Five Presidents' Report is one that needs to be discussed seriously. Yet this approach, too, must be based on a shared political will so that each Member State will engage with it.

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Introduction

There is consensus across all ideological boundaries that the eurozone is imperfect as an institution.² The common monetary policy, in combination with national scope in fiscal policymaking and a non-optimal currency area has painfully exposed its weaknesses, not only in relation to the dramatic developments in Greece but also in the shape of the slow recovery of the European economy. While countries such as Germany have emerged fortified from the crisis, France's growth, for instance, continues to weaken—despite an annual budget deficit of 3%.³

Within Europe, opinions differ as to which fiscal policy will best pave the way out of the crisis. While Germany publicises its healthy finances in the form of low levels of debt and minimal inflation,⁴ countries such as France view expansionary fiscal policy as a crucial factor for future growth. The Stability and Growth Pact provides a framework for fiscal policy, although differences of opinion are evident when it comes to its implementation and compliance with the rules. In Germany in particular, the recent relaxed handling of violations of the signed rule set was criticised.

The lack of will—weaker nowadays—within the eurozone to align fiscal policy with shared monetary policy and advocate a standardised stability culture weakens the European economy and further integration, generates uncertainty on the international financial markets and, in political terms, also leads to intergovernmental issues. Furthermore, this makes joining the euro unattractive to growing countries such as Poland. In times of political upheaval, whether brought on by Brexit or the change of government in the U.S., political unity within the eurozone is particularly necessary now more than ever in order to be able to address the current challenges effectively. The economic situation in Greece, too, has moved back onto the political agenda.

Manifold reform efforts have begun in answer to the crisis in some eurozone Member States, both on an EU level and within the countries themselves.⁵ They were characterised by controversy over the design of the changes, which represented the major contribution to the stabilisation of the eurozone by consolidating government debt and reviving the competitiveness of the Member States.

This controversy stems from countries' diverse, heterogeneous economic evolution; the crisis-stricken countries in particular expect a return to growth and a reduction in unemployment. Others, on the other hand, see their challenge as new risks that could be a threat to them in the future through their liability for government debts in other countries, and therefore focus on consolidation and competitiveness.

The adopted strategy for overcoming critical developments in some euro countries also has entailed elements of stronger economic integration in the EU. In continuing along this path, we must assume that sources of friction to the Member States' inherited economic and stability cultures will continue to exist and will shape the political discourse.

In the current research project conducted by Konrad-Adenauer Foundation, in collaboration with the Polish Institute of International Affairs (PISM), the various fiscal governance systems belonging to France, Poland and Germany were systematised and used as illustration.⁶ France and Germany are two major euro

² See e.g. R.A. Mundell, "The Theory of Optimum Currency Areas," *American Economic Review*, vol. 51, no. 4, 1961, pp. 657–665. On the theory of optimum currency area and current debates: P. Krugman, "Revenge of the Optimum Currency Area," *NBER Macroeconomics Annual*, vol. 27, no. 1, 2012; J. Stiglitz, *The Euro and Its Threat to the Future of Europe*, 2016; or P. DeGrauwe, "Flaws in the Design of the Euosystem?," *International Finance*, vol. 9, no. 1, 2006, pp. 1468–2362.

³ France, *IMF Country Report*, 2016, 16, 227, and Germany, *IMF Country Report*, 2016, 16, 202.

⁴ See e.g. President Jens Weidmann in the daily *Handelsblatt* from 18 May 2016.

⁵ *Structural Reforms in Europe*, Better Policies Series, OECD, 2015, www.oecd.org/eu/structural-reforms-in-europe-achievements-and-homework.pdf.

⁶ The project consists out of the report of the Polish Institute of International Affairs (2016): "Stability cultures' in Germany, Poland and France. What do they mean for economic integration in Europe?" and the public event "Stability Cultures and the European Integration—Views from Germany, Poland and France" held in Berlin on 14 December 2016.

countries and founding EU Member States while Poland is an aspiring member country that, after the UK's leaves the bloc, will be the largest EU country not in the eurozone but committed to joining it in the future.

