

## **Economic policy co-ordination in the Eurozone : what has been achieved? What should be done?<sup>1</sup>**

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Much has already been written and said on European economic policy co-ordination<sup>3</sup>. It is explicitly mentioned as a common objective of member countries in the Treaty of Maastricht<sup>4</sup>. The Eurogroup was created in order to implement an aspect of co-ordination in the area of economic policy, and while some governments initially were reluctant, a large number of them now seems to have accepted the idea. The issue of co-ordination has therefore become consensual enough for the observer to wonder whether it is still worth discussing. Indeed, the current European context points to many alternative priorities: how to make the current Inter-Governmental Conference on institutional reform a success; how to manage a process of enlargement involving many diverse countries; how to maintain a certain level of efficiency in the EU when the number of members is likely to double in the coming future; and, as important, what should be the end-goal of European integration be discussed. With such an overburdened agenda, the co-ordination of economic policies does not seem a hot topic to consider.

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

- To think about co-ordination is a useful way to address the wider issue of governance of the EU and the Eurozone. We believe that the usual «community approach» has reached its limits. In many key areas – defence, for example -, member states are at the same time both willing to co-operate and reluctant to transfer further national sovereignty. Within these areas, future European integration must increasingly rely on new forms of co-operation that by-pass the well know shortcomings of the intergovernmental approach. Hence, the debate on economic policy co-ordination is not a debate between economists worshipping an illusory optimum, but a crucial contribution to the debate on the institutional organisation of the European Union.
- The GDP growth shortfall accumulated by the Eurozone during the last ten years in comparison to the US is more than ten percentage points. If the objectives which were set

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<sup>3</sup> See for example Buti and Sapir (1998), Boyer (1999) and von Hagen (1999).

<sup>4</sup> e.g. Articles 103(1) and 103(3).

at the Lisbon summit, namely to achieve full employment and to rejuvenate innovation, are ever to be reached, this will require a significant enhancement of the quality of economic policy in the Eurozone. Despite the current recovery, the challenge remains to be met, and there is a distinct possibility that economic growth in Europe slows down prematurely due to a failure of its policy system to deliver the kind of balance between macro-economic and structural policies or between fiscal and monetary policy that is required. Since the first version of this paper was written, the continuing decline of the external value of the euro and the failed attempts by European policymakers to resist it, or the confusing messages sent to the public and the markets on the degree to which responses to the oil shock should be co-ordinated have in our view confirmed the need to a revisited, more cogent approach to the issue. Economic policy players – governments and the European Central Bank – should consider improving the economic policy system of the Eurozone as one of their most urgent priorities.

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

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

### ***I. Economic Policy Co-ordination in Context***

Between mid-1999 and mid-2000, economic recovery in the Eurozone has gained strength. Dynamic job creation has been one of its characteristic features. Unemployment has declined swiftly, even though it remains much too high with 9.1% per cent of the labour force unemployed in mid-2000. Inflation has initially remained moderate, reaching 1,1 per cent in 1999, but accelerated in 2000 due to the rise in oil prices, to the decline in the value of the euro, and to price tensions generated by overheating in some European economies. Consumer price inflation has reached and even exceeded the 2% ceiling set by the ECB, prompting several interest rate hikes by the central bank. It is too early to assess the effects of monetary tightening on growth and inflation, but it is already apparent that it has not had the desired effect on the euro exchange rate. At the same time, general government deficits have been significantly reduced, and no less than five EMU member states are forecasted to reach a surplus in 2000. At the same time, however, The aggregate structural balance of the Eurozone has stopped improving in 2000 and the International Monetary Fund has projected a deterioration in 2001. The Eurozone is thus moving in the direction of a tighter monetary policy combined with looser fiscal policies.

The debate on economic policy co-ordination in Europe thus takes place in a context that is fundamentally different from that which prevailed when EMU went into force. The issue is no longer to achieve fiscal consolidation while fostering an long-delayed recovery but :

- to confront an adverse supply shock which both hampers growth and fuels at least headline inflation, if not, for the time being, core inflation ;
- to address the problems raised by higher than expected cyclical divergences within The Eurozone ; the problem has been known for long but as the economy has moved from low to high pressure, the implications of divergences of a cyclical or a more structural nature become more visible and questions arise that have not received consistent and systematic answers yet <sup>5</sup>;
- to demonstrate that Europe has both the will and the ability to create propitious conditions for developing the ‘new economy’ and that it is thus a place to invest in;
- to provide markets with convincing messages that member countries share a common understanding on the objectives of economic policy in the Eurozone and a broad consensus on the corresponding assignment of monetary, fiscal, tax and structural instruments.

