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AS THE EURO PREPARES FOR TAKE OFF: A CRITICAL REVIEW OF THE FIRST THREE YEARS OF EMU

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FOREWORD

In a few weeks' time the euro will become a day to day reality for nearly three hundred million Europeans, after having been a fact of life for the financial markets for three years.

Although I played a part in this adventure of which I am proud by chairing the committee which gave birth to the euro, I must admit to being astounded by the political audacity of the resolute manner of its introduction. The "economic giant and political dwarf" that is Europe now has a place on the world stage by virtue of one of the primary tools that give the power to act.

And the first effects of this common power were not slow to be felt. Over the last three years, several international financial crises have occurred without bringing with them anything like the panic shown by the national authorities in previous similar circumstances. If a few despondent souls - often the same ones who were opposed to the principle of the single currency - set up a daily lament about the supposed "weakness" of the euro, it has to be said that as far as everyday life goes there doesn't seem to be anything worth losing sleep over, which is in itself a considerable change.

Does this mean that by inventing "the currency without a state", as Tommaso Padoa-Schioppa so neatly put it, we will have managed to square the circle? Not entirely. We have the tool to do the job, but as yet nothing that can wield it in order to achieve what remains the objective: a common economic prosperity. We have created an independent monetary authority, overtly federal in nature, but we remain divided and hesitant when it comes to using it in an optimal "policy mix" which would associate it with economic and budgetary policy in order to follow a controlled path for growth and employment. I have had many opportunities to say that this weakness of the economic aspect is not something I recognise as being "my" baby, nor yet its aim.

So what is to be done? Should we hope for salvation through a crisis which will force tighter economic integration? You would have to be something of a masochist. Should we wait wisely for the single European currency to create a European state? You would have to be a hopeless functionalist, and in any case that is certainly not the Europe that I am hoping for, absorbing everything, standardising everything. What remains is the path of effective coordination, which respects all the personalities involved and allows a concerted response to common challenges, without pushing all effective political activity up to the Brussels level.

This is the path which Lluís Navarro explores here, in a detailed examination of the steps forward and the hesitations which have marked the first three years of existence of the single currency. From it he derives some realistic proposals, which call for discrimination and determination, but no fundamental upheaval, which is not what we need. It is a lucid vision with which I find my self wholeheartedly in agreement.

Jacques Delors

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INTRODUCTION

The launch of the euro in January 1999 marked what was at once the culmination of the long road towards Economic and Monetary Union (EMU) and the start of a period which poses quite new challenges for economic policy. The euro has re-drawn the economic map of Europe, accelerating the process by which the economies of participating States merge into a more tightly integrated entity: the euro zone.

To manage the economic policies of this new zone, the Maastricht treaty established an institutional framework unique in its form. Monetary policy was centralised, under the control of the European Central Bank (ECB), a supra-national and independent institution. The other levers of economic policy, however, remain the responsibility of a large number of players at many levels, European, national and sub-national. The Treaty and the European Council have also established a series of instruments and procedures along with an informal body, the Eurogroup, with the aim of coordinating the decisions of all these players both with each other and with the European Central Bank.

Well before the launch of the third and final phase of EMU, the relative weakness of the arrangements of its economic side, in contrast to the powerful institution set up to oversee monetary aspects, had led some to fear that this imbalance might endanger the success of the project. Today, with nearly three years' experience behind us since the launch of the single currency, we may wonder whether such fears might have been too alarmist, or whether these institutional imbalances have indeed handicapped the operation of Economic and Monetary Union. The path has been a short one, but far from uneventful.

The launch of this European adventure in January 1999 took place against a difficult background. After a decade of sluggish performance, the crisis in emerging markets threatened once more to compromise growth in the new "euro zone". In Germany and Italy, where growth in the first half of 1999 stood below 1%, there were even fears of a recession. This uncertain environment quickly offered an opportunity to highlight some of the major advantages of Economic and Monetary Union. Since exchange rates between the currencies of the countries participating in the single currency have been irrevocably fixed, the euro zone is a large area of internal stability, which hardly felt the effects of international financial turbulence. Furthermore, in April 1999 the European Central Bank lowered its reference interest rates by half a point. This relaxing of monetary conditions across the whole zone made it possible to support internal demand and rapidly brought an end to the slowdown. The gradual weakening of the euro has also made a substantial contribution to the recovery, which was confirmed as 1999 progressed.

Once the disturbances of the first months were over, economic policy coordination operated quite smoothly for a time; the various procedures were gradually introduced as the operators concerned learned to work within the new framework. Increased levels of activity indirectly led to inflated tax receipts: all Member States found it easier to meet their commitments under the Stability Pact and continued to make progress towards balancing their budgets. Against this background of restored growth, "coordination" came about naturally, without great effort, and the multilateral surveillance required by the Treaty often took the form of a mutual backslapping exercise.

However, once the first tensions began to appear this apparent order and harmony dissolved. The gradual decline of the euro in the currency markets continued throughout the year 2000 raising anxieties among economic and monetary authorities in the zone, spreading confusion and further weakening the European currency with a hail of contradictory reactions and remarks. Furthermore, European governments, who had initially been taken by surprise by the cyclical growth in their receipts, were not slow to take advantage of this development and to bring in significant tax reductions without any prior consultation, thus fostering suspicion of tax competition. Rising oil prices and the widespread protests which followed in the autumn of 2000 led to an identical reaction from different governments: inconsistent responses which served to exacerbate the problems rather than tackling them in a united fashion. The approach of elections in many euro zone countries only accentuated this trend towards taking economic policy decisions on the basis of national interest alone.

It is important to draw lessons from these events because economic circumstances have worsened considerably, and against this background the implementation of the most appropriate policies is now even more crucial. Unfortunately, discrepancies have grown among the economic policy-makers of the euro zone. While the Commission and the European Central Bank maintain that Member States should continue to meet the budgetary objectives set out in the Stability Pact procedures, the governments of the largest countries in the zone - faced with a less favourable environment than had been foreseen - are now letting their public deficits rise considerably beyond the agreed targets. On the other hand, even if inflation is progressing on a downward trend, it still remains above the 2% threshold for price stability thus established by the ECB, diminishing its margin of manoeuvre to support economic activity. The ECB has followed only later, and to a limited extent, the aggressive interest rate cuts pursued by the other main central banks across the globe. This has, in turn, led Finance ministers of the euro zone to publicly express their discontent with the Bank’s monetary policy stance.

The background of fragile growth against which the euro zone is now operating poses at least two challenges to economic policy makers. They must get to grips with the structural reforms needed to increase economic efficiency within the euro zone and to restore its growth potential; and they must seek out the most appropriate mix in macroeconomic policy to boost economic activity and job creation. The unfinished state of the institutional framework of Economic and Monetary Union makes it difficult to meet these challenges and limits the capacity of the euro zone to react to shocks.

After a brief review of the arguments in favour of economic policy coordination, the first part of this paper will describe the main features of the existing institutional framework and the process through which they have gradually been introduced. The second and third parts will discuss, in the light of the events of these first years, the capacity of the players and institutions responsible for EMU to establish a consistent and appropriate raft of economic policy measures for the euro zone to meet existing and future challenges. Finally, the fourth part will suggest some ways in which to improve the structure of economic governance and to profit from all the opportunities offered by Economic and Monetary Union.

I - THE THEORETICAL NEED FOR COORDINATION IN THE CONTEXT OF AN EMPIRICAL INSTITUTIONAL FRAMEWORK

1.1. The theoretical basis for economic policy coordination

a) Monetary union creates a new state of interdependence[1]

Coordination of budgetary policies

The arguments for coordination usually focus on budgetary policy. The traditional argument relates to the external impact of public budgets on the economic activity of partner countries: a direct impact, due to the volume of trade between countries in the EU, and indirect effects due to the resulting variations in interest rates. For example, activity stimulated within a country by budgetary expansion has a positive impact on that country's imports from other States in the zone. It also increases the demand for private savings, which must finance the rising deficit (or the reducing surplus) of the country in question and exercises upward pressure on interest rates. Previously the rise in the borrowing rate was mainly confined to capital markets in the country pursuing the expansionist policy, but under Monetary Union it affects the euro zone as a whole.

These two types of external impact, goods and capital markets, operate in opposite directions and to some extent cancel each other out. Some writers therefore claim that the arguments for budgetary coordination are weak. But the single currency also leads to entirely new kinds of interdependence. Budgetary policy in each member impacts on macro-economic variables shared by all euro area countries. This includes exchange rates, the balance of payments, and, most importantly, average inflation rate of the zone[2]. In turn, the changes in these variables have decisive effects on the common monetary policy set by the European Central Bank. Changes in prices or exchange rates can, for example, be affected by the expansive budgetary policies of one or several Member States and cause the ECB to tighten monetary conditions. Thus the costs of lenient budgetary policies in a single country or group of countries fall on all the members of the zone.

What is more, the EU's own budget is very small: less than 1.3% of GDP, against around 47% for the total expenditure of public administrations in the euro zone. It is thus the budgetary deficit of the euro area countries taken together which is critical for the policy-mix, i.e. the combination of monetary and budgetary policies. Countries which have adopted the single currency have an increased interest in monitoring their partners' policies, so the aggregate fiscal stance is not merely the product of decisions taken in each country. This does not necessarily mean that all Member States must follow the same budgetary policy, but that choices which clash with common objectives, for example in order to meet an asymmetric shock, must be taken in consultation with the partners.

The preservation of the stability and credibility of the euro as a public good provides a further reason for the proper coordination of national budgetary policies, which influence the inflation rate and may thus compromise the ECB's main objective, price stability.

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[1] Many studies of EMU have discussed the theoretical basis of economic policy coordination. See: Buti and Sapir (1998), Gross and Thygesen (1998), Boyer (1999) and P. Jacquet and P. Ferry (2000).
[2] These economic variables shared by EMU members are known as "club goods". For a detailed discussion of the implications of these "club goods" see von Hagen and Mundschenk (2001).

Coordination of structural policies

Although the external impact of structural policies (those which concern the operation of the labour market, fiscal systems, pensions schemes, the market for goods, capital markets etc.) is apparently less direct, the reasons for coordinating national policies are similar to those relating to budgetary policies. Changes in macro-economic variables are closely linked to the operation of the markets at micro-economic level. Improvements in markets for labour, goods and capital increase the potential productive capacity of the economy. This makes it possible to increase economic activity without unleashing inflationary tensions and increases the room for manoeuvre in terms of monetary policy. The modernisation of the institutional and regulatory framework of the labour market also has a significant impact on the capacity of growth to generate employment, and thus on the public budget. All structural measures have a direct or indirect impact on public finances and affect the fiscal stance in the euro zone.

The coordination of structural policies is also necessary if the internal market is to operate smoothly. In a given sector, varying levels of taxation, regulation or liberalisation among countries can create major distortion. This has occurred, for example, in the energy and transport markets. The opposition in some states to liberalisation in the electricity sector gives an advantage to companies which continue to benefit from a monopoly in the country of origin and are free to operate in other Member States. In the transport sector, divergent tax regimes were behind the widespread protests triggered in September 2000 by the rise of petrol prices. Finally, coordination can also be an opportunity to learn from the experience of the partners and provide mutual encouragement where difficult measures have to be introduced.

Several of these arguments for economic policy coordination are inherent in any process of economic integration and do not only affect those countries which have adopted the euro. Monetary Union only strengthens these arguments because it is a force for integration. However, some of the interdependence between euro zone countries results from major structural changes due to the introduction of the single currency. This new state of interdependence justifies a different approach to coordination.

b) The euro zone is not an optimal currency area (OCA)

Monetary Union has strengthened and accelerated the integration process and the synchronisation of national economic cycles. Nevertheless, this is a slow process; diverging inflation rates and rhythms of growth remain, and the heterogeneous nature of manufacturing structures does not remove the danger of localised shocks or disturbances in one or more countries in the zone.

The disappearance of exchange rates between European currencies means that devaluation or revaluation are no longer available as shock absorbers to dampen the effects of cyclical changes. Although the use of this mechanism was already limited under the Economic Monetary System (EMS) well before the introduction of the euro[3], the irreversible fixed exchanged rates created by Monetary Union increase the need to find alternative responses.

The OCA theory developed by R.Mundell and R. MacKinnon in the early 1960s analyses the adjustment mechanisms which provide an alternative to adjustment in parity. The operation of

[3] The EMS was a system of fixed but adjustable parities. It enabled a gradual stabilisation of fluctuations between European currencies.

these mechanisms will determine whether an economic area is ready for a single currency, and able to absorb the effect of asymmetric shocks and thus compensate for the main cost of disappearing exchange rates. These mechanisms are the mobility of production factors, the reactivity of relative wages and budgetary transfers.

