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## **A Scheme to Coordinate Monetary and Fiscal Policies in the Euro Area**

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## A SCHEME TO COORDINATE MONETARY AND FISCAL POLICIES IN THE EURO AREA

by Carlo Panico<sup>1</sup> and Marta Vázquez Suárez<sup>2</sup>

1. This paper deals with the problems of coordination between monetary and fiscal policies in the Euro area. It examines how the existing institutions handle these problems and presents a proposal to re-organise them.

The need for policy coordination within the European Monetary Union (EMU) was recognised by the Council of the Ministers of the European Union (the Council of Europe) in a meeting held in Luxembourg in 1997. The Council concluded that ‘the move to a single currency will require closer community surveillance and coordination of economic policies among euro area member states’. This major acknowledgement has not led, as the literature points out, to a satisfactory institutional organisation. Von Hagen and Mundschenk (2003, p. 279), for instance, claim that the present arrangements lead to inefficient policy outcomes on account of the non-cooperative attitude that they induce in the monetary and fiscal authorities of the area. They also claim that coordination is needed only in the case of cyclical (short-run) policy, since ‘in the long run monetary policy can achieve price stability without interfering with fiscal policy’ (Von Hagen and Mundschenk, 2003 p. 293).

The term coordination has different meanings in this literature. According to some (von Hagen and Mundschenk, 2003; Wyplosz, 1999, 2002; Pisani-Ferry, 2002), it refers to the set of arrangements and activities aiming at the identification of a unified framework for monetary and fiscal policies and the introduction of commitments on policy decisions at national and super-national level. For others (Buti, Eijffinger and Franco, 2002; Fatàs and Mihov, 2003; Beetsma and Debrun, 2005; Calmfors, 2005), ‘coordination must be understood as an agreement to enforce fiscal discipline among members of EMU to avoid any spill-over caused by irresponsible policies’ (Fatàs and Mihov, 2003, p. 126).

The dissatisfaction with the present organisation has led those using a broad definition of coordination to call for academic research, since ‘solutions are urgently needed’ (Wyplosz, 1999, p. 2) and ‘institutional building is necessary’ (Wyplosz, 1999, p. 23). They have also provided

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suggestions to improve on the existing institutional arrangements (see Wyplosz, 1999, 2002; Casella, 2001; Pisani-Ferry, 2002, Von Hagen and Mundschenk, 2003). The authors accepting a narrow definition of coordination have instead made proposals to improve the economic content and the enforcement of the rules imposing fiscal discipline in order to avoid a return to fiscal policy discretion (for a survey of these proposals see Buti, Eijffinger and Franco, 2002; Franco, Balassone and Francese, 2005; Calmfors, 2005).

With respect to the large amount of publications on this issue, the analyses proposed by the Post Keynesian literature appear little developed. Hein and Truger (2006) is, as far as we know, the only Post Keynesian work dealing with the debate on this issue and providing some indications as to how to reform the Stability and Growth Pact (SGP). Other writings refer to the issue without dealing with it in detail. Angeriz and Arestis (2006, p. 3) argue in favour of coordination between monetary and fiscal policies in a paper dealing with the conduct of monetary policy in UK. Arestis and Sawyer (2003a, p. 4) claim that the rules presently governing EMU make it extremely difficult to implement coordination of monetary and fiscal policies.<sup>3</sup>

The aim of this paper is to propose a Post Keynesian perspective of these problems. It points out, contrary to what is often stated by the literature, that there is a need for coordination between monetary and fiscal policies when both cyclical (short-run) and structural (long-run) problems are dealt with. Then, it assesses how coordination is carried out under the existing institutional arrangements and proposes a new scheme, which intends to make them work effectively.

The paper is so organised. Section 2 deals with the arguments in favour of coordination between monetary and fiscal policies in both short- and long-run analysis. Section 3 and 4 describe the existing institutional arrangements and procedures to handle the problems of coordination within the European Union and the Euro area. Section 5 summarises some proposals of reform present in the literature. Section 6 proposes a new scheme to make these arrangements work more effectively than they do at present.

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<sup>3</sup> According to Arestis and Sawyer (2003a, p. 4), a strict interpretation of ‘the requirement ... that national governments (and hence the fiscal authorities) should not exert any influence on the ECB (and hence the monetary authorities) ... would rule out any attempt at co-ordination of monetary and fiscal policies’.

2. A single monetary policy and a single currency were introduced in the Euro area in 1999 and in 2002 respectively. A set of new monetary institutions, the European System of Central Banks (ESCB), the Eurosystem and the European Central Bank (ECB), was created to manage it.

As Wyplosz (1999, p. 1) points out, the architecture of these institutions reflects the 1980s' conventional wisdom and is a heritage of the rational expectations revolution applied at the policy-making level. It is based on the principles of neutrality of money, inter-temporal inconsistency and the superior performance of an independent central bank.

The conduct of monetary policy, as Arestis and Sawyer (2003b) clarify, follows the lines of what is known as the 'new consensus' in macroeconomics (NCM). The model underlying the NCM is again related to the rational expectations revolution and is based on the following elements:

- Say's Law holds, so that effective demand does not play any role in the long-run determination of the level of economic activity.
- The long-run level of economic activity is supply-determined and corresponds to the NAIRU
- The potential growth of the economy is fully exploited.
- Money is neutral, in the sense that it does not affect the long-run level of economic activity.
- In cyclical (short-run) analysis, the level of economic activity fluctuates around the NAIRU.
- Monetary policy, operating through the interest rate, is the key element of short-run economic policy, which deals primarily with inflation, but must also take care of the short-run output gaps.
- The money supply is an endogenous variable, in the sense that its amount depends on the demand for money at the level of the interest rate stabilised by the monetary policy.
- Monetary policy should be operated by an independent central bank.<sup>4</sup>
- The independence of the central bank enhances its credibility and improves the effectiveness of monetary policy.
- Transparency is essential to the working of monetary policy: it allows the authorities to operate in a discretionary way while avoiding the problems of time inconsistency.

