What priorities for the economic governance of the EU?

With contributions from
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Introduction

The European Union is currently redesigning itself. According to the Chair of the Convention on the Future of Europe this time the new design should last for the next fifty years. As the Convention is scheduled to deliver its project for the constitution of the new Europe by the summer of 2003 the Italian Presidency of the European Union will have to deal with the fundamental issue of how to organise the economic governance of the EU over the next decades.

Economic governance is a rather vague term and its interpretation is sometimes contentious as the discussion in the working group of the Convention showed. In the Convention the majority seems to be leaning towards the view that the existing economic policy institutions, i.e. those basically created by the Maastricht Treaty, remain sufficient even for an enlarged and deepened EU of 25 plus. It is thus unlikely that the constitutional project that the convention is preparing will contain sweeping proposals for increasing the powers of the EU in governing the European economy.

This lack of enthusiasm for fundamental reforms in economic governance might surprise in face of the dismal state of the European economy. Should one not expect from serious economists a totally different position? However, the contributions assembled here, which come from a variety of schools of economic thought and different national backgrounds do not call for fundamental revisions in the Treaty. Each of these contributions points out a particular area where improvements might be useful. But the thrust of the solutions proposed is not only to give the EU level a bigger say in how the European economy is run. Most of the contributors emphasise rather the responsibility of national policy makers.

What are the weak points in the governance of the European economy singled out by the contributors?

A very topical concern related to the weak present state of the European economy is that of the danger of deflation. The point of the contribution by Adair Turner is not so much that deflation is imminent in Euroland today, but that one should be prepared should it arise. He finds that the upper limit of inflation set by the ECB (or rather Eurosystem) for itself is too low if judged by the experience of the UK and the US. This leads him to recommend that the ECB should a adopt a different policy, i.e. an inflation target with a range whose centre is above the current ceiling of 2 % chosen by the ECB.

Moreover, Adair Turner also warns that deflation carries one further danger, namely large scale banking failures due to bad loans that can accumulate without being recognised as such because at extremely low interest rates the ability of borrowers to stay current on interest payments is no longer a good indication of their ability to repay the principal. Could one deal with this danger in the present set-up in Euroland where national banking supervisors are only loosely coordinating their actions? Adair Turner is sceptical and recommends that one should not rule out unconventional approaches, such as giving the EDB the power to finance a rescue operation of a major bank by money creation if it feels that this is indispensable to preserve the stability of the financial system of the Eurozone.

The theme of financial markets and their integration is taken up again by Norbert Walter in his contribution "Make financial markets a driving force in the EU economy". As the title indicates his main concern is not to avoid dangers, but to capture an opportunity, namely to overcome the still remaining fragmentation of (national) financial markets in Europe. What should be done in this domain? First, the EU should live up to its own promises which are contained in the Financial Services Action Plan (FSAP) which contains, much like the famous Internal Market programme of 1992, a list of the most important steps that need to be undertaken to create a fully integrated market for financial services.

Will implementing the FSAP be enough? Norbert Walter argues that more could, and should, be done. Financial markets innovate constantly, the EU thus needs to adopt a framework for financial market supervision that is flexible enough to follow the constant evolution of instruments and practices. This is what the Lamfalussy approach was meant to achieve. It thus needs to be implemented, and perhaps complemented by the creation of a European institution that supervises financial markets.

Over three years ago the EU set itself an ambitious goal in Lisbon, namely to become the most competitive economy in the world. But what instruments does it have to achieve this lofty goal? What instruments does the EU have to foster employment? Has the open method of coordination worked or do we need new EU competences in the field of labour markets and social policies? Juan Jimeno tries to answer some of these questions by concentrating on labour markets. He shows that the contribution of the EU to a better functioning of labour markets can be only be limited, but some small steps may nevertheless by useful. For example one could simplify the structure of so-called national action plans (NAPs), which member countries are required to produce to show how they can contribute to the Lisbon goals. Supervision of the implementation of employment policies promised the NAPs and the evaluation of their effectiveness should be strengthened to make sure that the most effective measures are actually implemented. Finally it will be important to link the development of employment policies with other measures in the area of social policies. Pension reforms aimed at increasing the retirement age need to be complemented by employment policies that make it more likely that older workers can actually find a job.

The most controversial institution in the entire EU framework for economic policy making is probably the Stability and Growth Pact. Finance Ministers have to discuss its application almost every time they meet. But there is also a lively debate among

economists. The question "Does the Stability Pact need to be reformed?" continues to divide the profession. Charles Wyplosz dares to deal with this issue. His answer is an unambiguous yes. This answer might not surprise many, but the solution he proposes might. He argues that some constraints on fiscal policy might indeed be useful to ensure sound public finances. But this requires limits on debt levels, rather than deficits, because the main danger from an irresponsible fiscal policy arises when debt levels are so high that financial markets doubt the solvability of a government. How can one safeguard the solvability of public finances when fiscal policy remains a national responsibility? Charles Wyplosz proposes to follow the example of monetary policy and delegate the authority to set a path of the evolution of the national public debt to an independent authority. The debt limits would be agreed with the EU instances (ECOFIN and Commission for example), but it would be left to national debt boards to decide on what annual deficits would be compatible with the target for the evolution of the debt.

The last contribution also deals with fiscal policy, but from a different angle. Lorenzo Bini Smaghi and Guido Tabellini discuss the role of the Eurogroup in strengthening economic policy coordination. They start by describing the differences in the functions of the Eurogroup and the "regular" Council of ministers of finance, namely ECOFIN. They find that the roles of these two institutions differ. ECOFIN is the institution that can take decisions under the Treaty, whereas the Eurogroup constitutes mainly an informal forum for the coordination of macroeconomic policies. Is this enough? Lorenzo Bini Smaghi and Guido Tabellini discuss briefly the nature of spill-over effects and do not find them large or predictable enough to justify binding coordination mechanisms in fiscal policy.

Where does this leave the Italian Presidency? Here are a few points:[1]

- There remains an important unfinished agenda in the area of financial markets. A short term target must be to ensure continuing progress on the FSAP. In a longer term view a discussion about the framework for financial supervision at the EU level needs to start.
- Progress on the Lisbon agenda in the area of labour markets has been unsatisfactory. The open method of coordination used so far in this area should be strengthened by simplifying the procedures and making the entire process more transparent.
- Reform of the Stability Pact must continue to address two concerns: its present pro-cyclical bias and the neglect, so far, of debts as opposed to deficits. The key concern is to allow for some short term flexibility in fiscal policy while preserving the strong long term commitment to sound public finances whose necessity is accepted by everybody.
- One should resist the temptation to try to reinforce the standing of the Eurogroup and transform it into an 'Ersatz' ECOFIN for the euro area. But ECOFIN itself might be strengthened through a more stable presidency.

[1] Not all of the authors necessarily subscribe to all of these proposals. This list represents a personal interpretation of the general thrust of the arguments put forward in the individual contributions below.

- **The independence of the ECB is not up for discussion. But this does not mean the institution should life in splendid isolation. There is an urgent need to discuss the appropriate definition of price stability to ensure that Euroland can avoid a deflation trap. Moreover, a fundamental reform of the decision making organs of the ECB in view of enlargement remains necessary because the proposals put forward by the ECB itself constitute clearly a second best.**

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The Monetary Policy Framework – Guarding against Deflation

Adair Turner

1. Introduction

The European Central Bank's policy has been criticised as too restrictive. This may be unfair. It is not clear that different interest rate policies could significantly have changed Europe's growth over the last two years: and the eurozone, unlike Japan, is not suffering generalised price deflation. But there are strong arguments for changing the ECB's inflation target. And there are dangers that if the eurozone ever did face deflation, its present division of responsibilities between 12 bank regulators, 12 fiscal authorities and one central bank would make offsetting actions more difficult. The eurozone's current policy framework and disposition of roles is ill-designed to minimise risks of deflation, and ill-designed to cope with deflation if it did arise.

2. What is the optimal rate of inflation?

The optimal rate of inflation is not zero but mildly positive. Significant price deflation, as in the early 1930s, can be as harmful as high and accelerating inflation. Even mild deflation, as in Japan today, can lock a country in a self-reinforcing low growth trap. To guard against falling into that trap, it makes sense to aim for a low but positive inflation rate, for three reasons. Measured inflation indices tend to overstate underlying inflation levels since they fail to reflect quality and capacity improvements: a ½% measured inflation rate probably reflects something close to zero underlying inflation. Mild inflation makes labour markets more efficient by facilitating real wage flexibility: people can accept wage increases below inflation far more easily than nominal wage cuts. And positive inflation preserves the ability of the Central Bank to set mildly negative real interest rates, avoiding the problem of the "zero-bound", if this is required to prevent a downward deflationary spiral.[2]

The optimal inflation rate is therefore one positive enough to deliver these benefits, but low enough to avoid a spiral of accelerating inflation and inflationary expectations. Defining the precise optimum is an art not a science. But recent UK and US experience suggests that inflation of 2-3% is certainly not too high. At these levels – unlike at 5 or 10% - inflationary expectations are highly stable and short-term relative price movements are not distorted by expectation volatility.

The ECB's current inflation "target" of 0-2% is therefore sub-optimal. It is lower than a reasonable judgement of the optimal level for mature rich economies, and particularly tight for the eurozone for two reasons. The first is that the eurozone includes, in Spain, Portugal and Greece, three countries which are significantly behind eurozone average income per capita, and which should catch up with the average if policies (both macro and micro) are well designed. Countries experiencing catch-up growth, if linked in fixed exchange rate regimes or currency unions with

[2] The "zero-bound" refers to the fact that nominal interest rates cannot fall below zero. In theory they could, but since this would require the time franking of note issue (with the value of a currency note dependent on the time elapsed since date of issue) it is in practical terms impossible.

the richer countries, naturally have and need to have higher inflation rates – the so-called Balassa-Samuelson effect (see box below).

The Balassa-Samuelson effect in practice

The higher inflation rate in the catch-up country occurs entirely in non-traded, primarily service sectors of the economy, with prices in the traded sector bound to increase at the same rate across the fixed exchange rate zone. The higher inflation rate in non-traded service sectors reflects the fact that as country A catches up with country B, a coffee served in a café goes from being much cheaper to being roughly the same price. To some extent the catch-up country's price index may overstate true inflation, since it fails to allow for quality improvements (e.g. the ambience of the café). but whether or not this is the case measured inflation in the non-traded sector of the catch-up country is bound to exceed the equivalent for the already rich countries.

If a catch-up country is in a floating rate regime, the same effect is achieved via real exchange rate appreciation (which is offset in the traded sector by more rapid productivity growth than in the richer country).

Either effect explains the fact that poorer countries are further behind richer ones on the basis of current exchange rate comparisons of GDP per capita than on PPP comparisons.

Convergence of income levels, which should bring current exchange rate and PPP comparisons into line therefore requires either (i) in a fixed exchange rate regime a faster growth rate in nominal income deflated by the rich countries inflation rate, than in nominal income deflated by the catch-up countries inflation rate. (ii) real exchange rate appreciation.

Several studies have attempted to measure the existence of the Balassa-Samuelson effect in practice (see e.g. Hobza "CEE Candidate Countries on the Way to the Eurozone", July 2002 for a summary of major studies). However, the effect required if income convergence is to occur over any given number of years can be calculated if we assume that OECD comparisons of income per capita on a current exchange rate basis and on a PPP basis are accurate, since catch-up would entail, ceteris paribus, the convergence of these two measures. If, for instance, Spain were to catch-up with the average GDP per capita of the 9 richest eurozone countries over 10 years, and Portugal and Greece over 15, and if the inflation rate in the 9 richer eurozone countries is 2%, Spain will need to run an average inflation rate over that period of 3.7%, Portugal of 4.2% and Greece of 3.7%. The optimal inflation rate for the whole eurozone is then an average weighted by shares of eurozone GDP. A similar calculation for the accession countries, assuming catch-up periods of 20-25 years, suggests higher optimum inflation rates for these countries, but no larger an effect on the optimum eurozone average because of the small size of these countries' GDP.

