POLICY CO-ORDINATION AND ECONOMIC ADJUSTMENT IN EMU: WILL IT WORK?

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Abstract

The EU has set in place a series of mechanisms to try to co-ordinate fiscal, 'structural' and monetary policies in order to achieve the objectives of EMU for the 12 members. All of these mechanisms are unique and untried. There is single monetary policy run by the combination of the national central banks and the new European Central Bank under the umbrella of the Eurosystem. There are restrictions on the scope of the member states' fiscal policies, which remain a national responsibility, and attempts to encourage co-ordination and discourage tax competition. Structural policies are governed by the processes of 'soft co-ordination', involving the setting of objectives and mutual surveillance. In comparison with the US these measures look rather limited. The basis for their structure owes more the practicalities of what could be agreed than to some careful assessment of the needs of efficient and effective policy.

This paper reviews the mechanisms and provides an empirical assessment of this policy structure in practice. We show that while there are problems in running a single monetary policy for a diverse area, the main problems do not relate to co-ordination among macro-economic policies. The policy balance is not necessarily going to be biased and fiscal policies are not inhibited from the diversity necessary to reconcile the differences among the member states. Co-ordination provides a benefit particularly to smaller countries. Initially the incentives behind soft co-ordination appear to be having an effect but structural change is traditionally the most difficult to effect.

The euro area is running policies directed at macroeconomic objectives of price stability, growth, equality and employment in a rather different manner from most large federal states. It has a single monetary policy and Stage 3 of Economic and Monetary Union will be completed in the first part of 2002 when the euro notes and coin are put into circulation and the existing national currencies with drawn. Fiscal policy on the other hand remains the preserve of the national government though subject to a set of constraints imposed by the Stability and Growth Pact (SGP) together with some constraints on the nature and level of taxation and expenditures. Planned and actual policies are assessed regularly by the European Commission and infringements of the Pact are subject to sanction. Employment policy also remains largely the preserve of the member states but with framework of priorities and targets following annual plans that are also assessed by the Commission. Here, however, there is no compulsion to conform and no power of sanction. A similar process is being applied to other 'structural' policies seeking to remove regulatory rigidities and distortions. These areas are brought together in the development of Broad Economic Policy Guidelines on an annual basis, drawn up from the Economic and Financial Committee and agreed by ECOFIN. This rather loose sounding process has been labelled 'open co-ordination'.

Other macroeconomic policy areas such as trade policy have been dealt with centrally by the Commission since the inception of the Common Market, while competition policy also involves a strong role for the Commission, not just as adjudicator but as the imposer of sanctions. The whole structure of regulation of markets, particularly agriculture, has been shifted towards common rules, developed by the Commission. While each rule may be microeconomic in itself, the changes as a whole are directed towards macroeconomic efficiency and have consequences for the flexibility of the macroeconomy. The necessary co-ordination extends beyond the policies themselves, for instance, into the co-ordination of the definition and collection of statistical information about the member states through Eurostat.

Issues relating to equality are dealt with differently. In general issues of income and wealth distribution are the preserve of the member states and there is no attempt at co-ordination. However, the summit at Nice in late 2000 made moves towards implementing similar ideas of open co-ordination in the field of social protection. Most importantly the automatic transfer of incomes and wealth through taxes, benefits and discretionary public expenditure between the regions, sectors and households that are doing well and those that are faring worse across the national boundaries is virtually non-existent. The total EU budget amounts to less than 1.2% of GDP and of that most is not directed towards structural issues of relative disadvantage. The largest part goes towards the Common Agricultural Policy, which as Franzmeyer *et al.* (1991) note, if anything makes the national discrepancies worse rather than smaller. However, the small size of the structural funds should not be belittled as they are highly focused on areas of the greatest perceived problems – long-term and youth unemployment and regions that are lagging well below the EU average or seriously affected by the closure of traditional industries. The great success of the Irish Economy over the last ten years is in part due to the major inflow of funds from the rest of the EU over an extended period to support infrastructure investment, training and the development of a competitive environment (O'Donnell, 1998). However, it is rather more debatable what proportion of the convergence of the disadvantaged regions as a whole in the EU has been due to the structural funds rather than to the wider removal of barriers between members of a 'growth club' who would have performed more similarly in the past without the constraints (Quah, 1993)

Co-ordination among macro-economic policies has two elements to it. The first is co-ordination among the members of the EU for any one policy to achieve goals that would not be attainable if they merely pursued their national interests separately. Different forms of co-ordination may be appropriate for different policies – if only because the extent of the possible externalities from the actions of the member states on each other are different for different policies. Such co-ordination is required on the one hand because policies with respect to common problems may differ and could conflict. On the other the economic shocks to the member states may affect some more than others, hence the states have to decide how to handle the different needs of the parts of the area under common policies. In the main it is the arrangements these problems of co-ordination that we have just listed, policy by policy. However, macroeconomic policies are interdependent and hand in hand with co-ordination within policies runs co-ordination across policies. Although the Broad Economic Policy Guidelines are a form of co-ordination both within and across policies, this is an area where the level of co-ordination in the EU is more informal than in many countries.

Monetary policy and fiscal policy are not co-ordinated by having a common body responsible. Although the Eurogroup of the 12 ministers of finance from the euro area countries is joined by a representative of the ECB at its meetings and the chairman of the Eurogroup and a representative from the Commission can attend ECB Governing Council meetings (without a vote). Co-ordination comes from the rules of the game laid down in the Treaty and in the Stability and Growth Pact. The ECB is charged with maintaining price stability – it does not have the multiple objectives of the US Fed – and having regard to the economic policies of the EU is only to be observed subject to the maintenance of that price stability. The SGP similarly imposes rules of fiscal rectitude on the member states, ensuring not just an upper limit to debt and the pursuance of sustainable policy but the avoidance of excessive automatic or discretionary volatility in the fiscal balance over the cycle.

th parties can therefore act in the knowledge of what the others are likely to do. In some respects : degree of mutual knowledge is greater than in the US, where the 1935 Banking Act, which cre-d the FOMC, simultaneously removed both the Secretary of the Treasury and the Comptroller of : Currency from the Federal Reserve Board. Nowadays the link is maintained inter alia through a ekly meeting between the Secretary and the Chairman of the Board (Meyer,2000).

