

Fiscal Discipline and Policy Coordination in the Eurozone:
Assessment and Proposals

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1. Introduction

This paper is about what can be improved in the policy system of the Eurozone. It focuses on current challenges and makes proposals for change. It is therefore by nature critical of current arrangements.

It could be objected that there is no reason to look for changes, because there is much to praise in what has been achieved in the first years of EMU: the transition to the new currency and the new policy regime has been a major success for the EU; macroeconomic management in Europe has improved significantly; and further microeconomic gains can be expected from this new step in integration.

Whereas this is obviously true, complacency would be a misguided attitude. Just because the EMU system is still in infancy, economists and policymakers have to learn from the early experience, to assess what the next problems could be and to discuss how they could be addressed. With only a few years of experience behind us, there is certainly no point in considering wide-ranging reforms, but there is room for serious discussions on what we have learned. We should aim at developing a vision of the direction for change that would help clarifying issues in current policy discussions and making proposals for step-by-step changes. The pace of change will depend on political and economic conditions. But to be able to respond to unexpected events and opportunities, policymakers need a roadmap.

The paper, which partially draws on my previous research on the same issues (Jacquet and Pisani-Ferry, 2001; Pisani-Ferry, 2002), focuses on two main topics, fiscal discipline and policy coordination. In a way, those are two aspects of the same broader question: what are the channels of policy interdependence in a monetary union and how should the policy system be designed to deal with externalities arising from this interdependence? But the distinction is nevertheless useful:

- the notion of *fiscal discipline* deals with the specific externalities associated to the adverse spill-over effects of excessive deficits leading to potentially unsustainable debt accumulation in member countries. Among economists and policymakers, there is not much disagreement, neither on the risk an irresponsible fiscal behaviour would create for monetary union, nor on the need for common rules or mechanisms that ensure fiscal discipline. However, there are controversies on the proper design of those rules and mechanisms. Hence, the discussion focuses on issues of design rather than of principle;
- the notion of *policy coordination* refers to other externalities that are not dealt with through mechanisms devoted to ensuring fiscal discipline. The key question here is whether national fiscal policies should be granted full autonomy, provided they abide by fiscal discipline, or whether there is a need for further coordination over and above what is required to avoid irresponsible fiscal behaviour. This has been a matter for discussion within the EU since the Delors report of 1989. The topic remains controversial, as some economists argue that coordination is simply not necessary (if not counterproductive) while other claim that it is required. The issue here is thus of principle as well as of design.

The paper is organised as follows: the main conclusions are first summarised in section 2. Section 3 then focuses on discipline and section 4 on coordination.

2. Main conclusions

Problems

A good starting point is to draw up a list of the problems we are facing. My own selective list is as follows.

- (1) *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.* The three main difficulties are (i) a focus on actual rather than cyclically adjusted deficits, which results in insufficient constraints on lax fiscal policies in good times and excessively tight constraints on responsible fiscal policies in bad times (this shortcoming is however being addressed, as the assessment of the budgetary situation is increasingly based on cyclically-adjusted data); (ii) a focus on the deficit rather than on the debt situation, i.e. on short term constraints rather than on long term sustainability. This strong

emphasis on the deficit is not based on the provisions of the treaty, but on the interpretation they were given in the specific context of the mid-1990s, when a decision on EMU membership had to be taken; and (iii) as regards the debt ratio, a narrow approach to the long term sustainability of public finance, which leaves aside off-balance sheet liabilities. Furthermore, doubts about the credibility of the Stability Pact, which had been around since the beginning, have increased as a consequence of the Spring 2002 decision on Germany.

- (2) *We still lack a generally accepted doctrine on the role of macroeconomic policy instruments in the Eurozone.* Asymmetric developments are clearly not of the responsibility of the central bank, however there is not much agreement on what fiscal policy should do to counter shocks hitting individual member states. The lack of a common doctrine on the role of discretionary fiscal policy was highlighted on the occasion of the Council recommendation to Ireland of 2001. As regards symmetric shocks, uncertainty about the strategy of the ECB leaves room to questions about the mix of monetary and fiscal reactions that is deemed appropriate in response to adverse shocks affecting the Eurozone as a whole. The slowdown of 2001-2002 was the occasion of reaching a common understanding on the role of automatic stabilisers in response to a slowdown in world demand, however this falls short of providing a complete response to uncertainties.
- (3) *The EU does not yet have a clear doctrine on why and when coordination is necessary.* Policy coordination remains a disputed issue, intellectually and institutionally. Some scholars claim that it is unnecessary, while others call for it. The aggregate fiscal stance and the aggregate fiscal position of the Eurozone were only recently recognised as relevant policy variables and the ECB is unwilling to take part in any exercise that could require that it commits on its future policy actions. Furthermore, member states, while paying lip service to coordination, are reluctant to relinquish their freedom to make discretionary choices. Finally, procedures for coordination are excessively complex and tangled, which weakens their impact on actual policy decisions.
- (4) *As the interaction between EU procedures and national decisions remains generally weak, implementation is not satisfactory.* The Broad Economic Policy Guidelines (BEPGs) are discussed in detail by government representatives, but their impact on national policy discussions is frequently negligible. The Eurogroup itself still lacks visibility (seen from, say, Singapore, it is not clear what it is supposed to do). It is difficult to escape the impression that a large part of the energy that is devoted to EU procedures is simply wasted.
- (5) *Structural reform ranks high on the agenda of the EU, but interaction between structural reform and macroeconomic policy remains weak.*

