

## ECONOMIC POLICY COORDINATION IN THE EUROPEAN UNION

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There are differing views about the need for economic policy coordination in the EU and about the adequacy of the system that has evolved under EMU. This article examines the case for such policy coordination, then describes and assesses the current arrangements for both 'hard' coordination – epitomised by the much-maligned Stability and Growth Pact (SGP) – and the 'soft' forms of coordination that have evolved in the EU to complement formal rules. Although the system achieves more than is sometimes recognised, it is shown to have weaknesses. Options for reforming the SGP and other facets of the system are discussed.

A crucial question for the success of EMU 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; Eichengreen and Wyplosz, 1998). The Stability and Growth Pact (SGP) – one of the most prominent facets of coordination – has consistently been lambasted by economists as an ill-conceived, blunt and ultimately counter-productive set of rules that encourage procyclical fiscal policy, inhibit economic recovery and damage the long-term growth potential of the EU economy. The charge sheet also cites the inability of the policy system to deliver a coherent policy mix and bemoans the lack of flexibility in the conduct of policy. Subtly, too, the effectiveness of the EU's fiscal policy rules has become an unofficial sixth test for the UK to sign-up to the euro.

Macroeconomic policy in the Keynesian tradition, as articulated by the likes of James Meade and Jan Tinbergen, conceived of the policy mix as a means of assigning the available policy instruments to a range of macroeconomic target variables. In the simplified systems of simultaneous equations used to model this mix, the number of instruments had to be at least as great as the targets. The Euro Area system is altogether different. Monetary policy is assigned to the ECB, which has strong independence, and is meant to focus primarily on the price stability of the Euro Area as a whole. Fiscal policy, by contrast, remains with the

Member States and is meant to be the means by which individual economies adjust the demand-side of their economies to reflect national divergences from the Euro Area average. The essential problem at the European level is how to ensure that there is compatibility between the single monetary policy and the potentially divergent national fiscal policies (and, indeed, other dimensions of economic policy).

Policy coordination can be defined in this context as supranational 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. Action to enforce the rules or, at least, to assure conformity with the spirit of shared policy aims will be triggered if there is a failure to keep within the parameters set by the legislation. For example, there are Treaty commitments to avoid excessive deficits that apply to all Member States (including those not participating in the euro), with sanctions if they fail to do so: this can be characterised as 'hard law' coordination. A different approach relies solely on soft law measures (such as naming and shaming governments) without the back-up of explicit formal rules.

Despite impressions to the contrary, the procedures for policy coordination in the EU are quite extensive (for an overview, see European Commission, 2002a). Article 99 of the *European Community Treaty* calls on Member States to regard economic policy as a matter of common concern and to coordinate their policies within Council (and through a range of committees and mechanisms) with a view to achieving, *inter alia*, stable and non-inflationary growth. It is, however, sometimes hard to ascertain where effective control lies in a system that

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involves so many players. Moreover, some facets of coordination apply identically to all EU Member States, while others are only applicable to participants in stage three of EMU, i.e. those that have adopted the euro.

There is an intense debate about whether more extensive macroeconomic policy coordination in the EU is desirable. Some protagonists are unequivocal. Alesina *et al.* (2001) and Issing (2002) are adamant that it is not necessary, arguing that although a case can 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. This echoes the warning of Rogoff (1985) that international macroeconomic policy coordination will endanger the credibility of stability orientated monetary policy – see also the survey by Muscatelli and Trecroci (2000). The essence of the Alesina *et al.* case is that if the respective authorities 'keep their houses in order', all will be well. In terms of who does what, it falls to monetary policy (and thus the ECB) to deal with symmetric shocks or adjustments, while fiscal policy (national finance ministries) has the primary responsibility for asymmetric shocks (see Buti and Giudice, 2002).

Equally, there are growing doubts about whether the mechanisms currently in place in the EU are doing their job. 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. Romano Prodi, the President of the European Commission, recently caused a stir (and, apparently, considerable dismay amongst some of his fellow Commissioners) by condemning the SGP as 'stupid'. 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.

Nevertheless, reform is in the air and major changes are already in the pipeline. This article examines the setting for economic policy coordination in the EU and, more narrowly, the Euro Area, assesses its effectiveness and considers how it might be reformed. In particular, we draw attention to the need to look beyond the SGP in rethinking coordination. The next section focuses on the rationale for policy coordination, then we describe and appraise the current system in the EU. Potential reforms are explored and conclusions complete the paper.

## The objectives of coordination

It is useful to clarify what the end goal of economic policy coordination (particularly as proposed in the Euro Area) is. In political economy terms, it can be thought of as a means of resolving two dilemmas. The first can be understood as a problem of social cost and concerns the difficulties of implementing many fiscal policies within a single monetary union. The second is essentially a problem of collective action and concerns the 'provision' of central bank credibility in a decentralised fiscal regime. Coordination aims to achieve a harmonious macroeconomic policy mix comprising fiscal and other policies that are both mutually compatible and consistent with the objectives of the ECB's monetary policy. The worth of the Euro Area's policy architecture should, consequently, be assessed on its ability to support both aims.

