Economic policy co-ordination in the euro-zone

What has been achieved? What should be done?

Pierre Jacquet and Jean Pisani-Ferry

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PRICEWATERHOUSECOOPERS

PricewaterhouseCoopers is delighted to sponsor this Centre for European Reform paper on economic policy co-ordination. We see it as a further valuable contribution to the debate on European economic governance.

Economic and monetary union has now been with us for some time. But the "E" in EMU is still imperfectly understood. It has tended to be the preserve of economic specialists and special advisers. In part, perhaps, this is because economic conditions in the European Union have meant that the imperative to consider economic policy co-ordination has been weak.

This paper brings the issue firmly back to the forefront of the wider debate by looking at how European economic governance works, and by examining how it could be strengthened in the future. The implications of the paper's conclusions are potentially far-reaching. They impact directly on the economic environment, through exchange rates, interest rates, inflation, tax and government spending, and thus on the business environment. Businesses therefore need to understand the emerging process of economic governance in Europe.

Furthermore, economic governance is not yet set in concrete. The views expressed in this paper are the views of its authors, not statements of fact or predictions. There is plenty of scope for further debate on the key issues, not least for influencing this emerging process. This is an important message for all those who do business in Europe: we not only need to understand the process, but we can also, if we choose, help to shape it and deliver the framework of economic governance that Europe's businesses—and Europe's citizens—need and expect.

In PricewaterhouseCoopers we recognise that EMU does not mark the end of the integration process. Rather, it is one driver, albeit a very important one, amongst many drivers for change in Europe. Over the next ten years, the economic drivers will interact with the political, the social, the technical and the environmental drivers to fashion the New Europe in which we all do business. We aim to work with our clients to understand and to shape the new business environment, and to fashion the best possible responses to the challenges of the New Europe; that is why we particularly welcome this paper and the debate to which it will contribute.

Rosemary Radcliffe
Chief Economist

To discuss the issues raised in this paper, or more generally the issues raised by the New Europe or the euro, please contact:

Rosemary Radcliffe *+44 20 7213 1589*
Mark Ambler *+44 20 7213 1591*

Introduction

European economic policy co-ordination is explicitly mentioned as a common objective in the Treaty of Maastricht. The Euro Group—that is the informal gatherings of finance ministers of countries in the euro-zone that was formerly known as Euro-X or Euro-11—was created in order to improve co-ordination in the area of economic policy. Some governments were initially reluctant to see this group created, but a large number of them now accept its value.

The issue of co-ordination has therefore become consensual enough for the observer to wonder whether it is still worth discussing, given that the EU has so many other priorities on its agenda. Member-states have been focusing their energies on treaty change and institutional reform, and on the management of a process of enlargement that involves many diverse countries. Equally important, there is a growing debate on what should constitute the end-goal of European integration. With such an overburdened agenda, the co-ordination of economic policies does not seem a key priority.

We believe, however, that to overlook the issue of co-ordination would be a serious mistake. We find two major reasons for this. One relates to the European integration process, and the other to growth and employment in the euro-zone:

★ Thinking about co-ordination is a useful way of addressing the wider issue of governance of the EU and the euro-zone. We believe that the usual "community method" has reached the limits of its usefulness. In many key areas—defence, for example—member-states are at the same time both willing to co-operate and reluctant to transfer further national sovereignty. Within these areas, future European integration must increasingly rely on new forms of co-operation that by-pass the well-known shortcomings of the traditional inter-governmental approach. Hence, the debate on economic policy co-ordination is not just a debate between economists pursuing an optimum, but rather a crucial contribution to the argument on the institutional organisation of the EU.

★ Euro-zone growth has lagged behind that in the United States by more than ten percentage points during the last decade. To achieve the objectives of the March 2000 Lisbon summit—namely full employment and the creation of a knowledge-based economy—will require a significant enhancement of the quality of economic policy in the euro-zone. Despite the current economic recovery, the challenge still has to be met. There is a distinct possibility that economic growth in Europe could slow down prematurely, due to a failure of its policy-making system to deliver the necessary balance between macro-economic and structural policies, or between fiscal and monetary policy. During 2000, we have seen the euro's continuing decline and a set of confusing messages sent to the public and the markets on the degree to which responses to the oil shock should be co-ordinated; both have confirmed the need for a more cogent approach to this issue. The makers of economic policy—governments and the European Central Bank (ECB)—should consider improving the economic policy system of the euro-zone as an urgent priority.

From a different perspective, we consider that the implications of the single currency have been both over-estimated and under-estimated. Over-estimated, because the euro has sometimes been portrayed as a miracle cure of Europe's illnesses and as a definitive recipe for growth. In fact, the real benefits that it will deliver are no alternative whatsoever to the necessary focus on innovation, education, or labour and goods market reform, in an environment of unabated technological progress. But we also find the implications of the single currency under-estimated, because not enough attention has been given to the institutional and political adaptations that are necessary to make EMU a lasting success. This can and must be corrected.

The first section of this essay briefly describes the current economic outlook for the euro-zone and discusses the implications for economic policy co-ordination. In the second section, we claim that the euro introduces new channels of interdependence and increases the rationale for co-ordination. Our third section assesses the current state of play. In the fourth section, we come up with a number of policy recommendations. The fifth section offers our conclusions.

1 Economic policy co-ordination in context

Between mid-1999 and mid-2000, economic recovery in the euro-zone gained strength. Dynamic job creation has been one of its characteristic features. Unemployment declined swiftly, even though it remains much too high, with almost 9 per cent of the labour force unemployed in the latter part of 2000. Inflation initially remained subdued in 1999, but it accelerated in 2000 due to the rise in oil prices, the euro's decline, and the tensions generated by overheating in some European economies.