The mobility of production factors, not least labour, makes it possible to adjust imbalances by the movement of the workforce from regions affected by a slow-down to more dynamic regions. In the United States this mechanism played a role in absorbing medium and long-term shocks. In Europe, however, there is little worker mobility: even between regions in a single country where linguistic and regulatory factors are at most only minor deterrents, differences in living standards are not enough to provoke significant migratory flows.

The same is true of the second adjustment mechanism: prices and wages are not very flexible in Europe, and certainly much less so than in the United States. A change in nominal prices essentially has the same effects as a change in exchange rates, for both alter the relative price levels between two economies. However, we cannot count on this mechanism to lessen the impact of cyclical divergences in the euro area. In the EU, prices and labour movements only partially reflect variations in activity; unemployment has repeatedly been the adjustment variable at every level (regional, national and European.)

Finally, the federal budget of a Monetary Union also plays a role in cyclical adjustments, because it permits an automatic redistribution when cyclical changes are out of step. If national contributions to the common budget (and the transfers which are received) reflect variations in activity, automatic changes in each country's net contribution help to absorb the asymmetries. However, the Community budget has little or no scope for implementing such adjustment: it is of negligible size compared with national budgets and almost all its components are determined *a priori* and independently of cyclical movements.

More recent studies show that the financial system can also lessen the impact of regional or national economic disruption. If individuals have access to a range of inter-regional options for savings and if they can borrow money in other countries, capital transfers in the private sector may absorb a localised slow-down in activity. However, the EU is far from having a single market in financial and capital services; savings remain very compartmentalised and the costs for businesses to raise money in several countries within the zone continue to be very high. Imperfect information in the financial markets seriously undermines the capacity for borrowing money and diversifying across national borders, both for individuals and companies, and hence reduces the impact of these mechanisms.

All things considered, none of the endogenous adjustment mechanisms are likely to contribute to smoothing out the cycle. There are two consequences of this. First, in the short term national budgetary policies are the only possible way of absorbing localised shocks. Countries in the euro zone must develop margins for manoeuvre so that they can react flexibly to particularly marked changes in activity, either by automatic stabilisers (variations in receipts and expenditure due to cyclical changes) or, in extreme cases, by introducing discretionary measures. However in a Monetary Union, the budgetary policies of each country influence the economy of the whole, and have an impact on shared macro-economic variables. Should an asymmetric shock affect one or more countries, it would increase the need for the coordination of national policies, each of which may be adopting a different approach. Secondly, introducing an effective coordination of budgetary policy does not make it any less desirable to accelerate the structural reforms aimed at making the euro zone an optimal currency area. Increased integration, and the modernisation of labour, goods and capital markets would reduce the likelihood and the severity of potential asymmetric shocks.

1.2 An institutional framework based on the growing awareness of existing inadequacies

a) The Maastricht Treaty and the Stability and Growth Pact

The outlines of Economic and Monetary Union were sketched out for the first time, at the request of the European Council, in the Delors Committee report submitted in April 1989[4]. The report proposed a three-stage plan for achieving Economic and Monetary Union and set out, in a description of what should be the final shape of the project, the necessary conditions for the successful operation of both monetary and economic union.

The Maastricht Treaty took up the fundamental conclusions of the Delors Report. Progress towards Economic and Monetary Union took place gradually, following the three steps recommended in the Report. Institutional arrangements also broadly reflected the proposals of the Report; monetary policy in the euro zone was entrusted to an independent supra-national body the main aim of which was to ensure price stability. The Delors Report, however, recommended a balance between the monetary and economic aspects which was, ultimately, only partially reflected in the provisions of the Treaty. During negotiations prior to the signing of the Treaty, the Belgian and French governments had expressed their wish to see a parallel between the institutions of the economic pillar and the powerful monetary authority. The then French finance minister Pierre Bérégovoy often used the phrase "economic government" in referring to the idea of an Ecofin Council with powers to formulate EU-wide economic policies.[5] The reluctance of the German representatives, who saw these proposals as an attempt to challenge the independence of the European Central Bank, finally forced the supporters of a strong economic authority to scale down their ambitions.

This haggling resulted in a Treaty which instituted the need for coordination in economic policy but which provided only two far from adequate measures with which to implement the principle. In Article 4 (formerly 3A) the Treaty calls for " the adoption of an economic policy which is based on the close coordination of Member States' economic policies"; article 99 (formerly 103) states that "Member States shall regard their economic policies as a matter of common concern" and calls for them to be coordinated within the Council. The Council is to carry out this coordination by issuing the "Broad Economic Policy Guidelines" (BEPGs) which serve to establish a frame of reference for economic policy in the Member States. The Treaty also established an excessive public deficit procedure.

Even before the third stage of Economic and Monetary Union, and throughout the third phase itself, the many inadequacies of these two measures became increasingly apparent. Awareness of these limitations led Jacques Delors in 1997 to put forward a proposal to the European Council which sought to enhance the Treaty provisions through an "Economic Policy

[4] This Committee, chaired by European Commission President Jacques Delors, was made up of the twelve governors or presidents of Community central banks, a member of the Commission, Frans Andriessen, and three experts appointed in their own right: Miguel Boyer, former Spanish economy minister; Alexandre Lamfalussy, Belgian Director of the Bank for International Settlements, and Niels Thygessen, Danish professor and economist.
[5] Ecofin is the Council body comprised of the economy and finance ministers of the Fifteen.

Coordination Pact ". Even though this proposal was not adopted, European leaders have continued to search for ways of progressively improving the existing instruments and supplementing them with additional measures. This was the reason for the creation of the Eurogroup (originally called Euro-11 or the "Euro Council"), an informal gathering of the Finance ministers of the euro area countries. The nature of the BEPGs themselves has also changed considerably, and the excessive deficit procedure was included in the Stability and Growth Pact, a binding instrument imposing budgetary discipline on Member States.

The Broad Economic Policy Guidelines (BEPGs)

BEPGs are principally intended to fulfil two roles: to provide guidelines for national economic policies, and to formalise a common analysis of the economic prospects, the aims to be achieved and the best measures by which to achieve them.

The procedure for drawing up the BEPGs, as set out in the Treaty, starts each spring with the preparation by the Commission of a recommendation which is presented to the Ecofin Council. The latter then adopts the Broad Guidelines on the basis of this recommendation, and these are subsequently approved by the European council. As from the year 2000 the procedure also includes contributions from other Council bodies concerned, from the spring European Council, and from the results of other coordination procedures (see below).

The Treaty also establishes a system for the multilateral surveillance of economic policies, based on the Broad Economic Policy Guidelines. The Ecofin Council monitors the compliance of Member States' policies with the BEPGs on the basis of reports submitted by the Commission. This surveillance mechanism also gives the Council a deterrent instrument: when the policies pursued by a Member State jeopardise the proper functioning of Economic and Monetary Union or fail to comply with the BEPGs, the Council may make recommendations to the country concerned and may also choose to make these recommendations public. This happened for the first time in the case of Ireland in February 2001.

The content of the Broad Guidelines and, to a lesser extent, the importance of the surveillance procedure, have changed significantly since the first BEPGs were published in 1993. During the early years, they focused mainly on reducing public deficits and monetary stability. They were part of a marginal procedure which brought little added value to the convergence process enshrined in the Maastricht criteria. Since 1998, and following two European Council resolutions[6], their scope has been extended to put more emphasis on structural policies. The text of BEPG reports has thus gradually adopted a more general approach and, since the launch of the third phase of Monetary Union, has been divided into two parts: general recommendations and recommendations addressed specifically to each country.

The Stability and Growth Pact

At the instigation of Germany, Article 104 (formerly 104 C) of the Maastricht Treaty on excessive deficits was more closely defined and extended at the European Councils held in Dublin (December 1996) and Amsterdam (June 1997), which resulted in the "Stability and

[6] Resolution of 13 December 1997 on economic policy coordination in stage 3 of EMU and on Treaty Articles 109 and 109b of the EC Treaty; Resolution of 16 June 1997 on growth and employment.

Growth Pact". This procedure seeks to address the interdependence of national budgetary policies and to prevent them from compromising the aims of monetary policy. In this pact, Member States undertake to respect the medium term aim of budgetary positions close to balance or in surplus. This should enable them to keep the government deficit within the reference value of 3 % of GDP during all phases of the economic cycle. Above this level, deficits are regarded as excessive. To take account of the budgetary situation in the majority of Member States at the time when the Stability Pact was adopted, the deadline for achieving the aim of balanced public finances was set by the Council for the financial year 2003.[7]

These provisions are accompanied by deterrent measures. The Stability Pact sets out sanctions which include a potential fine of 0.5% of GDP when a member State has exceeded the 3% annual deficit threshold. These sanctions have never been applied, as, since the Stability Pact was approved, Member States have respected its provisions. All euro area countries had succeeded in reducing their deficits below 3% (which was one of the Maastricht criteria) before the switch to Monetary Union, and in 1999 and 2000 budget deficits continued to improve gradually.

The Stability Pact also introduced a procedure for *multilateral surveillance* similar to the procedure for the BEPGs. Each year the countries which have adopted the single currency submit national stability programmes in which they set out their strategy and budgetary aims for the next three years[8]. The first wave of programmes was submitted between late 1998 and early 1999, and since then countries have updated their plans annually. The Commission issues a recommendation on each programme, and on the basis of these recommendations the Ecofin Council submits the programmes for *peer review* and publishes its opinion.

<u>b) The procedures subsequently added by the European Council</u>

The acceptance that it was necessary to extend coordination beyond budgetary policies, and the readiness to give an added impetus to structural reform in Member States, led the European Council to create three new processes at the summits of Luxembourg (December 1997), Cardiff (June 1998) and Cologne (June 1999). These processes focus on the labour market and goods markets, and coordination of macroeconomic policies.

The first of these is the *Luxembourg Process*. Introduced by the Amsterdam Treaty, this process seeks to promote coordination in employment policy. It is based on the employment policy guidelines drawn up by the Commission and adopted by the Social Affairs Council. These guidelines are translated into national employment action plans in which Member States set out the measures which they have taken or intend to take. The Council, assisted by the Commission as in the case of the BEPG and Stability Pact procedures, assesses Member States' policies. Council and Commission together draw up an annual Joint Employment Report which evaluates each State's implementation of its national action plan and employment policies in the EU as a whole.

The second process is the *Cardiff Process*. This concerns economic reforms in product, capital and service markets. It begins with a Commission report on structural reforms

[7] The Commission suggested that advantage should be taken of favourable periods in the economic cycle to advance this deadline to 2002. However, the largest Member States put this objective back.

[8] Countries which remain outside the euro zone present very similar plans known as national convergence programmes.

implemented by Member States and on the operation of the markets within the EU. The Economic Policy Committee[9] then examines the measures which have been adopted country by country and presents its conclusions to the Ecofin council for discussion.

Finally, the Cologne Council launched the European employment pact which includes the Luxembourg and Cardiff processes and adds a third, the *Cologne Process.* This aims to establish a dialogue among all those involved in macroeconomic policy: the social partners (who determine labour conditions and wages), governments (responsible for budgetary policies) and the European Central Bank (which controls monetary policy). Dialogue takes place in informal, confidential meetings at which the different groups can exchange information and points of view. The main aim of this process is to ensure that wage formation is compatible with the Community's other policies and to encourage everyone concerned to take account of the impact of their decisions on the EU as a whole.

The results of the three processes under the European employment pact, together with the multilateral surveillance procedure set up by the Stability Pact, are all taken into account when the BEPGs are drafted and adopted. BEPGs thus play a consolidating role and remain the main instrument for coordinating economic policies in the EU. Nevertheless, the somewhat disordered multiplication of instruments and procedures has markedly increased the complexity of the initial institutional framework.

c) The Lisbon "open method" and the European Council's annual spring meeting.

In March 2000 the Lisbon European Council decided to restore structural reform at the heart of the EU's policy priorities. At a summit devoted to employment, economic reform and social cohesion, Heads of States and Governments adopted the aim of achieving full employment by 2010 and of making the EU *"the most competitive and dynamic knowledge-based economy in the world"*.

Unlike previous European Councils which had claimed to relaunch economic reforms, the Lisbon Council introduced no new process. The accent was instead placed on rationalising the existing framework and establishing a new "open method of coordination".