### *Economic policy coordination and the problem of social cost*

Under EMU, social costs may arise when Member States act in an uncoordinated fashion and produce national fiscal positions that are seriously harmful to economic stability in other Member States. If Euro Area fiscal policies can be coordinated so as to deal with the common concern of all Member States, the side effects of fiscal profligacy will be reinternalised (Commission Working Group 4a on Governance, 2001). From a Mundell-Fleming open macroeconomy perspective, if exchange rates are able to float freely, deficit spending by a domestic government would have 'crowded out' private investors in the domestic economy through a higher domestic interest rate. Aggregate demand would have been depressed still further by the appreciation of the domestic exchange rate in the face of monetary tightening. Under these circumstances, a government had little incentive to pursue a loose fiscal policy since this would cause only tighter monetary conditions and a loss of international competitiveness. Within a supranational monetary union, however, internal exchange rates are fixed and there is a single interest rate for all members. A Member State running a deficit will no longer face a higher real exchange rate vis-à-vis the rest of the currency zone, while the burden of crowding out will be shifted onto the currency zone as a whole in the form of a higher unified interest rate. Thus, Member States can externalise the costs of excessive deficits and the need to exercise fiscal restraint is, by implication, diminished (Aizenman, 1994; Allsopp and Vines, 1996; Beetsma and Bovenberg, 1999). If all

Member States are free to act on this incentive – and this is clearly the case in a decentralised fiscal regime – then a retaliatory and discordant mix of fiscal policies will lead to a deterioration in the aggregate fiscal position (Agell *et al.*, 1996; Collignon, 2001). Assuming that the single currency has a flexible exchange rate vis-à-vis the rest of the world, the effect will be a higher currency zone interest rate and a loss of international competitiveness. This outcome is socially suboptimal for the currency zone and we argue that a similar logic applies to supply-side policies.

### *Economic policy coordination and the problem of collective action*

Independence from unwanted political influence and clear and unambiguous policy preferences are the corner stone of credible monetary policy (Cukierman, 1992). Even with such measures in place, however, fiscal policy – as Sargent and Wallace (1981) famously noted – must be consistent with the objectives of monetary policy if the credibility of the central bank is to be maintained. However conservative or independent the central bank might be, a fiscal authority that runs excessive budget deficits over a prolonged period will place the bank under mounting pressure to monetise the public debt and hence compromise its commitment to stable prices. In the case of EMU, a Member State that defaults on its public debt will lead to capital impairment amongst its creditors, not least the commercial banking system. The risk that this banking crisis will spread to the rest of the Euro Area would place the ECB under intense pressure to bail out the profligate Member State, even if this destabilised Euro Area prices in the process (Eichengreen and Wyplosz, 1998). So long as private agents believe that the ECB would succumb to this pressure and providing that Member States retain the right to behave in a profligate manner, the central bank will ultimately lack credibility. Again, much the same logic applies to various supply-side policies. Consider, for example, the prospect of inflationary wage settlements. Wage bargaining that pushes the Phillips' curve outwards will, arguably, engender pressures for the bank to accommodate the resulting inflation to avoid industrial unrest.

This can be interpreted as a problem of collective action if the credibility of monetary policy in a federal union is viewed as a public good. The good is non-excludable in the sense that each Member State will benefit in terms of price stability and a lower cost of disinflation once the central bank policy is perceived as being credible

(Blinder, 1999) and non-rivalrous, in as much as no member can be excluded from these benefits once credibility can be achieved (Jacquet and Pisani-Ferry, 2001). As with all public goods there is the risk that some Member States might free-ride on the fiscal prudence of their peers and still enjoy the benefits of credibility. But if too many do, the aggregate stances of other policies will be inconsistent with the objectives of monetary policy, thus eroding the credibility of the central bank. The end goal of economic policy coordination, in this instance, is, to borrow a second phrase from the Commission's White Paper on European Governance (Commission Working Group 4a, 2001), to promote consistency between national policies and the Community's objective of monetary credibility.

### *The case against coordination*

The core of the argument against coordination is the fear that an arrangement under which monetary authorities seek instruction from fiscal authorities (and vice versa) would directly compromise Article 108 (TEC), confuse the roles of fiscal and monetary policy (Issing, 2002) and jeopardise the credibility of the ECB. Even if the institutional ties between fiscal and monetary authorities remain unchanged under coordination, the mere fact that centralisation reduces the number of independent fiscal players in the Euro Area will increase the (potential) pressure on the ECB to monetise excessive public debt. If the bank shows signs that it would capitulate to this pressure and permit Member States to externalise the costs of excessive deficits, then the prior constraints on fiscal profligacy will have been removed (Beetsma and Uhlig, 1999). Under these circumstances, the common policy approach to coordination contradicts its primary purpose by generating greater inconsistency in the macroeconomic policy mix.

In a similar vein, Alesina *et al.* (2001) criticise proposals for enhanced fiscal and monetary policy coordination on the grounds that they would unavoidably create a forum in which Member States could bring pressure to bear on monetary policy. Policy coordination might help to solve the problems of social choice and collective action, but in so doing it jeopardises the credibility of monetary policy. Since monetary credibility is an overarching principle in the design of EMU, politicians and economists alike have largely discounted common policy as a realistic cure for the Euro Area's ills.

