Center for European Studies
Working Paper Series #103

Hard and soft economic policy coordination under EMU: problems, paradoxes and prospects

by
Iain Begg*
Visiting Professor, European Institute
London School of Economics and Political Science

Abstract

Although the launch of the euro went better than many expected, sluggish growth, persistent unemployment and growing disenchantment with key elements of the economic governance system have led to demands for change, especially in policy coordination. This paper examines the criticisms of economic policy in the EU and the mechanisms through which it is coordinated, and considers how the EMU policy system might be reformed. It points to problems and paradoxes in the way economic governance operates, notably those surrounding its ability to deliver a coherent policy mix that brings together monetary fiscal and supply-side policies. The paper concludes with a discussion of whether *gouvernment économique* might offer a way forward.

* This article draws on a research project generously funded by the British Economic and Social Research Council and the 'Govecor' project funded by DG Research of the European Commission (www.govecor.org).

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, have been subject to increasing condemnation. Awkward questions are being asked about the rationale and arrangements for economic policy coordination (see, for example, Pisani-Ferry, 2002). Indeed, 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 emerging system of economic governance (Buiter et al., 1993; Boyer, 2002). In particular, the Stability and Growth Pact (SGP) – never loved – is in trouble and appears to have been undermined by a reluctance to abide by its terms on the part of large Member States, one of which – Germany – is the very country that demanded it.

The record so far…
Despite these concerns EMU has, in many respects, exceeded expectations. The machinery for decision making on monetary policy functions effectively and few people look back nostalgically to national monetary policymaking. The introduction of euro notes and coins has been so smooth that the catalogue of horror stories that the more euro-skeptic press, notably in the UK,[1] 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 States and this can raise problems in the coordination of Member State policies called for in Article 99. But it is, perhaps, worth stressing that, 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.

However, the EU now has to confront sluggish growth, persistent unemployment and an apparent inability to deal with weaknesses in the supply side of the economy. As successive forecasts are scaled back,[2] 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 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 analyzed and dealt with.

With enlargement of the EU now agreed, a fresh look at the structure of economic policy in Europe is, therefore, warranted and timely. There are growing doubts about whether key components of economic policy – notably the 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). In particular, it

[1] 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."
[2] The latest Commission biannual forecasts, published in April 2003, have emulated those from the four previous rounds in having lower growth projections for the next two years (Commission, 2003a) than those published six months before.

is worth asking what the evidence reveals about whether the right choices have been made about *how* policy is coordinated.
The questions about economic policy coordination 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 coordination 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 coordination is to be enhanced? Advocates of firm rules, drawing on the seminal contributions of Kydland and Prescott (1977) and Rogoff (1985), appeared to have won the battle to shape the EU policy system by tying the hands of both fiscal and monetary policy-makers. Yet it is the rigid application of these firm rules that is now in the dock, witness Prodi's clarifications of his "stupid" comments on the SGP.

There is, however, more to the EU system than simple rules for the two sides of demand management. The system brings together very different mechanisms of coordination, 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, 2002a). Although the only dimension of economic policy to which the open method of coordination (OMC) is formally applied is employment policy, soft forms of coordination operate in a number of other ways, most notably through the Broad Economic Policy Guidelines (BEPGs).

This paper examines the criticisms of economic policy in the EU and the mechanisms through which it is coordinated and considers how the EMU policy system might be reformed. The next section reviews the emerging system of economic governance in the EU (and specifically EMU), and points to where, and how, hard and soft mechanisms apply. The subsequent section discusses some of the problems and apparent paradoxes inherent in the system, then prospects are discussed. Concluding remarks complete the paper.

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 brought together in a policy framework that differs markedly from those of Member States. Yet it is often analyzed 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. In addition, because of political imperatives that have resulted in a delicate balance of power between Member States and the supranational level, EMU has also had to establish means of coordinating a range of national policies in a much more explicit and ordered manner than the largely informal arrangements seen at the level of the G7/G8. Only the post-war Bretton Woods system came close to the scope of demand-side coordination now in place in the EU, and there is no obvious parallel for the supply side.

Since the late 1980s, a consensus has developed on the broad orientation of economic policy that can be characterized 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 SGP rules. 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 labor market. A characterization 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, for fiscal policy to fulfill its adjustment role, there has to be a margin to allow the automatic stabilizers to work. The gap between "close to balance or in surplus" and the 3 percent 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 regularly been 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 fifty rather than twenty-five 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 counterproductive, so that again it is a moot point whether the Fed or the ECB has followed the best route.