These theoretically required Balassa-Samuelson effects are within the (rather large) range of measured actual effects reported in Hobza, op. cit.

A reasonable estimate suggests that this effect could add 0.25% to the optimal overall eurozone inflation rate today, with another 0.2% increase in the target required if and when the accession countries join the euro. The existence of this effect also implies that we should not be concerned by small inflation divergences across the eurozone, and should accept that countries like Poland and the Czech Republic, once in the eurozone, should have measured inflation rates of about 5-6%. The convergence criteria for eurozone entry therefore need to be changed: insisting that Poland achieves on inflation rate within 1.5% of Germany's before entering the euro will impose a perverse deflationary burden on the Polish economy.

A second European specific factor also argues for nudging the inflation target up. Going into EMU involved fixing exchange rates irrevocably, and it is possible that the exchange rates frozen at entry were sub optimal (i.e. not the best reflection of relative costs and competitiveness). In particular there is a reasonable prima facie case that Germany is now locked into an uncompetitively high exchange rate, requiring several years of below average real wage increases to achieve equilibrium. That adjustment will be more easily achieved if lubricated by positive inflation: with very low or zero inflation it will either require nominal wage cuts or occur only very slowly.

A midpoint inflation target of say 2.5%, within a range of 1.5 to 3.5%, on the basis of the HICP inflation index is therefore more appropriate than the ECB's current 0-2% range.[3] And it is particularly important that the bottom end of the range (e.g. 1.5%) is significantly positive and a target to be exceeded except in extreme circumstances.[4] In fact, over the last year, eurozone core inflation has been close to 2.5%, and the problem has been less the ECB's actual policy than the damage to credibility resulting from a more restrictive target declared and then missed, and the deflationary impact of the target's influence on expectations of future ECB behaviour. The ECB should therefore now adopt a higher target, with that target agreed or confirmed by some combination of national governments, the Commission, and the European Parliament.[5] Central banks with long track records, operating within a single state and political culture, can achieve both credibility and

[3] There is no science to fixing a precise rate. But if we took the Bank of England's 2.5% as a successful benchmark, we would need to reduce it to express it on an equivalent HICP basis (calculations of the systematic bias suggests about a 0.8% difference), but then increase it by, say, 0.25% for the current eurozone Balassa-Samuelson effect, suggesting a midpoint rate of 2% before enlargement. The need for additional flexibility to deal with the danger of exchange rates set at a "wrong" level argues, however, for a slightly higher target. 2.5% would give that additional flexibility but still, almost certainly, be below the level which would generate increasing inflationary expectations.

[4] In the Bank of England regime, the Governor of the Bank is required to write a letter of explanation to the Chancellor of the Exchequer if inflation goes above 3.5% or below 1.5%, and it is clear that each divergence represents an equally important failure of policy. The lower limit of 1.5% carries the implication that if inflation is in danger of falling below this limit, the Bank should take all necessary measures to prevent this, first by moving short-term interest rates to zero, and if this does not work by less conventional means such as monetisation.

[5] The question of who should set and agree the target – ECOFIN, the Commission, the Parliament, etc. – is extensively debated but secondary to the principle that (i) there should be a clearly agreed and publicly understood target (ii) it should be publicly endorsed by all governments thus providing clear legitimacy. One way forward which would avoid the need for treaty change would be for the ECB itself to propose an appropriate inflation target and for this to be endorsed by the Council.

legitimacy on the basis of implicit rather then explicit targets: a new central bank operating in a multi nation currency zone cannot. Consumers, businesses and markets throughout the eurozone need to have a clear expectation of mildly positive inflation. And if at some future date interest rates need to rise significantly to prevent too high inflation, citizens need to know that this is to meet targets agreed by their democratic representatives, not for reasons known only to central bankers in Frankfurt.

3. The European context

A positive and symmetric inflation target is an essential and central element of the eurozone's macro policy framework. It is particularly important in Europe because the burden on monetary policy is increased by fiscal policy constraints. The specific rules of the Stability and Growth Pact can be debated and other essays in this collection consider them. There are good arguments for redefining the SGP around cyclically adjusted fiscal positions and perhaps for excluding tightly defined categories of public investment. But we should recognise that, whatever the changes made, the fiscal policies of some eurozone countries will be constrained for several years. The Maastricht fiscal criteria and the SGP are not irrational masochism, but in essence serve sound Keynesian purposes. By demanding that countries have low stocks of debt (the 60% of GDP rule) and achieve nil deficits at the mid point of the economic cycle, they make it possible (if the rules are met) for automatic fiscal stabilisers to operate, with deficits able to increase in a recession unconstrained by fears that debt levels will become unsustainable. The essential problem is not the Maastricht and SGP constraints, but that the criteria were not fully met before EMU was launched and that countries did not use the good growth years of 1999 and 2000 to improve structural positions. Facing the current downturn the US, the UK, and some eurozone countries (e.g. Ireland and the Netherlands) are in a position to allow deficits to rise substantially to stimulate their economies. Germany and Italy are not and no amount of technical tinkering with the SGP will change that reality. A major risk to European growth exists as a result.

The risk increases the importance of a clear inflation target, and if necessary of forceful action by the ECB to pursue it. Such a target, by requiring early response to signs of deflation, would make it likely that deflation could be avoided using only the conventional tool of central bank interest rate policy. But it is important to clarify what steps the ECB could take if deflation did nevertheless take grip. That consideration reveals further risks within the existing eurozone policy framework.

In theory, even if deflation does become established, it can always be cured. Indeed combined deflation of output and prices – such as Japan now faces – is almost the only economic problem to which there is a clear and almost costless solution – the stimulation of additional nominal demand through fiscal and monetary policy combined. A fiscal authority and central bank together, operating within a fiat money system, can always create additional nominal demand as long as they are willing to progress from conventional to unconventional policies. If zero short-term interest rates do not prevent deflation, the central bank can monetise existing government and private sector securities, depressing long-term interest rates, increasing bond prices and thus creating wealth effects, and increasing private sector

holdings of cash. And if this doesn't work, the central bank can progress to direct and openly explained monetisation of the new flow of public debt, relieving the constraints on fiscal policy and making possible money-financed tax cuts of the sort Milton Friedman envisaged in his famous "helicopter money" analogy.[6] Deflation is a totally avoidable economic problem and Japan is now in deflation because the Bank of Japan and Ministry of Finance together are failing to pursue the obvious solutions. Policy making failure arising from institutional and political relationships explain Japan's deflation, not an absence of policy options.

Institutional relationships could also make unconventional but feasible policies difficult to agree and execute in the eurozone. Indirect monetisation of public debt is possible under ECB rules, but the ultimate unconventional action (direct and overt monetisation of the new flow of public debt) requires agreed co-ordination between fiscal and monetary authorities, and that would be more difficult to achieve with one central bank and 12 fiscal authorities. And such direct monetisation would also raise major distributional and moral hazard issues in a multi-country currency zone.[7] The

[6] Direct and openly explained monetisation entails making it explicit that at the consolidated level of the central bank and government combined, a debt which has been monetised by the central bank does not exist, and that no debt servicing burden exists, since the interest paid by the government to the central bank is exactly offset by the seigneurage profits the central bank makes, which ultimately belong to the government. There is as a result no limit to the tax cuts and expenditure increase which a government can undertake to stimulate an economy if it owns a central bank able to monetise its debt, and the idea that there are absolute rather than self-imposed limits to Japanese (or any other) fiscal policy is simply wrong.

The non-existence of government debt at the consolidated government/central bank level applies, of course, whenever government debt monetisation occurs. But this fact is deliberately disguised by conventional measures – which typically focus on general government debt without the central bank consolidated – because we rightly fear that a government's limitless ability to implement money-financed tax cuts and spending increase would be abused if too widely understood. There are dangers, however, that in extreme circumstances this deliberate disguise can undermine the effectiveness of monetary stimulus – with the Bank of Japan monetising government debt, but with the stimulating effect of this offset by the fact that Japanese consumers/taxpayers are being told about a rising (non-consolidated) government debt burden, implying a future tax burden, which need not however exist. Policy should therefore aim to ensure (via an inflation target with a clear minimum) that the need for the ultimate unconventional policy never arises, but should preserve the freedom to remove the deliberate disguise in extremis. This might entail for instance, the central bank funding the government deficit through the purchase of non-repayable, non-interest bearing securities, which it is obvious to all create no future debt servicing burden.

[7] The ECB has the legal power to buy any securities it wishes, including the debt securities of any national country, but it is specifically forbidden (Article 21 of the Protocol) to purchase those securities directly from a government (rather than in the secondary markets) or to lend directly to governments.

If the ECB does purchase interest-bearing securities (public and private) with money, generating seigneurage profits, those profits flow back to governments according to an agreed formula. At the total eurozone level, therefore, indirect monetisation should have the same effect as in Japan. But such monetisation could not (under current rules) be used directly to remove the fiscal constraints of a highly indebted member state. And if the rules were changed to allow this, such monetisation would (i) create a distributional issue – since the fiscal benefit would accrue to the citizens of the specific country involved, while all eurozone citizens paid via slightly higher unanticipated inflation (ii) create a moral hazard risk since countries knowing that this option existed would have reduced incentives to keep debt at sustainable levels.

The prohibition of direct money-financed tax cuts is therefore an almost inevitable feature of the one central bank multiple countries system: but one which could create, in extremis, a deflationary risk.

most extreme form of unconventional policy – money-financed tax cuts or spending increases on the helicopter money model – may therefore be inevitably excluded in Europe. It is therefore vital to avoid ever reaching the point where unconventional policies would need to be considered, reinforcing the importance of an inflation target range with a significantly positive minimum.

4. Implications for financial market supervision

One change to existing institutional roles and policies, to cope with the deflationary risks of large bank failures, should also, however, be debated. Deflationary cycles often undermine bank solvency: and bank insolvency (even when not openly recognised) can reinforce the deflationary cycle. The Japanese banking crisis is core to Japan's deflation problem. Its resolution requires the recapitalisation and effectively the nationalisation of insolvent banks, followed by clean up and sale to more competent managers. This, however, will require large scale public resources, estimated in Japan's case at up to 10% of GDP. Such resources are conventionally provided by the fiscal authority, not by the central bank directly, and bank rescue thus increases public debt. But if the central bank subsequently monetises the public debt created, the feasibility of the operation is not limited by fiscal constraints. The Japanese Financial Services Authority, the BoJ and the MoF can therefore if they wish agree and execute a bank recapitalisation project which does not add to the future burden on Japanese taxpayers, and which is therefore feasible even if existing public debt levels look uncomfortably high. The deflationary risks of large bank failure are always avoidable.

In the eurozone, however, the same operation would be more difficult. The key problem would not be the relationship between multiple regulatory authorities and the ECB, but inter-country distributional complexities and fiscal constraints. National rather than European level bank supervision, though arguably untidy, can still create workable processes for identifying bank liquidity and solvency problems. And the European System of Central Banks, through the National Central Banks, can offset temporary liquidity problems in the normal way.[8] The problems arise, however, if a major bank is not only illiquid but insolvent, requiring new capital injection in order to avoid failure and systematic risk. Fiscal support will then be required, but it may not be clear who should and could provide that support. For in an increasingly integrated European economy, the troubled bank will have wholesale and, increasingly, retail depositors spread throughout Europe, and a major bank failure would harm the whole European economy not just the national economy of the home country of the head office. The home country's finance ministry could therefore argue that it should not be solely responsible for the required fiscal support. And if that home country is already heavily indebted and

[8] Conceptually the dividing line between liquidity problems and solvency problems is clear: and central banks are typically empowered with limitless powers to offset pure liquidity problems, lending money against collateral, but with the fiscal authority involved if sufficient high quality collateral is not available or if there are other reasons to doubt solvency. As Professor Charles Goodhard has pointed out, however, the dividing line in practice is fuzzier, and almost all liquidity problems which cannot be resolved in the free market and thus require central bank support entail "the whiff or rumour of possible insolvency".

running a large deficit, it may be unable to take on that burden without breaking the SGP or without a rise in the accumulated debt stock to an unsustainable level (or at very least to a level which imposes debt servicing requirements which necessitate deflationary tax increases). In the one-country one-central bank case, this fiscal constraint can always be overcome by agreed monetisation of the debt created. In the eurozone this route is less clearly available.

