MACROECONOMIC POLICY CO-ORDINATION IN THE EURO AREA

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Abstract
This paper reviews the rationale for co-ordination of macroeconomic policies in the euro area. It makes clear what co-ordination can do and what it cannot do in European practice. It concludes that with the Pact for Stability and Growth, the framework for co-ordination of fiscal policies has by and large been completed. As regards co-ordination of structural policies the implementation and review process should be strengthened. The optimal form of policy co-ordination in this field will differ from case to case. With regard to the policy mix, only an exchange of information and analyses will improve policy-making, as more far-reaching forms of co-ordination will annul the benefits of functional separation.

Key words: EMU, macroeconomic policy co-ordination, European integration

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1. Introduction

European Economic and Monetary Union (EMU) implied a new environment for economic policy co-ordination in Europe. The new environment asked for new and practical solutions on how economic policy co-ordination should be organised. The Ecofin Council (1999) therefore wrote a report on economic policy co-ordination, which has been welcomed by the European Council of Helsinki (11/12 December 1999). The report assesses the experience gained so far and proposes steps to improve the effectiveness of the existing framework. The report takes the need for policy co-ordination as given, since the Maastricht Treaty includes an obligation on Member States to regard their economic policies as a matter of common concern. This paper reviews the rationale for economic policy co-ordination and distils lessons for European practice. The approach differs, therefore, from that followed by Mooslechner and Schuerz (1999), who conclude from a survey of the literature on policy co-ordination that the practical information value can only be described as limited.

This paper concentrates on the rationale for co-ordination of fiscal policies, of structural policies, and of the policy mix. It reviews the existing framework for co-ordination in these fields in order to identify shortcomings. It will not dwell on the arguments in favour of or against the single monetary policy. Co-ordination is defined for the moment as a significant modification of policies in recognition of interdependence between Member States or between policy areas, be it resulting from a mere exchange of information or from negotiations, including full harmonisation. A more precise definition is given where needed.

The remainder of this paper is organised as follows. Paragraph 2 deals with the question why to co-ordinate from a fairly general perspective. The other paragraphs go more into detail. In paragraph 3, co-ordination of fiscal policy is discussed, both at Member State and aggregate level. Paragraph 4 takes a closer look at co-ordination of structural policies. Co-ordination between authorities (policy mix) is discussed in paragraph 5. Paragraph 6 concludes.

2. The rationale for co-ordination

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2 In the economic literature, looser forms of co-ordination are often referred to as co-operation. In game theory, however, co-operation implies the existence of binding agreements. In this article, we only use the term co-ordination in order not to create confusion.
Why co-ordinate in EMU?
The general case for economic policy co-ordination is that there are spillover effects from one
country to another or from one policy area into another. Spillover effects are defined here as
unintended linkages between policy outcomes. Policy outcomes could be improved, in principle, by
taking spillover effects into account when designing policy. In principle, as it has to be assessed
whether the spillover effects are large enough, i.e. whether the gains from co-ordination outweigh
the costs of co-ordination. This is a non-trivial issue. Any potential benefits from co-ordination must
be set against the risk that the benefits from functional separation and decentralisation are
undermined.

The fact that monetary policy is centralised at the European level does not necessarily imply
that other policy areas should also be centralised or co-ordinated. However, EMU tends to increase
the economic integration between euro area countries, via both financial markets and trade links.
This implies that national policy measures will be increasingly felt outside national borders. The
potential benefits of co-ordination therefore increase and the trigger point for co-ordination will be
reached earlier – assuming that the costs of co-ordination remain constant. This argument justifies a
rethinking of policy co-ordination in the euro area context. Of course, it is also conceivable that the
coordination mechanisms before EMU were not adequate enough already.

Moreover, monetary, fiscal and structural policies do have a bearing on each other. It is thus
logical to consider whether co-ordination of the policy mix could improve policy outcomes. For
example, it is only natural to contrast the aggregate budgetary stance with the single monetary policy
stance. This could also be motivated by an argument of political nature: in some line of thinking, the
power of the European Central Bank (ECB) needs a countervailing power. As monetary policy
impacts the aggregate level, there should be another authority that can impact the aggregate level in
order to prevent abuse of power. This is sometimes considered all the more important as the ECB is
an independent institution that is not accountable to any other institution or authority.

Is co-ordination beneficial?
In both the theoretical and empirical economic literature, co-ordination generally improves welfare.