Consumer price inflation has now reached and even exceeded the 2 per cent medium term ceiling set by the ECB, prompting several interest rate hikes by the central bank.

It is too early to assess the impact of monetary tightening on growth and inflation, but it seems not to have had the desired effect on the euro exchange rate. At the same time, general government deficits have fallen significantly, and no less than five EMU member-states are forecast to record a budget surplus in 2000. However, the underlying budgetary position within the euro-zone did not improve in 2000. The International Monetary Fund is forecasting a deterioration in 2001. The euro-zone is thus moving in the direction of a tighter monetary policy, combined with expansionist fiscal policies at the peak of the economic cycle.

The debate on economic policy co-ordination in Europe is consequently taking place in a context that is fundamentally different from when the single currency was launched. The issue is no longer, how to achieve fiscal consolidation while fostering a long-delayed recovery, but rather:

★ How to confront an adverse supply-side shock which both hampers growth and fuels headline inflation, if not core inflation; and how to deal with the consequences of a potential US slowdown.

★ How to address the problems raised by higher than expected cyclical divergences within the euro-zone. Policymakers have long been aware of this potential problem. However, the heightened economic pressures have made divergences of a cyclical or a structural nature more visible. The economic questions which subsequently arise have not received consistent and systematic answers.[1]

★ How to demonstrate that Europe has both the will and the ability to create propitious conditions for developing the "new economy", and that it is a suitable place for investment.

★ How to convince the markets that the member countries share a common understanding of the objectives of economic policy in the euro-zone, and that they are developing a broad consensus on the corresponding roles of monetary, fiscal, tax and structural policy instruments.

There is a risk that the still favourable economic conditions are creating disincentives for co-operation. Recent policy behaviour in most member states—including France, despite its repeated insistence on the need to co-ordinate policies—highlights that in "good times" co-ordination becomes a less urgent priority. Renewed economic prosperity conceals underlying macro-economic and structural problems. Furthermore, there is a temptation to "nationalise growth", by presenting it as the result of national, not European policies.[2]

Conversely, policy co-ordination becomes more appealing during recessions. For now, however, there is an increasingly prevalent market view that the euro-zone suffers from a lack of consistency between the views and the actions of its major policy players. The weakening of the euro can obviously not be ascribed to co-ordination problems alone. It is rooted in long-term capital outflows from the euro-zone to the United States, the rationale for which can be found in trends on foreign direct investment and portfolio diversification. But the apparent lack of a counter-balancing investment in the euro, in spite of a significantly undervalued exchange rate, is an indication that markets doubt the ability of euro-zone policymakers to address the current challenges in a co-operative and efficient way.

[1] Sir Alan Walters, former economic advisor to Mrs Thatcher, gave his name to a critique of monetary union that has relevance today: in case of cyclical and inflation divergences, real interest rates are lower in the over-heating economies than in the lagging ones. This was indeed the case in June 2000: short term real interest rates were 3.1 per cent in Germany, but -0.3 per cent in Ireland.

[2] As aptly remarked by Jean-Paul Fitoussi in "Le Monde", 5 May 2000.

2 Monetary union and economic policy co-ordination

Policy competition and co-ordination

It is not obvious that economic policies require co-ordination. The widespread preference in Europe for national autonomy, and for policy competition between member countries, is based on many good and valid arguments. The ECB's responsibility for monetary policy requires governments to rely on other economic policy instruments. The subsidiarity principle suggests that decentralisation is *a priori* preferable on the grounds of both democratic accountability and efficiency. Policy competition can also be expected to encourage efficient practices.

Furthermore, co-ordination always generates negotiation costs, incentives to cheat, and possible conflicts in the delegation of authority. A valid case for co-ordination must consequently rest on evidence that it brings more benefits than costs.

The European jargon is sometimes confusing, so it is important in the current debate to insist on the differences between the concepts of co-ordination, harmonisation and convergence. The objective with co-ordination is not to homogenise fiscal, regulatory or social policies. Nor is it to make policy converge towards a common goal, for co-ordination in the fiscal field may require national policies in fact to take divergent directions. But it is to treat the interaction of the member countries' policies in these areas as a subject of common interest.

Both economic policy competition and co-ordination have been integral parts of the European integration process since its origins. Advocates of either one of these approaches too often overlook the other's benefits. The correct method should rather be to identify on a case-by-case basis what is the right balance between competition and co-ordination in any given policy field.

Arguments in favour of co-ordination

The economic literature provides two rationales for economic policy co-ordination. The first sees co-ordination as a means of supplying public goods which decentralised actions are unlikely to produce. In a European context, the most obvious examples of economic public goods are the preservation of the single market and stability in the financial markets within the euro-zone. In the macro-economic realm, fiscal discipline also became a sort of European public good during the transition to EMU. Co-ordination based on this line of reasoning often aims at preserving an existing regime, that is to say preventing potentially destabilising behaviour by some actors, but not necessarily at reaching an optimum. Peter Kenen usefully distinguishes between regime-perserving co-ordination and policy-optimising co-ordination. For example, rules that enforce fiscal discipline do not aim at reaching the best possible distribution of fiscal decisions, but only at avoiding irresponsible fiscal behaviour by a member-state that would give rise to financial disruption in the Union as a whole.

