Will EMU lead to a European economic government?

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PricewaterhouseCoopers is delighted to sponsor this Centre for European Reform paper on European economic governance.

Economic and monetary union is already with us. But the 'E' in EMU is as yet imperfectly understood. Hitherto it has tended to be the preserve of economic specialists and special advisers. This paper brings the economic issues firmly to the forefront of a wider debate by looking at how European economic governance works, and by examining what the implications may be.

And the implications of EMU will be far-reaching. It impacts 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 the statements of fact or predictions. There is plenty of scope for influencing this emerging process. As the paper has it, economic governance will hammered out on the 'anvil of events'. This is an important message for all those who do business in Europe: we not only need to understand the process, 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 aim we particularly welcome this paper and the debate to which it will contribute.

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1 Introduction
Ben Hall

Both proponents and opponents of economic and monetary union (EMU) have always viewed it as an engine of further European integration and as another milestone on the road to an ill-defined 'political union'. After all, the architects of the single currency—Helmut Kohl, François Mitterrand and Jacques Delors—saw it in part as a way of binding a reunited and more powerful Germany into a closer European Union. And if one looks back over the last four decades of European history, one might suppose that EMU will lead to the pooling of sovereignty in areas other than monetary policy. Each step in the development of the European Union has tended to lead on to yet more integration. This may be because one achievement provides political impetus to the project of ever closer union, or because it exposes the rationale for additional integration, or because such a step cannot work well without accompanying measures. Thus Europe's leaders would not have contemplated EMU without the success of the single market, which itself required a single currency in order to fulfil its potential.

Over the longer term, EMU's most significant impact may be psychological and indirect. A successful monetary union will encourage the EU's political class to think about further integration in other areas. Now that the euro is in place, Elisabeth Guigou, France's minister of justice, talks of establishing a European judicial space, a new European project that has, in her words, 'all the Delors-like ingredients of a mobilising Utopia'. A single currency that helps to sustain higher levels of growth and employment should greatly strengthen the popular legitimacy of the EU's policies and institutions. On the international stage, the EU will speak with a single voice in monetary affairs and may in time adopt a more coherent position on global trade, finance and currency questions. The global role of the euro may come to symbolise the convergence of previously divergent national interests, providing a fillip for the Union's nascent common foreign and security policy.

But in order to make the euro a success, will there have to be further centralisation of economic policy-making? In short, will the euro lead to a single European economic government?

At the beginning of the 1990s, the French government proposed that the EU should have an "economic government". Precisely what this would consist of was unclear. But it did reflect a belief that the member-states' combined fiscal stance (public spending, tax and wages) should play a greater part in the EU's economic policy, as a balance to the European Central Bank (ECB). French leaders have always felt that the well-being of European citizens could not be left to the arbitrary power of unelected central bankers. Some of them, like Jacques Delors, argued that the EU needed some mechanism for co-ordinating fiscal policy, so that it could reflate the European economy during times of recession.

But there was a philosophical divergence between the French and German ruling elites over how EMU should work. While German governments pursued a mechanical, rules-based approach to European economic government, the French stood for the more active involvement of elected politicians. Thus the French strongly opposed Helmut Kohl's attempt, at the Dublin summit in December 1996, to ensure that the Stability and Growth Pact would automatically fine any country which borrowed excessively. Jacques Chirac made sure that no fine could be imposed without a vote among the member-states.

Helmut Kohl's government was highly suspicious of any proposal that risked constraining the absolute independence of the ECB, or weakening the EU's commitment to fiscal retrenchment. But the election victory of Germany's social democrats, in September 1998, and the appointment of Oskar Lafontaine as German finance minister, appeared to remove that philosophical divide. Mr Lafontaine agreed with his French counterpart, Dominique Strauss-Kahn, on the need for national governments to strengthen their co-ordination of economic policy.[1] These two finance ministers undoubtedly had their differences of emphasis. Nevertheless, during the six months in which they both held office, the pressure for more policy to be centralised at the EU level, for example on tax, appeared to grow. Now that Mr Lafontaine has departed, that pressure seems to have diminished.

[1] *See their joint article in* Le Monde*, 15 January 1999*

The aim of this pamphlet is to discuss whether there should be and will be further centralisation of policy-making. Our authors examine the EU's current system of economic governance and argue, by and large, that greater centralisation is both unnecessary and unlikely.

The one dissenter is **Heiner Flassbeck**, a close adviser to Mr Lafontaine. Of all our contributors, Dr Flassbeck is the greatest advocate of extending the boundaries of economic policy co-ordination. He argues that since the euro has removed the freedom of governments to devalue their currencies, the EU should now address equivalent kinds of "competitive depreciation"—such as the reduction of business taxes, as well as social, labour and environmental costs—all of which distort competition. Only if the EU ensures common standards can true competition—that which is based on productivity gains—flourish. And Dr Flassbeck argues that if those productivity improvements are to translate into higher employment, monetary policy—alongside co-ordinated fiscal and wage policies—must be targeted on economic growth.

Sir Nigel Wicks, by contrast, favours the decentralisation of as much economic policy as possible to the member-states. But he acknowledges that one country's budgetary policy—and hence all of the component policies that feed into it—is now of concern to all the other members of the euro-zone: if one government runs up an excessively large public deficit, the others may have to pay the price in terms of higher interest rates or higher inflation. So the EU has an interest in virtually every aspect of national economic affairs, and its members should discuss with each other their performance on, for example, budgetary policy and structural economic reform. Policy-making should take place through peer review, the exchange of best practice and the application of political pressure. But Sir Nigel points out that ultimate responsibility lies with national governments, which remain free to deal with their own particular problems.

Tommaso Padoa-Schioppa is another decentraliser. But he emphasises how the decisions of each policy-making institution—whether a national government or an EU level body—can make a large impact on the situation of the others. Mr Padoa-Schioppa believes that the EU's arrangements for co-ordinating policy amongst countries and between different policy-making institutions (the ECB and the council of finance ministers, for example) provide real discipline. But he thinks they do not go far enough for the EU to be able to pursue a common fiscal response to a Europe-wide shock. Nevertheless he highlights the risk of over-centralisation of other aspects of economic policy. In particular, he argues that member-states need to retain maximum flexibility over their employment policies and wage costs if they are to tackle unemployment under a single currency.

David Currie looks more closely at the issue of tax harmonisation. In a single market, wide tax differentials may be unsustainable, but it is the single market rather than a single currency that creates pressure for convergence of tax rates. In the field of company taxation, there is a good case for governments co-operating to prevent "discriminatory competition", such as taxes that are levied at different rates according to the nationality or activity of the company. But there is no need to harmonise rates of corporate taxation. Lord Currie argues that the EU may need environmental taxes, if it is to reduce its greenhouse gas emissions. But he believes that co-ordination at EU level will cover only a very small proportion of taxes, and that most of the EU's involvement in tax policy should and will remain subject to unanimity.

A successful EMU will require not only co-operation between the member-states of the euro-zone, but also between national governments and the European Central Bank. **Jean Lemierre** argues that the first crucial challenge for the ECB and for Euro-11 (the informal forum for euro-zone members) is to ensure a good mix between monetary and fiscal policy. Against a background of global financial instability, the EU must achieve a policy mix that sustains European growth—both to tackle unemployment and to aid a global economic recovery.

Any system of economic governance must, in a democratic society, provide for those exercising power to be held to account. **Alan Donnelly** argues that although the European Central Bank has independence over both its operations and its goals, it needs to win legitimacy in the eyes of Europeans. That means that it must become more transparent in the way that it explains its decisions to the media and the markets. Mr Donnelly also argues that the European Parliament—in his view the only body that can truly represent European public opinion—should take on a greater role in holding the ECB to account.

All our contributors believe that the existing mechanisms of economic governance will evolve, within the parameters set by the treaties. Arrangements for policy co-ordination will be shaped on the anvil of events. Those aspects of economic policy which concern the single market will remain the responsibility of the EU, with the Commission making proposals, the Council of Ministers and the European Parliament amending and passing legislation, and both the Commission and the Court of Justice policing the system. But in most of the newer areas of policy co-operation covered by this pamphlet, such as tax, budget and wage policy, co-ordination will remain essentially inter-governmental. National governments will retain ultimate control, but ministers will be hemmed in by peer pressure, by the setting of targets at an EU level, by the mutual surveillance of each others' policies, the exchange of best practice, and—in the case of budgetary policy—by the rules of the Stability and Growth Pact.

Europe will not have a single finance minister presiding over a single economic ministry based in Brussels. The Union's budget is unlikely to increase much beyond the current ceiling of 1.27 per cent of GDP. That compares with member-states' budgets that account for between 40 and 60 per cent of national GDP. Both Eurosceptics and some federalists argue that inside EMU—with governments having lost the freedom to adjust exchange rates and interest rates—a much larger EU budget will be needed, to provide assistance to any member-state in dire financial straits.

But in fact, economic shocks affecting only one EU country are now extremely rare. Most shocks will hit groups of countries or regions within countries. And if a country does suffer an "asymmetric" shock, it can still use its budgetary policy to cushion the effects. The EU's governments intend to apply the constraints of the Stability and Growth Pact—under which each member-state should keep its budget deficit to within 3 per cent of GDP—flexibly. In any case, a country suffering a severe recession is, under the terms of the pact, excused the 3 per cent rule. So long as governments manage to control their public deficits, and undertake essential structural reforms, their budgets and their economies should prove flexible enough to cope with rare country-specific shocks.[2]

[2] *See Charles Grant, "The unshocking truth about EMU",* CER Bulletin, *July/August 1998*

Of course, it remains to be seen whether the EU's existing, decentralised mechanisms of economic governance are strong enough to ensure further consolidation of public finances and more rapid structural reform. But it would be difficult to design arrangements that placed greater obligations on the member-states to reform, whilst respecting their right to deal with their own national or regional problems in the way they want. National governments throughout the EU defend that right vigorously. And under a common monetary policy they will need to retain maximum flexibility over other policy instruments, in order to deal with the many economic, social and cultural conditions which are country- and region-specific.

As the French government has recently proposed, there is a case for strengthening the European Commission's role in analysing economic trends in the EU. Governments could co-ordinate more closely their public spending plans, to maintain growth and prevent overheating of Europe's economies. And there should be a closer and more constructive dialogue between finance ministers and the European Central Bank. Nevertheless further centralisation of decision-making would not necessarily speed up the process of structural reform. At best it would be a distraction, at worst an obstacle to reform. It is more important for the EU to build a stronger political consensus, amongst politicians, officials and electorates, on the nature of the problems and the best ways of solving them. The EU's evolving arrangements for peer review offers a better way forward than centrally-set rules. They herald a new model of European economic integration.

2 A decentralised model of economic governance

Nigel Wicks

With the launch of the euro a crucial question arises: will the arrangements for deciding and implementing economic decisions in the European Union prove adequate for a smoothly functioning economic and monetary union? The broad outlines of the new system of economic policy co-ordination are already reasonably clear. In some cases the mechanisms are set out explicitly in the treaty texts. In others they are implicit in what the treaty says. And in others, events will drive them in a particular direction. There will have to be evolution, as the authors of the Maastricht treaty had expected and intended. Policy-makers will have to adapt to the new situation created by economic and monetary union.

The Treaty of Maastricht clearly defines the new arrangements for the EU's monetary affairs: an independent European System of Central Banks (ESCB) with a European Central Bank (ECB) at its centre with the primary objective of price stability. But the monetary dimension is only half the story. EMU is an *economic* and monetary union. In this economic union, each member-state in the euro-zone will have an interest in the totality of economic developments within the euro area, and in economic developments within each fellow member-state. The reason is clear: a single currency will intensify the economic spill-overs.

Two examples of this are budgetary policy and the so-called structural policies for economic reform.

Central EU expenditure, that from the EU budget, amounts to some 1.1 per cent of total EU GNP. This figure will not change significantly in the foreseeable future. The EU budget is not an instrument of macro-economic management and there are no plans to make it one. So it will be the national budgets of the member-states that will have a major impact on the euro-zone's economy, not the EU budget. It will be the member-states' budgets that contribute to the budgetary side of the policy mix equation. So there will be an EU interest in the totality of the Euroland member-states' fiscal positions and in the contribution of each to that total. That philosophy is already set out in the treaty, notably in article 104c regarding excessive deficits, and is elaborated in the Stability and Growth Pact.