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<sup>4</sup> The independence of a central bank may regard its ability to decide the use of the instruments of monetary policy ('instrument' independence or 'technical' independence), the power to decide the level of the objective variables of monetary policy ('goal' independence), the power to decide the relative relevance of different objectives, e.g. the weights to be attributed in the social loss function to the output gap and to inflation ('priority' independence), and other forms of independence (see Panico and Rizza, 2004). Most central banks enjoy 'technical' independence. Unlike the others, the ECB enjoys 'instrument' and 'goal' independence too.

The acceptance of Say's Law and the neutrality of money are the elements that mainly differentiate the 'new consensus' from the Keynesian theoretical positions. They both belong to long-run analyses.

In Keynesian analysis Say's Law does not hold, effective demand plays a role in determining the long-run level of economic activity, the potential growth of the economy is not always fully exploited, money is not neutral, and both monetary policy, operated through the interest rate, and fiscal policy can affect the long-run level of production.

Keynes introduced these views in a typed paper from which he appeared to have lectured in November 1932.<sup>5</sup> There, he clearly showed his intention to abandon the traditional neoclassical standpoint and to propose a new theoretical approach, which he named a "monetary theory of production" to underline the fact that the long-period equilibrium level of economic activity cannot be determined independently of monetary considerations. He wrote:

The root of the objection which I find to the theory under discussion, if it is propounded as a long-period theory, lies in the fact that ... it cannot be held that the position towards which the economic system is tending ... is entirely independent of the policy of the monetary authority. (Keynes, 1979, pp. 54-55)

Soon after, he added

On my view, there is no unique long-period position of equilibrium, equally valid regardless of the character of the policy of the monetary authority. On the contrary there are a number of such positions corresponding to different policies. Moreover there is no reason to suppose that positions of long-period equilibrium have an inherent tendency or likelihood to be positions of optimum (i.e. full employment) output. (Keynes, 1979, p. 55)

These positions, which Keynes further elaborated in *The General Theory*, were subsequently developed by Harrod's seminal article 'An essay in dynamic theory', which conceived of modern growth theory as a Keynesian theory. It worked out the views that the economic system does not tend necessarily to full employment and that the rate of growth may be affected by three sources of autonomous demand, coming from the government sector, the private sector, in the form of autonomous investment, and the foreign sector.<sup>6</sup> Some years later, Kaldor's 1958 Memorandum to the Radcliffe Commission considered Government policies necessary to pursue stability and growth. His opinion was that, although both policies must constantly be used in a coordinated way, monetary policy is the appropriate tool against the fluctuations of the economy, while fiscal policy is the appropriate tool to use in the pursuit of the long-range objective of sustained growth.

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<sup>5</sup> For an analysis of the evolution of Keynes' thought on these problems, see Panico (1988).

<sup>6</sup> For a detailed treatment of this interpretation of Harrod's contribution, see Commendatore, D'Acunto, Panico and Pinto (2003) and Panico (2003).

In the Memorandum Kaldor used the Post Keynesian theory of growth and distribution to examine the role of Government policies.<sup>7</sup> Yet, he did not present a formalised analysis, which was worked out later by the debate on the role of the Government sector in the Post Keynesian theory of growth and distribution<sup>8</sup> and by the writings on the same topic coming from the Kaleckian tradition.<sup>9</sup>

The need for coordination between monetary and fiscal policies was widely recognised during the post-war Keynesian era. In 1956, intervening in a debate between the Treasury and the Federal Reserve, Samuelson underlined it by writing:

There is no legitimate clash between Treasury and Central Bank policy: they must be unified or co-ordinated on the basis of the over-all stabilisation needs of the economy, and it is unthinkable that these two great agencies could ever be divorced in functions or permitted to work at cross purposes. (In particular it is nonsense to believe, as many proponents of monetary policy used to argue, that fiscal policy has for its goal the stabilisation of employment and reduction of unemployment, while monetary policy has for its goal the stabilisation of prices. In comparison with fiscal policy, monetary policy has no differential effectiveness on prices rather than on output) ... I have already asserted that the Treasury and Central Bank have to be co-ordinated in the interests of national stability, so I am little interested in the division of labour between them (Samuelson, 1956, pp. 14-15).

In the subsequent years several lines of arguments were presented to criticise the discretionary use of fiscal policy to stabilise the economy. In an attempt to re-state the case for fiscal policy Arestis and Sawyer (2003b) have recently recalled the limits of these arguments. One of them assumes that the economy permanently fluctuates around a supply-side equilibrium position, corresponding to the Natural Rate of Unemployment (NRU) or to the Non-Accelerating Inflation Rate of Unemployment (NAIRU) and representing the potential output of the economy. The empirical identification of this position is difficult because the estimation of the rate of structural unemployment is influenced by the rate of unemployment that has actually prevailed in the market (see Blinder, 1997, Stiglitz, 1997, Gordon, 1997, Staiger, Stock and Watson, 1997, Blanchard and Katz, 1997, Galbraith, 1997). As a consequence, the natural rate of unemployment, which should represent a stable reference point for the actual rate, tends instead to follow it: the estimated value of the former depends on the prevailing levels of the latter.

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<sup>7</sup> The 1958 Memorandum referred to the determination of the rate of profit proposed in Kaldor (1955-56). This theory was subsequently developed by Pasinetti (1962).

<sup>8</sup> Steedman (1972) provided the first formal presentation of the Post Keynesian theory of growth and distribution, which explicitly introduced the Government sector. Later on, Fleck and Domenghino (1987), Pasinetti (1987) and others contributions analysed this issue in different respects (for a review of this debate, see Panico, 1997).

<sup>9</sup> See You and Dutt (1996), Lavoie (2000) and Dos Santos and Zezza (2004).

Dealing with this problem, Solow has expressed serious doubts on the applicability of the natural rate hypothesis in the USA:

As this is written, the unemployment rate has been below the once canonical 6 percent for five year, but the GDP deflator has decelerating during that interval, and hourly compensation, while accelerating slowly, is much more viscous than the 6-percent-Nairu story would have led a reasonable person to expect (Reconciling the course of European unemployment with the standard model requires even more in the way of late-Ptolemaic epicycles.) Of course, the Nairu story can always be saved by agreeing that whenever the rate of inflation is falling, the current unemployment rate must be below the Nairu. Yes, but unless the Nairu changes only very slowly or very rarely or is well predicted by the background model, the story has been saved by emptying it of content (Solow, 2000, p. 157).