me co-ordination among policies has emerged from practice. Although the generalised arrange-nts for exchange rate policy remain the preserve of the Council of Ministers it is clear that the istence of the price stability mandate for the ECB means that they ECB will run the practice of change rate policy. Otherwise the two could readily conflict. When the euro declined against the ; dollar in its first year of existence there were initially some suggestions by finance ministers that mething should be 'done' about it. However, within the first few months of 1999 the primacy of : role of the ECB in this regard was established and hence the nature of the 'co-ordination' be-een monetary and exchange rate policy. Thus the foreign exchange interventions in the second lf of 2000 were undertaken by the ECB as they saw the depreciation of the euro compared with rceived fundamentals threatening price stability (ECB, 2000a).

ie governance of the ECB and the Eurosystem is itself an exercise in co-ordination and determi-tion of an agreed policy. The structure of the Governing Council by having the Governors of the . participating national central banks (NCBs) and the six members of the Executive Board of the CB (who are directly appointed by the agreement of the member states) differs from that in other ge currency areas, although it has a lot in common with the structure of the Bundesbank.

ll these arrangements are relatively untried and several of them are unique to the EU. Novelty and iiqueness do not have any intrinsic implications for success or failure. Simply having a decision-aking body of 18, which will, of course expand if new members join the euro area, is regarded as ing unwieldy by some outside observers (Crooks, 2001; Buiter, 1999). However, such objections ay merely reflect a disagreement with the actual decisions taken or a disagreement with the un-rlying view of how the economy works or the objectives for policy. The time period for judge-ent is very short. As Alesina *et al.* (2001) note in the third CEPR review of the progress of ECB, 'he ECB has shown, overall, good judgment in its actions.' (p.xv). The debate is much wider. ontrary to the general thrust of the literature that co-ordination tends to be beneficial, Alesina *et al.*) on to say (p.xiv) 'Formal meetings between the monetary and fiscal authorities designed to co-dinate policies are either unnecessary or harmful.'

In this paper we seek to provide an initial assessment of just some of the aspects of this new framework for macroeconomic policy. In Section 2 we consider monetary policy, in Section 3 employment policy and section 4 fiscal policy. Section 5 considers co-ordination issues and concludes. We begin in Section 1 by developing the overall framework.

1 The Framework for Macroeconomic Policy in the Euro Area

The framework for macroeconomic policy in the EU, set out in Table 1, shows that a variety of approaches are applied. Indeed no branches of policy are run with identical structures. The picture is further complicated by the fact that Denmark, Sweden and the UK have not joined Stage 3 of Economic and Monetary Union (EMU) and hence are not part of the single monetary policy, even though they are full participants in the rest of the process of co-ordination. This means that discussions about what the 12 participants in the euro area should do over fiscal policy and related issues cannot be undertaken in the normal meeting of ECOFIN where all 15 countries are present. They have to take place through the 'Eurogroup' meetings of just the 12 participating finance ministers in a somewhat unofficial arrangement.

It would be easy to conclude that this hybrid was the typical product of a committee and that the more normal arrangement in federal countries, where the participating states play a reduced in matters of fiscal, structural and employment policy, would apply without the national political constraints. A weaker criticism would be that the arrangements were the results of constructive economic and political pragmatism. In this view the EU has gone as far as it can politically towards a more centralised scheme and the arrangements are near optimal subject to those constraints. However, an even more charitable construction can be put on the arrangements by suggesting that in practice they come close to what might be optimal from an economic point of view, given that the EU is still relatively diverse. Greater uniformity of policy and central direction of it might in this view actually be counterproductive.

Clearly any such interpretation, given the nature of the negotiations over the last decade or more, is likely to be a matter of ex-post rationalisation rather than clear-sighted planning from the outset. This does not of course make it invalid. A single currency and the attendant monetary policy needs to be run by a single decisionmaking body. Furthermore, the time consistency literature (Walsh, 1998, 2000) suggests that the institutions for monetary policy need to be clearly independent of short-run political concerns if inflation bias is to be avoided. They also need to be given an unambiguous objective (in this case price stability), credible powers to achieve it and a legal framework, which makes changing these rules seem relatively unlikely. (Since financial stability is also an essential ingredient of macroeconomic stability (Kindleberger, 1996; BIS, 2001) it also helpful to have the Eurosystem address these issues.)

If monetary policy and the overall fiscal stance are to be run in a harmonious manner then fiscal policy needs to be constrained to run according to prudential principles. Otherwise they may try to offset each other in a costly struggle. Furthermore any uncertainty on the part of the central bank as to the intentions of the fiscal authorities may lead them to take a rather tighter policy stance on average. The same need for predictability applies to monetary policy from the point of view of the fiscal authorities. They need to be good at predicting how the monetary authority will respond to fiscal decisions.

However, beyond the dictates of prudence, which are normally thought to relate to sustainability and the avoidance of undue short-run volatility, it is arguable that further constraints on the content and management of fiscal policy may be unnecessary. The EU actually imposes a somewhat greater constraint on sustainability than is strictly required, as fiscal policy not merely has to be consistent with long-run stability but the ratio of debt to GDP must be less than 60%. Provided the SGP is credible, it may in fact go as far as is needed, given that there are also limits to acceptable tax (and benefit) competition agreed by the EU (such as over the coverage and rates for VAT). Thus within the overall prudent constraints the member states are free to find detailed revenue and expenditure policies that will best meet their local institutional and structural environment. It is argued by (Melitz, 2000 that while there may be some characteristics of fiscal policy that will or will not work in a variety of environments that the effectiveness of many policies depends on their context. Thus it is the whole system of reinforcing institutions and behaviour that have a major impact on the outcomes and the particular balance of policies must take this into account to be efficient. To take a simple example. The transmission channels vary across countries. Where equity finance is more important than debt finance the effect of an interest rate change on output and inflation will be different. Hence in the face of a single monetary policy the combination of other policies will have to be different to compensate (Guiso *et al*, 2000; Leichter, J and Walsh, C, 1999).