### *Coordination in the design of EMU*

The two main blueprints for monetary union in Europe, put forward in the 1970 Werner Committee report and the 1989 Delors Committee report which was largely taken forward in the Maastricht Treaty, had diametrically opposed proposals on fiscal policy. Under the Werner plan, exclusive competence for monetary policy would have been transferred to a European Central Bank, while the responsibility for formulating a consistent Community fiscal policy would have rested with a parallel Centre for Economic Decision Making. The contrast with the decentralised approach to fiscal policy now in force is evident. This change of heart reflected growing misgivings about the benefits of policy coordination alongside doubts amongst certain Member States about the true motives for further fiscal integration. Germany, most notably, feared that a supranational fiscal authority would become a Trojan horse from which politicians could emerge to attack the independence of the ECB (Dyson, 2000).

In part, the reasoning reflects the seminal contribution of Rogoff (1985), who warns that a binding commitment to coordinate macroeconomic policies would create an incentive for individual central banks to jeopardise their commitment to price stability. Yet, although a centralised fiscal policy was thus unpalatable to Member States, so too was the prospect of a fully decentralised approach. The case against decentralisation reflects, in part, the suboptimality of an optimal control approach to stabilisation policy in the presence of rational agents and when the underlying structure of the economy is not well known. Kydland and Prescott (1977) find that under such circumstances, maximising the social objective function with regard to the current period will lead to a higher rate of inflation and an unemployment level that is no lower than the optimal rate. The solution for Kydland and Prescott (1977, p. 487), lies in a coordinated approach to economic policymaking, which makes it 'a difficult and time-consuming process to change policy rules in all but emergency situations'.

If the logic of Rogoff (1985) is reflected in the absence of a centralised approach to fiscal policy within the institutional architecture of EMU, then the Kydland and Prescott (1977) approach to economic policy is reflected in the presence of two distinct modes of decentralised coordination. However, although they are conceptually distinct, in practice the two modes operate in tandem.

*Hard policy coordination* tends to have top-down policy formulation, with the supranational level playing the dominant role. Implementation lies with national authorities, but failure to conform may lead to enforcement by the supranational body or the triggering of financial penalties and fines. It has a disciplining role and seeks to impose an agreed model of how the economy functions, a feature which has been heavily criticised (see Boyer, 2002). It nevertheless combines wide discretion for national authorities within the context of a common commitment to coordination backed up by more specific legal rules. The binding rules are designed to guard against extreme political decisions (Rawlinson, 1993) or deleterious effects which might result from common policies.

*Soft policy coordination* takes the form of 'guidelines, frameworks, communications, codes and even at times letters' (Cini, 2001, p. 194), designed to achieve a balance between policy credibility, political stability and policy flexibility. It entails a multi-annual approach to economic policymaking, which publicly precommits Member States to deliver agreed policy objectives. Soft policy coordination also goes beyond the coercive logic of Kydland and Prescott (1977) by placing greater emphasis on policy learning and consensus building. Mechanisms such as peer review and benchmarking are, nevertheless, used to promote a common approach. What distinguishes this form of coordination is that it has the positive aim of improving the quality of policy, rather than constraining discretion. It also, to some extent (and this is especially true of the supply side) provides incentives to governments to stick to agreed approaches so as to lessen the spillover effects of divergent policy. In regulating, for example, governments may have a collective interest in avoiding the so-called 'race to the bottom'. Moreover, as Hughes Hallett *et al.* (2000) show, effective labour market reforms can ease the macroeconomic coordination problem.

### **Main features of coordination in the EU**

In practice, both hard and soft coordination as described above are in evidence in the EU today, although, as we show in table 1, the 'soft' approach can be further subdivided into what we characterise as 'guided' coordination and 'loose' coordination. The former is unique to the EU in that there are formal guidelines and procedures that Member States agree to follow that flow from Treaty commitments. By contrast, the looser forms of coordination are much more akin to

**Table I. Modes of coordination: key characteristics**

Mode of coordination and EU examples	Legal and institutional setting in EU	Coercive mechanisms			Non-coercive mechanisms		Potential	
		Legally binding	Financial penalties	Peer pressure	Exchange of best practice	Consensus building	Advantages	Disadvantages
Rule-based: the SGP	Explicit in the Treaty and given force in formal regulations.	Yes	Yes	Yes	No	Initially, but disputes over 'true' economic model.	Precise and easily monitored.	Difficult to trigger. Little emphasis on learning or national diversity.
Guided: the BEPGs and the European Employment Strategy	Treaty-based, but only enabling provisions.	No	No	Yes	Yes	Ongoing	Easier to trigger and fit to national circumstances. Provides scope for learning.	Lack of enforcement. Cosmetic?
Loose: Lisbon aims	Result of European Council conclusions.	No	No	Limited to exhortation.	Only informally.	Tries to be, but national interests intrude.	Sets long-term agenda.	Subject to vague commitments.