Nevertheless, a key worry about the ECB is that its 2 percent reference value for price stability is simply too low, resulting 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 (de Grauwe, 2002). 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 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 (see de Grauwe, 2002). The trouble with the proposed compromise is that it will 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 coordination

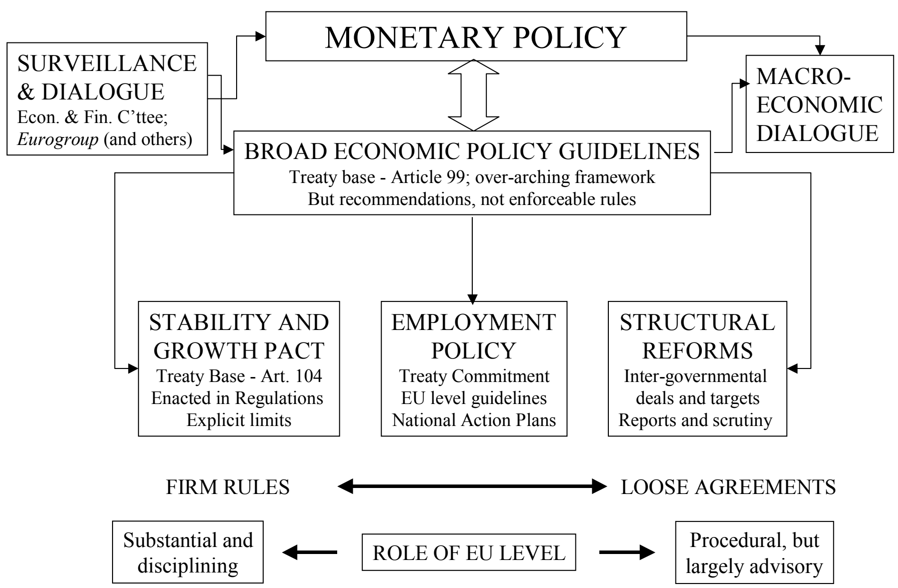
Although fiscal policy in the EU remains a competence of Member States, it is subject to constraints embodied in the SGP. From a theoretical perspective, the reasons for restricting the ability of individual Member States to borrow can be summarized under two main headings:

> – 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 monetize debt. If Member States face limited market sanctions, they will have incentives to raise debt levels,

engendering risks of a need for a bailout. 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 coordination at EU level (see chart). Policy coordination can be defined in this context as supranational rules or norms which are agreed upon 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 some Member States have internal rules as well.

What is conspicuously missing however, is any formal means of coordination 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, although there are the two mechanisms shown for exchanges of views, including the political forum of the Eurogroup. Thus, on one of the key issues of policy management, it is soft procedures which dominate and which, in practice, represent the sole means of arriving at an overall macroeconomic policy orientation. One consequence of this arrangement is that opportunities for normative input into the choice of policy are severely circumscribed, so that the underlying "stability" model is not subject to challenge.



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 also a critique that 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 intergenerational equity. Moreover, a single reference value such as the 3 percent 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 policymakers 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 (see, for example, Louis, 2002).

Supply-side policies
On the face of it, the supply side is well covered in the policy framework, with explicit processes covering employment (Luxembourg) and product market reform (Cardiff), topped up by the looser ambitions agreed at the 2000 Lisbon European Council. The European Employment Strategy (EES) has, arguably, contributed to a general rethinking of how labor-market adjustment can be achieved, although it is open to the criticism that too many of the guidelines are tangential to a genuine adjustment strategy, with their focus more on activation and equity related aims. This is, in part, because the focus of the EES has been on employment policies *per se* and not on the broader contribution that they might make to steering the economy. But it is also because the links from the Luxembourg process to other structural reform measures have been inadequately developed in the institutional framework. In particular, the hard parts of labor-market reform, notably the flexibility of wages and of the regulatory framework, are only tangentially affected by the Luxembourg process and outside the scope of the Cardiff process, even though the BEPGs have, for several years, ritually called on Member States to speed up labor-market reform: thus, chapter 3 of the guidelines in 2002 was headed "Invigorate labour markets." Yet even here, the detailed recommendations stop short of confronting these two dimensions of flexibility convincingly.

Although the Commission review of the 2002 BEPGs offers a broadly favorable assessment of how the labor-market recommendations have been implemented, signs are detected that the pace of reform may have slowed, while hidden away is the statement that "reforms of employment protection legislation (EPL) have received little or no attention" (Commission, 2003b: p.25).