In the case of the theoretical literature, this should be hardly surprising given the way most
models are constructed: extra information used by welfare optimising policymakers should lead to
better outcomes almost a priori. More interesting is the conclusion of Bryant (1995) from the
theoretical literature that the largest gains of co-ordination may result already from governments
exchanging information and acting strategically rather than acting in an insular or myopic manner.
Information exchanges can help to reduce uncertainty and thereby improve national policy decisions. Canzoneri and Edison (1989), for example, study games that centre on gains from information exchanges and surveillance, and from agreements about instrument choice. They conclude that the gains from information sharing and surveillance tend to be about ten times as important as from agreements about instrument choice, which are in turn about ten times as important as the gains from going to full-scale co-ordination.

In empirical studies, the results of individual countries’ welfare maximising behaviour are compared with the outcome when countries maximise a joint welfare function. The empirical estimates of the size of gains from policy co-ordination have been modest at best. The seminal paper of Oudiz and Sachs (1984), for example, suggests incremental gains of ½%-1% GNP. Gains of that size are broadly comparable to the forecast errors of target variables (Currie et al 1989). However, it is difficult to draw policy conclusions from these estimates. The size of gains appears sensitive to the models used and the definition of non co-operative and co-operative outcomes.

Though co-ordination seems to pay-off in theoretical and empirical models, there are many arguments that point to the fact that co-ordination may be counterproductive as well. Most of these arguments are of an institutional or political economy nature.

One line of argument is that co-ordination may deflect the attention of national governments from higher priority national actions and/or that it might give them incentives to delay policy actions they ought to take (e.g. Vaubel 1985, Feldstein 1988). Policy co-ordination efforts will sometimes even be prompted to deflect blame for poor domestic economic policy and performance, leading to international conflict instead of co-operation. An example might be the sharp discord between British and German officials during the 1992 ERM crisis (Willet 1999). This line of argument is also related to the risk that national governments use co-ordination in order to pursue otherwise unsustainable policies. That is, co-ordination may allow a sub-optimal policy to be less harming if other countries pursue the same policies. An example might be excessive wage increases having less detrimental impact if competitors do just the same. Such an outcome could be particularly relevant in cases where it is politically costly to pursue the optimal policy. As Wyplosz (1999) notes, the notion that future gains justify sacrifices today is hard to sell because scepticism is the rule. In the above example, scepticism may be the result of the well-known insider-outsider problem. Insiders may be sceptical about their long term gains as it is likely that the gains of abstaining from wage increases will largely go to the outsiders and that they will not be compensated for their implicit loss.

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3 Full-scale co-ordination should be interpreted as that all of the players in a co-operative game commit their policy instruments to minimizing a weighted sum of their individual losses.
Moreover, efforts at policy co-ordination could in some circumstances weaken beneficial forces of competition among policymakers or work in the direction of undercutting the market’s monitoring role, both of which may be important vehicles for encouraging better individual policy performance (Winkler 1999). Rogoff (1985) pointed to the fact that co-ordination might be counterproductive if relevant third parties are left out, i.e. when a subgroup of players co-ordinates amongst themselves.

Other arguments point to model uncertainty making co-ordination more difficult. Frankel and Rockett (1988) have illustrated empirically how co-operative action based on the wrong model can produce a worse outcome than if governments acted independently. They used simulations with 10 different large econometric models defining one as ‘true’ model and two others as the own models of the authorities of two countries to base their decisions on. By comparing the non co-operative outcomes to the co-ordinated outcomes, they concluded that a co-operative policy package is as likely to improve welfare as to reduce it. In a reaction to Frankel and Rockett, Holtham and Hughes Hallett (1992) even go further. They conclude from simulations that it is better to co-ordinate only when the result is welfare improving in the models of both authorities, or put differently “some disagreement is better than unanimity in error”. Dobson (1991) notes in that respect “at the Bonn summit [1978], the difficulties in arriving at a common analytical view that could also support a politically feasible agreement took so much time to overcome that, with the clarity of hindsight, it appears the policy package finally implemented actually overaccelerated the growth of the aggregate demand”. However, we cannot jump to conclusions, as a number of studies come to reverse results by showing that model uncertainty may also provide an incentive to co-ordinate policies. In particular Ghosh and Mason (1991) showed that co-ordination dominates uncoordinated regimes, as policymakers learn about the use of models.