In extreme conditions of deflation and major bank failure the eurozone's current institutional structure could thus prove incapable of acting fast enough and aggressively enough to prevent an intensification of the deflationary cycle. The first line of defence against this danger is an inflation target with a clear and positive minimum. But specific procedures to deal with a large bank crisis should also be debated. One possibility it to give the EU itself the fiscal authority to issue debt to provide fiscal resources if needed to support bank recapitalisation (but only for this purpose). Another highly unconventional but feasible possibility would be to give the ECB the authority to fund bank recapitalisation directly with money creation if it believed that this was essential to avoid a deflationary cycle developing.[9] Both options have disadvantages, as indeed does any system of banking system support, even in the one country one currency case.[10] But without some procedures to deal with extreme conditions, there is a danger that the eurozone could prove as ineffective at dealing with deflation as Japan has been.

[9] The two possible options set out would become effectively the same if the issue of debt by the European Union to support a bank rescue was followed immediately or shortly thereafter by the monetisation of that debt by the ECB, and if the seigneurage profits of the ECB on this monetisation were handed over to the EU.

[10] The fundamental problem is moral hazard. If bank management or bank depositors know there is a mechanism to prevent bank insolvency, they have reduced incentives to be prudent. And the easier it is for the authorities to provide cash, the weaker the incentives for prudence since the more likely support is perceived to be: money-financed support appears easier and less costly than fiscal support, therefore an overt acceptance of the possibility of money-financed bank support loosens market discipline. This is no different, however, than in the one central bank one fiscal authority case. And the way out is to have a bank support mechanism which entails pain (i.e. loss of jobs) for existing bank management, and possibly some controlled elements of loss for depositors, while providing sufficient support to prevent systemic risks and offset possible deflationary consequences.

Make Financial Markets a Driving force in the EU Economy

Norbert Walter

1. Europe's economy needs efficient and competitive financial markets

If Europe wants to achieve the objective of becoming the most competitive and dynamic economy in the world capable of sustainable economic growth, as defined at the Lisbon European Council in 2000, it needs more efficient and competitive financial markets.

The completion of the EU's single market in financial services is a key target along the way. This will allow full realisation of the potential advantages of the euro in the single currency area, improve capital allocation and lower financing costs. The benefits of reaching the target are real and substantial: completing the single market in financial services may boost EU growth by as much as 1.1% and total employment by up to 0.5%.[1] The EU's manufacturing industry alone has been calculated to gain in excess of 0.75% in value-added if a genuine internal market for financial services is achieved.[2]

These potential benefits must not be withheld from Europe's consumers and enterprises. Rather, the integration of Europe's financial markets has to be pushed forward forcefully in order to achieve and enhance international competitiveness. Driven by the European Commission and the Financial Services Action Plan (FSAP), much has been achieved in this regard over the past months. But the bulk of work still lies ahead.

2. Market fragmentation limits economic development

Financial-market integration in the EU has come a long way. Since the 1980s, a number of important internal-market principles have been applied to key aspects of financial-market legislation, including the freedom of movement of capital, services and establishment. Additional progress has been made by introducing the core rules of mutual recognition, the single passport, home-country control and harmonisation of essential standards in a number of fields. A further essential step was made by eliminating exchange rates among EMU member states and by creating the single currency.

Despite this progress, there are still substantial barriers to cross-border financial transactions within the EU. In practice it has become evident that the degree of cross-border integration is still very low in key markets. For example, while the introduction of the euro created a highly integrated money market, market fragmentation is still strong particularly in retail banking and insurance as well as in

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[1] Cf. "Quantification of the Macro-Economic Impact of Integration of EU Financial Markets", Final Report to The European Commission - Directorate-General for the Internal Market, London Economics in association with PricewaterhouseCoopers and Oxford Economic Forecasting, November 2002, p. *v*.

[2] Cf. Mariassunta Giannetti, Luigi Guiso, Tullio Jappelli, Mario Padula and Marco Pagano, "Financial Market Integration, Corporate Financing and Economic Growth", European Economy, No. 179, November 2002, p. 4.

the issuing and trading of equities, bonds and mutual funds. Payments business and securities settlement still remain geared to national markets.

There are many reasons for the continued lack of integration. Some of them are natural, including the EU's linguistic and cultural diversity as well as specific customer preferences which limit the geographic scope of action for consumers and providers. This diversity represents a marked difference between the single economic area of the EU and that of the US and will remain a barrier to economic integration for some time to come. In addition, product characteristics and market structures that have grown over time, differing across member states and even regions, cannot be changed over night to a European dimension, given legacy systems and the customs of market participants.

Other obstacles to a single market in financial services, however, originate from past actions of policy makers and can therefore be influenced by political action today. It is these regulatory obstacles which should determine the EU's political agenda on financial services, because, first, they do inhibit the development of financial markets and therefore of the EU's economy as a whole. Second, the long-term benefits of completing the single market will, in the vast majority of cases, by far exceed the costs of eliminating these barriers. And, third, the existence and persistence of natural and structural barriers to creating a large, single financial market put the EU at a significant competitive disadvantage to the US anyhow. It follows that compensating this unique disadvantage by exhausting economically viable means to ensure the cross-border freedom of movement for consumers and financial service providers becomes a necessity in the struggle to defend the EU's competitive position in the international economy.

EU financial-market legislation has to tackle three key areas:

- First, in crucial areas of the financial markets, the single-market principles have not yet been harmonised and legally implemented throughout the EU because these areas lack clear-cut regulations on cross-border activities and a level playing field. Examples of this are contract law in the insurance industry and the market for pension funds.

- Second, existing legislation allows a number of exemptions and the possibility to assert divergent national laws in the interest of the general good. Their legitimate use, but also their abuse in protecting national vested interests, can cause friction in the single market. Particularly problematic here are the national regulations on the protection of consumers and investors.

- Third, the rapid advances in financial markets, such as changing market structures and new products, mean that many EU rules have become either incomplete or obsolete and therefore no longer correspond to market realities. At the same time, adjustments to existing EU law require a lengthy march through the entire legislative process. This is illustrated by the example of new financial instruments, such as derivatives, and their treatment in the directives on prospectuses and investment services.

Smooth cross-border financial activity can only be achieved if the EU addresses these issues effectively.

3. The EU's road to the single financial market

With the 1999 Financial Services Action Plan (FSAP), the EU has quite successfully resumed its efforts towards completing the single market in financial services. The EU is scheduled to remove significant barriers and enable consumers and providers to better exploit its benefits by means of more than 40 individual measures which have to be implemented in their entirety in 2005. The deadline for measures pertaining to securities markets even expires already at the end of the current year.

The FSAP has identified four strategic objectives. First, it aims at creating a single European wholesale market. This is the most pressing and ambitious part of the FSAP and includes measures to ease raising capital across the entire EU (e.g. directive on prospectuses), to provide a common legal framework for securities and derivatives markets (e.g. directives on investment services and market manipulation), to promote cross-border corporate restructuring (e.g. directive on corporate take-overs), and to establish a single market for investors (e.g. the directives on UCITS).

Second, the FSAP aims at creating open and secure retail markets. Most importantly, the directives on distance selling of financial services and on consumer credits are intended to alleviate cross-border transactions for the retail customers of financial service providers. Third, it is set to modernise prudential rules and supervision, primarily adapting the existing legislative framework to market realities. Finally, a number of wider conditions for optimising the functioning of financial markets have been devised, featuring efforts at introducing EU-wide rules on taxation and corporate governance.

Despite some recent progress, the EU is running behind schedule in delivering the FSAP. In 2002, the Commission pushed ahead with the Action Plan, so more than two-thirds of the measures have been completed, including important acts such as the regulation on International Accounting Standards and the directives on collateral, distance marketing of financial services, insurance intermediaries and financial conglomerates. On the directives on market abuse, pension funds and prospectuses, important political agreements have been reached. However, with seven major legislative initiatives currently under negotiation and four measures yet to be drafted by the Commission, a great deal of work still lies ahead of the EU. In particular, it is doubtful whether the FSAP's major EU directives can be transposed into national law before the 2005 deadline and especially prior to the 2003 deadline for securities market legislation.

In the latter case, the EU has taken additional steps intended to speed up regulatory activity as well as to ensure efficient and consistent implementation and application of Union rules. Following the recommendations of the Committee of Wise Men chaired by Baron Alexandre Lamfalussy in February 2001, a four-level approach has been devised as a consequence of which securities-market acts are now being designed as framework legislation. Framework directives and regulations are subsequently supplemented by detailed rules for implementation by the European Commission and after consultation with two newly established committees, the European Securities Committee (ESC) and the Committee of European Securities Regulators (CESR). Furthermore, CESR and the Commission have committed to

ensuring efficient and consistent implementation as well as strict enforcement of existing and future securities-market regulation.

Together, the FSAP and the Lamfalussy procedure are two invaluable instruments for pushing ahead with EU financial-market integration. They represent a pragmatic approach towards achieving an ambitious objective: a clearly defined set of measures to be implemented along a pre-defined time-table and – in the case of securities-market legislation – by means of a more efficient legislative process. All the same, the 2003 and 2005 deadlines are nearing quickly, and regulatory practice is showing ever more clearly that completing the single market in financial services will require more work, going beyond the measures foreseen in the FSAP.

4. The way ahead

The EU has come closer than ever to achieving its objective of completing the single market in financial services, but it is not there yet. Considering the size of the potential welfare gains to consumers and companies from reaching the goal, the political momentum created by the FSAP and the establishment of a streamlined legislative procedure must not be lost. In the months to come, the EU therefore has to concentrate on four broad fields of policy-making:

Finalising the FSAP

The FSAP needs to be finalised in time. At EU level, slightly more than a year is left to complete the measures foreseen in the Action Plan. The remaining work programme includes major legislative pieces such as the directives on pension funds, prospectuses, take-over bids, investment services, consumer credit, transparency, company law and insurance solvency. Furthermore, Commission initiatives are expected in the fields of clearing and settlement, corporate governance as well as capital adequacy, i.e. the transposition of Basel II rules into EU law.

Most of the important measures under the FSAP require implementation at the member-state level. Member states should be prepared to take the necessary legislative measures swiftly so as to ensure timely completion by the end of 2005.

At both the EU and the member state levels, legislative, regulatory and supervisory activity in the context of the FSAP needs to be guided by the ultimate objective of achieving an internal market in financial services. Countering measures for the single market on the grounds of protecting particular interests will inhibit the creation of an efficient financial market and will, in the long run, weaken the competitive position of enterprises in the EU.

Operating and extending the Lamfalussy procedure

The Lamfalussy procedure is key to making important measures under the FSAP work, and is likely to bring substantial benefits to policy makers and market participants. In order to capitalise on the new framework, a number of steps need to be taken in the coming months pertaining to the operation of the simplified legislative process as well as to its extension.

As to the operation of the simplified legislative process, CESR, the ESC and the Commission have accomplished an enormous amount of work in the past months.

This success needs to be continued. First, the possibility of delegating implementing legislation to the Commission should, in line with the findings of the Wise Men Report, be used extensively in each piece of securities-market legislation under negotiation. Second, despite their purpose of providing detailed rules specifying the underlying framework principles, implementing decisions, too, should be guided by the overarching objective of an efficient single European financial market and should not lead to over-regulation. Third, timing and sequencing of framework and implementing measures should be set carefully and should contribute to the smooth and efficient handling of legislative work.

Fourth, at both stages of the legislative process, ample scope ought to be provided for consultation with market participants. In order to ensure quality legislation which promotes rather than limits the development of the EU's financial market, the Institutions and Committees should exhaust all opportunities to consult with market participants, taking private-sector concerns into due consideration and explaining legislative steps so as to ensure sufficient *ex post* transparency and accountability in the consultation process.