The second rationale emphasises economic spill-overs between countries, and the consequent relevance of co-ordination in assessing economic policy externalities. In this view, the need for co-ordination increases with the degree of economic interdependence between countries. Co-ordination will require member-state economic policies to be conceived in a co-operative way, even when the key objectives remain purely national.[3]

The euro substantially revives the case for co-ordination and this is not just because of traditional transmission channels. Monetary Union magnifies both the positive spill-over effects of an expansionary fiscal policy through goods markets and its negative spill-over effects through capital markets. The net effect of a fiscal reflation on output in neighbouring countries is thus arguably ambiguous, which leads some scholars to conclude that co-ordination is unnecessary.[4]

However, the euro introduces new transmission channels because national policies affect a set of henceforth common policy variables or objectives. For example, any national policy that impacts on the common exchange rate impacts on the partner countries, competitiveness, because

[3] This second type of co-ordination has led to an abundant economic literature, in general based on Game Theory and on the existence of national loss functions that governments attempt to minimise.

[4] Paul de Grauwe and Magdalena Polen, "Increased Capital Mobility", paper presented at the Kiel Institute of World Economics annual conference, June 2000

participants in a monetary union share a common exchange rate vis-à-vis the rest of the world. The same kind of reasoning applies to the common current account and the common inflation rate.[5]

Inflation may well be the most telling example. The ECB aims at controlling average euro-zone inflation. If monetary policy alone had an impact on inflation, there would be no need for co-ordination. But this is, of course, not the case. National fiscal or structural policies do impact on national price levels and therefore on average price inflation as well. Any such policy may thus impact on the common monetary policy, especially when the country taking action is a large one. This is a new kind of external effect, one that is specific to monetary union, and totally independent of any assumptions about the size of goods markets or the interaction between capital markets. It is particularly important when cyclical divergences exist within the zone, between overheating and slow-moving economies. Similar lines of reasoning apply to interdependence through other common policy variables.

Finally, there is also a political economy case in favour of co-ordination. Co-ordination between governments may act as a crucial support for national policies in the following three areas: policy formulation, through the mutual exchange of information and debate; multilateral commitment around national policy programmes that are bound into an over-arching global programme for the zone, as exemplified by the Maastricht convergence programmes for price stability and fiscal consolidation; and peer pressure, which through adequate surveillance facilitates the effective implementation of national programmes.

Furthermore, co-ordination among governments within the Euro Group highlights their collective responsibility. This relieves the European Central Bank from the excessive burden of being viewed as the sole economic policy actor within the zone, and possibly (but wrongly) being held responsible for the entire macro-economic outcome. In contrast to a widely held but quite superficial view, member-state co-ordination may thus reinforce the Central Bank rather than threaten its independence. It would be quite wrong for the ECB to be held accountable beyond the

[5] *When these variables are seen as objectives, they are so-called club goods, that is, public goods whose access is limited to club members, here the euro-zone. See Jürgen Von Hagen (1999), in Alexandre Lamfalussy, Luc D. Bernard and Antonio J. Cabral (eds.), "The Euro-Zone: A New Economic Entity", Bruylant, Brussels.*

range of its responsibilities.

Which policies to co-ordinate?

The debate on economic policy co-ordination within Europe traditionally leads to discussions on fiscal policy co-ordination on the one hand, and the formulation of the policy-mix on the other. A third aspect also needs to be considered, namely the interaction between cyclical and structural policies. On each of these aspects, we now review arguments particular to EMU.

The specific need for co-ordination of fiscal policies within EMU results from their impact on the common variables identified above. This is particularly important when cyclical divergences in national economic situations call for differentiated fiscal policy responses.

The need for co-ordination between *national fiscal policies and euro-zone monetary policy* arises from the potential costs of uncertainty regarding the direction of the policy-mix at the euro-zone level. To give an example, a negative demand shock (for example, a slowdown in world demand) may be met either by a more expansionary monetary policy or by a more expansionary fiscal policy. But national governments need to anticipate the ECB's response in order to make their own fiscal decisions. Equally, before deciding whether or not to support demand, the ECB must assess not only the national fiscal policy stances, but also the resulting impact on the overall policy-mix for the zone.

Structural policy co-ordination is often deemed unnecessary, because economic and social reforms benefit the reforming country in the first place, and thereby penalise countries that do not implement them. However, structural policies affect potential output and thereby also the environment in which the ECB has to decide its interest rate policy. If euro-zone members simultaneously engage in structural reforms that boost potential output, they should expect that the ECB would take this into account and make room for faster growth. The prospect of a positive ECB reaction, with a growth-friendly policy-mix, may give governments the incentive to act, given that structural reform often carries short-term economic and political costs. For example, a tightening of the eligibility conditions for unemployment benefits may appear more acceptable in a period of dynamic job creation than in a context of slow growth.

In the context of the euro-zone, the implementation of structural policies involves further problems of collective action that in the absence of co-ordination would give rise to a dilemma and possibly lead to inaction.[6] The dilemma is that for structural reform to deliver an acceptable pay-off in the form of lower interest rates, a sufficient number of countries, especially the larger ones, have to make a clear commitment to reform. But given the short-term costs involved, some of these countries may be reluctant to undertake structural reform, because they are not convinced that other countries will follow suit.

[6] *This is an example of the so-called "prisoners' dilemma", an archetypal model of Game Theory.*

3 The European experience with co-ordination

The EU is not as experienced as one would initially expect in the field of economic policy co-ordination. Until the introduction of the euro, Europe employed two broad methods of integration: the harmonisation of legislative or regulatory provisions (which might be regarded as rule-based co-ordination), and the delegation of a number of functions to a common institution at the EU level (the federalist approach).[7] The single market laws and the Stability Pact (designed to prevent excessive budget deficits) belong to the former approach, the Common Agricultural Policy and competition policy to the latter.