3. The arrangements regarding the coordination between monetary and fiscal policies in the EU and the EMU are rather complex. Many institutions participate in the process and several procedures have been set up to pursue this objective.

Among the institutions participating in the coordination process the **European Commission (EC)** occupies a central position. It participates in the meetings of all other bodies, sets the agenda for the Council of Europe and proposes the procedures regarding the financial sustainability of the member states.

The **Council of Europe (CE)** takes formal resolutions on all policies within the Union. It is composed by the Ministers and the staff of the public administration of all countries of the Union. The **Council of Economics and Finance Ministers (ECOFIN)** is the section of the Council of Europe dealing with government deficits, spending and taxation. During the meeting held in Luxembourg in December 1997, the Council of Europe explicitly declared that the ECOFIN is the centre of coordination of the economic policies of the member states. The European Central Bank (ECB) has the right to participate in the meetings of the ECOFIN in order to favour the dialogue between these institutions on economic policies. At the same time, the President of the ECOFIN participates in the ECB Governing Council.<sup>10</sup> He has no right to vote, but can submit motions to this body.

The **Eurogroup** was set up in the meeting held in Luxembourg in 1997 to allow the Euro countries to discuss their policy issues without the participation of the other member states of the Union. It

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<sup>10</sup> When the Presidency of the CE falls on a non-euro state, the President's participation in the ECB Governing Council is represented by the chairman of the Eurogroup, whose composition is described below.

meets every month, before the meetings of the ECOFIN. Participation in its meetings is limited to the Ministers of Economics and Finance of the Euro countries, to one member of the European Commission and to the President of the ECB, each accompanied by another person. The Eurogroup has no formal decision-making authority, which remains with the ECOFIN. Its role is limited to assessing the economic situation of the area and discussing its major policy issues. The lack of decision-making authority prevents the Eurogroup from playing the same role that the Eurosystem plays with respect to the ESCB.

The **Economic and Financial Committee (EFC)** was set up in 1999 to provide the ECOFIN with analysis and advice on the economic and financial issues that the ECOFIN has to deal with. It is composed by experts belonging to the European Commission, to the member states and to the ECB. The EFC prepares the analytical basis upon which the decisions of the Council of Europe are taken. By doing that, it favours the dialogue between the Council of Europe and the ECB on issues like the economic policy orientation of the EU<sup>11</sup>, the monitoring of the fiscal policies pursued by the member states as they are described by the stability and convergence programmes that the states have to present each year, and the positions that the European Union should have on international economic and financial problems. The EFC also deals with other technical issues, like questions related to the printing of money, institutional reforms and the international economic relations of the EMU and the EU. The analyses of the EFC are used for the meetings of the ECOFIN and of the Eurogroup. The ECB participates in this activity by contributing to the evaluation of the economic perspectives of the euro area and of the exchange, of the financial sustainability of the member states' budgets and of the general orientation of the national fiscal policies.

The **Economic Policy Committee (EPC)** was set up in 1974 and has a composition similar to that of the EFC. Unlike the latter, which deals with macroeconomic and financial policies, the EPC deals with the structural reforms of the member states. It meets annually for analysing economic and social reforms related to the aging of population and to the working of the markets for goods, services, capitals and labour, and for discussing the possibility of introducing some forms of coordination in the policies of the different European countries on these issues.

The previous description of the institutions participating in the process of coordination of monetary and fiscal policies underlines that the arrangements chosen by the European Union are characterised by the following elements:

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<sup>11</sup> This is the dialogue on the content of the Broad Economic Policy Guidelines (BEPGs), which will be described below.

- The analyses upon which the coordinating activity is carried out are elaborated by the Economic and Financial Committee and by the Economic Policy Committee, in which all parties, including the ECB, participate.
- The European Commission leads the processes, by setting the agenda of the Council of Europe and by proposing and developing the coordinating procedures.
- The Council of Europe (and the ECOFIN for the economic policies) is the formal decision-making authority.
- The Eurogroup deals with economic policy within the Euro area, but has no formal decision-making authority. It does not play, with respect to the Council of Europe, the same role that the Eurosystem plays in relation to the ESCB.

Thus, in spite of the fact that the single currency creates a broader need for policy cooperation, within the Euro area ‘a framework for cooperative policy making among the ECB and the national governments has not yet been developed’ (von Hagen and Mundschenk, 2003, p. 293). The absence of a place where the actors can define a common stance on monetary and fiscal policies and enter binding commitments on their policy choices, makes the institutional organisation of the Euro area more oriented towards the exchange of information than towards the identification of lines of action on coordinating activities. This deficiency, as von Hagen and Mundschenk (2003, pp. 280 and 293-294) conclude, leads the actors to non-cooperative attitudes. The ECB, feeling uncertain about the fiscal choices of the national governments, tends to defend its freedom of action in order to be able, if necessary, to counteract their deficit bias. The national governments, feeling unable to persuade the ECB to pay more attention to the specific conditions of their economy and uncertain about the fiscal behaviour of the other governments, are induced to be sceptical on cooperation, prepared to counteract any restrictive stance of monetary policy and unwilling to accept further reductions of their fiscal sovereignty. The result, as some econometric analyses also reveal (see Wyplosz, 1999), is that monetary and fiscal policies in the Euro area are conducted as strategic substitute, rather than complement: ‘the more inflation is tolerated by the central bank, the less incentive for the government to attempt to expand through a deficit. Conversely, the more expansionary is the budget, the lower is the central bank’s incentive to inflate’ (Wyplosz, 1999, p. 10).

4. Coordination between monetary and fiscal policies does not work through delegation to community institutions, as it is the case of the single monetary policy and the administration of the Single Market. It is based on a narrow approach, which only tries to challenge the national policies

that are expected to affect in a negative way the economic performance of the area (see von Hagen and Mundschenk, 2003, p. 288).

The methods used for the harmonisation of policies mainly rely on “soft enforcement”, i.e. the ability to persuade the actors to follow proper behaviours through monitoring, dialogue, exchange of information, warnings and peer pressure. Only in some cases do they try to establish “common rules of behaviour” that the national governments have to follow.