Instead, there is a risk that still favourable economic conditions create disincentives for co-operation. Recent policy behaviour in most member states, including France despite its repeated insistence on the need to co-ordinate policies, highlights that in ‘good times’, there seems to be a perception that co-ordination becomes less urgent, because the sense of returned economic prosperity displaces the perception of macro-economic as well as structural problems. Furthermore there is a temptation to «nationalise growth»<sup>6</sup> by picturing it as a result of national, not European policies. Conversely, the reference to a lack of co-ordination becomes more appealing during recessions.

This contrasts with the increasingly evident market perception that the Eurozone suffers from a lack of consistency between the views and the actions of its major policy players. The weakening of the euro can obviously not be ascribed to co-ordination problems alone. It is rooted in long term capital outflows from the Eurozone and into the United States, the rationale for which can be found in foreign direct investment behaviour and portfolio diversification trends. But the apparent lack of equilibrating investment into the euro in spite of a significantly undervalued exchange rate is an indication that markets may doubt the ability of the Eurozone policymakers to address the current challenges in a co-operative and efficient way.

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<sup>5</sup> Sir Alan Walters, former economic advisor to Mrs. Thatcher, gave his name to a critique of monetary union that has relevance today: in case of cyclical and inflation divergences, real interest rates are smaller in the overheating economies than in the lagging ones. This is indeed the case in June 2000 : short term real interest rates (on the basis of three-months interest rates) are 3,0% in Germany, but – 0,6% in Ireland.

<sup>6</sup> As aptly remarked by Jean-Paul Fitoussi in *Le Monde* (5 May 2000).

## ***II. Monetary Union and Economic Policy Co-ordination***

### **A) Policy Competition and Co-ordination**

It is not obvious at all that economic policies should be co-ordinated. There is a widespread preference in Europe for national policy autonomy and policy competition between member countries, based on valid arguments: the assignment of the monetary policy instrument to the ECB requires governments to maintain their ability to rely on other instruments; the subsidiarity principle suggests that decentralisation is *a priori* preferable both on democratic accountability and on efficiency grounds; and policy competition can be expected to encourage the selection of most efficient practices.

Furthermore, co-ordination always generates negotiation costs, incentives to cheat, and possible conflicts in delegating authority from the institution within which policy responsibility is entrusted (the parliament as regards fiscal policy) to the negotiating party (for example the Finance minister). A valid case for co-ordination must consequently rest on the evidence that it brings more benefits than it generates costs. In the current debate, it is important to insist on the differences between the notions of harmonisation and uniformity, and also between the concepts of co-ordination and convergence. The objective is not to homogenise fiscal, regulatory or social policies, but to treat their interaction between member countries as a subject of common interest. Both economic policy competition and co-ordination have thus been integral part of the European integration process since its origins.

### **B) Arguments in favour of co-ordination**

The economic literature provides two rationales for economic policy co-ordination<sup>7</sup>. The first one sees co-ordination as a way to provide public goods that a decentralised action is unlikely to generate. In a European context, the most obvious examples of economic public good are the preservation of the Single Market and financial stability within The Eurozone<sup>8</sup>. In the macro-economic realm, fiscal discipline has also become a sort of European public good during the transition toward EMU. Co-ordination based on this line of reasoning often aims at preserving the existing regime<sup>9</sup>.

The second rationale emphasises economic spill-overs between countries and the role of co-ordination in taking into account economic policy externalities. In this view, the need for co-ordination increases with the degree of economic interdependence between countries. Co-ordination in this sense, requires that national economic policies are conceived in a co-operative way even when objectives remain purely national<sup>10</sup>.

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<sup>7</sup> For a discussion, see Thygesen (1992), Jacquet (1998).

<sup>8</sup> Peace and clean air are examples of non economic public goods.

<sup>9</sup> Peter Kenen usefully distinguishes between regime-preserving co-ordination and policy-optimising coordination.

<sup>10</sup> This second type of co-ordination has led to an abundant economic literature, in general based on game theory and on the existence of national loss functions that governments attempt to minimize. For a review, see for example Frankel et al. (1991).

The euro introduces new external effects that need to be taken into account and that mainly stem from sharing a single monetary policy and a single currency. While the monetary union modifies *international* interdependence in an admittedly ambiguous way, it creates new, strong *multilateral* interdependence through the policy variables<sup>11</sup>. EMU member states share a number of economic variables that act as vectors of economic interdependence among them<sup>12</sup> such as: the common average inflation objective, the common euro exchange rate, the Eurozone balance of payments, and even the common monetary policy, whose transmission channels differ between countries<sup>13</sup>.