When it comes to employment policy and structural policies then, under this favourable reading, there is even less need to provide constraints or uniformity at the European level, beyond fiscal prudence and the banning of anticompetitive practices. Thus ruling out certain forms of state aids and encouraging a common focus may be the necessary minimum. The EU approach of trying to improve the ability of the member states to learn from each other and the introduction of incentives for es to outshine each other in the successful pursuit of higher employment may then be seen as ing a positive step that other countries have not. By not taking uniformity too far they avoid im-ing unnecessary costs and by speeding up the learning process and introducing an element of npetition and rivalry among states they may be speeding up the adjustment process.

could attempt to take this argument further by appraising competition and commercial policy the argument is weakest in the area of fiscal federalism and the transfer of resources to disad-itaged areas. The EU has decided to keep the overall budget very small by comparison with indi-ual countries and in the Berlin Council in 1999 also decided to limit the extent of net contribu-is/benefits still further. Thus the degree to which there is any redistribution of benefits from the ter development of the EU as a result of integration is strictly limited. This certainly goes further n any of the advocates 'trickle down' benefits argue. However, even allowing for any counter-ductive influences from the Common Agricultural Policy, EU 'structural' policy has been very ivily targeted on the areas of greatest need: low income per head, high unemployment, poor in-structure. The argument presented (Commission, 1999) is that in most cases the limits of the ab-ptive capacity of the regions being targeted have been approached and hence beneficial transfers this sort were not being severely limited. In any case most systems of fiscal redistribution involve irge element of 'deadweight' and the net flows involved are considerably smaller than the gross.

NIESR (1991) we estimated that regional spread of incomes per head in the EU could be reduced he target level (none below 85%) with a total transfer of only around 2.5% of EU GDP. Even the re vigorous role foreseen in the 1977 MacDougall report was only for a 7% budget in total. A ibling in net terms is of course totally outside anything contemplated in the EU at present. So iough the adjustment may seem small in national terms where tax changes equivalent to 1% of)P are common in a single year, it is completely inconceivable in an EU context and therefore ferentiates the EU from common practice elsewhere. However, the sources of EU revenues are in the form of income taxes (mainly customs duties and VAT) and hence are more difficult to for stabilisation policy as they are not progressive.

vertheless, taking all these facets of macroeconomic policy together it is not clear that the EU is ining a system that is massively different from what might be thought appropriate in a more fed-il system. However, for such an enterprise to work adequately, it has to be able to cope both with likely stream of economic shocks to the EU economy and be credible. We deal with these ques-ns sector by sector, starting with monetary policy.

As with the other facets of the macroeconomic policy of the euro area it is far too soon to label monetary policy a success of failure. Less than three years have elapsed since the creation of the ECB and only just over two years since the start of the euro in money markets. The euro itself will not be introduced in the form of notes and coin until January 2002 and the current national currencies not withdrawn for a few months after that. It is only in the last year or so that any judgements have been made in a quantitative manner on the success of the longest running of the new monetary policy regimes, that of New Zealand (Huang *et al.*, 2000; Svensson, 2001). These come after 10 years and the estimates are both tentative and not very well determined. Similarly judgements on US policy in the 1970s and 1980s are only now beginning to come through with clarity (Sargent, 1999; Orphanides, 1999). It is therefore only possible to make judgements on the basis of institutional structures and earlier experience of the euro area.

Of course popular judgements are not inhibited by the lack of evidence and any monetary institution will be subject to criticism or praise according to whether the policy settings it follows match the forecasts that market commentators have made for their clients. There have also been some measured assessments by the CEPR (Begg *et al.*, 1999; Favero *et al.*, 2000; Alesina *et al*, 2001), by the Shadow Committee and by OECD (2000). While these have primarily been based on how the ECB has been addressing its task rather than on the particular policy settings a modestly favourable assessment has been made of what the ECB has done. Criticism of the nature of the twin pillar strategy is largely irrelevant for our present purposes as it does not in the main relate to the appropriateness of the framework for policy.

Here there are several issues that relate to the credibility of policy. We only concern ourselves with three:

- The structure of decision-making
- The information available for the co-ordination of policy
- The strains placed on a single policy from the diversity of the member states

It is not that the others are irrelevant, merely that similar arguments apply.

2.1 *The structure of decision-making*

The Treaty lays down that in the Eurosystem the Governor of each of the participating central banks has a seat on the Governing Council along with the six members of the Executive Board, which includes the President and Vice President. The Governing Council is responsible for the running of the Eurosystem of NCBs and the ECB, most importantly for monetary policy. Not only is the balance of power different from that of the Federal Open Markets Committee, with the Governors having, currently, twice as many votes as the Executive Board but the range of responsibilities is much greater. Although the running of each NCB remains the responsibility of the individual Governor the Eurosystem has delegated far less responsibility for the running of the ECB to the Executive than is the case in the US. Governing Council meetings thus have monetary policy decisions as only a part of their agenda. Not surprisingly therefore, particularly, since the Eurosystem is still in the initial learning phase it meets fortnightly – three times as frequently as the FOMC.

These differences in structure and functions mean that direct comparisons between the Eurosystem and the Fed can be misleading. Even in response to equal news policy changes would occur in the Eurosystem roughly only a third of the frequency of meetings as in the US. (Large shifts could be spread across meetings rather more readily in the Eurosystem.)

The Governing Council has come in for round criticism (Buiter, 1999) and robust defence (Issing, 1999) for being too large and hence unlikely to be able to take decisions efficiently. It is certainly the case that most central banks' monetary policy committees are smaller (9 in the UK, 7 in Sweden and the Czech Republic and so on (see Svensson (2001))). In the US the FOMC has a membership of 12 (the seven Board members, the President of the New York Fed and four other Fed Bank presidents by rotation). However, the FOMC is effectively of the same size (19), as the other seven nonvoting Fed Bank Presidents also come to all of the meetings and speak on equal terms but do not of course vote. The challenge for the ECB Governing Council would be if membership increases. It could increase to 21 if all the current members of the EU joined and eventually to 34 if all the current applicant countries successfully participated in EMU as well. This is not however a current problem, as on the present timetable, new members are not due for admission to the EU before 2004 and even if they were to qualify immediately it would require a further two year transition period before they could join the Eurosystem.