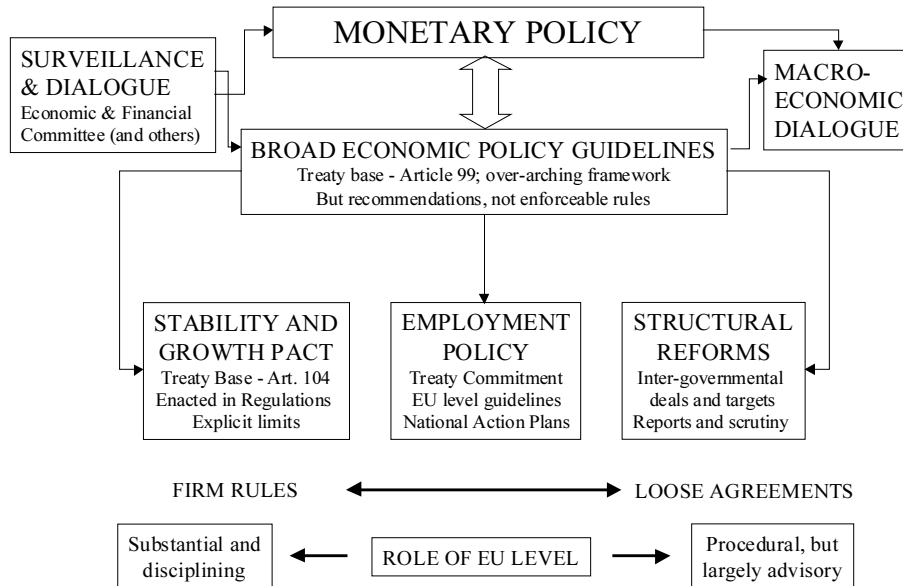
the sort of target-setting that emerges from inter-governmental fora such as the G8 or the OECD. The coordination mechanisms have grown up partly to facilitate the conduct of monetary policy, but partly also to provide means of dealing with other perceived policy challenges. The ECB has the power to set interest rates and to enact laws binding on the Member States. Those states in turn are obliged to comply with those norms under their general duty of loyalty articulated in Article 10 EC or run the risk ultimately of an enforcement action being brought against them before the European Court of Justice by the EC Commission under Article 249 EC. Coordination of policy via the SGP is intended to limit the degree of divergence between countries so as to avoid either spillovers that might have an impact on others or aggregate fiscal policy that would engender problems for monetary policy. Formally adopted by the European Council in June 1997, it is designed to 'safeguard sound public finances as a means to strengthen the conditions behind price stability . . . and to ensure that national budgetary policies support stability oriented monetary policies'.<sup>1</sup>

In addition, there are various means by which economic policies more generally are coordinated. The most comprehensive of these is the *Broad Economic Policy Guidelines* (BEPGs) through which the EU level sets out a series of recommendations for the broad thrust of economic policy. These guidelines comprise general policy aims for the EU as a whole (and not just the Euro

Area), together with specific recommendations for individual Member States. They are both broad and comprehensive, covering macroeconomic policy (for which, read fiscal), a range of labour market and other supply-side policies, and sustainable development. Overlapping with the BEPGs are specific coordination 'processes' that try to foster common approaches to employment policy (the Luxembourg process), structural policies (the Cardiff process), pension reform and social inclusion policy.

Behind these processes are committees, composed largely of representatives of national ministries, which have the task of preparing decisions in the respective Councils of Ministers. The most powerful of these is the Economic and Financial Committee (EFC) which brings together high level officials from the national finance ministries and central banks, as well as their EU level counterparts. Provision has also been made for a forum – the macroeconomic dialogue or 'Cologne' process – through which the social partners meet representatives of the finance ministries, of the Commission and of the ECB to discuss the macroeconomic policy stance. There is, too, an agenda set at the Lisbon European Council held in March 2000 that sought to promote the EU as 'the most dynamic knowledge-based society in the world,' while also paving the way for a modernisation of the European social model. 'Lisbon' has, since, become institutionalised through the holding of a special meeting of the European Council (that is, the

**Chart 1. The structure of economic policy coordination in the EU**



heads of state and of government) each spring, the primary purpose of which is to discuss economic reform. Chart 1, adapted from European Commission (2002a) summarises the current system.

When it comes to peer pressure and multilateral surveillance the EU has more elaborate review procedures and involves higher-level national decision makers than either the IMF in Article IV consultations or the OECD in Economic Development Review Committee country reviews (Thygesen, 2002). It also has a more developed political input into decision-making and policy formulation, mainly through the Council of Ministers – Ecofin (for macroeconomic policy) and parallel councils for employment or for social affairs. It is, however, apparent that these formal councils are rather cumbersome for agreeing policy. By contrast, the informal *Eurogroup*, comprising just one official and one politician from each member of the Eurosystem, is reported to be much more political in its deliberations and to offer means of debating policy options more overtly.<sup>2</sup>

**Supply-side coordination**

The most developed forms of supply-side coordination in the EU are the European Employment Strategy (EES) – which now has an established institutional cycle comprising guidelines from the EU level and National Action Plans for implementation – and the more diffuse

ambitions to achieve structural reforms encapsulated in the ‘Lisbon’ agenda. The latter, to a considerable extent, is an extension of the drive to complete the EU’s internal market launched in the mid-1980s. Liberalisation of markets for financial services, enhancing the provision of risk capital and rendering network industries more competitive are current preoccupations, all of which have as an underlying aim boosting the EU’s competitiveness, especially in knowledge-intensive industries. The procedures for moving towards common policy include the conventional ‘hard law’ Community method of directives and regulations, and ‘Action Plans’ and commitments by governments that are softer forms of intergovernmental coordination. In addition, the Lisbon agenda comprises initiatives to promote social inclusion that have also now been institutionalised through National Action Plans, while pensions, too, have now been brought within the ambit of what has become known as the open method of coordination.