Fifth, next to legislation and implementation, policy efforts need to be stepped up with respect to improving the consistent application and enforcement of securities market legislation, as suggested by the Wise Men Report. With a growing number of directives adopted at EU level, CESR and EU securities regulators are set to intensify co-operation to ensure their consistent and timely transposition. In the same vein, the Commission will need to devote increasing resources to monitoring and, where necessary, compelling member states to adopt and fully implement EU securities market legislation.

Finally, the potential benefits of Lamfalussy-type legislation must – beyond securities markets – be made available to the remaining areas of financial-market legislation, i.e. to acts related to banking, insurance and conglomerates. Fundamental inter-institutional questions have been voiced in this regard which need to be resolved in early 2003 to enable timely completion of the FSAP before the 2005 deadline, and certainly before EU eastward enlargement may render decision-making even more cumbersome than it is today.

Laying the foundations for a unified regulatory and supervisory infrastructure

The Lamfalussy procedure represents a significant intermediate step towards the completion of the single market in financial services and will, if applied consistently, help improve regulatory and supervisory practices in the EU significantly. In the final analysis, however, the single European financial market necessitates that a single EU regulatory and supervisory authority be established.

Such a European Financial Services Authority (EFSA) needs a strong and autonomous position within the legal order, rooted in the EU Treaty. Its establishment will require thorough preparation over the coming years, but also immediate action today: in the forthcoming revision of the EU Treaty provision needs to be made for the required institutions and procedures so as to enable the establishment of a European Financial Services Authority at a later stage of the unfolding internal market in financial services. Inserting an enabling clause into the new Treaty for creating an EFSA later on should therefore be an important item on

the Convention's agenda if the EU wants, a few years down the road, to avoid major constitutional revisions which are foreseeable today.

Drafting the post-FSAP agenda

Financial-market legislators and regulators will soon need to think farther ahead – beyond the completion of the FSAP. With the complete implementation of the Action Plan, the EU will have made a big leap towards the goal of a single market in financial services, but it is unlikely to arrive there yet. The FSAP does not – and cannot – tackle all of the causes of the fragmentation of the EU's financial market. Diverging national rules remain in place in many key areas, including contract law and consumer protection. In some segments, the single market rules may fail to lead to closer integration. In others, fast-changing market structures and new products will render current rules incomplete or even obsolete.

Approaching the deadline for its FSAP-related legislative activities in mid-2004, the EU will therefore have to consider the next steps. This does not mean that the EU should rush into a new round of financial-market legislation, disregarding the effects and effectiveness of its past actions. Quite to the contrary, a thorough evaluation of the state of development of the single financial market, the performance of the installed legislative, regulatory and supervisory framework as well as a careful analysis of those areas where market fragmentation continues to inhibit the activities of consumers and companies, including a cost-benefit analysis of legislative and regulatory action in these areas, should necessarily precede any detailed planning of the post-FSAP agenda. In pursuing a thoughtful approach, the EU will nevertheless find it useful to maintain the pace set by the FSAP and use the political momentum it has created.

5. Conclusion

At the Lisbon European Council in 2000, the EU gave itself an ambitious economic objective – becoming the most competitive and dynamic economy in the world. The single EU market in financial services is a critical element in the EU's macroeconomic strategy: If the Union succeeds in establishing an efficient and competitive single market in financial services in the foreseeable future, it will clearly have a better chance of reaching the overall economic objective. If, however, the EU fails in the financial markets, failure to become the most competitive and dynamic economy in the world will be inevitable. The stakes for EU financial-market regulation are correspondingly high, and the way to go is clear: completing the FSAP, applying the Lamfalussy procedure intensively and extensively, paving the way for a unified regulatory and supervisory infrastructure, and preparing the EU's post-FSAP strategy.

The pressure on policy makers to succeed in building the single financial market is mounting. So should be expectations on the private sector, which has to seize the benefits of the single market and translate them into growth and economic dynamism. In financial services, consumers and service providers have in many instances failed to do so. Cross-border transactions have remained extraordinarily low, even though regulatory framework conditions have improved dramatically in the past. Many opportunities being offered by the internal market are being missed day by day.

Employment and Employment Policies: What role for Europe?

Juan Jimeno

1. Introduction

The EU set itself ambitious goals in Lisbon, but what instruments does it have to achieve them? What instruments does the EU have to foster employment? Has the open method of co-ordination worked or do we need new EU competences in the field of labour markets and social policies?

The main impact of the European Union on the labour market situation of member countries is made through the European Employment Strategy (EES, hereafter), launched at the Luxembourg Jobs Summit in 1997, and further strengthened at the Lisbon European Council (2000) as one of the basic instruments aiming at making the European Union "the most dynamic and knowledge-based economy of the world, capable of sustainable economic growth while providing more and better jobs and greater social cohesion".

2. The Lisbon goals

The Lisbon European Council established the following targets by 2010: the average aggregate employment rate on the EU should be as close as possible to 70%, the average female employment rate on the EU should be higher than 60% for women. The Stockholm European Council in 2001 set intermediary target of 67% for the aggregate employment rate, and 57% for the female employment rate by 2005, and introduced a new target of 50% for workers aged 55 to 64 by 2010. As of today, there are rather significant differences between the Member States in terms of the level of employment rates reached, and in terms of the pace of improvement towards the fulfilment of these targets.

Looking ahead the EU employment rate targets look like very ambitious objectives. In 2001 the overall employment rate reached 63.9%, the female employment rate was 54.9%, and the employment rate of older workers was 38.5%. The macroeconomic situation in 2002 and the forecasts for 2003 are not favourable to a rise in employment, which according to latest forecasts grew 0.3% in 2002 and is expected (optimistically) to grow by 1% in 2003. Moreover, as population is ageing the weight of the older workers in the labour force is increasing. Since these workers have lower employment rates, the overall employment rate will fall due to a composition effect, if employment rates for this group do not significantly increase.[1]

3. … and how to get there

Thus, more aggressive actions should be taken if those targets ought to be met. In principle, the EES has a sound design. It identifies the main structural problems, grouped them in four pillars (employability, promoting entrepreneurship,

[1] Given EUROSTAT's forecasts on the EU population age structure in 2010, were the employment rates by age and sex specific population groups remain constant at the 2001 levels, the overall employment rate would be at 63.5%, 0.4 percentage points lower than the level in 2001.

adaptability, and equal opportunities in the labour markets), and requires the National Action Plans (NAPs, hereafter), elaborated each year by the governments, to describe actions and measures specially addressed to solve these problems. The diagnosis of the European labour market problems is correct, as it focus on the activation of unemployed workers, job creation, and the adaptability of workers and firms to new socio-economic conditions. It also favours equality in the labour market and the maintenance of an "European social model" in which participation of collaboration of the social agents plays a key role. Finally, it is a good instrument to promote co-operation and co-ordination among the government of the Member States in the area of employment policies, and, in some countries, among the Central and the Regional and Local governments that also pursue employment policies.

In practice, the EES has had some impact on national employment policies, basically by promoting the adoption of active and pre-emptive measures. Over the last five years the employment rate of the EU has increased by about 3.5 percentage points, while the unemployment rate has fallen by almost 3 percentage points. However, it is first difficult to assess to what extent the rise of employment and the fall in unemployment are due to structural improvements in the labour market. Other factors, like the business cycle and the start of the monetary union, have surely affected macroeconomic policies, and, hence, the evolution of employment. Secondly, it is difficult to measure the exact contribution of the EES to the structural reforms being carried out in some countries. The EES puts much emphasis on the description of measures in the NAPs, but less emphasis on the real application of those measures. Thus, there is no much independent ex-post evaluation that could inform the political process about the real effectiveness of the employment policies being pursued by the Member States.

An additional drawback of the EES is the rather complex procedure implementing the strategy. For 2002 there were 18 specific actions under the four pillars, to which the national governments are required to react. Moreover, during the last two years six horizontal objectives have been introduced: i) enhancing job opportunities and providing adequate work incentives so as to raise employment rates in line with the Lisbon and Stockholm targets; ii) ensuring that Member States policies lead to an improvement in the quality of work; iii) increasing participation in education, training, and lifelong learning; iv) promoting comprehensive partnerships with the social partners; v) urging to respect the integrated nature and equal value of the Guidelines across the four pillars and giving adequate attention to the regional dimension; and vi) stressing the importance of strengthening indicators to evaluate progress under all four pillars. With all these listings of pillars, guidelines, horizontal objectives and measures, it is very difficult to assess in which actions are national governments putting more emphasis and to what extent those actions would have been implemented independently of the EES. It also impedes a close follow-up of the application of the NAPs.

4. The challenge: National or European?

Whatever the successes or the failures of EES over its first five years of functioning, the EU's main challenges for the future in this area are: i) to increase employment rates (at a higher pace) to meet the Lisbon and Stockholm targets, ii) to reduce social

disparities in terms of gender, regions, etc., and iii) to rise productivity so as to improve the quality of work and to increase GDP per capita.

The first two challenges require more fundamental structural reforms in the labour market. In a context of population ageing, structural change, immigration, and the existence of deep regional disparities with bottleckness in many sectors and regions while around 13 millions residents of the EU remain unemployed, increasing employment rates requires decisive actions. These actions do not only refer to employment policies, but also to reforms in product, capital and service markets, and in social policies programs, especially pension reforms to delay exits of older workers from the labour market. Labour mobility is also of particular importance to reduce disparities and avoid bottleckness in the labour market. To meet the productivity challenge, some employment policies like training and incentives for workers' lifelong learning could be helpful, but the main sources of productivity growth are accumulation of knowledge and technological progress, something which should be addressed by educational and R&D policies.

All of these areas, employment policies, education and R&D, are mostly in the hands of national governments. Thus, it is difficult to see what can be done from the EU level without interfering with the sovereignty of the Member States. Moreover, the principles guiding social policies and employment policies in each Member State come from different traditions and histories. Thus, not surprisingly, most of the EU initiatives in this regard are of the nature of "promoting co-operation" and "favouring open co-ordination". While these initiatives are to be welcomed and had some impact on policies, they are not sufficient to spur structural reforms in the Member States, as indicated by the experience of the last five years.

5. What needs to be done?

The EES, despite its achievements at changing the political process in this area and improving the weight of active and pre-emptive measures, cannot, by itself, accelerate the pace of structural reforms. However, it could contribute even more to improve the effectiveness of employment policies if some changes are introduced (some of the following have also been recommended by the European Commission)

i) Simplify the structure of NAPs, reducing guidelines and horizontal objectives, to put more transparency to the identification of the main new measures being undertaken by each Member State.

ii) Improve the supervision of the implementation of employment policies included in the NAPs and the evaluation of their effectiveness. Co-ordination with the social agents, co-operation among different layers of national governments (Central, regional, local) and institutional co-operation have been improved by the EES, and new advances could be achieved in this front. However, this is not enough if the effectiveness of policies is not properly evaluated. In this regard, the contributions of the European Social Fund to the EES should be made more transparent and rigorous economic evaluation of programmes should be introduced, so as to put more emphasis in the effectiveness of measures when deciding the distribution of resources devoted to employment policies.

iii) Link the development of employment policies with other measures in the area of social policies. This is particularly relevant in the case of older workers. Pension reforms aimed at increasing the retirement age should complemented by employment policies aimed at eliminating the demand and supply factors that motivate workers to retire early.

Besides the EES, other initiatives at the EU level could be undertaken. First, the improvement of educational systems and the provision of incentives for lifelong learning are the basis for future productivity growth and increasing competitiveness of the EU in the long run. The construction of a knowledge society starts at the school, and training programs and other schemes under the heading of active labour market policies cannot substitute a good school system providing the flexible skills needed in the current socio-economic scenario. Secondly, labour mobility needs to be strengthened. Changing regulations to allow the portability of pension rights across countries has been in the agenda of the European Commission for too long without significant results so far. The introduction of mobility grants to unemployed workers when moving to another country could be a powerful (and, initially, not very expensive) instrument to "grease the wheel of European labour markets". Finally, the growing interdependence of employment and social policies and the arrival of more immigrants call for less dispersion in the provision of social benefits across Member States. In this regard, one possible initiative could aim at the co-ordination of assistance social benefits so that a Pan-European social safety net could emerge in the long run.