Changing the voting arrangement would require a change to the Treaty, something that would be highly contentious. Large countries would no doubt be rather unenthused about rotation on the US model, small countries would be unhappy about arrangements based on size as that would enable them to have a vote only rarely. (That problem already applies to the Executive Board. If, which is not the case, members were to be appointed by rotation and seats available roughly by GDP or population, small countries would feel lucky to get one of the eight-year appointments each century.) Grouping countries geographically or by size to create constituencies perhaps along IMF or World Bank lines is also unattractive because it assumes that such groupings have some relevance for voting interests.

Unlike the FOMC the members of Governing Council of the ECB have no brief to report on or represent the interests of their particular region. Their concern is to be solely for the maintenance of price stability in the euro area as a whole. Attributed individual views are not recorded and the minutes are not published. So the chances of members being able to air views which reflect solely their views on how the euro economy works and how people respond to policy, even when this would not be to the short-run interest of their region, are enhanced. (Obviously one cannot police the source of the members' views and some might still be concerns about nationally adverse views getting out.)

Hence most models based on median voter behaviour or other decisions based on supporting the interests of the countries from which Governors or even the Executive Board members come should be rather irrelevant to the modelling of the decision-making (Persson and Tabellini, 2000). Any future groupings that would make best sense from the point of view of being representative of the range of opinion would be chosen by the governors among themselves in a search for colleagues with like-minded views. In any case it is not at all obvious why one should only look to reduce the number of voting NCB governors if the total is to be squeezed. Why should all six Executive Board members continue to have a vote? The General Council (on which the Governors of all 15 NCBs sit) only has the President and Vice-President as members among the Executive Board members. If there is going to be any well thought out and organised interest group whose views could be represented by some of their number it is likely to be the Executive Board, who are working next to each other every day. Such a reduction could prolong the date by which some other arrangement has to be made and maintain the idea of each country having both a seat at the table and a vote. It is normal in corporations for executives to attend board meetings but not necessarily to have a vote.

In any case, up till now the Governing Council has not voted on monetary policy issues but has proceeded by consensus. Some (Blinder *et al*, 2001, for example) have suggested that this also represents a departure from normal monetary policy committee behaviour and that it will lead to slower decisionmaking by the ECB. However, this interpretation rests partly on three illusions. The first is that MPCs usually disagree on what to do. An examination of the voting records of the Fed (Meyer 1998) shows that normally the members of the Committee are either completely or almost completely agreed about what to do. –The second illusion is that MPCs are normally discussing chang-

monetary policy at their meetings. Most meetings result in no change and having serious dis-
;s about whether and by how much to change interest rates is unusual except round expected ing points. Lastly it is also an illusion to believe that consensus means that everyone must ;e. Not only will those in a small minority usually give in if they do not feel passionately about ssue but the large majority would want to enforce their will if they could see no virtue in the mi-ity case. The number of occasions when those on the losing side want to register dissent, even in UK, which appears to have a rather more contentious system than many, is small. In the ECB ; there is very little downside to registering dissent. The rest of the Governing Council have no over the appointment of other NCB Governors and the members of the Executive Board cannot :eappointed. Holding clearly different views may grate with one's colleagues but it is not a ca--threatening issue as it could easily be within an internal MPC or one where tenure is short and ;wable.

ıs many of the suggestions in this regard that the ECB cannot operate in as effective or objective anner as other central banks are therefore likely to be misplaced.

The information available for the co-ordination of policy

co-ordination of policy to take place effectively a central bank has to be very 'transparent' and ;dictable'. It is not that other decision-makers will know what policy is going to be but that they l understand how it will be formulated and what the central bank's current thinking is about the ıre. In Castren and Mayes (1997) we set out what these conditions are (see also Mayes (1999)). ;ummary:

Outsiders need to be clear what the bank's objectives are.

They need to understand what the bank's view of the future is, both in terms of the most likely outcome and the risks that the bank is taking into account.

They need to know how the bank thinks the economy works.

Finally they need to know how the bank intends to respond to unexpected shocks.

th this knowledge they can plan their own strategy in the light of their views about the outlook the economy and how it works – which will probably differ from those of the bank. They can be ·ly clear about how the bank will react to their decisions and hence plan for the future in a mework that allows not only for their own decisions but for the expected decisions of the bank as ll (Tarkka and Mayes, 1999).

;se information requirements can be boiled down to three things:

- a clear discussion of the bank's objectives and strategy in meeting them;
- an exposition of the bank's 'model' of how the economy works
- and a full published forecast that covers likely risks over the time horizon relevant for policy.

These are quite exacting requirements. The Norges Bank and the Reserve Bank of New Zealand probably come closest to providing them, as do the Bank of England and the Sveriges Riksbank. The Fed does not go that far, in that its forecasts are not clearly published and its strategy and objectives are fairly vague. (Bernanke *et al.* (1999) and others advocate that it also should make changes along the lines we have suggested above.) The ECB is on the way to meeting these requirements and what it has published thus far largely represents the development of its work. It now publishes a limited forecast twice a year. In its Monthly Bulletin and four weekly press conferences it is developing an exposition of its objectives and strategy so that an idea can be built up of how it responds to shocks. It has published one of its models (the Area Wide Model) and no doubt when its large Multi-Country Model is completed that will also be published.

Not surprisingly this falls short of what the market would like – indeed it is unlikely that one could ever meet that. The forecasts are currently on the assumption that interest and exchange rates will remain constant. A range is shown for a limited number of variables (currently excluding the fiscal stance) rather than the Bank of England/Riksbank fan charts. The exact meaning of the price stability target is not yet as clear as those in the inflation-targeting countries. Indeed the ECB is keen to – point out that it is not following just an inflation-targeting strategy but one with two pillars. The first pillar involves monetary aggregates, particularly a reference value for M3 growth and the second likely price developments. The published forecast is part of the assessment of the second pillar and does not explicitly interact with the monetary aggregates. ECB watchers thus have a difficult task of judging how the ingredients are being put together. The main difference between the ECB and the Fed is not so much in terms of how much information is available but in the length of the track record. Having had the same Chairman for fourteen years the Fed has been able to provide a lot of evidence on how policy is determined. With only two years and data on the euro area only now emerging there is no means of providing a comparable basis. This can only come with time.