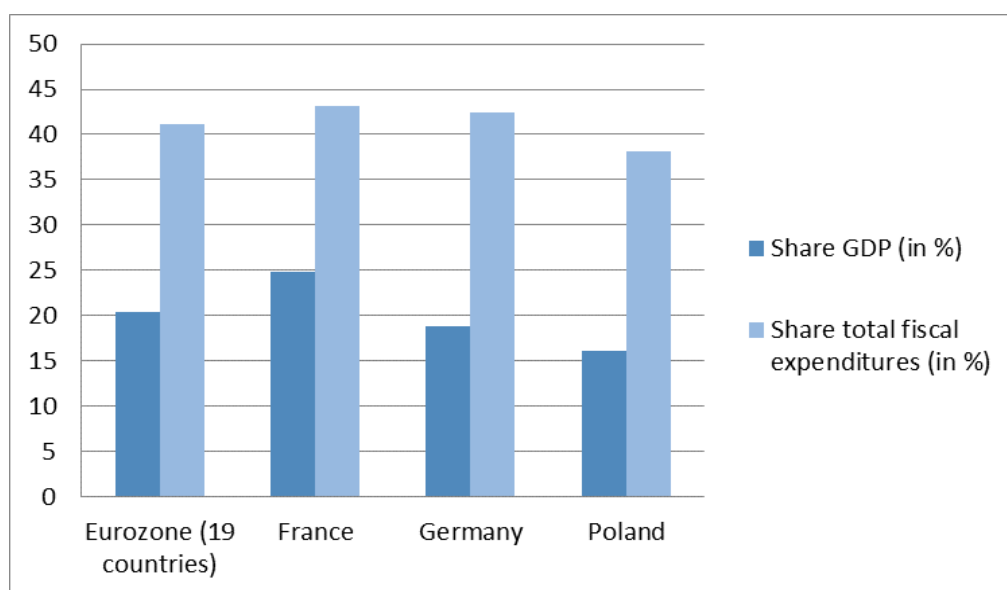
Some questions to answer: how can stability cultures be systematised; how relevant are the differences for the eurozone's evolution, what commonalities are they; and, how likely is the implementation of shared solutions if there is more in-depth economic integration?

Current Developments in the Eurozone and the EU

If we consider the EU, or even just the eurozone as a whole, it is apparent that the economic situation in the EU has stabilised since the beginning of the financial crisis in 2007.⁷ Forecasts promise growth of 1.5% in the next year, along with rising employment figures. The eurozone nonetheless remains susceptible to external shocks. The ECB's expansionary monetary policy is contributing to the current positive trend.

In addition, the economic recovery of the eurozone remains weaker than that of non-eurozone countries, or of countries outside the EU such as the U.S. At the same time, we can see economic progress drifting apart. The differences between the countries are reflected not only in the growth of GDP but also in national debt.⁸

Figure 1. Growth rate of real GDP, change compared to previous year (data source: Eurostat).

