Economic policy coordination in the EU: economic & political rationales

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Introduction

Economic and monetary union (EMU) is, undoubtedly, a unique and bold experiment. Although the introduction of the euro went well, the economic management of the EU as a whole, and the euro area in particular, has been subject to growing criticism (see, for example, Pisani-Ferry, 2002). Today, the EU has to confront sluggish growth, persistent unemployment and an apparent inability to deal with weaknesses in the supply-side of the economy. The optimism surrounding the launch of the euro just four years ago has been replaced by a pervasive feeling of gloom. Rather than looking with envy at Ireland, many are now looking with trepidation at what has happened in Japan since 1990.

What is less clear, however, is whether the difficulties now apparent are the result of policy mistakes, flaws in the architecture of the EMU policy system, or the impact of longer-run changes that have been inadequately analysed and dealt with. A crucial question is whether the combination of a monetary policy set by an independent, supranational central bank and fiscal (and other) policies controlled by national governments is conducive to both price stability and economic growth. Since the inception of the euro in 1999 and even during the period of convergence that preceded it, there has been a steady stream of criticism about the EU's machinery for economic policy coordination (Buiter et al., 1993; Boyer, 2002).

The record so far...

In many respects, EMU has exceeded expectations. The machinery for decision-making on monetary policy functions effectively and few people look back nostalgically to national monetary policy-making. The introduction of euro notes and coins has been so smooth that the catalogue of horror stories that the more euro-sceptic press, notably in the UK[2], had looked forward to publishing lies mouldering in the archives. A first economic downturn, exacerbated by the tragic events of 9/11 has been weathered, even if the recovery has been halting, and the various elements of the policy system appear to have done their jobs broadly as intended.

Gradually, too, economic governance of the euro area (and the EU as a whole) is being fleshed-out as modalities for policies complementary to monetary policy are established. The various committees responsible for developing policy, such as the Economic and Financial Committee (successor to the old Monetary Committee, focusing on the shorter-term) and the Economic Policy Committee (more concerned with longer-term macroeconomic matters) are reported to function effectively. Ecofin, the body that, in principle, is the custodian of the 'E' in EMU often has to balance the interests of Member

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[2] In the autumn of 2001, the economics editor of one prominent British tabloid told the author that his newspaper *already* had such stories on file, ready to be brought out when notes and coins went 'live'.

States and this can raise problems in the co-ordination of Member State policies called for in Article 99. But it is, perhaps, worth stressing that the contrary to the experience of the past twenty years, Member States have avoided marked budgetary imbalances, although the recent 'lapses' by Germany, Portugal and France could become problematic.

...but what next?

With enlargement of the EU now agreed, a fresh look at the structure of economic policy in Europe is, however, warranted and timely. There are growing doubts about whether key components of economic policy – notably the Stability and Growth Pact (SGP) and the monetary policy strategy followed by the European Central Bank (ECB) - are doing their job. More generally, questions have to be asked about the inability of the policy system to deliver a coherent policy mix and the lack of flexibility in the conduct of policy (House of Lords, 2003).

Nevertheless, reform is in the air and major changes are already in the pipeline. This article examines the criticisms of economic policy in the EU and the mechanisms through which it is co-ordinated, discusses how enlargement changes the outlook, and considers how the EMU policy systemsystem might be reformed.

The policy architecture

EMU is a system of economic governance in which the different elements – monetary policy, fiscal policy and supply-side policies have been reconfigured in a policy framework that differs markedly from those of Member States. Yet it is often analysed as though it is little more than a narrow reassignment of interest rate policy to the supranational level. In fact, the new policy regime combines a specific philosophy of economic policy, a novel distribution of responsibility between the national and supranational levels of economic governance, and a reconfiguration of policy instruments and targets. It is easy to forget just how profound the change is.