Just as there will be intensified common interest in budgetary policies, so there will be common interest among the member-states in Euroland in each other's structural policies for economic reform. Unemployment will not be just the concern of the country that is affected. It will have budgetary consequences and will therefore be of concern to all. In short, the economic element of economic and monetary union will create a need for greater co-operation and co-ordination between the member-states.

The basic elements are therefore clear: a central monetary institution and the need for co-operation and co-ordination between the member-states over other areas of economic policy. How will that co-operation and co-ordination be expressed and what form will it take? To some extent events will help determine its form. But I am confident about the form that the co-operation and co-ordination will not take.

Co-operation and co-ordination

We will not see a European economic government in the sense of an EU finance minister presiding over an EU ministry of finance in Brussels. Many aspects of economic union will not be decided by some central authority precisely because of their very national nature. In all the member-states, budgetary issues are regarded as a matter for national governments. The Stability and Growth Pact makes it quite clear that "...in stage 3 of EMU member-states remain responsible for their national budgetary policies, subject to the provisions of the Treaty...", those provisions being the treaty requirement to avoid an excessive deficit.

That recognition of member-state responsibility was not an ephemeral outcome of the negotiations at Maastricht. It reflects the enduring fact that, throughout the EU, national parliaments cherish their role in national budgetary issues.

The same philosophy of member-state responsibility applies, by and large, to most other aspects of economic policy. And it is right that the member-states retain responsibility for matters which often reflect deeply entrenched national cultures and ways of doing things, and which go to the heart of member-state identity. So running the economic union on a decentralised basis is the only way of proceeding efficiently without provoking tensions.

Trade and internal market policies, which are set out in Articles 100a and 113 of the treaty, are exceptions to the system of decentralised decision-making in the economic union. But it would be wrong to use the centralisation of these policies as a reason for centralising of other aspects of economic policy. The powers in Articles 100a and 113 are essential to establish and to operate the single market, in both its internal common market and in its external customs union aspects. So there is a clear functional need, universally accepted among the member-states, for action at EU level with the full panoply of arrangements—a Commission proposal, qualified majority voting, directives, regulations and so on.

The single market is a very different case to the many national economic issues which lie at the heart of the debate about the nature of economic government. For these issues, anyone who ignores Europe's diversity in designing its future economic governance risks a botched job. Europe is a mosaic:

★ Euroland stretches from the Arctic Circle down to near the shores of Africa;

★ it comprises countries with different political cultures;

★ the peoples of the various member-countries have different conceptions of their relationships to the state;

★ and member-states are organised according to different constitutional principles, some federal, some unitary.

The diversity of the Union was recognised by the authors of the Maastricht treaty. Article 103 of the treaty is one of the key elements setting out the arrangements for economic policy. It is shot through with references to the member-states' economic policies. Its general tenor makes clear that economic policies are a member-state responsibility.

The tools for economic policy

The challenge before the member-states is thus to reconcile the political reality of national responsibility with the need to establish a smoothly functioning economic union. It would be idle to pretend that the European Union already has fully developed equipment for this task. But the elements of the framework are already there, in the form of the instruments, the fora and the preparatory process.

First, the instruments. Article 103 of the treaty provides the central instrument—the broad economic guidelines—whereby the member-states co-ordinate their economic policies within the Council. The guidelines take the form of politically committing, but not legally binding, recommendations. This is typical of the form of instrument which is being developed for economic co-ordination. Similarly, the Stability and Growth Pact rests upon a resolution of the European Council in which the member-states, the Commission and the Council make political commitments to implement stability and growth. This resolution—to use its own words—"provides firm political guidance".

The fact that the European Council—of heads of state or government—has to come to a conclusion on the broad economic guidelines underlines their centrality to the process of economic co-ordination. But the existing broad economic guidelines procedure certainly needs strengthening. And ministers agreed some steps in that direction at the October 1998 meeting of the council of economics and finance ministers (Ecofin). The new procedures are now being used for the 1999 exercise. They involve improvements to the format of the guidelines, a clearer understanding of their coverage and suggestions for the timing of their consideration by Ecofin. Another example of this sort of instrument for economic co-ordination—based on a political commitment among governments—is the recently established Code of Conduct Group on unfair tax competition, a peer review process which Britain's Financial Secretary, Dawn Primarolo, is chairing.

Second, the fora. The treaty makes clear that the decision-making forum for economic co-ordination is the Ecofin council. This was reaffirmed in a resolution of the European Council in December 1997, which referred to the establishment of informal meetings of ministers from the euro-zone—the so called Euro-11 group.

Third, there is the preparatory process. The Commission services, notably the excellent DGII under Giovanni Ravasio, will have an important role in preparing analyses and other inputs for all this work. But the member-states, too, will need to contribute, for example on budgetary prospects, on developments in their economies as well as across the EU, on the evolution of structural policy and so on. And the Economic and Financial Committee, the successor to the EU's Monetary Committee, will provide the crucible for the preparation of the advice which will go to finance ministers, whether in the formal Ecofin council or in the informal Euro-11.

So the tools are there—instruments, fora and preparatory process—for economic decision-making in EMU Europe. Of course, these tools will be developed on the anvil of events—pragmatically, with policy-makers learning by doing and confronting problems when and where they have to be decided as a matter of practice. This is how the Ecofin ministers prepared for EMU, setting out in broad terms the objectives—the vision—and then meeting those objectives on a case-by-case, step-by-step basis. A happy synthesis of the Cartesian and the utilitarian approaches!

The international arena

The international representation of the euro and the member-states' international economic and financial policies are also an issue for economic government in Europe. Because interests can differ between those member-states inside and those outside EMU, and between members of the G7 and G10 and the others, the Ecofin ministers wisely postponed discussion of this issue until the main decisions establishing the single currency had been taken.

It is useful to define here the sort of issues that are likely to arise. First, there are those which are clearly to do with the euro, "matters of particular relevance to economic and monetary union", to use the words of article 109(4) of the treaty. For example, exchange-rate policy between the euro and third currencies is clearly a matter of EU competence upon which only the "in" member-states can vote.

Second, there are the issues which have nothing to do with the euro, such as policy on economic developments in Asia and Russia, the recent financial turbulence, the funding of the International Monetary Fund (IMF) and so on. All these issues are matters for all 15 member-states. It is on these issues that we have heard many calls for “Europe to make its voice heard”, for “Europe to show a presence”, or for “Europe to act”. In fact most of the issues are not, in the terms of the treaties, a matter for the EU, since they fall clearly into the competence of member-states. It is the member-states which are responsible for the IMF, not the EU. It is the member-states which regulate the banks that do business in Russia and Asia, and which provide export credit and other bilateral support.

These are issues of high constitutional principle, and they present the same challenge as that of managing Europe’s economic union: aligning the national interest with the greater interest of Europe as a whole, but within the framework of member-state responsibility.

The elements for settling these complex international issues are already in place. First, there needs to be a preparatory process, so that ministers can come to a common view and then make provisions for follow-up and implementation. The Economic and Financial Committee is the obvious body to perform this function. Second, there need to be instruments for promulgating ministers’ common views. Article 109(4) provides for a decision-making process on matters to do with EMU. For member-state issues, one way forward is to seek to establish “common understandings” of all 15 countries, which would set out a non-binding common line with political force. Third, there need to be fora in which ministers can discuss and decide issues. Ecofin, the Euro-11 group and informal meetings of ministers and central bank governors provide ample opportunities for discussion.

Fourth, there needs to be some participation for EMU Europe in international groupings and in the international institutions. Clearly the ECB needs to be present. But what about the economic side of the union? These issues were the subject of intensive discussion by Ecofin in preparation for the Vienna European Council of December 1998. The European Council endorsed the distinction between the representation of the EU at the international level, as regards issues of particular relevance to economic and monetary union; and representation on matters which do not belong to the EU competence, but on which it may be appropriate for member-states to express common understandings.

Regarding representation for issues of particular relevance to EMU, the European Council set out three principles: the Union should speak with one voice; it should be represented at the ministerial and at the central bank level; and the Commission should be involved in the EU's external representation, to the extent required to enable it to perform the role assigned to it by the treaty. The Council then went on to suggest some pragmatic solutions to representation at the G7 finance ministers' and bank governors' group, at the International Monetary Fund and for the composition of Ecofin delegations for missions to third countries. These proposals were endorsed by the heads of government in December and are now being discussed with the non-European G7 countries.

Fifth, Europe needs to make its presence felt on a systematic basis through missions and visits. This is already happening. Chancellor Brown, when president of Ecofin, visited Asia, while Minister Edlinger, during the Austrian presidency, visited Russia. This process will be developed further.

The roles of the European Parliament and the Commission on issues where there is EU competence are set out in the treaties. This paper has focused on member-state issues where the European Parliament has less of a role. For member-state issues the Commission's role is different from its role with Community issues. It is based, in the first place, on analysis; on helping to establish codes of good economic practice; on promulgating best practice; on monitoring member-state performance; and on putting forward recommendations if it thinks that a government's policies are not consistent with the broad economic guidelines.

Conclusion

EMU will not bring an economic government in the sense of a unitary, executive organisation. But it will require a system of governance and it will be based on the system which is sketched out in the Maastricht treaty. The governance of EMU Europe will rest on three pillars:

★ the monetary pillar, based on ESCB and the ECB;

★ the Community economic pillar, responsible for trade and the internal market;

★ the member-state economic pillar, where national governments remain responsible for a great range of domestic economic policies, subject to their co-ordination within the Council, and for most external financial policies, other than euro matters.

This is a system which places at the centre what functionally has to be decided at a European level, and leaves to member-states what is best decided at national level. Of course, there will be challenges in making all this work. There will be frontier disputes. But the lines are clear. This is a system of governance which well suits the diverse mosaic of Europe.

3 Europe's new economic policy constitution

Tommaso Padoa-Schioppa

Since the launch of the euro on January 1st 1999, a new constitution for economic policy—based on the treaties of Rome and Maastricht—has come into force in most member-states of the EU. This is a momentous event in the history of economic policy. Not only does the new constitution apply to the second largest economy in the world, but its very characteristics are unprecedented. The effects of the Rome-Maastricht constitution will take several years to come through, and the rules and processes are likely to evolve by interpretation, implementation and even amendment. But there needs to be a proper discussion on these new arrangements from the very outset, since policy-makers and market participants need to adapt their behaviour to fit the new framework.

The debate is already under way, focusing primarily on policy co-ordination, in other words, on the way policy-makers interrelate. Indeed, whenever economic policies are assigned to different autonomous policy-making bodies, the decision of one may alter the effect that the others are seeking to achieve. These so-called spill-over effects can happen within individual countries (where, for example, there is an independent central bank), as well as between a number of different countries. In the case of the European Union, the problem is further complicated by the fact that policy decisions are taken at more than one level: national and European.

The purpose of this article is to discuss the key issues of economic policy co-ordination in the EU. It is confined to the domestic aspects of economic and monetary union (EMU), leaving aside the relationships between the euro-zone and other major economic areas.

There are two categories of co-ordination. In the EU, co-ordination may be *horizontal*—meaning that policy-makers responsible for different policies co-ordinate their actions, for example central bankers and finance ministers co-ordinating the so-called fiscal-monetary policy mix. And co-ordination can be *vertical*—between countries on each policy, for example on fiscal, monetary, employment and structural policies, as will be illustrated below. Various degrees of centralisation and national autonomy are possible in both of these categories. These arrangements will evolve over time, but it is already clear that there are some dangers. One is posed by the apparent weakness of arrangements for the co-ordination of national fiscal policies, the other by the risk of an "over co-ordinated" employment policy.