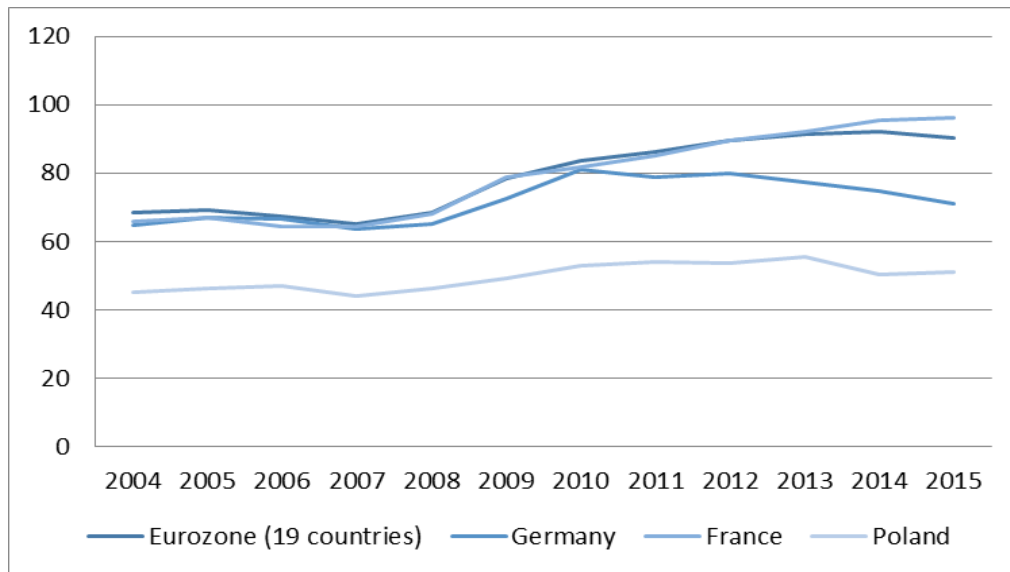


Source: Eurostat.

⁷ *Autumn 2016 economic forecast*, European Commission, 2016, https://ec.europa.eu/info/business-economy-euro/economic-performance-and-forecasts/economic-forecasts/autumn-2016-economic-forecast_en.

⁸ *France*, IMF Country Report, 2016, 16, 227, and *Poland*, IMF Country Report, 2016, 16, 210.

Figure 2. General government gross debt

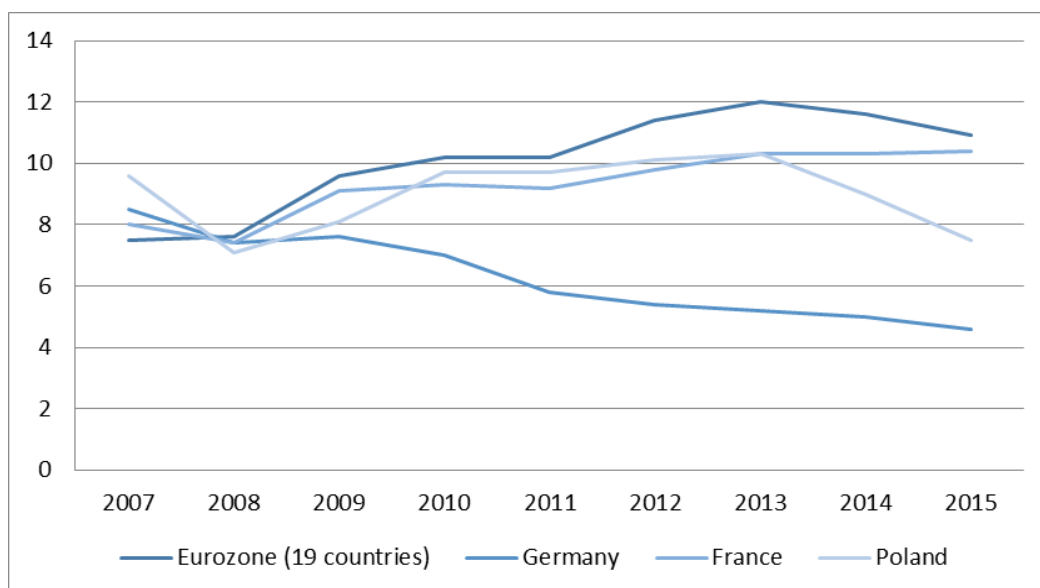


Source: Eurostat.

While Poland, though not part of the eurozone, was able to grow even during the euro crisis. France is stagnating due to its steadily increasing national debt. With its strong export market, Germany is profiting from the weak euro and the structural reforms put in place, and has been able to gradually reduce its national debt without fiscal restrictions.