Fiscal Policies in the European Monetary Union

Charles Wyplosz

1. Introduction

The European Monetary Union is an unprecedented achievement. By deciding to abandon their currencies, a number of countries have given up a very significant element of sovereignty. They have relinquished control over a crucially important economic policy instrument, but they have also shed one of the key symbols of statehood. This step has been the object of extremely detailed preparations which left little room to improvisation.

Yet, one gaping hole in the overall construction remains: the conduct of fiscal policy in the Monetary Union. The framers of the Maastricht Treaty seem to have been mainly pre-occupied by the need to guarantee fiscal discipline. Fiscal discipline represented a key entry condition, but what would happen after? The main reference to the conduct of fiscal policy is the European Treaty's Article 104, which aims at making permanent the entry conditions. The Stability and Growth Pact provides for the implementation of Article 104.

The Treaty and the Pact are largely silent on the other aspects of fiscal policy. The organizing reference is Article 99: "Member States shall regard their economic policies as a matter of common concern and shall coordinate them within the Council". A number of observers and policymakers have concluded that a formal process of fiscal policy coordination is required to match the Eurosystem.

This note reviews the arguments presented in the debate. It concludes that the economic gains from fiscal policy coordination are limited and the political costs are high, that the Stability and Growth Pact does not contribute to coordination and is the wrong approach to budgetary discipline. It suggests an alternative approach that relies on national institutions instead of a rigid rule enforced by "Brussels".

2. The role of fiscal policy in a monetary union

National authorities dispose of two instruments to deal with macroeconomic disturbances, monetary and fiscal policies.[1] In the monetary union, having given up monetary policy, fiscal policy is the only remaining instrument. If economic conditions were to be the same in all euro area countries, the loss would be mostly symbolic since a well-managed ECB would mimic what each national central bank would, or should do. The situation is different if economic conditions differ, the case of asymmetric shocks where the ECB actions are necessarily ill-adapted to the needs of at least some countries. In this case, fiscal policy becomes crucial. The flexibility and effectiveness of fiscal policy are understood to be limited, certainly inferior to monetary policy, but that is all that is left. Ideally, it should help stabilize macroeconomic conditions in every country.

[1] There has always been a fierce debate about whether either of these instruments is effective as a stabilisation tool, and the debate still continues. I assume that each instrument has *some* role to play, without taking stance on its effectiveness or speed of action.

Irrespective of whether the shocks are symmetric or not, one country's fiscal policy affects conditions elsewhere. For example, if Germany's fiscal policy succeeds in raising growth there, it will also raise exports and therefore growth elsewhere in the euro area. This can be welcome where growth is weak, but unpleasant where the economy is already booming. The first group of countries will wish more German action, the second group will ask for no action, or the opposite action. This is the first case for fiscal policy coordination. It is fairly general, but stronger in the case of a monetary union. Indeed, the other countries could offset unwanted or insufficient action in Germany by appreciating or depreciating their currencies, an option eliminated with the single currency.

The second case for fiscal policy coordination, specific to a monetary union, arises from the fact that all euro area countries now share the same interest and exchange rates.[2] Inasmuch as national fiscal policies affect these rates, the impact spreads throughout the whole area. Put differently, along with the common monetary policy, it is the combined action of all member countries, the overall fiscal stance, that determines the euro interest and exchange rates. In this view, each country's fiscal policy, which contributes to the overall stance, should be a matter of common concern.

The third case for common concern is of a different nature. It concerns the risks created by fiscal indiscipline. The fear is that a national government may be unable to service its debt and forced to default. Art. 103, which rules out any bailout, provide little solace since a default by one country could well trigger an adverse reaction in financial markets and result in a generalized loss of confidence. Interest rates would rise, the exchange rate would depreciate and heightened uncertainty would depress asset prices. This not a case for coordination *stricto sensu* but for measures designed to prevent indiscipline. This is what the Stability and Growth Pact is all about.

3. The Stability and Growth Pact approach

The Stability and Growth Pact (SGP) rests on a rule – deficits are not to exceed 3% of GDP except under precisely defined circumstances – and on an enforcing mechanism, the Excessive Deficit Procedure. Its key characteristics are a focus on annual budget deficits, a single quantitative and asymmetric rule, a highly restricted escape clause, and implausible sanctions imposed from outside. Each of these elements is problematic.

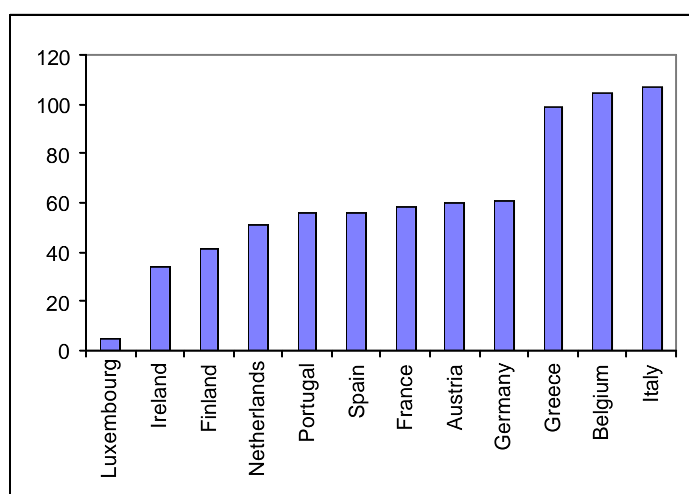
- Fiscal discipline is an elusive concept. Formally, it is an intertemporal constraint: it relies heavily on future actions since a deficit today can be matched by a surplus tomorrow, which may be good policy. The SGP's focus on annual budgets balances, by preventing most intertemporal burden-shifting, imparts an important degree of rigidity to the SGP.

[2] The ECB controls the short-term interest rate, but the long-term rate may be influenced by fiscal policies.

- The SGP's 3% limit is arbitrary. It is based on back-of-the-envelope calculations of the link between the 60% debt limit[3] and feasible budget balances. It is sometimes related to the German Golden Rule, which considers that it is all right that public investments – presumed to average 3% of GDP – be financed through borrowing. But the border between public spending and public investment is fuzzy, and there is no guarantee that public investments generate a rate of return that matches the cost of borrowing.

- The 3% limit applies to each and every country irrespective of its debt situation. flies in the face of common sense. As Figure 1 shows, some countries are saddled with huge debts while others can afford some slippage. Furthermore, if wisely designed, public investment is likely to be more productive in some countries – this will be the case in many of the accessing countries – than in others. Both points are acknowledged in the Commission's proposals of November 2002.

Figure 1. Debts as% of GDP in 2002 (Maastricht definition)



Source: *Economic Outlook*, OECD, December 2002.

- The SGP's approach to enforcement is to privately (peer pressure) and publicly (the excessive deficit procedure) embarrass delinquent governments, and eventually to impose a fine. External sanctions conflict with political legitimacy and would generate deep "anti-Brussels" resentment. Fines, in particular, elicit bad memories of war reparations and are unlikely to be imposed. If this assessment is correct, much of the SGP's alleged rigor evaporates.

- The SGP is asymmetric. It can only be binding during downturns, during which fiscal policy may have to become pro-cyclical, preventing the operation of the automatic stabilizers. This flaw too has been recognized, prompting two additional measures.

[3] The 60% public debt limit is also included in the SGP. In 2002, the euro area debt amounts to 71.4% of GDP, four countries have debts above 60% and three more have debts above 57%. Pragmatically, this limit has been ignored so far.

First, the SGP includes a non-binding presumption that budgets will be kept close to balance or in surplus in normal conditions. This is designed to allow for enough room for the automatic stabilizers to fully operate. On current estimates, unfortunately, the automatic stabilizers are too weak.[4] Second, in case of a serious recession, the 3% rule is suspended. What constitutes a serious recession is made more precise by two thresholds, which correspond to deep and rarely observed recessions.[5] The thresholds miss the less dramatic, yet highly uncomfortable slowdowns that concern governments and citizens alike.

4. Is there a need for coordination?

While the SGP fails to offer an adequate solution to the need for budgetary discipline, is the absence of formal coordination problematic? The first case relies on the effect of the budget on cyclical conditions. These effects are sizeable only when they originate in large countries. Even then, it should be the case that many large countries act in the same direction at about the same time. If it is the case that cyclical conditions are synchronized among the large countries, then the smaller countries are bound to share the same cyclical conditions. In that case, coordination would not be needed to agree on the direction of fiscal policy action – expand or contract – but on the dosage, an issue of secondary importance.

The second case for fiscal policy coordination arises from the effects on the euro interest and exchange rates. This is a dead end. The euro area is widely integrated in world financial markets, so a little more or less public borrowing is unlikely to impact the interest rates. Regarding the exchange rate, there is currently no good understanding of the link from fiscal policy to the exchange rate, and zero empirical evidence.

This is not to deny that policy makers from the euro area need to inform each other of their actions, present and planned. Coordination is a much higher order of complexity, for it means that each government is willing to modify its policy to adjust to other government actions. This is wholly unrealistic. Having lost the monetary policy instrument, individual countries need budgetary flexibility. They must be able to use fiscal policy to cope with country-specific shocks. Furthermore, in each country, the decision process regarding the budget is highly political. It is already difficult to achieve reasonable policies when massive domestic political and economic interests come to bear on the decision process. Euro area considerations are unlikely to carry any weight, at least in the large countries which determine the overall stance. It makes little sense, therefore, to invest political assets in such an ultimately hopeless goal.

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[4] Rough estimates suggest that, on average, the automatic stabilizers lead to a deterioration of the budget of some 0.5% of GDP for any 1% decline of GDP. So, in principle, starting from a position of balance, the automatic stabilizers will keep deficits below 3% for a slowdown as deep as 6%. The problem is that, on average, a 1% increase in the budget deficit (or reduction of the surplus) boosts GDP by about 0.5%. The automatic stabilizers thus cushion the slowdown only by one quarter of the initial shock.

[5] Since 1961, in the EU an annual GDP decline in excess of 2% (the automatic threshold) has been observed in 1.3% of all cases, while declines between 0.75% and 2% (the presumption threshold) occurred with a probability of 4.1%.

5. A better way

In the end, fiscal discipline is the only concern that merits serious collective attention. If the SGP is inadequate, is there a better way? Three observations suggest the direction to explore. First, any strict rule eventually becomes counterproductive: by design, rules prevent common sense to be applied in presence of unforeseen events. Well designed institutions work better than rules by presenting policy makers with adequate incentives while resting on good judgment to deal with unexpected events. Second, there cannot be a universal fiscal policy quantitative rule/objective; as Figure 1 reminds us, Italy differs from Luxembourg. Third, legitimacy for fiscal policy is national, so this is the level at which discipline must be enforced.

How central banks do it

The challenge faced by central banks is fundamentally similar to that of fiscal authorities, even though monetary and fiscal policies are very different in nature and scope. Both face an apparent contradiction between long-run discipline and the need for shorter-run flexibility. Central banks aim at price stability in the long run, while taking some responsibility for dealing with business cycles and financial disturbances. Fiscal policy must aim at long-run debt sustainability while being available to deal with cyclical fluctuations. In both cases, the shorter-run concerns should not be driven by inappropriate political considerations.

In the case of monetary policy, the solution to these apparently conflicting goals has been to make central banks independent from the political authorities and simultaneously to give them a mandatory long-run mandate. Modern central banks are now run by independent experts who are called upon to exercise judgment when cyclical difficulties arise. Throughout the world, independent monetary policy committees (MPCs) balance with great skill their short and long run objectives. They have proven that independent experts can deliver both.