Co-ordination: definition and rationale

Although this article addresses only the specific issue of co-ordination among policy-makers, a broader notion of co-ordination should be borne in mind. A market can be seen as a single entity, and is often the most efficient way to co-ordinate the decisions of economic agents. Indeed, the need for policy intervention (and therefore policy co-ordination) only arises to the extent that markets fail to function properly. This is also one of the basic tenets enshrined in the Treaty establishing the European Community. It implies, *inter alia*, that the deregulation of markets may sometimes be the most effective way to improve the co-ordination of economic decisions.

As regards economic policies, their implementation by different and at least partially independent bodies creates potential conflicts, insofar as one actor's behaviour can negatively interfere with that of the others. These spill-over effects may result from the interactions between different policies (e.g. monetary and fiscal) or between countries for a given policy. The objective of limiting the scope for such negative spill-overs is the rationale for co-ordination.

Co-ordination is often defined in economic literature as the "engagement among separate actors to take, and comply with, joint decisions". According to this definition, there would appear to be grounds for co-ordination whenever policy spill-over can be identified. It would indeed be hard to deny the benefits of co-ordination when the policies of different entities can be modified in a mutually beneficial manner before they are implemented. However, the general case in support of taking into account policy spill-overs does not imply that a commitment to adopt joint decisions is, in practice, always necessary, workable or even desirable. In other words, it cannot be taken for granted that a joint decision will always be possible, nor that its outcome will always be superior to that resulting from separate decisions. Indeed, co-ordination may raise serious problems concerning information transmission, incentives and enforcement among policy-making bodies. In particular, each has its own legal basis, mandate, constituency, policy paradigm and decision-making procedures that can hardly be subordinated to a joint decision in all circumstances.

If defined as a systemic engagement by different policy-making entities to take joint decisions permanently, co-ordination is an intrinsically weak even self-contradictory process. As such, it is bound to fail. No organisation could permanently forego its autonomy without ceasing to be an entity in itself. Either the co-ordinating procedure is so strong that the joint decision is always taken and implemented, in which case the many actors have effectively been replaced by a single, collective one; or joint decisions will only be taken occasionally. This suggests that there are three different modes of co-ordination among policy-making bodies entrusted with their own (policy or geographic) area of responsibility:

★ single institution: many bodies are replaced by a single one which becomes the new decision-maker, such as the Eurosystem (which comprises the ECB and the central banks of the member-states which have adopted the euro) or the EU legislative bodies;

★ joint rule: the rule acts as a permanent constraint on the discretion exercised by independent decision-makers (for example, the Stability and Growth Pact, or EU directives); and

★ joint forum: independent entities meet in a forum within which joint decisions are a possible, but not an obligatory outcome (for example, the G-7 or the Euro-11 group). The "joint forum" mode is often referred to as co-operation rather than co-ordination. However, it is connected to the "single institution" and the "joint rule" modes, not only because it exists as a response to the same problem, but also because it may *occasionally* result in a joint decision, that is to say a co-ordinated response.

The assertion that the three modes outlined above are the set of possible responses to co-ordination problems is corroborated by the history of international economic and monetary policy relationships. These have combined, to various degrees, rule-based systems with the loose co-ordination as specified in the "joint forum" mode.

Obviously, in the "joint rule" mode, the implementation and enforcement of the rule always leaves policy-makers some room for discretion, and thus the issue of how to co-ordinate the discretionary parts of policies resurfaces. (This is not the case for a single institution, where several policies are merged into a single one.) However, the choice of appropriate joint rules may go a long way towards steering the incentives for individual actors in a desirable direction, possibly obviating the need for any additional co-ordination.[3] Furthermore, the aforementioned categorisation suggests that, despite common binding rules or guidelines, discretion is not only permissible, but also, to an extent, necessary, when it comes to the implementation of the rules. Obviously, in the "joint forum" mode, discretion is not only permissible, but the general rule.

[3] *The Maastricht treaty and the Stability and Growth Pact provide such a framework*

The policy framework of the euro area

The European economic constitution foresees several forms of co-ordination, both among countries (vertical co-ordination) and across policies (horizontal), within a market-oriented philosophy. Table I attempts to illustrate this decision-making structure. It must be borne in mind that, to concentrate on the macro-economic perspective of this article, the scope of structural policies has been limited to labour markets (employment policies), although product and financial markets also play a major role in EMU.

As is clearly illustrated in Table I, the euro area policy framework combines the aforementioned forms of co-ordination: a *single institution* (a single decision-maker, the Eurosystem), a *joint rule* (the Stability and Growth Pact, which acts as a permanent constraint on the discretion exercised by the fiscal authorities) and *joint fora* (regular exchange of views among independent actors through several bodies: the Ecofin council, the Euro-11 group and the Economic and Financial Committee).

Table 1: Structure of the policy-making process within the euro area

Policies	***Actors involved***	***Mode of co-ordination among countries***	***Mode of co-ordination across policies***
Monetary	*Eurosystem*	*Single insitution*	
Exchange-rate	*Eurosystem* *Ecofin* *Euro-11 group*	*Single institution*	
Fiscal	*Euro level* (Ecofin, Euro-11 group, European Commission) *National, Sub-national* (Regions/Länder)	*Joint rule*	*Joint fora* (Ecofin, Euro-11 group, Economic and Financial Committee)
Employment	*Euro level* (Ecofin, Euro-11 group, European Commission) *National* (Governments/ Parliaments/ Social partners) *Sub-national* (sectors)	*Joint fora*	

Let us first consider *vertical co-ordination*. What is unique about the euro area policy framework is that it has a single monetary policy and a single exchange rate, while other policies remain largely the preserve of national actors. Indeed, both employment and budgetary policies are predominantly the responsibility of member-states, despite being subject to the relevant EU provisions, such as Article 104c of the Treaty establishing the European Community (concerning the excessive deficit procedure) and the Stability and Growth Pact (SGP). Each of these policies should be considered in turn.

There is broad consensus that stable prices are a major pre-condition for sustainable economic growth, and that price stability is the key contribution which a central bank can make towards such growth. This is reflected in the fact that the single **monetary policy** of the ECB has been assigned the maintenance of price stability as its primary objective. The treaty also stipulates that the Eurosystem shall be independent, in recognition of the fact that the pursuit of price stability—which is a long-term commitment—is more effective if it is sheltered from the pressure of elected authorities which are inclined to give priority to short-run objectives.

Article 7 of the statute of the ESCB makes clear that “when exercising the powers and carrying out the tasks and duties conferred upon them by this treaty and this statute, neither the ECB, nor a national central bank, nor any member of their decision-making bodies shall seek or take instructions from Community institutions or bodies, from any government of a member-state or from any other body. The Community institutions and bodies and the governments of the member-states undertake to respect this principle and not to seek to influence the members of the decision-making bodies of the ECB or of the national central banks in the performance of their tasks.”

The treaty, however, also states that, without prejudice to the objective of price stability, monetary policy should support the general economic policies of the Community. This means that the central bank is able, in principle, to accommodate any rate of non-inflationary growth, including the growth rate that generates and maintains full employment. For this rate to be achieved it is of course necessary—as is further elaborated below—that the other actors behave, in their respective fields, in ways that are conducive to non-inflationary growth.

Exchange-rate policy is also, by definition, a vertically integrated policy. This is a direct consequence of the single currency. According to the treaties, exchange-rate policy is a competence that governments and the central bank share. Article 109 outlines a complex joint procedure to adopt possible exchange rate “arrangements” or “formal agreements on an exchange-rate system for the ecu [now the euro] in relation to non-Community currencies”, as well as possible “general orientations for exchange-rate policy”. In interpreting this matter, the European Council came to the conclusion (in December 1997, reiterated a year later) that the euro exchange rate should be seen as “the outcome” of all relevant economic policies, rather than as an objective to be set independently. It also concluded that "general orientations" for the exchange-rate policy of the euro area may only be formulated in "exceptional" circumstances, for example in the case of a clear misalignment, and without prejudice to the primary objective of the Eurosystem to maintain price stability. The Eurosystem agrees with this position.

Fiscal policies are the preserve of the national authorities, but the latter are bound by the rules of the excessive deficit procedure, which are in turn reinforced by the SGP. By prescribing a fiscal deficit close to balance or in surplus over the cycle, the SGP aims to provide an appropriate fiscal cushion so that governments can comply with a 3 per cent upper deficit limit in the event of recession (the limit will not apply in the event of a severe recession). Under EMU, the stability programmes submitted to the European Commission on an annual basis are discussed by the member-states in the Economic and Financial Committee, in advance of the Ecofin council meetings. Such country-based exercises are complemented by the "broad guidelines of the economic policies of the member-states and of the Community"—to which reference is made in Article 103 (2) of the treaty, and which have been published annually since 1993. The guidelines are prepared by the Commission and adopted by the Ecofin council. In addition to these formal procedures, the Euro-11 group, which is a sub-group of the Ecofin council limited to the euro-zone members, regularly addresses the issue of member-states' fiscal stances.

Employment policies are the main instrument of economic policy that is ultimately and effectively available at the national level. However, according to Articles 118a and 118b of the EU treaties, the Commission is entrusted with the task of encouraging social dialogue at the EU level and of enacting legislation to improve the working environment. Moreover, the European Council meeting in Cardiff in June 1998 defined a strategy to promote employment consisting of a "monitoring of nominal and real wage developments" and the "close examination of national employment action plans, dealing in particular with active employment policies in accordance with the employment policy guidelines and the exchange of best practice".

As regards *horizontal co-ordination*—that is between different policies (monetary and fiscal being the most obvious)—the predominant mode, at the European level as well as at the national level, is the less stringent one of “joint forum”. Indeed, the European Council, in line with the treaties, has called for “a fruitful dialogue among European institutions”, making clear that co-ordination between independent policy-makers, that is among the ECB, the Commission and national authorities, falls into the “joint forum” category, as defined above. A framework has consequently developed within which all decision-makers, including the ECB, may provide the others with information on their respective fields of competence:

★ regular exchanges of views and mutual information are ensured through the participation of the president of the ECB in the Ecofin council and Euro-11 meetings, when matters related to the Eurosystem’s tasks are dealt with (Article 109b (2)). Conversely, the president of the Ecofin council and a member of the European Commission may participate, without having the right to vote, in the meetings of the governing council of the ECB (Article 109b (1));

★ Ecofin meetings are prepared by the Economic and Financial Committee (EFC), which comprises senior officials from the Finance Ministries, the European Commission, the ECB and national central banks. The EFC replaced the Monetary Committee at the beginning of 1999 (see Article 109c of the Treaty establishing the European Community). The ECB is represented in the new EFC by its vice-president and an executive board member.

As it stands, the decision-making structure of the euro area implicitly assumes that potential spill-over effects which may arise from the interactions of different policies are, on the whole, negligible, in particular between a single *monetary* policy conducted at the euro area level and other policies—*fiscal, employment* and other *structural* policies—set largely in a national context.

Nonetheless, two kinds of spill-over may generate problems: horizontally, between monetary policy, fiscal and employment policies; and vertically, when fiscal or employment policies are inconsistent between countries.

(In theory, conflicts between authorities over a given policy are possible at the euro area level, since exchange-rate matters are a competence shared by the Ecofin Council and the ECB. However, as mentioned above, the European Council has made it clear that the exchange rate of the euro is, in fact, the outcome of all other policies and not a separate pre-planned objective.)

It is important to note that these two categories of spill-over are closely linked. Inconsistent strategies among national authorities responsible for fiscal and employment policies may result in an overall stance that endangers the credibility of the single monetary policy. From that perspective, the sections below discuss co-ordination arrangements for fiscal and employment policies, respectively.

Fiscal policy

In discussing the problems of fiscal policy co-ordination posed by the EU's rather unique economic constitution, it may be useful to bear in mind the distinction, outlined above, between vertical co-ordination (among countries) and horizontal co-ordination (between different policies).

With regard to vertical co-ordination, it must be noted that the SGP constitutes a useful source of discipline for national fiscal policies, but in no way provides the euro-zone with a capacity to decide and implement an area-wide fiscal policy of its own. Indeed, the main peculiarity of the EMU constitution for economic policy lies in the lack of a central fiscal authority.