What is striking about the trends since the financial and economic crisis is that the three countries we are focusing on here experienced similar negative economic trends in the financial crisis: overall, economic growth went through a considerable slump (even if it was not always concomitant with recession) while unemployment, national debt, and state consumption increased considerably.

Figure 3. Unemployment rate among the workforce

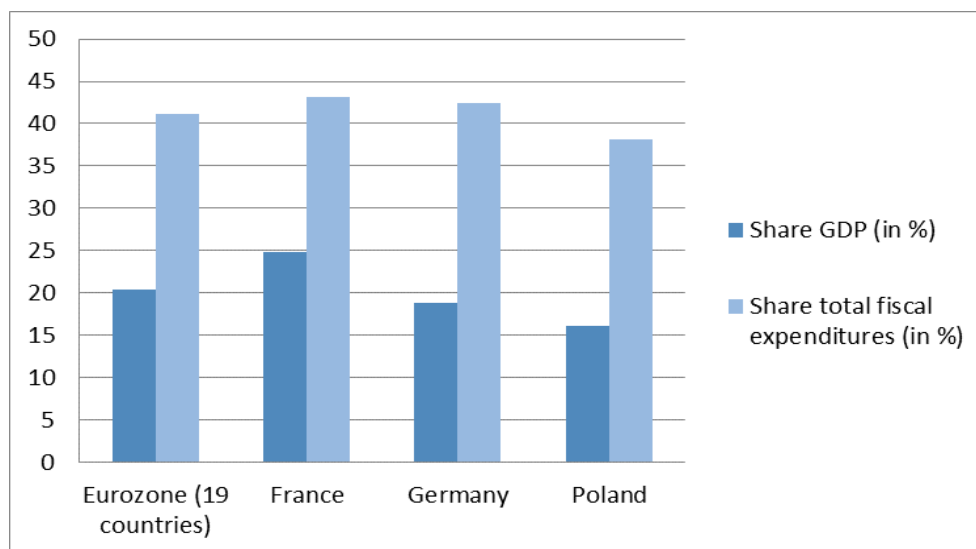


Source: Eurostat.

It is noticeable that, in the following period, different trends emerged.

While higher growth rates adjusted in the short term and the peaks of unemployment and national debt gradually began to subside again in Germany and Poland, France did not manage to reverse the negative trend that manifested itself during and after the crisis. Even though we can observe positive trends in recent times, the consequences of the crisis on the French economy remain palpable in comparison to Poland and Germany.

Figure 4. Government spending on social security in 2014



Source: Eurostat.

We can as well refer to further results regarding social security. In 2014, France and Germany spent a comparable proportion of their total public spending on social security, which was slightly higher than in Poland; however, when compared to GDP, it was significantly higher in France; in other words, France uses a higher share of its economic power to guarantee the same level of social security as Germany and Poland. These differences in economic growth reflect to a significant extent the differences in views and practices concerning fiscal policy and stability culture. The economic situation in the individual countries varies considerably, as does, therefore, the need for action seen in the respective countries. Guidelines issued from external sources, whether EU institutions or the International Monetary Fund, are thereby problematic. It was further reiterated that the growth forecasts as drawn up, for example, by the IMF for Greece, often did not come to pass; economic growth failed to meet expectations and thus the frustration over the economic and political situation became even more exacerbated.⁹

Moreover, it should be noted that, in economics, there is no consensus over the “right” fiscal policy and it is often the case that its consequences cannot be generalised in relation to all countries.

⁹ D. Rosnick, *Potential for Trouble: The IMF's Estimates of Potential GDP*, Center for Economic and Policy Research CEPR, 2016.

Stability Culture in the EU

So, how big are these differences really in relation to the outlook on fiscal policy and stability, i.e., the differences in stability culture, and what do they mean for European integration and the development of the euro? In order to discuss stability culture at all, it is first necessary to develop a consistent system.