The method consists of drawing up guidelines at European level for Member States to incorporate into their national and regional policies. This is followed by periodic joint evaluations of the progress achieved by the various countries in terms of "qualitative and quantitative indicators" which have been developed by the Commission and approved by the Council.

The aim of the open method of coordination is to reconcile the convergence on joint objectives with the diverse approaches and systems existing in Member States. Its flexible nature means that progress can be made in politically sensitive areas where the traditional approaches of regulation and harmonisation are inappropriate or politically unacceptable. Finally, the method encourages the spread of good practice: in areas of national competence, governments can learn from the experiences of other States and take inspiration from the best examples.

[9] A committee made up of senior officials from Member States, the Commission and the European Central Bank which helps with preparatory work for the Ecofin Council. It mainly focuses on the examination of structural reforms.

In actual fact the essential features of this *new* method reflect the type of decentralised coordination which already characterised economic policy in the BEPGs and the Luxembourg and Cardiff processes. Since the Lisbon Council, this type of coordination has been applied in other areas, such as the information society, business policy, education, research policy or social integration. Furthermore, the coordination of structural policy now relies on specific deadlines and quantitative indicators for some of its objectives.

At Lisbon, the Council also strengthened its own involvement in social and economic policy guidelines of the EU. The Lisbon conclusions state that the Council will take on "*a pre-eminent guiding and coordinating role to ensure overall coherence and the effective monitoring of progress towards the new strategic goal."* To carry out this monitoring, and to maintain the impetus, it was decided to hold a European Council meeting each spring devoted to these subjects. It was also agreed that this annual review would be carried out on the basis of an annual synthesis report drawn up by the Commission. The Stockholm summit last May, held under the Swedish presidency, was the first of these follow-up summits.

The new approach introduced by the Lisbon summit also has repercussions for the BEPG and European employment pact procedures. Since last year, some recommendations in the Broad Guidelines have reflected, in practical terms, the "strategic objectives" set out by the European Council. For example, in line with the Lisbon priorities, they include a sub-section devoted to measures to promote innovation and the spread of new technologies and training, while another section, for example, focuses on sustainable development.

II. ECONOMIC POLICY COORDINATION IN PRACTICE

2.1 Budgetary policies

a) The target of balanced budgets recedes

Since the launch of the euro, all Member States have complied with the provisions of the Stability Pact. In the run-up to the third stage of Economic and Monetary Union, and with the rush to meet the Maastricht criteria, the countries of the EU had already begun to make gradual improvements in their public finances, substantially reducing their deficit ratios and accumulated debt. This trend, assisted by a rise in tax revenues due to high growth in economic activity, continued during the first two years of the single currency. Almost all the countries met the targets they set in their stability programmes; deviations were minor, and few in number. In 1999 several countries actually did better than they had forecast, and in 2000, following unexpected revenue from the sale of third generation mobile telephone licences (UMTS), the budgetary balance in the euro zone as a whole was in surplus (0.4%). Even excluding receipts from UMTS licenses, four "small countries" were in surplus in 2000 (Finland, Luxembourg, Ireland and the Netherlands), and another (Belgium) balanced the budget.[10]

The overall picture during this first period was thus positive. Nevertheless, some less encouraging aspects cast a shadow over this analysis. The targets which member states had set in their stability programmes were not very ambitious and this, in conjunction with stronger growth than had been anticipated in 1999 and 2000, made them relatively easy to meet or exceed in many cases. However, even when activity was weaker than initial expectations (i.e. Germany and Italy in 1999), the Member States concerned succeeded in meeting their undertakings.[11]

But the pace of adjustment gradually slowed. Some countries profited from exceptional revenues to finance tax cuts. Flagging efforts at consolidation are testified to by the fact that public finances in the zone deteriorate between 2000 and 2001. Further, the current unfavourable environment has led several governments to review their budgetary objectives for 2001: public deficits in some countries will exceed their commitments under the stability programmes.

On the other hand, according to the Commission's forecasts, the improvement in both actual deficits and the underlying balance should pick up again in 2002. In 2004, all euro zone countries should have finally achieved the medium-term aim of the Stability Pact - that of balancing the budget or recording a surplus. Today, however, these forecasts seem highly

[10] Germany, France, Italy, Austria and Portugal again recorded a deficit equal to or above 1% of GDP. Between these two groups, Greece (-0.9%) and Spain (-0.4%) also recorded a deficit.

[11] In March 1999 Italy, because of a slow-down in growth, called on the Council to revise its deficit target upwards. On this occasion the Commission held that the reversal of activity suffered by the country was temporary, and that failure to meet the original objective would damage the credibility of economic policy in EMU. The Council nevertheless consented to the Italian request and amended the Commission's Broad Guidelines to bring the Italian deficit objective up from 2% to 2.4%. In the event, Italy did not use this extra margin granted by the Council, as stronger than expected recovery in the second half of 1999 boosted its tax revenues.

optimistic and should be adjusted to take account of changes in the cycle, which remains particularly uncertain.[12]

Box 1: Budgetary balances within the euro zone

Primary balance and structural balance

To assess the budgetary situation in the euro zone and the impact of tax reforms undertaken by governments within the EU, it is of interest to consider the different elements of the actual budgetary balance.

- Primary balance: this is the budget deficit recorded excluding debt repayments and interest. Apart from the existing level of debt, the amount of these costs is directly tied to changes in interest rates, a variable over which governments have but limited influence.

- Underlying balance (corrected for cyclical effects). Cyclical fluctuations in activity affect both the volume of revenue and public expenses. This is due to the automatic stabilisers: in a dynamic phase of the business cycle the tax base grows and, simultaneously, compensatory allowances fall; a recession has the opposite effect. The concept of the structural or underlying balance reflects the budgetary position disregarding its cyclical elements. This balance gives an idea of the impact of government decisions on fiscal structure, in terms of both revenues and spending.

Changes in aggregate public accounts in the euro zone

Government finances in the euro area countries improved substantially during 1999, the first year of monetary union. The deficit fell considerably (by 0.9% of GDP), from 2.1% to 1.2%. Budgetary improvements continued in 2000, though at a slower pace; the deficit fell to 0.7% (excluding UMTS revenues), or a reduction of half a point of GDP.[13] This trend was clearly halted in 2001.

However, the gradual improvements of the first two years of Monetary Union cannot be solely attributed to Member States' consolidation efforts. It was also due to increased revenues resulting from higher growth and a reduction in interest payments due to lower rates. The fall in interest payments and debt servicing in the zone was particularly significant in 1999: 0.5% of GDP, or more than half of the improvement in the actual balance. This aspect of spending continued to fall in the following years, but to a lesser extent. According to the commission's forecasts, the reduction in interest and debt repayments will alone reduce the deficit by another half point of GDP between 2000 and 2002.

If we also subtract the short-term effects of the business cycle it can be seen that the structural balance of the zone as a whole has been deteriorating since 2000. Coinciding with an increasingly buoyant internal demand and the consequent expansion of the tax base, many

[12] We refer to the European Commission's forecasts in spring 2001. However, circumstances have changed considerably since these forecasts were published. The most recent private sector forecasts suggest a euro zone deficit of about 1.4% this year, instead of the 0.8% anticipated by the Commission last spring.
[13] For the Fifteen i.e. the twelve euro zone countries and the three countries outside it (the United Kingdom, Denmark and Sweden), the aggregate balance was in balance in 2000, but slips into deficit again in 2001.

Member States announced substantial tax reforms in 2000. In general, the discretionary tax cuts introduced by governments have not been linked to reductions in spending to compensate for falling revenues. For the euro area as a whole these reforms will have an impact estimated at 0.45 of GDP between 2000 and 2001 on the primary balance corrected for cyclical effects.

Although the tax measures introduced by many governments within the zone will increase the underlying deficit, it should be noted that they should have a positive supply-side impact and contribute to easing fiscal pressure in the zone, which is still too high. Similarly, the effect of these reforms will help off-set the effects of weakening internal demand.

b) Weaknesses in existing procedures

Even if the euro area budgetary position is deteriorating in 2001, it has approached a state of balance and in some Member States shows a surplus. The provisions and procedures set out in the Stability Pact, like the Maastricht convergence criteria, were formed in radically different circumstances (the high deficits and rates of indebtedness of the early 1990s). Under these circumstances the aim of those designing the Pact was to rationalise public finances and ensure budgetary discipline.

The Pact specifies that Member States must present budgets which are "almost balanced, or in surplus". Despite the adjustments made in response to the pressure of the Maastricht criteria, euro zone countries were still far from achieving this medium term objective when Monetary Union took place: in 1998 the deficit was 2.1% for the zone overall, and close to the 3% threshold in some countries. The Stability Pact served to ensure - not without difficulty - that the gradual adjustments of the convergence years were not lost. In this way the concept of "budgetary policy coordination" was systematically linked with the reduction of deficits.[14]

The 3% rule was intended to avoid serious deviations on the part of Member States, which could conflict with the ECB's main aim and seriously compromise the success of Economic and Monetary Union. It was vital, particularly in the early days of the European Central Bank, to prevent any country from implementing an undisciplined budgetary policy which could put the stability and the credibility of the euro at risk. Under these circumstances, the precise and binding nature of the Pact's rules was necessary. But where Member States have achieved deficits comfortably below the 3% threshold, this rule has lost all relevance for the present day management of budgetary policy in the euro area.

Under the convergence "model", the macroeconomic role of public finances was also solely identified with balancing budgets. The possibility of using budgetary policies as a tool for macroeconomic stabilisation was not envisaged in Community procedures, nor were the implications of the structural characteristics of public finances taken into account.
The nearer we draw to the medium term objective of balanced budgets, the more obvious the inadequacies of the Stability Pact, under these new circumstances, become. First, it is an artificial device which takes no account of quality or long-term considerations. Secondly, compliance with the upper limit of 3% does not prevent some national policies from taking a pro-cyclical approach which has a negative external impact on other members of the zone.

[14] This approach was defined as the convergence "model" by the Commission, which recently recognised its limits in a Communication on strengthening economic policy coordination in the euro area. This Communication will be discussed below.

Finally, it sets inflexible rules for public deficits, ignoring the effects of the cycle in each country and the overall situation in the euro area.

1) The stress on the size of deficits and indebtedness takes no account of the structural nature of public finances or long-term considerations.

Apart from the macroeconomic role of fiscal policy, more qualitative aspects of public finances - the breakdown of public spending, tax and benefit incentives, the tax burden and its distribution etc. have a considerable impact on employment and the development of the economy. The Stability Pact ignores these structural questions.

BEPG recommendations on budgetary policy and the national stability programmes have become more detailed with successive revisions and are partially compensating for the limitations of the Stability Pact. For example, in recent years the Broad Guidelines have considered the quality of public finances and have urged Member States to improve the efficiency of their tax systems or to reduce the tax burden on low incomes. Since the Lisbon Council, they have also mentioned the need to allocate resources to building the knowledge society and investing in physical and human capital. The Commission and the Council have also gradually extended their surveillance of national finances to take account of balances corrected for cyclical variations. This variable includes more information on the nature and feasibility of the adjustments carried out, and on the available margins for budgetary manoeuvre.

Last March the Ecofin Council and the Commission, responding to a request from the Lisbon European Council, presented a report assessing the contribution of public finances to growth and employment. In this report, as in the Broad Guidelines, the emphasis is on the sustainability of public finances. One of the problems with the Stability Pact and the associated programmes is that they focus on the short to medium term (three years at most), whereas there is a consensus on the importance of long-term developments, not least the impact of demographic ageing. The future burden which is inherent in retirement and social security schemes will lead to rising public expenditure, which is likely to bring pressure to bear on national systems.[15] This is particularly the case in those countries which already have substantial levels of debt. Fiscal policies should already be taking the future costs of an ageing population into account, by reducing indebtedness as quickly as possible to increase the future scope for manoeuvre and revising the role of public finance in employment growth. The scale of the challenges posed by demographic change led the European Council itself to consider the topic at the Stockholm and Gothenburg summits in 2001.

However, the inclusion of qualitative issues in fiscal policy coordination procedures is still in its infancy. Hitherto, the measures taken have not provided systematic monitoring of these aspects. Thus, for example, even if the Council of Ministers, the Commission, and the European Council have declared their determination to examine closely the sustainability of public finances across the EU, many Member States remain tight-lipped when it comes to indicating their long-term forecasts in the national stability programmes. The Commission's introduction of targets for changes in spending in the Broad Guidelines for 2001 has given rise to objections in certain countries (not least the UK which is not part of the euro zone).