[7] *Or, to be precise, "positive" integration. Economic integration proceeds both through negative integration (elimination of trade barriers) and positive integration (implementation of common policies).*

The euro introduces a totally new situation. Monetary policy has effectively been delegated to the European Central Bank, but no progress has been made towards a federal budget. On the contrary, it was explicitly decided that the current EU budget would not be increased as a result of EMU. Thus the introduction of the euro requires us to experiment with a new approach, closer to inter-governmentalism than to the traditional community method—as is also the case in other new areas of EU involvement such as justice and home affairs, or defence and security. A common economic policy can only emerge on the basis of co-ordinated action between independent actors, some of which (the ECB) are federal institutions and others (the governments) are not. Co-ordination is thus necessary, unless one has faith in the argument that the quality of the institutions (the independent status of the ECB) and of the common rules (the Maastricht criteria) is enough to create a "good" economic policy for the zone.

The convergence model, as applied within the European Monetary System (EMS) and in the run-up to EMU, inspired the Stability Pact of 1996 and the stability programmes which are now at the core of the co-ordination process. Co-ordination has consequently become intimately associated with convergence towards predetermined targets. Such an approach, which can be called "prudential", is not without shortcomings. We can point to at least four limitations:

★ The approach is of little help in addressing the overall policy-mix of the euro-zone, because it is based on the idea that the interactions between the various economic policy actors are of little importance. Consequently, it is assumed that the proper policy-mix will be maintained as long as each policy maker reaches its assigned objective.

★ It reduces the interaction between monetary and structural policies to a one-dimensional relationship, namely that structural policies should provide the right environment for monetary policy. But, as previously stated, the expectation of a policy response from the ECB can be instrumental in providing the proper incentives for structural reform.

★ It is based on the questionable view that fiscal limits that are not even derived from explicit principles and objectives of economic policy can epitomise economic policy soundness for all countries at all times.[8] However, the monitoring of the current deficit and debt ratio does not provide a sufficient assessment of the actual state of public finances. This is particularly true if there are implicit and other "off budget" liabilities (such as pension commitments or guarantees to public entities) that may threaten fiscal sustainability in the long run. Instead, one needs to have a medium- to long-term vision, based on the concept of sustainability. This requires a comparison between the present value of public liabilities (including future spending and implicit liabilities) and the present value of public assets and future receipts.

[8] The Maastricht limits are 3 per cent of GDP for the budget deficit and 60 per cent of GDP for the public debt ratio, the stability pact calls for a budgetary balance normally "close to balance or in surplus".

★ This prudential approach does not take cyclical factors sufficiently into account. As a consequence, it puts more emphasis on preventing a deterioration of the fiscal deficit during an economic slowdown, even though this may only be the result of a growth shortfall, than in preventing a deterioration of the structural deficit during a boom.

The Stability Pact and its associated provisions do not constitute a sufficient set of principles and procedures to organise economic policies in a proper manner within the euro-zone. In particular, the absence of a jointly elaborated and shared economic philosophy leaves little room for useful analysis during EU economic policy debates. The texts where such a philosophy should appear, such as the Broad Economic Policy Guidelines, too often result from a nitty-gritty negotiation over every comma, by governments anxious to avoid any overt criticism. As a consequence, the directions of the overall policy-mix remain uncertain. Observers and markets may get the impression that the policy-mix results from political and diplomatic games rather than from a consistent and active conception of the role of the economic policy. Such a level of uncertainty comes with a cost that should not be underestimated, inevitably impacting on market expectations.[9]

[9] *Daniel Gros, "Quo Vadis Euro: The Cost of Muddling Through", Second Report of the CEPS Macro-economic Policy Group, 2000*

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In sum, the undeniable efforts undertaken so far have not succeeded in creating a genuine "culture of co-ordination" in the euro-zone. As a result, national governments do not find sufficient incentives to conceive of national economic policies as being of common interest, not even as a basis for the exchange of information and consultation. One might have hoped that EU governments would at least embrace a "culture of co-ordination" in new areas of potential co-operation such as the licensing of third generation mobile phone networks, green taxation, and reactions to the recent oil shock. But even on these issues, the question of whether it would be desirable to take a co-ordinated approach has not been addressed.

The Euro Group deserves some credit for creating a consensus on the appropriate response to the international economic slowdown in 1998-99, and on the problems posed by the weakening of the euro at the beginning of 2000. More generally, it has allowed discussions to take place between economic policy-makers in the euro-zone that would not have occurred otherwise. But its informal nature seems to be a handicap, since it does not allow any decision-making and it provides for no alternative to unanimity. The Euro Group has not established a collective vision of the overall economic situation of the euro-zone, despite some progress in sharing statistical information. This has been a real barrier to effective co-ordination: only a truly common vision could shed light on the interaction between national economic policies and the common monetary policy, and thereby allow a redefinition of national programmes. Finally, the Euro Group has not acquired enough external visibility. Its role is still not clearly perceived by market participants, especially outside Europe.

The Euro Group has therefore proven its usefulness, but has also reached its limits within the current framework. Disillusion may be waiting around the corner. The lessons we draw are that the Euro Group is a necessary structure which now requires a clarification of its responsibilities and working methods; that it needs to increase its external visibility; and that it should be granted formal decision-making powers.

4 Guidelines for progress

In formulating proposals for the better organisation of economic policy within the euro-zone, one should not be constrained by the traditional EU approach. Instead, the specifically inter-governmental nature of the problem to be solved should—at least for the time being—be recognised, as well as the unique status of the ECB. It should also be accepted that if the Commission were prepared to supply intellectual resources and act as a secretariat for the still largely inter-governmental executive body, it would contribute to effective co-ordination and thus gain in influence. For President Prodi to claim—as he did recently in an address to the European Parliament—that the Commission rather than the Council of Ministers should be the natural interlocutor of the ECB is of little help as long as national governments and parliaments retain responsibility for making and implementing policy in both the fiscal and the structural fields.