How to combine fiscal discipline with short-term policy flexibility

A few annual deficits do not matter, the concern is that continuous deficits result in a public debt that cannot rolled over forever. Discipline is achieved when, over a long horizon, the public debt is maintained at – or brought down to – an acceptably low level, typically in proportion to GDP. In order to maintain short-run flexibility for counter-cyclical policy, the horizon used to define debt sustainability must be sufficiently long, at the business cycle frequency (five years or more).[6]

There is no agreed-upon definition of an optimal public debt level. It depends on the initial condition and on an assessment of the very long run, although most euro area countries currently have clearly excessive debts (which also vastly underestimate future liabilities associated to the ageing problem). Obviously, the target should be different for each country. Countries with reasonably low debts may simply wish to stabilize or reduce them moderately. Countries with high debt levels should

[6] The horizon can be defined *ex ante* to give credibility to the target, but business cycles are known to be irregular in size and length. This would require allowing for some margin in judging whether the set target is reached. Alternatively, judgment could be made *ex post* over completed cycles, which are fairly straightforward to identify.

endeavor to bring them down cycle after cycle, and not year after year as with the SGP.[7]

National fiscal policy committees

Following on the central bank model, each country is to establish a Fiscal Policy Committee (FPC) composed of independent experts. Each national FPC is to be given a precise mandate, debt sustainability in the form of a long run debt-to-GDP target and the exclusive authority to set each year's deficit.

In order to be an acceptable alternative to the SGP, this arrangement must provide a guarantee that it will effectively deliver fiscal discipline. The statutes need to include formal independence from political powers, the principle of a mandatory long-run debt objective, and procedures to enforce FPC decisions and to hold the FPC accountable. The statutes of the national FPCs must be harmonized (as is already the case with national central banks). Even if they may not be identical, they ought to fit into precise terms of references to be jointly decided at the outset. Second, each country's long-run debt target (as a proportion to GDP) must be approved by all euro zone members, taking into account the starting position and any relevant particular condition.

Such an arrangement implies that the national government and parliament do not control anymore the deficit decision. It is important to observe that they retain joint authority for deciding on all the other budget parameters: the size and structure of public spending and the tax structure. This may seem radical and politically unacceptable, but on further inspection it should not. The reason why fiscal policy must be under direct political control is that it powerfully redistributes income. The important choices here concern the size of government, the design of public spending programs and the structure of taxation. Budget deficits, in contrast, have negligible redistribution effects.[8] Taking the deficit and the debt out of the standard political process does not imply any loss of democratic control where it is fully justified. The macroeconomic aspect of fiscal policy is no different from that of monetary policy which is delegated to experts.

How it would work

At a suitable frequency[9], national governments would propose to the Eurogroup a debt to GDP definition of debt sustainability. Countries with large public debts would have to commit to a sizeable reduction, countries with low debts would be given more freedom, countries with huge public spending needs (e.g. the UK and most accessing countries) could make a case for some debt increase.

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[7] The November 2002 Commission proposal to look at annual structural deficits wholly misses that point. In addition, measuring the structural deficit is a highly imprecise exercise, open to endless litigation if it were to be used as the basis for imposing fines.

[8] Deficits redistribute income across generations, most of which are not yet born and play no part in democratic control. This is one additional reason to remove this decision from political control which seems to suffer from a deficit bias that harms future generations.

[9] Ideally, this would be done every 5-6 years, following the logic of business cycles (and, say, UK practice in setting the inflation target. An alternative would be to set the target at the beginning of a legislature, following the logic of political mandates derived from elections. Other arrangements are conceivable, e.g. on the basis of officially measured cycles.

Each year, before the budget cycle, the national FPC would issue its decision regarding the deficit (or surplus) that must figure in the budget law submitted to and accepted by the parliament. The FPC would have to publicly document its decision: its growth, unemployment and inflation forecast, how the proposed deficit fits into the debts sustainability target, and an evaluation of the risks associated with the forecasts.

During the fiscal year, the FPC – which would be backed by an adequate staff – would monitor the evolution of the budget and of general economic conditions. In case of slippage, it would either be requested to approve, and gives its reasons for approving, the slippage, or be empowered to issue an order aimed at correcting the budget. The government and parliament would have to conform, which means agreeing to spending cuts or tax increases, at their own discretion. In case the government and parliament fail to adjust appropriately, the FPC would have the right to impose mandatory spending cuts.

After the fiscal year, the FPC would audit the budget outcome. If a slippage were to emerge, the FPC would be expected to take it into account regarding the following year's budget execution. With a fixed horizon target, bygones cannot be bygones.

Each national FPC would have to be accountable to both its legislature and to the Eurogroup. Vis-a-vis the legislature, a failure to deliver the debt target would be considered a violation of its mandate and would lead to a dismissal[10]. Vis-a-vis the Eurogroup, the FPC's recommendations would be scrutinize and the Eurogroup could issue comments and warnings.

Advantages

The proposed arrangement is simple and transparent. A debt target is easy for the public to understand and for the authorities to justify. The FPCs will operate in full light and will have a strong incentive to explain their decisions.

The arrangement combines short-run flexibility with long-run discipline. Like MPCs, FPCs will be able to exercise expert judgment in the face of unexpected shocks, balancing short-run and long-run objectives. FPCs must be accountable to their respective national parliaments, but only for their compliance with the long term mandate.

Importantly, the proposed arrangement fully restores national sovereignty over fiscal policy. There is no need anymore for the politically-charged, Brussels-led excessive deficit procedure. Each country owns its FPC and its debt target. The only restriction is that the debt targets will have to be agreed upon at the euro area level. That would allow to take into account each country's situation: the debt targets, and the associated stream of budget balances, no longer have to be uniform.

[10] An interesting question, not pursued here, is whether FPC members are individually or collectively responsible. This would affect both the information about its deliberations and the sanctions in case of violation.

How to improve economic governance?

The Coordination of Macroeconomic Policies in Europe

Lorenzo Bini Smaghi and Guido Tabellini

1. Introduction

With the Maastricht Treaty the European Union made a clear decision concerning the institutional framework underpinning the process of economic and monetary integration. On the monetary side, sovereignty was transferred at the Union level, with the creation of a European Central Bank in charge of taking decisions and implementing a single monetary policy. On the remaining aspects of economic policy, in particular budgetary policy, sovereignty was kept at the national level, although bound by coordination mechanisms and procedures.

The coordination between the member countries' economic policies is based on three pillars. First, the Stability and Growth Pact (SGP), signed by the member states in 1997, which aims at ensuring budgetary discipline and avoiding excessive deficits, as requested in the Treaty. Second, the Broad Economic Policy Guidelines (BEPGs), a document published each year in June, setting the main policy objectives for the euro area and the member countries. Third, the Eurogroup, an informal version of the Ecofin council, restricted to euro area countries, is the forum where coordination between the countries' budgetary policies, and between the latter and the single monetary policy, is expected to take place.

This paper concentrates on the Eurogroup. It examines how it has functioned since its inception and whether there are grounds to strengthen its role, in particular by formalizing its functions in the Treaty as suggested by some in the context of the Convention. The analysis looks in particular at the additional powers that could be given to the Eurogroup, and whether this would be consistent with an efficient functioning of Economic and Monetary Union (EMU).

We conclude that fiscal policy should remain largely decentralized, and there are no valid grounds for transferring powers away from member states towards the Eurogroup. Some reallocation of tasks is nevertheless desirable, but between the Ecofin Council and the Eurogroup. In particular, it could make sense to reformulate the SGP so as to apply it mainly or exclusively to EMU countries. Once this is done, the Eurogroup could acquire a formal competence in administering and implementing the SGP.

The outline of the paper is as follows. Sections 2 and 3 describe and briefly assess the current functioning of the Eurogroup. Section 4 discusses whether it would be desirable to reallocate fiscal policy tasks away from member states and towards the Eurogroup, while section 5 discusses the reallocation of tasks away from the EU (or rather the Ecofin Council) towards the Eurogroup. Section 6 concludes and formulates some recommendations.

Glossary

Ecofin: EU Council of Finance Ministers, currently at 15; Accession countries will participate as observers from the second half of 2003. Meets once a month. Sit at the main table the Finance Minister, his deputy and the country's Permanent Representative at the EU. Presided by the Finance Minister of the Country holding the Presidency.

Eurogroup: Informal group, composed of the Finance ministers of the 12 members of the euro area. The Commission and the ECB are also invited to participate. Meets the evening before the Ecofin. Sit at the table the Finance minister and his/her deputy.

Economic and Financial Committee (EFC): Committee composed of Finance Ministers and Central Bank Governors' deputies, representatives of the Commission and the ECB. Meets once a month, prior to Ecofin. Chaired by a Finance Ministries' representative for two years. Prepares the meetings of the Ecofin and Eurogroup.

Coreper: Committee of the Permanent Representatives at the European Union. In charge of formally preparing the Council of Ministers' meetings. For the Ecofin this task is largely conducted by the EFC.

BEPGs: Broad Economic Policy Guidelines. Document published in June, after endorsement by the European Council, prepared by Ecofin. Defines the main macroeconomic and structural policy guidelines for the EU, the euro area and individual countries. The Commission publishes an implementation report six months later.

2. The functioning of the Eurogroup

The Eurogroup was created in 1997, following a French proposal, in parallel with the adoption of the SGP. The intention was to create a restricted forum for dialogue with a view to strengthening the coordination of economic policies and the dialogue with the ECB. The Ecofin could not perform such functions satisfactorily because: i) it is not restricted to euro area participants; ii) its formal nature and the large number of participants would not favour frank exchanges of views; iii) the ECB would not engage in an open dialogue in such a formal body.

The proposal was initially resisted, in particular by those that feared that the new group (initially called Euro-11) could represent a threat for the independence of the newly established ECB. It was also resisted by some countries that did not initially adhere to the euro, in the fear that this would establish a strong inner core of countries that would dominate the discussions on economic policies, including in those areas, such as taxation or structural policies, that are related to the implementation of the internal market, which is an undertaking of the whole European Union.

The proposal was finally adopted, with two proviso. First, the Eurogroup would remain informal, and thus not take formal decisions. Decisions would continue to be taken only by Ecofin, where all EU countries participate. Second, the technical preparation of the Eurogroup discussions would take place mainly in the Economic and Financial Committee (EFC), and thus involve also representatives of countries outside the euro area.

The Eurogroup is composed of the Finance Ministers of euro area countries. The ECB President and the Commissioner in charge of Economic and Financial affairs are invited to participate to the meeting. The attendance is restricted to the above persons, accompanied by at most one additional person, generally the Treasury representative in the EFC. The President and Secretary of the EFC also attend. The Eurogroup is chaired by the Minister of the country holding the EU presidency. In case the Presidency is held by a non-euro area country, the Presidency is held by the country having the next Presidency.[1]

The composition and nature of the Eurogroup entail substantial differences with the Ecofin. Attendance is restricted and excludes the permanent representatives at the EU. The preparation of the meeting is exclusively in the hands of the EFC, rather than Coreper, the Committee of the permanent representatives. The Commission, not being a member, has formal no right of initiative. When it deliberates, for instance in the form of statements, the Eurogroup does so on the basis of work conducted by mainly the Presidency and the EFC. The Commission only provides input on request.

The Eurogroup typically meets on the eve of the Ecofin meeting. The items discussed are the economic and financial conditions in the euro area and in the other main partners, budgetary policies, also in light of the SGP, the mix between monetary and budgetary policies, occasionally exchange rate developments, the changeover to the euro, structural policies.

Typically, each meeting starts with a review of the economic situation, based on presentations by the President of the EFC, the Commission and the ECB. The review considers developments in the real economy, financial markets and most recent policy developments. There are regular discussions on the budgetary stance of major countries. The main lines of countries' budget policy intentions are discussed generally in July, ahead of the presentation of national budgets. A review also takes place in the fall, in parallel with budgetary discussions, and early in the year, when stability programmes are discussed and assessed. Discussions on budget policies also take place before the BEPGs, in May and June. The difficulties experienced in the last few years by the largest euro area countries in implementing the recommendations of the SGP increased the frequency of discussions on budget policies in the Eurogroup.

The Eurogroup discussed intensively the cases in which the implementation of the SGP have led to formal decisions. In early 2002, it discussed the Commission recommendations to give early warnings to Germany and Portugal, in view of the risks that these countries' budgets could breach the 3 per cent reference value. On that occasion, an intense discussions among ministers led to the decision not to issue an early warning. The two countries adopted firm policy commitments and the Commission withdrew its proposal of giving an early warning. The next day Ecofin ratified the Eurogroup decision.