[15] N. Ferguson and L.J. Kotlikoff (2000) identify demographic ageing as a major risk to EMU, since governments will be forced to allow deficits (or fiscal pressure) to rise to such an extent that this will bring them into conflict with the European Central Bank which is anxious to ensure price stability.

Furthermore, the sums intended for investment, for training of human resources and research, development and innovation policies are rarely if ever mentioned in the existing procedures.
The recent report on the contribution made by public finances to growth and employment takes stock of these issues and sets out a few guidelines, but falls far short of proposing concrete objectives. In general, the open-ended and discretionary nature of all the guidelines dealing with the structural characteristics of public finance contrasts sharply with the stricter tone of the terms of the Stability Pact.

Respect for the subsidiarity principle has often provided an argument for those who are less than enthusiastic about any attempt to expand the content and level of detail of the examination of fiscal policies at European level. They consider that the European authorities should restrict themselves to monitoring the net budget figures, without going into the national accounts in detail or the specific policies and circumstances of individual countries. Nonetheless, the subsidiarity principle should not be applied indiscriminately in this area without a measure of prudence. The judgement to be made when collectively assessing national policies cannot ignore more concrete or more qualitative aspects which are likely to have an impact on the medium- and long-term development of the overall fiscal stance. Furthermore, to be able to assess national policies the Council and Commission need to take account of certain considerations, such as the investment effort made by each country.

2) Under the quantitative limits, the Pact rules cannot prevent policies having adverse external effects on the euro area as a whole.

Deficits above 3% may be severely sanctioned. However, when Member States respect this limit, they have considerable latitude in the actions they take. The Pact may provide some counter-productive incentives. In periods of strong growth, when public finances improve simply because of vigorous activity, governments are reasonably free to cut taxes or increase spending. This pro-cyclic policy under favourable economic circumstances exaggerates the impact of the economic cycle by calling for stringent budgetary discipline when activity slows down.

Recent developments in the business cycle have clearly exposed this asymmetry in the Stability Pact. At a time when economic prospects for the euro zone seemed very good, several States used their exceptional revenues to make tax cuts which were not accompanied by any corresponding cut in spending. If the current slow-down lasts these States may be forced to take painful steps to tighten their budgets. The Commission holds that, despite the present slow-down, States which did not benefit from the recent period of strong growth to introduce rapid improvements in public finances must not leave the automatic stabilisers to operate freely. They have not acquired a sufficient margin for manoeuvre to avoid compensating for reduced fiscal returns in some way. By contrast, those countries which substantially improved their budgetary situation are now able to allow revenue to fall without fear that they will fail to meet the Stability Pact constraints.

Multilateral surveillance and peer evaluation, based on the Broad Guidelines and national stability programmes, should, in principle, make good the deficiencies of the Stability Pact, by guarding against pro-cyclical policies and articulating the interdependence of national actions.

These mechanisms were thoroughly tested recently when Ecofin issued a recommendation to the Irish government (see Box 2). Under Article 99 (4) of the Treaty, these recommendations provide the most powerful deterrent available to the Commission and the Ecofin Council for applying peer pressure and encouraging Member States to comply with mutually agreed undertakings. But this public reproof is far from binding on the Member State concerned as was clearly shown by the reaction of the Irish government. The Finance Minister, Mr McGrevy, expressed his disagreement with the Commission's arguments and stated that he had no intention of altering his country's budgetary policy. Although any Member State at fault is expected to comply with such recommendations, states are ultimately free to ignore them if they so wish.

Box 2: The case of Ireland

In the Broad Guidelines for the year 2000, Ireland was recommended to pursue an counter-cyclical policy to counter the obvious risks of overheating. Buttressed by supply-side constraints, prices were still rising; average inflation stood at 5.6% in 2000. But contrary to the advice of the Council and the Commission, the Irish budget for the financial year 2001 (an election year) proposed at once to increase current government spending and to make significant cuts in taxation. These measures entailed an anticipated reduction in the Irish government's surplus from 4.7% to 4.3% of GDP.

Under these circumstances, and following a proposal from the Commission, the Ecofin Council issued a formal recommendation in February 2001, suggesting that the Irish government should review its decisions on budgetary policy to bring them into line with the Broad Guidelines. The recommendation called on the government to take compensatory measures to avoid a fall in its budget surplus.

Although it was beyond question that the budget approved by Ireland was in flagrant contravention of Community guidelines, the Council's recommendation and the Commission's initiative aroused a great deal of controversy. Whilst monetary authorities, including the National Bank of Ireland, publicly recorded their approval of the Commission's proposal, the Irish government, widely supported by the press and many experts, challenged the Community recommendation. In fact the economic arguments supporting the recommendation were weak. The scope for fiscal stabilisation in a small country which is very open to trade like Ireland is significantly less than that of its larger neighbours. Irish prices are mostly the result of internal factors, and its impact on the euro zone’s average inflation is negligible. What is more, the performance of the Irish economy is enviable, both in terms of public finance - it has a surplus of more than 4% of GDP, totally in line with Stability Pact rules - and of growth and employment. Politically speaking, the effects of the recommendation may have been pernicious. If the Irish authorities maintain their position and ignore these suggestions, the credibility of the procedure will be undermined. Even if Ireland adopts the recommendations, the Council and the Commission can hardly hope to strengthen their authority by rebuking a small country. This episode is unlikely to provide a precedent to deter other governments from pursuing expansionary policies which run counter to their European commitments. Finally, the Irish people did not take kindly to having their country accused by its bigger, and in many respects less virtuous neighbours - and this certainly played its part in the result of the Nice Treaty referendum[16].

Furthermore, even when stability and convergence programmes are in line with the Broad Guidelines, and the Council has approved them, there is no guarantee that they will not later drift off course. In practice, stability and convergence programmes are fairly weak commitments. Although deficits have only diverged to a very limited extent from the targets set, spending plans in the early programmes have
been substantially exceeded on several occasions. Member States do not feel bound by the programmes they put forward. Only a few days after the approval of its 2000 programme - which stated that exceptional revenues would be used to reduce the deficit - France announced tax cuts which plainly ran counter to this commitment. In March 1999, Italy revised its budgetary objectives in a manner which also clearly demonstrated the lax nature of the stability programmes. In a similar manner, due to the worse than anticipated slow-down, some countries will not be in a position to meet the commitments for 2001 adopted in their most recent programmes. The fact that these programmes are somewhat out of touch with national and regional procedures also restricts the ability of Finance ministers - whose powers and authority also vary from country to country - to enter into binding commitments on behalf of their governments.

3) The Stability Pact imposes a rigid framework which is ill-adapted to national circumstances and the situation in the euro zone as a whole.

The Stability Pact does not provide real coordination. It imposes inflexible *a priori* rules to be respected by each State individually, and it does not attempt to set out common targets appropriate to the euro zone. In fact, there has never been an attempt to introduce the best policy for the euro zone as a whole. The fiscal stance of the zone, which determines the budgetary component of its policy-mix, has always been determined by default; it is the combined result of members' independent policies. The absence of an overall strategy compromises the transparency of the aggregate budgetary situation across the zone. Nor, on the other hand, does the Stability Pact make allowances for national circumstances and cyclical developments. Since monetary union was launched, growth and inflation have continued to diverge within the zone and at times the disparities have even increased[17]. There are no tools or principles to cope with these divergent national situations.

Although the rules of the Stability Pact are the same for all Member States, the country-specific recommendations in the Broad Guidelines and opinions issued by the Council make it possible to adapt the general rules of conduct to the cyclical position and characteristics of each country. Experience during this first stage has demonstrated, however, that it is difficult to ensure effective coordination with soft guidelines. Apart from the explicit requirements of

[16] For a concise evaluation of the complexities of the Irish referendum see Brigid Laffan, “The Nice Treaty: The Irish Vote”, www.notre-europe.asso.fr
[17] These differences in growth and inflation partly reflect cyclical factors, such as the uneven lowering of real interest rates when the single currency was introduced, or the fact that cycles in different countries are out of sync. The structural effect of prices and productivity catching up with those in the richest countries of the zone also played an important part in the more rapid growth and inflation of some countries of the periphery. Finally, the disparities can be explained to a great extent by other structural aspects, such as different competitive positions, varying labour market structures or the diverging significance of the external sector. Because they are partly structural in origin, these disparities are likely to persist, and the future enlargement of the zone will accentuate this situation.

the Stability Pact, the existing mechanism is far from being capable of compelling a country to amend its policies, even when these could endanger the common interest.

Further, the argument for coordinating national actions is stronger in the case of large countries, whose polices have a sizeable impact on overall stability, than for small countries where the external effects are often marginal. Existing procedures make no distinctions based on the size of the country concerned. Although the legal equality of all Member States demands that they be treated identically, the economic justification for coordination depends on the potential impact of one country's actions on the others. Before a formal recommendation is issued to a Member State suggesting a change in policy, there should be a rigorous assessment of the issues at stake for the zone as a whole.

2.2 The coordination of structural policy

a) From Lisbon to Stockholm: a slow process

The Luxembourg, Cardiff and Cologne processes, together with the gradual enhancement of the BEPGs, all aim to introduce a structural framework to strengthen the economic reforms which are necessary to the EU. At Lisbon, the heads of state and government solemnly launched a new program of economic and social reform, setting ambitious targets for the next decade. It seems, however, that the good intentions signalled at the European summits are running aground due to the deep-rooted conflicts of interest and the radically different visions and philosophies which Member States bring to the EU. In economic reform at least, the open method of coordination has not so far helped to accelerate the necessary reforms.

The overall picture is not entirely negative, however. The Union has made significant advances, though progress has not been uniform in all domains or in all countries. Major steps forward have been made in telecommunications markets. Increased competition in this sector, which will be boosted by the new rules on unbundling[18], has brought about significant reductions in rates and have played a part in cutting the cost of internet access. The information society has also seen a number of major successes, for example the adoption of the directive establishing a regulatory framework for e-commerce. The Lisbon indicators record a considerable rise in the number of households (up from 18% to 28% between March 2000 and January 2001) and schools (already over 80%) connected to the Internet. Most Member States are also gradually introducing substantial labour market reforms and we are witnessing a convergence on "active measures" in accordance with BEPGs and the Employment Guidelines.

The European Company Statute, which has been on the table for the last thirty years, was finally approved at Nice. Although there is as yet no tax regime for "European companies", the opportunity to make use of this new legal status should enable companies which operate in several Member States to restructure more efficiently and to benefit from a considerable reduction in administrative costs.

Despite these successes, the reforms needed to achieve the Lisbon objectives have been stymied in most fields. Progresses in the services sector, for example, have been very disappointing. The extent to which gas and electricity markets have been opened to

[18] The regulation requiring long-standing operators to share with new entrants the lines connecting subscribers to the telephone network.

competition varies from one country to another, and although most States have agreed to move towards liberalisation, the European Council has not succeeded in getting negotiations moving and setting deadlines for opening up these markets. The Commission's proposals for deregulating the postal services market are still awaiting Council approval. Many other structural weakness persist in Europe, and there has been rather little progress: environmental regulation is heavy and forces business to excessive administrative costs; education and life-long learning are still only available to a minority, whilst Europe continues to suffer from a skills shortage, etc. Turning to financial markets, another essential area if we are to reap all the benefits of the euro, the EU has adopted a long term action plan (deadline 2005), and progress is so slow that even this distant date may not be met. The "Lamfalussy report"[19] was approved at Stockholm, but the recommendations of this text only applie to legislation and regulatory instruments for the securities markets. Reform of the market in retail services remains a distant project.

b) The institutions

The spring-time meeting: much ado…

As has been seen, the European council decided in Lisbon to hold an annual spring meeting to assess the process and give the necessary political impetus to social and economic reforms. The Stockholm Council (March 2001) was the first of these meetings, and an opportunity to confirm the commitments made previously.

Before the Lisbon summit, the European Council was already involved in economic affairs because, as set out in the treaty, it was responsible for approving the Broad Guidelines each year. However, it devoted little time or attention to the BEPGs, which were adopted without discussion. In practice the Stockholm summit did not bring about any great change. Between the speeches, meetings with heads of government from third countries and discussions of other subjects (BSE, foot and mouth disease, external relations etc.), the European Council lent the bare minimum of attention to the many documents on economic reform which had been submitted. The Commission's synthesis document, which was intended to serve as the basis for discussions and focus debate on the key proposals (there were no fewer than fifty), ended up as just one paper among the many preparatory reports submitted by each of the Council's divisions. Furthermore, the General Affairs Council, which was supposed to provide coordination and summaries of the work by the Council's different formations, was virtually excluded from the preparatory work for this summit, which was not attended by foreign affairs ministers.