The main procedures of economic policy coordination in the EU can be so listed:

- The Broad Economic Policy Guidelines (BEPGs)
- The process of multilateral surveillance
- The process of “early warnings”
- The process of peer pressures
- The “Macroeconomic Dialogue”, known as the Cologne Process.
- The Excessive Deficit Procedure (EDP)
- The Stability and Growth Pact (SGP)

The BEPGs are the core of the coordination process in the EU. They define the general orientation of economic policy in the Union on the basis of the analyses developed by the EFC, with the participation of the ECB. The European Commission proposes the BEPGs to the Council of Europe and to the ECOFIN, which take formal decisions on their content by unanimity vote.

The BEPGs form the reference framework for the multilateral surveillance, which monitors the economic situation and the state of policy implementation in the Union and in the member states. The EFC develops these analyses by moving from the “stability programmes” that the Euro countries submit each year.<sup>12</sup> The European Commission proposes the results of the monitoring to the European Council and to the ECOFIN for formal approval. Some of these results are conveyed, confidentially or publicly, to the member states and used to give “early warnings” and recommendations. In some cases they set in motion a process of peer review, aiming at persuading the national governments to adopt fiscal policies that do not affect in a negative way the economic performance of the area.

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<sup>12</sup> In order to participate in the process of multilateral surveillance, the non-euro countries present instead a “convergence programme”.

The tendency to use methods of “soft enforcement” led the European Council to introduce in 1999 in Cologne the Macroeconomic Dialogue. The Council decided that an informal meeting be held every six months in order to clarify how to deal with the European Agreement on Employment (which further develops the coordination process on unemployment set up by the “Luxembourg process”) and how to solve the problem regarding the efficient working of the goods and capitals markets (as a way of keeping the Cardiff process at work). The meeting sees the participation of the representatives of the member States, the ECB, the European Commission, the central bank of a country that has not adopted the euro, and the representatives of the unions of the workers and the entrepreneurs. The Dialogue is carried out without trying to impose specific lines of action on the participants. It only aims at inducing collaborative behaviours among the actors involved.

The procedures envisaged to enhance the coordination of monetary and fiscal policies also try to establish “common rules of behaviour”, as in the case of the Excessive Deficit Procedure (EDP) and the Stability and Growth Pact (SGP). These procedures, based on the results of the multilateral surveillance, stipulate:

- the prohibition of “bailing out” individual governments that cannot meet their debt obligations;
- the prohibition of exceeding a 3 per cent ratio between the government budget deficit and the GDP unless “either the ratio has declined substantially and continuously and reached a level close to the reference value or, alternatively, the excess of the reference value is only exceptional and temporary and remains close to the reference value”;
- the prohibition that the gross government debt exceed 60 per cent of GDP, unless it is diminishing and approaching the reference level “at a satisfactory pace”;
- the governments’ adoption of a medium-term (or cyclically adjusted) objective of a budget position “close to balance or in surplus”.

The procedures are set in motion by a report prepared by the European Commission, which clarifies the existence of the violation and of any other relevant factors that can affect the decisions regarding the subsequent actions to be taken. The EFC examines the report and formulates an opinion on it. The Commission then decides whether to send the ECOFIN a statement regarding the existence of the violation and a recommendation suggesting the appropriate policy actions to correct it. The ECOFIN takes a formal decision on the existence of the violation and gives the country a recommendation on the correcting measures with two deadlines regarding the adoption of the measures and the correction of the violation. If the member state fails to observe the deadlines the

ECOFIN can give notice to it and can require the country to make a non-interest bearing deposit with the Commission, whose amount is related to the extent of the violation. If the ECOFIN decides that after two years the violation has not been corrected, it can ask the conversion of the deposit into a fine.

From the start of the monetary union in 1999 there have been several violations of what the Maastricht Treaty and the GSP stipulate. Portugal in 2001, 2005 and 2006, Netherlands in 2003, Greece for the whole period, France in 2002, 2003, 2004 and 2006, Germany from 2002 to 2005, Italy from 2003 to 2006 have exceeded the 3 per cent limit for the ratio government deficit – GDP. The high number of violations testifies to the rigidity of the form of coordination chosen and the need to make it more flexible and in conformity to the needs of stabilisation and growth of the national economies.

The application of the procedures too has proved difficult. In the case of Netherlands in 2003 the procedures were applied as the Treaty and the SGP prescribed. Yet, in all other cases, they have not been enforced in the stipulated way. The cases of the violations of France and Germany are the most relevant. In November 2003 the ECOFIN halted the application of the established procedures against these two countries. This decision induced the Commission to take legal steps in the European Court of Justice. In 2004, the Court annulled the ECOFIN's decision, but stated that the steps of the EDP are not automatic: even if the Treaty and the SGP envisage them, they are subject to ECOFIN's decisions based on a qualified majority.

The problems that emerged in the management of these cases led to a reform of the EDP and the SGP in March 2005. The reform, as Calmfors (2005, pp. 58-70) points out, watered down the economic content and the enforcement of these procedures. It rightly introduced 'greater tolerance of deficits in severe downturns, the differentiation of medium-term fiscal objectives in order to take heterogeneity among countries in both debt levels and potential growth rates into account, the attempts at increasing the emphasis on debt developments in general, the plans on better assessment of implicit debt and long-run sustainability, and the "commitments" to avoid procyclical fiscal policy' (Calmfors, 2005, p. 69). Yet, the way in which the reform specifies the meaning of a "severe economic downturn" allowing the overtaking of the 3 per cent ratio between government deficit and GDP and of "the other relevant factors" that enter in the evaluation of whether a deficit

is excessive has made the content of the rules less transparent.<sup>13</sup> Moreover, the new reform refers to both cyclical and structural factors, such as the Lisbon agenda, R&D, innovation, debt sustainability and public investment, thus contradicting the view that rules and coordination are only needed in relation to cyclical problems because the long-run level of activity always exploits fully the growth potentials of the economy. Finally, the changes introduced by the reform in the deadlines set to the member states for correcting the violations substantially reduce the strictness of the enforcement and ends up by representing a movement away from the use of “common rules of behaviour” and towards a return to unconstrained discretion in national fiscal policies (see Calmfors, 2005, pp. 63-66). Instead of strengthening the coordination of economic policies by endowing the procedures with stricter enforcement and greater flexibility with respect to the specific needs of the individual economies, the reform has reduced the level of coordination by making less transparent the economic content of the rules, weakening the enforcement and favouring unconstrained national discretion.