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

Finally there is also a political economy case in favour of co-ordination. Policy co-ordination may act as a crucial support for national policies along the following three dimensions: policy formulation, through mutual exchange of information and debate; multilateral commitment through national policy programs that are bound into a global program for the zone; and peer pressure, which through adequate surveillance, facilitates the implementation of national programs. Furthermore, co-ordination among governments within the Eurogroup highlights their collective responsibility. This relieves the Central bank from the excessive burden of being considered by public opinion as the sole economic policy actor within the zone, and possibly (but wrongly) of being held responsible for the entire macro-economic outcome.

### C) Which policies to co-ordinate ?

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

The specific need for co-ordinating *fiscal policies* within EMU comes into existence because of their impact on the common variables identified above. This is particularly important when

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<sup>11</sup> What we call « international interdependence » here refers to the traditional policy transmission channels through goods and capital markets, which often work in opposite ways : fiscal policy transmission is positive by the transmission of demand through the goods markets, and negative through the capital markets by the transmission of the interest rate effect. Both types of policy spill-overs presumably increase as a result of forming a monetary union, the net result being ambiguous, leading some (for example De Grauwe and Polen, 2000) to dismiss the case for co-ordination.

<sup>12</sup> When these variables are seen as objectives, they are so-called « club goods », that is, public goods whose access is limited to club members, here the Eurozone. On this, see von Hagen (1999).

<sup>13</sup> See for example Dornbusch et al. (1998).

cyclical divergences in national economic situations call for differentiated fiscal policy responses.

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

*Structural policy co-ordination* is often deemed unnecessary, because economic and social reform benefits the reforming country in the first place, and thereby penalises countries that do not implement them. However, structural policies affect potential output and thereby also the environment in which the Central bank is to decide its interest rate policy. If Eurozone members simultaneously engage in structural reforms that boost potential output, they are to expect that the Central bank will take this into account and make room for faster growth. This expected reaction may be a necessary incentive to act, since structural reform often carries short term economic and political costs, which suggests that being rewarded by a growth-friendly policy-mix may be decisive. For example, a tightening of the eligibility conditions for unemployment compensation may appear more acceptable when there is a dynamic job creation process than in a slow growth context. As a result, the implementation of structural policies in the Eurozone involve collective action problems that recall the prisoner's dilemma. The dilemma is that for structural reform to deliver an acceptable pay-off through a recognition by the Central bank and corresponding monetary ease, a sufficient number of countries, especially the large ones, must commit to it. But given the short term costs involved, some of these countries may be reluctant to undertake structural reform because they are not sure that other countries will follow through.

### ***III. The European experience with co-ordination***

Europe is not as well trained as one could expect with respect to economic policy co-ordination. Until the introduction of the euro, Europe has experienced two broad methods of integration<sup>14</sup>: the harmonisation of legislative or regulatory provisions (rule-based co-ordination), and the delegation of a number of functions to a common institution at the EU level (federalist approach). The latter is reflected in the CAP, in competition policy, as well as in the single monetary policy within EMU, while Single Market provisions and the Stability Pact belong to the former approach.

The euro introduces a totally new situation. Monetary policy has effectively been delegated to the European Central Bank, but no progress has been made towards a federal budget. On the contrary, it was explicitly decided that the current Community budget would not be increased as a result of EMU. As is the case in other areas such as justice and internal affairs or defence and security, the introduction of the euro thus requires to experiment with a new approach

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<sup>14</sup> Or, to be precise, « positive » integration. Economic integration proceeds both through negative integration (elimination of trade barriers) and positive integration (implementation of common policies).

which is closer to the intergovernmental one than to traditional community ones. A common economic policy can only emerge on the basis of co-ordinated action between independent actors, some of which (the Central bank) are federal institutions and others (the governments) are not. Co-ordination is thus necessary, unless one has faith in the argument that the quality of the institutions (the status of the Central bank) and of the common rules (no bail out, fiscal deficit limits) is enough to create a «good» economic policy for the zone.

The convergence model as applied within the European Monetary System (EMS) and in the run-up to EMU has provided inspiration for the organisation of economic policies within the Eurozone through the Stability Pact and the pluriannual stability programs which are today the core of the co-ordination process. In this light co-ordination practically came to be assimilated to convergence towards predetermined targets. Such a co-ordination approach, which can be called «prudential», is not without shortcomings. We can point to at least four limitations :

1) The approach is of little help to address the global policy-mix of the Eurozone, because it is based on the idea that the strategic interactions between the various economic policy actors are of little importance. Consequently, it is assumed that the proper policy-mix will be maintained as long as each policy maker reaches its assigned objective.

2) It reduces the interaction between monetary and structural policies to a one-way relationship (structural policies are needed to provide the right environment to monetary policy), while the expectation of the policy response from the Central bank can be very instrumental in providing the proper incentives for structural reform.