Since the late 1980s, a consensus has developed on the broad orientation of economic policy that can be characterised as 'stability orientated'. The essence of the approach, which is at the heart of EMU, is that macroeconomic policy should focus primarily on limiting the volatility of output and prices. The Treaty explicitly requires the ECB to assure price stability. Fiscal policy remains with Member States, but there are obligations to maintain the soundness of public finances, backed-up by the rules of the SGP. The aggregate effect is to limit the scope for discretionary macroeconomic policy and this, in turn, places more of the burden of adjustment on the supply-side of the economy, especially the labour market.

A characterisation is that the role of monetary policy (and thus the ECB) is to deal with system-wide economic effects - including *symmetric* shocks – while national autonomy (fiscal and supply-side policies) is retained to deal with effects specific to the Member State – notably *asymmetric* shocks. This division of tasks leads to two immediate practical considerations (Buti et al., 2001).

First, if fiscal policy to fulfil its adjustment role there has to be a margin to allow the automatic stabilisers to work. The gap between 'close to balance or in surplus' and the 3% hard threshold for the deficit in the SGP is justified by this aim. Second, the longer-term sustainability of public finances – especially, though not exclusively, in relation to pension commitments – requires attention to public sector balance sheets. So long as nominal GDP grows, maintaining the public finances in balance will lead to a progressive reduction in public debt as a proportion of GDP, thereby providing scope for dealing with long-term concerns.

But there are also occasions when increased public expenditure is required in the short- to medium-term for other than cyclical reasons or today's geopolitical imperatives. The new members of the EU, for example, are bound to have substantial public investment needs, just as Spain and Portugal had

after they joined the Union. More generally, the ambitions articulated at the Lisbon European Council to effect a transformation of the EU economy will have expenditure implications. The problem with the current policy framework is that such aims cannot easily be accommodated.

Monetary policy and the approach of the ECB

The ECB has been regularly castigated for obduracy in the assertion of its independence, too narrow an interpretation of its primary target of price stability and a lack of sensitivity to apparently worsening general economic conditions in the euro area. In practice, though, the decisions on interest rates have mostly been about right: some rate changes could have been a month or two sooner or been 50 rather than 25 basis points, but these are fine technical judgements. The Federal Reserve has, manifestly, been more activist in its approach, but monetary policy is a slow acting instrument and excessive changes can be counter-productive.

Nevertheless, a key concern about the ECB is that its 2% reference value for price stability is simply too low and results in a reluctance to cut interest rates when there is no obvious risk of inflation. Moreover, both the reference value and the target for monetary growth have consistently been exceeded, casting doubt on the credibility of the targets. The remedy is straightforward: a higher reference value and, possibly, adoption of a symmetrical target similar to that in the UK, as has recently been advocated by two prominent French economists (Fitoussi and Creel, 2002).

It is also accepted that the decision-making procedures of the ECB will have to change after enlargement, because the addition of up to fifteen additional national central bank governors would make the Governing Council too unwieldy. The ECB itself has come up with a complex proposal involving rotation of Members within groups of countries and uneven voting weights instead of the present one member one vote arrangement and this has now been endorsed by the European Council, in spite of misgivings on all sides. The more radical solutions of a monetary policy committee or giving the decision to a beefed-up executive have been rejected (for a discussion, see de Grauwe, 2002). The trouble with the proposed compromise is that it will still leave the decision-making body larger than at present and open to the charge that national governors will vote on national rather than euro area grounds.

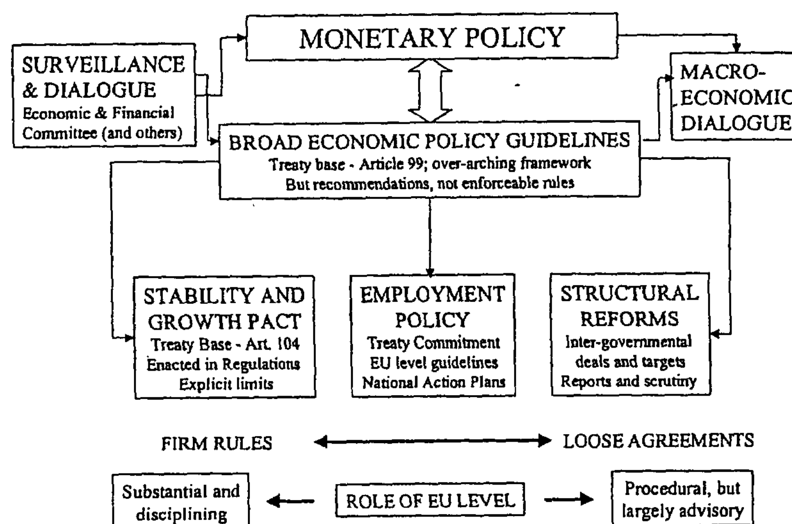
Fiscal policy and the dilemmas of co-ordination