To sum up, the existing arrangements regarding the coordination between monetary and fiscal policies in the Euro area appear unsatisfactory in several respects:

- The frequent violations of what the Maastricht Treaty and the SGP stipulate testify to the rigidity of the forms of coordination chosen and the necessity to make them more flexible with respect to the needs of growth and stabilisation of the national economies.
- The 2005 reform of the SGP has rightly recognised the need of greater tolerance of deficits in the presence of cyclical downturns and the necessity to take into account the heterogeneity of countries on their debt position, international competitiveness and potential growth. Yet, instead of strengthening the coordination between monetary and fiscal policies by endowing the procedures with stricter enforcement and greater flexibility with respect to the specific needs of the national economies, the reform has reduced the level of coordination by making less transparent the economic content of the EDP and the SGP, weakening the enforcement of these procedures and favouring unconstrained national discretion. Under these conditions there is a serious risk that in future downturns fiscal

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<sup>13</sup> In the original regulations of the EDP and the SGP, a fall of 2% of the GDP automatically allowed the overtaking of the 3 per cent ratio, whereas a fall of 0,75% could represent an exceptionally case allowing the overtaking if the ECOFIN recognised it. The 2005 reform allows overtaking if there is “a protracted period of very low growth relative to potential growth”. The ambiguity of the new regulation is clear. As to the fact that the declaration of “excessive deficit” has to “take into account all other relevant factors”, while the previous regulation did not specify which factors could be considered, the new reform recalls factors like “potential growth, prevailing cyclical conditions, the implementation of policy in the context of the Lisbon agenda and policy to foster R&D and innovation” as well as “fiscal consolidation efforts in good times, debt sustainability, public investment and the overall quality of public finances”. Moreover, attention has to be paid to “any other factors which, in the opinion of the Member State concerned, are relevant in order to comprehensively assess in qualitative terms the excess over the reference value”. See Calmfors (2005, p. 61)

policies in the Union will go out of control due to contagious effects with high deficits spreading from one country to another.

- The existing institutions and procedures are more oriented towards the dialogue and the exchange of information than towards the identification of lines of action on coordinating activity.
- In spite of the fact that the single currency creates a broader need for policy coordination, the Euro area is not endowed with a specific institution where the actors can identify a common stance on monetary and fiscal policies and enter binding commitments on policy choices. This deficiency enhances non-cooperative attitudes among the actors, with the ECB giving priority to the defence of its freedom of action and the national governments being unwilling to accept further reductions of their fiscal sovereignty. The creation of a specific institution where common objectives can be clearly defined and set at the basis of subsequent policy choices appears as a crucial step to improve the current situation.

5. The need to change the existing arrangements is testified by the high number of reform's proposals recently presented. The main weaknesses of these arrangements have been found in the difficulty to identify a common stance for economic policies, in the weak enforcement of the rules of the SGP, in their lack of transparency and flexibility, in the fact that the rules do not differentiate among the conditions of the economies, in the limited attention paid to financial sustainability, to the introduction of structural reforms, to the avoidance of pro-cyclical policies, and to the pursue of policies favouring innovation and the formation of physical and human capital.

The differences in the proposals reflect the diverse views on these problems and the meanings attributed to the term coordination. For some authors (see Alesina, Blanchard, Gali, Giavazzi and Uhlig, 2001; Buti, Eijffinger and Franco, 2002; Calmfors and Corsetti, 2003; Fatàs and Mihov, 2003; Beestma and Debrun, 2005; Franco, Balassone and Francese, 2005), the introduction of rules imposing fiscal discipline on national governments and the independence of the central bank generate satisfactory policy outcomes. In this case, coordination is understood in a narrow way, as an agreement to enforce fiscal discipline. No other form of coordination, like that focusing on the introduction of institutional arrangements that can favour the identification of a common stance for monetary and fiscal policies among the national governments and the European Central Bank, is needed.

Like Canzoneri and Diba (1999) and Alesina, Blanchard, Gali, Giavazzi and Uhlig (2001), Franco, Balassone and Francese (2005) claim that the maintenance of the “cyclically adjusted budget” close to balance and the independence of the central bank represent an effective form of policy coordination.<sup>14</sup> They claim that the working of automatic stabilizers in line with tax smoothing theory contributes to the achievement of an optimal fiscal stance both at national and at Euro area level.

Several other authors, moving along similar lines, have proposed changes in the economic content and in the enforcement of the rules of the SGP. Their proposals try to achieve a satisfactory balance between the need to impose clear and transparent constraints on national fiscal policies in order to protect the independence of the ECB and the need to introduce sufficient flexibility in the rules of the SGP in order to allow national governments to use counter-cyclical fiscal policies effectively.

Fatàs and Mihov (2003, pp. 118-119 and 129) have noticed that the use of a “cyclically adjusted budget” as the reference value of the SGP contributes to achieving greater flexibility. Yet, the process of calculation of this variable introduces arbitrary elements that reduce the transparency of the rules and favour political manipulation. They have proposed to avoid referring to simple numerical rules and to take into account national differences, claiming that ‘as long as restrictions are not a simple numerical rule, but are built in as checks and balances in the budgetary process, they can prevent policy-makers from implementing large and frequent politically motivated discretionary changes in fiscal policy. (Fatàs and Mihov, 2002, p. 118). The meaning of “checks and balances in the budgetary processes”, however, is not clear in their work. Fatàs and Mihov first recognise that this solution may somehow resemble that of Wyplosz (2002), which calls for the introduction of Fiscal Policy Committees (see below), then they claim that the surveillance of the European institutions may be able to constrain the formation of the national budgetary processes, as shown by the large reductions in the government deficits in the 1990s after the adoption of the Maastricht criteria.