There are three stages in the EU’s ‘guided’ policy coordination cycles. First, Member States agree collectively on economic policy objectives for the EU as a whole: typically, proposals are put forward by the Commission, then adopted by the Council of Ministers. Second, each Member State formulates a national action plan to deliver these objectives in a manner that takes into account the specific structure of the national economy. Third, the design and implementation of the national action plan is monitored through a system of

multilateral surveillance, which involves the European Commission, Council of Ministers and individual Member States. If a Member State deviates from the national action plan (or if the plan is deemed inadequate to begin with) the Council can issue a public recommendation for corrective action. However, there is neither a legal obligation to conform (as in the case of Community legislation) nor the threat of financial sanction (as in the case of the Excessive Deficit Procedure); instead it operates through a combination of pressure from the Commission and other countries, benchmarking and deliberation.

### *The system assessed*

What is immediately apparent from this array of coordination machinery is that it does not cover the core of the traditional notion of policy mix, namely how fiscal and monetary policy are combined. Instead, the emphasis is on what might be called *horizontal* coordination across individual policy areas. As portrayed in chart 1, the only real links between monetary policy and other economic policies are consultative. That monetary policy is not part of the equation is simply explained; an independent central bank with the primary responsibility to assure price stability cannot plausibly engage in the sort of bargaining with other policy actors that would be implicit in coordination. If it did, it would open itself to the possibility that the ensuing bargain might mean trading-off higher inflation for other goals, such as faster growth or lower unemployment. The issue is not whether or not such an outcome is desirable (the contrast with the Fed's dual mandate is obvious), but whether it is constitutionally allowed, and our interpretation of the legal texts is that the room for manoeuvre is very limited.

Buti, Roeger and in't Veld (2001) find evidence to suggest that an inconsistent policy mix simply cannot be avoided (in the face of demand shocks) when monetary and fiscal authorities assign different weights to real and monetary objectives. Faced with a demand shock, a monetary authority that is preoccupied with price stability and reluctant to alter interest rates will favour a high level of fiscal stabilisation and (contingent on that fact) a low degree of monetary stabilisation. A fiscal authority on the other hand, which assigns little or no weight to price stability and considerable importance to output stabilisation, will seek a high degree of monetary stabilisation in the wake of a demand shock. With each authority relying in these circumstances on the other to

do more, the result is a failure in coordination and an inconsistent set of monetary and fiscal policies (see, also, Leith and Wren-Lewis, 2000).

A second broad observation about the present system is that it embraces both formal obligations rooted in hard law and very soft guidelines and recommendations, with the latter as legally enforceable as these two words imply. Indeed, there have already been high-profile instances of national governments openly disagreeing with, and ignoring, recommendations: the 'reprimand' to Ireland for its pro-cyclical fiscal policies – issued under the BEPGs and not the SGP as is sometimes mistakenly assumed – is a case in point. In 2001, Ireland planned to raise public expenditure and to cut taxes which, with a budget surplus projected to be well over 4 per cent of GDP, it could comfortably afford. In the BEPGs, however, Ireland had been advised to keep fiscal policy tight to avoid exacerbating an already overheating economy, i.e. to beware of procyclical fiscal easing. Yet from a domestic political perspective, a reluctance to distribute some of the fruits of Ireland's phenomenal growth would have been difficult, and it was also argued that the economy needed a boost to public investment to ease supply constraints. In short, the 'Brussels' recommendations were not only at odds with Irish preferences, but also predicated on competing economic analyses. In the event, the Irish Finance Minister was able to fend off the attempted reprimand, though not without some political embarrassment (Meyer, 2002). With hindsight, it is a moot point who was correct, but what is clear is that the soft coordination of the BEPGs was unable to discipline the Member State policy.

In principle, the 'hard' coordination of the SGP, with its escalating sanctions (see box 1), should avoid this difficulty. There is a clear policy rule – that a deficit should not exceed 3 per cent of GDP – and explicit procedures for issuing warnings to delinquent Member States and (though almost certainly never to be used) the ultimate sanction of financial penalties. Yet as practice in 2002 demonstrated, the Council of Economics and Finance Ministers (Ecofin) has the discretion to overturn a properly constituted Commission proposal to issue an early warning of an impending 'excessive deficit', as it did when Germany and Portugal were spared such a warning early in the year. An *ex-post* rationalisation is that the German government, in particular, had signalled that it would deal with the problem, so that the desired outcome would be achieved without resorting to the formal machinery. Cynics might interpret Ecofin's

### Box A. The Stability and Growth Pact – centrepiece of policy coordination under EMU?

The principal policy device for coordinating fiscal policy under EMU is the Stability and Growth Pact (SGP). In principle, the Pact is a component of the wider coordination machinery provided for in Article 99 of the Treaty and, as such, constitutes one ‘pillar’ of the Broad Economic Policy Guidelines (BEPGs). The latter, however, only have the status of recommendations, whereas the SGP imposes obligations on Member States.