3) It is based on the questionable view that what is a sound economic policy can be determined for all countries at all times, and it rests on fiscal limits (3 percents of GDP for the deficit, 60 percents of GDP for the public debt ratio, and a fiscal balance normally «close to balance or in surplus») that are not derived from explicit principles and objectives of economic policy. The observation of the current deficit and debt ratio, however, does not provide a sufficient assessment of the actual state of public finances. Instead, one needs to have a medium to long term vision, based on the concept of sustainability. This requires a comparison between the present value of public liabilities (including future spending and implicit liabilities) and the present value of public assets and future receipts.

4) Although this dimension has recently been emphasised, it still does not take cyclical dimensions sufficiently into account. As a consequence, it puts more emphasis in preventing a deterioration of the fiscal deficit during slowdowns (even though this may only be the result of a growth shortfall) than in preventing a deterioration of the structural deficit during in times of boom (even though this paves the way for subsequent deterioration).

The Stability Pact and associated provisions do not constitute a sufficient set of principles and procedures to organise economic policies in a proper manner within the Eurozone. In particular, the absence of a jointly elaborated and shared economic policy philosophy leave little room for analysis in the economic policy debates in Europe. The texts where such a philosophy should appear, such as the Broad Economic Policy Guidelines, are too often the result of a nitty-gritty negotiation to the comma by governments anxious to evacuate any critique. As a consequence, the directions of a global policy-mix remains uncertain, and observers and markets may get the impression that the policy-mix results from political and diplomatic games rather than from a consistent and active conception of the role of the

economic policy. Such a high level of uncertainty comes with a cost that should not be underestimated because of its impact on market expectations<sup>15</sup>.

In sum, the undeniable efforts undertaken so far have not succeeded in creating a genuine «culture of co-ordination» in the Eurozone. As a result, national governments do not find sufficient incentives to think of national economic policies as issues of common interest, not even as a possibility for exchange of information and consultation. One should have thought that the «culture of co-ordination» would have reached at least all the new areas of co-operation (such as UMTS licensing, green taxation, policy responses to the oil shock, etc.), but not even here does the question appear of whether it would be desirable to take a community approach.

The Eurogroup deserves some credit for having facilitated the emergence of a consensus on the kind of policy-mix that was appropriate to respond to the international economic slowdown in 1998-99, and for having fostered the emergence of a consensus on the problems created by the weakening of the euro at the beginning of 2000. More generally, it has allowed discussions to take place between economic policy-makers in the Eurozone, that would not have occurred otherwise. But its informal nature seems to be a handicap, since it does not allow any decision making and it provides no alternative other than unanimity. The Eurogroup has not established a collective vision of the global economic situation of the Eurozone, despite some progress in statistical information. This has been a real barrier to effective co-ordination, because only a global vision can shed light on the interaction between national economic policies and the common monetary policy and thereby allow a redefinition of national programs. Finally, the new structure has not acquired enough external attention.

The Eurogroup has therefore proven its usefulness, but has also reached its limits within the current context. Disillusion is around the corner. The lesson we draw from experience is that the Eurogroup is a necessary structure whose responsibility must be clarified, who must adopt clear and consistent working methods, acquire external visibility and be given decision power.

#### *IV. Guidelines for progress*

In formulating proposals for a better organisation of economic policy for the Eurozone, one should not feel constrained by the traditional EU approach. Instead, the specifically intergovernmental nature of the problem to be solved – at least for the time being –, should be recognised, as well as the unique status of the ECB. It should also be accepted that the more the Commission will be willing to play a role of intellectual resource, and of secretariat for a still largely intergovernmental executive body, the more it will contribute to effective co-ordination and gain in influence. To claim that the Commission, instead of the ministers, is the natural interlocutor of the ECB, as president Prodi did recently, is of little help as long as governments and national parliaments retain responsibility for policy formulation and implementation in both the fiscal and the structural fields. But to speak of an «economic government», as some Frenchmen like to do, is misleading because it suggests that something like a government exists in Europe. We prefer to speak of «economic governance», which suggests a plurality of actors and a necessity to define and adopt «best practices» in a number of economic policy areas. Nonetheless, such governance must be firmly formalised and

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<sup>15</sup> Gros (2000) illustrates the point.



organised, because intergovernmental decision making is already difficult at 11, 12 or 15, and will become even more so after the next enlargement. Co-ordination does not mean unstructured negotiation between governments.

How daring should the proposals be? The economic policy system in the Eurozone partly results from treaty provisions which are inconceivable to change (such as, everything having to do with the Central bank's independence and mandate, and the provisions of the Stability Pact which, despite its shortcomings, symbolises the member States' commitment to fiscal discipline). Besides, the treaty is too recent and our experience under the treaty too limited for any substantial change to be desirable. Suggested improvements should therefore imply modifications at the margin, compatible with existing provisions but possibly complementing them. This does not imply, however, that new measures that would have to be part of a new treaty should be ruled out, provided that they would remain broadly compatible with the current system. Introducing amendments on the occasion of an IGC leading to treaty revisions would be fully compatible with the EU tradition.