The question therefore is not so much whether the EU has optimal co-ordination arrangements for a world in which EMU is as mature as the US or other large economies but whether it has something suitable in the current state of knowledge. Popular complaints about the ECB not 'speaking with one voice' reflect partly that Governing Council members may be speaking for themselves and not just for the Eurosystem but also that listeners are trying to dissect the detail to find out how the strategy and views of the future are being developed. Differences without substance will inevitably appear at that level of scrutiny. All central banks suffer from it. In one press conference in 1995 Don Brash, Governor of the Reserve Bank of New Zealand remarked to a questioner, 'Please stop trying to read between the lines. There is nothing written there.'

Several other features make comparison between US and Eurosystem monetary policy more difficult than might appear at first blush. The difference in structure between the Fed and the ECB assist that misinterpretation aided by the use of titles. The Chairman of the Federal Reserve Board is by design a far more central figure in the process of monetary policy formulation than is the President of the ECB. However, the titles of the office holders and their institutions imply exactly the opposite relationship. The President of the ECB is the Chairman of a decentralised system. He sets out the views agreed by his colleagues. The Chairman of the Fed on the other hand is very much the leader of a more centralised system. Secondly, as mentioned already, the difference in objectives means that the responses of the two organisations to similar shocks are likely to be different both in timing and extent. Expectations of one based on experience of the other will therefore tend to be incorrect.

2.3 *The strains placed on a single policy from the diversity of the member states*

There has been some concern in the literature that it would be difficult to run a single monetary policy for a diverse region. Clearly if monetary policy is more constrained than in the past, particularly in the sense that the exchange rate cannot be used as a means of adjustment between the member countries, then other adjustment mechanisms will have to compensate. However, as Vanhala (2000) points out, it is an illusion for many of the existing members that they have any great loss of freedom of action. Since most of them were exchange rate targeting within the ERM of the EMS they were largely following German monetary policy and were deliberately trying not to have exchange rate variation, as that was deemed to be an important cost. Furthermore asymmetric shocks are a feature of existing economies and sectors have always had to adjust without the 'benefit' of an adjustable nominal exchange rate.

However, our concern in Mayes and Viren (1998, 2000 and 2001) has been to explore the nature of the divergences within the euro area that policy has to cope with rather than to question whether that coping is feasible. We have shown that there are four main difficulties for policy:

- The parameters for many of the main variables in the transmission mechanism vary considerably in size (by at least a factor of two)

- The speed of the transmission mechanism also varies by a factor of around two across the member states
- There are clear nonlinearities and asymmetries in the relationships between unemployment and inflation (the Phillips curve) and the rate of economic growth and unemployment (Okun curve)
- Behaviour will change progressively from being the sum of the individual countries' responses to that of a new more integrated economy

Between them they have very clear implications:

- First of all, running policy off the arithmetic average for the euro area without regard to where the shocks come from will be inefficient.
- Secondly, until the price formation mechanism changes substantially, the euro area is likely to remain much more open than reference to the share of external trade in euro area GDP would imply.
- Thirdly, the responsiveness to shocks will depend on the dispersion of unemployment across the area and the extent of co-ordination of the economic cycles (and not just the position in the economic cycle and the level of unemployment or the output gap).
- Responsiveness to policy differs clearly depending upon whether capacity is slack or under pressure.

None of these results are particularly surprising and do not represent any particular difference from other economies, even small ones. As we show in Mayes and Viren (2000) for Finland and Buxton and Mayes (1986) for the UK.

All of our remarks are of course dependent on the degree to which observed behaviour in the recent past is a good indicator of likely behaviour in the coming few years. Our estimates in the main relate to behaviour over the period 1987 to 1998 as this represents a fairly coherent monetary policy regime aimed at price and exchange rate stability in what is now the euro area. However, Stage 3 of EMU is deliberately aimed at changing behaviour. In the first place it is designed to try to anchor price expectations on stability. This will affect price and wage formation. Secondly it is intended to reduce uncertainty and make the transmission of price signals across the euro area more efficient. While the former should reduce the inflationary impact of shocks and hence the impact on real activity the latter should mean that shocks are transmitted more rapidly and that the euro area becomes more of a price setter and less of a price taker. These mechanisms alone will alter the behaviour of the euro economy.

However, the most important aspect is expected to be an increase in the sustainable rate of economic growth. The removal of the interest rate premium for the more inflation prone countries should reduce the real rate of interest on average, ceteris paribus, thereby stimulating investment. The increased efficiency and the removal of structural rigidities that are also planned should also form part of the basis for faster growth. (Of course, as expected returns increase real interest rates will rise with them.) The ECB claims that these effects are yet to be observed (Hämälainen, 2001).

All of these changes mean that macroeconomic policies and monetary policy in particular will have to evolve over the coming years, which will not help for some aspects of their predictability and transparency. Adjusting to changes in the underlying rate of growth is one of the most difficult processes to sort out as the experience of the Fed in adjusting to the 'new economy' in the US in recent years demonstrates. Given the differences in size and role of the IT and related industries across the EU countries the assessment of the problem may be even more difficult.

3 Employment and the Operation of Open Co-ordination

The open method of policy co-ordination is well described in Hodson and Maher (2001). Although the term was only formally adopted in the Lisbon Council in 2000 it is a description of the organised form of the three 'processes' set in motion by the Luxembourg (1997), Cardiff (1998) and Cologne (1999) Councils. The Luxembourg Process is addressed to the employment objectives of the EU and requires the member states to carry through an annual process of

- drawing up Employment Guidelines in the Council to set priorities,
- setting out National Action Plans by each member state to achieve the objectives
- assessment by the Commission and Council on the plans and the performance of the member states in achieving the objectives.

The main novelty in the process is that while the priorities are set out under the four headings of

- employability
- entrepreneurship
- adaptability and
- equal opportunities (for men and women)

the means of achieving them are not prescribed. Each country has the opportunity to set out its own ideas and it can choose how much effort to expend under each heading. Similarly the assessments produce recommendations but not compulsion. The objectives are not merely qualitative but quantitative in nature. The process thus involves the opportunity for benchmarking against the best practice in the member states. As a result there is a clear element of competition among the member states to come out well in the assessment.