The purpose of the SGP is to maintain the fiscal disciplines that the ‘Maastricht’ convergence criteria imposed on countries that wanted to be part of the single currency.

Its legal base is an agreement reached at the 1996 Dublin European Council, formally adopted as a resolution six months later at Amsterdam and given force in two Council regulations agreed in 1997 (1466/97 and 1467/97). The first regulation covers surveillance and coordination of economic policies, while the second stipulates what constitutes an excessive deficit and how the rules are to be enforced.

Targets are central to the Pact which constrains Member States by restricting the permissible size of the budget deficit to **3 per cent of GDP** in the short term and prescribing a medium-term target of ‘**close to balance or in surplus**’. In exceptional circumstances, defined as a fall in GDP of at least 2 per cent, a Member State is allowed to breach the 3 per cent limit.

**Surveillance** of Member States entails the regular production and updating of *Convergence Programmes* for those countries not yet participating fully in stage 3 of EMU and *Stability Programmes* for Euro Area countries. In practice, they cover very similar ground in setting out short- and medium-term plans that show how fiscal disciplines will be respected. These are monitored by the Commission and considered periodically by Ecofin.

**Sanctions** can be imposed on Member States that breach the 3 per cent rule, but only after a protracted process involving warnings and peer pressures. In theory, a country that fails to rein in an excessive deficit sufficiently promptly could be subjected to financial penalties in the form, initially, of a non-interest bearing deposit, but with the further threat that this will be converted into a fine. Most informed commentators believe that the financial penalties are unlikely ever to be imposed, and the expectation is that peer pressures will be sufficient to avert problems.

Note: For a succinct presentation of the institutional framework for policy coordination, see European Commission (2002a).

demurrals as other members of the club not wanting to upset a peer who might subsequently sit in judgement on them. In the event, both countries *were* issued with excessive deficit proceedings under Article 103(4) of the Treaty in the autumn of 2002 and an early warning was also issued to France.

Again, the question is not whether the fiscal policy being urged on Germany, Portugal and France is appropriate – indeed, many would argue that it is not – but whether the system for coordination works, or can be made to work, as intended. In relation to the excessive deficit provisions of the SGP, a guarded answer is that although the precise threshold (the 3 per cent limit) may not hold, the degree to which it is breached is likely only to be minimal. The difficulties are, however, more acute in relation to the second aim of the SGP: the requirement to keep public finances in the medium-term ‘close to balance or in surplus’. Overall, what seems to bedevil the system is that political decisions on policy are dominated by national interest considerations, rather

than the interests of the Euro Area as a whole. This highlights the lack of a coherent counterpart to the supranational monetary authority.

The rationale for the medium-term target under the SGP is straightforward: because deficits rise as automatic stabilisers are allowed to work in periods when the economy is below trend, a margin is needed. A medium-term fiscal position of balance means that the deficit can inch up to 3 per cent without difficulties when there is a slowdown, whereas if the deficit is already close to the SGP limit, there is little scope for it to do so. In addition, if governments are to provide for long-term obligations, especially the anticipated pensions bill, it is argued that the public sector needs to take action now to bolster its balance sheet. Sweden, for example, already targets a 2 per cent surplus for just this reason and is discussing proposals to go further (Swedish Government, 2002). It should be noted that, by maintaining fiscal balance, the ratio of debt to GDP will fall asymptotically towards zero so long as nominal GDP grows.

## Rethinking EU economic policy coordination

Three main findings emerge from our analysis. First, neither hard nor soft coordination can deliver a harmonious macroeconomic policy mix to the Euro Area. Second, there can be strong complementarities between hard and soft law instruments. Third, however, the institutional design sets limits on what can be done, above all by leaving monetary policy on a pedestal. Yet, although the EU system as presently constituted has obvious shortcomings, it achieves a greater degree of coordination of economic policy than is often recognised, and is apt to be unfairly criticised. Certainly, there are policy areas that are meant to be coordinated where effective coordination is lacking and, even where it is robust, rules or norms in place are open to criticism.

Although demands for a rethinking of policy coordination have centred on reforming the SGP, it is by no means the only avenue to explore. Criticisms have also been expressed about the profusion of processes, actors and timetables, with the suggestion that the aggregate contrives to be less than the sum of the parts. Politically, the willingness of some Member States (especially the larger ones) to shirk their commitments when times become tough has undermined the political basis for coordination. Two substantial difficulties deserve to be stressed. First, the system as a whole does not have effective means for agreeing an overall set of policy targets, other than in the banal sense of a wish-list of desired outcomes. The second is that of imbalances in influence and cohesiveness between different policy actors. Perhaps paradoxically, in view of the frequently articulated condemnations of the over-weening power of 'Brussels', the EU level has relatively little power over economic policymaking outside the domain of monetary policy. As a result, neither fiscal policy nor supply-side policy has the coherence of monetary policy and this, in turn, means that an appropriate macroeconomic policy mix may not emerge.