Proposals

- (1) *Structural deficits and output gaps measured according to a common methodology should be published by the Commission and serve as a basis for the evaluation of the budgetary situation in the member states.* The methodology, its implementation and proposals for improvements should be regularly audited by an independent panel.
- (2) *When possible, the emphasis of fiscal discipline should be shifted away from the year-by-year monitoring of the deficit to a more medium-term oriented approach that focuses on the long run sustainability of public finance.* This could be done through offering member states the option to subscribe to a “Debt Sustainability Pact”. Countries participating in this new pact would have (i) to publish comprehensive public finance accounts according to improved EU accounting standards that allow to assess the potential future impact of off-balance sheet liabilities; (ii) to keep their public debt ratio (Maastricht definition) below, say, 50% of GDP; and (iii) to set a five years target for this ratio, that would serve as a benchmark for assessing their budgetary policy. Countries satisfying these three conditions would automatically qualify in the no-excessive deficit procedure and be exempt from the fines envisaged in the Stability Pact. Failure to comply with any of the above three conditions would automatically activate the standard excessive deficit procedure and, if relevant, trigger sanctions.

- (3) *An economic policy charter for the Eurozone (a code of conduct) should be prepared for adoption by the Eurogroup.* This code of conduct would not have a binding character, but would represent a common understanding on economic policy principles.
- (4) *The Stability programmes should be developed into fully-fledged instruments of surveillance and coordination.* They should spell out how it is intended to alter budgetary policy in response to output and price surprises, as well as in case of revenue shortfall or surpluses. Those presumptive responses would not need to be identical across countries, however they would have to be consistent with common principles as spelled out in the code of conduct. They would serve as a benchmark against which policy decisions would be assessed by EMU partners and market participants. The interaction between European procedures and national budgetary procedures should be both streamlined and reinforced in order to make sure that domestic policy decisions are consistent with commitments made in Brussels. Especially, decision on the Stability programmes should be made part of the national budget preparation procedures, including as regards the role of national parliaments.
- (5) *Coordination among the members of the Eurozone should be strengthened.* Since it has been agreed that the budgetary position of the Eurozone as a whole should be regarded as relevant variables. The Eurogroup should begin its surveillance exercise with an assessment of it. Further steps could be (i) a reciprocal binding agreement by the member of the Eurozone to consult their partners and the Commission before significant economic policy decisions are taken, as proposed by the Commission; (ii) the replacement of the rotating presidency system by the designation of a Eurogroup president for a fixed period; and, which is more controversial, (iii) the transformation of the Eurogroup into a collective executive body with the ability to make decisions by qualified majority voting.
- (6) *A constructive dialogue should be developed between the ECB and the Eurogroup on the interaction between structural reform and macroeconomic policy.*

3. Fiscal Discipline

As already mentioned, there is not much disagreement on the need for fiscal discipline in a monetary union. Controversies about the Stability Pact nevertheless began as soon as it was agreed upon (Eichengreen and Wyplosz, 1998) and they have not ended. It is generally recognised that the Pact has triggered reductions in the deficits within the Eurozone, but it is frequently claimed that it is too rigid and prevents fiscal policies from fully playing their stabilisation role. It is also claimed that it does not bind fiscal policy choices enough when tax receipts abound. Furthermore, the Spring 2002 Council decision not to issue a formal early warning as the projected German fiscal deficit was getting close to the 3% limit has revived old doubts about the credibility of sanctions.

The question is thus not whether we need a Stability Pact, but whether the design of the current one provides the appropriate incentives to national governments while achieving the right mix between short-term flexibility and long-term constraint. A discussion on these issues requires clarity about the rationale for and the aim of fiscal discipline. In what follows, I thus start by summarising the main arguments for fiscal discipline. Next, I turn to the design of rules and to proposals for improvement.

Rationale

The main arguments for fiscal discipline rules are¹:

- a. *moral hazard.* Although the provisions of the Maastricht treaty explicitly spell out that EMU members should not expect any form of bail-out, the potential costs of a default on public debt by a member state (especially a large one) could constrain the ECB in its policy choices. For example, the central bank could be forced to refrain from raising interest rates if it anticipates that

¹ Beetsma (2001) provides a summary of the arguments.

this would aggravate the risk of a financial crisis². Hence high, potentially unsustainable debt ratios are to be avoided;

- b. *macroeconomic spillovers*. In an integrated capital market, public debt accumulation may exert an upward effect on the long term interest rate. It also impacts short term interest rates if monetary policy targets inflation and fiscal policy affects prices. Hence, there is an externality that national fiscal policy may fail to take into account. As a result, debt ratios and the long term interest rate both tend to be too high. Fiscal rules are needed to correct this;
- c. *political failures*. Democratic governments are short-sighted and tend to run excessive deficits. With separate currencies, this political failure is (at least partially) taken care of by the threat of exchange crises (in a fixed-but-adjustable exchange rate regime) or the inefficiency of fiscal refraction (in a floating exchange rate regime). In a monetary union, there is no automatic check on the risk of fiscal profligacy.