Fiscal dimensions to stability culture

In the presentation by PISM on the concept behind the research project, two core dimensions were identified as being crucial to this. On the one hand, countries differ in their politicisation of fiscal policy. Thus, countries can manage fiscal policy in a largely automated way by using regulations. This achieves planning security and stability amongst other things. This approach can, however, make a country less flexible and less able to react ad hoc to topical economic developments. This is significantly easier where political decisions are dominant and more oriented towards the current need for action than long-term regulation.

The second dimension contrasts the focus on fiscal expansion with the focus on fiscal stability and contraction. While many countries place the emphasis on sustainable finances, even in times of economic crisis, others prioritise stimulating the economy over potential cost-cutting objectives. The debates around the respective country-specific stability culture therefore take place within a context of tension concerning the various catalogues of objectives and measures.

Through these classifications of dimensions and characteristics, four types of approaches can be identified: flexible (political decision-making with a focus on growth); moderately flexible (regulation of the decision with a focus on growth); moderately restrictive (political decision-making and focus on fiscal stability); and, restrictive (regulation of the decision and focus on fiscal stability). These are illustrated in diagram form below:

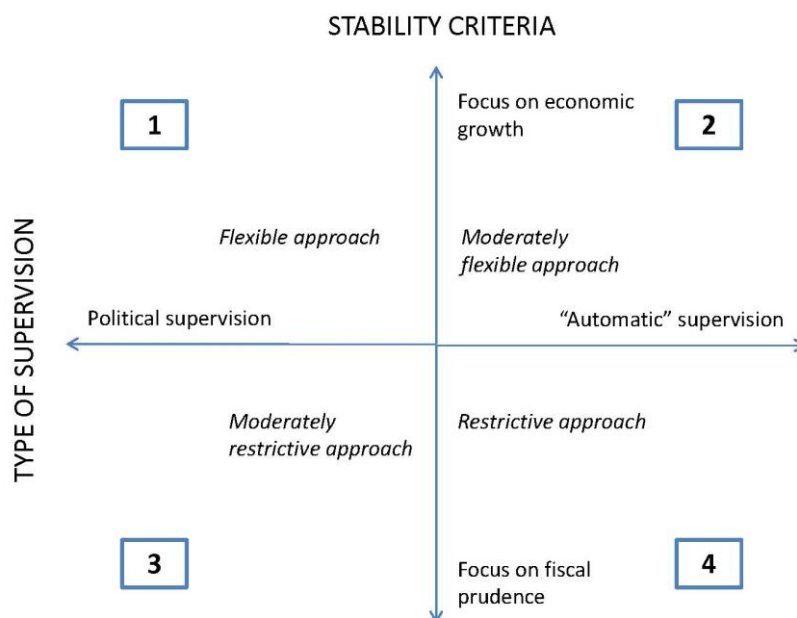


Figure 5. Classification of Fiscal Policy Approaches¹⁰

¹⁰ S. Plóciennik, "Stability cultures' in Germany, Poland and France. What do they mean for economic integration in Europe?," presentation on the public event "Stability Cultures and the European Integration—Views from Germany, Poland and France," 14 December 2016, Berlin.

A precise analysis is carried out based on various criteria, such as public debt and deficit (interpreted via Maastricht criterion), the unemployment rate (compared to the EU average), government subsidies (compared to the eurozone average), and foreign assets (measured by the Net Internal Investment Position, see Appendix 1).

In addition, the presentation included an expanded analysis of types of capitalism in national economies, since these also have considerable influence on the stability culture. Thus, a tendency towards fiscal prudence can be attributed to coordinated market economies such as Germany's while liberal market economies, such as the one in the U.S., and state-led economies, operate in a mostly stepped up, anticyclical way.

France's economy, which, in any case, is already strongly guided by the state, will thus have an extra tendency towards fiscal flexibility. How big, therefore, are the differences within the EU?