Although fiscal policy in the EU remains a competence of Member States, it is subject to constraints embodied in the SGP. From a theoretical perspective, the reasons for restricting the ability of individual Member States to borrow can be summarised under two main headings:

- First, there may be a collective cost if some countries are fiscally profligate, insofar as the aggregate effect is inflationary and, as a direct result, the ECB has to impose tighter monetary policy than if fiscal policy had been more restrained. The outcome is adverse for the fiscally virtuous as well as the sinners.
- Second, the credibility of the ECB will rest, in part, on its ability to resist pressures to monetise debt. If Member States face limited market sanctions, they will have incentives to raise debt levels, engendering risks of a need for a bail-out. If the ECB's credibility is damaged, then again the euro area as a whole will be the loser.

The SGP does not, however, work in isolation. On the one hand, it is just one component in the increasingly elaborate machinery for policy co-ordination at EU level (see chart). Policy co-ordination can be defined in this context as supra-national rules or norms which are agreed by all Member States, leave primary responsibility for the policy area with national authorities, but set limits on their discretion. The Broad Economic Policy Guidelines also set parameters for fiscal policy and there is a

growing number of policy domains subject to the open method of co-ordination (OMC), the most developed of which is employment policy.



The system brings together very different mechanisms of co-ordination, using a mixture of rules and obligations that are backed by 'hard' law and non-binding agreements that operate through 'soft' law mechanisms such as peer review, benchmarking and exchange of experience (for a succinct description, see Commission, 2002).

What is conspicuously missing however, is any formal means of co-ordination between fiscal and monetary policy: the conventional notion of the policy mix. As the chart shows, there is provision for dialogue between monetary policy and other policy domains, but no overt channels for joint decision-making. Nor does the Pact have any means of adding up the individual deficits to arrive at an EU-wide fiscal stance. If the collective fiscal position is too loose, the ECB would, *ceteris paribus*, be expected to react by keeping interest rates higher, and vice-versa (for a discussion, see Allsopp, 2002). The result is that the aggregate fiscal policy of the euro area Member States will not necessarily be consistent with monetary policy nor will the resulting policy mix always be suitable for the economic circumstances and could be asymmetric in the manner in which it functions. The asymmetry arises because, although the SGP has clear rules for preventing excessive deficits, it has no provisions for dealing with fiscal positions that might be problematic for other reasons. An excessive *surplus* could, for instance, have spillover effects on other economies in much the same way as a deficit does, if in the opposite direction.

The fiscal rules have also been condemned as economically illiterate, an accusation levelled most vocally, and with characteristic robustness, by Willem Buiter (Buiter et al., 1993; see also Eichengreen and Wyplosz, 1998), but has wide support in the economics profession, if not in cognate disciplines. In essence, it is that there is no underlying rationale for having arbitrary limits on deficits, because governments should be free to choose – taking whatever consequences there are for borrowing costs or inter-generational equity. Moreover, a single reference value such as the 3% deficit ceiling is highly unlikely to be correct for all countries at the same time or all the time. Some may have a need for higher public investment to remedy deficiencies in infrastructure or to bolster the technological base –

such as the UK today or the Central and Eastern European Countries tomorrow – while others might need to engage in net public savings, either to run down excessive debt or in anticipation of future pension demands – Italy is the obvious example.