Meanwhile, the ambitious programme set out at Lisbon had been watered down, and most national delegations went to Stockholm with the firm intention of protecting their national interests in sensitive areas. It is hardly surprising that under these circumstances the only significant progress was the approval of the Lamfalussy report. The presidency conclusions thus merely reiterated those points on which there was already agreement. However, the many blocked issues on which the European Council ought to have been able to reach a decision were sent back unresolved to their respective Council formations.

[19] The report of the Committee of Wise Men on the Regulation of European Securities Markets. The report proposes a new mechanism to adapt existing regulations to meet developments in the financial markets more effectively.

An open method, soft coordination

At Lisbon, the European Council also approved the *new* "open method of coordination", according to which the coordination procedures for economic policy, including the Broad Guidelines and the Employment Guidelines, are organised. At first sight this seems an appropriate method for achieving the necessary progress, especially when coordinating structural policies. Such vast areas as labour market reform, the regulatory framework for businesses or product and service markets provide an ample canvas for mutual learning and the spread of best practice. Collective pressure, furthermore, has more chances of success when it relates to issues regarding which the Council has already reached a consensus: if all the ministers are in agreement over a raft of structural reforms or the measures and timescales for the deregulation of a given market, subsequent peer review will serve to encourage laggards. The BEPGs and the Lisbon indicators, like the evaluation report on the implementation of the Broad Guidelines, may provide the Council with a useful basic tool for surveillance.

Although it is still too soon to make any definitive assessment of how well the new coordination method is working, it should be recognised that in the field of economic reform only scant results have so far been achieved. Because of the soft nature of the procedure, the success of coordination is necessarily dependent on political will, and on the determination with which the Council monitors results. Soft coordination is completely decentralised as ultimate responsibility for decisions lies with national governments, who are free to tackle problems in ways which meet their own particular situation. The Guidelines implementation should be consciously monitored by the Ecofin Council and its sub-committees, who ought to debate the policies conducted by the different Member States. This Council, however, is not a suitable body to carry out such a task (see next section). At the same time, the initial readiness to tackle reforms has gradually dwindled, and interest groups which apply pressure to block developments in one sector or another have too often carried the day.

Ambitious but impractical tools

The Broad Economic Policy Guidelines are the main tool for coordinating economic policies. Their role is particularly important in structural reform. BEPGs bring together the initiatives launched by the other processes: they assemble the analyses of the Cardiff and Luxembourg reports, and include the assessments resulting from the macroeconomic dialogue. They now provide a very complete account, including recommendations for each Member State on most of the economic policies which fall within its remit. In this way, they do not merely fulfil their main task of setting out policy guidelines and drawing up a joint analysis; they also provide a degree of consistency to the wide range of existing mechanisms for coordination.

Nevertheless, the task of bringing together the analyses of the various processes has changed the BEPGs into a long list of recommendations of varying nature and importance, which makes them very open to interpretation when it comes to assessing how far measures adopted by Member States comply with the Guidelines. They have become a sort of shopping list. Furthermore, the evolution of the BEPGs content has not been reflected in their language, which remains very cautious. As their name suggests, the guidelines are not very precise - they are *broad* - and only those relating to budgetary policies include quantified objectives (generally those set out in the stability programmes). Nor do they contain timescales or deadlines; in most cases, recommendations apply to the current year, which contrasts with the medium to long-term vision of the objectives adopted by the Lisbon Council. These remarks do not only apply to the BEPGs; the Employment guidelines also should be more tangible if they are to be of practical value.

2.3 Coordination when confronted with economic events

The procedures governing economic aspects of EMU which we have discussed above relate to three groups of policies: macroeconomic policies (mainly budgetary policies, since monetary policy and wages are not under the control of governments or the Commission), reforms in product and capital markets, and measures affecting the labour market. Under the Lisbon process, the aspects of economic policy handled at European level have been extended to include other areas, such as innovation and training. Although the existing coordination covers a wide range of fields, events have nevertheless regularly forced both national governments and the Commission to respond to circumstances which were not foreseen by the official procedures. In most cases, the European authorities have reacted in a disorganised fashion.

The oil crisis in the autumn of 2000 provides an example of the inability of Member States to meet common challenges in a coherent manner. The discontent unleashed by rising fuel prices was handled by Member States piecemeal and in haste. This is a sector where different rates of excise duty significantly distort competition; taxation which varies from one country to the next is a matter of great concern to those businesses which are most affected by rising fuel prices. The concessions granted in certain countries automatically triggered demonstrations in their neighbours. This had regrettable consequences as resentment against those who yielded first put back any prospect of reaching agreement on the taxation of fuel. What is more, the tax reductions which took place in several countries did not avoid loss of revenue resulting from the oil bill. On the contrary, they held back the reduction in demand for oil imports, resulting in some of the increases in energy costs ending up in the coffers of the State.

The fiscal reforms introduced by the largest States also revealed a lack of cooperation. Against the background of high taxation in the euro zone, reforms aimed at reducing fiscal pressure should be seen as good news: they relieve the burden on enterprise, and increase household purchasing power. They can thus make a far from negligible contribution to boosting the economy at a time when growth is running out of steam. However, the manner in which these reforms were introduced poses a number of questions. They were announced without previous consultation, in response to electoral considerations and competitive pressures heightened by the single currency. In the new situation, in which European currencies are tied in an irrevocable fashion (and no longer exist except as separate denominations for a common currency), and in which prices and costs may be easily compared, taxation becomes a key tool for increasing the competitiveness of a country and attracting investment.

Apart from the lack of coordination which marked their introduction, the nature of these reforms is also questionable. The Commission, in its report on EMU public finances published in May 2000, proposed four criteria to identify those cases where a Member State could cut taxes without compromising the aim of budgetary consolidation set out in the Stability Pact: 1) tax cuts without accompanying reductions in public spending should only be considered by States which have achieved the aim of budget surplus or near-balance; 2) these cuts should not be pro-cyclical; 3) they should factor in the level of the public debt and the long-term *sustainability* of public finances; 4) reductions in fiscal pressure should be part of a wider programme of reforms, which should also include social protection systems.

These criteria, which won broad support from finance ministers when they were discussed, have not been respected. Tax cuts were introduced at a time when growth prospects were very good. They also had their origin in precisely those countries with the largest deficits (Germany and Italy). At the same time, the reforms mainly affected changes in the structure of revenues, with only minor spending cuts. Finally, in almost all countries, tax cuts were not part of an overall reform package; instead, they were implemented in isolation.

The reactions to rising oil prices and the tax reforms introduced in 2000 were not the only examples which exposed the absence of coordination in the conduct of economic policies in the EU and the euro zone. The award of third generation telephony licences also took place without any consultation. The gradual depreciation of the euro since its launch elicited contradictory declarations from both political and monetary authorities on several occasions. In practice, institutions and governments were seldom equal to the task when events tested their ability to respond in a coordinated fashion to unexpected events in the economic environment.

III. THE PLAYERS

In contrast to the centralised management of monetary policy, economic aspects of Economic and Monetary Union depend upon a wide range of players at both national and European levels[20]. The operation of this complex institutional framework and the management of economic policies in the zone is largely dependent on the interaction between the different players and the manner in which they carry out their respective roles.

3.1 At the heart of the economic management of EMU: the Council and the Commission

The Commission tries to encourage coordination and seeks to assert its role

The Commission has consistently tried to encourage the proper working of the mechanisms for coordination and debate on the EU's economic policies. For example, it has clearly indicated those countries which are pursuing unambitious budgetary policies and which should be moving more quickly to balance the budget. In its follow-up reports on the BEPGs, it has also presented precise assessments of the implementation of the guidelines addressed to each country. As it also showed when it proposed to issue a formal recommendation to Ireland, the Commission intends to make use of all the opportunities provided by the Treaty to play its part to the full.

Furthermore, it has also launched fresh initiatives to improve the existing framework. In its first report on the state of government finances in the EU it not only gave a country by country update on developments and budgetary prospects, but also - as we have seen - suggested criteria for assessing the relevance of fiscal reforms.

In February 2001 the Commission went still further, adopting a Communication in which it put forward a series of measures to enhance coordination of economic policies within the euro zone while at the same time increasing its own role. It suggested, inter alia, carrying out a more systematic review of the balance of macroeconomic policies in the zone, based on its own preparatory studies. For their part, Member States should inform the Commission and other countries before introducing any economic policy measure which was likely to have an impact on the euro zone, so that they could take account of any suggestions. The Commission's proposals also include the drafting of a set of guidelines for economic policies in the zone and to set out the measures to be taken in the event of a given shock. It also suggested that a working party should be set up in the Economic and Financial Committee to prepare Eurogroup meetings, and that there should be regular meetings organised between the Eurogroup president, the president of the ECB and a Commission representative. Finally, it suggested that external representation of the euro zone should be provided by a triumvirate of these institutions.

[20] For the different players and levels of decision-making for economic policy in the euro zone, see Padoa-Schioppa, "Europe's new economic policy constitution" (1999).

But the Commission's proposals have met with considerable reluctance

The Member States' reactions to the Commission's ideas were distinctly discouraging. Several of its proposals, such as the suggestion for the external representation of the euro zone, have been explicitly rejected by the current Eurogroup president, Belgian Finance Minister D. Reynders. Some governments are even opposed to the principle of prior information. The Commission's first report on public finances had received an equally adverse reception from member States which are anxious to preserve budgetary (and structural) policies from any interference from Brussels. In addition, any attempt to introduce closer coordination between the countries which have adopted the euro automatically arouses the suspicions of the States which remain outside the zone.

During the drafting of its recommendation for the BEPGs, the Commission consults with Member States. The definitive document submitted to the European Council is then finalised by the Council, and this leads the Commission - reluctant to see its text substantially modified - to "self-censorship". Even under these conditions the procedure has not always been friction-free, as was seen in 2001 when some countries objected to the inclusion of targets for public spending trends. All this reveals the eagerness of finance ministers, jealous of their privileges, to restrict the Commission's role[21].

The Ecofin Council is not an operational body

Under the Treaty, the Ecofin council is the body responsible for coordinating economic policy and is the only one with legislative powers in this area. In practice, however, Ecofin is not a suitable body for steering economic policy in the EU and still less in the euro zone. It has become an excessively formal institution, not at all appropriate for in-depth discussions or for developing economic policy strategy. In most cases ministers are content to approve without discussion the documents prepared in advance by the Economic and Financial Committee[22]. Although the Council usually takes up the Commission's opinion, it is rare for ministers to query the stability or convergence programmes submitted by their colleagues. Around one hundred and fifty people attend these meetings. This is too many to allow a real discussion among ministers. Nor does the media attention focused on the Council's meetings create a suitable environment for open discussions, and ministers avoid challenging the policies conducted by their partners in order not to suffer the same fate when it comes to their turn.

For all these reasons, it is doubtful whether peer pressure really works (at least at the political level), and this also applies to the mutual learning process which is an integral part of the Lisbon strategy and which should ensure the application of the BEPGs. The Ecofin Council is far from fulfilling the crucial role in coordination and surveillance which it holds under the Treaty.

The increasing power of the European Council should have boosted these procedures and encouraged Ecofin to make more rapid progress in its discussions, leaving only the most

[21] Following the Commission's Communication on economic policy coordination, Mr Reynders went so far as to emphasise that in the Eurogroup, the twelve ministers take the decisions and that "other participants are guests" (press conference, Monday 12 February).

[22] This Committee is made up of high-level treasury representatives from the Fifteen and national central banks, with two representatives from the commission and the ECB. It is a powerful committee responsible for the technical preparation of Ecofin Council meetings.

important or most sensitive issues to be decided by heads of State and governments. Instead, the various formations of the Council of Ministers have not hesitated to inundate the European council with an avalanche of documents. Regardless, the European Council cannot take the place of Ecofin, whose role is established in the Treaty. Economic policy management in the euro zone is a task which must be performed on an day-to-day basis, and, what is more, the problems of the Ecofin Council are also found - sometimes even amplified - in the European Council itself.

3.2 From Euro-11 to Eurogroup: a timid but positive step

In practice, part of the void left by the inertia of Ecofin is filled by the Eurogroup, an informal body attended by finance ministers of euro zone countries together with the president of the European Central Bank, the Commissioner for economic and financial affairs and the president of the Economic and Financial Committee.