At the national level, once governments have brought their budgets into balance or into surplus, the SGP allows (within the 3 per cent deficit limit) for normal cyclical fluctuations to be absorbed via the operation of automatic stabilisers (like social security spending) and, if need be, through additional discretionary measures (lower taxation, public spending on infrastructure and so on). In fact, the SGP, if implemented properly, will help national fiscal policies to regain room for manoeuvre. This may be needed in a monetary union where independent monetary and exchange-rate policies are no longer available to national policy-makers. Seen from this perspective, the SGP provides a framework for national policy-making that is characterised by decentralisation, discipline and flexibility, all of which can be considered desirable.

As a fiscal policy framework for the euro-zone, however, the SGP lacks the flexibility of a normal central fiscal authority to respond effectively, if need be, to Euroland-wide (symmetric) shocks. In other words, the increased room for manoeuvre created by the SGP raises the issue of when and how to co-ordinate the discretionary parts of national fiscal policies. Thus, while the SGP reduces the risk that swings in countries' fiscal positions may result in spill-over effects, it does not necessarily facilitate co-operation among fiscal authorities. Against this background, the SGP is only a satisfactory framework for actors that have a preference for a totally decentralised fiscal model. The "joint forum" procedure based upon the Ecofin council and the Euro-11 framework and the EFC is a weak co-ordination device. Over time, it may prove desirable for the EU to be capable of developing its own fiscal policy stance.

As regards horizontal co-ordination (between fiscal and other policies), the treaty provides a clear division of responsibilities between the Eurosystem and the fiscal authorities. Although this division of labour is currently the subject of much debate, it should be emphasised that it is no different, in principle, from what we find in countries with central bank independence, such as the euro-zone countries prior to EMU, the United States, Canada or the United Kingdom. There are no mutual public commitments on either side, nor bargaining processes, nor joint decisions in any of these countries. This was perhaps the case in countries such as the United Kingdom or France before the central bank was granted independent status, but it is not the case today. The absence of hard co-ordination in shaping the policy mix is not specific to EMU. The policy mix at the euro-zone level is to a large extent (although not totally) the outcome of rule-based policies rather than prior discreet negotiation.

However, the lack of a specific fiscal policy for the euro area, and the nature and composition of the fora in which these issues are discussed (the Ecofin council, the Euro-11 group and the EFC) bear witness to significant differences between the euro-zone and the national arrangements mentioned above. For one thing, the lack of a euro-zone fiscal policy decision-making process is an obstacle to a fully-fledged policy mix, and the credibility of monetary policy is not supported by the credibility of the fiscal framework. Furthermore, fora such as the Ecofin council or the EFC are not really suitable for the quiet, confidential and often effective consultations between monetary and fiscal authorities that have long functioned at the national level. There are, quite simply, too many people in the meeting rooms; the machinery for preparing the meetings is too heavy and too formal; and there is too much immediate exposure to the media. Thus, even if there were to be a fiscal policy for the euro-zone, the appropriate "joint forum" procedure—to facilitate the discussion of monetary and fiscal policy in an effective but non-binding manner—would still have to be developed.

Employment policies

In the constitution enshrined in the treaties, employment remains a predominantly national or sub-national competence. The treaties, of course, provide for the freedom of movement of workers and, since Maastricht, for a protocol on social policy. In addition, the EU has outlawed a number of protectionist measures that have historically been used to defend and promote employment at the national level, since they conflict with the rules of the single market. Finally, the adoption of the single currency has deprived national policy-makers of the exchange-rate instrument that, until recently, had been used to gain (or regain) competitive advantage and sustain employment. Employment policy has thus a considerably narrower range of instruments at its disposal, but it has nevertheless remained national, with national and sub-national bodies retaining control over the key determinants of the cost of labour. Such determinants fall within the competence of a variety of actors: central government, local governments, various regulatory bodies, trade unions and employers at the national, industry and company levels.

The advent of monetary union has provoked, over the years, two different arguments over the future of employment policy. The first criticises the single currency for depriving member-states of the ability to make an exchange-rate response to asymmetric shocks—shocks that do not hit the euro-zone in a uniform way and may require nationally diversified responses. The second, more recent argument consists in advocating a "common employment policy" as a complement to the single currency. Both assertions are relevant to the issue of policy co-ordination and must be answered in turn.

In fact, the two arguments are connected because wage settlements and other arrangements affecting labour costs (whether enshrined in labour contracts, in regulations or in ordinary legislation) are likely to be the *only* relevant source of country-specific asymmetric shocks. This is due to the fact that other potential shocks are either asymmetric but not country-specific, as they hit regions or sectors of the economy (as did the crisis in the steel industry, or the oil crisis) or, if they are country-specific, they are provoked by the policy-makers themselves, and so the euro and the SGP will make them impossible or unlikely.

Inconsistency between monetary and employment policies has thus rightly been identified as a considerable risk for the smooth functioning of the euro area, insofar as labour markets, and in particular wage-setting processes, may significantly influence prices. Flexibility in labour markets, however, will preclude the need for horizontal co-ordination between monetary policy and employment policies. It will prevent employment policies from being themselves a source of asymmetric shocks—shocks that monetary policy can no longer cure—and it will help to repair the damage done by shocks that may come from other sources. Appropriate employment policies can exert downward pressure on price developments, thus allowing higher non-inflationary growth. This, in turn, would increase fiscal sustainability, on both the income (via improved tax collection) and expenditure (through reduced social security costs) sides of the budget. At the same time, the consolidation of public spending and the reduction of deficits should ideally comprise measures aimed at reducing labour costs, although these may temporarily place a strain on public finances.

Thus the need for labour cost flexibility is bound to be at the heart of any employment policy. This is all the more necessary in an area such as the European Union, within which there is unlikely to be a great deal of labour mobility, even in the longer term. Labour cost flexibility and geographic mobility are closely linked: if wage-bargaining processes in the various countries, regions, sectors and firms reflect disparities in productivity among workers, regions and sectors, they will contribute to the objectives of both price stability and mobility.

The second issue, that of developing a common employment policy, is gaining ground in the EU political debate. This is partly because the reduction of unemployment is the first policy priority in almost every country, but also because the launch of the euro illustrates the value of co-operation, thereby encouraging governments to work closely to co-operate in other fields of policy. In Cardiff in June 1998 and in Vienna six months later, Europe's leaders put unemployment at the top of the EU agenda and promised action. These developments seem to indicate a desire for vertical co-ordination (between countries) in the labour field. Depending on the way in which this desire is put into practice, the effects may be positive or negative.

The effect would be negative if vertical co-ordination were to lead to a uniform wage level for the whole area. Although centralised income policies have played a fundamental role in containing inflation in several European countries over the past years, Euroland-wide wage bargaining, resulting in a single wage level, would aggravate rather than alleviate the unemployment problem. Indeed, such policies would severely undermine the competitiveness of countries and regions within which low labour costs are fostering income and employment growth. It should not be forgotten that the high levels of unemployment in the Italian Mezzogiorno and in eastern Germany are largely due to premature wage equalisation.

However, the desire for vertical co-ordination could also be channelled in positive directions. For example, vertical co-ordination could create pressure for the removal of rigidities, particularly in the services sector and in non-tradable goods. And it could lead to the formalised exchange of best practice in job creation. To this end, a common monitoring of national policies, aimed at producing greater labour market flexibility, would be useful.

In a single market there is inevitably competition, not only for goods, services and capital, but also among workers. The role of social legislation is to prevent such competition from pushing working conditions and workers' rights below the threshold of what is considered socially and morally acceptable. The treaties' protocol on social policy has contributed to the fulfilment of this role. However, since it is hard to believe that European unemployment could be reduced without the help of more competition in the labour market, that should now be the focus of further EU co-operation.

Conclusion

The institutional set-up in the EU provides for a clear assignment of policy competences between the Community and the member-states. It also contains various mechanisms for policy co-ordination among the member-states themselves. This essay has sought to investigate whether the existing forms of co-ordination—both across policies (horizontal) and amongst countries (vertical)—are appropriately designed to fulfil the objectives of economic policy in both the area as a whole and its individual components.

The success of EMU will critically depend on the commitment of the different policy-makers to make the present economic policy constitution work, to pursue their respective objectives effectively and to engage in a continuous dialogue. An optimal use of the existing constitution would go a long way "to promote economic and social progress", which is the EU's first objective, as enshrined in the Treaty on European Union (Article B).

Nonetheless, the current framework and the present debate about it suggest two conclusions. First, the SGP does not fully satisfy the need for co-ordination among fiscal authorities. It provides for discipline, but it does not really permit the prior definition of a policy stance for the EU. The "joint forum" procedure based upon the Ecofin council, the Euro-11 framework and the EFC appears to be a rather weak co-ordination device. This has implications for a fully-fledged policy mix, insofar as the credibility of monetary policy is enhanced by the credibility of the fiscal framework.

Second, the various actors (the unions, the employers, central and local governments and the legislatures) responsible for employment policies, which are mainly national actors, could and should attack the causes of unemployment, which are mostly of a structural nature. They hold the keys that open the door to job creation. Resorting to harmonisation of national practices in the field of employment is not necessary and may even be harmful. Organising joint action to promote flexibility and competition in the labour market would, on the contrary, be beneficial.

4 Employment, stability and efficiency: the essentials of European economic policy

Heiner Flassbeck

The launch of the euro is a powerful expression of the European Union's common responsibility for economic policy, and a symbol of its new decision-making capacity. The euro, however, is not the culmination of the process of European unification, but rather the beginning of a new era of economic policy challenges. Under economic and monetary union, national economies will irreversibly grow together to form a single European economy.

Competition forces participants in markets to seek out optimum economic conditions. This is an economic principle that deserves full political support. Indeed, common responsibility for economic policy in Europe will actually strengthen market forces by removing various impediments to trade between states, a process that will be enhanced with the introduction of the euro. At the same time, the process of economic adjustment must not be distorted by widely differing country-specific rules.

In any case, perfectly functioning markets are not necessarily sufficient to tackle Europe's most urgent economic policy challenge, the need to reduce unemployment. This challenge requires a sound macro-economic policy, that is to say a co-ordinated strategy of monetary, wage and fiscal policies.

Divergence and efficiency

In a functioning single currency area, government incentives, financial or otherwise, may pervert the normally rational economic behaviour of producers and consumers, and actually create an inefficient market. The avoidance of such inefficiencies is central to the European Union's policy of controlling state aids and, more generally, to the concept of a single market. With the advent of the euro, further action will be needed to prevent competition being distorted. One of the important functions of economic policy is to prevent the potentially significant market distortions that may stem from differences in wages, taxes, social legislation, social security systems and environmental rules.

This does not mean that the harmonisation of country-specific rules should become an objective of the Union in its own right. But the euro has implications for the nature of economic policy. Price transparency and the removal of exchange-rate risk within Euroland should generally bring lower transaction costs. As a consequence, differences in national economic policy will have a much more significant impact than before on the way the market works. This can be a problem for the European economy as a whole, for example, when individual tax rules in one particular member-state become more important for investors than their analysis of markets and other factors influencing business location. By distorting the market, such political decisions add up to a negative-sum game, leading inevitably to an overall loss of prosperity. And if other member-states then think that they need to adopt similar rules there will be competition to promote "worst" practice within the Union, with no hope of a better outcome for the EU as a whole.

In particular, those countries which count on measures like tax holidays to maintain their overall competitiveness will generally suffer losses of tax-based revenues, and thus be forced to live with poorer public services and infrastructure. Countries which resort to such a strategy—aimed at attracting foreign investment and increasing exports—may in the long run become more dependent on financial aid from Brussels, whilst their infrastructural endowment steadily deteriorates. This is a high price to pay for what can only be a temporary benefit. Ultimately, such a country's prosperity may become more dependent on the outcome of decisions taken at a European level.

In view of the EU's common responsibility for economic policy, this sort of competition must be prevented. Therefore the EU must co-ordinate a minimum of the relevant conditions that are required to establish a proper framework for competition. Apart from a number of obvious cases, it cannot be said at the moment what, in detail, these conditions are. Nobody can know today how much dynamism will be triggered by the euro, nor which rules may at some point in the future be regarded as "bad practice". In any case, the question of the dividing line between autonomous national decisions and the need to establish the prerequisites of a functioning EMU—between divergence and efficiency—will remain on the agenda of European economic policy-makers for years to come. In this context, a European economic policy requires an agreement that no individual member-state can benefit from EMU unless all benefit.