Criticisms of the policy framework

Although there have been no evident policy disasters so far, the system for economic governance is in a period of "learning by doing" and has to evolve in a number of directions to fulfill its role. The current phase of stagnation of the EU economy, now forecast (Commission, 2003b) to persist throughout 2003 and with forecasts for 2004 also having been reined back, is putting additional stress on the SGP's credibility. Italy is now expected to join France and Germany in exceeding the 3 percent reference value which means that the three largest economies – over two thirds of the euro area GDP – would be in breach of the rules. Although formal excessive deficit procedures have now been launched against Germany and Portugal, with a warning issued to France, and Italy possibly next in line, there is little sign that these formal procedures are having any meaningful influence, other than embarrassing the respective governments through the impact on public opinion.

On the whole, decisions on monetary policy have been consistent with the policy framework, while fiscal policy has not been too out of line. The slippage on deficits can be attributed principally to the lethargy of the recovery, though some critics claim that Germany and others might have done more in the favourable economic climate of the early years of the euro to "consolidate" their budgets. Meanwhile, structural reforms continue to be difficult to achieve. This suggests that the problems of governance lie more with the policy framework. Six main strands of criticism 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 policymaking 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 destabilizing.

– 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 off 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. 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 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.

[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*.

These problems point to a number of obvious potential directions for reform, with the emphasis on rethinking the system of governance rather than the rules themselves. They also highlight the importance of optimizing between hard and soft approaches, and reform will also need to take heed of a number of apparent paradoxes in the functioning of the system.

Paradoxes

EMU, as an economic system, clearly has to have economic coordination, as provided for in Article 99 of the Treaty, if policy anarchy is to be avoided. But there are a several inconsistencies or, indeed, paradoxes inherent in the system. First, the supposedly hard rules are regularly breached by both the monetary and fiscal authorities. Yet it is generally agreed that the ultimate sanctions 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.

A second paradox is that the soft processes cannot be enforced and it will be all too easy for Member States to opt out of coordination precisely when it becomes most necessary. This may be the result of a lack of credible incentives as much as prospective sanctions: it can be argued that the strong target of entry into stage 3 of EMU provided substantial incentives to governments to conform to a coordination system, but in the current system, the rewards are lesser.

Third, the least tractable structural problems are regarded as off limits for policy coordination, not because coordinated action, as such, is adjudged to be the wrong approach, but because the governments have been loath to take the first steps. Thus, in employment policy, modernization of the regulatory framework has been very timid, while wage flexibility is not confronted. An interesting slant on the various supply-side policies is contained a line in the 2003 spring Presidency Conclusions (European Council, 2003) in which the "European Council invites the Commission in preparing its report for 2004, to analyse the measurable differences which Lisbon's integrated approach has brought about, and assess how Member States have achieved this success and improved their position, including showing how the Lisbon objectives are being achieved through regulatory reform." Reading this, the impression is that the evidence is less than compelling.

A further paradox is that a supposedly rule-based system, with hard law provisions governing both fiscal and monetary policy, relies so heavily on soft procedures – dialogue and consultation, as shown in the chart – to achieve a coherent policy mix. Despite the aim, articulated in the 2003 spring Presidency conclusions, of achieving "a more comprehensive, efficient and coherent approach" within which "sound macroeconomic policies must be pursued in order to restore confidence and economic growth," the means of achieving both the horizontal coordination of fiscal policy and the mix with monetary policy are not spelled out. In the 2003 BEPGs, the aim is "stabilising output around a higher and sustainable growth trend," yet when the it comes to *how*, the emphasis is predominantly on fiscal and supply-side policies, with no reference to monetary policy.

The challenges confronting coordination

A challenge for coordination, plainly, is to 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 skeptical about the need for more extensive and explicit macroeconomic policy coordination 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 coordination that might lead it to compromise its mandate. Many other economists disagree vehemently and argue not only that coordination between fiscal and monetary 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 can only be one feasible strategy for euro area policy is rejected by the latter group.

The alternative view is that piecemeal coordination – a range of procedures and coordinating 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 counterweight 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.

Can better, more effective coordination, possibly with a fresh approach to the implementation of hard and soft mechanisms, be achieved? In the last year or so, the procedures for policy coordination have come under intense scrutiny. The current imbroglio focuses attention especially on the respective merits of hard and soft means of policy coordination. Although once again it is the SGP which has been to the fore, the outcome will also see major changes in the way soft coordination functions. The aim of the changes is, above all, to achieve better coordination of the various forms of coordination, while also making it more strategic in character: "streamlining" is the watchword. Yet it is also apparent that, paradoxically, it is in the soft policy arena that a way forward has been settled, whereas reform of the SGP remains in abeyance. Thus, the BEPGs have been shifted from an annual to a triennial cycle (albeit with provision for annual updates), while the Employment Guidelines have not only been reorientated towards medium-term "Lisbon" objectives (2010), but have also been significantly remodeled: the "ten commandments" (see box 1).