Eurogroup meetings, at which each participant is only accompanied by a single assistant, are thus more restricted than Ecofin meetings and are confidential. This means that ministers are able to engage in more frank and sharper discussions, both among themselves and with the president of the ECB. The scope of these discussions, on macroeconomic and financial prospects for the euro zone and the budgetary policies of those attending, were extended under the French presidency (in the second half of 2000) to include structural questions such as labour market or fiscal policies. The fact that only euro zone finance ministers take part in these meetings makes the Eurogroup the ideal forum for coordinating decisions or debating issues relating to the economy of the zone, such as the balance between budgetary and monetary policy or exchange rate policy.

As the forum for discussions of economic policy in the zone the Eurogroup has *de facto* taken over some of the tasks of the Ecofin Council. This certainly applies to the assessment of budgetary policy in euro zone states: for example, when the recommendation was addressed to Ireland, Ecofin accepted the decision already approved by euro zone ministers meeting alone. In exchange rate issues too, the powers of Ecofin are merely formal, since the policy body for economic aspects of the euro is the Eurogroup. It is also the Eurogroup president, rather than the Ecofin president as set out in the Treaty, who occasionally attends ECB meetings. However, in order to avoid offending the countries which do not take part, the Eurogroup remains simply an informal body.

During the French presidency in the second half of 2000, Mr Fabius, acting president of the Eurogroup, made the enhancement of this body a priority and introduced a package of practical reforms[23]. Three changes were made to the way meetings are held: they now have a formal agenda; their scope has been extended to cover structural reforms; and they are often held the day before Ecofin meetings rather than on the day itself to allow them sufficient time. The Eurogroup president, with the European Commissioner for economic and financial affairs, also holds a press conference. Finally, since September 2000, a set of economic indicators for the euro area published monthly. The Belgian presidency of the Eurogroup, which followed the French presidency, stressed that it was keen to continue enhancing the

[23] It was also under the French presidency that Euro-11 was renamed Eurogroup, so that the name would not have to be changed with each successive enlargement of the euro zone.

Eurogroup, and although this has not been translated into any substantial changes the practical improvements introduced by Mr Fabius have been consolidated[24].

These practical reforms were significant. It was essential to structure the meetings better, and to allow them more time. The press conference has increased the visibility which the Eurogroup lacked. It also offers the opportunity to give an update of economic developments, to explain joint positions and to restrict - for one day at least - declarations on the euro and euro area policies to a single person, thus reducing the contradictions which had become the rule. The monthly publication of a series of indicators makes it possible to identify macroeconomic changes and prospects for the euro zone as a whole.

However, the institutional arrangements governing the group and its links with the Ecofin Council remain unchanged. Ministers in the euro zone enjoy the restricted and confidential nature of the meetings, but it must be realised that the participants' stimulating discussions have not yet had a practical impact on policy decisions in the zone. Eurogroup members have not always succeeded in coordinating their actions effectively or in ensuring that the common interest takes priority. Similarly, they often have difficulty in issuing a joint position on the challenges which confront the euro zone. In practice, the consultative and informal nature of the Eurogroup substantially limits its possibilities.

3.3 Coordination of the European policy-mix: the Eurogroup-ECB dialogue

So far the analysis has mainly focused on the policy coordination of the economic aspects of EMU. But the question of coordination between the economic players and the monetary authorities, and of the policy-mix in particular, has also taken on major importance since the single currency was introduced. Before Monetary Union, highly mobile capital and the tight trade links between European economies, both with each other and the rest of the world, had reduced the autonomy of Member States monetary policy and the effectiveness of their budgetary policy. EMU radically changed this situation, since the euro zone is a large-scale economic area with relatively little external trade[25]. Against this background, macroeconomic policies are effective once more. As a consequence, management of the interdependence and balance of monetary and budgetary policies (the policy mix) has now become a major challenge for the ECB and the Eurogroup.

As has been seen, the nature of the European policy-mix is very uncommon. Whereas the ECB is responsible for the single monetary policy of the whole euro area, budgetary policy is the net result of twelve policies individually determined at the national level. The institutional framework of EMU includes certain forms of dialogue between the ECB and finance ministers, but no mechanism for coordination. In practice, the provisions of the Maastricht Treaty are implicitly based on the theory dating from the 1980s, which held that monetary policy can exercise no long-term influence on growth in the long-term, and that its short-term impact is limited to the effect of unexpected inflation on relative prices and wages. Under these circumstances the establishment of an independent central bank with the aim of controlling prices can eliminate inflation without damaging growth. The Stability Pact should then be enough to avoid a conflict of aims between the ECB and governments. This strategy

[24] Exceptionally, Belgium holds the Eurogroup presidency for a twelve month period since it held this role during the six months during which Sweden, which is not in the euro zone, held the EU presidency.
[25] The average exports and imports in the euro zone represent some 12% of GDP. Before EMU this figure stood at 25% for France or Germany.

thus sets out a clear division of responsibilities. The European Central Bank ensures price stability, which is its main objective. It may also respond to economic developments throughout the euro zone without compromising this aim. National governments, for their part, continue to control budgetary policy, the priority of which is to reduce indebtedness, improve public finances, and as far as possible meet national cyclical conditions. This view of the role of public finances has gradually evolved to include qualitative questions which have an impact on the economy.

Against the background of this division of responsibilities, some writers claim that insofar as each player pursues his own objectives in a disciplined fashion or "keeps his house in order", there is no need to try to coordinate the moves of political and monetary authorities[26]. Another argument advanced by those who reject the need for macroeconomic coordination is that finance ministers could use it as a pretext to put pressure on the ECB. In reality, budgetary and monetary policies are highly interdependent, for each inevitably influences the aims of the other. Through its control of interest rates, the ECB's monetary policy acts on the business cycle throughout the zone and the cost of deficits and public debt. Budgetary policy, through its impact on aggregate demand and the expectations of the economic actors, in turn, has a significant influence on inflation. The same is true of structural policies which have a supply side impact. The exchange rate is also affected by macroeconomic policies. Furthermore, empirical studies confirm that the measures taken by central banks and economic authorities are interdependent insofar as each party reacts to the policies of the other[27]. Similarly, the ECB is recognised as one of the most independent central banks in the world. It is highly unlikely that political powers could influence its decisions in any effective fashion, particularly at this early stage when the Bank is keen to demonstrate and assert its independence[28]. In any case, a constructive dialogue can only exist between two independent bodies. Moreover, the monetary authority and finance ministers share certain powers, such as exchange rate policy and the euro changeover.

To sum up, even if the arguments in favour of explicit coordination of monetary and budgetary authorities do not go unchallenged, there is no shortage of reasons for establishing at the very least consultation and a fruitful dialogue between the ECB and finance ministers. This should serve to foster exchanges of information and a better understanding of each others' views, so that all those involved can take decisions with full knowledge of the measures being taken by the others, and, where appropriate, these decisions can be coordinated. Any joint positions regarding the euro or the economic situation should also be reached through this dialogue, as happened in the case of two joint declarations issued by the Eurogroup, the Commission and the ECB in 2000.

Meetings in a poor climate

The framework for dialogue between the ECB and those responsible for economic policies does exist. The president of the Central Bank has taken part from time to time at Ecofin meetings. Article 113 (formerly 109 B) of the Treaty states that he shall be invited when the Council discusses matters which have a link with the ECB's own tasks and aims. Under the

[26] See A. Alesina, O. Blanchard, J. Galui, F. Giavazzi and H. Uhlig (2001)
[27] Wyplosz (1999) and Melitz (1997).
[28] Eijffinger and de Haan (2000) make a comparison between the various studies on the ECB's independence. The unanimous conclusion is that the European Central Bank is even more independent than the American Federal Reserve, the Bank of England or the Bundesbank.

same Article of the Treaty, the Ecofin president and a member of the Commission have also occasionally attended meetings of the Council of Governors of the ESCB. They have thus had an opportunity to join in discussions, though without voting rights[29].

However, contacts between monetary and economic authorities have been most regular within the Eurogroup. The ECB president or vice-president always attends their meetings, which provide the ECB and finance ministers with a fortnightly opportunity to compare their views of the situation in the euro zone and the appropriate policies to adopt. However, in the euro area, the problem of macroeconomic coordination is particularly complex since the policy-mix depends on the European Central Bank and the twelve national budgetary policies. The aggregate fiscal stance of the zone as a whole is not an objective in itself, and the many problems with the budgetary procedures make it far from transparent. While in the United States, an informal meeting between the president of the Federal Reserve and the treasury secretary is enough for a constructive exchange of views, all dialogue in the euro zone must necessarily involve many more people[30]. Moreover, the ECB member who attends Eurogroup meetings is outnumbered by the twelve finance ministers. Finally, the mutual criticisms which have several times been expressed by the ECB and Eurogroup presidents reveal the tensions between the two bodies. Statements of this kind cannot but have a very adverse effect on the understanding and dialogue which are needed between economic and monetary authorities.

3.4 Exchange rate policy and the external representation of the euro zone: who does what?

Exchange rate policy: shared territory

Exchange rate policy, and in particularly the division of responsibilities between the Central Bank and finance ministers, is still full of ambiguities. The institutional arrangements leave this question open. The Treaty hands formal responsibility to the political authorities, since it states that the Council can set out "general guidelines" for exchange rates which the ECB and national central banks must follow[31]. The practical implications of this arrangement are, however, very limited. The Treaty specifies that these guidelines may not affect price stability, giving the ECB a *de facto* right of veto, since the Treaty does not specify whose responsibility it is to decide whether the exchange rate guidelines could impact on inflation. Similarly, the European Council in Luxembourg (December 1997) stated that the use of such guidelines would be restricted to "exceptional circumstances". As a result, it appears very unlikely that the Council will ever impose formal exchange rate guidelines on the ECB.

In the absence of general guidelines, the ECB president has publicly stated that both the initiative and the actual implementation of any intervention remains the exclusive responsibility of the Governing Council of the ECB[32]. Unlike the US Federal reserve or the Bank of Japan, the European System of Central Banks is solely responsible for the managing

[29] As has been seen, in practice the Eurogroup president replaces the president of Ecofin during those periods when they are not one and the same person.
[30] B. Smaghi and C. Casini (2000) argue that, in comparison with the situation before the introduction of the single currency, cooperation between monetary and fiscal authorities has deteriorated.
[31] Similarly, the Treaty states that it is the Council's responsibility to conclude formal agreements on an exchange rate system for the euro vis-à-vis other currencies, and to amend the central rate accordingly, although this must always be done in consultation with the ECB. The decision-making powers thus rest with the Council, with only ministers from euro zone member countries having a vote.
[32] Press conference, 5 October 2000, Frankfurt

of the reserves which it holds: it needs no authorisation to conduct foreign exchange market operations. However, not only do exchange rates not feature among the ECB's objectives, it is also preferable to handle any intervention directly in collaboration with the other G3 or G7 countries. Such cooperation implies a political initiative.

In practice, the political and monetary authorities have reached an agreement which organises several of these questions: strategic exchange rate decisions are taken jointly by the ECB and finance ministers of the euro area, and the tactical aspects - their implementation - are left to the Central Bank[33]. The wave of interventions in autumn 2000 was carried out in this way. Coordination with central banks in the other countries taking part in the first intervention in September was organised by the ECB, but it was the Eurogroup which provided the vital political contacts which preceded the intervention.

The complexity of the existing exchange rate arrangements is due to the fact that it is impossible to dissociate monetary and exchange rate policy. It would nevertheless be preferable to clarify the decision-making mechanisms and responsibilities. The current confusions have certainly affected the external value of the euro, increasing uncertainty and speculative risks[34].

Representing the euro zone in international bodies

Two other aspects, which concern not the coordination of economic policies but the external visibility of the euro zone, remain unresolved. These are the communication of the economic and monetary authorities with markets and opinion, and the external representation of the euro area.

The lack of visibility of the Eurogroup and the absence of a coordinated communications strategy (an area where the ECB has also been remiss) have damaged the credibility of the new currency. The euro zone has suffered from the lack of a political authority alongside the ECB to speak on behalf of the euro and the economy in the zone, as the treasury secretary does in the US. The many conflicting statements issued by policy makers in the countries of the zone have served to expose their lack of unity.

Nor is the representation of the zone on international bodies satisfactory. At the G7, finance ministers from the three countries concerned are joined by the Eurogroup president. However, the fact that this one changes every six months with the EU presidency, and that his European responsibilities are in addition to his normal role as Finance Minister of his own country, puts him in an awkward position when it comes to soundly representing the interests of the euro area. To make matters worse, unless the Eurogroup president is also a minister of one of the G7 member countries, he may only attend meetings concerned with exchange rate policy and the global economy. The same goes for the president of the ECB, who is only present at certain meetings and has to make way for the governors of the Bundesbank, the Banque de France and the Banca d'Italia.