I regard argument (a) as the most convincing of the three because it puts emphasis on a potential threat to monetary and financial stability, i.e. on what EMU was made to achieve. It is important to stress that the type of externalities it puts emphasis on are of a long run nature. The corresponding analytical setting is the standard long run one in which prices are flexible and have their level determined by monetary policy alone, while output is supply-determined. In such a framework, monetary and fiscal policies can be used independently provided the public debt remains sustainable. Thus, there is no case for coordination to go beyond avoiding the build up of unsustainable fiscal positions³.

In view of the distinction between discipline and coordination, argument (b) has more to do with the latter than with the former, because while it is true that spill-over effects exist, there is no reason to focus exclusively on the excessive deficit – interest rate channel. Other channels of interdependence – e.g. through goods market linkages, the common exchange rate and the common balance of payment, or the average inflation rate of the Eurozone – can also be significant. Taking all these channels into account, it is disputable that what is needed is a rule that exclusively aims at preventing excessive deficits.

Argument (c) builds on evidence accumulated by the political economy approach to fiscal policy. However, it is not clear to what extent a possible political failure that results in excessive government borrowing, but does not have adverse effects on partner countries, should be addressed through common rules rather than reforming national institutions and procedures. It may be true that governments behave in a less responsible manner when the threat of a crisis is absent, but from that observation does not follow that this failure should be corrected through European disciplines.

The main rationale for fiscal discipline rules is thus that excessive debt accumulation with possible consequences on other member states should be avoided. This admittedly rather narrow definition of the goal has the advantage of providing guidance to address the issues of design.

Design

The significance of argument (a) was recognised in the preparation to the Maastricht negotiations, with the result that emphasis was put on debt sustainability issues⁴. But as the debt ratio of several member states exceeded 100% of GDP in the mid-1990s, debt had to be put aside as a practical criterion to assess the ability of member states to participate in EMU. It was still true when the Stability Pact was negotiated in 1997 and as a consequence, the pact simply overlooks the debt criterion. As a result,

² The consequences of a default on the public debt would obviously depend on the country's size. Arguably, a default on German or Italian public debt would have a systemic character while a default on the Irish debt would not. However, the ECB could hesitate to precipitate the default of a small member state because it could have both serious political consequences and a strong signalling effect. This is a justification for requiring that all member states abide by the same fiscal discipline rules.

³ von Hagen and Mundschenk (2001) develop the argument.

⁴ This is apparent in Emerson et al. (1990). See also Italianer (1993) and Bini-Smaghi, Padoa-Schioppa and Papadia (1994).

fiscal discipline has so far been essentially assessed and enforced on the basis of the *deficit* rather than on the *debt* situation. This raises several difficulties.

What deficit?

The most obvious problem arises from the monitoring of the deficit on the basis of headline rather than cyclically adjusted figures (in part because of disagreements on how to take cyclical factors into account). This approach results in insufficient constraints on lax fiscal policies in good times and excessively tight constraints on responsible fiscal policies in bad times, which is unfortunate, since it has been observed (Buti and Sapir, 1998) that fiscal policy precisely tends to behave pro-cyclically in periods of above-trend growth. The latest cycle has confirmed this tendency: major mistakes tend to be made in ‘good times’ rather than in ‘bad times’.

A reason for the initial focus on headline figure is that there was no agreement on how to take cyclical factors into account. In recent years, the EU has made progress towards a refined approach to budgetary surveillance. The Ecofin (2001) now explicitly states that “the assessment of the appropriateness of the member states’ medium term objectives and the examination of their fulfilment have to take explicit account of the cyclical position and its effect on the budget”. At the initiative of the Economic Policy Committee, it was recently agreed to change the measure of the output gap from a purely statistical methodology to a more economically-based one. Member states have also agreed that automatic stabilisers should be allowed to play their role in both direction, provided the deficit remains below the 3% threshold. Several of them have adopted expenditure targets that have the advantage of insulating public spending from the effects of cyclical economic fluctuations and of letting fluctuations in receipts play their stabilisation role. The resulting system can thus be described as ‘cyclically-adjusted approach when possible, and nominal when necessary’.

What role for the ‘benchmark’?

A refined approach to budgetary surveillance is certainly a positive development, however there are some remaining difficulties. A budgetary policy that is geared to avoiding to breach the 3% limit during a slowdown may lead the debt ratio to converge on significantly different debt levels, depending on the short run elasticity of tax receipts and the sensitivity of the country to macroeconomic shocks. For example, according to the Commission, the so-called “cyclical safety margin” varies from 1.5% of GDP in France to 4.3% of GDP in Finland (Artis and Buti, 2001). Assuming a 0.5 percentage point additional margin, this translates to “benchmark” budgetary balances of, respectively, - 1% and + 1.8% of GDP. With, say, 2.5% growth and 1.5% inflation, this implies steady state values of - 26% and + 47% for the net wealth of the public sector.

The ‘benchmark’ interpretation of the SGP thus had the uncomfortable effect of implying significantly different steady state values for the public debt ratio. To instruct, implicitly at least, member countries to converge on such different levels of public debt and therefore to confront the associated consequences for intergenerational redistribution, can hardly be justified on the basis of a parameter as inconsequential as the short term elasticity of tax receipts.

Why zero debt?

Partly as a consequence, the EU has moved away from relying on the “benchmark” that was used in the late 1990s to assess the budgetary situation in the member states. In its July 2001 *Opinion on the content and format of the stability and convergence programmes*, the Ecofin stated that the minimal benchmarks are “an additional working instrument, but not a target per se”⁶. The emphasis is now put on the achievement of (structural) budgetary balance by 2004, an objective that was endorsed by the European Council in Barcelona. This means that the net wealth of the public sector should converge on a positive or zero value in all member states.