Competition among states?

The widely held view that nation-states should compete with each other is based on the same rationale as mercantilism—the idea that a country can only get richer to the detriment of others. These ideas saw a remarkable revival after the transition to flexible exchange rates in the mid-1970s, and with the prevalence of supply-side policies. As part of the same intellectual fashion, there was more emphasis on autonomous economic policy (with more independent business cycles, taxation and wage settlements), on attacking inflation through monetary policy and on creating jobs through boosting exports. Economic policy became increasingly focused on the creation of relative competitive advantage, based on the theory of "competition of systems". Some of the core elements of this philosophy deserve support: that public policies must, of course, enable the market to work well, and that governments should also learn from abroad by emulating the "best practice" of other countries. If this leads to a rise in productivity, then wages and incomes in general can, of course, rise quicker than otherwise.

But this "competition of systems" is as wrong and counterproductive if it takes place by depreciating a nation's costs—wages, taxes, regulations and public investment—in the manner of devaluing a nation's currency. As exchange rates are no longer an economic instrument in a single currency area, member-states might resort to this type of real devaluation in order to improve their competitiveness. Such a mercantilist strategy is not compatible with the functioning of proper European markets. The most important example of real depreciation is that of wage increases that are below improvements in productivity. But real depreciation also takes place when the tax burden is artificially lowered, causing a reduction of public spending and the restriction of public services. Each strategy that aims at real depreciation is contrary to the idea of free trade. Within a single currency area, it is even destructive.

Competition is constructive among companies and states if it involves competing for the highest level of productivity. But it is destructive if it is competition in belt-tightening, when it has the sole aim of reducing costs, without increasing the efficiency of the economic system as a whole. Competition cannot be for the benefit of society unless the conditions in which companies compete are comparable and sufficiently stable. Competitive advantage must not be the result of changes to the regulatory environment alone, nor the product of monopoly profit-making, which increases a company's (or country's) share of economic activity without increasing total level of output. Competitive advantage should come from entrepreneurial efforts and the realisation of productivity gains by means of new products and methods in a fully competitive environment—where all companies face equal costs for their inputs of materials and labour.

A European economic government must create and secure the necessary framework for such competition. Four conditions are required.

Conditions for functioning markets

The introduction of the euro, and the elimination of exchange-rate risk for transactions within Euroland, is the first and most important condition for efficient markets. A unique political decision was taken to replace the otherwise permanent task of exchange-rate stabilisation. The pre-condition of the launch of the euro was the recognition that volatile exchange rates create more problems than they solve. But received ideas about sovereignty, about exchange rates as an instrument to counter inflationary pressures, and about the autonomy of monetary policy have overlapped and retarded the implementation of the euro. Many still regard the collapse of the Bretton Woods system as evidence of the impossibility of maintaining fixed exchange rates. However, the high expectations of the flexible exchange-rate system which followed the collapse of the Bretton Woods system were not born out in practise.

By introducing the euro, EU governments have eliminated distortionary nominal exchange-rate adjustments. As a consequence, businesses and politicians are restricted to making real economic adjustments. Thus the prevailing consensus on the inadequacy of changes in the value of money over time (inflation) to solve economic problems has been extended to analogous experiments regarding changes in the value of money in space (flexible exchange rates). On the basis of this thinking, the claim of

Swedish economic theorist Knut Wicksell is unequivocal vis-à-vis monetary policy: "As currency is primarily a measure of value, it ought to be possible ... for a country to maintain that standard just as constant as, for instance, its standards of length, capacity or weight."

This logic behind the euro cannot stop at the present borders of Euroland. For this reason, the enlargement of the European Union must, right from the start, take into account how the currencies of the potential new EU members can adjust to the euro. The question of the exchange rates between the large currency zones, as well as between them and the emerging markets, is based on the same logic.

The second condition for economic efficiency, the uniform price of money, has also been fulfilled with the introduction of the single currency. The national money and capital markets have now become European markets. Under the guidance of the ECB, they operate with uniform interest rates. Thus one of the most important factors in allocative decisions, the price of money and capital, is the same for the whole of Euroland.

The third precondition for efficient competition concerns the development of wages. The adjustment of wage levels upwards within the currency area cannot be the objective in itself. Given the German experience after unification, such a wage-policy orientation must be avoided. But, on the other hand, an adjustment of wage rates via competition to the lowest level can and must also be avoided. In order to prevent potential inflationary and deflationary effects of wages policy, unit labour costs must be held constant in absolute and relative terms; in other words, constant in each country and thus also between individual economies.

This precondition is fulfilled when changes in the level of wages follow changes in productivity. This means that in the medium-term, productivity gains in individual countries are used as the basis of wages policy, since the fundamental decisions that are relevant to the development of productivity are still taken within the national framework. However, from now on there will be a uniform inflation rate across the euro-zone. Therefore, when determining guidelines for wage policy, relevant productivity gains must be considered in addition to the common inflation objective. In the very long term, the average productivity gain throughout the currency area, together with the normative inflation rate, may gradually become the basis for wage-setting guidelines.

Poorer countries will not be prevented from catching up with richer ones if unit labour costs remain constant throughout Euroland. But they will have to do so via the only route to growing prosperity and higher incomes, that is via productivity gains rather than lower labour costs. We need fruitful competition between companies in pursuit of higher productivity, rather than various types of "real depreciation" or beggar-thy-neighbour policies, if the member-states' economic convergence is to be sustainable. One-off moderate wage agreements and tax cuts would prove counter-productive, provoking a wage-cutting and tax-cutting race, ending up in deflation and the reduction of real income for all.

The member-states are directly responsible for the fourth element in a framework of efficient competition: that is tax systems, special tax rules, tax bases and tax rates. There is no doubt about the general problem of differing taxes. That is why, with regard to the functioning of the single market, the harmonisation of indirect taxes already forms part of the *acquis communautaire*. As a result of the euro, direct taxes are becoming an increasingly significant factor in investment decisions. There is probably agreement amongst EU policy-makers that widely different tax rules can distort allocative decisions as much as, for instance, state aid. Wide differentials undermine the efficiency of EMU, and thus the potential for wealth creation. So they are a problem which must be put on the EU's political agenda.

Just as we have articles on indirect taxes in the EU treaty, we also need rules on direct taxes. In its 1998/99 annual report, the German Council of Economic Experts dealt in detail with tax competition. According to the Council, the principles of transparency and equal treatment must be observed, and it must be guaranteed that "the call for tax competition must not foster inadequate harmonisation efforts". The aim is in fact not the harmonisation of direct taxes, but rather the prevention of "real depreciation" via taxes. Social and environmental standards must be reconsidered against the background of the same objective.

Thus the creation of framework conditions for European markets is an ongoing task for "economic government". The clearer the consensus on the conditions for market efficiency, the easier the necessary co-ordination. National measures and rules must be reviewed with regard to the question of whether they meet the necessary conditions for a properly functioning EMU.

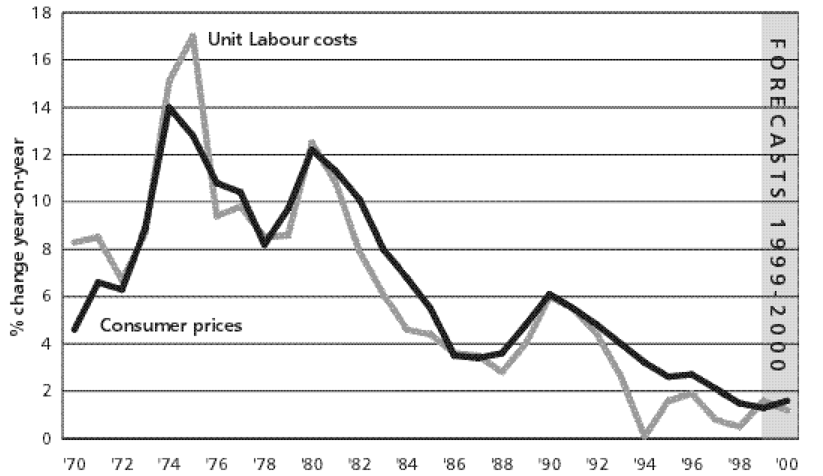
Employment policy

For a long time *laisser-faire* economics prevailed among policy-makers at both EU and national levels. Reduce distortions that are due to state regulation, guarantee stable money, and you will get an efficient single market and high productivity gains. This message of economic liberalism from the 17th century, which is in principle contrary to mercantilism, saw a revival in the supply-side policies of the 1970s and 1980s. The message is not wrong, but is only half the truth. After a quarter of a century in which the underlying level of unemployment has consistently risen, the belief that efficient markets automatically result in the full employment of all resources has begun to waver.

There is a shortage of 18 million jobs in Europe. They cannot be created by means of export surpluses. The European Union must solve its employment problem in a different way. Supply-side policy that aims at high productivity gains cannot be the solution on its own. Productivity gains which do not generate higher real income and thus higher demand will even lead to the shedding of labour. Many citizens in Europe have experienced the process of industrial rationalisation in the last few years. Many have therefore come to the erroneous conclusion that productivity gains are the reason for unemployment and that redistribution of work is the only solution. Such ideas are, paradoxically, the result of a policy that promised more employment through greater gains in productivity.

Neither can wage policy carry full responsibility for employment. Wage rises that considerably exceed overall productivity increases have an inflationary effect and rightly call for a restrictive monetary policy, which has a negative impact on jobs. But the level of employment is also jeopardised by rises in nominal wages that are below overall rises in productivity. Falling unit labour costs are the main cause of deflationary processes. The Great Depression in the 1930s is a deterring example. As soon as investors and consumers expect falling prices, demand dwindles. The present economic situation in Japan shows how difficult it is to move out of a downward spiral into a cyclical recovery. For this reason, wage policy—contrary to the neo-classical approach—is not only an inadequate, but even a dangerous instrument of employment policy. Wage policy can and must stabilise costs and prices. As the figure below demonstrates, it cannot do any more.

FIGURE 1: UNIT LABOUR COSTS AND CONSUMER PRICES IN EUROPE



EU 15, WEIGHTED WITH 1996 NOMINAL GDP ON US DOLLAR BASES AT 1995 EXCHANGE RATES. SOURCE: OECD, FORECASTS FOR 1999 AND 2000

In the Keynesian tradition, fiscal policy is often seen as a tool for employment creation. In this context, people fail to see that, for Keynes, deficit spending was the policy of last resort, to be deployed only when monetary policy has been fully used and interest rates tend towards zero. In this situation, a public spending programme to boost effective demand and to reverse expectations is in fact the only thing that remains to be done. But the European economy has not yet reached this stage. Monetary policy can still be used for employment purposes. Therefore fiscal policy does not yet have to stray from the path of reducing public deficits.

The role of monetary policy

Mass unemployment in Europe cannot be vanquished by outdated economic policy responses. Supply-side policy is able to raise labour productivity, but it cannot expand the volume of labour. Wage policy can help to stabilise the level of demand in the economy, and it can help secure price stability by reducing the production costs faced by companies. But it cannot be used on its own as an employment policy instrument, since policy changes would pass straight through into inflation or deflation. Fiscal policy can directly shift purchasing power from the private sector to the public sector and vice versa. But in the medium term it does not create higher employment. Neither is deficit financing of public expenditure a means to reduce unemployment sustainably. Altogether, the contribution of fiscal policy is restricted to the free play of automatic stabilisers and the short-term prevention of demand slumps. The latter may be of particular importance, given the potential impact of monetary policy on demand.

So, given the inflationary and deflationary risks of wages policy, on the one hand, and the limited scope for using fiscal policy for employment creation on the other, the debate inevitably turns to the role of monetary policy. The creation of money is a political act, not the result of decisions by private actors. Monetary policy, unlike fiscal policy, does not give rise to the economic problem of "crowding out", whereby increased public borrowing displaces private spending. It can give impetus to additional investment without causing contractionary effects on the money, capital and commodity markets. The power of monetary policy-makers over the price of money—the central allocation mechanism in modern economies—inevitably confers responsibility for investment and thus employment.