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

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

In this context, we now turn to six recommendations to develop economic policy co-ordination in the Eurozone. They are organised in three sections : first of all we go through the concept and nature of economic policy within the zone; secondly the institutional framework for implementation is analysed; and, finally, the external economic and monetary policy for the zone is reflected upon.

## A) Clarifying the principles and rules of conduct for economic policy

### *Guideline #1 : An economic policy charter*

In order to strengthen the co-ordination process, EMU members need to develop gradually, in consultation with the ECB, an economic policy philosophy that goes beyond mere procedures and criteria. Progress has already been achieved in this direction by agreeing on the objective of price stability, on a framework for fiscal discipline, and, more recently in Lisbon, a medium term strategy. Several ingredients are still missing, though: principles for deciding how to use the various economic policy instruments in response to shocks; a definition – other than a vague reference to equilibrium – of how medium term fiscal objectives will emerge now that convergence has made substantial progress through the stability programs; or even a discussion of how to respond to local asset price bubbles. These lacunae make the economic policy system of the Eurozone less transparent and feed ongoing uncertainty on the future orientations of monetary and fiscal policies in the zone. It is all the more important, to evolve principles that could guide economic policy decisions as well as market expectations.

The formulation of such principles, however, should not be left to negotiation as they would be produced through various trade-offs and concessions. It should rather, as in some past occasions<sup>16</sup>, be entrusted to a group of qualified experts and unquestionable personalities. The European Commission has to play an important role in this process, notably in fixing the terms of reference for the study, in monitoring progress, and in organising the debate that is necessary to refine ideas and approaches. We would expect the group to produce a draft charter that would then mature through a general debate and should be submitted to the Council for discussion and amendments before being formally adopted. Of course, the ECB would need to be involved as a fully independent participant in the preparation of the draft charter on areas involving monetary policy.

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

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

- assignment principles for responding to economic shocks. For example, it could make it explicit that symmetric shocks should be responded to by the common monetary policy, while asymmetric ones should call for national fiscal policy responses;
- rules of conduct for fiscal policy behaviour that would make clear how the budget is managed over the cycle and how governments envisage to respond to unexpected revenue bonuses (or shortfalls). Some inspiration could be found, for example, in the British code for fiscal responsibility or in the French medium term public finance program, which is based on a public spending target set in real terms, together with a decision to let

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<sup>16</sup> For example, the Padoa-Schioppa 1987 report.

- automatic stabilisers play freely<sup>17</sup>. Those rules should leave room for diversity in the formulation and the implementation of fiscal policy strategies;
- a forward looking approach to fiscal policy that would go beyond the Stability pact and involve accounting efforts to develop a balance sheet of the public sector which could serve as a basis for formulating long term goals<sup>18</sup>.

*Guideline #2 : more transparency and predictability in economic policies*

Co-ordination does not necessarily require decision makers to change their decisions according to the common good. The quality of the policy-mix can be greatly improved through a greater transparency and better predictability of the individual decisions. With transparency and predictability each decision maker – government or ECB- can anticipate the others' orientations and reactions to shocks. This requires progress in four areas<sup>19</sup>:

- the quality and homogeneity of statistical information must be substantially improved, most notably regarding the less developed areas (wages, quarterly accounts, public finance);
- qualitative advances with respect to infra-annual information on public finances are required for national budgets to be monitored effectively ;
- the ECB policy needs to be clarified. Transparency suffers from a quantitative uncertainty on the final objective (the inflation target) and from the Central Bank's «double-pillar» strategy based on a monetary aggregate and on inflation forecasts. We think that such clarification should imply that quantitative control of the monetary aggregate would be abandoned, because of its weak information content. The ECB should also make its inflation target more precise, first of all by making explicit the methods it uses to form its projections of inflation, and secondly by formally recognising that undershooting the inflation target should be corrected with as much vigour as overshooting it;
- member states should adopt contingent fiscal policy principles. All Eurozone member States have now fixed stability programs within which they formulate their fiscal policy. For these programs to become full-fledged co-ordination instruments, it would be desirable to integrate them into the national fiscal strategies, which generally implies their adoption by the national parliaments. They should also explicitly envision rules of behaviour, which need not be identical within countries, as already mentioned. To the contrary, contingent rule making should be conducted along the lines of reflexive law, according to which the centre sets out the principles and then limits its role to monitor conformity between these principles and the national policy decisions in each Member State.