Yet there is a contrary case that typically troubles economists while being persuasive to the legal scholars. This is that without the anchor of simple rules enshrined in hard law, policy anarchy is much more probable. The nature of the rules may be doubtful or at variance with the inferences drawn from the economic reasoning, but as political economy devices which help to keep policy-makers on course, they can have a pragmatic impact that belies their questionable theoretical rationale. This is just one example of the importance in thinking about how to run EMU of how the juridical viewpoint can enrich the economic analysis, rather than being seen as tangential to it. Economists would do well to take heed of works such as the *Eurospectator* study led by Jean Victor Louis (Louis, 2002).

The questions about economic policy co-ordination are many and there are strongly held views about its extent or form (see the contributions to: the special issue of *Empirica*, Vol 26.3, published in September 1999; Brunila et al., 2001; Buti et al. 2002; and Begg, 2002). How much co-ordination should there be? Should it be confined to individual policy areas or have a wider remit to cut across policy borders, perhaps even leading to outcomes where bargaining occurs on the settings of different policies? Should it be formal or tacit? What legal and institutional reforms will be needed if co-ordination is to be enhanced?

Criticisms of the policy framework

Although there have been no evident policy disasters so far, the EMU system is in a phase of 'learning-by doing' and has to evolve in a number of directions to fulfil its role. Six main strands of criticism of the current framework can be enumerated.

First, both monetary policy and fiscal policy are considered to be too focused on stability and not enough on growth. This is, in part, the result of the dominance of a single 'model' of how the economy works, but it also reflects the institutional separation of policy-making and the dominant position of the single monetary policy vis-à-vis fragmented fiscal policy and is compounded (Pisani-Ferry, 2002) by the uncertainty about what macroeconomic policy should try to do.

Second, the rules governing fiscal policy are pro-cyclical to the extent that governments (for example, Germany at present) are pushed to engage in fiscal tightening in a downturn, but do not face pressures for fiscal consolidation in good times and consequently lack incentives to do so. Thus, fiscal policy is too tight in a downturn and too loose in an up-turn and the overall impact is destabilising.

A third concern is that the policy machinery relies too much on rules that have no evident economic logic to them and that the underlying objectives become lost. The reference value for monetary policy and the use of concurrent fiscal ratios irrespective of the point in the cycle can be considered too crude and conceivably lead to ill-judged responses. Moreover, the underlying purpose of fiscal restraint – sound public finances – is not easily captured in simple rules. As Pisani-Ferry (2002) points out, 'there is wide agreement on the need for fiscal discipline in a monetary union, but there are several problems with our current definition of it'. He refers especially to the use of current rather than cyclically adjusted ratios, the neglect of public debt and of ~~all~~ balance-sheet public liabilities. In addition, the comment in a recent Commission Communication on reform of the SGP that 'the process of budgetary consolidation has ground to a halt since 1999, and in some cases has reversed' (Commission, 2002b) is symptomatic of a broader concern that the Pact does not (and cannot) promote fiscal discipline effectively.

The fourth criticism is to question whether the same rule makes sense for all Member States, a question that lay behind the comment of Romano Prodi, the President of the European Commission, who recently caused a stir by condemning the SGP as 'stupid'. In particular, a heavily-indebted

country that runs a deficit is at much greater risk of fiscal instability or indeed solvency problems. Equally, if a country has a good case for raising public spending – most obviously to bolster investment (the UK today; the new Member States tomorrow!) – the rules ostensibly inhibit such spending.

Fifth, it is evident that demand-side and supply-side policies are inadequately integrated, and also that there are gaps within the supply-side 'processes' – see TEPSA (2003).[3]

Finally, the ease with which some (especially larger) Member States have been able to flout (or at least appear to flout) the fiscal rules undermines their credibility. France, most prominently, has asserted its right to choose when to meet the medium-term targets of the SGP and, in so doing, has inflamed an already delicate dispute between larger and smaller Member States. The reluctance to comply is exacerbated by the nature of the enforcement mechanisms and sanctions. Giving Ecofin discretion to determine when early warnings should be issued – and ducking the hard choice at virtually the first time of asking – suggests that asking a peer group to judge a potentially delinquent Member State is unlikely to work.