Finally, attention must be paid to how agreement on adopting policies may be reached and how such agreements may be effectively implemented – as there is always the risk that policymakers do not stick to their commitments. Three main elements of the process framework for co-ordination may be identified (Crockett 1989): 1) policy objectives and guidelines; 2) surveillance and; 3) adoption of recommended policy changes. In this respect, it can be noted that clear rules are expected to have some advantages (Mooslechner and Schuerz 1999): fear for loss of reputation or peer pressure can be incentive mechanisms not to reneg. Moreover, rules are expected to protect small players against larger ones. Rules could be augmented by mechanisms such as sanctions. In the end, however, co-ordination is the result of political will, which is particularly important to remember when discussing policy co-ordination in EMU.

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4 Which means that there are 1000 possible combinations in the simulation.
We can conclude from the above arguments that policymakers should carefully assess the need and design of co-ordination, as co-ordination may sometimes be welfare undermining instead of welfare increasing. A practical checklist could contain the following elements: 1) is there a clear policy objective?; 2) is exchange of information enough or is there a need for rules or other co-ordination mechanisms?; 3) does co-ordination not deflect from national priorities?; 4) can co-ordination be misused to blame others for poor domestic performance?; 5) does co-ordination mean that otherwise unsustainable, detrimental policies will be pursued?; 6) is any relevant party left out? We will use this checklist (implicitly) in the remainder of our analysis.

3. Co-ordination of fiscal policies

3.1 Fiscal policy at Member State level

*Why co-ordinate?*

With EMU, there is a single monetary policy in the euro area that will react to aggregate developments in order to maintain price stability. Fiscal policy is the main instrument left to counter asymmetric shocks in the Member States. The need to use fiscal policies at the national level will thus be felt more and activist, discretionary behaviour will become more attractive. Depending on the relative strength of the transmission channels (direct Keynesian effect versus interest rate effect), this leads to positive or negative spillover effects. Without co-ordination the result would be respectively an overly restrictive or an overly expansionary fiscal policy at the euro area level, as respectively the marginal benefits and the marginal costs of fiscal expansion decrease.

The strength of Keynesian spillover effects will depend on the trade links between countries. As close trade links already existed between euro area countries before EMU, it can be expected that Keynesian spillover effects are not that much affected by EMU per se. Moreover, with a view to European fiscal positions, Keynesian spillover effects did not appear to have led to overly restrictive policies in the past. To the contrary, the debt built-up in most European countries over the last two decades has been widely regarded as excessive (Masson 1996). The strength of the interest rate effect depends on financial market integration. As it is likely that the financial markets within the euro area have become more integrated and interdependent since the existence of the euro, EMU

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5 To the extent that they are not absorbed by market adjustments.

6 Alternatively, one could argue that given a specific target for output, positive (negative) spillover effects might lead to overly expansionary (restrictive) fiscal policies.
may have had more impact on the interest rate spillover effects than on Keynesian spillover effects. From these arguments it might be considered more important to counter any overly expansionary fiscal policies.

This conclusion is reinforced by arguments pointing to the fact that there should be a safeguard against monetary financing. Although the Maastricht Treaty prohibits monetary financing, a scenario in which a debt crisis is jeopardising financial stability is conceivable. In such a case, the ECB could be forced to step in anyway (Eichengreen and Wyplosz 1998). Beetsma and Uhlig (1999) argue that the inflation bias might even be more general. Assuming that future elections induce national policymakers to have a short time horizon, and thus to be inclined to raise too much debt, a central bank may find itself in the dilemma of ensuring low inflation and eroding the debt burden. This dilemma could be even worse in EMU as the national authorities will tend to ignore the impact of their actions on the common inflation rate. The premise here is that central bank independence alone is not sufficient for the credibility of monetary policy but requires the support of a generalised “stability culture” and of fiscal discipline in particular (Artis and Winkler 1998). A deficit rule could help to ensure that fiscal policy does not lead to inflationary biases.

Both large and small countries have an interest in co-ordination of fiscal policies to counteract spillover effects. Large countries will influence the euro area levels in a direct way. Small countries thus have a direct incentive to curtail the behaviour of large countries. On the other hand, small countries are more likely to get into a prisoner’s dilemma. As they do not influence euro area levels substantially, especially small countries might wish to adopt a more expansionary (restrictive) budgetary stance than they would have desired otherwise. However, though they do not individually affect euro area interest rate levels, the aggregate effect might still be an overall rise in interest rates. Without co-ordination, the outcome could very well be a too expansionary (restrictive) policy for the aggregate. Thus large countries have an incentive for co-ordination too.