Country-specific differences

In practice, alongside solid and sustainable finances, German stability culture also comprises stable institutions, cautious monetary policy and low inflation as well.¹¹ This is also accompanied by a rejection of mutualisation of debts at the present time without shared control of their consequences. An overly expansionary or interventionist fiscal policy is equally as unsuitable to the German understanding of fiscal policy; in principle, stability follows from regulation and regulatory compliance, including in times of crisis. Structural reforms in particular are consistently seen as alternatives for increasing productivity and prosperity. According to the report, Germany evidently falls into the restrictive approach category.

In France, a country that has to contend with economic stagnation, the situation is different. Prior to the introduction of the euro, both fiscal and monetary policy was run along expansionary lines. The euro brought considerable change; nevertheless, France's economic policy remains growth-oriented and can thus be attributed to a flexible, politics-dominated approach.

For Poland, accession to the euro is a long-term scenario since, unlike Denmark, the country occupies no special position through an opt-out clause.¹² With current economic growth and annual growth rates of 3%, Poland is nonetheless able to pursue sustainable budgetary policy without recourse to cost-cutting measures. According to the criteria referred to above, Poland's stability culture is closer to Germany's than France's. Internally, Poland is currently adopting a "wait and see" position. While the eurozone is not defined by stability and predictability, accession remains a less attractive option. A return to the approach of different models of capitalism is likewise possible.

While Germany's stability culture underlines its form of coordinated market economy, the French model is closer to a government-controlled market economy. In this regard, too, the Polish model could be seen as being closer to the German model, and can certainly be outlined in terms of a liberalised market economy. This is illustrated by its growth since the financial crisis. While Poland quickly saw a return to high growth rates and Germany took concerted action to prevent a rise in unemployment, France remained in a challenging economic situation. The coordination of measures to stabilise the German economy took place in the country with the consensus of employers and employee representative groups, as well as with the government and its social security systems. As a result, the crisis was less pronounced and palpable than in France. France is still facing a challenging economic situation even today, presumably also due to the reaction to the crisis, which was not adopted in consensus with key stakeholders and which, additionally, was not aligned with the French stability culture.

¹¹ *Perspectives for a common stability culture in Europe*, Konrad-Adenauer-Stiftung, 2013, www.kas.de/wf/doc/kas_33313-544-2-30.pdf?130121114248.

¹² See: www.bundesbank.de/Navigation/DE/Bundesbank/Eurosystem/Europaeische_Waehrungsunion/europaeische_waehrungsunion.html.

Outlook: what could integration look like?

The three countries researched for illustration purposes demonstrate significant differences both in the economic data and, most of all, in their economic development and the stability cultures. They exist despite the trade intensity, interdependence within the European Single Market, advanced standardisation of production, partially shared European currency, and quite uniform fiscal context. This is challenging because the rising intensity of integration tends to call for increasing homogeneity among the members.

Furthermore, the economic model of the EU as a whole, if we extrapolate from the difference described, is facing new issues that place other global economic powers on the agenda and that conflict with the EU's values and concepts of stability. This affects the prospects for prosperity of all EU citizens.

It is, therefore, even more important to transpose the various views on stability culture into a common approach that makes it possible not only to face external challenges but also to represent an effective, alternative political and economic plan to counter frustration, populism and a weakening of European unification.

There is no shortage of proposed solutions to institutional advancement and further-reaching economic and political integration: from the EU's Five Presidents' Report¹³ to ambitious plans by the EU Commission¹⁴ and concepts by think tanks, many different ideas are being formulated. These include proposals ranging from EU-wide unemployment insurance to increasing the fiscal capacity of the eurozone and the completion of the European banking union.

But what is the reaction of the Member States to these practical proposals?