Political action is, needless to say, orientated towards the shaping of future conditions. Objectives need to be reached. This does not mean, especially with regard to employment policy, securing the status quo, but rather overcoming it by creating suitable conditions for the future. A monetary policy which assumes rates of economic growth that are extrapolated from times of high unemployment cannot solve the unemployment problem. The ECB money supply target is at present calculated on the basis of historical productivity gains and some other ex post data. The calculation for 1999 is 2.5 per cent. The Bank's monetary policy therefore prevents higher growth rates, regardless of what is happening in the rest of the economy. Inevitably this results in lasting unemployment. The ECB should conduct monetary policy specifically to alleviate unemployment, rather than to accommodate assumed productivity growth.

Nobody can predict what rates of growth such a policy can achieve and how large the productivity increase will be in the medium term. We cannot know how dynamic the economy will be in the future. Economic policy-makers can only attempt to prove crude relationships between economic variables by empirical modelling. It is even less easy to model monetary policy. But uncertainty about the growth potential of an economy should not lead to the setting of monetary policy based on historical productivity gains, nor to the blind extrapolation of the present trend of potential growth as a model for the future. A backward-looking monetary policy is not able to assume responsibility for future developments and in fact prevents general economic policy from doing so.

Co-ordination of macro-economic policy

The existing consensus on common responsibility for economic policy is a necessary, but not a sufficient precondition for a successful employment policy and the maintenance of price stability. Co-ordination means process management. However, the objective of co-ordination and the underlying strategic concept is often not clear. An incorrect policy approach cannot be corrected by means of more co-ordination. For example, a co-ordinated agreement to spend less in a recession may even exacerbate the unemployment crisis. For this reason, each aspect of economic policy co-ordination must be accompanied by a discussion of the economic interrelations, namely its impact on employment. This task must not be simply relegated to science. Politicians must participate in the process of forming an opinion, and enrich the debate by asking critical questions.

Considerable progress has been made recently, as far as consensus on theoretical positions and the diagnosis of problems are concerned. Convergence exists with regard to basic economic policy ideas, providing the foundations for a co-ordinated economic strategy.

In summary, the following essential elements of a European economic policy must be highlighted:

★ Impediments and distortive state incentives that hinder competition in European markets must be removed. This task is even more urgent now that the euro has been launched. It would, however, be an illusion to believe that such a process can ever be regarded as complete. Both the dynamism of the markets, and an understanding that sufficiently harmonised framework conditions raise overall prosperity, will remain the driving forces behind economic convergence and integration.

★ Budgetary policies of the member-states must be credibly orientated towards medium-term consolidation. This is not in contradiction to the free play of automatic stabilisers. Industry must be able to rely on the fact that fiscal policy will not deepen economic slumps through cutting spending in a downturn.

★ Wage policy plays a central role in smoothing economic cycles. It must prevent both inflationary and deflationary outcomes by setting wage rises within the framework of the overall economic productivity improvements. Wage policy is the stabilisation anchor within EMU.

★ Under these conditions—with a clear strategy for the consolidation of public spending and the reduction of structural deficits, and slight rises in unit labour costs in line with the ECB inflation target—the way is paved for a new monetary policy that gives impetus to investment, whilst not jeopardising the objective of price stability.

5 Does the euro herald a common system of taxation?

David Currie

The launch of the euro at the start of 1999 was smooth and trouble-free. In the last few months of 1998, the prospect of the euro cast a stabilising influence over the participating currencies: the lira and other currencies that would have come under pressure from the turmoil in international financial markets benefited from the euro umbrella—in contrast to some of the "out" currencies. The attraction of monetary union's stabilising influence became clearer in late January, when Brazil was forced to abandon the real's exchange-rate peg. This has led some in Latin America, notably in Argentina, to take heed of the European example and consider whether the adoption of a single currency, namely the dollar, is the only way of achieving macro-economic stability amidst global capital markets. This was the lesson drawn by far-sighted Europeans from the 1992/93 crisis in the European Monetary System: the only practical choice is between floating, and volatile, exchange rates and a single currency.

To ensure that the euro continues to work well, European policy-makers will need to rise to several challenges.[4] One is to ensure that monetary and fiscal policy are conducted in a stable manner, so as to avoid situations in which monetary policy, set by the European Central Bank, and fiscal policy, determined by national governments, pull in different directions. Another challenge is for national governments to ensure that labour and product markets are dynamic and flexible, so that Europe can escape the trap of high unemployment, with all the economic and social waste that it entails. But these policy adjustments would have been equally necessary without the euro. After all, the last decade or more in Europe has not been free of high unemployment and macro-economic instability. The euro does mean a common interest rate across the whole of the euro-zone, and this may not always be appropriate for particular regions or countries. But this

[4] See Currie, "The Pro and Cons of EMU" and "Will the Euro Work?" (Economist Intelligence Unit 1997 & 1998)

drawback is more than outweighed by the benefits of freedom from currency instability, of much greater price transparency and of the deeper economic integration that the euro makes possible. Without the euro, Europe's single market project would remain incomplete.

Opponents of the euro, especially in the UK, overplayed their hand by predicting first that the euro would not happen, and then that it would run into difficulty from the very beginning. These fears have failed to materialise, and consequently we have seen public opinion move in favour of the euro. While a substantial majority remains against membership, eurosceptics should be concerned that the pragmatic British may be won round by a continued smooth performance of the euro, belying gloomy predictions. The card that they will increasingly play is the federal one, exploiting fears that the euro will bring much greater centralisation in Brussels and, in time, a form of European government. Talk of common euro-taxes, under the rubric of tax harmonisation, is the most obvious manifestation of this concern.

The issue of tax harmonisation and economic government is particularly prone to obfuscation and confusion, usually resulting from a gross over-simplification of the issues involved. To illustrate, critics readily argue that the euro will bring an inevitable imposition of high taxes on low-tax Britain. Yet they rarely note that successive British governments, including the current one, have long argued for tax harmonisation in an upward direction in the area of excise duties on drink and tobacco (where UK taxes are high). They also seldom acknowledge that the European Community was based on an initial act of tax harmonisation, namely the replacement of a wide variety of sales taxes in the original founding six by a common system of value-added tax. Without that initial act of harmonisation (of the tax base, not the rates), the subsequent development of the European single market (which many euro-critics support) would not have been possible, and European consumers and companies would have been the losers.

This illustrates the wider point that the main impetus for tax harmonisation comes from the process of economic integration in the single market. Greater economic integration makes it harder to sustain wide differentials in some key taxes, without inducing arbitrage to circumvent the high rates. But as the US experience shows, it does not require equalisation of tax rates. As such, the pressure for tax harmonisation is not particularly a consequence of the euro, though by accelerating the process of economic integration and enhancing the single market the euro adds to that pressure. As significant is the fact that such tax harmonisation as occurs will apply to the whole European Union, not just to the Euro-11. If tax harmonisation is to be regarded as a threat, it is one largely independent of whether or not the UK participates in the euro.

What, then, is the case for tax harmonisation, and how far does it extend? It is important to differentiate two principal motivations for the co-ordination of tax decisions between the member-states of the EU or the euro-zone: a macro-economic motivation and a micro-economic one.

There are grounds for arguing that with a single currency it is sensible for the member-states to co-operate in the conduct of fiscal policy (the budgetary stance). This arises from the interdependence of the policy stances of the different countries. To pursue its objective of stable prices, the European Central Bank must set monetary policy so that, together with the fiscal policies set by national governments, overall demand in the euro-zone grows steadily and slowly, so as not to generate inflation. If one country embarks on an expansionary fiscal policy, then two things must happen. Either the other countries must tighten their fiscal policy in an off-setting way, so that the overall stance of fiscal policy at the level of the euro-zone is unchanged. Or the European Central Bank must raise interest rates, so that a tighter monetary policy offsets the looser overall fiscal stance. But neither tighter fiscal policy nor higher interest rates are attractive to other countries. Thus unilateral fiscal expansion represents a beggar-my-neighbour policy, bringing benefit to one country at the expense of others. Since any country could initiate such policies, there is a case for all countries to co-operate to avoid such outcomes. This co-operation could take the form of a set of rules that constrains their freedom to run unilateral policies, which is what the Stability and Growth Pact does.

It can well be argued that the desirability of such co-operation is not particularly related to the advent of the euro. After all, the communiqués of G7 summits have long been littered with calls for both monetary and fiscal policy co-ordination. And the clearest example of the damage caused by the lack of effective policy co-ordination occurred in the United States in the 1980s, when the Reagan fiscal expansion led the dollar to gyrate against the Deutschmark and the Yen. Thus the case for co-operation on fiscal policy within Europe can be made with or without monetary union.

Indeed it may well turn out that the principal motivation for fiscal policy co-ordination in Europe will come from concern over the external value of the euro. There have already been calls, most noticeably from the recently departed Oskar Lafontaine and from the Japanese, for target bands for the three main world currencies. These are almost certainly unrealistic: the forces of international financial flows are too great for even the combined resources of the US Federal Reserve, the European Central Bank and the Bank of Japan to combat. But policy-makers will have to respond to such calls by showing concern for the external value of the euro. For if the European Central Bank emulated the Fed by adopting a policy of benign neglect on the matter, the euro would be volatile against the dollar, with disruptive consequences for the world economy.

But influence over the external value of the euro can only be achieved effectively by the joint use of monetary and fiscal policy. If there is long-term consistency between monetary and fiscal policy, then the European Central Bank can simultaneously target low inflation, as it is required to do by treaty, and have regard for the external value of the euro. Indeed, the strength or weakness of the euro is likely to be one of the indicators that the ECB will wish to examine in the setting of euro interest rates. But if fiscal and monetary policy are inconsistent, then the Bank will have no choice but to pursue its target of stable prices, even if that leads to an over-valued euro.[5]

[5] As did Paul Volcker in the 1980s, when faced with the burgeoning Reagan fiscal deficit

This macro-economic case for fiscal policy co-operation has some force. But it requires only co-operation among finance ministers, bolstered perhaps by a framework of rules as in the Stability Pact. It does not require the harmonisation of taxes or any form of European government. This is equally true of the role of fiscal policy in helping to smooth the economic cycle, particularly to deal with country-specific shocks. This stabilising role can be performed perfectly well at the national level, and there is no need for this to be organised at the European level. Indeed, given that the member-states have large budgets, fiscal stabilisation can only be managed at the national level: the

European budget is too small to be used for tackling country-specific shocks. Of course, for the European economy as a whole, it is the responsibility of the European Central Bank to use monetary policy to avoid excessive expansion or deflation, and thereby ensure long-term price stability. It is therefore less important to co-ordinate fiscal policy for this purpose.

Notwithstanding these macro-economic considerations, critics of the euro—who argue that it will lead inevitably to federalism—usually highlight the pressures for tax harmonisation at the micro-economic level. And in this context taxes can be interpreted broadly to include benefits (or negative taxes). The supposed threat is that the euro necessarily entails a European welfare state.

This argument has two prongs. The first, to which some europhiles will subscribe, is that the euro necessarily leads to tax and welfare harmonisation. The second is that the euro necessarily lends momentum to political integration and that that in turn will lead to such harmonisation.

It would be foolish for supporters of the euro to deny these possibilities. But they should strongly resist their inevitability. The euro does not require national governments to abandon control over taxation. But it may well be in the member-states' interests to agree to more co-operation on tax issues at a European level. This agenda needs to be advanced positively, not defensively.

Specific examples of the need for such co-operation abound. There is a need for a common basis for European corporate taxation (though not a common rate), akin to the common basis for value-added tax.[6] Without this, it will always be open to companies to play games with their accounting procedures, to minimise their overall European tax liability, to the detriment of the taxpayer in Europe. If one can harmonise the tax base, differences in the overall tax rate become less important: the incentives to arbitrage between a 30 per cent and 40 per cent are much less than those between 30 per cent and the 0 per cent rate which arises when some transactions are left out of the tax base. Such harmonisation of the tax base may well make general sense, even when it

[6]There will of course be national differences in exemptions, as for VAT, but they should be kept to a minimum

closes off certain opportunities for trade that are based essentially on tax arbitrage.