[33] Gross et al. (2000) explain the situation in these terms in the second CEPS report on the euro zone.

[34] It is not possible to determine how far the lack of transparency in exchange rate policy has played a part in its gradual devaluation of the euro since January 1999. However, common sense suggests that uncertainty, due both to the ambiguity of the arrangements in place and the ECB's poor communication strategy, has made its contribution. Favero et al. (20000), in their report for the CEPR, *Monitoring the ECB2*, mention these two factors among the "plausible" explanations for the weak external value of the euro.

As for the Commission, it only takes part in discussions of subjects which relate directly to its own powers. We thus have the paradox that the Commissioner for economic and financial affairs can talk about aid to Russia but not about the euro. All these arrangements are the result of a very poor compromise: if the countries of the zone had a single representative their negotiating powers would be more in line with their economic weight and financial contribution. It is essential to resolve this question. At a time when the volatility of currency markets calls for closer economic and financial cooperation, the international bodies must play a crucial role in the regulation and public supervision of the global financial system.

IV. WHICH WAY FORWARD?

The previous chapters have highlighted the inadequacies regarding the economic pillar of EMU, and the consequential failure to produce the necessary progress in economic policy coordination. The existing arrangements are based on the hypothesis that the euro zone would coincide with the EU itself, and that coordination concerns all Member States in the same way. The Broad Guidelines and the Stability Pact do not distinguish to any marked extent between countries in or out of the euro zone[35]. The only element introduced that is particular to the countries which have adopted the euro is the possibility for their finance ministers to meet informally amongst themselves in the Eurogroup.

These arrangements do not fit the new situation in which euro zone countries have found themselves since January 1999. Besides, as is demonstrated by the No vote in the Danish referendum on EMU, and the prospects for enlargement, different levels of economic and political integration will coexist in the European Union, at least over the medium term. Those countries which share a single currency and a single monetary policy must have the means to take the increased interdependence of their policies fully into account.

It is hard to imagine that the centralised management model adopted for monetary policy could be reproduced in economic policy. States will not agree to new significant transfers of sovereignty as they wish to keep a broad degree of latitude in their national policies. Nevertheless, the actions of all those involved in shaping economic policies must be coordinated effectively if the whole is to be consistent and appropriate throughout the euro zone. The complex framework for coordination set up by the European Council, with its "soft" procedures, has not always met expectations. Today's weak coordination, which often resembles mere intergovernmental cooperation, cannot ensure that the best economic policies are adopted.

The more thoroughgoing coordination needed by the euro involves a number of interests which often conflict: countries in the euro zone and those which have stayed outside, finance ministers and the Commission, the ECB and the Eurogroup, etc. As we have seen in the preceding chapters, economic governance is a complex subject. However, in contrast to monetary policy which is clearly regulated by the provisions of the Treaties, the arrangements regarding economic aspects of EMU are more open. These leave room for progressive improvement based on a gradual learning process and need to respond to the new challenges which arise. Against this background of constant change, the ideas which we put forward here - several of which have already been proposed in one quarter or another - would enable us to go a step further and benefit more from the advantages inherent in the single currency. They are intended to form a consistent set of measures which, without forcing new constraints on Member States, would remedy the weakness of existing mechanisms and procedures and respond to the problems of governance by re-examining the role and remit of the institutions and players involved.

[35] For the first time, the BEPGs for 2000 introduced some specific paragraphs on macroeconomic policies for the euro zone.

4.1 Giving more substance to the Eurogroup

There are many reasons for enhancing the Eurogroup and recognising its role as distinct from that of the Ecofin Council. Firstly, discussions and decisions on subjects which concern the euro area countries alone - such as euro exchange rate policy or the orientation of the aggregate fiscal stance - should take place in a restricted body. Second, as has been seen, euro zone countries have a particular interest in coordinating their policies and monitoring their partners' decisions. This special need for coordination should be met by the Eurogroup. Third, it is only in these small gatherings that finance ministers of the euro area can establish dialogue and consultations with the ECB, which is seldom represented at the Ecofin Council. Finally, the cumbersome and formal nature of the Ecofin Council is inappropriate to the needs of the euro zone.

The Eurogroup's meeting procedures have been improved, but the group still needs to enhance its *raison d'être*. The Eurogroup has not assumed the critical role which it ought to play in piloting the economic policies of the euro zone. It ought to act as a *steering council*[36]. The Eurogroup is the sole body in which euro area economic policy makers can analyse their common concerns together and reach concerted responses to those economic circumstances which are not sufficiently taken into account in the formal procedures, or which were unforeseen at their time of drafting. It should also approve general directions which serve as a frame of reference for economic policies within the euro zone.

This could be given practical effect in three documents:

1. Prior guidelines for stability programmes.

> Aggregate budgetary data should be incorporated more systematically into the process through which national decisions are reached. Before national budgets for the coming year are drafted, the Eurogroup should carry out a joint analysis of the situation in the euro zone and the desired direction for the overall fiscal policy stance. The Eurogroup could draw up a number of broad guidelines for the preparation of national stability programmes.
>
> The starting point for these guidelines should be a joint assessment of the macroeconomic situation. The *regular report* on the euro area and the policy-mix evaluation which the Commission has undertaken to produce in its recent Communication on the economic policy coordination will provide the basis for this joint assessment of economic prospects.
>
> An *a priori* idea of the orientation of the stability programmes would not only ensure a more consistent approach from national policies, but would also have the advantage of improving the transparency and predictability of the fiscal stance of the euro area, both for the ECB and market operators.

[36] This idea is inspired by Von Hagen (1999) who suggests the creation of an *Economic Policy Council* who would issue recommendations to Member States on their budgetary policies, and by Jacquet and Pisany-Ferry (2000) who propose that the Eurogroup should become a joint executive and adopt guidelines and economic policy recommendations by qualified majority voting.

2. A reference framework for economic policies in the euro area

The prevailing circumstances differ considerably to those at the time when the Stability Pact was signed. Economic policies in the euro zone must adapt to this new context. Divergences between countries in the zone must be managed, pro-cyclical policies must be avoided, and national policies must be monitored to ensure that they do not have an external negative impact on the zone as a whole. We need to implement the most appropriate policies, both at national and European level, taking full account of the cycle and characteristics in each country as well as the overall economic situation in the euro zone.

The Stability Pact gives no hints as to the answers to these questions, and takes insufficient account of the European dimension. *Peer evaluation*, based on BEPG recommendations and the opinions on stability programmes has filled, to some extent, the void in existing arrangements in cases where national deficits are below the numerical limits set in the Stability Pact. Yet this approach is insufficient. There are many scenarios for which there is no frame of reference. The current slow-down has exposed the lack of common principles: whilst the Commission claims that some Member States have not developed a sufficient margin of manoeuvre to let the automatic stabilisers operate, governments are willing to let deficits rise above the agreed levels. Nor are there any set criteria for objectively assessing the failure of some Member States to carry out the agreed programmes. The Irish case has also shown that, even in periods of vigorous economic activity, disagreements may arise as to the appropriate policies for one or another State, or on how they should be judged. Without a common framework of analysis, the Council's formal recommendations can be challenged or may lack legitimacy in the eyes of the country concerned.

As the Commission suggests, the existing framework should be supplemented by a code of conduct, a charter of principles to guide economic policy in the euro zone and set out the shifts which may be allowed to meet changing circumstances[37]. These principles would cover the use of automatic stabilisers and other discretionary levers of budgetary policy, the management of shocks affecting one or more countries in the euro zone, the appropriate orientation for any fiscal reforms, etc. The principles would be drawn up by the Commission in consultation with the ECB before approval by the Eurogroup.

3. Specific measures for the euro zone in the BEPGs

It would also be helpful to introduce a section in the Broad Guidelines devoted specifically to the euro zone so that these could take full account of the special need for coordination between the countries which share a single currency. The most recent BEPGs have already made a distinction, in the macroeconomic section, between euro zone countries and the others. This initiative goes in the right direction, but it should be taken further. More precise guidelines should be provided each year for the euro zone states. Whilst the responsibility - which derives from the Treaty - for adopting the Broad Guidelines would remain with the Ecofin Council, Ministers in the Eurogroup should approve in advance the part which concerns them.

[37] The Commission's suggestion coincides, for the most part, with the idea presented by Jacquet and Pisany-Ferry (2000) of creating an economic policy charter for the euro zone.

Any attempt to strengthen the Eurogroup is intrinsically linked to the level of formal recognition which is envisaged for this body. At present, no review of the arrangements which set it up at Luxembourg in 1997 is on the agenda. The improvements which we suggest do not necessarily presuppose any formal role for the Eurogroup, and could be adapted to the procedure sometimes already used under which the Ecofin Council endorses the results of discussions in meetings of the Twelve. The Eurogroup could also issue more ample and frequent communiqués, including economic policy guidelines.

This approach meets the need to tackle the failures in the existing institutions without subjecting them to major changes which would delay the introduction of any improvement. However, in the future, more definite reforms will be needed to enhance the structure of the economic pillar of EMU. Economic policy management of the Twelve euro area countries cannot be indefinitely subjected to the procedures of the Fifteen. The fact that the Eurogroup is only an informal meeting of ministers, with no legislative or executive powers, considerably limits its impact. While preserving its restricted and dynamic nature, the Eurogroup should eventually become a proper institution, responsible for steering the economy of the euro zone and with an enhanced external status.

4.2 Making the mechanisms more effective

1. An enhanced European budgetary procedure

There is plenty of scope for strengthening the Stability Pact procedure and, in particular, for improving the range and content of national stability and convergence programmes. In this a set of measures could play a part:

– Adopting more complete and precise stability programmes

> In 2001, a number of governments will not meet the targets which they set out in their programmes. This could have been avoided if the programmes had considered several growth scenarios, identifying the changes in budgetary policy which would apply in response to variations in the level of activity (this is already being done by some countries). This would make it possible to respond to unexpected cyclical developments within an agreed framework, without deviating from the programmes in ways which cause loss of credibility and tensions between the various institutions.
>
> Equally, all the programmes should be based on the same hypothesis for economic prospects so that they are consistent and comparable. They should also include estimates of the impact on public accounts of fiscal reforms or any other economic policy measures. Member States should also provide more information on the structure of spending and revenue, which would enable to the Commission and the Council to take the qualitative aspects of fiscal policy into account when making their assessments[38].
>
> Finally, the Stability Programmes should be extended to include a more long-term perspective. They should indicate the likely future costs due to demographic ageing,

[38] Von Hagen Jürgen, A. Hughes Hallett, R. Strauch (2000) suggest that the quality of adjustment should be an explicit criterion in assessing national programmes. Focusing attention on the structure of budgets would make it possible to counter the pro-cyclic aspect of the Stability Pact during upsurges in the cycle. Some of these changes to the Stability Programmes were also suggested by the Commission (2001b) and the OECD (2001).

giving more information on the indebtedness implicit in health and retirement schemes, and should set out the anticipated long-term developments of public finances.

– Refocus the approach on underlying deficits

The downturn has re-opened the debate on the problems inherent in the Stability Pact and related programmes objectives which are set in terms of nominal deficit. Focusing attention on the balance corrected for cyclical variations would compensate for the pro-cyclical incentives of the Stability Pact and make it possible to assess the origin and nature of adjustments or deviations in a more precise manner. Even if, under the current unfavourable circumstances, focusing on stable underlying deficits and letting the automatic stabilisers operate would imply an increase in nominal deficits, applying budgetary restrictions at the moment would further depress internal demand.

On the other hand, the recent suggestion that the parameters of the Stability Pact should focus on spending rather than deficits is potentially dangerous. To concentrate solely on spending would leave Member States free to pursue lax policies with regard to revenues, for example through discretionary tax cuts. The most satisfactory approach is to set targets in terms of underlying deficits, maintaining them firmly throughout the cycle, even during expansionary phases when governments are tempted to indulge in tax handouts.

– A firm but flexible approach to the recommendations

Recommendations to Member States under Article 99.4 are the most compelling mechanism available to the Council for ensuring that national polices comply with the Broad Guidelines. Insofar as the BEPGs take account of the evaluation of stability programmes, the recommendations also aim to prevent countries from falling short of the budgetary targets.