**How to co-ordinate?**

The policy objective of the co-ordination effort could be defined as to counter any overly expansionary fiscal policies. It can be doubted whether an exchange of information would be enough in this case to reach that goal. The political economy would suggest that it is necessary to look further into the details of the budget process itself as the institutional rules can shape the outcome of the process. In some countries, for example, the prime minister together with the minister of finance

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7 Theoretically, this should not be the case, given the no-bail out clause in the Maastricht Treaty.
have the responsibility for setting the budgetary targets, whereas in other countries the spending departments play a relatively large role – with imaginable effects on the budget. Von Hagen and Harden (1994, 1995) provide a theoretical underpinning of this argument as well as an empirical investigation of the budget process within individual EU-countries. They suggest that a target-oriented approach – the set-up of binding numerical targets for the budget - will be most adequate for multi-party coalition governments to curb expansionary biases. A parallel can be drawn to the international level, where binding rules might be used to curb expansionary behaviour.

What has been done thus far?
The aforementioned spillover effects have been recognised as a case for co-ordination at an early stage. The Maastricht Treaty and the Pact for Stability and Growth provide a check for budgetary policies by setting policy rules. By doing so, inflationary biases are effectively curtailed. The ceiling of 3% gdp for government deficits means that any expansionary bias is curtailed. Moreover, the provision of the Pact that Member States should have deficits close to balance or in surplus (over the business cycle) implies that fiscal policy can be used to counteract (asymmetric) shocks to a certain degree, mainly via automatic stabilisers, without leading to excessive deficits. This implies that co-ordination does not deflect from the national priority of the stabilisation function of fiscal policy. The fiscal plans of individual Member States are reviewed by the Ecofin Council by means of stability programmes. The Stability and Growth Pact even provides for the imposition of sanctions by the Ecofin Council. Governments could not blame others for a poor domestic performance, as they are themselves responsible for sticking to the common rules. The no-bail out clause in the Treaty should ensure that market sanctions in the form of default risk premia on government debt remain effective.

What could be done more?
The institutional framework for co-ordination of fiscal policies thus seems to be ready to a large extent. Nevertheless, there are some areas of improvement.

The incentives to behave prudently were very strong in the run up to EMU, as sound fiscal policies were a prerequisite for entering EMU. It is questionable, however, how strong these incentives remain after entrance in EMU, as there is no threat of expulsion. Moreover, the current rules do not provide explicit incentives to behave prudently in good times: there is no direct reward for bringing the budget down to safety margin levels. Of course, one could argue that the safety

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8 Gains from an expansionary policy are felt without high cost, as detrimental (national) interest rate effects are smoothed out over the Union.
margin level itself is the reward as it provides insurance for bad times. Whether this is a large enough incentive is eventually an empirical question.

The binding nature of rules depends inter alia on the power of individual countries to postpone the achievement of targets over time versus the power of the Ecofin to enforce the original dates for reaching the targets. In this respect the review process in Brussels could be strengthened. The Helsinki report recalls paragraph 6 of the Stability and Growth Pact, which allows for the possibility of giving early warning by addressing a recommendation under Treaty Article 99(4) to an individual Member State in the event that the Council identifies significant divergence of the budgetary position from the medium term budgetary objective, or the adjustment process towards it. However, the Council has thus far not used its powers under these provisions. In the review process, the repeated game still seems set at “not criticising too much”. To some extent this is an unavoidable outcome of the process (Von Hagen 1998). However, it might in part be due to the current framework of policy reviewing, in which the country “under review” plays a relatively large role in the formulation of policy recommendations. The review process is effectively a consensus procedure, although recommendations could be issued by qualified majority. An informal consensus rule could ultimately be an obstacle to addressing openly policy problems in a specific Member State (Italianer 1999).

The Brussels process contrasts to some extent with the policy review process at the IMF. The arguments of the Executive Director (ED) representing the country “under review” are not reflected in the minutes of the Board-meeting, thus strengthening the peer pressure content of the minutes\(^9\). Of course the ED can try to influence his colleagues, but his role seems to be more restricted than the role of the Finance Minister in Brussels. A conduct of the review process in Brussels more similar to that in Washington could thus be desirable. It is, however, probably hard to realise in the near future, given the political importance of the Brussels decisions.