The draft 2003 BEPGs adopted in early April by the Commission do now relate employment objectives to those in the parallel employment guidelines: indeed, the relevant passages in the BEPGs explicitly mention the individual employment guidelines to which they relate. Similarly, the Employment Guidelines stress the need for a common approach noting that "the Broad Economic Policy Guidelines provide the overarching economic policy coordination for the European Union." All the right words are articulated in the promise "to increase transparency and efficiency, avoid overlap and repetitions in the formulation of guidelines, and ensure consistency, complementarity and coherence." As always, it looks good…

But the draft BEPGs (Commission, 2003d) again illustrate the core policy-mix problem in the ultimately pointless statement (given that it paraphrases what the Treaty says) that: "**Monetary authorities should pursue price stability** and, subject to this being achieved, support the general economic policies."

This is followed by three rather bland recommendations concerning: respect for the "close to balance or in surplus" rule and a commitment to improve the cyclically adjusted budget balance by 0.5 percent of GDP; the avoidance of pro-cyclical policies, especially in anticipation of a return to growth, coupled with stronger coordination; and wage moderation.[4] Moreover, the text addressed to the euro area risks being seen as "motherhood and apple pie" recommendations, rather than anything with bite (see box 2). What this illustrates is the inherent difficulty in a soft, strategic process of saying enough to be meaningful and constructive in highlighting problems, being broad enough to be strategic, yet respecting subsidiarity and national sensitivities.

Thus, despite the reform initiatives of the last year, key coordination challenges are likely to remain unresolved. A crucial question is whether the political will, not to mention the means, exists to assure compliance with the agreements. For hard policy coordination this could well be crunch time: can a reformed SGP

[4] It could be argued that the conjunction of a recommendation to move towards balance – even softened by the reference to the cyclically adjusted budget position – and one about the avoidance of pro-cyclical fiscal policy is oxymoronic (or perhaps the "oxy" should be deleted…).

be made to fulfill its designated role, or should a different approach to fiscal policy coordination now be put in place? A key characteristic of soft coordination is that it encourages policy learning and enhancement, and can thus be portrayed as having positive rather than disciplining functions. But to the extent that soft processes also have to constrain Member State discretion in the pursuit of common aims, can they be effective, and if so, how?

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 optimizing the policy mix, whether by coordinating national fiscal positions or providing a means of integrating fiscal, monetary and supply-side policies. Even so, a cursory look at how policy is being coordinated 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 coordination 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.

Towards reform

The starting point for reform must be to review the overall economic governance system for EMU in the light of "streamlining." It is a new policy regime that would be damaged if it were radically altered, but equally it must adapt and change where there are problems. An incremental approach to reform is therefore called for. An obvious resolution of the first two paradoxes outlined above would be simultaneously to soften the hard processes and to harden the soft processes. Placing the Broad Economic Policy Guidelines rather than the SGP at the core of coordination is an important start. Their thrust is less on fiscal discipline, narrowly defined, and more on the overall conduct of economic policy, including better integration of the supply side. One key development is the establishment, in the context of rationalizing – or perhaps re-weighting – the Council formations, of the Competitiveness Council. While it should give greater coherence to the supply side, it remains to be seen whether the gaps in supply-side coordination can be bridged.

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. 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. 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.

More radical proposals should, nevertheless, be explored. Scharpf (2002), in looking at social policy, has advocated what he calls framework directives as a means of providing legal underpinning to the OMC. It can be argued that the case for doing so in relation to the BEPGs might be stronger still, as it would be a means of enhancing their disciplining role. "Punishments" such as withholding of Structural Funds' payments have been mentioned, but would probably poison relationships rather than help. Instead, it is important to look beyond a narrow, disciplining view of economic governance both to ensure that the underlying economic policy aims are not forgotten and that political commitment to successful policy – even if it is awkward in the short term – is reinforced. In this context 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 the 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 centralized economic power may be necessary to coordinate and agree the conduct of policy, with the implication that the existing coordination 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?

References

Alesina, A., Blanchard, O., Galí, J., Giavazzi, F., and Uhlig, H. (2001). *Defining a macroeconomic framework for the Euro area*. Centre for Economic Policy Research, London.

