# BEPA MONTHLY BRIEF

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## Contents



BEPA Bureau of European Policy Advisers

**EDITORIAL** *by Stefano Bertozzi*

April's BEPA Monthly covers four main issues, namely, the importance for Europe's policy-makers to keep promises, the harmful impact of the world crisis on Africa's growth prospects and housing markets of three EU Member States, and, lastly, how migration flows to Europe and job opportunities for migrants have adjusted to the deteriorating economic situation in Europe.

The first lead article, by **Vítor Gaspar** and **Jan Qvigstad**, traces the historical importance of the concept of commitment and shows that it is vital for Europe's policy-makers to honour their public promises. Failing to do so would engender greater social costs and lead to suboptimal solutions, which can have adverse effects on different areas, including the single market and budgetary and monetary policies.

The second lead article, by **Ricardo Soares de Oliveira**, offers a compelling analysis of how Africa's economic growth will be adversely affected by the global economic slump. He maintains that this sharp economic decline, compounded by the food, commodity and energy crises, can wipe out the remarkable headway made by Africa in the last decade. This crisis has shown how ill-equipped Africa's growth model is to cope with unexpected economic downturns, which can also jeopardise previous socio-economic reforms.

The third lead article, by **Rueben Borg** and **Paul Van den Noord**, is highly topical and provides useful insight into how the global financial and economic slump has taken the wind out of the sails of British, Irish and Spanish housing markets. The analysis broadly substantiates an assessment, published in the BEPA Monthly Brief of July 2007, which, at the time, looked at the possible risks of the housing boom in the U.S. and in some EU Member States.

The fourth lead article, by **Alessandra Venturini**, endeavours to highlight the impact of the world crisis on migration flows and on the employment opportunities that are on offer for third-country nationals. She contends that migrants will either be engaged in unskilled and low-paid jobs or be laid off, thereby making their integration into the host societies more difficult. Careful consideration is also given to the thorny issue of labour exploitation and to the rise in irregular migration flows.

April's BEPA Monthly also features "What citizens say", "What others say" and "Gender matters", while, in the ethics section, **Maurizio Salvi** draws our attention to the formidable challenge thrown up by Europe's policy on human stem cells.

**Editors:** Stefano Bertozzi (Tel. 21220), Martin Larch (Tel. 69244) and Myriam Sochacki (Tel. 21429)
**Assistant:** Catherine Isler (50087), Maria Malmberg (56967)

# 1 European Promises

*By Vitor Gaspar and Jan Qvigstad**

## On Keeping Promises

Keeping promises is a key to successful social co-operation. In economic transactions the ability to make credible promises opens a whole range of possibilities. In its absence only simultaneous, spot transactions would take place. Exchange across time and geographical space would be infeasible. For example credit contracts involving the delivery of cash today against the promise of future repayment could not take place. The same applies to investment in assets, where the investor relies on promises by managers and the government that the investment will not be expropriated.

Credible commitment is also central in the conduct of economic policies. It is well known that central banks have benefited greatly from this insight over the past two decades, but this principle also applies in other important areas of economic policy. More specifically, it crucially applies to the policies needed to support the Single Market, Trade Policy and budgetary discipline in conformity with the Stability and Growth Pact.

In modern Economics, research was pushed forward as early as in 1960 by the pioneering work of Thomas Schelling[1], who used the notion of commitment. He is frequently asked whether he has originated the concept. Graciously, he defers to Xenophon, who preceded him by almost 2500 years. In *Persian Expedition*, Xenophon describes why he chose, when retreating back to Greece under pressure from the Persian army, to offer battle with the rear of his army cornered against an impassable ravine: "I should like the enemy to think it easy going in every direction for him to retreat; but we ought to learn from the very position in which we are placed that there is no safety for us except in victory."[2] Under these conditions the commitment to fight hard is credible. The commitment worked both among Greeks and between Greeks and their enemy. The ravine acted as the commitment device. Commitment operates by eliminating some options and induces changes in the behaviour of others.

## Why is keeping promises so difficult? Why is it so important?

Finn Kydland, from Norway, and Edward Prescott, from the U.S., showed that optimal plans, derived by policy-makers, are time inconsistent. In plain words, after announcing a recession of policy actions, the policy–makers have incentives to renege on this announcement when the time comes. The easiest example involves a monetary authority that dislikes inflation but would like unemployment to be below the natural rate. *Ex ante* the monetary authority's optimal plan involves delivering inflation at target and unemployment at the natural rate. If such plan were followed, inflation expectations of the private sector would also be in line with the target. However, once such expectations were formed and observed by the central bank, it would have incentives to engage in surprise inflation leading to unemployment below the natural rate. The problem is that the private sector could anticipate the authority's actions. Under such expectations the outcome would be inflation above target and unemployment at the natural rate. The absence of a commitment devise would lead to a socially inferior outcome. The argument of Kydland and Prescott is one of the foundations for central bank independence and the primacy of price stability.

The importance of commitment goes well beyond monetary policy. In fact, recent research by leading historians has placed commitment at the origin of the institutions that support the proper functioning of a market economy. The state, as famously asserted by Max Weber[3], has the monopoly over the use of violence (coercion) on a given territory. When the state uses its powers to protect property rights and enforce contracts (at the same time that it ensures the provision of public goods) it provides the institutional groundwork for the functioning of the market economy. But if the state has the power to do this, then it would seem that it could use it instead to confiscate property and to make sure that it could renege on its own contracts at will. The Sovereign would seem to lack the ability to commit in virtue of Sovereignty itself. Historically, this general problem has been particularly important in the context of the emergence of international trade

* Deputy Governor of Norges Bank

centres (from the XII to the XVI century) and of the modern tax state (a little later). Both processes are at the root of modern constitutional democracies and the concept of limited government[4]. The problem of sovereign access to debt financing is particularly enlightening.