Given the Treaty, there is little scope for a major 're-design' and it is implausible that the independence of the ECB will be relinquished. This would appear, in turn, to exclude the possibility of a traditional fiscal-monetary policy mix. How, then, could economic policy coordination in the EU be improved, recognising that the constitutional constraints of the Treaty (even allowing for some modest changes in the next Treaty revision due in 2004) limit what can plausibly be envisaged? We first present and comment on the

proposed reforms of the SGP. We then argue that further reforms are needed in institutional structures and procedures, and in enhancing political commitment to coordination.

### *Reforming the Stability and Growth Pact*

Pressures to reform the SGP grew in the course of 2002, partly because the experience of the slowdown in 2001 had exposed problems in conforming to the letter of the rules, but partly also because several Member States had come to question the rationale for the rules themselves, notably the medium-term aim of balancing the books. Indeed, the French Government went so far as to state, unilaterally, that it would not implement policies to achieve balance by 2004, but would instead do so when it judged the time to be ripe, and not before 2006.

In November 2002 the European Commission issued a communication to the Council of Ministers and the European Parliament, which called for a strengthening of budgetary policy coordination within the European Union (European Commission, 2002b). The communication follows open criticism of the SGP by the Commission President Romano Prodi – calling it 'stupid' – and comes in advance of the Spring Summit of the European Council at which proposals for reinforced economic policy coordination will be discussed.

The communication reaffirms the Commission's commitment to the medium-term balance rule but recognises 'a number of difficulties with the implementation of the SGP'. Such difficulties include a reluctance on the part of Member States to enforce the SGP (in spirit and in letter), poor quality budgetary statistics and a failure to communicate the rationale behind the SGP to the media, markets and public. The SGP is also criticised for its failure to enforce an adequate degree of budgetary consolidation during conditions of favourable growth in 1999 and 2000 and for its failure to distinguish between the quality and sustainability of public finances across Member States. The Commission presents five proposals that are designed to reconcile the importance of sound public finances with the need for a more flexible interpretation of the SGP. First, the medium-term balance rule should be interpreted with respect to the economic cycle, according to an agreed methodology. Second, Member States which are in breach of the medium-term balance rule should, as a principle, be required to consolidate their public finances by at least 0.5 per cent of GDP per year until the situation is rectified. Third, the SGP

should work symmetrically so as to avoid a procyclical budgetary position during periods of economic upswing. Fourth, it is recognised that the SGP should cater for ‘the inter-temporal budgetary impact of large structural reforms’ that boost growth or employment and improve the overall health of public finances. In practice, this would permit Member States which have already achieved a healthy budgetary position and a low level of public debt to run a deliberate but temporary deficit, providing that the additional resources generate economic and budgetary benefits. Finally, Member States should adopt the sustainability of public finances as a ‘core policy objective’ and thus pay closer attention to debt ratios and the challenge of ageing populations in the process of economic policy coordination.

These proposals, intriguingly, would tilt the SGP more towards the UK fiscal framework and could therefore help to answer an emerging UK concern about participation in the euro. But they fail to deal with some key concerns. In particular, there is still only limited recognition that high public debt can be a problem distinct from the current deficit and that it bears on the sustainability of public finances. Equally, increased public investment may well be justified (consider the UK today, or the needs of the central and eastern European countries set to join the EU in 2004), so that there may be circumstances in which it makes sense to increase the deficit and the debt in order to build up public assets. Nor do the reforms bring us any closer to the notion of policy mix.

Reform of the ECB might be an alternative that would engender less pressure to change the SGP. Fitoussi and Creel (2002), for example, have argued that a move towards the Bank of England model, with a higher symmetrical inflation target, would be a great improvement. De Grauwe (2002), too, suggests that the ECB’s 2 per cent reference value is not appropriate and also criticises the use of a monetary target that has been consistently exceeded. But even if reforms of this sort are enacted (and it should be made clear that as these are operational matters, the ECB is at liberty to introduce them), there would still be a problem of coordination between monetary policy and the other arms of macroeconomic policy.

### *Institutional structures and procedures*

Although the current policymaking system has worked procedurally, it has been fragmented and has had a patchy record in terms of implementation and outcomes

that has led to calls for improvement. The watchword at present for institutional change is ‘streamlining’, the aim of which is to synchronise the different processes and timetables. Instead of being prepared and processed separately, as has happened hitherto, reports on the functioning of the EES, structural reforms and macroeconomic policy will be integrated, discussed at the spring European Council (which is supposed to focus on economic reform), then (following required consultations) decisions on guidelines and recommendations will be taken in June. It can be argued that this change will go some way towards ensuring that coordination itself is better coordinated (Begg, 2002). Reform will also see the BEPGs becoming less detailed and moving to a three-yearly rather than annual cycle, albeit with scope for annual updating. Changes to the SGP are also in prospect, although there is, as yet, little sign of a consensus, although proposals recently tabled by the Commission (described above) have received a cautious welcome from the ECB.