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<sup>17</sup> On this, see the report prepared by the French Government for the 2000 public finance law, *Politique Economique* 2000, Paris : Economica.

<sup>18</sup> Emphasis on the « quality of public finance » was recently suggested by the European Commission (2000).

<sup>19</sup> The French Government made similar proposals in Dresden, in April 1999.

## B) Implementing the joint economic policy

### *Guideline #3 : transforming the Eurogroup into a collective executive body*

Leaving the implementation of a co-ordinated Eurozone economic policy to an informal organisation that would at best be the depository of lip service declarations is unlikely to provide the necessary credibility and effectiveness. Such implementation should not, either, exclusively or even mainly be based on a normative approach involving explicit legislation, as is the case with the Stability Pact. It is important to think of the best way, within the existing framework, to organise the executive function needed to define and implement economic policy orientations or joint decisions according to the guidelines suggested above.

Von Hagen (1999) recommends the creation of an Economic Policy Council which would have precisely this function. It would associate national finance ministers or their direct representatives, and would make fiscal policy recommendations to EMU Member States. The merit of this proposal is that it specifies the functions that are necessary for implementing a co-ordinated economic policy approach. Instead of creating a new EU instance, however, our preference is to explore what already exists. The need for such an executive function provides an opportunity to consolidate and further develop the Eurogroup.

To think about the future evolution of such a group, let us first ask whether the EU would need a euro council if all EU members had joined EMU. We think the answer is yes. It is time to separate the European Council's executive function from its legislative one. When ECOFIN meets to adopt European directives, it acts within its formal responsibilities, partly shared with the European Parliament applying specific procedures. Ministers are assisted by a whole team of civil servants whose task is to ensure conformity with the texts. The inevitable result, as Jacques Delors has noticed, is that physical distance in itself kills dialogue. Besides, ECOFIN ministers more and more come to read a well prepared declaration in preparation for a vote.

On the contrary, the Eurogroup exerts no legislative responsibility, but fills a strategic function that is well in tune with its reduced format (minister plus one). Its role is not to manage procedures or adopt legislative texts. Instead, it is well suited to become a collective executive body. We think that it should evolve into a true *Eurozone Economic Policy Council*, where decision makers (ministers and, as a frequent guest, the governor of the ECB) reach agreement on appropriate strategies responding to structural problems or economic and financial shocks, and where they decide on relevant orientations and give them an operational content. A relevant task today would be to define a sustainable growth strategy for the Eurozone, and explain how governments and the ECB should behave to maintain the current recovery. This Council should also be able to adopt economic policy documents.

We also think that such an economic policy council cannot remain a forum deprived of decision making power. It must be granted the possibility of voting at a qualified majority, not on legislative provisions, but on policy guidelines. This economic policy council must be able to adopt strategic economic policy guidelines, white papers on structural reform, as well as specific economic policy resolutions or recommendations. It must also be able to take a position on international policy co-ordination and exchange rate issues. But these texts would

have no legal value, except in case where the ECOFIN also adopts them and thus transforms them into legal texts<sup>20</sup>.

This leaves an important question: Should this co-ordination framework be limited to the Eurozone or extend to all EU member States (even those who are not EMU members, yet – like the UK)? The current co-ordination framework is based on the idea that all EU member States are interested in solving EMU specific dilemmas. Hence, convergence programs are adopted by the ECOFIN, like the Broad Guidelines, even though their *raison d'être* derives from EMU. This idea, apparently dear to the UK, is acceptable during a transition period. It will increasingly become a handicap if Eurozone countries are led to submit their macroeconomic policy debates to the deliberation of a Council which includes member states not interested in adopting the euro. All that is specific to EMU-wide economic policy co-ordination should therefore be transferred to the euro Council.

Although the existence of the euro strengthens the need for co-ordination among the Eurogroup countries, the case for co-ordination remains valid for the EU as a whole,. One could accordingly imagine that the proposed Economic Policy Council could meet in a full EU format as well as in a narrower Eurozone format. In other words, our proposal does not imply that countries that are «out» of the euro should be excluded from a more efficient co-ordination approach. The nature of the exercise, however, suggests that the Eurogroup should take the lead and that the specific Eurozone co-ordination problems should receive explicit recognition and attention.

#### *Guideline # 4 : a better interaction between EU procedures and national decisions*

Co-ordination currently suffers from being organised through complicated EU procedures which have poor interaction with Member States' own decision procedures. The threefold approach initiated by Cologne, Cardiff and Luxembourg is satisfactory in principle, and the Broad Guidelines can become a useful instrument to explain the strategies, but it is too difficult to be operationally transparent. Jacques Delors had proposed that a first «EU semester» should be followed by a second «national semester» with the adoption of national budgets. This altogether attractive option is today hard to implement due to the half-yearly rotating of the presidency. But its spirit can be saved. Moreover, there is a need to make the Eurozone situation and prospects more visible, as was recognised by the Lisbon summit, with the decision to have a European Council meeting on the economic and social state of the Union each Spring.