Although this is a vital instrument, events surrounding its first application, in the Irish case, have demonstrated that it must be applied with extreme care. A formal recommendation from the Council is interpreted as a public reprimand. It also entails an explicit request that a State change its policy. Not only, therefore, should each recommendation be based on a clear violation of jointly approved principles or guidelines; it should also reflect a rigorous assessment of the potential impact of the Member State's conduct on the euro zone as a whole. These recommendations are perceived as interference in the domestic affairs of a Member States. They must therefore be justified in terms of the common interest; where a country's policies have a negligible impact on its euro area partners, the economic justification for a formal recommendation is weak.

– Better integration of the various processes

Processes, accounting procedures, and above all the dates of drafting and approval of national budgets should all be brought into line. The timetable for the various stages should be set so that joint guidelines can be adopted before the budgets and national stability programmes[39]. The long delays which currently occur between the submission of

[39] With this in mind, Jacques Delors had suggested that Community and national policy making should occupy alternating half-year periods.

programmes and the Council's evaluation on them damages both the compatibility of the underlying hypotheses and the clarity of the overall stance of the euro area.

The political credibility of the targets set by each country in its national stability programmes also needs to be reinforced. National parliaments could debate and approve the programmes. A closer link between these programmes and national budgets would strengthen the democratic legitimacy of budgetary policy throughout the zone and of the commitments entered into by the Member States governments[40].

2. More practical BEPG

Economic policies conducted by different countries in the euro zone are often inconsistent, and structural reforms are not progressing at the rate hoped for. By strengthening the Broad Economic Policy Guidelines, which are the central mechanism for coordinating economic policy, we could increase the likelihood that the open method of coordination might start to yield the expected results.

The BEPGs might highlight a reduced number of "key recommendations" for the current year. Of course, BEPGs must provide a broad overview, including guidelines for markets in products, services, capital and labour, but the number of recommendations has proliferated to the point where they harm the evaluation of overall compliance. The BEPGs should thus explicitly indicate which are the main objectives for each year and which are likely to bring genuine added value to the other procedures. Subsequently these objectives can be included in the synthesis report submitted by the Commission to the spring European council.

At the same time, in the spirit of the method launched at Lisbon, recommendations should become more practical and measurable, inter alia by the introduction of benchmark targets linked to the performance of the best countries. The aim is not to introduce binding targets, but to provide tools and references for assessing the progress achieved by different countries in an objective fashion. It would also be helpful to distinguish between long-term aims, as defined at Lisbon, and their practical expression in year-by-year progress.

Finally, all those concerned should play their part to the fullest. The Council and the Economic and Financial Committee should shoulder their responsibilities and, where appropriate, undertake the surveillance in a resolute fashion.

4.3 A Commission which is fully involved

1. A Commission capable of providing analysis, inspiring the work of the Eurogroup, and representing the general interest

The Commission is, by its very nature, well placed to increase the operational capacity of the Eurogroup - as well as of the Ecofin Council - and to improve the standard of debate by providing economic analyses, stimulating discussions, and promoting a group culture among euro zone finance ministers and the ECB president. It has the resources to monitor euro area

[40] In the same line, the Berès report of the European Parliament (2 October 2001), proposes increased participation of national parliaments in the preparation of the BEPGs.

economic developments in depth as they happen, which the Ministers - including the Eurogroup president - are unable to do because of their internal commitments. The Commission, like the ECB, can also view matters from a perspective which is unaffected by national considerations.

The Commission should also represent the general interest at times when cooperation between Ministers alone does not lead to joint responses. The current trend towards a more intergovernmental approach to Economic and Monetary Union has often run aground due to the absence of common views. Each new difficulty has revealed the extent to which national governments give priority to internal concerns and are unwilling to lend full cooperation at the European level. Under these circumstances, the Commission must play its full part developing synergies with the Eurogroup. It should also provide independent evaluations of national policies and identify the best - and the poorest - practice. In concrete terms, the impetus from the Commission is essential if the Lisbon strategy is to succeed, particularly in terms of carrying on the necessary structural reforms. It is the Commission which encourages peer pressure, by pointing out those cases where earlier commitments to reform have not been respected or have been postponed. Because of its independent position, it can also provide continuous monitoring of the financial and foreign exchange markets. However, such monitoring - which should form the basis of exchange rate policy - requires a series of mechanisms and techniques not yet available to the Commission.

The Commission must therefore continue its attempts to encourage the upgrading and harmonisation of statistical data in the euro zone. The Eurogroup and the ECB need high quality statistical information if they are to follow economic developments throughout the zone without delay. Rapid information is required on changes in GDP, wages, industrial production, fiscal policies etc., in individual countries and the zone as a whole[41]. Inadequate statistical information makes it difficult for economic and monetary authorities to do their job, and also influences market operators who, bombarded with national statistics, end up following those of just a few countries (Germany, in particular). The gaps have already been identified. The Commission's statistics office Eurostat and the ECB have jointly drawn up an action plan for statistics covering EMU. This plan includes priorities for Member States and measures provided by the Commission. Member States should prioritise the full implementation of this plan, providing the resources required to harmonise their national statistics and ensuring that these can be collected and delivered as quickly as possible.

2. Reorganise the euro zone's representation and communications

As we have already pointed out, the six monthly changeover in the Eurogroup presidency leaves the external representation of the euro group in a very uncertain position. In international organisations, the Eurogroup president - unless he is from a G7 country - has no time to establish his position among representatives from other countries or to become familiar with the way the organisation operates. As for policy communications regarding the single currency, finance ministers do not all have the same influence, not only vis-à-vis the international financial community, but among the general public in the zone. Here again, the system of revolving presidencies does not give the Eurogroup president time to make a

[41] In its monthly bulletin for April 2001, the ECB published an assessment of economic statistics in the euro zone. It emerged that the estimates for some key indicators, such as variations in GDP, arrive very late as compared with the time in which they are available in the best performing States in the zone or other countries such as the United Kingdom or the United States.

reputation. Similarly, the fact that the president is a minister in one of the twelve participating countries implies that he cannot devote as much attention as would be desirable to continuous monitoring and analysis of economic and financial developments in the zone as a whole.

This is an area in which Member States, and their Finance ministers in particular, are very jealous of their prerogatives. At present the Commission has no powers in international finance. This is why the most commonly proposed solutions to the problem of external representation are more intergovernmental than Community-based. This applies to the appointment of a "Mr. Euro" representing euro zone policy in economic affairs and international finance, modelled on the representation of the Common Foreign and Security Policy[42]. This solution, however, would complicate the problem and add confusion, due to the existence of two Mr. Euros: the ECB president, for monetary affairs, and the Eurogroup representative for political matters. Besides, experience in the CFSP is not entirely satisfactory for the area which concerns us. The confusion and fragmentation of powers has partially negated the advantages of a joint representation. The high representative has only been given an insufficient secretariat while the Commission has both the remit and the administrative and financial resources to carry out this role. Finally, applying the CFSP model to Economic and Monetary Union is not appropriate, because EMU is part of the first pillar and thus belongs in the Community domain. It would therefore be preferable to give the Commission a larger role in representing the euro zone and in communicating with the wider public, market operators and international bodies.

[42] S. Everts (1999) proposed the appointment of a *Mr. Euroland.* Gross et al. (2000) also suggest the appointment of a *Mr Euro* who would be President of the Economic and Financial Committee.

CONCLUSIONS

Much was at stake when it was decided to go down the road towards Economic and Monetary Union. The abandonment of national currencies and the handing over of monetary policy to a federal institution like the European Central Bank entailed a transfer of sovereignty unequalled in the past. Member States reacted by strictly guarding their prerogatives in those economic policies which remained under their control.

But, paradoxically, Monetary Union created a radically new situation in which economic policy coordination assumed the greatest importance. In budgetary matters, for example, it is the overall stance - whether resulting from a joint decision or arising by default - which determines the policy mix in the euro zone. Similarly, national budgetary policies directly influence partner countries' economies and the shared macroeconomic variables, such as interest rates, exchange rates, or average inflation. The smooth operation of Monetary Union also necessitates progress in all aspects of structural reform: decompartmentalisation of the markets in financial services, modernisation of labour markets, or liberalisation of markets for product and elimination of the many surviving fiscal barriers which still hinder the completion of the single market.

Governments in the euro zone have gradually come to realise the importance of these issues. The Eurogroup was established so that finance ministers of the twelve countries having adopted the single currency could meet informally to discuss economic questions of concern for the euro zone. A range of “soft law” processes has emerged, as instruments similar to those of the new open method of coordination have been applied in the field of economic policy. But this approach has not been up to the challenges it has had to face. Soft coordination, mainly based on peer pressure and the open method of coordination, has many advantages and can be effective in some areas. However, when it comes to politically difficult reforms, or decisions which are not entirely compatible with immediate national interests, the limits of this method are easily revealed. As can be seen from the reversal of the tendency of budgetary consolidation or the halting progress in structural reforms, the most important areas for joint action cannot be left to "soft" procedures alone if coordination is to be ensured.

Tackling these problems is particularly complex because economic policy in the euro zone is run by a host of different players at various levels, each responsible for a part of the policies which determine economic developments over the whole zone. But however difficult it may be, a way must be found to improve the management of Economic and Monetary Union.

With this in view, the final part of this study proposed a set of measures. Firstly, they relate to the inadequacies of the existing procedures, which must be made more effective. Joint objectives should carry more weight when national policies are implemented. A significant margin exists for improving the integration of national and European budgetary policies, and for enhancing the scope and content of stability programmes. The Broad Guidelines should be more practical and take account of the specific need for coordination between countries in the euro zone.

In order to establish an effective system of economic governance, we also need to redefine the roles of those involved and how they interact. The Eurogroup has proved itself to be a useful body, enabling ministers to hold valuable discussions and to get to know each other's points of view. But the fact that it is a mere discussion forum, with no set doctrine or decision-making powers, severely restricts its potential. The Eurogroup should be strengthened so that it can provide economic control in the euro zone and play a *steering role*, which it could do by providing some broad orientations for economic policies in the euro area and ensuring their implementation. The Eurogroup, which is a strictly intergovernmental body, must also work together with the Commission, which should be able to represent the common interest when ministers find it difficult to reach an overall view, as well as providing impetus. The Commission should also be involved in the external representation of the euro area.

This is a set of measures which could be put in place, initially, without formal changes to the existing institutional framework. These reforms would be part of the gradual evolution which has characterised the economic pillar of EMU since its beginning; their introduction is simply a matter of political will. However, in the long term, an in-depth revision of the institutions and arrangements existing in the euro zone will become necessary: the organisation of Economic and Monetary union must take pride of place in the debate on the future of the EU which began at Nice. The imbalance between the economic and monetary aspects persists. The euro zone needs to adopt a robust "governmental" structure, either as part of a future amendment of the Treaties, through "enhanced cooperation", or by creating a series of mechanisms and institutional arrangements specific to euro zone countries, outside of the Treaties. Whatever the option chosen, the economic pillar of EMU must be organised in an effective and convincing fashion.

A practical step might be to establish a Euro Council similar to the Eurogroup, but with powers enabling it to organise genuine coordination of national decisions, ensuring that appropriate and consistent policies are applied throughout the zone. If the euro zone wants a voice and an influence in accordance with its economic and financial weight on the international stage, it should acquire a strong, unified representation. Despite the reluctance of the ministers concerned, the Commission should be given the job of spokesperson, alongside the ECB. Mandated and supervised by the Eurogroup, the Commission would thus represent the euro zone in international bodies, as happens in the case of EU trade policy.

Overall, the experiences of nearly three years of Monetary Union have been constructive. The favourable economic environment has certainly played a large part in this. But at the same time, events during these early years have also exposed the weaknesses inherent in the existing institutional framework. Now that the situation has deteriorated, and economic prospects have become uncertain, policy makers in the euro area have to face up to a very delicate situation for the first time.

Although the impact of the worldwide downturn in growth has been stronger than expected in Europe, the euro zone is not simply at the mercy of events among its trading partners. The single currency and the sound fundamentals of the European economy give economic policies in the zone more independence and effectiveness in responding to adverse shocks. The euro area countries principally depend on themselves in reacting to deteriorating economic circumstances, and reviving growth, bringing down unemployment, and pursuing the Lisbon objective of making the European economy the most dynamic and competitive in the world. To achieve these aims, we need a mix of macroeconomic policies which sustains activity, coupled with better integration and modernisation of European markets. The euro and the common monetary policy offer a precious opportunity to introduce the appropriate economic policies. But unless this goes hand in hand with an enhanced institutional framework for economic matters, the considerable potential of the euro will not be realised to the fullest.

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