The paradox is however that as member states get closer to this objective, it becomes less and less justifiable to impose strict limits on their short term borrowing. Assuming that a country whose

⁶ Ecofin Press release of 10 July 2001.

government is, say, 20% of GDP would run for a short period of time a budget deficit of 3 or even 4% of GDP, it is hard to imagine how the Council could claim that its policy threatens monetary and financial stability and thus how it could justify to fine that country.

This would especially apply to a government which borrows to finance public investment. For example, could the EU claim that there are overriding reasons why an accession country with a low public debt ratio should not finance investment in infrastructures, education or the cleaning up of the environment through public borrowing? On both efficiency and intergenerational equity grounds, it may be a perfectly sensible policy to front-load such expenditures and to make future generations pay for the investments they will benefit from. This argument is especially relevant for catching-up member states and the accession countries.

The risks of the status quo

It is a fact of life that a law that has lost justification is not considered legitimate anymore and cannot be credibly enforced for long. The same could happen to the Stability Pact in a not-too distant future. Actually, this was already implicitly recognised in the Council decision of February 2002 on the convergence programme of the UK: although the British government envisaged a deficit of 1% of GDP in 2005/2006, the Council approved the programme. This is a recognition that the same rules may be applied differently when the debt ratio is 100% of GDP and when it is below 40%.

To focus on the short-term limits rather than on long-term intertemporal constraints was certainly justified in the context of the run-up to and the first years of EMU. However, it is less and less the case. At end-2001, already 8 of the 12 countries participating in the euro and 11 of the 15 current EU member states were below the 60% debt threshold. The proportion is roughly the same for accession countries (at end-2000, the debt ratio remained below 60% in 9 of the 12 candidates), and some of them such as Estonia, Latvia and the Czech Republic are hardly indebted at all. This suggests that time has come to consider a more balanced approach to fiscal discipline.

Proposals

Whatever its shortcomings, the Stability Pact is an asset because it embodies the commitment of the EU to fiscal discipline. Reforms should build on what has been achieved, and be phased in a way that preserves the credibility of the system. Thus, options for change should address both long term perspectives and issues of transition.

Cyclical adjustment

A straightforward avenue for improvements is to rely on a common methodology for measuring the output gap and the budgetary impact of cyclical factors. As progress has been achieved recently in this direction and EU now agrees on a methodology, structural deficits measured according to it should now be published by the Commission and serve as a basis for the evaluation of the budgetary situation in the member states. The methodology should also be communicated to the markets and the public. Finally, in order to make these figures as indisputable as possible and in order to preserve the comparability of structural deficits across countries, the methodology, its implementation on a country-by-country basis, and proposals for improvements should be regularly audited by an independent panel.

A debt-based approach

The main direction for change should however be to focus more on debt sustainability and to reward countries whose public finance situation is fundamentally sound with a relaxation of short term constraints. This would be in accordance with the essential rationale for fiscal discipline that has been outlined.

For this approach to be operational, however, two difficulties must be addressed. First, the Maastricht debt criterion as it is measured is much too crude to be relied upon to assess the soundness of public finance in the member states. This was already pointed out in Commission studies and the need for a more developed approach was endorsed by the European Council in Barcelona. Off-balance sheet liabilities must be taken into account, especially implicit liabilities resulting from the prospective

imbalance in the financing of pay-as-you-go pension systems. According to EPC (2001) calculations, over the next fifty years the burden of old-age pensions should increase by more than 3 percentage points of GDP in the EU as a whole, but by several times more in some member states. Depending on discount rate assumptions, this implicit liability may represent as much or more than the market debt. It would thus make little sense to shift the emphasis on debt sustainability without improving the public accounting framework.

Reforming the public accounting framework in order to better represent the existing and potential future claims on public resources is obviously fraught with difficulties. But this could not be a reason not to act. To focus exclusively on the deficit as it is measured in the national accounts could only lead member states to develop innovative financial techniques to circumvent common constraints. Whatever the definition of discipline that is adopted, progress is needed on the public accounting front.

The second difficulty is that even when the debt ratio is made the target variable, the deficit remains the control variable. In practical terms, focusing on debt limit alone could result in significant slippage as member states could not adjust their deficit fast enough to meet their commitments. This implies, first, that any reformed arrangement should include safety margins and, second, that the consistency between the current and projected deficits and the debt target should be monitored closely.

A Debt Sustainability Pact

Taking these elements into account, a practical proposal would be to offer to member states the *option* to subscribe to a “Debt Sustainability Pact”. Participation in this new pact would be voluntary. Those countries who would choose to take part in it would have:

- (i) to publish comprehensive public finance accounts according to improved EU accounting standards that allow to assess the potential future impact of off-balance sheet liabilities;
- (ii) to keep their public debt ratio (Maastricht definition) below a certain threshold, say 50% of GDP (the safety margin should be large enough to ensure that the debt ratio remains below 60% even in case of a significant slippage);
- (iii) to set a five years target for this ratio, that would serve as a benchmark for assessing their budgetary policy. The target level should take into account the existence of implicit liabilities and be subject to multilateral surveillance, as for the Stability programmes. It would then become part of the medium term commitments of the member state’s Stability programme. The consistency between current fiscal policy and this medium term commitment would be assessed annually in the framework of budgetary surveillance.