As Madsen *et al.*, (2001*a, b*) have set out, the various National Action Plans appear to cluster in three groups:

- A 'Nordic' group, which also includes the Netherlands, of countries that are undertaking a wide range of measures under all headings.
- A 'Southern' group, which also includes Belgium, where the level of action is clearly more limited
- A group with the somewhat ironic title of 'Anglo-Saxon' as it includes both Ireland and France, where the effort is somewhat more focused.

Not all countries fit easily with in the framework and its clear that the pattern is changing over time, with countries such as Ireland increasing their efforts noticeably. Efforts also vary with the extent of the problem. Success will tend to be marked by a reduction in spending as employment and participation ratios rise.

The Cardiff process extended the same ideas to what is described as 'structural policies'. These cover the whole range of markets for goods, services, labour and capital. Here the annual process involves the formulation of Broad Economic Guidelines. This follows on an assessment by the member states of the state of play in the flexibility of operation of various aspects of the economic system. As we consider in more detail in the next section the picture is completed by the Essen Process under Stability and Growth Pact where co-ordination process is less soft and sanctions can be brought to bear for those who do not comply. However, as far as the Broad Economic Guidelines are concerned there is no matching set of sanctions as there is for the Excessive Deficit Procedure under the SGP.

The Cologne Process integrates the Cardiff and Luxembourg Processes with the Macroeconomic Dialogue, which involves the 'social partners' (employer and trade union organisations), the ECB, the Commission and the Council in six-monthly discussions of the overall policy mix. This last exercise is a largely informal opportunity to gather information and exchange views. It does not make recommendations.

What the Lisbon Summit did was codify these processes as way forward for integration that could be applied to other areas of activity and should be used as part of a 10-year programme to turn the EU into a competitive, knowledge-based economy that combines sustainable growth with high employment and 'social cohesion'. As Hodson and Maher explain these processes can be characterised by

- The setting of guidelines with quantitative targets and timetables for achievement
- The establishment of performance indicators and benchmarks to allow comparison of best practice
- Periodic monitoring and review, with an emphasis on mutual learning

The open co-ordination process has been extended to the annual Joint Action Plans developed with the accession countries to monitor and assist their progress towards membership. Here again there is a common framework, targets to work towards, assessment of progress by the Commission and the opportunity to learn from the others who are simultaneously having to set out their intentions and actions. Here of course the incentives to strong performance are obvious.

Of course, efficient and effective co-ordination in the field of employment and related policies does not entail that the policies themselves will be any more effective than in other countries. If the consequence of co-ordination were to be an agreement to restrict competition among the EU countries with respect to the replacement rate or the tax wedge then this would merely serve to limit incentives to increase employment across all the member states. Co-ordination per se is not necessarily a plus if the content of the co-ordination does not advance the macroeconomic objectives. In Gold and Mayes (199?) for example we explore the extent to which employment 'protection' measures, such as limitations on hours, restraints on firing etc. can conflict with achieving faster growth and efficiency.

4 Fiscal Policy and the Broad Economic Policy Guidelines

Most attention is normally placed on fiscal policy under the terms of SGP, as it is here that there are sanctions. The main concerns expressed are over whether the sanctions will actually be effective in restraining behaviour or indeed whether they will actually be applied, as the Council has discretion in applying the decision. However, the focus of our interest in the current framework is not so much on the avoidance of extremes, ie excessive deficits or failure to bring public debt levels down below 60% of GDP but more on whether there can in practice be voluntary agreements and prudent actions within the bounds.

For example, the system would not work well if the member states manage their fiscal position over the cycle in such a way that there is a serious threat of breaching the deficit limit (3% of GDP in normal circumstances) every time there is a downturn. Buti *et al.* (1998) estimate that, if countries were to aim at a fiscal structure that generated balance across the cycle as a whole, then normal automatic stabilisers would be unlikely to generate excessive deficits in all but the worst downturns, such as the Finnish and Swedish crises of the early 1990s. The problem therefore is not so much with automatic stabilisation as with discretionary changes and it is here that the first problem has emerged, in the case of Ireland. It is clearly in the interests of small countries that there should be co-ordination in the case of shocks as their ability to have much effect on their economies alone is decidedly limited. This is particularly the case for automatic stabilisers, as then it is not a matter of persuading other countries to act at the time. It just happens anyway because of the structure of their tax and benefit systems. (This is also an area where there is a clear difference from the US. The forces for automatic stabilisation, particularly at the state level, are much more limited there because of the lower tax and benefit rates. Greater reliance on discretionary policy is therefore required to have a similar effect.)

While in the case of structural policy, the incentive for the member states to want to control each other is relatively limited, the argument is not the same for fiscal policy. In structural policy it will obviously help develop markets if each country can expand both its long-run ability to grow without generating inflation and its ability to respond relatively costlessly to shocks. Both will have favourable spillovers to the other member states. However, it would only be gross changes that would upset the balance of macroeconomic policy management over the course of the cycle in a programme implementing change over a ten-year period. However, because it is the balance of fiscal policy that is the main concern, relatively limited changes in the structure of revenues or expenditures can have an effect that would elicit responses from the markets and from the ECB. Secondly, because of the progressive structure of direct tax systems both real growth and inflation require periodic adjustments if the share of the public sector is not to keep rising. The timing of these – discretionary – changes, especially if they are done in anticipation of particular growth or inflation outcomes, can affect the overall picture. Thus for the euro area as a whole, a reduction in the surplus of one country may have a similar effect to the increase in the deficit of another. So both are a matter for joint concern. (Note that this is subject to our remarks about nonlinearity in the previous section. Actions that increase excess demand in one part of the euro area will have a greater effect on inflation than actions that reduce excess supply by a similar amount elsewhere (Mayes and Viren, 2000).)