3.2 Fiscal policy: the aggregate level

*Why co-ordinate?*

It is conceivable that in some cases collective action of euro area fiscal authorities is required. For example, there might be a severe recession throughout the euro area, which would call for budgetary expansion. With no co-ordination among Member States, the result would in all likelihood be

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\(^9\) The arguments of the national authorities are already reflected in the Article IV report itself. Similarly, the arguments of the national authorities in the Brussels process are reflected in the stability programmes.
suboptimal, as explained in paragraph 3.1 above. This would call for central decision making on the overall fiscal policy stance.

Another case for co-ordination of fiscal policy at the aggregate level would be international risk sharing with regard to asymmetric shocks. Risk sharing requires a central transfer mechanism, with transfers being paid by relatively overperforming countries and received by underperforming countries. In the US, for example, the federal budget performs a stabilisation function of 10-15% of a drop in state income (for a review of empirical studies see Von Hagen 1998). This compares to a smoothing provided by automatic stabilisers of approximately 40% on average in the EU Member States (OECD 1999a).

Finally, the aggregate fiscal policy stance could be used to fine-tune the euro area cyclical development. However, a fiscal policy that reacts on cyclical circumstances runs into the well-known risks of discretionary policy-making. For one thing, it is very difficult to predict economic growth with the needed accuracy. A recent assessment by the Commission of its forecasts reveals that there is not much evidence of a mean forecast error, but forecasts mispredict actual outcomes quite substantially from year-to-year (Keereman 1999). Furthermore, the decision-making process in fiscal policy is normally not flexible enough to allow for the quick reactions that would be needed. This is true a fortiori for the euro area, where decision-making would be further delayed through a time consuming co-ordination of policies. Given these time lags fiscal policy could easily work pro-cyclical rather than countercyclical. Indeed fiscal policies have worked more pro-cyclical than anti-cyclical in Europe in the past (OECD 1999b). As a last point, Member States should agree on the burden sharing in countering any symmetric shock. However, as budgetary policies should also address asymmetric shocks, it is plausible to assume that this is a too complicated task to achieve.

How to co-ordinate?

From the above arguments, it can be concluded that the policy objective of co-ordinating fiscal policies in order to influence the aggregate level is not very clear. There might be special circumstances, which require action. However, there seems to be no case for designing rules on the aggregate policy stance. By providing room for automatic stabilisers, the Stability and Growth Pact already allows for a countercyclical budgetary stance, also in case of symmetric shocks. In the case of a severe recession, countries are allowed to surpass the 3% ceiling on a temporary basis. Indeed, rules for the aggregate budgetary stance might deflect attention from the rules set under the Stability and Growth Pact, e.g. because countries could be allowed to surpass the 3% ceiling also in case there

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10 In the Pact for Stability and Growth, a severe recession is defined as an annual decline of real GDP of at least 2 per cent.
is no severe recession as the overall budgetary stance is considered not to be endangered. It can be expected that such behaviour undermines the political will to stick to sound budgetary rules. At the least, it will be harder to explain at home why the government is pursuing relative fiscal austerity while others are not.

What has been done thus far?

At present, there is no official procedure for assessing the overall budgetary stance, although there is some statement in the Broad Economic Policy Guidelines (BEPG, see also §4). Moreover, it remains unclear how any desired overall budgetary stance would translate to the fiscal policies of individual Member States.

What could be done more?

Notwithstanding the foregoing, it will be important to monitor the aggregate level of the budgetary stance. The following two procedures could be chosen to assess the aggregate level. First, the Ecofin Council could decide to a new regulation for the assessment of the aggregate level, based on Article 99.5 of the EC-Treaty. Second, and more likely to occur, the aggregate level could be assessed more rigorously in the context of the BEPG. Whichever method is chosen, for the reasons mentioned above, it should be ensured that it is fully consistent with the Pact for Stability and Growth and that it gives the aggregate level its proper weight (i.e. only a target in very special circumstances).

4. Structural policies

Why co-ordinate?

As regards structural policies, co-ordination might be needed to even out the barriers to the exploitation of economies of scale, e.g. with regard to a common market for electricity or financial assets. Spillover effects relate to policies designed at attracting business, capital and or labour at the cost of others (which if retaliated by others could lead to “race-to-the-bottom” behaviour), barriers to the level playing field, and inability of adopting the structural reforms needed for a more smooth functioning of the monetary union. Regarding the latter point, in the past, rigid economies would have had to cope themselves with the cost of not being flexible. Nowadays, under the single monetary policy, the whole union could be affected. Examples relate to differences in the transmission process of monetary policy and to differentiation in the potential room for manoeuvre for monetary policy (e.g. through substantially different levels of the NAIRU across countries).
one-size-fits-all monetary policy might give countries an incentive to become more flexible anyway. However, co-ordination might be needed to strengthen this process.