Countries that choose to opt for this pact and satisfy the three conditions would automatically qualify in the no-excessive deficit procedure of Art. 104 (ex 104c) and would thus be exempt from the fines envisaged in the Stability Pact (but they would still have to prepare Stability programmes). However, failure to comply with any of the above three conditions would automatically activate the standard excessive deficit procedure and, if relevant, trigger sanctions as envisaged in the Stability Pact.

Why offer an option rather than reform the Stability Pact? First, because there is still wide dispersion in the public finance situation of the member states; for the countries whose debt ratio remains above 60% of GDP or close to that threshold, it would be hardly appropriate to move from a deficit-based approach to a debt-based approach. Second, because an attempt to reform the pact would immediately be regarded as an attempt at softening discipline. Third, offering an option could serve as an incentive for member states to improve their budgetary situation and reform their accounting procedures in order to qualify as ‘tier 1’ countries⁷.

⁷ It must be said, however, that an approach could be devised that would address the same concerns while leaving the Stability Pact nominally unchanged. A possibility would for example be to make the ‘close to balance or in surplus’ target dependent on a country’s debt level and on its off-balance sheet liabilities. Member states whose debt and implicit liabilities are low would be able to run higher deficits those who do not meet that condition.

Adopting this approach would have the advantage of restoring a degree of subsidiarity in public finance decisions, while addressing the externality the Stability Pact was created to deal with.

4. Coordination

Rationale

The issue of policy coordination in EMU has been a matter for discussion since the Delors report of 1989, which stated that national fiscal policies would have to abide by “binding rules” that “would permit the determination of an overall policy stance”. It has become a topic for analytical research, but remains a disputed one. Numerous authors (of which Gros and Hobza, 2001, De Grauwe and Polan, 2001, Alesina et al. 2001, Beetsma, Debrun and Klaassen 2001) argue that it is not necessary, and can even be counterproductive. Others (such as Artus, 1999, Jacquet and Pisani-Ferry, 2001, von Hagen and Mundschenk, 2001, 2002, Collignon, 2001) maintain that it would significantly improve the policy outcome.

The political case

Before summing up the main economic arguments put forward in the controversy, it may be useful to briefly discuss the *political* case for coordination. As Paul De Grauwe (1998) once eloquently argued, the legitimacy of the ECB does not rest on its isolation. On the contrary, it comes from its shareholders and gains strength from the fact that ministers are able to talk to each-other and to take collective responsibility for what belongs to governments (and not to the central bank): fiscal policies, tax policies and structural policies, to mention only three major aspects. An ECB that would be perceived as acting in isolation, without the backing of its shareholders, would lack legitimacy. An ECB that would be perceived as the only policy player of the EMU system would risk being held responsible for whatever does not work in the Eurozone⁸ – which could only result in a clash with public opinion.

More generally, a policy system in which no one could be held responsible for the overall policy outcome would be vulnerable to attacks on the ground that such a functioning is not compatible with the responsiveness citizens are entitled to expect from democratic governments. To use a provocative analogy: a French convict recently committed suicide in the police offices after he had killed eight members of a municipality. An official report concluded that all rules and procedures had been respected and that no specific responsibility could be invoked. Citizens were understandably unconvinced, to say the least: having respected rules and procedures cannot exempt those who are in charge from their responsibility when something goes badly wrong. This also applies to the proper functioning of the policy system of the Eurozone⁹.

The economic case

Turning to the *economic* side of the discussion, a first line of argument (Gros and Hobza, 2001, De Grauwe and Polan, 2001) stresses that as monetary union increases both the positive spill-over effects of fiscal policy (through goods markets integration) and the negative ones (through capital markets integration), the resulting net effect is indeterminate. Thus, it is argued that monetary union does not increase the need for fiscal coordination in comparison to a floating exchange rate regime.

It is obviously correct that in an Mundell-Fleming setting, the sign of the spill-over effects of fiscal policy is a purely empirical issue. But the argument is not really convincing:

- a. to claim that an issue can only be settled at the empirical level (as opposed to the theoretical one) does not prove that it is irrelevant;
- b. the argument does not show that the policy outcome could not be improved through better coordination, it only says that the case for coordination may not be higher after EMU than before.

⁸ The argument was also used by Strauss-Kahn (1998) as an reason for the creation of the Eurogroup.

⁹ Similar points are made by British officials in their description of the UK policy system. See for example O’Donnel (2001).

- c. by focusing on horizontal spill-over effects, the argument misses that the common inflation rate, the common exchange rate and the common current account balance are ‘club goods’ which are specific to a monetary union. This does not come from any increase in horizontal spill-over effects but simply from the fact that those variables are or may be regarded as common policy objectives. Examples include the common inflation rate which is treated as a policy objective by the central bank and can, at the same time, be affected by fiscal policies. Other relevant variables are the exchange rate and the current account (or the overall saving rate) if they become regarded as policy objectives. The existence of such club goods creates a channel of interdependence which is both specific to EMU and unambiguous in sign¹⁰;

This however does not end the discussion. The recent literature on EMU policy coordination (for example Beetsma, Debrun and Klaassen, 2001, Dixit and Lambertini, 2002, Uhlig, 2002) on which Alesina and his co-authors (2001) draw recognises the existence of interactions through common objectives, or ‘club goods’. However, several authors rely on a well-known result from game theory to emphasise that a coordination that is limited to a subset of players (the governments) and does not involve a major one (the central bank) could be counterproductive. While it is in effect possible that coordination among a subset of players reduces global welfare, it is important to stress that this is not a general result¹¹. Depending on the assumptions on the structure of the economy as well as on the governments’ and the central bank’s objective, coordination can have positive, negative or neutral effects on welfare.