Illustration: The Five Presidents' Report

The Five Presidents' Report on the completion of Europe's Economic and Monetary Union was intended to analyse this.¹⁵ It was compiled by the presidents of the five large EU institutions—the Commission, Parliament, Council, Central Bank and Eurogroup—under the direction of the president of the Commission, Juncker. It links to the earlier work of the Commission and sets itself the goal of completing the European Economic and Monetary Union.

It stresses in particular that all countries must benefit from deepened integration and that the democratic involvement of all countries must be ensured, without which further transfer of responsibilities could hardly be legitimised. The report also mentions practical proposals such as the completion of the banking union, yet also addresses social inequality between the countries as the main issue. At the same time, it demonstrates the relevant need for action from the perspective of stability culture in the context of fiscal policy and the coordination of economic policy.

The Five Presidents' Report is therefore cited here by way of illustration, because it seeks to resolve the area of tension between different stability cultures on the European level by means of strengthened shared institutions. How can we assess these proposals regarding deeper economic and political integration based on the preceding evaluations?

¹³ *Five Presidents' Report: Completing Europe's Economic and Monetary Union*, European Commission, 2015, https://ec.europa.eu/commission/publications/five-presidents-report-completing-europes-economic-and-monetary-union_en.

¹⁴ *Economic and Monetary Union, Policies, information and services*, European Commission, http://ec.europa.eu/economy_finance/euro/emu/index_en.htm.

¹⁵ *Five Presidents' Report...*, *op. cit.*

Proposals for changes in fiscal policy and the coordination of economic policy

The report considers *ex-ante* coordination to be regulated already, not only by the Stability and Growth Pact but also by the fiscal pact that sets supplementary framework conditions. These are not questioned in the report. Instead, it promotes additional mechanisms to control fiscal policy and fiscal stabilisation. A “European fiscal board” could assess national policies according to shared standards in a more objective way than is currently the case. Closer coordination of economic policy also ought to make it possible to set new stimuli for the convergence of Member States and the stability of the shared currency.

With regard to fiscal stabilisation, the report remains vague. Indeed, it does refer to the necessity of having a mechanism that can react to macroeconomic shocks; at the same time, it points out that many aspects require consideration, including that stabilisers do not progress to lasting transfers, or that incentives for stable finances must not be weakened. The creation of a budget for the eurozone will, however, be seen as imperative to long-term stabilisation.

In view of the convergence of Member States, the report takes into account increasing the liability of the Commission’s recommendations for national reforms in support of growth and employment, without Member States being denied the opportunity to submit their own political assessments of the recommendations.

Overall, the report is, in fact, less ambitious than in comparable earlier releases.

At the same time, for that very reason, think tanks such as Bruegel attest to the report being more realistic in terms of implementation.¹⁶

The report represents a good base for analysis of country-specific reactions because in it the EU institutions are demanding with one voice deeper integration in practice. This in turn makes reaction from Member States essential.

Political reactions

Analysis by the media site Euractiv highlights strong differences.¹⁷ While the former French minister of Economic Affairs and current presidential contender Emmanuel Macron takes the view that the credibility of the eurozone can only increase given shared financial resources, and President Francois Hollande has also highlighted the importance of separate resources, not only in the form of transfers to euro institutions, the response from Germany was considerably more sceptical. Chancellor Angela Merkel spoke of a “small shared budget” and referred to existing finance pots. These only come to €145 billion, however, or about 1% of Europe’s GDP.

In Poland, in the context of the National Bank of Austria’s annual conference on European integration, the head of the Polish central bank rated the proposals in the report as being good ideas, albeit as not going far enough.¹⁸ He stated that the report left many practical questions unanswered and had to be measured against reality.¹⁹

The reactions of governments only illustrate one part of the debate. Within countries, too, opinion is divided. It is thus important to analyse the views of the eurozone population to fiscal policy changes as well.

¹⁶ “Euro area governance: an assessment of the ‘five presidents’ report,” blog post, Bruegel, 2015, <http://bruegel.org/2015/06/euro-area-governance-an-assessment-of-the-five-presidents-report>.