At first sight it would seem that the sovereign's option of reneging on his obligation to pay back interest and principal is the sovereign's creditor's problem. That is certainly the case *after* debt has been contracted and credit has been extended. However, the opposite is the case *before* the extension of credit. In fact, if the sovereign is unable to credibly commit to repay debt as agreed he will not have access to credit in the first place. In case credit access is valuable, then finding a credible way to commit is a challenge for the sovereign[5].

Historically, the evolution of military technology and strategy after the XV century pushed towards centralization and made it necessary to keep a permanent, professional army as a means to ensure the survival of the state[6]. The need to ensure regular payment to the army (and the emerging public administration) combined with uneven revenues and important peaks in expenditure (linked to frequent warfare) made the access to finance crucial. During the XVIII century finance was a major source of strategic advantage to Britain in its confrontation with France[7]. Rulers and their advisers were clearly aware of the challenge. For example, in the 1770s, Montyon, a senior civil servant in the French Finance Ministry, wrote that[8]:

"Great Britain finances by taxation neither all nor part of the costs of war, it finances them by loans and increases the annual tax burden only by the amount necessary to face the interest and redemption of the loan. That is the regime that France must adopt, and will adopt sooner or later because its value is only too obvious, and our own mistakes will force us to return to this policy. In wartime it is our habit to in-crease taxes, at a time when perhaps they should be de-creased. Indeed in wartime the country suffers enough from the labour withdrawn from agriculture and manufactures to be sent into the army, the navy, and into the production activities necessitated by war."

The solution in Britain involved the primacy of Parliament in controlling tax revenues, made clear after the Glorious Revolution of 1688, the creation of the Bank of England to centralize public debt issuance in 1694, and the consolidation of judiciary independence. Hence, the institutional basis for allowing sovereign access to finance led to a system of checks and balances, limiting government and to the rule of law. As part of this trend, the "Law Merchant" that developed gradually in the Middle Ages to explicit international trade became part of the internal legal order. These elements proved decisive institutional foundations for the modern market economy[9].

**European promises.**

In 1958, Europe launched the Common Market project. Over time, ambition broadened leading eventually to the beneficial dynamics of "One Market, One Money" with the Single Market program. The last fifty years were a period of unprecedented peace and prosperity in the history of Europe. The main driver of this favorable development was and continues to be market-driven economic integration[10]. Successive enlargements show the success and power of attraction of the European project. Barry Eichengreen points out that multilateral commitment to liberalization and openness are at the origin of the impressive economic performance of Europe in the post-war period. In the European Union, the Member States' multilateral commitment is institutionally grounded in the rule of law, the European Union Treaty, safeguarded by the European Commission and the European Court of Justice. The functioning of the European Single Market rests, inter alia, on competition policy in line with the principle of an open market economy with fierce competition. Competition rules, in the context of Global Crisis, are particularly relevant as they apply to state aids. The urgency of the crisis makes it hard to design rescue packages in compliance with the rules. Nevertheless, rules must be kept. The acid test of promises is keeping them when it is hard to do so. Our prosperity depends on keeping promises.

## ENDNOTES

[1] Schelling, Thomas C., 1960, *The Strategy of Conflict*, Cambridge, Harvard University Press.

[2] Xenophon, *The Persian Expedition*, translation Rex Warner, London, Penguin, 1957.

[3] Weber, Max, The Profession and Vocation of Politics, in Peter Lasman and Ronald Speirs (eds.) *Weber Political Writings*, Cambridge: Cambridge University Press, 1994.

[4] See, for example, Douglass North, The Rise of the Western World, chapter 10 in Understanding the Process of Economic Change, Princeton: Princeton University Press, 2005.

[5] See, for example, Kenneth Schultz and Barry Weingast, The Democratic Advantage: Institutional Foundations of Financial Power in International Competition, International Organization, Vol. 57, No. 1 (Winter, 2003), page 10.

[6] Joseph Schumpeter was pioneer in placing the emergence of the modern tax state as a response to the crisis of its predecessor based on feudal relationships. See The Crisis of the Tax State, in Richard Swedberg (ed.) *Joseph Schumpeter: The Economic and Sociology of Capitalism*, Princeton: Princeton University Press, 1991 (German original 1918).

[7] As it had been earlier for the Dutch Republic in its conflict with Spain.

[8] Quoted in Sargent, Thomas J. and François R. Velde, 1995, Macroeconomic Features of the French Revolution Source: *The Journal of Political Economy*, Vol. 103, No. 3 (June), pp. 474-518

[9] See Douglass North, op. cit.

[10] See Gaspar, V., "Markets and Politics: From War to Sweet Commerce", in "The Eurosystem. The Union and Beyond, the Single Currency and Implications for Governance", an ECB colloquium held in honour of T. Padoa-Schioppa, Frankfurt, 27 April 2005.

[11] Eichengreen, B., Institutions and Economic Growth: Europe after WWII, in Nicholas Crafts and Gianni Toniolo (eds.) Economic Growth in Europe since 1945, Cambridge University Press, 1996.