How to co-ordinate?
As to the policy objective, it is important to note that the rationale for co-ordination in structural policies lies to a large extent in the internal market, and not in EMU per se. Thus co-ordination between countries in this field is - and should be - EU-wide, not euro area wide. A further point to note is that the costs of different co-ordination procedures will vary quite heavily from case to case. There might be cases, which call for harmonisation or the set-up of minimum standards, especially where it comes to deregulation and certain tax issues. However, there are cases, which call for differentiation too, e.g. with respect to the labour market. A default strategy of harmonisation would annul the flexibility at the national level, which is needed to cope with diverging economic developments, with the different structures and preferences of nations, and with differences in the stage of development. Furthermore, the outcome of harmonisation could very well be that policies that can no longer be maintained at the national level are transposed to the aggregate level. All this implies that the rationale for harmonisation at the euro area wide level is confined.

It can be doubted whether contracting over reforms is possible. In practice, it will be very hard if not impossible to quantify reform or to verify reformers’ actions. Fundamental reforms are therefore often targeted indirectly (Sibert 1999). Sibert points to the criteria for joining EMU, which are aimed at countries undertaking structural reforms in order to lower inflationary biases. In many cases, however, indirect targeting will be hard to achieve too.

A case to case approach, i.e. a framework for co-ordination fine-tuned to the specific field of policy, thus seems to be called for. Four elements could be put central in such an approach: 1) benchmarking at best practices, as Member States can learn from each other’s or third countries’ experiences; 2) avoidance of a race-to-the-bottom, which would be detrimental to all countries involved; 3) guaranteeing of the level playing field, as one of the premises of the EU is the principle of an open market economy with free competition; and 4) due consideration of the need for flexibility at the national level, which is needed given the one-size-fits-all monetary policy.

A last point to note is that the risk of interference of different policy measures is high in this area, as there are many overlapping competences, e.g. between the Ecofin Council and the Labour and Social Affairs Council. It is thus of importance to define clear responsibilities and to set a clear hierarchy in policy rules.

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11 The last argument might be particularly relevant after EU-enlargement.
What has been done thus far?

Central in the co-ordination process are the BEPGs, which have their basis in the Treaty (Article 99). The BEPGs are issued annually. They are intended to define the main objectives and policy orientations. In this way, they direct the different processes mentioned below by putting forward an integrated and consistent view. They also validate and combine previous initiatives in these processes. In this sense, they stand at the beginning and at the end of annual process of policy implementation and surveillance. If the Ecofin Council considers that the economic policies of a Member State are not consistent with the BEPGs or risk jeopardising the proper functioning of EMU, the Council may, acting by a qualified majority on a recommendation from the Commission, make recommendations to the Member State concerned (Article 99.4), in order to step up peer pressure. These recommendations can also be made public, again on the decision of a qualified majority. However, these instruments have not been used up to now. There exists no formal sanction procedure.

More focussed co-ordination takes place under the headings of the Cardiff and Luxembourg processes. The Cardiff process is directed at structural reforms in capital and product markets. A first annual review of national economic reform policies was conducted at the beginning of 1999 (Cardiff II-report); the results were included in the 1999 broad economic policy guidelines. The Council also reviewed the progress in eliminating the remaining impediments to the Single Market (Cardiff I-report). Employment guidelines are issued under the heading of the Luxembourg process. In the context of these guidelines, the Member States set up national employment action plans. All mechanisms used are primarily aimed at peer pressure and peer review.

What could be done more?

In the context of structural reforms, it seems to be especially surveillance and the adoption of recommended policy changes that are lagging behind. There is as yet no clear review process for policy implementation. The Ecofin report to the European Council of Helsinki points to the same shortcoming and defines the following steps to reinforce effective policy co-ordination:

1. The BEPGs are kept at the centre of the co-ordination process. The Ecofin Council will review closely the implementation of the BEPGs on the basis of a Commission report prior to the adoption of a new vintage. Furthermore, the Council has expressed readiness to act on recommendations under Article 99.4 and, if necessary, to make them public.

