CALLS are growing for a redesign of Europe's framework for operating its single currency. Economic activity in the euro area has stalled, yet the European Central Bank is unlikely to cut interest rates until inflation falls within its target of “less than 2%”. Meanwhile, the EU's stability and growth pact prevents governments from using fiscal stimulus.

Most European policymakers are dismissing such calls for change. They blame the euro area's dismal performance on structural rigidities. It is true that rigid labour and product markets curb the region's potential growth rate; but poor macroeconomic management can also depress growth below potential. The danger is that rising unemployment will then make it even trickier to persuade voters to accept structural reforms.

Jean-Paul Fitoussi and Jérôme Creel, two French economists, argue in a pamphlet* just published by the Centre for European Reform that both the ECB and the stability pact need urgent reform. Unlike many of the bank's critics, they conclude that the ECB's monetary policy has been broadly appropriate for the euro area as a whole, given its rates of inflation and growth. Others have argued that the ECB was too slow to cut interest rates last year, when America's Federal Reserve reacted vigorously to evidence of slowdown. The authors point out, however, that at the start of last year the ECB's interest rates were lower than the Fed's. The euro area also had higher inflation and suffered a less severe slowdown than America. So the ECB did not need to cut rates by as much as the Fed did.

One reason why the ECB's policy has been perceived as being overly cautious is that, eager to establish a tough reputation, it always tends to explain changes in interest rates in terms of inflation, giving the impression that it does not care about growth. Yet its actions show that it does care: the ECB has allowed inflation to remain above its target for most of the past three years.

Even so, the authors argue that the inflation target is too tight. Most countries' central banks have higher ones. Britain's and Australia's both have a mid-point of 2.5%; the Reserve Bank of New Zealand, which started with an inflation target of 0-2% in 1990, now has a range of 1-3%. Ideally, the ECB's target should be raised so that it, too, has a mid-point of 2-2.5%. What is more, Mr Fitoussi and Mr Creel suggest that the inflation target should be fixed not by the ECB, but by the European Parliament. This would make the ECB more accountable, and at the same time make it harder for politicians to criticise a policy that they themselves had set.

European economies that can no longer set their own monetary policy need more scope than in the past to let fiscal policy play a role in stabilising economies. At the very least, built-in fiscal stabilisers, ie, the automatic decline in taxes and increase in welfare benefits in a recession, must be allowed to operate fully. Yet under the stability pact, governments have to balance their budgets over the medium term, and deficits may not exceed
3% of GDP. As slower growth has squeezed tax revenues and swelled budget deficits, the stability pact is, bizarrely, forcing governments to tighten fiscal policy just as their economies move towards recession.

The tendency for prices in different countries to converge can also cause problems. Market forces tend to cause prices to rise faster in lower-cost countries, such as Spain or Ireland, than in high-cost countries, such as Germany. Ideally, a high-inflation country needs higher interest rates; yet the perversity of a single currency gives the likes of Ireland the lowest real rates. At the other extreme, countries with slow growth and low inflation, notably Germany, face the highest real interest rates, cramping growth. High-inflation countries may therefore need a more restrictive fiscal policy, and low inflation countries a looser one.

The dispersion of inflation rates in the euro area offers another reason for thinking that the ECB’s inflation target is too low. In effect, it implies a target of less than 1% for Germany. If aspiring countries from Eastern Europe were to adopt the euro, then the ECB’s target would be even less sensible. The new entrants will have a lower GDP per head than existing members, and as they catch up they will naturally have higher inflation, as the prices of non-traded goods and services adjust upwards. If the ECB keeps its inflation target at less than 2%, higher inflation in some countries will mean even lower inflation, if not absolute deflation, in Germany. Enlargement increases the case for a higher inflation target and more flexible fiscal policy.

Should the stability pact be scrapped? The authors would prefer to modify it, arguing that there is a need for some fiscal constraint within a monetary union, to discourage reckless borrowing in a single country that may push up interest rates across the whole area. At the very least, the stability pact should be redefined in terms of the fiscal balance adjusted over the economic cycle. That would give governments a bit more room to respond to a slump. Then again, if the real concern is the level of debt, any rule should be set in terms not of the budget deficit, but of the ratio of public debt to GDP. That would give a country like Germany, whose public debt is just 60% of GDP, compared with over 100% in Italy, more room to support its economy.

* "How to Reform the European Central Bank", by Jean-Paul Fitoussi and Jérôme Creel. Centre for European Reform.