The case of Ireland illustrates this problem nicely. The Irish budget for 2001 foresaw a balance of tax cuts and expenditure increases that would reduce the fiscal surplus from 4.7% of GDP in 2000 to 4.3% of GDP in 2001 (see Hodson and Maher, 2001). The actual outcome will of course depend crucially on the rate of growth that occurs and on the impact on the automatic elements of tax receipts and benefit payments. Following a report from the Commission ECOFIN Recommended that Ireland stick to a budget that was expected to keep the surplus constant (ECOFIN, 2001). The basis of the Recommendation was two-fold, first some scepticism over the impact of the changes on real behaviour and second the view that when a country is showing clear signs of overheating fiscal policy should not add to the problem.

Both of these sources of objection are important from the point of view of voluntary co-ordination. The first relates to a difference of view over the effect of measures and the second a difference of view over what constitutes prudent policy. Governments (not just in Ireland) have a history of optimism over the outcomes of fiscal policy that impart an inflationary bias to policy over the medium term (Rogoff (1985) for example). The process of multilateral surveillance and opinion by the Commission offers a mechanism whereby a more 'objective' view can be elicited and hence more prudent policy be followed in the EU than is the case in most nation states that do not have any similar external controls – except of course through the verdict of the markets through interest and exchange rates. Since these are forward-looking judgements, one cannot know at the time which party has the more accurate assessment. The key is credibility of the regime. If national governments reject Council judgements then not only do these judgements tend to have less force in the future but it may encourage governments to be more inflation-biased in their judgements about likely outcomes.

In a sense it does not matter if the Irish government has actually made the better forecasts. It is the principle that counts for credibility. Outcomes in any case are dependent on the unforecastable shocks that occur during the year. The second debate about prudence is even more important in this regard, as it reflects a difference of view about the way economies work and about how policy rules should be set. The simple approach that ECOFIN is following is that when a country is experiencing problems of overheating, its year by year policies should not make the problem worse. This is a simple rule but one with only a twelve month horizon. Ireland, on the other hand, sets the general flavour of its macroeconomic policy according to a series of four-year agreements between the government, employers, trade unions and a wide range of interest groups in society (Hodson, 2000). These agreements have formed a key part of Ireland's success (Kilponen *et al.*, 2000). The 2001 Irish Budget is part of that longer-term agreement, expected to elicit supply-side improvements that will enable the exceptional Irish performance to continue despite the constraints that are now being encountered. (In Mayes and Viren (2001) we suggest evidence in the EU framework that most EU countries would tend to benefit in terms of growth if they were to take the opportunity to ratchet the tax system downwards.)

Here the argument is reversed. Governments can only introduce medium-term improvements to the fiscal system involving tax cuts or expenditure increases at a time when the economy is doing relatively well. If they do it when things are going relatively badly then they will increase both debt and deficits. (When things are going relatively well they will slow the rate of debt repayment and decrease surpluses.) In any case when things are going relatively badly the automatic stabilisers will be operating to help reduce the impact (also increasing deficits and debt). Thus the basis of the Irish argument is that with a surplus of over 4% of GDP they are already putting heavy downward pressure on the economy. By altering the structure of the economy towards enduring faster growth at a time when it is doing well they can help avoid an unnecessary downturn. The counter-argument is that by not having harsher downward pressure now they will only cause an even bigger cycle later and pass inflation costs on to the rest of the area in the short run and employment costs in the longer term when the downturn appears.

The plus side of open co-ordination is that it permits this debate to occur and for a country to maintain its own point of view. Ireland will still have to face the terms of the excessive deficit procedure if it has made a bad judgement and enters a severe recession with too expansionary a budget structure. It will then have to tighten in a recession. Something no government is likely to plan to do deliberately or even run as a plausible risk. On the negative side it emphasises that the SGP is asymmetric and that, while the worst excesses may be avoided in recessions, there will not be equal concerns in booms, hence maintaining some of the inflationary bias of fiscal policy and thus placing a greater burden on monetary policy. This then reopens the debate about whether the EU arrangements deliver the appropriate policy mix.

The treatment of Ireland could represent a change in attitude of ECOFIN or possibly reflect the fact that Ireland is a small country. In 1999 Italy also got into difficulty in that a reduction in growth prospects made the Italian government suggest that it might be unable to meet its plans for deficit reduction. The Commission reacted unfavourably, recommending that Italy take extra measures to bring the expected deficit back on track. The Italian government not surprisingly contested this and the Council (Council, 1999) chose not to follow the Commission's lead and toned the phraseology down using the word 'encourage' rather than 'recommend'. At the time, there was some feeling that this meant that when difficult circumstances emerged ECOFIN might tend to be conciliatory in its interpretation of the constraints of the SGP. Since then it has turned out that the Italians were pessimistic and were in fact able to do rather better than the original plans for reducing the deficit.

It remains that the evidence on the rigour with which the fiscal policy constraints will be applied has to rely on infra-marginal concerns. The 3% deficit barrier has not yet been in serious danger of being breached by any of the member states. That is largely because in the initial period up till the first part of 1998 the member states also had qualification for Stage 3 of EMU at stake as well as the potential censure from the SGP. Since then the phase of the economic cycle has been for recovery and then growth in excess of the longer-run average. The real test of the constraints in the SGP will only come in a downturn. On other occasions, member states who appear to be running their policies with insufficient margin in better times can hope that, like Italy, when the future actually comes it will turn out not to pose too harsh a test. They could thus gamble on not having to take strong measures but still be able to take them much closer to an excessive deficit occurring if it turned out to essential.

5 The Framework for Co-ordination

The issue of the policy mix is where we conclude. Governments have tried to impose on themselves rules that avoid an inflationary bias to policy stemming from allowing short-run concerns to dominate longer-term prudence. These can be very effective through giving central banks clear targets for price stability and assigning them the independence and powers to achieve it. Fiscal Responsibility Acts in the same vein are not so common. (New Zealand adopted one in 1994 and the UK has adopted some of the same principles.) They are also much more difficult to achieve in practice as it is not possible to constrain real behaviour and the budgetary balance within such tight bands as it is inflation. Harsher fiscal constraints are of course imposed effectively on lower tiers of government in many countries. But there the central government stands ready to provide assistance should there be adverse shocks whether or not asymmetric to the particular region. This mechanism does not exist in the EU.