Blanchard and Giavazzi (2004), after stating that the SGP ‘is increasingly held responsible for the inability of the euro area economy to sustain demand and maintain growth’, have proposed a rule that distinguishes between current and investment expenditure, claiming that the latter must be excluded from the restrictions imposed by the SGP. Fiscal discipline has to achieve a balanced budget between total government revenues and current expenditure, including capital maintenance

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<sup>14</sup> Alesina, Blanchard, Gali, Giavazzi and Uhlig (2001) clarify that monetary policy should be conducted in an “appropriate and prudent way”, as in the case of inflation targeting.

and depreciation cost, but excluding government expenditure on investment. The application of this “golden rule” would add flexibility to the process, favour those government expenditures that increase future revenues and prevent the negative effects of the SGP on the growth potential of the economies.

Calmfors and Corsetti (2003) have argued against the “golden rule”, which, according to them, makes the reduction of excessive ratios of government debt to GDP slower and the rules of SGP less transparent.<sup>15</sup> They have claimed that ‘there is no theoretical reason why a golden rule should apply to physical capital investment, but not to investment in human capital or to other expenditure increases or tax reforms that will generate future revenues. But extending a golden rule in this way makes it impossible to operate: the political-economy risks that fiscal laxity could then always be justified would simply be unmanageable’ (Calmfors and Corsetti, 2003, p. 7). They have instead proposed to condition the deficit ceilings to the debt levels of each country, presenting a table in which higher deficit ratios, numerically specified, are associated to lower ranges of debt ratios.

As an alternative to this proposal, Calmfors and Corsetti (2003), like Buti, Eijffinger and Franco (2002), have suggested to maintain the 3 per cent deficit-GDP ratio, but to allow countries with low debt-GDP ratios to use extra-budgetary “rainy-day funds”, which can be established by channelling government surpluses into them during upswings in order to use them for stabilisation purposes in downswings. This rule, they claim, would enhance the use of counter-cyclical fiscal policies and favour the countries with low debt-GDP ratios.

Finally, Calforms and Corsetti (2003), like Calmfors (2005), have underlined the importance of having an effective enforcement of the SGP and have proposed to transfer the decisions against the states violating the rules from the political level of the ECOFIN to the judicial level of the European Court of Justice.

Another rule proposed to reform the SGP is that envisaged by Buiter and Grafe (2004), named “Permanent Balance Rule“, which identifies a tax rate that can guarantee a sustainable long-term path for the government debt. The tax rate is calculated by introducing the condition that government debt must not be greater than the present value of the future primary surpluses. According to Buiter and Grafe (2004, p. 77) this forward-looking rule has several advantages. It allows discretion within the limits set by the envisaged solvency condition; it takes into account the

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<sup>15</sup> For a critique of the golden rule see also Buti, Eijffinger and Franco (2002) and Calmfors (2005).

inflation and growth rates foreseen for each country; it amends and extends the golden rule by considering within the solvency condition all future sources of revenues affected by public investment. Yet, this proposal, like the previous ones, introduces arbitrary elements both in the choice of the solvency condition and in the determination of the future value of the variables involved.

A second group of reform's proposals has been advanced by some authors (Wyplosz, 1999, 2002; Casella, 2001; Pisani-Ferry, 2002; von Hagen and Mundschenk, 2003, Hein and Truger, 2006) who consider it necessary to modify the institutional organisation. For them, the term coordination refers to the set of arrangements and activities aiming at the identification of a unified framework for monetary and fiscal policies and the introduction of commitments on policy decisions at national and super-national level. The main difficulty faced by these authors is to propose changes that are acceptable to reluctant and non-cooperative actors. This preoccupation has conditioned their proposals, introducing in them some puzzling elements.

Wyplosz (2002) starts by comparing the organisation of monetary policy and that of fiscal policy in recent years. He argues that 'the crucial change that has rehabilitated monetary policy has been the move from rule design to institutional reform' (Wyplosz, 2002, p. 5). In the Seventies the conduct of monetary policy was restricted by "rules" (e.g., that relative to the rate of growth of the money supply), which proved difficult to be implemented. In the subsequent years, the tendency has been to replace these "rules" with delegation to institutions endowed with independence and a clearly specified objective to achieve. Fiscal policy, Wyplosz (2002, p. 5) says, is following similar lines with some delay. It is currently dominated by "rules", which are difficult to be implemented, and there are already discussions to replace the "rules" with delegation to newly created institutions.

The mechanism of delegation is based on a principal-agent relationship over the achievement of a clearly specified objective. Price stability is the one chosen in monetary policy. Fiscal policy, Wyplosz says, has to fulfil two main tasks. The first, which is concerned with the structure of the tax system and the composition of expenditure, directly redistributes benefits among groups of citizens. The immediate political implications of this task make it impossible to delegate it to an agent (see Wyplosz, 2002, p. 8). The second is concerned with the dimension of the budget balance. It generates macroeconomic effects, which vary in intensity but are not fundamentally different

from those generated by monetary policy decisions.<sup>16</sup> Like the latter, decisions concerning this task can be delegated to an agent, provided that it is endowed with technical independence and has been assigned the achievement of a clearly specified objective. For Wyplosz (2002, p. 9) this second task of fiscal policy should be conducted by giving an explicit mandate to ensure “debt sustainability” over the appropriate horizon to a new institution, named Fiscal Policy Committee (FPC). This institution, which is similar to the Monetary Policy Committee (MPC), founded to conduct monetary policy, can provide competent judgement and generate better results than any conceivable rule: ‘Competent and dedicated policymakers are better able than quantitative ceilings and rules to exercise good judgement and deliver the adequate mix of restraint and flexibility. To do so, however, they must be shielded from temptation and pressures that are part of political life’ (Wyplosz, 2002, p. 14).

For Wyplosz, Fiscal Policy Committees should be set up at national level, should only decide the annual deficit figure in percentage of planned GDP, and should have no power over the composition of the government budget (see Wyplosz, 2002, p. 9). They should approve the budget bill before it becomes law and, in the event of abrupt changes in economic conditions, they should ask the parliament to revise the budget law. According to Wyplosz, they can also enhance coordination among national fiscal policies and between fiscal and monetary policies at the Euro area level.

It is fair to conclude that formal coordination of fiscal policies is unlikely to be agreed upon in the foreseeable future. Informal exchanges, on the other side, are highly desirable as they may help avoid the most grievous mistakes. Such an informal approach would be much easier to organize among independent, non-political FPCs than it currently is among Finance Ministers.