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

- all structural guidelines, including those with fiscal or tax implications, should be decided in the second half of the calendar year so that member States could draw the implications for their own budget program;

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<sup>20</sup> Dominique Strauss-Kahn (2000) recently made a proposal that starts from similar premises but reaches a partially different conclusion : he also proposes to give the euro Council an executive capacity in areas pertaining to macroeconomic policy, but also proposes that the euro-Council receives a legislative capacity. The difference is that, in Strauss-Kahn's view, euro members are considered at the vanguard of a reconstruction of European institutions.

- national public finance programs should be submitted early enough for a review of the aggregate Eurozone fiscal prospects and policy stance to take place before national programs are scrutinised. This would allow the necessary modifications of these programs to take place in view of a global outlook, and should also allow national programs to be adopted before any decision is taken concerning the national draft budgets for the following year<sup>21</sup>. This aggregate review should be undertaken in the context of the European Council on the economic and social state of the Union decided at Lisbon;
- this procedure would allow the medium term prospects for the Eurozone to be presented at the European Parliament in the first calendar year semester. Ideally, this presentation should be given a solemn character, for example with an official address on the economic and social state of the Union and a debate with euro-parliamentarians;
- all economic documents that accompany the draft bills of finances submitted to national parliaments would have to include a joint chapter on the Eurozone situation and prospects;
- finally, all directions and ministerial departments in charge of preparing the national bills of finances should be more directly involved in the co-ordination process. A simple way to do this would be to integrate them in the Economic and Financial Committee, instead of the national Central banks whose participation in the national delegations, under the leadership of the Treasury departments, does not fit well with the new institutional architecture of the Eurozone.

### C) Developing an external economic and monetary policy for the Eurozone

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

During the decline of the euro, the hesitations of governments and the contest of influence between the Eurogroup and the ECB have provided a sufficient illustration of what could have been expected - neither the treaty provisions on exchange rate policy nor the early 1999 compromise on the external representation of the Eurozone are truly operational. They must be amended to give the Eurozone an effective exchange rate policy and a credible external representation.

The Eurozone exchange rate policy is in principle described in article 109(2)<sup>22</sup>, which allows for general exchange rate policy «orientations». These «orientations» are implicitly addressed to the ECB, which is questionable since changes in fiscal or structural policies also have a significant impact on exchange rates. Their significance, however, has been considerably weakened: first, the treaty itself specifies that they «do not affect price stability», but does not explain how possible inconsistencies should be addressed and by whom; secondly, the Luxembourg resolution confines their use to «exceptional circumstances», for example in case of a clear misalignment. Article 109 (2) was not used during the fall of the euro, and, for all practical matters, exchange rate orientations have probably become like a weapon of deterrence, and, as such, are bound to be never used. In the absence of an operational procedure, the Eurogroup can only adopt a position on exchange rates if there is a consensus, which is a handicap. As for external representation, it has been entrusted to the

<sup>21</sup> Such a proposal has already been made by Dominique Strauss-Kahn during the Dresden April, 1999 ECOFIN and euro-11. It had then been wrongly interpreted as an attempt to relax the Stability Pact discipline by concentrating on an aggregate Eurozone balance.

<sup>22</sup> 111(2) in the new, Amsterdam treaty, numbering.

ECOFIN/Eurogroup Chairman, who is internally fully legitimate, but who often lacks experience of and exposure to international monetary discussions. In addition, the ECB president takes part in the G7 when macroeconomic or exchange rate issues are considered, and is replaced by national central bank governors when other issues come to the floor.

In a situation characterised by uncertainty on the distribution of roles and responsibilities, some, like Wyplosz (2000) have suggested that exchange rate policy be entrusted to the sole Central Bank. We do not believe that this is the solution. The fall of the euro has forcefully illustrated that situations of misalignment imply much more than the sole monetary policy, namely the whole economic policy organisation, structural reforms, fiscal policies, etc. What is needed, is not a strict allocation of roles, but an operational *modus vivendi* to organise the necessary co-operation between governments and the Central bank in an area of shared responsibility. We think that this implies a number of changes:

- a systematic and permanent surveillance of the exchange rate should be organised within the Eurogroup, on the basis of analyses from the Commission and from the ECB (Coeuré and Pisani, 2000; Davanne and Jacquet, 2000). This surveillance should include the following elements: a discussion of what could be agreed on as a real equilibrium exchange rate benchmark; a monitoring of current exchange rates, and an attempt to interpret potential divergences from the benchmark (do they reflect economic divergences or a pure market behaviour that is likely to change under an appropriate communication or intervention policy?); and a discussion of the appropriate responses and changes to the current policies, if any, when divergences from the equilibrium benchmark can be explained by economic policy divergences. Such exchange rate surveillance, which is as appropriate for the Eurozone as it is for the G7, highlights the exchange rate as a potential signal and indicator. For the Eurozone, it would give substance to the discussion on the overall economic policy stance and would contribute to economic policy co-ordination within the zone;
- the respective responsibilities of the Eurogroup and of the ECB must be made public. As Gros (2000) claims that this would help avoid misunderstandings and counterproductive speculations;
- if it is ever to take a position and to express it, the Eurogroup should be given, on the exchange rate question as on others, the possibility to take decisions at a qualified majority. This would be compatible with the reality, since the ECOFIN council has in practice transferred its exchange rate responsibilities to the Eurogroup<sup>23</sup>;
- a Belgian 1998-99 proposal provides a solution to the external representation problem, with the idea of adjoining to the rotating Eurogroup chairman a vice-chairman who would always come from a G7 country, and would receive authority to talk on international monetary issues on behalf of Eurozone ministers. This vice-presidency would rotate between the three EMU countries also being members of the G7 jointly with their presidencies of the Union<sup>24</sup>.
- finally, the compromise according to which national central banks participate in one part of the G7 meeting, and the ECB in another, is a half-baked measure that satisfies nobody. From a logical EMU standpoint, the ECB should externally represent the Eurozone on behalf of its monetary authorities.

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<sup>23</sup> The treaty stipulates that only EMU members vote on exchange rate matters.

<sup>24</sup> Gros (2000) proposes an alternative solution, namely the nomination of a « Mr. euro », who could be the chairman of the Economic and Financial Committee. We prefer the Belgian option, which would avoid the adjunction of a technical representative to existing political representatives.

### *Guideline # 6: A monetary strategy for the enlargement*

While the enlargement of the EU is currently under negotiation, the time has come to address the enlargement of the Eurozone itself. It cannot be made only conditional to the candidate countries respecting the Maastricht criteria. The enlargement procedure has been undertaken with the assumption that EU candidates, once accepted, will sign up for the whole «acquis communautaire», and therefore become potential EMU members upon EU accession (formally, they have no «opt out» clause). But to welcome countries for whom there is no guarantee that an irrevocable pegging into the euro would be politically or economically sustainable would subject the whole zone to a very high risk. This would also send a very unfortunate signal about the strength of the euro to the rest of the world. This is why any ambiguity must be ruled out from the start.

In particular, a specific transition period should be instituted including a long experimentation of monetary cohabitation, before EU candidates may join the euro (for example, a minimum test period of 5 to 10 years, renewable every 5 years), and with convergence criteria more sophisticated than the ones that were applied in 1997, in order to assess the sustainability of EMU participation (in the spirit of Gordon Brown's «five economic tests»). In exchange, the Eurozone might grant candidate countries a degree of monetary co-operation that goes beyond ERM II. In particular, it might be more forthcoming in helping countries sustain unilateral pegging policies, be they of a rigid nature (currency boards) or of a more flexible variety (crawling pegs). The traditional argument against such monetary co-operation, namely that it could be dangerous for monetary stability within the Eurozone, is not convincing, because stability would be much more endangered by premature EMU memberships than by possible interventions to support associated currencies, whose limited weight suggests that interventions could hardly threaten price stability in the Eurozone.

Finally, the enlargement of EMU also confronts the ESCB with organisational and operational problems, notably with respect to monetary policy decision procedures. The «one man, one vote» principle, when the number of participants in the decision process increases, may soon lead to indecision and confusion. The current IGC tries to sort out the necessary changes of the processes of representation and decision making at the Council level. The ESCB will thereby not be able to escape a reform of its own procedures and should immediately engage in preliminary discussions.



## ***V. Conclusion***

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

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

In particular, it is possible and useful to make progress toward defining an economic policy charter immediately, improving the transparency and predictability of economic policies, improving the interaction between EU procedures and national decisions, and preparing the transition of EU candidates toward the euro. The advent of a genuine exchange rate policy, which also includes the organisation of the external representation of the Eurozone, is more demanding, as it implies, beyond a necessary agreement on the principles and means for such a policy, a more formal agreement on how to interpret and implement the relevant treaty articles. The transformation of the Eurogroup into a genuine collective executive body for the zone necessitates a change in the treaty, and requires accordingly a more ambitious approach whose spirit could be made part of the discussions under the current IGC. In the interval, however, it is possible and desirable to strengthen the visibility and role of the Eurogroup, even within the current institutional and legal context as set by the Maastricht and Amsterdam treaties.

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