However, to speak of an "economic government", as some Frenchmen still like to do, is misleading, for it suggests that something like a government exists or is about to exist in Europe. We prefer to speak of "economic governance", which suggests a plurality of actors and the necessity to define and adopt "best practice" in a number of economic policy areas. Nonetheless, such governance must be firmly formalised and organised, because inter-governmental decision-making is already difficult with 11, 12 or 15 member-states, and will become even more so after the next round of enlargement. Co-ordination does not mean unstructured negotiation between governments.

How daring should our proposals for co-ordination be? The economic policy system in the euro-zone results in part from treaty provisions which could not conceivably be changed, such as the statutes establishing the independence of the ECB. Besides, the treaty is too recent and our experience under the treaty is too limited for any substantial change to be desirable. So any suggested improvements to the current system should therefore imply modifications at the margin, compatible with existing provisions but possibly complementing them. This does not imply, however, that new measures that would have to be inserted into the treaties should be ruled out, provided that they remain broadly in line with the current system. Introducing amendments during an IGC that revises the treaties would be fully compatible with the EU tradition.

What areas should the proposals cover? Co-ordination can take place along two broad lines: rule-making, or mutual dialogue and commitment. The first method was used for the Stability Pact. It has merits, but also shortcomings, especially because of a lack of flexibility. The second method works within the Euro Group, and has symmetric shortcomings and merits: more flexibility, but at the price of negotiating costs and the uncertain credibility of individual commitments.

In the European context, the discretionary approach that works well when there are only a few players involves high negotiation costs. We therefore conclude that the EMU countries should try to obtain the maximum benefits from rule-based co-ordination. Rules, however, should respect the subsidiarity principle, which implies that individual countries should be allowed to define their own behavioural rules on the condition that they be judged compatible with the imperatives of co-ordination. Modern economic approaches, which focus on transparency and predictability, suggest that such an approach may be rewarding. There are limits, however, to what a rule-based approach can achieve. This is why we believe that the Euro Group should be strengthened to such a degree that it is able to sustain effective and efficient discretionary co-ordination.

In this context, we now turn to six recommendations to develop economic policy co-ordination in the euro-zone. They are organised in three sections: first, we explore the concept and nature of economic policy within the zone; second, we analyse the institutional framework for implementation; and, finally, we reflect upon the external economic and monetary policy for the zone.

Clarifying the principles and rules of conduct for economic policy

Guideline 1 : An economic policy charter

In order to strengthen the co-ordination process, EMU members need to develop gradually, and in consultation with the ECB, an economic policy philosophy that goes beyond mere procedures and criteria. Progress has already been achieved in this direction, with agreements on the objective of price stability, on a framework for fiscal discipline, and, more recently in Lisbon, on a medium-term strategy for economic reform.

Several ingredients are still missing, however. The Euro Group needs to establish principles for deciding how to use the various policy instruments in response to economic shocks (there should even be a discussion of how to respond to local asset price bubbles). Now that the stability programmes have achieved a substantial amount of convergence, it should define—in ways other than a vague reference to budgetary equilibrium—how medium-term fiscal objectives will be formulated. The appropriate fiscal policy reference might well differ among member-states, depending on their explicit and implicit debt levels. This suggests that national governments should keep a broad latitude in defining medium-term fiscal policy targets, and that the exact definition of such targets should involve substantial subsidiarity.

These gaps make the economic policy system of the euro-zone less transparent than it should be; they help to feed continuing uncertainty on the future orientations of monetary and fiscal policies. It is crucial to develop principles that can guide economic policy decisions as well as market expectations.

The formulation of such principles, however, should not be left to negotiation, since they would then result from various trade-offs and concessions. The formulation should rather, as on some past occasions (for example, the 1987 Padoa-Schioppa report), be entrusted to a group of qualified experts and personalities of high integrity and professional reputation. The European Commission should play an important role in this process, notably in fixing the terms of reference for the study, in monitoring progress, and in organising the debate that is necessary to refine ideas and approaches. We would expect the group to produce a draft charter that would be developed further through a general debate, and then submitted to the Council for discussion and amendment before formal adoption. Of course, the ECB would need to be involved as a fully independent participant in the preparation of the draft charter, particularly on areas involving monetary policy.

Needless to say, the idea is not to produce new Tables of the Law or a rigid, stone-engraved constraining document. The charter's provisions would not be part of the treaty (this is not what treaties are made for) and they would evolve over time. We should think of it as a benchmark, not a syllabus.

Without prejudging the future work of such an expert committee, a policy charter (or a code of conduct) would need to include at least three elements:

★ Assignment of responsibility for responses to economic shocks. For example, the charter could make it explicit that symmetric shocks should be responded to by the common monetary policy, while asymmetric ones should call for national fiscal policy responses.

★ Rules of conduct for fiscal policy behaviour that would clarify how the national budget is managed over the cycle, and how governments envisage responding to unexpected revenue bonuses (or shortfalls). Some inspiration could be found, for example, in the British code for fiscal responsibility that sets broad rules for the evolution of the debt ratio over the cycle; or in the French medium-term public finance programme, which is based on a three-year public spending target set in real terms (and which does not vary with the economic situation) plus a decision to let automatic stabilisers play freely.[10] These rules should leave room for diversity in the formulation and the implementation of fiscal policy strategies.

★ A forward-looking approach to fiscal policy that would go beyond the Stability Pact and involve efforts to develop in each state a public sector balance sheet. This could serve as a basis for formulating long-term goals for national fiscal policy.