Allsopp, C.J., (2002). "The future of macroeconomic policy in the Euro area." Presented to the Austrian Institutute of Economic Research (WIFO), February 2002. Available as Discussion Paper 7. External MPC Discussion Paper Series, Bank of England.

Begg, I. (2002a). "Running EMU: the Challenges of Policy Coordination," in Begg I. ed, pp. 13-28.

Begg, I. ed. (2002b). *Europe, Government and Money – Running EMU: the Challenges of Policy Coordination*. London: The Federal Trust.

Boyer R. (sous la présidence) (1999). *Le gouvernement économique de la zone euro*. La documentation française, Paris.

Boyer R. (2002). "Coordination of economic policies in Europe: from uncertainty to apprenticeship," in Begg I. ed., pp. 39-54.

Brunila, A, Buti, M. and Franco, D. eds. (2001). *The Stability and Growth Pact: The Architecture of Fiscal Policy in EMU*. Basingstoke: Palgrave.

Buiter W.H., Corsetti, and Roubini N. (1993). "Excessive Deficits: Sense and Nonsense in the Treaty of Maastricht." *Economic Policy* 16: 57-100.

Buti M. von Hagen J. and Martinez-Mongay C. eds. (2002). *The Behaviour of Fiscal Authorities*. Basingstoke: Palgrave.

Creel, J., Latreille, T. and Le Cacheux J. (2002). "Le Pacte de stabilité et les politiques budgétaires dans l'Union européenne," *Revue de l'OFCE* 81 (March).

Commission (2002a). "Coordination of economic policies in the EU: a presentation of the key features of the main procedures." DG for Economic and Financial Affairs Euro Papers No. 45.

Commission (2002b). "Communication to the European Parliament and Council: strengthening the coordination of budgetary policy." 27/11/2002, COM(2002) 668 final.

Commission (2003a). "The report on the implementation of the 2002 Broad Economic Policy Guidelines." (To be published as *European Economy*. No. 1 2003. Office for Official Publications of the EC. Luxembourg).

Commission (2003b). "Spring 2003 economic forecasts." Directorate-General for Economic and Financial Affairs, Brussels.

Commission (2003c). "Proposal for a Council decision on guidelines for the employment policies of the Member States." Brussels (8 April).

Commission (2003d). "Commission recommendation on the Broad Guidelines of the Economic Policies of the Member States and the Community (for the 2003-2005 period)." COM(2003) 170 final, Brussels, (8 April).

European Council (2003). "Presidency Conclusions, Brussels European Council, 20 and 21 March 2003." Brussels.

Fitoussi J.P. and Creel J. *How to Reform the European Central Bank*. London: Centre for European Reform, October 2002.

De Grauwe P. (2002). "Challenges for monetary policy in Euroland." *Journal of Common Market Studies* 40: 693-718.

House of Lords (2003). *The Stability and Growth Pact Report of the European Communities*. Select Committee.

Issing, O. (2002). "On macroeconomic policy coordination in EMU." *Journal of Common Market Studies* 40: 345-368.

Jacquet, P. and Pisani-Ferry, J. (2001). *Economic Policy Coordination in the Euro-Zone: what has been achieved? what should be done?* London: Centre for European Reform.

Kydland, F.E. and Prescott, E.C. (1977). "Rules rather than Discretion: Time Inconsistency of Optimal Plans," *The Journal of Political Economy* 85,3: 473-492.

Louis J-V. ed. (2002). *The Euro in the National Context*. London: The British Institute of International and Comparative Law.

Pisani-Ferry J. (2002). "Fiscal Discipline and Policy Coordination in the Eurozone: Assessment and Proposals." Paper prepared for the European Commission President's Group of Economic Analysis.

Rogoff, K. (1985). "Can international monetary policy cooperation be counterproductive?" *Journal of International Economics* 18: 199–217.

Solbes, P. (2002). "Economic Policy Coordination - the Way Forward." Brussels Economic Forum, 2 May 2002, mimeo

Box 1: The Employment "Ten commandments"

To support the three objectives of full employment,
quality and productivity at work
and cohesion and an inclusive labour market,
the new guidelines identify ten priorities ("ten commandments") for action:

1. help unemployed and inactive to find a job, prevent long-term unemployment
2. encourage entrepreneurship and improve climate for business start-ups
3. promote adaptability of workers and firms to change
4. provide more and better investment in human capital
5. increase labour supply and promote active ageing
6. promote gender equality in employment and pay
7. combat discrimination against disadvantaged groups
8. improve financial incentives to make work pay
9. reduce undeclared work substantially
10. promote occupational and geographical mobility