There may well be areas where co-operation on tax needs to extend beyond tax bases to tax rates. Discriminatory corporate taxation may be one such area. The practice of offering tax holidays or subsidies to attract new inward investment to a country or region, when these inducements are not available to existing firms in that area, is widespread. Such practices are clearly discriminatory and distort the operations of the single market. And to the extent that all countries indulge in them, they are essentially self-defeating. There is much to be said for countries in Europe agreeing to a self-denying ordinance to ban such practices.

There is also a strong argument for co-operation in the EU on environmental taxes, particularly a carbon tax. There are major benefits to be had from Europe, and more generally the international community, agreeing on the need for concerted action to tackle global environmental issues. This is because environmental damage spills over from one country to another and cannot be handled by the nation-state alone.

Finally, there may be other areas of national taxation that require greater convergence of tax rates. This is likely to be the case for categories that are mobile: capital that moves around, people that are willing and able to move (rather limited at present), and goods that can be readily traded across national borders. For such catagories, wide disparities of tax rates may well induce shifts to the lower tax area. This will create pressure for harmonisation of rates for these taxes. This harmonisation may take the form of EU agreements to fix common rates of tax; or it may involve national governments responding to market pressures by lowering high rates; or, more likely, some combination of the two.

But such harmonisation will affect only a small proportion of the taxes of national governments. Indeed, were tax harmonisation to become more prevalent, a serious problem of consistency between micro-economic and macro-economic policies would arise. Because of the different economic structures of the European countries, a common set of tax rates and tax rules would yield very different levels of tax revenue (as a proportion of GDP), which would be inconsistent with the need to run prudent fiscal policies at the macro-economic level. This is a very powerful argument against the feasibility of wholesale tax harmonisation.

None of the likely forms of co-operation on tax policy that this essay has considered represents a move towards federalism. They rely principally on mechanisms of inter-governmental co-operation, motivated by enlightened national interest. They do not entail the creation of a pan-European system of taxation, but rather a gradual evolutionary convergence, an approximation of tax regimes. This co-operation may involve a move to decision-making on the basis of qualified majority voting in some areas, but not across the board: co-operation is feasible without the abandonment of the principle of unanimity.

Of course, some will not be satisfied by this gradualist approach to tax co-operation in Europe, and there will be calls for greater harmonisation and the widespread adoption of qualified majority voting. But there will be equally strong opposition to such calls from a majority of member-states. The UK will not be isolated in its opposition, unless it plays its negotiating hand lamentably. And this hand would be strengthened, not weakened, by the UK committing to the euro.

Europe is in a state of evolution. It is possible in time that a number of countries will wish to put in place a tighter system of European federation. It may be that some will wish to embark on the type of integration that Germany, Italy and Switzerland each underwent in the last century, when different entities coalesced into what we now regard as nation-states. And it may be that the European Union will need to adapt to enable a subset of its members to realise this wish. But it will have to do that in a way that respects the wishes of those countries which do not wish to go down that road. As it evolves its structures of governance, as it must, Europe will need to demonstrate flexibility. Otherwise it will not be able to embrace all the current and prospective members of the European Union within a workable structure.

However, it is more plausible to suggest that the European Union is evolving a new form of governance that is something between a national federation and looser forms of international agreement, based on co-operation between independent nation-states. The euro both embodies deeper co-operation and greatly expands the scope for it. But the euro makes it essential that the problem of Europe's democratic deficit be addressed, so that deeper co-operation has the necessary political legitimacy. The euro can and will work without a European government. By expanding the scope of European co-operation, it will strengthen the process of deep integration initiated by the single market programme. The result will be a healthier and stronger European Union, to the benefit of all its members.

6 Making policy co-operation effective

Jean Lemierre

The theme of "economic government" has always been dear to the heart of French governments and it now has a distinctive Gallic sound to European ears. A great deal of water has flowed under the bridge since the phrase *gouvernement économique* was coined by Pierre Bérégovoy, who proposed the concept on behalf of France during the Maastricht negotiations. At that time, he encountered considerable scepticism, to say the least, on the part of some member-states. Looking back, it is striking to see how far the idea has progressed.

Economic government is now embodied in effective institutional arrangements. Procedures have been set out in the Maastricht treaty, both for member-states' economic policy co-ordination (articles 103 and 104), and for the independent monetary policy of the European Central Bank (article 105). The treaty also carefully limits the joint competence on external monetary questions (article 109), and lays down procedures for dialogue between the Council and the ECB (article 109b). Subsequent negotiations have filled in some of the blanks and answered new questions. An informal forum has been launched, the Euro-11, to deepen the co-operation between the finance ministers of the euro-zone. The Amsterdam European Council has initiated new procedures for member-states to co-operate on employment questions. Most recently, member-states have reached a common view on how to organise the external representation of the euro-zone in international fora.

This is not the place to go back over past debates but rather to take a longer term perspective. I shall concentrate on two sets of issues. First, is there scope for closer co-operation within the present institutional framework? Second, is there scope for broadening the traditional field of co-operation? As monetary union becomes a reality, where will be the "new frontier" of policy co-operation?

Ensuring a good policy mix

I totally share Sir Nigel's view that the tools for economic decision-making in Europe will be developed "on the anvil of events", learning by doing. Therefore, the ideas that follow do not only reflect the French government's position on policy co-ordination, but are also drawn from my own experience as a member of the Monetary Committee, now the Economic and Financial Committee.

As I have already mentioned, the institutional framework for policy co-operation was laid down in the Maastricht treaty. Co-operation is structured around procedures for macro-economic and budgetary surveillance. The backbone of the surveillance process is formed by the so-called " broad economic policy guidelines" issued by the Council, and the "stability" or "convergence" programs submitted by the member-states (the name depends on whether or not they belong to the euro-zone).

However, the treaty only partially acknowledges the specific discipline required by monetary union. We are all convinced that the euro will help to set us free from the unrest of financial markets, to improve the effectiveness of economic policies and to enhance micro-economic efficiency. This is what the whole project is about. But the euro also brings new constraints. It is no longer possible to "monetise away" our errors, and that means new long-term disciplines, such as maintaining the sustainability of public finances and improving structural competitiveness.

Moreover, while the ECB will help to manage the average economic cycle of the euro-zone, only national budgetary policies can deal with the various situations of participating countries. Monetary union increases the effectiveness of budgetary policy (which could otherwise be diminished by currency movements) and reinforces growth spill-overs between the member-states. This strengthens the case for a good mix between fiscal and monetary policy. Many years of effort have created the conditions for a cycle of European growth and price stability. It is our responsibility to ensure that this opportunity will not be missed.

Economic policy co-operation has two purposes: managing the cycle in the euro-zone, and exchanging views on structural and long-term issues. The need for policy co-operation was recognised at an early stage, but there have been two distinct approaches to it in recent years: the “specialisation” approach advocates separate budgetary and monetary authorities, each with strict rules and disciplinary mechanisms; and the “co-ordination” approach advocates a close dialogue between budgetary authorities and the ECB, and in the case of unexpected events, decisions being taken jointly.

The present framework, with the Stability and Growth Pact on the one hand and Euro-11 on the other, probably represents a good balance between these two approaches. The Euro-11 is an informal body, since it was not specifically provided for in the Maastricht treaty. In all matters, the formal decision-making body is the Ecofin council, which comprises the 15 member-states. The Euro-11 is a forum for the co-ordination of economic policies, and for dialogue with the ECB. The format of the Euro-11 is restricted to the minister plus one aide, and its proceedings are confidential in order to promote frank discussion. The meetings are held prior to the traditional Ecofin meetings and most of them are attended by the ECB president, Wim Duisenberg, so that he can exchange views with the ministers on economic conditions in the euro area.

Now that these institutions are in place, they have to be run smoothly. This raises a range of practical questions, such as: what should be the “sequencing” of monetary and budgetary decisions? And what margin of manoeuvre do we have to accommodate unexpected shocks within the limits of the Stability and Growth Pact?

The economic context in early 1999, at the time of the launch of the euro, is already providing the first test. The world is experiencing an unexpected slowdown in the wake of the 1997-98 crisis in financial markets and in emerging economies. It is of the utmost importance that growth be maintained in Europe, for reasons that are both internal and external. The average level of unemployment is still very high and a sustained period of growth would help bring it down. European citizens would not understand if they were deprived of the early benefits of monetary union. Moreover, European consumers and firms must continue to fuel world growth, along with the United States. This is part of Europe’s global responsibility.

So, the first big test for the EMU institutions, and in particular for the Euro-11 and ECB, is their ability to maintain the right policy-mix against the background of global uncertainty. This probably requires flexibility on both sides. On the one hand, in the context of weak inflation in the euro-zone, the ECB can pay attention to economic developments: its credibility will be best achieved if growth is stabilised. On the other hand, governments have to weigh up carefully the short-term benefits of policies supportive of growth, and their long-term cost for fiscal sustainability.

These discussions also include exchange-rate questions. The birth of the euro comes at a time of unprecedented volatility on global markets. Portfolio reallocations will add to the uncertainty, because their scope and pace are difficult to predict. They should be monitored carefully. There should be a constant and confident dialogue between the ministers and the ECB regarding the external value of the euro, so that Europe can speak with one voice to its major G7 partners.

In defining the policy-mix for Euroland, the EU's institutions should take account of the exchange-rate effects of economic and monetary policy decisions within the area. With the technical support of the Commission, the Euro-11 should monitor developments on foreign-exchange markets and assess periodically the level of the euro against the dollar and the yen. If necessary, the Council should stand ready to issue general orientations for exchange-rate policy, in accordance with Article 109 of the Maastricht treaty.

The Economic and Financial Committee (EFC) will play an important role in identifying all these questions. It is in charge of preparing the ministerial meetings (Ecofin and Euro-11), and it is the central forum for technical discussions between governments and central banks. It is important that the EFC can assist the ministers and the ECB properly. With the support of the European Commission, the EFC will have to build the appropriate conceptual tools, and to identify the best statistical indicators to monitor economic developments inside and outside the euro-zone. If necessary, euro-zone finance ministers and the ECB president should agree on terms of reference, drawn up by the EFC, for communication with the markets on exchange-rate matters.

These are major challenges for the months to come. At any rate, trust between all the actors will be crucial to finding the right equilibrium. I am convinced that transparency can play an important role in this respect. Whatever decisions are taken, either on the fiscal or on the monetary side, they will have to be carefully explained and considered in a longer-term perspective. If decision-makers can do this, month after month, decision after decision, co-operation will become effective.

Broadening the scope of co-operation

In addition to management of the cycle, the EU has to address a series of structural policies which are national in essence and not necessarily related to monetary union, but which will probably require greater co-operation or at least more frequent consultation in the years to come. The main reason for this is that the completion of the single market, further enhanced by the euro, will accelerate economic integration in the Union. As recent history has taught us, the integration of markets creates both positive and negative spill-overs between countries, providing new opportunities and requirements for co-operation. This applies, for example, to employment and taxation policies.

Co-operation on employment policies is natural, given that the functioning of the labour market affects short-term economic trends and the transmission of monetary policy. It is therefore legitimate for member-states and the European System of Central Banks to monitor employment, wage and productivity developments. Besides, member-states have devised very different strategies when it comes to fighting unemployment, and the results have been very diverse over time, depending on the categories of workers targeted. Therefore, all member-states will benefit from the exchange of "best practice" in this field. A framework for this has been set out in the Amsterdam treaty, and employment guidelines are now being issued. In a field where policies are defined at national level, this is an example of how co-operation can be implemented with due regard for the principle of subsidiarity.

As for taxation policies, the need for co-operation, not to say "harmonisation", has been a matter of intense public debate. In this field too, the approach must be pragmatic. The objective is neither to unify national tax systems nor to abandon national responsibility in tax matters. Moreover, it is true that to some extent, tax "competition" is a natural corollary of the single market. A company which can locate freely within the Union is decreasingly willing to pay taxes which are not justified by the quality of public infrastructure or the skills of employees; an executive who has a choice between different countries will necessarily look at future returns on the pension contributions deducted from his salary. Such comparisons are legitimate and welcome, in order to encourage greater efficiency on the part of the public sector.