The coordination between national governments and the ECB has not been satisfactory so far, largely because the ECB insists on keeping governments at arm’s length. Here again, it can be expected that the ECB will find it less threatening to entertain informal contacts with like-minded, independent FPCs. (Wyplosz, 2002, p. 13)

Wyplosz’s proposal clearly specifies the institutional changes to be made and the tasks to be performed. Yet, by avoiding interventions at the Euro area level, it plays down super-national coordination and the relevance of a policy mix. Moreover, his proposal does not clarify why political bodies, which are reluctant to lose further control over fiscal policy’s decisions, should prefer doing it in favour of a technocratic national entity rather than in favour of a super-national entity, for instance the Eurogroup, in which they are directly represented.

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<sup>16</sup> From a Keynesian perspective, changes in the interest rates and in the demand coming from the government sector generate redistributive effects too. These effects however operate through complex market mechanisms related to the interaction between aggregate demand and supply.

Pisani-Ferry (2002) underlines the need to strengthen coordination at the Euro area level and to identify the right *policy mix* in the conduct of monetary and fiscal policies. His main proposal is ‘the transformation of the Eurogroup into a collective executive body with the ability to make decisions by qualified majority voting’ (Pisani-Ferry, 2002, p. 4). His suggestions regarding the way in which this change should be done raises two doubts. The first regards the need that decisions taken at the Euro area level are not subsequently contradicted by the choices made at national level. Pisani-Ferry (2002, p. 4) proposes that the Eurogroup should formulate and adopt an economic policy charter for all its members and that ‘the interaction between European procedures and national budgetary procedures should be both streamlined and reinforced in order to make sure that domestic policy decisions are consistent with commitments made in Brussels’. This claim is however opposed by the subsequent statement that this code of conduct should not be binding, but should represent a common understanding on economic policy principles, a solution that preserves the current situation in which, as said above, the lack of binding constraints drives the national governments and the ECB towards non-cooperative behaviours. The second doubt regards the coordination between monetary and fiscal policies and the forms and the degrees of independence that the central bank should be given in this context. Pisani-Ferry (2002) rightly recalls the problems coming from an excessive degree of independence attributed to the central bank, like that on goals and priorities enjoyed by the ECB.<sup>17</sup> He claims that ‘an ECB that would be perceived as acting in isolation, without the backing of its shareholders, would lack legitimacy. An ECB that would be perceived as the only policy player of the EMU system would risk being held responsible for whatever does not work in the Eurozone – which could only result in a clash with public opinion’ (Pisani-Ferry, 2002, p. 9).<sup>18</sup> In the subsequent pages, however, he questions whether the code of conduct adopted by the Eurogroup should include elements of the ECB strategy and, instead of noticing that the technical independence of the central bank is not undermined by the identification of a satisfactory policy mix at the Euro area level, he claims that ‘the ECB would certainly be reluctant to participate in an exercise that might jeopardise its independence’ (Pisani-Ferry, 2002, p. 13). This conclusion fails to distinguish between different forms of central bank independence and to appreciate that it is the ‘goals’ and ‘priority’ independence enjoyed by the ECB that makes it perceived as the only policy player of the EMU system. The identification of a policy mix does not undermined ‘technical’ independence that the ECB enjoys, like all other central banks. The lack of clarity on these topics reduces the strength of this proposal, which, again, tends

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<sup>17</sup> For an analysis of the relation between central bank independence and democracy and of the different meanings and forms of independence, see Panico and Rizza (2004).

<sup>18</sup> Pisani-Ferry (2002, p. 9) recalls on this point the conclusions of De Grauwe (1998)

to preserve the current conditions that drive the national governments and the ECB to adopt non-cooperative behaviours. It overlooks the suggestion of von Hagen and Mundschenk (2003), recalled above in Section 4, that to reform the institutional organisation of policy coordination in the Euro area it is necessary to modify the incentives that affect the attitude of the national governments and the ECB.<sup>19</sup>

6. The analysis presented in the previous sections has clarified the limits of the existing arrangements regarding policy coordination in the Euro area and has suggested what should be changed to avoid future economic problems and a loss of legitimacy for the European institutions. Moving from these conclusions we present in what follows a proposal to reform these arrangements.

The first objective to be achieved by a reform is the transformation of the Eurogroup from a body where exchange of information and reciprocal understanding are realized to one where

- the economic situations of the Euro area and of the economies belonging to it are analysed,
- the fiscal and financial conditions prevailing in these countries are commonly verified,
- the preferences of the central banks and of the national governments over monetary and fiscal policy decisions are made explicit,
- a common stance on these policies is identified,
- the constraints to be put on these decisions at decentralised levels are commonly decided and binding commitments on them are credibly assumed by the central bank and the national governments.

The Eurogroup thus has to be transformed into a **Euro Area Fiscal Agency (EAFA)** able to perform the following functions:

- to analyse the economic, financial and fiscal situation of the area and of its economies,
- to decide the common aggregate targets for monetary and fiscal policies,
- to identify how fiscal policy has to be conducted at national levels in order to be in line with the Euro area targets and requirements and with the specific needs of each economy.

The Agency must combine political and technical abilities and must have formal decision authority on matters regarding the coordination of monetary and fiscal policies. Its governing board has to be

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<sup>19</sup> Wyplosz (1999, pp. 18-19) reaches the same conclusion as von Hagen and Mundschenk (2003).

composed by the representatives of the European Commission, the European Central Bank and the national governments, in the same way as the Eurogroup. Its President can be nominated as that of the Eurogroup.<sup>20</sup> He sets the agenda of the monthly meetings, in which the current situation is monitored, the targets and requirements of monetary and fiscal policies are identified, and formal decisions on all matters regarding coordination between these policies are taken.

To perform its functions the Agency must be endowed with qualified technical staffs, appointed by the national governments. They must elaborate, in collaboration with the Economic and Financial Committee and the European Central Bank, the analytical basis upon which discussions are carried out at both technical and political level and decisions are taken by the governing body of the Agency.