[10] See the report prepared by the French government for the 2000 public finance law, "Politique Economique", 2000, Economica, Paris.

Guideline 2: More transparency and predictability in economic policy
Co-ordination does not necessarily require decision-makers to modify their decisions for the sake of the common good. The quality of the policy-mix could be greatly improved through greater transparency and better predictability in decision-making. Then each individual decision-maker—a government or the ECB—can anticipate the reactions of the others to shocks. This requires progress in four areas:

★ The quality and homogeneity of statistical information must be substantially improved, most notably in areas such as wages, national accounts and public finances.

★ In order for national budgets to be monitored effectively, updated information on the position of public finances must be made available on an on-going basis during the year.

★ The ECB's policy approach needs to be clarified. The recent decision by the ECB to publish "projections" is a positive development, but the transparency of ECB policy-making needs to be improved further. It is still undermined by the uncertainty over its inflation target; and by the Bank's "double-pillar" strategy, which is based on monitoring monetary statistics and on inflation forecasts. We think that the quantitative control of the monetary aggregate should be abandoned, because of its weak information content. The ECB should also make its inflation target more precise, first of all by making explicit the methods it uses to form its projections of inflation, and secondly by formally recognising that any undershooting of the inflation target needs to be corrected with as much vigour as an overshoot.

★ Member-states should adopt fiscal policy principles for contingencies. All euro-zone countries have fixed stability programmes within which they formulate their fiscal policy. For these programmes to become fully-fledged instruments of co-ordination, it would be desirable to integrate them into the national fiscal strategies, which generally implies their adoption by the national parliaments. They should also explicitly envisage rules of behaviour, which need not be identical between countries. On the contrary, rule-making for contingencies should be conducted in a decentralised way, while keeping overall consistency with commonly defined principles. The centre should thus set out the principles and then limit its role to monitor conformity between these principles and the exact definition of rules in each member-state.

Implementing the joint economic policy

Guideline 3: Transforming the Euro Group into a collective executive body

The implementation of a co-ordinated euro-zone economic policy cannot be left to an informal organisation that is unlikely to provide the necessary credibility and effectiveness. Nor, however, should it be based mainly on a prescriptive approach involving explicit legislation, as is the case with the Stability Pact. Instead, it is important to establish within the existing framework a means of defining and implementing economic policies according to the guidelines set out above.

Von Hagen[11] recommends the creation of an Economic Policy Council which would have precisely this function. It would consist of national finance ministers or their direct representatives, who would make fiscal policy recommendations to EMU member-states. Instead of creating a new EU institution, however, our preference is to explore what could be achieved with those which already exist. The need for an executive function provides an opportunity to consolidate and further develop the Euro Group.

[11] *Op cit.*

To think about the future evolution of such a group, let us first ask whether the EU would require a euro council if all its members had joined EMU (this avoids being distracted by questions about membership). We think the answer is yes. It is time to separate the Council of Ministers' executive function from its legislative one. When Ecofin meets to adopt European directives, it acts within its formal responsibilities—partly shared with the European Parliament—and applies specific procedures. Ministers are assisted by a whole team of civil servants whose task is to take care of the technicalities. The inevitable consequence, as Jacques Delors has noted, is that a large number of participants requires a huge room, with the result that physical distance in itself kills dialogue. Increasingly, rather than engage in dialogue on essential policy choices, the ministers turn up and read a well-prepared declaration prior to a vote.

The Euro Group, in contrast, has no legislative responsibility. It does fulfil a strategic function that is well in tune with its reduced format (a minister plus one, as in the Group of Seven's ministerial meetings). Its role is not to manage procedures or adopt legislative texts, but to assess the economic situation and to discuss major policy issues. It is well suited to become a collective executive body. We think that it should evolve into a true euro-zone Economic Policy Council, where decision-makers—the ministers and, as a frequent guest, the governor of the ECB—decide on the appropriate strategies for dealing with structural problems or responding to economic and financial shocks. It is, and should become even more so, a forum that promotes agreement on relevant policy orientations and gives them an operational content. A relevant task today would be to define a sustainable growth strategy for the euro-zone, and to explain how governments and the ECB should behave, in order to maintain the current recovery. This Council should also be able to adopt economic policy documents.

We also think that such an economic policy council cannot remain deprived of decision-making power. When there are disagreements that cannot be decided upon by consensus, they need to be settled. This requires qualified majority voting provisions, not for legislation, but for policy guidelines. This council must be able to adopt white papers on structural reform as well as specific economic policy resolutions or recommendations. It must also be able to take a position on international policy co-ordination and exchange rate issues. But these texts would have no legal value, except in cases where they are also adopted by Ecofin.[12]

This leaves an important question: should this framework for co-ordination be limited to the euro-zone or extended to all EU member-states, including the UK which has an opt-out, Denmark which has voted against membership of EMU, and future EU members, which may not be ready for the euro for some time? The current framework is based on the concept that all EU member-states are interested in solving problems that are specific to EMU. Thus Ecofin adopts convergence programmes, even though their *raison d'être* derives from EMU. This idea, apparently dear to the UK, is acceptable during a transition period. But it will increasingly become a handicap if euro-zone countries have to submit their macroeconomic policy debates to the deliberation of a council which includes member-states not interested in adopting the euro. All that is specific to EMU-wide economic policy co-ordination should therefore be transferred to the euro council.