[1] For instance, in the second half of 2002, with Denmark holding the EU Presidency, the position of Eurogroup President was held by the Greek Finance Minister, since Greece holds the Presidency in the first semester of 2003.

Similar intense discussions took place on the occasion of the launch of the Excessive deficit procedure against Portugal and Germany at the end of 2002 and the early warning to France in January 2003.

The Eurogroup discussed on several occasions the interpretation of the SGP, also in light of repeated criticisms raised in public debates. In October 2002, the Eurogroup issued a statement in which it endorsed the proposal by the Commission to assess progress towards the objective of a budgetary position “close to balance or in surplus” on the basis of the cyclically adjusted deficit. The required yearly minimal reduction of the deficit should be at least 0.5 per cent of GDP. The proposal aimed at taking into account the impact of economic developments on budgetary targets and outcomes. By previously focusing only on nominal budgetary targets and deadlines for achieving balanced budgetary positions, the SGP had lost credibility since targets were consistently not achieved and postponed, partly as a result of the unexpected growth slowdown. Aiming at yearly adjustment efforts in cyclically adjusted terms is easier to monitor and avoids pro-cyclical policies.

At each Eurogroup meeting, the President of the ECB describes the latest assessments by the Governing Council of the underlying situation in the euro area and of the reasons for the latest policy decisions. The ECB stated at the first Eurogroup meeting that it did not intend to enter into ex-ante coordination, revealing policy intentions or speculating about possible trade-offs between monetary and budgetary policies, since this would jeopardise its independence. Coordination could thus only be limited, on the ECB side, to exchange of information about current developments and assessments.

In the first two years of EMU, the Eurogroup often discussed developments in the foreign exchange market, in view of the continuous depreciation of the euro. The Eurogroup issued several statements indicating that the value of the euro did not reflect underlying fundamentals and pointed to the potential for appreciation. The Eurogroup also defined the modalities for the coordination with the ECB in the monitoring of foreign exchange markets, in the dialogue with the US and Japan, especially in case of concerted intervention.

The President of the Eurogroup represents the euro area, together with the President of the ECB, at G7 meetings, when surveillance of the world economy is discussed. The preparation of these meetings takes place in the meeting of the Eurogroup preceding the G7 meeting.

Another topic that has been discussed at Eurogroup meetings is structural reforms, in light of the need to increase the growth potential of euro area economies. Comparison of experiences on issues such as tax reform, labour markets, pensions have taken place.

The output of the Eurogroup meeting is a common view on the major issues for the euro area, in particular on the implementation of the SGP, on budgetary discipline, on exchange rate developments. This shared view is presented by the President of the Eurogroup in the press conference that follows the meeting and some times in statements.

3. An assessment

Looking at its first 4 years, the Eurogroup seems to have been successful mainly in crisis management, in particular with respect to the implementation of the SGP. Success is understood here to mean the ability of the euro area countries to express a common position.

As mentioned above, the implementation of the SGP led to several decisions on whether or not to recommend some countries to change their budgetary policies. The initial recommendation of the Commission did not always meet the consensus of the members. In January and February 2002, the proposal to give an early warning to Germany and Portugal, in view of the risks to breach the 3 per cent limit received a divided support among member states. After a long night, the agreement was reached that the two countries should make explicit policy commitments to take measures aimed at avoiding to breach the 3 per cent limit, so as to enable the Commission to withdraw its recommendation. The informal nature of the discussions was essential in making Ministers express their views openly and understand each others' positions. This could not have been possible in the Ecofin, where more than 100 people attend.

Intense discussions took place ahead of the launch of the excessive deficits procedures against Germany and Portugal and of the early warning to France, in the course of 2002 and 2003.

In the exchange of information on national budget policies, the experience has been relatively positive, as Ministers have had the occasion to explain the broad philosophy underlying their policies, the main objectives, the difficulties in implementation. This has helped understand better each other point of views. Here also, peer pressure worked well on several occasions, when countries were tempted to relax policies. For instance, after the Austrian elections, in 2000, the new Government aimed at a larger budget deficit, close to 2 per cent of GDP. The intense pressure in the Eurogroup led the Government to change direction, achieving balance in the following year.

The attempt to coordinate specific policy responses to external shocks has been rather unsatisfactory. In Versailles, in September 1999, euro area countries tried to engineer a common tax reaction to the sharp increase in oil prices. Although the intention was publicly stated, subsequent national reactions were quite different.

On broader policy response, the Eurogroup has still some difficulty to look at the overall policy stance in the euro area as a whole. The different positions across countries and the closeness to the 3 per cent reference in some cases prevents a euro area approach to budget policy. For instance, the deterioration in the environment during the Summer 2002 and the fear of a war in Iraq did not spur a decision on a common policy view. The recommendations of the BEPGs agreed in June, although clearly unrealistic, especially with respect to the commitment to achieve a budget position close to balance by 2004, were still considered formally valid in the fear that a reopening of the discussion could be interpreted as a relaxation of the SGP. Even the proposal of the Commission to postpone to 2006 the objective of close to balance did not receive consensus.

The exchange of information between the monetary and budgetary authorities has been rather scanty, given the unwillingness of the ECB to exchange views in a forward looking manner. The difficulty to commit the ECB Council, whose decisions are taken by 18 members, has been a factor. The ECB President is rarely in a position to express clear views about future monetary policy developments. As a result, the exchange of information that takes place in the Eurogroup seems weaker than the one that was taking place within individual countries between the central bank and the finance ministry before EMU.[2]

On exchange rate policy and external representation, the Eurogroup achieved progress, although not fully satisfactory. On the external value of the euro, the Eurogroup succeeded, not without some difficulty, to implement some discipline in statements by its members. This discipline would have to be tested also in a scenario in which the value of the euro strengthens.

On external representation, the rotating presidency every 6 months does not allow the President of the Eurogroup to represent a credible interlocutor for the US and Japanese counterparts. Each Eurogroup President has just one or two chances to attend G7 meetings, and so do their deputies. This is clearly insufficient to implement a continuous dialogue with counterparts and to defend in a credible manner the interests of the euro area.

Furthermore, the Eurogroup and ECB Presidents attend only part of the G7 meeting, the one dedicated to surveillance, and is not present when other international financial issues such as crisis prevention and resolution, IMF issues, etc. are discussed. This practice, which diminishes the role of the euro area, will continue as long as the broader issues of financial stability remain in the exclusive competence of member states and as long as coordination remains largely of an informal nature. This is an issue which is also being discussed in the Convention.[3]

The Eurogroup has not performed very well in addressing issues of a more structural nature. Part of the reason is the failure to link budgetary policies and the policy mix with the need to increase the growth potential of the euro area economy through structural reforms. Some difficulties in establishing clear monitorable targets are also at the origin of the little progress made in this area. Another problem is also that Finance ministers are not the only ones responsible in their countries for structural reforms.

Overall, the Eurogroup seems to have been successful in addressing specific problems related to budgetary policies in some member states. It has been less successful in addressing area specific issues, such as the slowdown of the economy or facing an oil shock. This may partly be due to the intergovernmental nature of the organisation and the difficulty to coordinate budget policies in a situation in which starting positions differ widely. The ability to represent externally the interests of the euro area has also been rather limited.

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[2] See Bini Smaghi, L. and C. Casini (2000), "Monetary and Fiscal Policy Co-operation: Institutions and Procedures in EMU", *Journal of Common Market Studies*, n.38 (3), pp. 375-391.

[3] See Bini Smaghi, L. (2003), "A Single EU Seat at the IMF?", mimeo.

Some proposals have been put forward to strengthen the role of the Eurogroup and to equip it better with a view to achieve its objectives. Before addressing this practical issue, we should ask which decisions should be managed at the level of the Eurogroup. There is no point in creating a new Council formation without any decision making power. At present there are no explicit decisions by the Ecofin Council that are confined exclusively to euro area countries, with the possible exception of sanctions in case of repeated excessive deficits. The current institutional set-up can be changed, if the allocation of competencies is changed in the Union. The allocation of new powers to an EuroEcofin could arise in two cases: first a transfer of powers from the member states to the euro area; second, a transfer of powers from the European Union to the euro area, for policies affecting the latter countries. These issues are examined in the next two sections.

4. Do we need more centralisation of fiscal policy among EMU countries?

The theory of fiscal federalism suggests that tasks that entail large spill-over effects across localities, or large economies of scale, ought to be centralised. Decentralisation is instead efficient if heterogeneity of preferences or of information is relevant. The traditional theory of fiscal federalism assumes benevolent governments, and focuses exclusively on the conflict of interest among different jurisdictions. If governments also have political concerns or face other incentive constraints, then these should be taken into account when discussing optimal task allocation.

It is useful to distinguish between three different types of fiscal policy instruments: A) the structure of taxation or specific tax rates, B) public infrastructures and public investment projects, and C) aggregate demand management

A) The structure of taxation

Currently, the power to tax resides almost entirely with national and local governments. While VAT tax bases are to a large degree harmonised, all other tax bases and rates are set unilaterally by Member States. Proponents of additional centralisation argue that this is inefficient because national governments have an incentive to engage in tax competition to attract mobile factors of production, producing a race to the bottom. The validity of this argument is best discussed separately for three types of taxes: personal income taxes, taxes on income from financial assets, and corporate income taxes.

Nobody is seriously arguing that personal income taxes should be centralised. The tax base is fairly immobile, and heterogeneity of preferences and local conditions is obviously very large.

Taxes on income from financial assets are at the opposite extreme. Since financial capital is very mobile and responsive to tax incentives, tax competition in this area has the potential to be very disruptive. The best solution would be to induce member states to exchange information on assets held by individual residents of other Member States. This would enable all countries to enforce the “residence principle” of taxation (individual financial income is taxed by the country of residence, irrespective of where the financial assets are held), thus side stepping the need to centralise tax rates. But since decisions on these matters are taken by unanimity, the

opposition of a few small member states has prevented reaching the first best. After long and tiresome negotiations, the EU has just agreed that 12 member states will fully exchange information on non-residents savings from January 2004. Luxembourg, Austria and Belgium (together with Switzerland and a few small off-shore tax centers) will instead levy a flat withholding tax of 15% on the income earned on non-residents savings, gradually rising to 35% from 2010 onwards. This agreement is a step in the right direction, but it illustrates the problems of unanimity rule, as opposed to decisions by qualified majority.

What about corporate income taxes? Here the conclusion is more controversial. Physical capital is clearly more mobile than labour. Hence, tax competition can induce governments to over-tax labour and under-tax capital, relative to what would be efficient and equitable. Since labour markets are far from competitive in Europe, high labour-income taxes reinforce other distortions that produce inefficiently high labour costs and high unemployment. This is the valid argument in favour of some centralisation of corporate income taxes. But there are valid counter-arguments too. Governments lacking credibility may have an incentive to over-tax capital and under-tax labor (the so called capital-levy problem). In this case, tax competition and the discipline offered by the threat of capital flight can actually help governments solve difficult commitment problems.

These considerations on task allocation have a practical implication for the design of European Institutions. How should governments decide on these matters? Advocate of more centralisation ask for more decisions by qualified majority. Opponents are in favour of the status quo, namely decisions by unanimity. The previous discussion suggests that qualified majority could be applied to indirect taxation, where tax rates are already largely harmonised, and to tax rates on the income from financial assets, to overcome the hold up problems discussed above. In all other cases, unanimity should be preserved, with one exception. In matters of corporate taxation, a standardised definition of the tax base could also be taken by majority rule. But the arguments for extending qualified majority also to corporate tax rates are weaker: heterogeneity in preferences here is bound to the high, and governments may have distorted incentives to over-tax corporate income. Concerning taxes on financial income, the need to take decisions by qualified majority would disappear if indeed the European Union were to move to the residence principle of taxation.

Finally, these matters of tax policy are not pertinent to EMU only. To the extent that there is centralisation, it should be to the level of the EU rather than the euro area.