A new reform of the rules regarding the economic content and the enforcement of the Excess Deficit Procedure and the Stability and Growth Path must accompany the transformation of the Eurogroup. The new arrangements have to provide incentives for all actors to enter binding commitments on coordination of monetary and fiscal policies and to make these commitments credible. The European Central Bank and the national governments are the agents to which these incentives must be offered. Those regarding the ECB must guarantee the maintenance of its technical independence and the possibility to consider credible the commitments on policy decisions entered by the national governments. The reform thus has to defend the 'technical' independence of the central bank and must be able to persuade the national governments to have a cooperative attitude in order to induce the ECB to conduct monetary policy in a way that is more attentive to the needs of the different economies of the area. On the other side, the national governments must be persuaded to have a cooperative attitude by granting them the maintenance of fiscal sovereignty and by giving the perception that the ECB, through the participation and the involvement in the decision process of the Agency, will be more attentive to the specific needs of their economy and that they are reducing their uncertainty about the fiscal behaviour of the other governments. Further incentives to cooperate can be found in the opportunity to overtake, under specific and authorised circumstances, the 3 per cent ratio between deficit and GDP, in the possibility to fund the activities authorised in excess of the 3 per cent ratio through the Agency, and in the fact that, if the national governments do not comply with the prescriptions of the new reform, they will certainly undergo the sanctions it envisages.

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<sup>20</sup> Following Pisani-Ferry (2002, p. 4) it can be proposed to designate the President for a fixed and not too short period.

To achieve these results the new reform of the EDP and the SGP *may* maintain the prescriptions relative to the no bailing out condition, the 3 per cent ratio between government deficit and GDP and the 60 per cent ratio between government debt and GDP.<sup>21</sup> In this case, it must eliminate the lack of transparency on the economic content of the rules introduced by the 2005 reform by avoiding any reference to ‘medium term’ or ‘cyclically adjusted’ budget that should be kept close to balance. The 3 per cent ratio should be taken as an actual requirement of the budget bill and of the ex post Government balance.

The new reform must also stipulate that a country can be authorised to overtake the 3 per cent ratio for cyclical and structural reasons.<sup>22</sup> During a recession, the Agency can identify whether and by how much the national fiscal policies can exceed this ratio. By allowing that, the new reform can avoid that the national governments break the stipulated rules during downturns and thus withdraw legitimacy from the European institutions. Moreover, when the Agency identifies that an economy has specific structural problems, like those related to high government debt and loss of international competitiveness, the national governments can be given a permit to deduce from its expenditure what is used to introduce measures, agreed with the Agency, aiming at the solution of these problems. As a further incentive the Agency, with the assistance of the ECB, can raise funds in the financial markets for the solution of these structural problems and make them available to the national governments.

To strengthen the legitimacy of the European institutions the new reform must also ask the national parliaments to organise regular public discussions of the economic, financial and fiscal situation of their country with experts appointed by the European Commission.<sup>23</sup>

Finally, as yet another way to strengthen the incentives to cooperate, the new reform must also make the enforcement of the EDP and the SGP strict and effective. The several steps of the enforcement have to be clearly specified and must be applied automatically by an authority like the European Court of Justice. The procedures should be set in motion by the European Commission, which asks the Agency, with the assistance of the EFC and the ECB, to prepare a report on the existence of the violation. The report is sent to the President of the Agency, who asks its governing body to take a formal decision on it. If the existence of the violation is recognised, the Agency

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<sup>21</sup> The 3 per cent deficit-GDP ratio

<sup>22</sup> Casella (2001) has proposed that national governments can trade in a market the permits to overtake the 3 per cent ratio between deficit and GDP. These permits are obtained by having presented in previous years a deficit lower than the 3 per cent ratio. According to Casella, the market mechanism provides an ‘efficient’ allocation of these permits.

<sup>23</sup> For a similar proposal see Calmfors, 2005, pp. 81-82.

sends the country a recommendation on the correcting measures with two deadlines regarding the adoption of the measures and the correction of the violation, as was prescribed by the Maastricht Treaty and by the original SGP. At the same time, the Agency officially informs the European Court of Justice that an excessive deficit procedure has been opened. The European Commission reports to the Court on whether the member state has respected the deadlines and, in the case of failure, asks the Court to give notice to the country and to make a non-interest bearing deposit with the Commission, whose amount is related to the extent of the violation. If, after two years, the violation has not been corrected, the European Court of Justice asks the conversion of the deposit into a fine.

The transformation of the Eurogroup into an Agency taking formal decisions on the coordination between monetary and fiscal policies in the Euro area, combined with a new reform of the EDP and the SGP, which introduces transparent rules on the economic content of these procedures and a set of incentives able to persuade the relevant actors to cooperate, including a stricter enforcement of these rules, can lead to satisfactory outcomes of the economic policies carried out at centralised and decentralised level and can enhance the stability and the growth potentials of the economies belonging to this area.

7. The current organisation of policy coordination in the Euro area is unsatisfactory and there is preoccupation that, after the rules of the SGP have lost enforcement with the changes introduced in 2005, irresponsible behaviours will dominate during the next cyclical downturn, damaging the economy and the legitimacy of the Union.

Many reform's proposals have recently been presented to deal with these problems. A first group of proposals has focused on the economic content and the enforcement of the rules of the SGP, trying to find a satisfactory balance between transparency and flexibility. This balance, however, proves difficult to be found.

A second group of proposals has focused instead on the institutional organisation of policy coordination in order to induce the national governments and the ECB to have a cooperative attitude and to identify a common stance of monetary and fiscal policies, to which they commit themselves. Those who have developed the second group of proposals have adopted a broad definition of coordination. They believe that "rule design", though necessary, is not sufficient to achieve

satisfactory policy outcomes and that, as it has happened in the organisation of monetary policy, there is a tendency, generated by the need to find suitable solutions to these problems, to replace “rule design” with the delegation to new institutions, endowed with technical independence and a clearly specified objective, in the organisation of fiscal policies too.

Following these lines, we have presented in the previous pages a proposal to reform the current organisation of policy coordination in the Euro area, whose central element is the transformation of the Eurogroup into a Euro Area Fiscal Agency, an institution able to combine political and technical abilities and endowed with formal decision authority on matters regarding the coordination of monetary and fiscal policies. The proposal has taken in several ideas already presented by the existing literature and has tried, at the same time, to maintain the links with the Post Keynesian tradition, in which, owing to the close interaction between monetary and real variables, coordination between monetary and fiscal is crucial when dealing with both cyclical and structural problems.

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