2. Regarding the Cardiff process more emphasis will be put on the identification of good practice of economic reforms in Member States. The Council will define priority subjects and monitor more closely the implementation.
3. The employment guidelines should be more sharply focussed on the functioning of labour markets. Moreover, it is deemed essential to make them more concrete by setting national targets and dates as requested by the European Councils in Vienna and Cologne.

These steps could be considered as consistent with the four central elements defined above: Benchmarking at best practices will take place; race-to-the-bottom behaviour should be contained by strengthening peer pressure; and the need for flexibility at the national level is accounted for by seeking national and not general solutions. The guaranteeing of the level playing field is one of the premises which is explicitly mentioned in the Helsinki report. This principle should be monitored sharply, however, as there is no automatic mechanism that this principle is vindicated in the procedures. By keeping the BEPGs at the centre of the policy co-ordination, the risk of interfering competences is sorted out.

5. Co-ordination between authorities (policy mix)

**Why co-ordinate?**

Sometimes it is suggested that the right policy mix could only be achieved through more active co-ordination of fiscal and monetary policies (Bayer, Katterl and Wieser, 1998). However, in the context of economic policy-making, it has been argued that monetary and fiscal policy should be separated for the following reasons. As Kydland and Prescott (1977) have shown, policies which are optimal ex ante become sub-optimal ex post, due to the fact that the private sector’s current decisions depend upon expectations of future government policies. This phenomenon has been described as the time inconsistency problem. In the Barro-Gordon model (1983), inflation is generated because wage setters expect the central bank to inflate in order to drive down real wages to a level consistent with the socially desired rate of employment. By setting nominal wages high enough, the wage setters can place the monetary authorities in a position where the social cost of inflation will outweigh the benefits of reduced employment. It is shown that this time inconsistency problem is in some circumstances resolved through the punishment which comes with a loss of credibility or reputation in case the policymaker switches away from the ex ante optimal policy to the sub-optimal time consistent policy. Rogoff (1985) has shown that with regard to monetary policy it will be best to appoint an independent conservative central banker that abhors inflation more than the median individual. In that way, the economic agents can be credibly convinced that there will be no surprise inflation to stimulate the economy and welfare will be maximised. Decision-making should thus not be put in the hands of one body.
This is not to deny that monetary, fiscal and structural policies have a bearing on each other. There is thus good reason for policymakers to exchange information. A dialogue among policymakers will improve decision-making and will create more support for the eventual decisions taken. This might be especially in the interest of the Eurosystem, as monetary policy risks to be scapegoated otherwise (Von Hagen 1999).

Scapegoating could result from the following process. Absent any central fiscal policy making, the Eurosystem will be the only visible institution responsible for macroeconomic policy at the euro area level. The public could mistake the Eurosystem to be the only responsible body too. The Eurosystem may thus become the focal point for all dissatisfaction in EMU with macroeconomic developments. In the current situation, the Eurosystem risks to be scapegoated for the unemployment problem. If the public perceives the problem as being caused by a too restrictive monetary policy, it will be hard for the Governing Council to escape this perception. For example, the public might perceive an interest rate increase as if the Eurosystem were not allowing economic growth to get to full steam. It is conceivable that this perception leads to political pressure to which the Eurosystem has to yield eventually. In the extreme, this means that monetary policy of the Eurosystem could become undesirably lax. It is thus in the interest of the Eurosystem to make clear that it is not the only body responsible for euro area wide policy-making. A higher accountability of the decision making process in Brussels may be needed to avoid this problem.

**How to co-ordinate?**

The policy objective should be to improve decision-making. This could be done by exchanging information and analyses, given implicit co-ordination rules, which guarantee functional separation. As indicated above and noted by Winkler (1999), under an efficient policy assignment the need for additional explicit and “activist” co-ordination beyond the implicit co-ordination of behaviour induced by an appropriate and clear allocation of policy functions and incentive structures will be rather limited. Co-ordination should thus not take the form of joint decision-making (ex ante co-ordination). That would implicitly mean that decision-making is put in the hands of a single body, although existing of more individuals in that case, thereby annulling the effect of functional separation.

In the process of exchanging information and analyses, it is particularly important for monetary and fiscal authorities not to forget the social partners as the third relevant group of players.