B) Public infrastructures and public investment projects

Some public investments in transport infrastructures are classic examples of projects with large economies of scale and high spill-over effects. As such, these projects ought to be jointly planned and financed. Nevertheless, the resources absorbed by these kinds of projects are unlikely to be relevant for the economy. While the case for centralisation here is strong, it really concerns specific decisions that are best decided on a case by case basis with a careful cost-benefit analysis. Moreover, with the possible exception of TENs (Trans European Networks) the group of countries likely to be affected is typically smaller than the whole EU. Institutionalising all public investment decisions at the level of the EU seems clearly inappropriate. Again, this

has nothing to do with EMU, so the EuroEcofin would have no reason to be involved a fortiori.

C) Aggregate demand management

Countries that joined EMU have given up monetary policy. Since the European business cycle is far from synchronised, this is already a big constraint on counter-cyclical stabilisation. They only have one tool left with which to stabilise their economies in the face of country specific shocks, namely fiscal policy. This is the simple but basic argument in favour of keeping fiscal policy largely in the hands of national governments.

What are the arguments in favour of fiscal policy coordination? Two arguments are often made. First, a coordinated fiscal policy response might be appropriate to cope with *aggregate shocks*. Second, fiscal policy coordination might be needed to internalise *spill-over effects*, to the extent that economic shocks or policy responses in one locality are felt by other localities (for instance, a fiscal expansion in times of recession undertaken in one country spills over in the form of additional demand stimulus in its trading partners).

Neither claim holds much water, however. First, careful empirical studies have always failed to find evidence of sizeable spill-over effects across countries. Fiscal policy multipliers tend to be small and imprecisely estimated, and largely confined to the domestic economy. Second, if EMU was hit by an aggregate shock that called for an aggregate fiscal policy response, each country acting in isolation would already have the incentive to react in the right direction. Such a decentralised reaction would be inadequate only to the extent that spill-over effects were relevant. Moreover, countries already have the opportunity to debate and communicate their policy intentions. Institutionalising fiscal policy coordination over and above that may be appropriate for other reasons, but not for the purpose of better calibrating aggregate demand management at the European level. On the contrary, the primary concern for task allocation here should be to preserve enough flexibility for decentralised fiscal policies.

More recently, a third argument in favour of fiscal policy coordination has been formulated.[4] It goes something like this. Even if there are no direct spillover effects of fiscal policy from one country to the other, having a common monetary policy creates links across countries. European monetary policy responds to aggregate output gaps and inflation in the euro area. Any national fiscal policy affecting such aggregate variables thus induces a monetary policy response. But the monetary policy response in turn impacts on the economies of other members of EMU, thus creating a spillover effect that calls for fiscal policy coordination. Suppose for instance that a country engages in an expansionary fiscal policy, either for opportunistic political reasons, or because it is hit by an adverse cost push shock. This increases inflation and reduces the output gap in the euro area, thus triggering a tighter monetary policy that hurts the other countries in EMU. They too will thus be induced to expand their fiscal policy, to offset the tighter monetary policy, but

[4] See for instance Uhlig, H. (2002), "One money, but many fiscal policies in Europe: what are the consequences?", Humboldt University working paper, Berlin.

this will trigger even further monetary tightening. In equilibrium, monetary policy is too tight, fiscal policy is too expansionary (or reacts too much to aggregate or national shocks), and all countries are worse off. Logically, the argument is correct, but its empirical relevance remains to be assessed.

Note that this case in favour of policy coordination suggests that, without coordination, countries are excessively reactive to shocks hitting their economies. The remedy calls for coordination (or institutions) that induce fiscal discipline or dampen discretionary fiscal policy responses, not the other way around. This argument in favour of policy coordination, therefore, contradicts the common idea that European fiscal policy is too passive and that policymakers should get together and coordinate a more aggressive discretionary response to aggregate shocks hitting their economies.

There is also another important argument against a set up that would encourage a more aggressive and coordinated discretionary fiscal policy reaction to cyclical events. It is very difficult to appropriately calibrate the timing of discretional fiscal policy decisions aiming to stabilize the economy. Because of decision making lags, implementation lags, and uncertainty over fiscal policy multipliers, active aggregate demand management could be counterproductive and de-stabilizing. Moreover, governments have political concerns, and are tempted to manipulate fiscal policy for electoral reasons. There is no guarantee that discretional fiscal policy decisions would be guided by the aim of stabilizing aggregate demand, rather than by the goal of temporarily boosting the economy ahead of the elections.[5]

The appropriate institutional set up, instead, should encourage reliance on automatic stabilizers. Countries should let their budget deficit swell automatically in downturns, and shrink in good times. Given the size of the European welfare states, these automatic fiscal policy responses would already go a long way towards stabilizing the economy in the face of business cycle fluctuations.

This takes us to the heart of the problem of fiscal policy in Europe, which is not fiscal policy coordination but the SGP. Indeed, the SGP does not allow for a full working of automatic stabilizers in all circumstances, especially in favourable cyclical developments. As currently formulated and implemented, the SGP has two features. One is the 3 per cent deficit limit. This is a very hard constraint, and the EU has set strong enforcement rules to impose the respect of this limit. The second feature is the medium run goal of budget balance. If on average countries were close to budget balance, then they would have ample room to let automatic stabilizers operate fully and even to enact some discretional countercyclical fiscal policy. But the EU does not have strong enforcement powers to induce countries to be close to budget balance. This asymmetry, between the inflexibility of the 3 per cent limit and the soft powers of moral suasion to achieve budget balance in the medium run, is the main source of the problem.

The SGP is needed in the first place because governments tend to be myopic. A myopic government has a tendency to remain close to the 3 percent deficit limit,

[5] Recent empirical research estimates that on average parliamentary countries cut taxes by about ½% of GDP in a typical election year.

postponing indefinitely the medium run goal of budget balance. This creates a problem, because it forces fiscal policy to be pro-cyclical. In good times, countries can relax and adopt loose fiscal policy since the deficit ceiling is not a binding constraint. But in bad times they are forced to enact tight fiscal policy.

In a few words, the main problem of the current institutional arrangements does not seem to be inadequate or insufficient policy coordination but rather the inability of the SGP to induce countries to keep their cyclically adjusted budgets close to balance.

Summary

To sum up, there are no strong arguments in favour of further centralisation of fiscal policy within the Eurogroup in the three areas considered, namely taxation, aggregate demand management and public investment. There are some relevant arguments that some tax policy decisions ought to be more centralised, but at the level of the EU as a whole, not only within the Eurogroup. Moreover, these arguments apply selectively to some tax rates only, not to the whole of tax policy. Current arrangements for aggregate demand management through fiscal policy are not satisfactory. But the central problem concerns the formulation and implementation of the Stability and Growth Pact, not the lack of fiscal policy coordination.

5. The transfer of powers from the EU to the euro area

Giving formal decision making powers to an EuroEcofin at the expenses of member states is not the only option. Another option would be to transfer some powers away from the EU as a whole, to give it to the euro area. Should this be done, and why?

The main reason would be one of efficiency. When the Maastricht Treaty was signed, the move to EMU was considered as involving all countries. In fact, the three-stage approach was designed in that context. Countries with a derogation, such as the UK, or not abiding by the convergence criteria, such as Greece, would remain in the second stage of EMU, while those adopting the single currency would move to the third stage. As a result, countries outside the euro area were considered to be a small temporary minority.

With enlargement, from 2004 countries outside the euro area will be a majority, 13 against 12. Even if some newcomers could join EMU in the next few years, the number of EU countries outside the euro area is bound to remain substantial. Is this a reason to reconsider the functioning of EU institutions, in particular when dealing with economic policy issues?

De facto, already today some decisions are implicitly taken by the Eurogroup and formalised the next day at the Ecofin. The decisions concerning the early warning in 2002 and in 2003 and the excessive deficits procedure were managed in the Eurogroup. Even the opinions on the Stability Programmes are discussed at the Eurogroup and ratified the next day. At present, the peculiarity can be easily dealt with, but this may be more difficult in the future, with more countries being outside the Eurogroup.

As originally formulated, the SGP should apply to all countries. This is why the Ecofin is competent for its implementation, except when sanctions are at stake. But in reality, given the link between the SGP and EMU, the practical implementation of the SGP is mainly a matter for euro area countries. Moreover, to the extent that loose fiscal deficits and lack of fiscal discipline in one member state impose negative spillovers on others, they do so only or mainly among members of EMU. The SGP has little or no rationale outside of EMU. Hence, the practice of de facto implementing the SGP through decisions of the euro countries makes sense. But the ambiguity over who is bound by the SGP and the contrast between the original formulation of the SGP and the practice of its implementation should be resolved in favour of the latter. Once this is done explicitly, a new EuroEcofin can be formally given the responsibility of administering the SGP. This would have several benefits. First, a correspondence between what is actually done and what should be done would increase transparency and foster trust in EU institutions. Second, the Commission would regain the proposal powers that it has in the Ecofin Council but not in the informal Eurogroup meetings, so that enforcement of the SGP could become more effective.

There should also be a clarification on the way stability and convergence programmes are assessed. If stability programmes are mainly a competence of euro area countries, who should be in charge of assessing convergence programmes, i.e the programmes of countries outside the euro area? Would it be acceptable that stability programmes are assessed only by euro area countries, while convergence programmes are assessed by all EU countries?

Another reason for devolving competencies from the EU to the euro area relates to external representation of the euro area. At present, the euro area is represented by the ECB President and by the President of the Eurogroup. This is however an informal arrangement, with some shortcomings in terms of continuity and effectiveness. In the general discussion taking place in the Convention, in which external representation is an important priority, formalizing the EuroEcofin, with an elected President, would ensure continuity and consistency. The formalisation would also allow to give some role to the Commission, thereby balancing the institutional equilibrium with the Council and possibly the European Parliament.

6. Concluding remarks

There seems to be a consensus that the Eurogroup should be strengthened, and several proposals have been formulated to reach this goal.[6] One idea is to lengthen the Presidency to two years, electing the President among the members. Given the workload, this would strengthen the role of the EFC and the Commission in the support to the President and the preparation of the meetings. This would solve part of the problems of continuity of dialogue, especially with the US and Japanese authorities. A second proposal is to maintain the Eurogroup as an informal body, but to add a formal Council of the euro area members only. This could be achieved

[6] See the various contributions to the Convention, for instance by the Commission of by France and Germany.

in two ways: either by creating a new Council formation, or by allowing that for some decisions related to the euro area non-euro area members of Ecofin Council would abstain. An euro area Ecofin, an EuroEcofin, would adopt decisions on euro area matters. These decisions would be taken according to the same procedure as the one used for regular council meetings, following a proposal or a recommendation by the Commission. Coreper would contribute to the preparation of EuroEcofin, together with the EFC, restricted to euro area members.

But what new tasks should the EuroEcofin take up? Unless we identify clearly what the EuroEcofin should do, there is no purpose in strengthening it as an institution. Several commentators suggest a strengthening of economic policy coordination as a generic recommendation. However, without some greater precision, there is the great risk to promote changes that would tilt the very delicate balance of responsibilities between the EU and the Member States. Members of EMU already have few instruments at their disposal to cope with national macroeconomic shocks, and one should be very careful before advocating a further transfer of fiscal powers away from member states and towards the EuroEcofin. A better idea would be to clarify that the SGP is administered and implemented by the EuroEcofin, for EMU countries only. The EuroEcofin would then take up some tasks currently performed by the Ecofin, without putting into question the allocation of competencies between the member states and the Union.

A second important issue concerns the degree of formality that the Eurogroup should have. What would be the advantages of a formal EuroEcofin? What would be its main decision making powers? The answer to these questions largely depends on how wide and how lasting will be the difference between the composition of Ecofin and that of the Eurogroup after enlargement. The most likely scenario is that the difference between the two will diminish overtime as the newcomers become also members of the euro area. But we cannot rule out another scenario, where several countries opt to remain outside the euro, not temporarily, but in the long run. In this second scenario, the justification for having two different and formalized Ecofin councils would be much more compelling.

Finally, how important are issues of external representation and interaction with the other two major economic and monetary zones? Are the current arrangements satisfactory? Would the current shortcomings be overcome if the Eurogroup was transformed into an EuroEcofin? The answers to these questions also have important implications for how to optimally complete the design of the institutional framework of EMU.

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