Conclusions and suggestions for reform

Any system of economic management has to balance competing aims and a continuing worry about the proposals for reform of the ECB and the SGP is that they are too tame. Stability remains the focus, with little concession to growth imperatives such as the acknowledged need to accelerate and support structural reforms. In addition, the reforms would still not allow for optimising the policy mix, whether by co-ordinating national fiscal positions or providing a means of integrating fiscal, monetary and supply-side policies. Even a cursory look at how policy is being co-ordinated in the EU shows not only that there is much of it going on, but also that it is being done through an eclectic range of approaches.

The underlying question, however, is whether current arrangements provide a policy framework that is robust enough for what EMU will become five, ten or twenty years hence. In particular, can the present reliance on the OMC for so many important areas of supply-side policy survive and prosper? On this, the jury is out, but there are other facets of policy co-ordination that also warrant more thought. At the heart of the matter is what the EU has become, or is moving towards, as a system for economic governance. If the *finalité économique* is to be a substantially integrated European economy as is implicit in Article 2 of the Treaty, not to mention the rhetoric surrounding the single market and the necessity for it of a single currency, then Member State economic policies will have to be more closely aligned. If they are not, tensions in the system will inevitably grow, making it more difficult to maintain the integrity of the single market.

A challenge for co-ordination, plainly, is deliver integrated policy, even if many economists (including such influential figures as Otmar Issing at the ECB: see, Issing, 2002; Alesina et al., 2001) are sceptical about the need for more extensive macroeconomic policy co-ordination in the EU. They argue that, although a case can be just about be made on theoretical grounds for a 'policy mix' approach in which fiscal and monetary policy are set jointly, any possible benefits are heavily outweighed by political economy considerations. Issing believes that it would lead to confusion in responsibilities and objectives, and could undermine the credibility of monetary policy. Indeed, it could be argued that if any central bank is genuinely to be independent, then it simply cannot countenance any form of co-ordination that might lead it to compromise its mandate. Many other economists disagree vehemently and argue not only that co-ordination between fiscal and monetary

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[3] A study for the European Parliament on the 2003 Broad Economic Policy, to be published shortly as study ECON 133 entitled *A Background to the European Economic Policy 2003*.

policy ought to occur, but also that there are dangers in pinning so much on a single view of how the economy works. The notion that there is only one true model (Boyer, 2002) or that there can only be one feasible strategy for euro area policy is rejected by the latter group.

The alternative view is that piecemeal co-ordination – a range of procedures and co-ordinating bodies, with fiscal policies under one set, employment under another and very loose means of achieving 'Lisbon' aims - is not enough and that they should be reinforced by a powerful counter-weight to the ECB, fulfilling functions similar to those of the Finance Minister in a Member State. Just as Javier Solana has a mandate to bring together national foreign policies, there is a case for what French advocates call *gouvernement économique* to bring together economic policies. The Eurogroup, in a limited way, does this at present, but is an informal body with limited authority.

Towards reform

The starting-point for reform must be to review the overall economic governance system for EMU. It is a new policy regime that would be damaged if it was radically altered, but equally it must adapt and changed where there are problems. An incremental approach to reform is, therefore, called for.

EMU, as an economic system, clearly has to have economic co-ordination, as provided for in Article 99 of the Treaty, if policy anarchy is to be avoided. A broad observation about the present system is that it embraces both formal obligations rooted in hard law and very soft guidelines and recommendations. Yet there are two paradoxes inherent in the system. First, the supposedly hard rules are regularly breached and it is generally agreed that the ultimate sanction in the SGP (fines for delinquent Member States) are designed not to be used. Instead, it seems to be soft sanctions (for example, 'naming and shaming') and the political problems, above all domestically, of being seen to be in the wrong, that force governments to change course. Meanwhile the soft processes cannot be enforced and it will be all too easy for Member States to opt out of co-ordination precisely when it becomes most necessary.