From a practical standpoint, Alesina et al. (2001) claim that coordination among fiscal authorities or between them and the central bank is “not necessary if the monetary and fiscal authorities (independently) follow appropriate and prudent policies”, by which they mean that the central bank follows an inflation targeting strategy and the fiscal authorities maintain a cyclically-adjusted balanced budget.

Alesina and his co-authors provide a clearly articulated view of how EMU should work, but one which is valid only if a number of implicit assumptions are satisfied. The most significant are the following:

- a. *monetary policy is entrusted with the task of managing aggregate demand in the Eurozone according to its inflation target.* This implies that monetary and fiscal authorities do not have conflicting policy objectives and that governments trust the ECB enough to refrain from actively managing the aggregate demand of the Eurozone. These would certainly be positive developments. The ECB, however, has been reluctant to explicitly recognise that it has a responsibility in managing aggregate demand beyond its mandate to ensure price stability, because it perceives that this kind of commitment would risk jeopardising its independence. It has not acknowledged that it follows an inflation targeting strategy and that it is willing to counter potentially deflationary shocks with the same energy as inflationary ones. And it stresses that potential output growth in the Eurozone is between 2 and 2.5% while the European council has set a 3% target;
- b. *the policy-mix is irrelevant.* In Alesina et al’s view, monetary policy and fiscal policy are perfect substitutes, so there is no point in trying to change the balance between the fiscal and the monetary stance. In other words, the aggregate public saving ratio of the Eurozone is an irrelevant variable (or at least there is no reason why it should deviate from zero). As a first approximation, it is certainly correct to focus on the level of aggregate demand. However the policy mix may matter, at least in an open economy setting, first because it has an impact on the interest rate and the exchange rate, thereby on the inflation / output balance, and second, because the policymakers’ objectives may include other variables than inflation and output, for example the current account or the real exchange rate.

¹⁰ Jacquet and Pisani-Ferry (2001) and von Hagen and Mundschenk (2001) develop the argument.

¹¹ Artus (2002) provides a nice overview of the results that can be expected from coordination among budgetary players when the central bank’s objective differs from the social objective. He shows that when the central bank is more conservative (i.e. inflation-adverse) than society while the governments’ objective function corresponds to the social objective, whether budgetary coordination improves or deteriorates social welfare depends on the sign of the fiscal policy externality.

Coordination sceptics often claim that while the policy mix may be relevant in theory, it is irrelevant in practice because of our inability to determine how exchange rates would respond to changes in the fiscal / monetary mix. While it would certainly be hazardous to attempt at fine-tuning the exchange rate in this way, there are circumstances in which it is reasonable for policy makers to decide on the policy mix. Recent examples include the Japanese case, where interest rate policy has become ineffective due to liquidity trap effects, the celebrated “Clinton-Greenspan” policy mix, or German unification. Looking ahead, the large and persistent current account imbalances within the G7 may lead to situations where controlling aggregate public saving would become a policy objective.

The view against coordination thus rests on significant assumptions which may not be satisfied in practice. An important element in the argument of Alesina et al. is however to recall that well-designed rules of behaviour reduce the need for discretionary coordination. This has relevance, because the respective merits of the rules-based approach and a discretionary approach to coordination depend on the institutional environment. Between the US Treasury Secretary and the Federal Reserve Chairman, periodic, discrete meetings may be enough to organise co-ordination. But in Europe, where decision makers are numerous and diverse – Finance ministers, for example, do not all have the same responsibilities – discretionary co-ordination inevitably implies high transaction costs. It is thus advisable for the EU to try to reap the maximum benefit from ex-ante (i.e rules-based) coordination, while keeping in mind that there are limits to what a rules-based approach can achieve and that procedures for effective discretionary action are needed.

Design

There is a considerable degree of confusion in Europe as regards the objectives, the scope and the procedures of coordination. Official documents pay lip service to it but fall short from defining why it is required, when it should be activated and how it should be implemented. For example, the end-1999 report by the Ecofin to the European Council in Helsinki, which was an early attempt at taking stock and defining avenues for progress, is full of vague statements and short on specifics. It mentions the principle of “close co-ordination” among the “fundamental principles” [of economic policy in EMU]. The motive for it originates in the fact that “the completion of the Single Market and the single currency accelerate economic integration in the Community and give rise to more and more spill-over effects” (without further precision), which means that “the relevance of policy co-ordination is particularly cogent within the euro area, especially, but not only, as regards macro-economic policies”. Such general statements do not provide a roadmap for making decisions.

Objectives

The official literature examined in Pisani-Ferry (2002) does not convey the impression that EMU has converged on a stable set of policy principles and on a broadly accepted doctrine on the role of macroeconomic policy instruments. While the core rules of monetary union such as price stability or the need for fiscal discipline are firmly established, there remain a number of open issues as regards the role of fiscal policies, the assignment of instruments to objectives, the extent of spill-over effects or the response to shocks of various types that should be expected from the policy system. Successive versions of the Broad Economic Policy Guidelines (BEPGs) have for example outlined different sets of principles for assigning instruments to objectives.