Will these changes go far enough? Although the ‘streamlined’ process will reduce the prospect of inter-institutional disputes preventing coordination, it leaves unresolved the underlying institutional weakness of economic policy decision-making: Ecofin is too unwieldy, while the Eurogroup lacks a formal status. The alternative of a *gouvernement économique* – a body with the power and authority to act as a fiscal counterpart to the ECB – has been put forward most forcefully by a number of French commentators (Jacquet and Pisani-Ferry, 2001; Boyer, 2002). It is an option that deserves serious consideration, not least because it might help to deal with the current imbroglio in which Member States find it so easy to flout the agreed common aims when it suits them, but the political obstacles are obviously formidable. We would, moreover, go further to advocate that the supply-side dimensions of policy should also be brought into a reformed system of economic governance.

### *Political commitment*

Perhaps the most intractable aspect of coordination is that it is caught in a political no-man’s land between the Member States and the supranational level. The nub of the problem is that if a Member State chooses not to play the game, there is little that can be done to chastise it, even under the (relatively) hard law provisions of the SGP. Sanctions might be an answer, but not (as in the SGP) when their strict application would exacerbate the problem that triggers them. Rather, the answer lies in

the progressive building of a common understanding and commitment. It is in this regard that some of the arguments against coordination fail to reflect what happens in the EU: coordination as a disciplining device will inevitably provoke resistance, but where its function is to improve the quality of policy, national authorities are less likely to approach it in a largely defensive manner. This will inevitably take time, as change will be incremental rather than dramatic. Equally, it would be wrong to expect too much too soon and a lack of hard evidence of change is not necessarily to be deplored in the short term. However, it also has to be seen to work to achieve legitimacy (Hodson and Maher, 2002) and this is where the politics becomes more tricky. While coordination has to be seen to work to be legitimate, the corollary also applies, i.e. coordination has to be seen to be legitimate before it can work. This highlights the importance of initiatives to streamline institutions and processes in a manner that increases transparency.

### Concluding comments

Economic policy coordination under EMU is not an end goal in itself. It is motivated by the fact that monetary integration has created fresh channels of interdependence between the Euro Area economies. Under such circumstances, a discretionary and decentralised approach to national economic policies could produce a set of fiscal policies which are incompatible with one another, an aggregate fiscal stance that is inconsistent with the objectives of the ECB, and competition in supply-side policies that could be damagingly disruptive. In so far as a centralisation of fiscal policy within the Euro Area is politically unacceptable, a harmonious macroeconomic policy mix can be pursued through either hard or soft modes of coordination or a combination of both.

Hard coordination, in the guise of the Stability and Growth Pact, institutionalises a rule-based approach to national fiscal policymaking. If a Member State breaches the rules, that is, if it fails to contribute to the desired macroeconomic policy mix, it is ultimately subject to financial penalties. The strength of hard coordination is reinforced through the non-pecuniary but nonetheless coercive mechanisms of peer pressure. The 'guided' soft coordination approach, as embodied in the BEPGs and EES, is designed to precommit Member States to policies that are consistent with a harmonious macroeconomic policy mix. If a Member State fails to adhere to these commitments then it will be publicly castigated.

Hard coordination – first the Maastricht convergence criteria, then the SGP – can claim some credit for the consolidation of public finances in the EU prior to 1999. To the system's further credit, all but four Member States (France, Germany, Italy and Portugal) have maintained a healthy budgetary position despite the recent slowdown. It is evident too from witnessing the BEPGs in operation that while soft policy instruments may not be able to enforce coordinated action, peer pressure can increase the political costs to national governments of policy reversal. Despite these achievements, three major weaknesses stand out.

First, the burden of macroeconomic coordination rests almost exclusively with the fiscal authorities, and it is fiscal policy that has to conform to the objectives of the ECB, rather than the other way round. However, the SGP ignores aggregate fiscal policy, concentrating instead on the health of national budgetary positions. If Member States are to deliver a consistent macroeconomic policy mix, a more conscious appraisal of the aggregate fiscal stance will be required.

Second, the SGP has, somewhat paradoxically, been criticised both for the perverse impact of its fiscal policy rules in the face of a global economic slowdown and the failure of Member States to implement these rules. The procyclical focus of fiscal policy rules can (and in all likelihood will) be adjusted in time, but the reluctance of some Member States to abide by the terms of the pact is a cause for concern. Experience suggests that Member States, which themselves face the risk of running excessive deficits in this or subsequent periods, have a strategic incentive to tolerate fiscal profligacy in others. This implies that a stronger enforcement role should be given in the process of hard coordination to an independent arbiter such as the European Commission.

Finally, Member States have shown a preference for widening and loosening the remit of soft coordination rather than deepening it, giving rise to the much looser and, arguably, rather empty targets that have emerged in relation to the EU as a knowledge-intensive economy. The risk is that there are now too many policies, processes and strategies and that they have become unwieldy. The Council's commitment to streamlining may help to sharpen the focus of soft coordination, such that a coherent system will emerge, but there is a case for making the whole process more strategic and less detailed in its incidence on national economies. But it is also important to recognise that coordination is the aim, not the SGP or other specific mechanisms as such.

## NOTES

- 1 See Article 99(3) EC and Regulation 1466/97 OJ L 209, 2.8.97, p. 1; Regulation 1467/97 OJ L 209, 2. 8. 97, p.6 and Resolution of the European Council on the Stability and Growth Pact, OJ C 236, 2.8.97, p.1.
- 2 Interviews carried out by the authors as part of ESRC project L213252034.

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