The resolution of both paradoxes is to soften the hard processes and to harden the soft processes. The answer may lie in placing the Broad Economic Policy Guidelines rather than the SGP at the core of co-ordination, with their thrust less on fiscal discipline, narrowly defined, and more on the overall conduct of economic policy, including better integration of the supply-side. The inter-play between the restrictions on demand management implicit in the SGP and the scope for reinvigorating the supply side warrants attention, notably because of the tendency for public spending cuts to fall most on the public investment that is needed to accelerate structural reforms.

More radical proposals should also be explored such as the adoption of a 'golden-rule' for fiscal policy under which higher levels of public investment could be justified on 'Lisbon' grounds (Creel et al., 2002). Although such a rule would require careful definition and monitoring of eligible investments, the problems are not insuperable. Moreover, a golden rule need not be a loose rule: if necessary the benchmark could be set at a figure below zero, and there might well be scope for setting differentiated targets depending on national circumstances, for example impending pensions obligations.

Maintaining coherence and discipline will never be easy and there are no easy answers for delinquent Member States. Compliance is more likely to be assured if there is, first, a minimum of ambiguity and if targets make economic sense. Attention to the logic and definition of rules and targets would help and a shift to cyclically or structurally adjusted deficits would be an obvious first step. But there also has to be a political commitment to act responsibly, with the corollary of a political price to be paid for transgression. Giving the Commission or an independent body, rather than Ecofin, the authority to issue warnings would be an improvement.

Finally, it is important to move beyond a narrow, disciplining view of economic governance or else wider economic policy aims risk being lost. Political input should be boosted rather than considered secondary. Perhaps a *gouvernement économique*, a much more political body with both the clout to stand up to the ECB and the authority to shape economic policy at EU level is the answer (Boyer, 1999 and 2002; Jacquet and Pisani-Ferry, 2001). Three different arguments can be adduced in support of this notion. The first is that there is simply an imbalance in power that could result in too great a weight being assigned to narrowly monetary objectives, and not enough to the real economy, although some would argue that a low inflation environment is, itself, a precondition for raising the sustainable growth rate (Alesina et al. 2001). Second, some form of centralised economic power may be necessary to co-ordinate and agree the conduct of policy, with the implication that the existing co-ordination machinery is not sufficient for this purpose. This second argument has mainly been articulated in relation to fiscal policy, but could, as discussed above, conceivably be extended to embrace the supply side policies. In this regard, Pisani-Ferry (2002) advocates starting with at least a dialogue between the ECB and the Eurogroup on the interaction between structural reform and macroeconomic policy.

A third factor is that unless there is scope for political input in arriving at agreed decisions, policy making will take place within a normative vacuum. A closely related question is whether there is a single 'true model' of the contemporary capitalist economy towards which all but the misguided will want to converge. In appraising the case for *gouvernement économique* an important consideration is whether much of economic policy can ultimately be reduced to technical choices or has such significant distributive consequences that the political dimension must inevitably be paramount. The EMU system is, on the whole, in the former camp. An independent central bank, fiscal policy constrained by rules and attempts to chart a common way forward on the supply-side all point towards both the technical paradigm and the existence of an agreed model. Yet even the apparently minor spat in 2001 between the Commission and the Irish government over how big a budgetary surplus Ireland should run revealed not just conflicting views on the underlying economics, but also the relevance of political aims.

To sum up, the case for a *gouvernement économique* looks compelling in some respects, yet remains paper-thin in others. In particular the continuing opposition of so many Member States (see Solbes, 2002), buttressed by the principle of subsidiarity, means that it lacks political credibility at present. The history of European integration, however, contains many examples of institutional developments that seemed implausible just a few years beforehand – consider how far common defence has moved – so that the political obstacles could easily fade.

As the Convention completes its business and paves the way for the 2004 IGC, attention will also focus on how the system of economic governance of the euro area and the soon-to-be-enlarged EU as a whole should develop. This paper has tried to highlight a number of areas in which reforms and enhancements of the system will be under the microscope. Some of the possible changes would entail difficult political choices and legislative action that would arouse controversy, but others would require no more than 'tweaking' of present arrangements. Will our leaders be bold enough?

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