Progress has certainly been achieved in recent years. Eurozone policy makers have embarked on a ‘learning by doing’ exercise and have made efforts to clarify their understanding on policy principles. Welcomed clarifications have occurred on the occasion of common macroeconomic shocks. This first occurred in 1998 in the aftermath of the Asian crisis, when the Eurogroup endorsed the view that the appropriate response to the expected slowdown in world demand would be to keep on reducing the deficits while relying on monetary policy to counter the effects of the slowdown; another important clarification occurred in Autumn 2001, also in response to a (more severe) slowdown, when the European Council decided that automatic stabilisers had to be allowed to play their role in full, unless there was a threat to exceed the 3% deficit threshold. The recent decision by the European council to regard the aggregate fiscal position of the Eurozone as a relevant policy variable (a notion that not long ago was anathema to some member countries) is also notable.

However there was much less coordination in responding to favourable shocks such as the unexpected rise in fiscal revenues in 1999-2000 and the windfall gain from the sale of UMTS licences. The Council was also rather unsuccessful when dealing with asymmetric shocks, as illustrated by the 2001 controversy on Ireland.

A reason for this state of affairs is that the treaty and accompanying legislation does not (and could not: international treaties are obviously not economic textbooks) spell out how the policy system of the Eurozone is expected to work. While the objectives and the broad definition of responsibility are clearly defined, important policy principles are missing. For example, it is not clear from the provisions of the treaty how fiscal and monetary policies should respond to a symmetric drop in aggregate demand, nor is it clear how fiscal policy should respond to an asymmetric price shock. The resulting uncertainty is compounded by the absence of a policy authority who is clearly entrusted with the role of a 'decision-maker of last resort' that is able to respond in a discretionary fashion to unexpected developments. This strongly contrasts with, for example, the UK setting, where the Treasury explicitly sees its role as that of a Stackelberg leader (Allsop 2002, O'Donnel 2001).

The paradox of the EMU policy system is thus that it is long on rules and short on principles.

Procedures

The EMU system relies heavily on ex ante rules but it also includes procedures for defining a common approach to economic policy choices (the BEPGs) and a body, the Eurogroup, which was explicitly conceived as a forum for elaborating a joint economic assessment and consulting on discretionary policy choices.

Experience with the rules-based approach suggests that in addition to the rigidity it implies, implementation is more complicated than anticipated. A key issue here is the degree of "ownership" by the various member states of the commonly agreed rules and the Stability programmes. The budgetary procedures of the member states have not yet fully adjusted to the new EMU environment and national policymakers still ignore, at least in part, what their country may be committed to vis-à-vis its partners. While the Pact and the programmes have in general had a significant influence on domestic budgetary policy choices, implementation has been more effective when they have explicitly been made part of the national framework for budgetary decisions.

The experience with the BEPGs can hardly be considered positive. The guidelines are discussed in detail by the representatives of the member states but they are frequently ignored by national policy makers. They are more the result of a line-by-line negotiation than the expression of a common strategy. They are furthermore difficult to enforce since Art. 103 does not have "teeth" and this was exemplified by the 2001 Council recommendation on Ireland, which was ignored by the Irish authorities.

As regards the Eurogroup, it is generally considered by participants to be a useful forum for policy discussions. A small number of participants, confidentiality of discussions and an informal atmosphere make it a body very different from the Ecofin. However, its external visibility is very limited and it has not yet produced noticeable results. Part of the difficulty lies in the rotating presidency, which prevents leadership and continuity in external representation. Part also lies in the inability of the Eurogroup to make decisions.

Proposals

'Coordination' involves both uncontroversial and controversial proposals. Among the relatively uncontroversial suggestions that could be implemented are those which could contribute to clarifying the common doctrine, to achieving a better information of the different players, and to making sure that commitments made in Brussels are put into practice at home. More controversial are the reinforcement of the Eurogroup and its transformation into a collective executive body.

A code of conduct for economic policy

To clarify the common doctrine, Jacquet and Pisani-Ferry (2001) have proposed to draw up an "economic policy charter" for the Eurozone that would develop principles to guide economic policy

decisions as well as market expectations. A similar idea has been put forward by the Commission in its communication of February 2001 under the name of a ‘code of conduct’. This code of conduct would not have a binding character, but would represent a common understanding on economic policy principles. It should especially include:

- (i) assignment principles for responding to (favourable or adverse) shocks of a symmetric or asymmetric nature. In the Commission (2001) words, the code would “lay down the principles on the basis of which the different policy instruments could be activated to increase the area’s economic growth potential and to cope with shocks affecting the area or some of its member states” ;
- (ii) rules of conduct for the management of public finance over the cycle and on how national budgetary policies are expected to respond to favourable or unfavourable shocks to the tax receipts (contingent rules);
- (iii) the common understanding on the rationale of and the scope for coordination.

From a policy standpoint, an approach based on state-contingent rules of conduct would represent a third way between a co-ordination model based on rigid rules and numerical thresholds (as in the Stability Pact) and a discretionary approach to co-ordination. The adoption of such rules would help market participants and more generally economic agents to form expectations on the likely policy reactions to shocks. It would thus improve the predictability of macro-economic policy.