Following the usual Mundell-Fleming arguments there is actually a difference in the incentives for the member states compared with the euro area as a whole. With a fixed exchange rate between them there is an incentive for the member states to follow a more active fiscal policy. For the euro area as whole where the exchange rate is flexible the relative position is changed and a less active fiscal policy but a more active monetary policy becomes attractive. (Marston, 1985; Viren, 2000) This therefore provides an interesting dilemma for the member states, who will want to be more active on this analysis in response to asymmetric shocks but collectively will want to see a less active approach to fiscal policy.

The Maastricht Treaty probably represents the high water mark (King, 2000) of independence for central banks. It is difficult to see that any stronger framework for achieving price stability could be agreed in a democratic environment at present. On the fiscal side, the EU has also managed to impose limits and incentives for prudent behaviour within those limits (which may or may not be very effective in the terms of our previous discussion). However, the concerns are not just one-sided. There is a danger that both monetary and fiscal policy could err on the side of restraint. The asymmetry of the SGP means that it is designed to reduce debt to GDP ratios. With 5% nominal GDP growth an average deficit of 3% GDP would maintain a 60% debt to GDP ratio. However, current policy is designed to reduce debt to GDP ratios (as several member states are still above 60% and the problems of the ageing of the population inter alia are likely to put pressure on debt levels in the future) so the 3% deficit is the upper limit not the average. Thus fiscal policy may be trying to improve the long-run structural position at the same time that it has some credibility problems (including those with the monetary authority).

The final question we address is whether those rules, on their own, impose sufficient co-ordination, as augmented by the bi-annual Macroeconomic Dialogue. Alesina *et al.* (2001) argue that not only are the rules sufficient but that the Dialogue runs the risk of weakening the credibility of the scheme. They argue that any opportunity for there to be discussions behind closed doors between the central bank and the fiscal authorities will weaken the public belief that the ECB will fulfil its price stability objective and will instead come to an implicit or unwritten agreement to limit monetary pressure for political reasons. They go on to suggest that credibility requires the ECB to be as transparent as possible and to make it very difficult for the Governing Council either to discuss deviations from the price stability objective or to react implicitly to external pressure. The absence of published minutes to meetings or any full 'Inflation Report' that ensures that no reasoning can be pushed under the carpet makes it more difficult for the Bank to give these assurances. The problem is that it does not matter if the ECB never in practice entertains such notions. What matters is that markets do not believe that any response to these pressures is possible. Credibility is a reflection of outsiders' attitudes and the problem is to structure the system to assist the holding of this credibility as far as possible.

In New Zealand for example (Mayes and Razzak, 1998) the Reserve Bank deliberately distances itself from both the Treasury and the government. Questions are regularly asked in parliament about how often the Governor and the Minister of Finance have met or spoken over the telephone. Forecasts are not discussed with the Treasury nor secret information sought by either side in preparation of forecasts. The Bank is therefore able to be completely open about the assumptions for its forecasts. Any inconsistency about the difference between the assumptions and the forecast could be picked up (after the event) should anyone try to rerun the model. The Bank therefore has to be completely honest in its building up of the view of the future, otherwise it runs the risk of being caught massaging the numbers. Any such detection would be disastrous for its future credibility. Credibility comes from having plenty at stake from deviating from the agreed procedures. (Even in the New Zealand case a report by Svensson (2001) suggests that both parliament and the external non-executive board of the bank should be given more resources so they can investigate the bank's processes and the quality of its monetary policy formulation more closely. The Bank has supported these recommendations but the decision of the Minister of Finance has not yet been revealed.)

The ECB has not been so forthcoming, although limited forecasts are now published. Alesina *et al.* (2001) argue against the presence of the Eurogroup president at Governing Council meetings on the grounds that this could be thought to permit influence, especially in the absence of a written record. This line of argument thus runs somewhat against the traditional literature, under which co-ordination between the two authorities is thought to lead to better outcomes (Ardy, 2000, for example) simply because it enables uncertainty to be reduced. The reason is that having these strict rules also enables a co-operative game to be run. Fiscal policy can be set in the knowledge of the likely monetary policy response and the known current strategy. At the same time, because of the constraints on fiscal policy from the SGP and the incentives for improving macroeconomic policy as a whole under the Broad Economic Policy Guidelines and open co-ordination, the monetary authorities can be more accurate in forecasting the inflationary impact of actual and future fiscal decisions.

It is clear from the ECB Governing Council's statements that it is a little sceptical about the fiscal authorities' likely zeal in following fiscal prudence and about the success of the process of open co-ordination in advancing the pace of deregulation and structural change to make the adjustment of the real economy less costly and increase the sustainable rate of growth. One might be forgiven for thinking that some EU Finance Ministers share exactly the opposite fear about the ECB (Lafontaine 2000). Their worry is that it will be too focused on its price stability objective. While such misgivings among the two authorities could lead to contradictory policies and hence cost from poor co-ordination, there is little indication thus far that the public voicing of concerns has been translated into a policy bias by either party.

The short time span means that it is impossible to draw definitive conclusions. Nevertheless, the experience thus far seems to be rather more promising than a simple examination of the sanctions (or lack thereof) might imply for the innovative co-ordination processes being employed in the EU. Time will tell, but the trend towards increasing transparency both by the ECB and by the process of multilateral surveillance against measurable benchmarks suggests that both the co-ordination and the credibility of the processes may also increase. Thus, while our analysis suggests no compelling reason for large institutional reforms to the EU system, clearly increased openness, more systematic policy rules and better expertise in assessments and forecasts will assist the effectiveness of these more open methods of co-ordination.

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Table 1 The Framework for Macroeconomic Policy in the EU

Policy area	*form*	*administration of Coordination*
Monetary	single policy	Governing Council of ECB
Fiscal	constrained national With sanctions	
Tax	National with limits	ECOFIN advice, regulation
Structural Funds (regional)	joint Commission and national	Commission
Employment	open coordination	Employment Committee on Commission assessment
Structural	open co-ordination	ECOFIN on Commission assessment
Borad Economic Policy	open co-ordination	ECOFIN on Commission assessment
Competition	Commission with national with sanctions	Commission including sanctions
Inter-country transfers	not agreed	
Macro	dialogue	informal Council/Commission
Exchange	single	ECB implementation ECOFIN regime
Commercial policy	single	Commission