¹⁷ A. Robert, “Hollande and Merkel join forces to push for eurozone integration,” Euractiv, 1 October 2015, www.euractiv.com/section/euro-finance/news/hollande-and-merkel-join-forces-to-push-for-eurozone-integration.

¹⁸ “Polish governor criticises five presidents’ report,” Central Banking, 15 October 2015, www.centralbanking.com/central-banking/news/2430615/polish-governor-criticises-five-presidents-report.

¹⁹ *Report on Conference on European Economic Integration 2015: Boosting EU Competitiveness—The Role of the CESEE Countries*, Austrian Nationalbank, 2015.

The people's views

A survey conducted by Bertelsmann Stiftung was one of the key points of reference here.²⁰ The Eupinions survey representatively interprets topical trends within the EU and from all over Europe. The focus in the current report is on the institutional design of the euro area.

According to the survey, 75% of the population sees the need for reform in the euro area and 57% are even of the opinion that it would be useful to have a European finance minister. The responsibilities of such a finance minister could include control over the spending behaviour of national finance ministers, 42% said; 39% also consider debt relief to potentially be part of the remit. A shared budget is plausible for 58% of the population; this should primarily be used for the purposes of reviving the economy.

The survey from 2016 makes it clear that the population has an appetite for reform. There are, though, country-specific differences here. Of French people, 53% consider that it would be useful to have a budget for the euro area allocated for a specific purpose. In Italy, this figure is higher, at 69%, while in Germany, only 47% think along these lines. There are also national differences evident when it comes to ideas on how funds will be used.

The survey thus shows that the populations of the euro states predominantly support deeper integration, even though there are differences between countries that reflect the differences in political reactions. These in turn form the Member States' ongoing public discourse that, in its turn, takes into special account the national stability cultures.

The current situation

In accordance with the current timetable, a white paper brought out this spring submitted practical proposals in light of the Five Presidents' Report. It appears, though, that there are currently other priorities taking precedence in the EU due to Brexit. The current Eurobarometer shows that only 26% of citizens view the national debt problem as the main issue; many more consider social inequality (36%) and unemployment (45%) to be the top priority.²¹ "The Forgotten Crisis" is the headline of the EU-financed blog "Reconnecting Europe."²²

Both, the will and shared vision for proceeding, appear to be lacking. We lack debate on the previous practical proposals over the question whether, in light of its experience regarding crises over the past decade, the EU really wants to be a union focused on stability as the guideline principle for a strong currency. Finally, this debate cannot be conducted in Brussels or Strasbourg; it must be conducted and, ultimately, also be concluded within the individual Member States.

Conclusion

It must be noted that, in the EU's current situation, i.e., moving toward further economic and political integration, it is important to consider the differences in the stability cultures of each Member State.

These differences are reflected not only in the practical regulation of economic, fiscal and social policy but also in concrete political reactions to proposals regarding deeper integration and in the different views held by the population.

In its current state, the eurozone would find it very challenging to respond to a further economic crisis without giving rise to frustration over the existing rule set in individual countries.

²⁰ *Ein europäischer Finanzminister mit eigenem Budget? Die Reform des Euroraums und die öffentliche Meinung in Europa*, Eupinions 4, Bertelsmann Stiftung, 2016.

²¹ *Future of Europe*, Special Eurobarometer 451, 2016.

²² Reconnecting Europe, 27 October 2016, <http://reconnecting-europe.boellblog.org/2016/10/27/the-forgotten-crisis>.

Further integration necessarily requires that a fundamental debate on this issue be held within the Member States as to whether, in terms of a shared, strong economic and political voice of the EU, there is willingness to defer nationally-shaped stability and economic cultures in favour of a shared European economic and monetary union, thereby making the EU an anchor of stability—both on an internal and external level.

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