Although the existence of the euro strengthens the need for co-ordination among the Euro Group countries, the case for co-ordination remains valid

[12] Dominique Strauss-Kahn's recent "Lecture Introductive à la Conférence International sur la Coordination des Politiques Fiscales dans l'Union Européenne" makes a proposal that starts from similar premises but reaches a partially different conclusion. He suggests that the euro council should take on a legislative capacity.

for the EU as a whole. One could accordingly imagine that the proposed Economic Policy Council could meet in a full EU format as well as in a narrower euro-zone format. In other words, our proposal does not imply that the euro "outs" should be excluded from a more efficient approach to policy co-ordination. The nature of the exercise, however, suggests that the Euro Group should take the lead; and that the specific problems of co-ordination within the euro-zone should receive explicit recognition and attention.

Guideline 4: A closer interaction between EU procedures and national decisions

Co-ordination currently suffers from being organised through complicated EU procedures which do not interact well with the decision-making procedures of the member-states. The threefold approach based on structural ("Cardiff"), labour market ("Luxembourg") and macro-economic ("Cologne") co-ordination processes is satisfactory in principle, and the Broad Economic Guidelines can become a useful instrument for explaining the EU's strategy. But the procedures are too complex to be operationally transparent. Jacques Delors had proposed a streamlined, more focused approach in which all EU procedures would be concentrated during the "EU semester", which should be followed by a second "national semester" coinciding with the adoption of national budgets. This attractive option would currently be hard to implement, due to the six-monthly rotation of the EU presidency. But its spirit could be saved through a better organisation of co-ordination procedures. Moreover, the EU needs to find a way of improving the visibility of the euro-zone's economic situation and prospects. This requirement was recognised by the Lisbon summit of March 2000, which decided that each spring the European Council should meet to review the economic and social state of the Union.

The chronological organisation of the yearly budget cycle should therefore be made in a much more coherent way:

★ All the EU's structural guidelines, including those with fiscal or tax implications, should be decided in the second half of the calendar year. This would allow member-states to take them into account in making their own budgets.

★ National public finance programmes should be submitted to the Commission in time for their impact on the fiscal prospects and policy stance of the euro-zone as a whole to be considered. Discussions on the appropriateness of the overall fiscal stance could thus take place within the Euro Group before these programmes are assessed. This would allow policy discussions on these programmes to take the wider picture into account, including the monetary policy implications of the expected fiscal stance in the euro-zone. The Euro Group should adopt these national programmes before national governments take decisions on draft budgets for the following year. This procedure would allow the medium-term economic and budgetary prospects for the euro-zone to be presented to the European Parliament in the first semester. Ideally, this presentation should be given a solemn character, for example with an official address on the economic and social state of the Union and a debate with MEPs.

★ In order to enhance the visibility of the common dimension of policy decisions, the draft national budgets submitted to national parliaments would include a common chapter on the euro-zone situation and prospects.

★ Finally, the departments in charge of preparing national finance bills should be more directly involved in the co-ordination process, instead of allowing Treasury departments to represent them. A simple way to do this would be to integrate them in the Economic and Financial Committee, where they could replace the representatives of the national Central Banks, whose participation in the national delegations, under the leadership of the Treasury departments, does not fit well with the new institutional architecture of the euro-zone.

Developing an external economic and monetary policy for the euro-zone

Guideline 5: A more effective external representation and a genuine exchange rate policy

During the long decline of the euro, the hesitations of governments and the battle for influence between the Euro Group and the ECB have shown that neither the treaty provisions on exchange rate policy, nor the compromise agreed in 1999 on the external representation of the euro-zone, are truly operational. They must be amended to give the euro-zone an effective exchange rate policy and a credible external representation.

The euro-zone exchange rate policy is in principle described in Article 109(2) of the Maastricht Treaty, which allows for Ecofin to establish general exchange rate policy "orientations". These orientations are implicitly addressed to the ECB, which is questionable, for changes in fiscal or structural policies also have a significant impact on the exchange rate. The potential impact of orientations, however, has been severely constrained. Firstly, the treaty itself specifies that they "do not affect price stability", but does not explain how possible inconsistencies should be addressed and by whom. Second, a later Council resolution confines their use to "exceptional circumstances", for example in case of a clear misalignment.

Article 109(2) has not been used during the fall of the euro, and, for all practical matters, exchange rate orientations have probably become like a weapon of deterrence—one that is never to be used. The Council has thus been silent on exchange rate matters, while in the absence of an operational procedure, the Euro Group can only adopt a position on the exchange rate if there is a consensus.

As for external representation, it has been entrusted to the chairman of Ecofin and/or the Euro Group. Within the Union this person is legitimate, because their chairmanship derives from treaty provisions, but he or she often lacks experience of and exposure to international monetary discussions. In addition, the ECB president takes part in the Group of Seven (G7) meetings when macroeconomic or exchange rate issues are considered, but is replaced by national central bank governors when other issues are discussed.

In a situation characterised by uncertainty on the distribution of roles and responsibilities, some have suggested that exchange rate policy should be entrusted solely to the Central Bank.[13] We do not believe that this is the solution. The fall of the euro has forcefully illustrated that situations of misalignment concern much more than monetary policy, notably structural reforms, or the lack thereof, and fiscal policies. A currency can be weak because market participants consider that there is no convincing economic strategy to remedy structural deficiencies, in fields such as innovation, labour markets or the financing of pensions. Thus what is needed is not a strict allocation of roles, but rather an operational *modus vivendi* to organise the necessary co-operation between governments and the ECB in

[13] Charles Wyplosz, "The Eurosystem, the Euro-11 and the euro: Can we do Better?" in "Financial Times Deutschland", 16-17 June 2000

this area of shared responsibility. We think this implies a number of changes:

★ A systematic and permanent surveillance of the exchange rate should be organised within the Euro Group, on the basis of analyses from the Commission and the ECB. This surveillance should include the following elements: a discussion of what could be agreed to be the real equilibrium exchange rate benchmark; the monitoring of current exchange rates; an attempt to interpret potential divergences from this benchmark; and a discussion of the appropriate policy responses when necessary. Such exchange rate surveillance highlights the exchange rate as a potential economic indicator. For the euro-zone, signals coming from the exchange markets should be regarded as illustrating what we have called interdependence through common variables. They should give rise to policy discussions and decisions on the appropriate response, which—depending on the reasons behind currency misalignments—can be foreign exchange market interventions, macro-economic policy reactions, or policy changes at a deeper, structural level.