**What has been done thus far?**
There is a lot of implicit policy co-ordination between fiscal and monetary authorities, both through rule-based co-ordination (Stability Pact, Treaty) and dialogue between budgetary and monetary authorities. The president of the ECB is invited to the Ecofin and euro-11 meetings if items related to the objectives and tasks of the Eurosystem are discussed. In practice the ECB is always invited to the euro-11 meetings. The president of the Ecofin Council may participate in the meeting of the Governing Council of the ECB, albeit without a right to vote. Another important forum for discussion is the Economic and Financial Committee. This committee brings together senior officials of the ministries of Finance in the EU, the National Central Banks (NCBs), the European Commission and the ECB. Furthermore under the heading of the Cologne Process a macroeconomic dialogue has been set up between all relevant economic policy makers and actors (monetary and budgetary authorities, social partners). The aim of this process is the built-up of mutual trust and the exchange of information and analyses.

What could be done more?
The above analysis makes clear that co-ordination of the policy mix is necessarily very restricted. What has been done already appears to be a sort of maximum. There is a clear assignment of policy responsibilities in Europe, implying an implicit co-ordination structure. Beyond that, there is an exchange of information and analyses, which should prevent that policy decisions are made in isolation. Nevertheless, transparency of policy-making could be increased. The Eurosystem should operate as transparently as possible in international meetings in order to create support for its policy. The Eurosystem could also help decision-making of other authorities by discussing specific policy issues with respect to the content. To make clear that the Eurosystem is not the only authority responsible for the euro area, it could also discuss the outcome of the Brussels process consistently in its monthly/quarterly bulletins and in speeches. The NCBs could do so with special regard to their national authorities. The Helsinki report also recognises the importance of transparency, but apart from suggestions to involve parliaments, no concrete proposals are made.

6. Conclusion

EMU has reinforced the debate on policy co-ordination within Europe. The rationale to rethink economic policy co-ordination within the euro area is, generally speaking, that EMU increases economic integration and thus spillover effects. Moreover, the single monetary policy naturally
provokes thoughts about co-ordination of the policy mix at the euro area level. From the economic literature, it might be concluded that co-ordination, especially its lightest form – exchange of information –, is welfare enhancing. However, there are many arguments that point to the fact that co-ordination may be counterproductive as well. Policymakers should thus carefully assess the need and the way of co-ordination. A practical checklist could contain the following elements: 1) is there a clear policy objective?; 2) is exchange of information enough or is there a need for rules or other co-ordination mechanisms?; 3) does co-ordination not deflect from national priorities?; 4) can co-ordination be misused to blame others for poor domestic performance?; 5) does co-ordination mean that otherwise unsustainable, detrimental policies will be pursued?; 6) is any relevant party left out?

The main conclusions from the assessment of economic policy co-ordination in the euro area are the following. As regards fiscal policy, the framework for co-ordination has by and large been completed. The Pact for Stability and Growth provides insurance against overly expansionary fiscal policies, which can be considered most important in EMU. There is no need for further co-ordination of fiscal policies at the aggregate level. A fiscal policy that reacts on cyclical circumstances runs into the well-known risks of discretionary policy-making. Moreover, the Stability Pact was designed inter alia to create room to let automatic stabilisers work at the national level. Nonetheless, there might be circumstances that warrant common action, but this will be in special cases only. Co-ordination could then take place on an ad hoc basis.

Co-ordination in the field of structural and tax policies has to be dealt with in a case to case scenario as the optimal form of co-ordination will differ from case to case. Four guidelines could be used when co-ordinating: 1) benchmarking at best practices, 2) avoidance of a race-to-the-bottom, 3) guaranteeing of the level playing field, 4) due consideration of the need for flexibility at the national level. At the moment it seems to be especially surveillance and the adoption of recommended policy changes that are lagging behind. The Ecofin report to the European Council of Helsinki has defined concrete steps to reinforce the review process for policy co-ordination and thus takes a step in the right direction.

With regard to the policy mix, there are clear gains from functional separation. The macroeconomic policy dialogue appears to be a sort of maximum of co-ordination, as only an exchange of information and analyses will improve policy-making. Nevertheless, transparency of policy-making to the general public could and should be enhanced. The Eurosystem could thus be protected from an undue judgement as if it were the only authority responsible for macroeconomic developments in EMU.

12 There is an inherent asymmetry in this field, as the ECB is an independent institution. According to the Maastricht Treaty politicians should not seek to influence the ECB and the ECB is not allowed to listen to
The review of economic policy co-ordination in this paper thus suggests that only in the field of structural policies, there remains significant room for improvement of the policy framework in the euro area.
References