An important issue is whether this code of conduct would include elements on the ECB strategy. As the above discussion has made clear, the definition of fiscal policy principles could hardly made much progress in the absence of predictability of the monetary policy behaviour. However, the ECB would certainly be reluctant to participate in an exercise that might jeopardise its independence. A practical way out would be for the central bank to clarify its own strategy simultaneously. As already advocated by many economists, this clarification should include the abandonment of the ‘first pillar’ and the adoption of a symmetrical inflation target.

As regards the method, the preparation of this code could draw on the recent experience of EMU and the progress made in the formulation of policy responses to events. But its elaboration should not be left to the negotiation. In order to preserve analytical clarity, it would be preferable that the Commission requests a panel of outside experts to draw up a proposal.

The Stability programmes as instruments of coordination

A second step would be to develop the Stability programmes into fully-fledged instruments of surveillance and coordination. This could be especially useful if short term constraints on deficits are relaxed as suggested in section 3. Apart from enhancing their role in national budgetary decision making, this approach implies that the Stability programmes should spell out how it is intended to alter budgetary policy in response to output and price surprises, as well as in case of revenue shortfall or surpluses. A simple example of such presumptive responses is the adoption by several member states of public spending targets that are not revised in reaction to revenue shortfalls or surpluses.

Those presumptive responses would not need to be exactly identical across countries, however they would have to be consistent with common principles as spelled out in the code of conduct. There would still be room for discretionary choices by the national authorities, but the presumptive responses would serve as a benchmark against which policy decisions would be assessed by EMU partners and market participants.

For the Stability programmes to play their role, the interaction between European procedures and national budgetary procedures should be both streamlined and reinforced. Simple reforms could include:

- (i) grouping the EU annual coordination and surveillance processes around two main procedures, a “structural” one and a “budgetary and macroeconomic” one, each of which would be the main focus of a Semester and result in a synthetic report to be submitted to the European parliament. The Ecofin (2001) decision to shorten the period for submission of the Stability programmes and to cluster their examination is a step in this direction;

- (ii) including in national budgetary bills a ‘first chapter’ on the zone’s perspectives and policy choices that would be debated by parliament ;
- (iii) making the decision on the Stability programmes part of the national budget preparation procedures, which means that the programmes would have to be adopted by parliament.

A more effective Eurogroup

These proposals would help clarifying the EMU rules of the game. However, it would not eliminate the need for concerted discretionary action in certain circumstances.

Since it has been agreed that the budgetary position of the Eurozone as a whole should be regarded as relevant variables, the Eurogroup should begin its surveillance exercise with an assessment of it (for this to take place, national public finance programmes had to be submitted to the Commission in time for their impact on the fiscal prospects and policy stance of the Eurozone as a whole to be discussed before individual country programmes are assessed. This is now the case). Further steps could be:

- (i) a reciprocal binding agreement by the member of the Eurozone to consult their partners and the Commission before significant economic policy decisions are taken, as proposed by the Commission;
- (ii) an institutional reinforcement of the Eurogroup through the replacement of the rotating presidency system by the designation of a president for a fixed period¹². Such a change would open the way for a more effective leadership and for a greater external visibility of the Eurogroup.

A certainly controversial change would be to transform the Eurogroup into a collective executive body by giving it the ability to take decisions by qualified majority voting (Jacquet and Pisani-Ferry, 2000). The idea behind the proposal is not that the Eurogroup should each year decide on the budgetary policies of the member states, but that it should have the capacity to set guidelines when it agrees that a change in the overall fiscal stance is needed. The corresponding procedure should be designed order to ensure that such guidelines are only issued when there is a clear case for joint action. It should also preserve the exclusive role of the Ecofin as a co-legislator, which implies that the Eurogroup should only be given the capacity to adopt policy guidelines.

A practical possibility would be to give to the Eurogroup the ability to adopt policy guidelines by qualified majority upon Commission proposal, after it has determined that the situation requires a common policy response. To remain credible, such guidelines should not be used too frequently, rather they should only be adopted when there is a clear case for joint action. The Council should refrain from instructing member states to modify their policy choices in the absence of explicitly defined externalities.

Interactions between macroeconomic policy and structural reform

This paper has focused on macro-economic policies. However the interaction between macroeconomic and structural issues is just as important. A good illustration of this state of affairs is the already mentioned gap between the Council’s growth target and the ECB’s evaluation of the growth potential of the Eurozone I. How this gap is supposed to be filled has not been spelled out – or, in other words, it is neither clear whether the structural reforms that are currently contemplated are expected to raise the growth potential by 0.75 percentage points in the coming years, nor whether implementing those reforms would lead the ECB to revise its own estimates of potential output. The risk is that uncertainty about the strength of the governments’ commitment to reform leads the ECB to adopt an excessively cautious attitude and that uncertainty about the monetary policy reactions to bold structural policy actions weakens the governments’ incentive to reform.

A constructive dialogue should be developed between the ECB and the Eurogroup on the interaction between structural reform and macroeconomic policy. The key policy variables around which this

¹² Whether this president would be one of the ministers belonging to the Eurogroup or a commissioner depends on the directions for reforming the EU institutions and goes beyond the scope of this paper.

dialogue could take place are, on the one hand, the NAIRU (or more refined concepts of the equilibrium unemployment rate) and the output gap of the Euro zone, and on the other hand the growth rate of potential output. The Commission could provide a significant input to this dialogue in the form of evaluations of the non-inflationary growth potential and of the impact of structural reforms implemented in the member states or at the Union level.

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