★ The respective responsibilities of the Euro Group and of the ECB must be made public. This would help to avoid misunderstandings and counterproductive speculations.

★ The Euro Group should take exchange rate decisions on the basis of a qualified majority. This would be compatible with current reality, since the Ecofin council has in practice transferred its exchange rate responsibilities to the Euro Group.[14]

★ A 1998 Belgian proposal would solve the problem of external representation. The Euro Group should appoint a vice-chairman who would always come from a G7 country, and who would have the authority to talk on international monetary issues on behalf of euro-zone ministers. This vice-presidency would rotate between the three EMU countries which are also G7 members, and in tandem with their EU presidencies.[15]

★ Finally, the compromise according to which national central banks participate in one part of the G7 meeting, and the ECB in another,

[14] *The treaty stipulates that only EMU members vote on exchange rate matters.*

is a half-baked measure that satisfies no-one. From a logical EMU standpoint, the ECB should represent the euro-zone on behalf of its monetary authorities.

Guideline 6: A monetary strategy for the enlargement

While the enlargement of the EU is currently under negotiation, the time has come to address the expansion of the euro-zone itself. Future accessions to the euro-zone cannot be made conditional upon meeting only the Maastricht criteria. The enlargement process has been based on the assumption that EU candidates, once accepted, will sign up for the whole *acquis communautaire*, and therefore become potential EMU members. Formally, they will have no "opt out" clause. But for the euro-zone to welcome a country whose adhesion to the euro-zone might be politically or economically unsustainable would subject the whole zone to a very high risk. This would also send a very unfortunate signal about the strength of the euro to the rest of the world. This is why any ambiguity must be ruled out from the start.

[15] Daniel Gros (op cit) proposes an alternative, the nomination of a "Mr Euro", who could be the chairman of the Economic and Financial Committee. But the Belgian option avoids a technical representative to existing political representatives.

Without denying applicant countries their right to become members of EMU, a transition process tailored on their specific situation should be designed.

★ A specific transition period should be instituted, including a sustained period of monetary cohabitation, before the current candidate countries may join the euro. A minimum test period of five to ten years, renewable every five years, would seem suitable.

★ It will be necessary to institute convergence criteria more sophisticated than those applied in 1997 (when the European Council decided who should join the euro), in order to assess the sustainability of participation in EMU—perhaps in the spirit of Gordon Brown's "five economic tests". This change would not aim to make membership of the euro more difficult for the accession candidates. But it would recognise that real convergence will be more difficult for countries starting from very different initial conditions than for countries that are broadly similar and have a long history of economic integration behind them. In exchange, the euro-zone might grant candidate countries a degree of monetary co-operation that goes beyond ERM II. The euro-zone members could aid candidate countries in sustaining unilateral pegging policies, be they of a rigid nature (currency boards) or of a more flexible variety (crawling pegs). The traditional argument against such monetary co-operation, namely that it could be dangerous for monetary stability within the euro-zone, is not convincing. Stability would be much more endangered by premature EMU membership than by intervention to support associated currencies, whose limited weight hardly suggests a serious threat to price stability in the euro-zone.

★ Finally, the European System of Central Banks will face organisational and operational problems following EMU enlargement, most notably with respect to monetary policy decision-making procedures. The 'one man, one vote' principle may soon lead to indecision and confusion, as the number of EMU participants increases. The Treaty of Nice gives authority to the European Council to change the composition of the ECB council, and this should be done before enlargement takes place. The ECB should start to come up with ideas on how to reform its governing body.

5 Conclusion

We have argued in this paper that the introduction of the euro reinforces the need to implement the kind of economic policy co-ordination that governments have committed themselves to support. Despite the fact that some progress has been made, current procedures do not provide a satisfactory response to this need. Furthermore, the current economic recovery threatens to weaken the perceived case for co-ordination and to delay implementation of a coherent overall economic policy for the zone. Europe's future economic growth is accordingly at risk.

In response, we have proposed six institutional guidelines which we think provide an operational answer to the current questions. These policy suggestions present varying degrees of institutional difficulty. Some can be implemented at once, without any modification of the current texts, others require minimal reforms, and yet others demand potentially deeper changes to existing treaties.

Progress can be made immediately in defining an economic policy charter, in heightening the transparency and predictability of economic policies, in improving the interaction between EU procedures and national decisions, and in preparing the transition of EU candidates toward the euro. The advent of a genuine exchange rate policy, which also includes the re-organisation of the external representation of the euro-zone, is more demanding.

This implies, beyond a necessary agreement on the principles and means for such a policy, a more formal agreement on how to interpret and implement the relevant treaty articles. The transformation of the Euro Group into a genuine collective executive body for the zone necessitates a change in the treaty. This requires, accordingly, a more ambitious approach, one which should influence future inter-governmental conferences.

In the meantime, however, it is possible and desirable to strengthen the visibility and role of the Euro Group, even within the current institutional and legal context set down by the Maastricht, Amsterdam and Nice treaties. The Nice treaty also provides the possiblity of making use of reinforced co-operation in the field of economic and monetary union, as long as this does not affect Ecofin's responsibilities as defined by the treaties.

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