But some countries could be tempted to attract firms, capital or human resources with tax incentives alone, rather than by improving the broader economic environment, because they expect the resulting inflows to offset the loss of revenue. This is a deliberately unco-operative policy. In such cases of "unfair competition", it is legitimate for member-states to co-ordinate in order to identify and eliminate international tax loopholes. This is why we have been working towards a code of conduct, through a peer review process. Looking some years ahead, it is also necessary for an enlarged Europe to be able to act in the event of a stalemate. It would then be logical to consider the possibility of extending the scope of decision-making by qualified majority voting.

Increasingly, and especially as we discover how markets are adapting to monetary union, the need for increased co-operation in other areas may arise. For instance, it is striking to see how fast stock markets are now moving closer together throughout Europe. Recent developments in the world financial system have shown the importance of an efficient regulatory framework for the smooth operation of financial markets. In the absence of regulatory mechanisms at the European level, some countries may be tempted to engage in a "regulatory competition" that would harm the proper functioning of markets and ultimately benefit off-shore centres. It may thus become necessary to harmonise to some extent the rules applying to market participants.

These are just some examples of the challenges that will arise in the years to come. I am convinced that European institutions will remain flexible and effective in finding innovative solutions.

7 Making economic government accoutable

Alan Donnelly

The advent of a single monetary policy and a single exchange rate has huge implications for the economic governance of Europe. The idea that EMU might entail some form of economic government is not a new one. It was foreshadowed in the Werner Report in 1970—the Community's original blueprint for monetary union—and was one idea put forward by the French government in the run-up to the Maastricht treaty. However, the current consensus among policy-makers is that the aim of both monetary policy and fiscal policy is stability, both in terms of stable prices and the avoidance of large-amplitude business cycles. Hence, the general view is that "economic government" should not contain many elements of an activist economic policy.

This is partly a reflection of the prevailing philosophy that governments' interventions have generally exacerbated economic problems rather than ameliorated them. In one sense, the minimal emphasis on an "active" economic government could be said to represent a failure of nerve on the part of ministers: they fear that electorates may punish their perceived incompetence by voting them out of office. However, it also reflects a more prudent approach to policy-making on the part of politicians who are aware that the quality of economic data and the efficacy of macro-economic modelling do not permit economic "fine-tuning" by fiscal or monetary policy measures. As a result, fiscal policy is now focused on achieving medium-term output stability (to avoid "boom and bust"), while monetary policy has been placed in the hands of independent central banks with price stability as their principal objective.

Within the European Union, the launch of the euro among 11 countries, transferring monetary and exchange-rate policies to the European level, has focused attention on whether fiscal and structural economic policies (those relating to product and labour markets), which are currently in the hands of national governments, will remain there.

Any discussion of European economic government must start from an appreciation of the current "political settlement". As far as member-state governments and their electorates are concerned, it is precisely because monetary sovereignty has been ceded to the European level, that is into the hands of the European System of Central Banks (ESCB), that other economic policies should remain in the hands of national administrations. But the question to be asked is whether—despite that political settlement—there are forces inherent in the establishment of EMU that will lead to European economic government.

If that question implies that there may be inexorable forces which dictate that economic government must follow monetary government—and be exercised at European level—then the answer must surely be no. But if the question implies that there may be forces which entail closer economic policy co-ordination, and which may eventually lead to a system of joint decision-making which resembles a European economic government, then the answer is likely to be positive.

It is difficult to speculate on how this evolution might proceed. What I would like to discuss is how the European monetary government, which 11 member-states have so recently embraced, is likely to develop, and in particular how this new area of government can be made accountable.

Few doubt the need to reassure the electorates of those countries in the single currency that the EU's new monetary government will not arbitrarily determine many aspects of their economic well-being. And indeed there is a similar need to reassure electorates in countries which have not yet adopted the euro. It is possible to argue that the best guarantee of the democratic rights of EU citizens against the arbitrary power of banker-technocrats is for national government to play a larger role. This is very much the French government position, and it has wider support than is sometimes recognised. Nonetheless this view is based on what I believe to be an untenable, and indeed illogical, position.

The point of transferring monetary sovereignty to the European level—supported in particular by the French—was to stop the most powerful economy (Germany) from alone determining Europe's monetary policy. Instead, decisions would be taken on the basis of EU-wide criteria. This is obviously the current situation, with the German government clearly irritated that European monetary policy is not being run according to the specific interests of the German economy. Were the role of national governments in monetary governance to be enhanced—for example by strengthening the role of the governing council of the European Central Bank (ECB) vis-à-vis its executive board—does anyone doubt that German views would be more likely to prevail? Any degree of democratic control exerted by governments in such a manner would clearly be indirect. But any control exerted by the European Parliament, on the other hand, would be more directly representative of the European citizen.

Some discussion of how the EU's system of monetary governance is currently performing may provide a few insights into how European economic government may develop in the future, and how it might be structured. It is important to note that the European Central Bank is one of the most independent banks in the world, not simply in terms of its operations but also in terms of its goals. It is the ECB, or rather the governing council of the European System of Central Banks (ESCB) which determines how the concept of "price stability" referred to in the Maastricht treaty is to be defined. In other words, the ECB sets its own inflation target. This is in contrast to the Bank of England, which has independence over its operations but not over its goals. In that case, it is the Chancellor of the Exchequer, Gordon Brown, who defines the inflation target for the UK.

Moreover, the treaties state that price stability is the principal objective of the ECB/ESCB, whilst other possible objectives are subsidiary. Only if price stability is achieved in the context of the established time-frame can the ECB take account of broader objectives, such as employment or output. Given that the ECB has this narrow remit, and almost total independence from national governments and from European institutions, how is the ECB to be held accountable and to whom?

Accountability denotes two things. It means democratic legitimacy, in other words that the authority of the institution in question derives from the assent of the people. It also means that the institution must be held responsible for its actions and, when it is in error, that some mechanism ensures that steps are taken to improve its performance.

How then is the monetary governance—or the activities of the ECB/ESCB—to be made accountable in these two senses? What structures are in place, or are foreseen, to give the Bank a due sense of legitimacy and responsibility?

There is little doubt that in framing the Maastricht treaty these two issues were not uppermost in the minds of the drafters (though Jacques Delors may have been an exception), nor of the politicians who agreed to the final treaty. The aim of Germany under Helmut Kohl was to secure a European central banking system in the image of the Bundesbank. But it should not be forgotten that the Bundesbank's impressive reputation and its high degree of independence evolved over many years, in a very specific national context; the Germans hold a particular fear of inflation that has been deeply embedded in their psyche since the Weimar Republic. The French government tried but failed to persuade the other member-states of the need for a strong system of European economic governance, to ensure an appropriate mix between national fiscal policies and the new European-level monetary policy. The then British Conservative government, principally concerned with negotiating a derogation from the treaty provisions, did not concern itself with accountability issues in relation to the ECB.

The Maastricht treaty thus created a monetary institution that is only minimally accountable. The one provision for democratic accountability lies in the requirement that those nominated by the European Council as candidates for the ECB executive board should appear before the European Parliament to be "assessed" on their suitability.

In terms of holding the ECB responsible for its actions, the treaty provides for its president—who also acts as the president of the governing council of the ESCB—to present an annual report on the activities of the ESCB and its monetary policy to the European Council and to the European Parliament. In addition, the president of the ECB, and other members of the executive board, may at the request of the European Parliament, or on their own initiative, be heard by the competent committee of the Parliament.

The key issue is whether these legal procedures work in practice and, even if they do, whether they are sufficient to achieve the necessary degree of accountability. In particular, will they ensure that European electorates accept the right of the ECB to determine important aspects of their economic well-being? As yet we have no final answers to these questions. But it is possible to comment on the experience so far.

During the 1998 hearings for appointments to the ECB's executive board, the European Parliament approved all six nominees. The procedure involved is not one where the Parliament must give its assent before the appointments can be made. However, it is interesting to speculate what might have happened had one or other of the candidates not received the support of the Parliament. Would the European Council have gone ahead with the appointment? Would the individual concerned have withdrawn his or her candidature?

In so far as the European Parliament may be regarded as having the necessary competence and the authority—derived from its position as the only directly-elected European institution—it would be appropriate to invest it with the power of *assent* over such appointments. My colleague Christa Randzio-Plath MEP called for the Parliament to gain this power in her 1998 report on the democratic accountability of the ECB.

As regards the appearances of the president of the ECB before the relevant parliamentary committees, the experience is mixed. Wim Duisenberg, the current president of the ECB, has agreed to appear at least four times a year, in addition to presenting his annual report. He has already appeared a number of times before the economic and monetary affairs committee. However, it is not clear what, if any, extra information has been imparted to the European Parliament by these appearances, or what influence the Parliament has exerted. This problematic situation is due to a number of factors.

The attitude of Wim Duisenberg is that of a central banker trained in the German/Dutch school of "opaque" policy development. Moreover, any information provided to the Parliament—in the form of press releases, the monthly bulletin, or specific reports or research—will also be provided to the media and to the general public, with no preference given to the

Parliament either in terms of content or of prior notice. Little or no information is provided on the reasoning behind the decisions of the ECB. Neither does Mr Duisenberg favour the publication of minutes—including or excluding voting positions (and the Parliament has not demanded their inclusion). This means that it is hard to judge whether a decision to alter or not alter interest rates is right or wrong.

It is also clear that the governing council of the ECB, which comprises the eleven national central bank governors of the euro-zone countries as well as the six executive board members, is the key decision-making body (in line, it should be added, with the treaty). The governing council meets every two weeks. This situation has led some commentators to argue that the ECB executive board acts merely as a secretariat, and that the 11 central banks act, effectively, as a "non-collegiate" European Monetary Council. I believe this view exaggerates the actual position. But if it became reality it would negate the exercise of monetary sovereignty at European level.

We do not know the extent to which this characterisation of the ECB's governing council as an inter-governmental council will hold true. But it certainly contrasts with the view of some eurosceptics, who portray the ECB as an un-elected, authoritarian and federalist body, taking decisions without regard to either national or democratic considerations. The truth is likely to lie between these two representations and will no doubt change over time. The crucial issue is whether and how the influence of the elected representatives of the European Parliament (in consultation perhaps with national parliaments) can be increased. This will depend partly on the Parliament developing expertise in the area of monetary policy, but also, critically, on the ECB accepting a radically different type of monetary governance.

In a modern, complex, rapidly-moving economy, central banks are themselves economic actors. A central bank cannot operate as if it is a *deus ex machina*. But while central banks are uniquely important economic actors, their main influence is via market expectations, and the impact of their operations is dependent, to a considerable extent, on the reactions of everyone else involved in the market.

There is therefore no alternative to complete transparency of the decision-making of the ECB/ESCB. Monetary governance in the modern economy is necessarily an open process. Ensuring that this is recognised by the ECB is a major task of the European Parliament.

What lessons, then, can be learned from the albeit limited experience of European monetary governance, and applied to the consideration of European economic government?

Economic government in the modern era is likely to be lean in content and diffuse in character. It will involve more democratic control structures, and more transparency. Put simply, this means that when governors seek the informed consent of the population, they must provide substantial explanation and reasoning for their economic decisions.

The dangers of moving too quickly, without the endorsement of the peoples of Europe, were amply demonstrated after the Maastrict treaty which launched the EMU project. In the French referendum, and in the two in Denmark, electorates only narrowly accepted an EMU which transferred monetary sovereignty to the EU level, but which left fiscal policy with the member-states. That is the current "political settlement", as endorsed by European electorates, and it must be respected.

If economic governance is to proceed, then we must find a more democratic way of advancing, so that the European Union—when common economic interests are manifest—can evolve new policies and new decision-making structures. I believe that the European Parliament has a crucial role to play in this process—including in the development of monetary and economic government, working with national parliaments and governments, and with other European institutions.

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